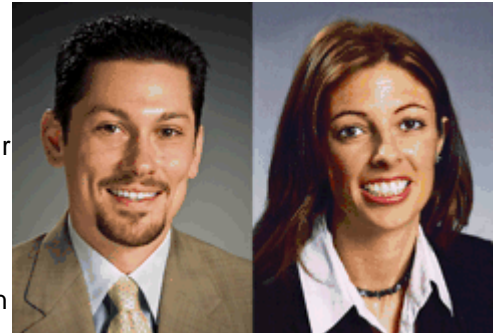


## New York's Less Kind and Gentle Tax Department -- Preparing for Criminal Investigations

by Jack Trachtenberg and Michelle Merola-Kane

Recently, our firm represented a client who was undergoing a seemingly routine residency audit by the New York State Department of Taxation and Finance. Our client moved out of New York many years ago, but the tax department contended that he continued to maintain a domicile in the state. The audit had been going on for many months, and mounds of documentation had been provided to, and reviewed by, the tax department's auditors. Settlement discussions had begun, and our client offered to settle. The tax department even made a counteroffer. Then our client received a letter from the state with a shocking message: His case had been referred for criminal investigation.



That is the world in which New York's taxpayers now live. Gone are the days of routine civil audits in which the focus was mainly on ensuring that the appropriate amount of tax -- whether it be personal income tax, sales tax, franchise tax, or some other tax -- was paid. Gone are the days when the assertion of a tax deficiency by the tax department was, more often than not, presumed to be the result of a mistake, a misunderstanding, or a difference of opinion regarding the application of New York's tax laws and regulations. And gone are the days when taxpayers could assume that they were not under criminal investigation simply because they had been selected for a civil audit. New York's tax department is now focused on enforcement. Thus every taxpayer should be aware that the commencement of a civil audit may carry with it an increased risk of a criminal investigation.

### A New Enforcement Mentality

In 2007 Gov. Eliot Spitzer swept into office with a mandate to reform government statewide. During his tenure as attorney general, Spitzer had built his reputation as a tough-as-nails prosecutor by taking on a host of high-profile civil and criminal cases concerning white-collar crime, securities fraud, and Internet fraud. Spitzer aggressively pursued what he perceived to be the excesses and corruption of big business and special interests in New York, and used every tool in his prosecutorial arsenal to, in the eyes of many, mercilessly bring his targets to their knees.

It therefore came as no surprise to many that Spitzer chose to appoint William J. Comiskey to fill the position of deputy commissioner for tax enforcement. Comiskey had worked with Spitzer in the attorney general's office and had been appointed by Spitzer to head the state's Medicaid Fraud Control Unit. As the head of that unit, Comiskey built a reputation as a prosecutor's prosecutor,<sup>1</sup> zealously seeking to ferret out and punish fraudulent conduct.

As deputy commissioner for tax enforcement, Comiskey has imbued the tax department with a similar enforcement and antifraud mentality. Under his leadership, the tax department has begun to retool itself with new enforcement initiatives. Among them is the tax department's campaign to launch an online mechanism for citizens to report "tax evasion" and its simultaneous efforts to publicize its criminal investigation activities. One goal of that campaign is to deputize citizens who have knowledge of fraud, thereby increasing the fronts of attack on tax fraud. Traditional enforcement mechanisms have also seen a resurgence. For example, there has been a clear increase in the use of subpoenas in tax department audits and investigations, as well as an uptick in the state's collection activities (including collection action against alleged liabilities that go back, in some cases, more than three decades). Moreover, as reported in the last edition of Noonan's Notes, the tax department (through Spitzer's recent budget proposal, made before his resignation in March) is seeking to dramatically scale back the voluntary disclosure program, which in some cases allows taxpayers to avoid criminal prosecution if they anonymously come forward and pay their back taxes.<sup>2</sup>

Comiskey has also reorganized the tax department and created a new Office of Tax Enforcement, which he heads. Now under its auspices are the tax department's Audit Division, Division of Collection and Civil Enforcement, and Investigation and Criminal Enforcement Division. Comiskey has also established a new special investigations unit that is designed to "deter tax avoidance and abuse" by coordinating the tax department's audit, collection, and criminal investigation activities.<sup>3</sup> A recent tax department press release describes the new unit as follows:

Increased criminal enforcement is a Department priority. Recently, we more than quadrupled our fraud fighting forces by deploying specially trained multi-disciplinary investigations units statewide. Teams of auditors, investigators and attorneys are using all the enforcement tools at their disposal to stop those engaged in tax evasion and fraud at the expense of other taxpayers and their communities.

