

Voluntary Compliance or Fresh Start: Now There's a Choice

by Glenn G. Rybacki

Reprinted from *State Tax Notes*, March 5, 2018, p. 861

Voluntary Compliance or Fresh Start: Now There's a Choice

by Glenn G. Rybacki

Glenn G. Rybacki is counsel in Day Pitney's Corporate and Business Law department where he provides state and local tax planning and representation to clients ranging from individuals and start-ups to national and international corporations.

In this inaugural edition of ConnTax, Rybacki compares Connecticut's voluntary disclosure program with the new Fresh Start program to help taxpayers choose which might work best for them.

Like many states, Connecticut offers a voluntary disclosure program (VDP) that allows taxpayers to come forward to resolve tax liabilities for prior periods. However, with the recent enactment of the new Fresh Start program (FSP), which runs through November 30, 2018, taxpayers now have two options for resolving Connecticut back taxes at a cost that may be less than the full statutory liability otherwise due. This article discusses the requirements, benefits, and possible drawbacks of each program to help a taxpayer choose which might work best in a given situation.

Voluntary Disclosure Program

Under Connecticut's long-standing VDP, a taxpayer's representative may contact the Connecticut Department of Revenue Services (DRS) on a no-name basis and request participation in the VDP. If the taxpayer is accepted into the VDP, the DRS will agree to not seek penalties or criminal prosecution in exchange for the payment of the tax and the interest due. More importantly, the DRS also may be willing to limit the "lookback period" — the number of prior tax years for which it will seek to collect back taxes — up to the immediately preceding three overdue tax years. (The potential lookback period is discretionary, and will depend on the taxpayer's

facts and circumstances. For instance, in the case of offshore foreign accounts, the DRS often applies the same lookback period as the IRS, which could be as long as eight years.)

A taxpayer is eligible to apply to the VDP, however, only if it has not had "a previous contact of any kind" from the DRS.¹ Such contact could include an inquiry, notification of an audit, and so forth. Such disqualifying contact, however, usually is limited to the specific tax type and the tax years to which the contact relates. In other words, it usually is *not* disqualifying if the taxpayer has had contact with the DRS regarding other tax types for the same tax years, or even other tax years for the tax type that is the subject of the VDP application. Nonetheless, it is good practice to disclose any prior contact in the VDP application (careful not to give away the taxpayer's identity) so that the DRS will have all the material facts in front of it when it makes its decision regarding acceptance into the VDP.

Although the name of the taxpayer does not have to be disclosed, the VDP application does have to provide sufficient information for the DRS to determine whether it will accept the taxpayer into the VDP. Such information typically would include the tax type, a description of the taxpayer's activities, the period in issue, and an estimate of the amount of tax and interest. The application also should provide an explanation of why the tax hasn't been paid. Although the taxpayer does not have to show "reasonable cause," it should try to present the reason for nonpayment in as sympathetic a manner as possible, such as referencing an otherwise conscientious and timely compliance history.

¹ Informational Publication 2010(18) (Sept. 28, 2010) (emphasis added).

The DRS's decision on whether to accept the taxpayer into the program will be predicated on the facts as represented in the application. Among the factors that the DRS will consider are the nature and magnitude of the taxpayer's presence and activity, evidence that the taxpayer was not in willful disregard of the tax laws, whether the taxpayer has collected any taxes, and the benefits to the state of accepting the taxpayer into the VDP. The DRS reserves the right to withdraw the acceptance into the VDP if it believes that there has been a misrepresentation (or a material omission) in the facts as stated in the application.

Once the taxpayer has been accepted into the VDP, the DRS will request that the appropriate returns be filed reasonably promptly, together with payment of the tax and interest. In some cases, such as with sales and use tax, the DRS will accept filing under the VDP using a spreadsheet rather than requiring the preparation of back returns. The DRS will specify in its acceptance letter the filing that it requires as part of the VDP filing. The DRS will also reserve the right to audit the filing.

After the VDP filing has been reviewed, the DRS will send a proposed closing agreement to the taxpayer. The closing agreement typically sets out the amount of the agreed-upon liability, which will be final "except upon a showing of fraud, malfeasance or misrepresentation of a material fact." (This language is taken from IRC section 7121(b).) If the VDP involves corporation business tax or personal income tax, the taxpayer will remain subject to the requirements of Conn. Gen. Stat. sections 12-226, 12-704(b), and 12-727(b), which require the reporting of changes to a taxpayer's federal or state (other than Connecticut) liability, respectively. The taxpayer will also be required to make its books and records available to the DRS.

The closing agreement will require the taxpayer to relinquish any right to claim a refund or to file any appeal for the periods and tax type that are the subject of the closing agreement. This does not include refunds based on computational or clerical errors.

