Navigating State Voluntary Disclosure Programs: Multistate and Single State Programs to Resolve Unseen Liabilities
Minimizing or Avoiding Penalties and Interest, Identifying Nexus Problems, and Quantifying Unseen Liabilities

TUESDAY, MAY 24, 2016, 1:00-2:50 pm Eastern

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Navigating State Voluntary Disclosure Programs

May 24, 2016

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What is a Voluntary Disclosure Program?

Michael L. Colavito, Jr.

May 24, 2016
Aronson LLC provides a comprehensive platform of assurance, tax, and consulting solutions to today’s most active industry sectors and successful individuals. For more than 50 years, we have purposefully expanded our service offerings and deepened our industry specialties to better serve the needs of our clients, people, and community. From startup to exit, we help our clients maximize opportunity, minimize risk, and unlock their full potential.
Today’s Agenda

I. **What is the voluntary disclosure program?**
II. “Creeping nexus” and reserves for uncertain tax positions as triggers
III. Taxpayer goals and strategies in VDPs
IV. Mechanics of multistate VDPs
V. Mechanics of individual state VDPs
VI. Voluntary disclosure agreements
What is the voluntary disclosure program (VDP)?

- VDPs are a way to become compliant with state tax liabilities by coming forward and voluntarily paying back taxes.

- Most states administer some form of a VDP.

- Multistate Tax Commission administers a multistate VDP program.

- Typically results in a binding agreement between taxpayer and taxing authority.

- Different than a state’s amnesty program.
**What is the voluntary disclosure program (VDP)?**

**Comparing VDPs and Amnesty Programs**

<table>
<thead>
<tr>
<th>Voluntary Disclosure</th>
<th>Amnesty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ongoing program</td>
<td>Temporary (usually 2-3 months)</td>
</tr>
<tr>
<td>Penalty waiver</td>
<td>Penalty waiver</td>
</tr>
<tr>
<td>No penalty for not participating</td>
<td>Non-participation penalties</td>
</tr>
<tr>
<td>Typically no interest waived</td>
<td>More likely to include interest waiver</td>
</tr>
<tr>
<td>Limited lookback</td>
<td>All back taxes</td>
</tr>
<tr>
<td>Payment terms negotiable</td>
<td>Less negotiation on payment terms</td>
</tr>
<tr>
<td>Anonymity</td>
<td>Typically no Anonymity</td>
</tr>
<tr>
<td>Broader tax types</td>
<td>Limited tax types</td>
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</table>
What is the voluntary disclosure program (VDP)?

• Why a taxpayer may want to participate in a VDP?
  – Penalty Abatement
  – Possible reduction in interest
  – Limited lookback period
  – Anonymity (*process initiated by authorized representative*)
  – Looking to sell the business/already in due diligence
  – Triggering event increases risk of a notice (e.g., IC/vendor gets audited)
  – Self-audit
  – May be more efficient than fling back returns
  – Financial statement impact
Which taxpayers are eligible for a VDP?

- Factors that determine VDP eligibility vary by state
- Typical requirements
  - Taxpayer has not previously been contacted by the state
    - Notice requesting a return
    - Notice of assessment
    - Nexus questionnaire
  - Taxpayer not currently under audit
  - Not registered with and/or never filed a return with the taxing authority
    - Requirement may be for all tax types or only the particular tax at issue.
  - Business taxpayers only (*many VDPs don’t apply to individuals*)
    - But benefits can still flow to non-resident owners of a disclosing business taxpayer
  - Collected and unremitted taxes (*may only impact eligibility for limited lookback*)
More on the Principal Benefits of a VDP

• Limited Lookback Period
  – There is typically no statute of limitations on assessments for non-filers (*i.e.*, typical 3-year SOL does not apply).
  – State can issue an assessment as far back as the earliest liability.
  – In a VDP, the Taxpayer pays last three years’ tax in exchange for the state waiving its ability to assess tax for any prior period.
  – Taxpayer is essentially receiving an abatement of tax.
  – Sample agreement Language (D.C.)
    - “Taxpayer shall remit to OTR the amount of $XXX in Corporate Franchise Tax and all required interest . . . in full and final settlement and discharge of the Corporate Franchise Tax liabilities for the periods beginning January 1, 2012 through and including December 31, 2014 and prior periods.”
More on the Principal Benefits of a VDP

• Waiver of Penalties

  – Don’t underestimate the value of a penalty waiver.