The new emphasis on criminal tax enforcement has yielded results. Since January 2007 the tax department has prosecuted (according to the press releases posted on its Web site) no fewer than 34 cases of tax evasion or fraud. And most, if not all, of those disclosed cases have resulted in a plea of guilty by the accused taxpayer. Indeed, in our own practice, we have seen a dramatic increase in the number of clients coming to us for advice and representation in connection with a criminal tax investigation or prosecution. The department has even publicized the start of criminal investigations of some taxpayers, going so far as to give one investigation its own catchy title -- Operation Gold Rush!<sup>4</sup> It is time for taxpayers in New York to become aware of the charges they may face, to know what rights they have in connection with a criminal tax investigation, and to know what steps they should take now to enhance the likelihood of a favorable outcome should an investigation arise.

### **New York's Criminal Tax Laws**

A good starting point for anyone who may be caught up in a criminal tax investigation is to understand what kind of charges he may be facing. New York's Tax Law contains various criminal penalties for actions relating to an array of taxes, including personal income taxes; corporate income taxes; estate, gift, and transfer taxes; motor fuel taxes; the alcohol beverage tax; the cigarette and tobacco tax; highway use and fuel use taxes; sales and compensating use taxes; and the real estate transfer tax. Most of the criminal investigations that we have seen, and most of the press releases discussed on the tax department's Web site, deal with alleged violations of the state's personal income tax and sales and use tax laws. Because a complete description of all of New York's criminal tax laws falls outside the scope of this article, we will focus on a few of those more commonly used provisions.

#### **Failure to File, or Filing a False Return**

One of the most common areas of concern in a criminal tax investigation is the taxpayer's alleged failure to file a tax return or the taxpayer's alleged filing of a false or fraudulent return. Generally, the linchpin to any such charges is the failure to file with the intent to evade tax, or the intentional or willful delivering of a false return. The following summarizes some of the statutes regarding failure to file and false filings that are applicable to New York's income and sales and use taxes:

- **Tax Law section 1801 (failure to file a return or report; supply information; or supplying false information).** That misdemeanor applies when a taxpayer, with the intent to evade taxes, fails to file an income tax return or supplies false or fraudulent information.
- **Tax Law section 1802 (repeated failure to file).** Under that provision, a person is guilty of a felony if he fails to file income tax returns for three consecutive years with the intent to evade taxes.<sup>5</sup>
- **Tax Law section 1817(a) (willful failure to file a return or report).** Any person who is required to file a sales or use tax return is guilty of a misdemeanor if she willfully fails to do so at the time required by law.
- **Tax Law section 1817(b)(1) (filing fraudulent return).** A person who willfully makes and subscribes to a sales or use tax return, report, or document which he does not believe to be true and correct regarding every material matter is guilty of a misdemeanor.
- **Tax Law section 1817(b)(2) (disclosing false information to the department).** A person who willfully delivers or discloses a list, return, report, account, statement, or other document that is required by the sales tax law, and that is known by him to be false or fraudulent as to any material matter, is guilty of a misdemeanor. That includes the omission of any material matter with the intent to deceive.

#### **Failure to Collect or Pay Tax**

Another charge commonly levied against taxpayers in criminal income and sales tax investigations is the failure to collect or pay tax. As in the case of a failure to file or the filing of a false return, an element of willfulness or intention is generally required in order to be found guilty of the crime. The following summarizes a few of the more relevant statutes in this area:

- **Tax Law section 1806 (withholding; personal income and earning).** That misdemeanor applies when a taxpayer "willfully" fails to collect or pay over to the state any income taxes that are required to be withheld.
- **Tax Law section 1810 (failure to pay tax).** That statute makes it a misdemeanor to fail to pay income tax if the failure to pay was with the intent to evade tax.

- **Tax Law section 1817(c) (failure to collect tax).** A person is guilty of a misdemeanor under this section if she willfully fails to collect sales tax. A felony charge may, however, be brought if the taxpayer fails to collect the tax with the intent to defraud the state or locality and the amount that the taxpayer failed to collect is \$10,000 or more; or fails to collect the tax and does so through a common scheme or plan consisting of 10 or more failures to collect tax on sales of \$100 or more each. Note that taxpayers who collect but intentionally fail to remit sales tax to the state may also be charged, under the penal law, with the crime of larceny.

