state tax notes™

Litigating a New York Tax Case, Volume 1: The Audit Process

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In this article, Noonan and Doolittle outline the audit process in New York, including the general procedures for different types of taxes, how to deal with the state's Department of Taxation and Finance, and the issues that frequently arise during audits.

This year is the 10th anniversary of this *State Tax Notes* column, which has covered a wide range of topics regarding the personal income tax, sales tax, withholding tax, and multistate taxes. The first column, complete with a goofy circa-2003 headshot, was titled "Litigating a New York Case From Start to Finish."[1] The column was initially called "Noonan's Notes on Tax Practice," so an article about procedural issues was a great jumping-off point. And though the name has been shortened to "Noonan's Notes," we still try to cover practical issues and considerations that practitioners in New York and across the country might be interested in.

As we reminisce on 10 years, Ariele and I thought it was time to readdress the most basic, important practice and procedure issues that practitioners face every day. Given the issues that arise from the start of a tax audit to its conclusion four or five years later in the New York Tax Appeals Tribunal or judicial courts, we're doing a four-part series on the stages of New York's tax audit and appeals process.

Volume one covers the audit process. In volume two, we will cover the conciliation conference process within New York's Bureau of Conciliation and Mediation Services. In volume three, we will walk through the appeals process within New York's version of tax court, the New York State Division of Tax Appeals. And finally, in the fourth installment, we will talk about what happens when tax cases get to "real court" within New York's judicial process.

But we will begin where most tax disputes start, with the friendly letter from the State Department of Taxation and Finance notifying the taxpayer that it has been selected for audit.

I. Starting Point: Who Can Help?

The short answer to this question is pretty much anybody. During any stage of an audit, taxpayers may be represented by someone else. Under New York's rules, this could include attorneys licensed to practice in New York, certified public accountants qualified to practice in New York, public accountants enrolled with the New York State Education Department, and enrolled agents authorized to practice before the IRS. Upon written request for permission, an attorney, CPA, or licensed public accountant qualified in another state may also be permitted to represent a taxpayer in such proceedings.[2]

The mechanics are straightforward. Suggested forms of power of attorney (POA) and notice of appearance are contained in N.Y. General Obligations Law, title 15, Article 5, and are available from the department and on its website as Form POA-1.[3] A POA must be notarized or be witnessed by two disinterested individuals, unless the authorized representative is an attorney, CPA, or public accountant licensed to practice in New York — or a New York resident enrolled as an agent to practice before the IRS.[4]

But as many practitioners have experienced over the past few years, the processing of these POA forms can be a little frustrating. The department now requires all POAs to be run through a central processing unit, which can sometimes take a week or so to process a new POA. Often this isn't a problem, especially at the beginning of an audit when things are moving at a measured pace. It becomes a bigger problem

[1]Timothy P. Noonan, "Litigating a New York Case From Start to Finish," *State Tax Notes*, Feb. 19, 2007, p. 487.

[2]20 N.Y.C.R.R. section 2390.1; *see also* 20 N.Y.C.R.R. sections 3000.2(a)(2) and 4000.2(b).

[3]For estate tax matters, an Estate Tax Power of Attorney (Form ET-14) must be filed.

[4]20 N.Y.C.R.R. section 2390.1

when you have to put out a fire quickly, such as when an urgent collection matter arises. The department has tried to address this issue by creating the E-ZRep TR-2000 form, which allows a practitioner a quicker way to get information for a client in an emergency situation.[5]

However, there are often more important strategic decisions at the outset of an audit for the taxpayer and practitioner. Does the taxpayer handle the audit? Should the accountant who filed the returns handle the audit? Or should we bring in a separate consultant or even a tax lawyer to handle it? Any approach could be appropriate given the circumstances. In some cases, the potential tax exposure wouldn't justify bringing in an outside consultant, accountant, or attorney. But outside those circumstances, the best practice is to make sure the taxpayer engages a practitioner who has significant experience handling audits of the type of tax at issue. Hiring a licensed attorney never hurts, but then again we're biased, since it offers the confidentiality of communications between attorney and client. But often, experience handling a particular issue or tax type is paramount. And the department's auditors are very much conditioned to seeing outside accountants or lawyers jumping in even at the early stages of the audit.