  – States are not in the business of waiving penalties, especially for non-filers.

  – Participation in VDP is typically not a request for a penalty waiver; the waiver is part of the agreement.

  – Many state sales tax penalties are 25 percent of tax due.

  – The penalty savings can easily be more than the representative’s fees.
Issue Specific VDPs

• Some states have VDPs that are specific to an issue or tax type.
• These programs are typically in addition to the state’s general VDP.
• Separate program due to tax type or circumstances warranting different procedures and/or different agency department assigned.

• **Examples**
  – Maryland
    • Corporate VDP
    • Unclaimed property VDP
  – New Jersey
    • Offshore Voluntary Compliance Initiative
The Use of Voluntary Disclosure Programs:
Non-Filers, “Creeping” Nexus and Uncertain Tax Positions

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The Use of Voluntary Disclosure Programs:
Non-Filers, “Creeping” Nexus and Uncertain Tax Positions

M. Robinson & Company, Tax Law Specialists, has successfully represented individuals and businesses in voluntary disclosure cases involving state, federal, and international (“offshore”) voluntary disclosures.

M. Robinson Tax Law is a recognized leader in tax audit defense for both businesses and individuals at audit, on appeal, and before the United States Tax Court and the Massachusetts Appellate Tax Board. Types of successfully concluded tax audit defense include corporate income, individual income, payroll, sale and use, unemployment, responsible party, and Massachusetts domicile audits.

See www.mrobinson.com for further details.

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The tax advisor must understand the underlying law in addition to the mechanics of Voluntary Disclosure.

Example: The Non-Filer who filed a return misclassifying a Massachusetts manufacturing corporation.
When Voluntary Disclosure May Be Helpful

- Non-Filers: Businesses and Individuals
- Sale of Businesses
- Helping Interstate Companies Come Into Compliance
- Non-Traditional Voluntary Disclosure: During an Audit
Tax Issues That Can Trigger Voluntary Disclosure

- Creeping Nexus – The Main Focus of Our Talk
- Uncertain Tax Positions
Types of Nexus

- Traditional Nexus
- “Creeping” Nexus
- New Forms of Nexus
  - Economic Nexus
  - “Click-Through” Nexus
  - Affiliate and Attributional Nexus
Traditional Nexus

- Authorized by the United States Commerce Clause
- Based on State Law
Traditional Nexus – Constitutional Issues

Traditional Standards of Nexus for Sales or Use Tax

- Substantial Nexus or Constitutionally Sufficient Nexus
  - Physical Presence – “brick and mortar”
- Temporary or permanent presence of people or property
- Defined by each state with variations
- Presence of people and/or property gives the state the right to require a company pay or collect and remit taxes
Traditional Nexus – Constitutional Issues

Control from U.S. Constitution under the Due Process Clause and Commerce Clause

- **Due Process Clause**
  - There must be a definite link or minimum connection between the state and the person, property or transaction it seeks to tax

- **Commerce Clause**
  - Higher standard; Requires a substantial presence in a taxing state of the entity that state wishes to tax

- **Typically referred to in state regulations**
  - “…asserting the tax jurisdiction of Massachusetts to the extent permitted by the Constitution and the laws of the United States…”
  - 830 CMR 63.39.1(3)
Public Law 86-272

- **Pre-emption of State Law**
  - Precludes the imposition of excise tax upon a foreign corporation if the sole activity of the corporation is the solicitation by the corporation’s representatives of orders for the sale of tangible personal property, provided that the orders are sent outside of the state for approval or rejection, and provided that the orders are filled by shipment or delivery by common carrier or contract carrier from a point outside of the state.