### **Other Potentially Relevant Criminal Statutes**

Readers should note that the above are just a few of the charges that may arise as the result of a criminal tax investigation. In the sales tax area especially, it is also typical to see a criminal investigation result in a charge of willfully failing to keep records that are required to be kept under the tax law. Other provisions make it a crime to sell goods or services in New York without a certificate of authority (or under a suspended or revoked certificate of authority); to fail to separately state the amount of sales tax collected on a receipt, bill, and so forth; or to issue a false resale certificate. Moreover, some of New York's more discrete taxes contain criminal tax provisions that are unique to the activity being regulated (for example, it is a crime under the motor fuel tax law to willfully make or produce for inspection a manifest that is required to be kept under section 286-b of the Tax Law).<sup>6</sup> Tax return preparers should also be aware that criminal sanctions may apply if one aids or assists in the filing of a fraudulent return, report, statement, or other document required to be filed with the tax department.<sup>7</sup>

Readers should also bear in mind that the courts have interpreted the scope and application of New York's criminal tax laws, as well as the defenses that may be brought to bear against any such charges. Thus, readers are cautioned to avoid a mechanical application of the law to the facts of any particular case. Taxpayers who are or may become the subject of a criminal tax investigation should immediately consult with an attorney to obtain a full understanding of the charges they may be facing and to determine what defenses they may have. Ideally, that consultation should take place before the investigation begins or as soon as the taxpayer is notified of the investigation.

### **Being Prepared for Government Audits**

In light of the tax department's increased focus on civil and criminal enforcement actions, many taxpayers (including both businesses and individuals) can expect that at some point they will be the subject of a government audit. Despite that reality, many taxpayers do not appreciate the value of preparing in advance for a tax audit. Preparation is frequently the single most effective way to reduce an assessment of additional tax liability and avoid a charge of criminal wrongdoing. Therefore, it is advisable to give thorough consideration to the following issues before any contact with the government.

#### **Organize Tax Documents**

First and foremost, taxpayers should maintain an orderly record-keeping system that segregates tax records from all other documents, especially those that may be privileged or confidential. Depending on the type of tax return that is under review, auditors may need to review business records related to income, sales, expenses, deductions, and credits. In other audits, taxpayers will need to document, with exemption certificates or otherwise, why a particular transaction should be deemed exempted or excluded from tax. Some audits will even require the taxpayer to produce for review some personal records, such as appointment calendars, telephone and mobile phone records, EZ Pass records, credit card and bank statements, frequent flyer records, and other travel documentation. Under New York's Tax Law, there is generally a three-year statute of limitations on tax audits, though in some cases (such as when fraud exists or when a substantial understatement has been made on an income tax return), the statute of limitations can last for as long as six years. And if the taxpayer has failed to file any return, the statute of limitations typically stays open indefinitely. Consequently, tax documents from at least the preceding three years should be kept on-site for ease of access. If you are a business or corporation, at least one individual should have a thorough understanding of the filing system, and that person should be prepared to act as a custodian of records during a government audit. The more organized the records are, the more confidence the auditors will have in the accuracy of the company's tax returns.

#### **Establish a Government Liaison**

Business taxpayers should establish a point of contact for government officials who either call or appear on-site to conduct an audit. That employee should be considered the government liaison for all such matters. Moreover, all employees, including support staff, should know who the government liaison is and how to reach that person at all times. Auditors are used to dealing with liaisons and generally appreciate that type of professional response to their inquiries.

Taxpayers should note that they are, under the Tax Law, entitled at all times to be represented by counsel during a tax audit or investigation. Moreover, when representation has been obtained, taxpayers may insist that all requests for records and other communications from the tax department be made directly to their counsel. And perhaps most importantly, taxpayers are entitled to have their attorney present should the tax department want to interview the taxpayer or any officer or employer, or if it should seek to conduct an on-site investigation of the business or other premises. Indeed, we strongly recommend that taxpayers obtain counsel before permitting the tax department to undertake anything of the sort.

### **Establish a Document Retention Policy**

Many tax audits and investigations result in the assessment of additional liability, and at times criminal charges, solely because the taxpayer is unable to locate the appropriate documentation. That is sometimes the result of a simple misunderstanding about the legal and practical consequences for document destruction. Therefore, it is advisable that business taxpayers document a process for record disposal and preservation that sets forth the types of records to be retained and how long they should be kept. A well-delineated policy will enhance the taxpayer's ability to maintain control over documents that are necessary to support its tax position. Also, employees should understand that the improper destruction of documents may result in criminal penalties.