II. Audit Process Generally

Audits come in two forms: desk audits and field audits. Desk audits generally arise from information matching — or mismatching — when a taxpayer files a tax return or, in some cases, files no return. The department gets wind of information that either conflicts with the filed return or, alternatively, information suggesting the taxpayer failed to file a required return. Desk audits are conducted strictly via correspondence, with no face-to-face interactions with the department's auditors.

Field audits, on the other hand, typically require face-to-face meetings with auditors and involve more departmental resources than desk audits. Indeed, field audits tend to delve deeper into the facts and issues. In recent years, the department has advanced its audit selection game through its sophisticated Case Identification Selection System Program, which uses data analytics to identify audit candidates.[6] With the advent of this program, it is safe to assume that randomly selected audits are a bygone era in New York.

To get a feel for some of the nuts and bolts of these audits, let's review what happens in the more prevalent audits areas: sales tax, income tax, and franchise tax.

A. Sales Tax Audits

Sales tax audits usually start with a letter from a sales tax auditor requesting copies of the sales tax returns and federal returns for the audit period. The auditor will also request a standard list of records, but normally the best approach — after getting this letter — is to sit down with the auditor, go through his laundry list of required documentation, and discuss what is needed to streamline the audit process and save your client (and the department) lots of time and effort.

Once the audit begins, auditors generally focus on four areas. First, the auditor needs to verify that every dollar of tax collected by the vendor was remitted with the vendor's sales tax returns. Normally, the auditor can resolve this issue by reviewing the tax returns and the vendor's sales tax accrual account to determine whether the numbers match up. This initial tax reconciliation is fairly straightforward.

The sales part of the audit is designed to ensure that the vendor is reporting all taxable sales made during the audit period and to confirm that the tax is being calculated correctly on all sales. Issues include whether the taxpayer is maintaining adequate records, how to pick the right test period, and how to "extrapolate" any test period errors over the entire audit period.

Finally, most sales tax audits also involve a review of the taxpayer's purchases to confirm that the vendor paid tax on purchases of materials, supplies, and services that recur throughout the audit period (the expenses portion of the audit) and to confirm that appropriate tax has been paid on larger items (the capital portion of the audit). Expenses are usually tested, so you find yourself getting into the same issues about test periods and extrapolation that you'll see in the sales area. But because capital purchases typically do not recur, an auditor will normally review every transaction during the audit period to determine if the vendor correctly paid tax on its purchases of fixed assets. That's right — every purchase over the three-year audit period will need to be examined.

Another issue that often comes up at the start of the audit is the auditor's request for a "responsible person" questionnaire. As most readers know, since the sales tax is a trust fund tax, the law permits the department to assert derivative liability against so-called responsible persons of the taxpayer. And while it is often obvious who those persons are, the department's practice is to start the audit with a request that responsible persons fill out a questionnaire outlining their level of authority in the business. For the most part, we try to resist this step at the early stages of an audit because the request is usually premature. The responsible person issue arises only if there is a tax liability, and ideally on day one of the audit, that hasn't been determined yet. Also, even if there is a liability, the responsible person issue only arises if the taxpaying company can't pay the liability. So why are we taking all these steps before the audit starts to identify things that will, in most cases, be irrelevant?

[5]Details at https://www.tax.ny.gov/e-services/otc/tr_2000_info.htm.

[6]*See* William J. Comiskey, "Sales Tax Reform: Technology and Escrow Accounts to the Rescue," *State Tax Notes*, Nov. 21, 2011, p. 511.