- **Scope**
  - Restricts the state’s jurisdiction with respect to sales solicitation activities only if the taxpayer’s activity is limited to solicitation of orders for the sale of tangible personal property
Examples of “Creeping” Nexus

• **New Market.** A business may be invited to bid on a project in a new state. The bid is successful and the business gets work. Over several years, its reputation builds, and soon the business is doing substantial work in that state. But no one told the accounting office, which did not break out sales to the new state. Similarly, the outside accountants were not told and did not prepare appropriate income taxes. Finally, someone notices that the business is non-compliant.

• **Changing Sales Procedures Not Communicated to Tax Department.** Fulfillment of sales order not under the protection of P.L. 86-272.
Triggers for “Creeping Nexus”

- In-state salespeople or agents
- In-state telephone number
- In-state advertising
- In-state customers
- E-commerce Associated with In-State Business
New Forms of Nexus

- Economic Nexus
- “Click-Through” or Agency Nexus
- Affiliate and Attributional Nexus
Economic Nexus

- **State Law Examples**
  - New Hampshire: “Business Activity” includes “a purposeful direction of business to the state....”
  - Massachusetts: “Income flowing to the taxpayer from residents of the commonwealth.”

- **Exceptions**
  - Constitutional – Quill (Physical Presence)
  - Public Law 86-272 (Income Taxes)
Economic Nexus - Continued

- **Economic Presence Nexus Applies to Three Types of Multistate Business Income**
  1. Sales of Services
  2. Interest income
  3. Royalty income from in-state use of tangible personal property

- About 35 States Have Some form of Economic Nexus
“Click-Through” Nexus

- **General Rule:** Out of State Seller is Exempt from Sales Tax – Quill

- **Exception:** Click-Through Nexus”
  - Out of State Seller Pays Commission to in-state business for a referral;
  - The referral results in a sale; and
  - The out-of-state seller’s annual sales reach a specified dollar threshold.

- About 20 States have some form of “Click Through” Nexus.
“Click-Through” Nexus States

* Arkansas
* California
* Connecticut
* Georgia
* Illinois
* Kansas
* Maine
* Michigan
* Minnesota
* Missouri
* Nevada
* New Jersey
* New York
* North Carolina
* Ohio
* Rhode Island
* Tennessee
* Vermont
* Washington
* Puerto Rico

Disclaimer: The listing may not be up to date.
Remote retailer holds substantial interest in or is owned by an in-state retailer and the retailer sell the same or substantially similar line of products under the same or similar name.

The in-state facility/employee is used to advertise, promote, or facilitate sale to an in-state consumer.

Example: Toys R Us

- Same Line of Business (Retail Sales)
- Same General Products (Children’s Toys)
- Use Same Intangible Property (Geoffrey the Giraffe)

About 20 States have Nexus based on such criteria.

Common ownership may not always be required
Amazon Laws

Click-Through Nexus

- Changing Legal Landscape — “Amazon Laws”
  - New York first in 2008: Rebuttable nexus presumption
    - Amazon.com LLC v. New York State Department of Taxation and Finance and Overstock.com, Inc. v. New York State Department of Taxation and Finance
      - NY law upheld: targeted physical solicitation activity by instate internet affiliates – more than “mere advertising”
  - Illinois law in 2010 with no rebuttable presumption
    - Performance Marketing Association v. Hamer
    - Entirely side-stepped Commerce Clause
    - Federal preemption by Internet Tax Freedom Act (IFTA)
  - Colorado notification law in 2010
    - Struck down by federal district court
    - Direct Marketing Association v. Brohl
Uncertain Tax Positions and Ambiguities in the Tax Law

- Transfer Pricing Issues
  - Transfer prices are used to control profitability
- Apportionment Issues
  - Apportionment of Services is Hard!
- Nexus Issue – Just Discussed
Dealing With Ambiguity

- Financial Accounting
  - Recognition of Ambiguity
  - Measurement of Ambiguity
  - Disclosure of Ambiguity
    - Accounting Standards Codification 740: Accounting for uncertainty in Income Taxes
    - Hedging with Insurance
Criteria include

- Taxpayer is required to maintain an accounting reserve under ASC 740
- No clear statutory guidance
- No controlling case law
- Not previously addressed in regulation, letter ruling, or other public written statement.