### **Establish a Protocol for Responding to Auditors**

Business taxpayers should establish a written protocol that sets forth the business's policy for responding to auditors or investigators. It should incorporate basic guidance that reduces the likelihood that auditors inadvertently intimidate employees. For example:

- The protocol should direct the liaison to immediately contact an experienced tax attorney regarding the auditor's presence. In many cases, it is advisable for the attorney to be present during the audit, and when it is not necessary for the attorney to be present, he should remain available in the event questions or irregularities arise. From that point forward, all communications with the auditor or investigator should go through the attorney, unless it is determined that some types of minimal contact between the state and the taxpayer are appropriate.
- The protocol should advise the liaison that auditors are required to explain the purpose and scope of the audit and outline the taxpayer's rights before commencing their investigation.
- The protocol should encourage the liaison to use the opportunity to ask questions, including the names of the auditors, the district office or division of the tax department that they represent, and their authority for conducting the audit.
- The protocol should direct the taxpayer's liaison to request, if not offered by the auditor, a complete written list of the records and audit period to be reviewed. When advance notice is given, the requested records should be compiled and reviewed by the liaison and the taxpayer's attorney to ensure that they are organized and complete.
- The protocol should make it clear that it is generally not a good practice to volunteer additional records or do anything to expand the scope of the audit. Also, the protocol should state that if the auditors ask for copies of specific company documents, the liaison should ask them to flag or otherwise identify the requested documents so that copies can be made and provided to the auditors in a timely fashion. That procedure will allow the taxpayer and its attorney an opportunity to review the documents that have been requested.
- In light of the complexities surrounding privileged communications and partial waivers, taxpayers must be extremely vigilant in ensuring that privileged and confidential documents are not disclosed. Thus, the protocol should direct the liaison to consult an attorney if there are questions about privilege.

### **Establish a Separate Protocol for Responding to Search Warrants**

Many criminal investigations are initiated in earnest with the execution of a search warrant. To obtain a search warrant, law enforcement must present evidence to a judge that demonstrates that there is probable cause to believe that evidence of a tax crime will be found at the subject location. Therefore, if the tax department proceeds by search warrant, the matter is serious and should be treated as such.

The protocol for responding to search warrants should incorporate the same concepts as those embodied in the civil audit protocol. However, the liaison should request identification from the agents executing the warrant, as well as the affiliation of the individual in charge of its execution. A copy of the warrant should be provided to the company and immediately faxed to legal counsel. The protocol should establish a procedure for immediate dismissal from the premises of all nonmanagerial staff in any area that is likely to be affected by the search. Those employees should be instructed not to remove any corporate documents or property from the premises. Managerial staff, in most cases, should remain on-site. They should be advised that if approached by a member of the search warrant detail, they must identify themselves and

their title. However, policy should prohibit managers from responding without the presence of an attorney to further inquiries from law enforcement. Therefore, managers should be familiar with the names and locations of counsel so that they can appropriately direct those inquiries. Managers should also carefully observe and memorialize the activities of the search detail. Finally, the protocol should tell all employees to direct any media inquiries to legal counsel.

## **Know Your Rights**

The final and most important form of preparation is education. New York state taxpayers are afforded specific rights during audits. However, taxpayers should not rely on government auditors to adequately convey those rights. During orientation or periodic training sessions, businesses should educate their employees regarding government audits and their protocols for responding to the audits. Employees should understand what agencies the company is regulated by. They should also know that tax audits are likely to become an increasingly routine part of government regulation in New York state over the coming years. That knowledge will reduce anxiety among employees and ensure that they react calmly and professionally. An auditor's first impressions, as well as his treatment, can have a significant effect on the final outcome.

Employee education should emphasize that the business has a right to know why specific information is being requested and how it will be used. Thus, asking questions is appropriate, but challenging an auditor is rarely beneficial (those challenges should be made, when appropriate, by the taxpayer's attorney). Employees should also be aware that auditors have an obligation to maintain the confidentiality of information obtained during an audit and that a breach of that obligation is a violation of state law. Finally, ensure that everyone understands the company's right to representation at any time during the audit. That includes the right to suspend a meeting at any time to retain that representation. Companies should counsel employees to consult with an experienced tax attorney before refusing to comply with an auditor's requests, because noncompliance may, in some cases, increase the risk of the taxpayer being subject to criminal charges.

## **Conclusion**

It is unclear what effect, if any, Spitzer's resignation will have on the enforcement and antifraud bent that has now characterizes New York's tax department. Taxpayers should anticipate, however, that the tax department's newly implemented enforcement initiatives will continue. Consequently, taxpayers must understand the new, perhaps unlevel, playing field of government tax audits and investigations. Nobody can afford to be complacent. Preparation and adherence to basic protocols must be the themes of the taxpayer's survival handbook, as experience demonstrates that those principles make the audit process far more palatable and greatly enhance the likelihood of receiving favorable audit findings. But perhaps most importantly, taxpayers should make sure that they are adequately represented by counsel during any civil audit or criminal investigation. That will help ensure that the outcome of any audit or investigation is a determination regarding the appropriate amount of tax due (if any) and not simply more "antifraud" headlines for the tax department.

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