B. Personal Income Tax Audits

1. Residency Audits

As readers of this column know, the department has continued its focus on individuals claiming residency in other states. These residency audits generally begin with a letter from an auditor requesting tax returns and a completed "nonresident audit questionnaire." Following this initial submission, auditors will generally issue a document request seeking records and confirmation establishing that the taxpayer was a resident of another state during the audit years. The scope of this request and the auditor's methods will vary based on the issues. If there is an issue concerning the location of a taxpayer's domicile, the auditor's questions will usually focus on the five primary domicile factors: the home factor, the items "near and dear" factor, the business factor, the time factor, and the family factor.[7] Utility bills, voting records, homeowners insurance records, and other items are generally part of this request.

But domicile is not the only issue in a residency audit. The tax law also provides that the term "resident" includes taxpayers who maintain a permanent place of abode for substantially all the tax year and spend more than 183 days in New York during the tax year.[8] To address this issue, auditors will request information to document the taxpayer's daily location, such as credit card records, telephone bills, EZ Pass records, travel documents, passports, contemporaneous calendars and diaries, and the like. And if the taxpayer is unwilling or unable to provide this information, the auditor can and sometimes will just get it herself. As in the sales tax area, the department has subpoena power and often uses it to obtain items such as telephone records.

2. Allocation

Another common area of review in a personal income tax audit involves nonresident income allocation. This issue is addressed in every residency audit, most obviously in those in which the residency issue is resolved in the taxpayer's favor. Under New York law, nonresidents are subject to tax on any income from New York sources, which generally includes wages from New York employment, income from New York real property, flow-through income from New York businesses, and so forth.[9] So here, the auditor will focus on any item of income that was included in the federal column of the taxpayer's nonresident tax return but not included in the New York column. And just like in the residency context, this review sometimes involves an analysis of days spent in New York — or in this case, days worked in New York.

In more recent years, particularly with the issuance of updated audit guidelines, auditors have also examined the operations of any business the taxpayer is involved in to determine if any income was derived from New York sources.[10] The new guidelines contain new sections about the kinds of issues and questions that auditors should be asking about when taxpayers are reporting flow-through income from partnerships, S corporations, limited liabilily companies, and so forth. In many cases, this leads to new audits of the entities themselves.

C. Corporate Tax Audits

In these audits, the nature of the inquiry may be more targeted. When apportionment is the issue, expect a series of information document requests about multistate activities. If it is a nexus issue, expect a nexus questionnaire or related questions. In years past, audits focused on combined reporting, so reviews of related-party relationships and intercompany transactions were prevalent. And under the old corporate tax regime, audits often delved into alternative bases of tax, income from subsidiary capital, and the like.

Of course, with New York's new corporate tax regime, expect audit techniques — and at least the general nature of inquiry — to shift. For example, taxpayers will surely be called on to support and explain sourcing methods under the new sourcing rules for services. So both taxpayers and the department will likely spend the next few years navigating the audit process through the new rules.

III. Wrapping It Up

The end of an audit comes with one of three results. If everything goes smoothly during the audit and no adjustments are proposed, the case will result in no change, and a no-change letter will be issued.

If audit issues or adjustments have been agreed to, a taxpayer can close out the audit by signing a Statement of Proposed Audit Changes, which permits the department to close out the audit and assess the tax without issuing the taxpayer a formal assessment. Once signed, the conventional wisdom is that the results are fixed and final and that the audit cannot be reopened. Indeed, though there's nothing explicit in this document indicating as such (per the law, it is discussed as a consent by the taxpayer to agree that the department does not have to issue a formal notice to create an enforceable tax assessment), the Tax Appeals Tribunal has held that a taxpayer's signature on the Statement of Proposed Audit Changes (sometimes referred to as a "consent to tax") rendered the tax fixed and final.[11] This issue arose

[7] Department of Taxation and Finance, Income Franchise Bureau, *2014 Nonresident Audit Guidelines,* (June 2014), *available at* http://www.tax.ny.gov/pdf/2014/misc/nonresident_audit_guidelines_2014.pdf.