It is possible that there have not been any case brought under the Massachusetts Uncertain Tax Position Program.
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Taxpayer Goals and Strategies for VDP

Michael L. Colavito, Jr.

May 24, 2016
About Aronson LLC

Aronson LLC provides a comprehensive platform of assurance, tax, and consulting solutions to today’s most active industry sectors and successful individuals. For more than 50 years, we have purposefully expanded our service offerings and deepened our industry specialties to better serve the needs of our clients, people, and community. From startup to exit, we help our clients maximize opportunity, minimize risk, and unlock their full potential.
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IV. Mechanics of multistate VDPs
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Taxpayer goals and strategies in VDPs

• Taxpayer Goals

  – Whether to participate in a VDP is the most important decision in the entire process.

  – Tax practitioner should have a discussion with the taxpayer
    • How did the exposure come to light?
    • What’s the activity creating the exposure?
    • Due diligence issue?
    • Is the issue financial statement related?

  – A VDP is not always the best option to obtain the goal of tax compliance
Taxpayer goals and strategies in VDPs

• Taxpayer Goals
  – Reasons for participation in a VDP program
    • Acquisition related
      – A taxpayer may enter into a VDP to resolve and quantify tax liabilities prior to an acquisition.
      – State tax exposures can delay transactions, so pre-acquisition resolution of state liabilities is advisable.
    • Waiver of penalties
      – Some state penalties are 25% or more
      – There may be interest that accrues on penalties
      – VDP can result in significant savings
    • Waiver of Interest
      e.g., Texas, Illinois, New Hamp.
Taxpayer goals and strategies in VDPs

• Pre-VDP Strategy – General Considerations
  
  – Did the taxpayer even have nexus in the applicable periods?
    • Negotiated settlement after issuance of assessment.
    • Ruling request
  
  – Filing prospectively is a consideration, especially if nexus-creating activity is minimal
    • Consider taxpayer’s business activity when assessing risk of audit.
    • State overall aggressiveness and datamining techniques.
  
  – Simply filing back returns may be more efficient than a VDP.
  
  – How many states are at issue; is the multi-state VDP a better option?
  
  – Is there an upcoming amnesty that may afford greater benefits?
Taxpayer goals and strategies in VDPs

- Pre-VDP Strategy – Always know the following:
  - The number of years with an outstanding liability
  - Exposure amount; quantify it (tax, interest and penalty)
  - Benefit against additional costs of VDP
    - Is the penalty waiver substantially more than professional fees for the VDP?
    - Are the state’s procedures burdensome?
    - Are returns required regardless
      - If the in-state activity has ended or is expected to end
      - If the state’s VDP process is anonymous
Taxpayer goals and strategies in VDPs

- **VDP Strategy – General Tips**
  - Calling the state before sending request to participate is a good idea
    - Establishes relationship with responsible agency personnel
    - Tax practitioner can reaffirm the procedure
  - Maintain anonymity of taxpayer throughout or for as long as possible
  - Educate the taxpayer on the procedures and your role
  - Prevent unforeseen unilateral action by the taxpayer
    - “I went ahead and registered with the Department.”
    - “I made a payment online”
Taxpayer goals and strategies in VDPs

• VDP Strategy – Terms to the Agreement
  – Reporting Issues
    • Request spreadsheet reporting; more efficient, especially for sales and use tax
    • Discuss with taxpayer the length of time required to prepare returns or other reporting document and add 30-60 days to that for due dates in agreement.
  – Terms of Payment
    • Full payment at a certain date (i.e., 60, 90 days upon signing of VDA)
    • Payment plan – some states are more flexible than others.
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Navigating State Voluntary Disclosure Programs: Working With the Multistate Tax Commission

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Navigating State Voluntary Disclosure Programs: Working the Multistate Tax Commission

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Attorney Morris N. Robinson, CPA, LL.M
What is the Multistate Tax Commission?