Finally, the closing agreement will provide that the taxpayer and the DRS agree to keep the terms confidential, except as may otherwise be required by law or in the ordinary course of

business (with the latter carrying the further requirement that the recipient be informed that the information is confidential and may not be further disclosed). The DRS states in Informational Publication 2010(18) that it will not discuss the voluntary disclosure agreement with the taxing authority of any other jurisdiction or the IRS.

Fresh Start Program

During the budget session in late 2017, the Connecticut General Assembly enacted the FSP, which runs through November 30, 2018, for taxpayers that either (1) failed to file a return, or (2) failed to report the full amount of tax on a previously filed return, due on or before December 31, 2016.

Under the FSP, eligible taxpayers that come forward voluntarily will receive the following incentives to settle their liabilities with the state:

- all penalties will be waived;
- 50 percent of the interest on the tax paid will be waived;
- in some cases, the DRS *may* agree to limit the lookback period up to three years and not pursue older, unfiled returns; and
- no criminal investigation or prosecution will be initiated.

Taxpayers will not be eligible for the FSP, however, if they:

- have received a bill from the DRS;
- are under audit;
- are a party to a closing agreement with the DRS;
- have made an offer of compromise that has been accepted by the DRS;
- have protested a determination of an audit; or
- are party to litigation against the DRS.

Taxpayers that want to take advantage of the limited lookback period under the FSP must call the DRS (877-729-6891) before filing an application under the FSP. The limited lookback period will cover three years of unfiled returns regardless of whether the returns are due annually, quarterly, or monthly. If the taxpayer complies with all the terms of the FSP, any liabilities before the three-year lookback period will be canceled. However, a taxpayer will qualify

for a limited lookback for a particular type of tax only if the taxpayer has neither registered for nor filed a tax return for that type of tax. Also, the limited lookback does not apply to trust fund taxes, such as sales tax or withholding tax, that the taxpayer collected but did not remit to the DRS.

The FSP applies to all taxes administered by the DRS except for the motor carrier road tax. Qualified taxes include personal income tax, business entity tax, sales and use tax, withholding tax, corporation business tax, and gift tax. The FSP does not apply to taxes that are not administered by the DRS, such as local property taxes or payroll taxes owed to the Connecticut Department of Labor, nor does it apply to fees imposed by the secretary of the state. The state expects the FSP to raise \$85 million of revenue.

To participate in the FSP, a taxpayer must complete an online application. Unless directed by the DRS, the taxpayer will not be required to submit the actual tax returns covered by the application. The taxpayer must enter the tax type, tax periods, and the tax owed on the online application, which then will calculate the reduced interest and total balance due. That balance due must be paid online at the same time that the taxpayer files for entry into the FSP. The DRS has indicated that it will notify a taxpayer only if the application has been denied. There will be no notification if the application has been approved.

The taxpayer also must agree to timely file all required tax returns and pay any associated tax to the DRS for the three-year period following the date of the FSP application. If the taxpayer does not timely file those returns and pay the corresponding tax due, the taxpayer will be in violation of the FSP agreement and the DRS may reinstate all applicable penalties and interest for the tax periods covered by the FSP application. Also, the taxpayer will lose any limited lookback period agreed to with the DRS and may be subject to criminal prosecution. Failure to file returns or pay tax after the three-year period may result in penalties, interest, and other sanctions, but will not revoke the FSP agreement.

There will be *no* refund or credit for any taxes overpaid under the FSP. Further, the filing of an FSP application does not preclude a subsequent audit by the DRS, which retains the right to make any additional assessments for the type of tax and

tax period covered by an FSP agreement. If the audit results in an assessment, the DRS may impose penalties and the full amount of interest on any additional tax owed.

Choice of Remedy

The DRS has indicated that the VDP will remain available during the term of the FSP, so a taxpayer will have a choice of remedies through November 30, 2018. Both the VDP and the FSP offer a waiver of penalties and criminal prosecution, as well as a limited lookback period in appropriate circumstances. As noted above, however, neither program will be available to a taxpayer that already has been contacted before submitting an application.

The VDP has the advantage that the application can be made on an anonymous basis and may provide a limited lookback period even if the taxpayer has filed returns for that tax type. Accordingly, a taxpayer will be able to know under the VDP whether or not it has been accepted, and whether or not there will be a limited lookback, before it has to reveal itself.

Further, the VDP process is concluded by a closing agreement, which by its terms is final unless there has been fraud, malfeasance, or material misrepresentation. The FSP periods, in contrast, remain open for audit and assessment — subject to the applicable statute of limitations.

There is no provision under the VDP, however, for the waiver of interest. With statutory interest in Connecticut running at 12 percent simple per year, the difference between VDP interest at 12 percent and FSP interest at 6 percent can be substantial.

The key advantage of using the FSP would be this potential 50 percent interest savings. To use it, however, a taxpayer must disclose its identity before it knows whether it will be accepted into the FSP. Further, there will be no limited lookback under the FSP if the taxpayer has filed prior returns for the tax type in issue.

Additional information concerning the VDP and the FSP may be found on the DRS website at www.ct.gov/drs. ■