[8] N.Y. Tax Law section 605(b)(1)(B).

[9] N.Y. Tax Law section 631.

[10] See *supra* note 7.

[11] *See Matter of Toomer*, Tax Appeals Trib. (Nov. 18, 2004); *Matter of Sica Elec. and Maintenance Corp.*, Tax Appeals Trib. (Feb. 26, 1998); *Matter of BAP Appliance Corp.*, Tax Appeals Trib. (May 28, 1992); and *Matter of Rosemellia*, Tax Appeals Trib. (Mar. 12, 1992).

when the department attempted to reopen a case after the taxpayer had executed a Statement of Proposed Audit Changes.[12]

In some circumstances, either the taxpayer or the department will request that parties enter into a formal closing agreement addressing the disputed issues being resolved as part of the audit. The one significant difference between a closing agreement and a Statement of Proposed Audit Changes is that, generally, taxpayers can seek a refund of payments through an informal Statement of Proposed Audit Changes within two years of payment. Under a closing agreement, however, refunds are generally not permitted. Also, closing agreements can be used to formally resolve tax issues such as the date of a domicile change from New York and the taxable status of purchases for sales tax purposes.

If the audit is not resolved, the case will be closed, and the department will issue its notice of proposed assessment as either a Notice of Deficiency (in corporate franchise tax or personal income tax cases) or a Notice of Determination (in sales tax cases). The importance of this statutory notice cannot be understated. For either notice, an appeal must be filed within 90 days of the notice date. There are few exceptions to this rule, and taxpayers consistently lose even if they are one day late. Often, however, issues arise regarding mailing of the notice, particularly when the department is not using a taxpayer's last known address. When the department fails to do that within the time limit to issue an assessment, taxpayers might be able to win on procedural grounds. And at the very least, the department's failure to properly mail a statutory notice can permit a taxpayer additional time if the 90-day deadline for appeal is missed.

IV. Audit Nuts and Bolts: Questions and Answers

To wrap up, it would be helpful to note some of the questions, strategy issues, and concerns that we have been asked about or experienced ourselves when handling audits. Often the answers to these questions can make all the difference in getting the taxpayer to a solid final result.

Question: Is it important to hold face-to-face meetings with auditors?

Usually this is the preferred option. This gives the practitioner the ability to walk the auditor through documents, go through timelines, and in general develop a working relationship with the folks on the other side of the table. An audit is like any other business deal or negotiation. It is a lot easier to deal with someone on difficult issues when you have a relationship with him.

These meetings are usually held in the field, meaning that the field auditors from the tax department will visit the taxpayer's location or a representative's office to do the audit process. The best practice is usually to have these meetings at the representative's office, but sometimes this is a matter of convenience more than anything else.

Question: Should the taxpayer attend the audit meetings?

For some practitioners, the answer is no. But there are nuances to every situation. Obviously, taxpayers hire practitioners to handle these situations, just as taxpayers hire someone to cut their lawns or do their taxes. These audits can be difficult and complex and sometimes involve very personal affairs. Taxpayers should have the right to outside help without having to deal with the auditors directly.

But sometimes we have found that it makes sense to bring the taxpayer together with an auditor. A good example is a difficult domicile issue in which the case on paper for establishing domicile in another state or country is not clear. In such a case, the best way to get the taxpayer's story across may be to have the taxpayer sit down with the auditors and talk about it. In most cases, the taxpayer is not needed for this type of back-and-forth, but practitioners should always consider this as an option.

Question: Should I sign a waiver extending the statute of limitations?

The answer depends on the circumstances. Sometimes it makes sense to sign an extension of the statute of limitations to give the auditor (and you) more time to complete the audit. The failure to sign such a waiver in almost every case will result in the auditors closing the case based on the information available. That generally does no one any good.