• Nearly 50 years old – Created in 1967
• Created by Multistate Tax Compact
• The MTC conducts audits of multistate companies
  • The MTC also facilitates voluntary disclosures of taxes owed to member states
• Its actions are recommendations and do not have the force of law
• Located in Washington, D.C.
  • Audit Offices: Chicago and New York
General Overview

• Who Runs the MTC Voluntary Disclosure Program?
  ➢ The MTC National Nexus Staff

• What is the Job of the NNS?
  ➢ To facilitate voluntary disclosure
  ➢ To mediate between taxpayers and state departments of revenue

• Which Taxpayers Can Participate?
  ➢ Taxpayer that has liability in multiple states
  ➢ Taxpayer that has not had contact with the state – See Excluded Taxpayers
General Overview

• Which States?
  ➢ Currently, about 35 states and the District of Columbia participate in the MTC voluntary disclosure process
  ➢ States not participating include:
    ➢ California
    ➢ Illinois
    ➢ New York
    ➢ Pennsylvania
  ➢ See the MTC Website for details.
General Overview (cont’d)

• Which Taxes?
  • Sales/Use Tax
  • Income/Franchise Tax

• What is Full Compliance?
  ➢ Reporting the Tax
  ➢ Paying the Tax

• Cost to Taxpayer?
  ➢ No charge to the taxpayer
Benefit to Taxpayers

- To Allow Taxpayers to Come Into Full Tax Compliance Quickly and Inexpensively
  - Single Point of Contact – the MTC’s NNP staff
  - “Substantially uniform procedure”
- Relief of all penalties during lookback period – “usually”
- Relief of back taxes and interest before lookback period.
  - But sales and use taxes collected must be remitted.

Benefit to States

- “Found money” they could not otherwise access
Pre-Application Considerations

• Lookback Period
  
  ➢ Generally, three to four years.
  
  ➢ Each participating state has its own rules for the look back period under voluntary disclosure under which the state will waive penalties.
Pre-Application Considerations

Minimum Liability

- **Amount**: $500
- Determined on a state by state basis.
- The National Nexus Staff will NOT process a Voluntary Disclosure Application where the amount due a state is less than $500.
Confidentiality

- The MTC treats the Applicant’s Identity as confidential throughout the voluntary disclosure process.

- The applicant can remain anonymous to the MTC!

- When is Applicant’s Identity Revealed? When applicant has signed a Voluntary Disclosure Agreement.
  - Until the VDA is signed the state does not know the identity of the applicant.

- To Whom is Applicant’s Identify Revealed? To the state with which the applicant has entered into a voluntary disclosure agreement.
  - The identity of the applicant is not revealed to any other state, including those with pending or signed agreements with the applicant.

- Secure Email Is Available
Excluded Taxpayers:

- Any prior contact with state department of revenue
  - Filing
  - Payment
  - Notice/communications
- A state is not required to accept a taxpayer’s MVD even if it is otherwise eligible
- Each state makes an independent decision with respect to eligibility
The MTC Voluntary Disclosure Application

- Transmission Method? Electronic or Paper Filing
- On Line Application
  - Taxpayer lists states and tax types
  - Application “customizes itself” to solicit only information needed for those states and tax types.
  - Information is entered once.
  - Information is transmitted to the MTC through a private network

- PDF Version – Download, Complete, Return to the MTC
  - Wording can’t be changed
  - Separate application is required for each state.
  - Completed PDF’s are emailed to the MTC
  - Paper applications are accepted
The MTC Voluntary Disclosure Application

- **Contact Person**
  - Employee of taxpayer
  - CPA
  - Attorney

- **Obligation to Supplement**
  - Material omissions
  - Material mistakes of facts
Content of Application

- **Nexus: Applicant’s “Nexus-Creating” Business Activities**
  - Nexus is the activities that confer authority to tax.
  - Examples:
    - Ownership of real estate.
    - Employment of personnel, “even if transitory.”