That said, there are certainly circumstances when a taxpayer should refuse to sign a waiver. If a case has been delayed for so long by the department without progress, the taxpayer would have every right to insist that the audit be concluded within a reasonable time frame without signing another waiver. Another situation is when the audit starts shortly before the statute of limitations expires. In the tax department's residency audit guidelines, auditors are instructed not to begin when there is a short time left on the statute of limitations.[13] Indeed, our antennas go up whenever an audit starts with an initial IDR and a request for a waiver. The audit should not *start* with a request for more time, and in those situations a good case can be made that the department must do everything it can to complete the audit within the regular statute of limitations and that no waiver should be granted.

Question: When should I request a closing agreement rather than just close the case via a statement of proposed audit changes?

This is partially addressed above, but the general idea is that a closing agreement makes the most sense when there are specific issues that the taxpayer or the tax department wants clarity on, such as the location of a taxpayer's domicile

[12] *Matter of Toomer*, Tax Appeals Trib. (Nov. 18, 2004).

[13] 2014 Nonresident Audit Guidelines, *supra*, note 7 at 85.

with specific tax treatment of an item going forward. While it is true that the tax department can put language into statements of proposed audit changes about things like domicile, taxpayers often feel more comfortable having those formal determinations incorporated into a closing agreement. Also, we usually find that the tax department is more likely to insist on a closing agreement when the case resolution is in the nature of a percentage-based settlement. This might be because taxpayers have the ability to request refunds after signing and paying a statement proposed of audit changes but not regarding closing agreements.

Question: What happens if I cannot get the auditor to agree with me?

We do not have any experience with this phenomenon.

Just kidding. At the start of every audit, the taxpayer is given an audit escalation letter showing the tax department personnel within the chain of command — including the auditor, the auditor's supervisor, the audit section head, and the audit manager of the district office, as well as personnel in the Field Audit Management in Albany. Any one of these folks can help with a difficult situation, but as is expected, it makes sense to pursue any issues or relief up through the audit chain. Oftentimes the problem can be resolved with a call to an audit supervisor or section head.

Question: What are best practices regarding potential penalties?

Two words: reasonable cause. In any audit in which there is an asserted liability, you should work with the auditor to demonstrate that whatever liabilities generated by the audit were due to reasonable cause and not willful neglect. The department's regulations set forth different standards outlining when reasonable cause can be met, and taxpayers (and practitioners) have the ability to work through these rules to demonstrate that penalties would not be appropriate in a particular case.[14] Often this is memorialized by a reasonable cause letter that the auditors can include in their final closed audit file. So like any other issue, practitioners are advised to take this issue seriously and work with the auditors on appropriate penalty abatement.

Question: Should I include later years in the closure of an audit?

Because audits can take some time, often when you are resolving an audit for the 2011-2012 years, for example, either you or the auditors will realize that similar issues are likely present for 2013-2014 as well. Sometimes because of changed circumstances or minimal liability, the practitioner can feel comfortable that there will not be a re-audit for later years. Other times it is a no-brainer, and the audit is coming. In these circumstances, practitioners should raise the question whether the auditors want to include the later years as part of any resolution. This happens in sales tax as easily as it does in personal income or corporate taxes. Sometimes the taxpayer simply wants to get the department out of his hair — and bringing in the later years on some sort of similarly negotiated basis makes a lot of sense. Also, in cases in which some sort of resolution is reached (such as a domicile determination or tax ability determination), it makes sense to work with the department to bring the case "current," so that the taxpayer can be assured of not having the problem arise again for periods before the agreed-upon determination. Again, handle this one case-by-case, but it is definitely a consideration to take into account when you are closing up an audit.

V. Next Up

If you are unable to resolve the audit, the next step is to proceed to the conciliation conference process in the Bureau of Mediation and Conciliation Services. Or is it? Tune in next time to find out! ✰

[14] *See* 20 N.Y.C.R.R. section 2392.1.