- **Prior Contact with State**
  - Any prior contact can disqualify the applicant from voluntary disclosure in the contacted state.
Content of Application

- On a State-by-State basis:
  - Types of Tax
  - Sales/Use and income/franchise
    - Reason for not wishing to settle income tax along with sales tax
    - Example: Public Law 86-272
  - Good Faith Estimate of Past Tax Liability During the Look Back Period
    - The $500 deminimis rule
  - Organization in the State
  - Prior Contact with the State
Protection from Discovery:

- An open case means that the taxpayer is protected from discovery in those listed states during certain deadline periods.
- States and Commission suspend all inquiry and enforcement activity with respect to taxpayer’s non-filer status and type of tax.
  - Pending completion of MVD in accordance with time limits.
- Taxpayer may assert its protection from discovery if contacted by a state.
  - Inform the Commission and provide the Commission with permission to disclose taxpayer identity.
Procedure for Obtaining a Voluntary Disclosure Agreement

Upon filing of the application:

• The multistate National Nexus Program Staff prepare a draft voluntary disclosure agreement for review by the applicant.

• The applicant comments.

• Following the applicant’s written approval, the NNP staff sends to the state department of revenue the applicant’s

  ➢ (1) Proposed Voluntary Disclosure Agreement along with

  ➢ (2) The Application for Voluntary Disclosure (with identifying information redacted)
Procedure for Obtaining a Voluntary Disclosure Agreement

- The state can request revisions in the proposed voluntary disclosure agreement.
  - The NNP staff can act as mediator.
- The state signs the voluntary disclosure agreement and returns it to the NNP staff.
  - This is the state’s voluntary disclosure offer.
  - The applicant is still identified only by Case Number.
- The applicant signs the voluntary disclosure offer and returns it to the NNP staff along with:
  - Tax registration and tax returns
  - Tax payment
  - Any other required information
- The NNP staff sends these documents to the state department of revenue.
- Time Limits
  - There are fairly tight time limits for each of the activities listed below – usually between two and four weeks.
  - Applicants must be committed to moving the case along.
Procedure for Obtaining a Voluntary Disclosure Agreement

Caution: These are general procedures. For details regarding the requirements of specific states, be sure to talk early and often with the National Nexus Program Staff.
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MULTISTATE SURVEY OF VOLUNTARY DISCLOSURE PROGRAMS: HOW THE STATE OF CALIFORNIA SHOULD PROCEED

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STATE LEVEL VDP MODELS

State level voluntary disclosure programs can generally be described within the following categories:

(1) full conformity models;
(2) moderate conformity models;
(3) moderately limited conformity models;
(4) limited conformity models;
(5) no conformity models.
A. Full Conformity Models

States using a full compliance model have a current VDP that includes individuals and have prior programs that ran the same year as the IRS OVDP.

There are a total of ten states that use this model: Arizona, Connecticut, Louisiana, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island and Vermont

B. Moderate Conformity Models

States using a moderate conformity model have a current VDP that includes individuals and have prior programs that did not run the same years as the OVDP.

There are a total of twenty states and one district that use this model: Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky
C. Moderately Limited Conformity Models

States using a moderately limited conformity model have a current VDP that does not include individuals and have prior programs that ran the same years as the OVDP.

There is a total of eight states that use this model: Alabama, California, Colorado, Nebraska, Oregon, Texas, Virginia and Washington.

D. Limited Conformity Models

States using a limited conformity model have a current VDP that does not include individuals and have prior programs that did not run the same years as the OVDP.

There is a total of eight states that use this model: Alaska, Arkansas, Idaho, Minnesota, Nevada, North Dakota, South Dakota and Tennessee.
E. No Conformity Models

States using a no conformity model do not have a current VDP.

There is a total of four states that use this model: Delaware, Hawaii, New Mexico and Oklahoma.

These states have an individual income tax but do not have voluntary disclosure programs.