

WHITEMAN OSTERMAN & HANNA LLP
New York Sales Tax Audits: 10 Frequently Asked Questions

1. *Why am I being audited?*

There are a number of reasons your business could have been chosen for a New York State Sales and Use Tax audit. Such reasons could include any the following: 1) your business was randomly chosen by the Tax Department; 2) your business is of a type that is the subject of a special initiative within the Tax Department (for example, restaurants appear to have been recently targeted for increased audit activity); or 3) there might have been something in your tax returns indicating a potential tax deficiency.

Bear in mind that although in some circumstances it might be comforting to know why your business was selected (if, for example, you were randomly selected and not because there was something suspicious about your tax returns), the point is academic: whatever the reason that you are being audited, you must prepare for the audit with the same intensity and attention to detail. If you are unprepared, you risk receiving a far less favorable outcome than you might otherwise be able to obtain.

2. *Do I have to give the auditors everything that they ask for?*

Yes. Essentially, the Tax Department has authority under New York law to request any books or records that represent the activities of your business. There are many ways that the auditors can determine the amount of sales tax that they believe you should have collected (more on this point in Question 4 below); they are not limited to examining your cash register tapes or computerized sales records. The law gives them the ability to obtain any documents that they may need for the task.

A crucial related point: Whenever there are “information gaps” such that the Tax Department cannot accurately determine the correct tax liability, those gaps will always be construed in a light least favorable to you. This means that facts will be assumed that generally will result in the highest tax reasonably possible, even if the actual tax liability may be lower.

Combine the two previous points with the potential criminal issues that arise when taxpayers attempt to hide information from the Tax Department, and full disclosure is the only option.

3. *Do I need to worry about criminal charges?*

The answer to this question seems to be changing. In the past, it was unusual to see criminal charges in anything other than the most egregious cases. Today, however, criminal charges are being brought in even relatively small cases. For example, in August of 2009, the Tax Department announced a case in which criminal charges were brought in connection with a sales tax deficiency of \$17,000. In this environment, the potential for criminal charges should therefore always be a consideration.

4. *I don't have any electronic records or cash register tapes – what will the auditors do?*

The Tax Law provides that every person required to collect tax must keep records of every sale in a manner suitable to determine the correct amount of tax due. Those records must be made available to the Tax Department for inspection upon request. New York State regulations provide that among the sales records required to be maintained are the following: sales slips, invoices, receipts, contracts, statements or other memorandum of sale, guest checks, cash register tapes and any other original sales documents.

If you fail to maintain these records (or if you do maintain them, but they are incomplete), the Tax Department can use any reasonable indirect method to determine the proper amount of sales tax due. The selected method does not have to produce exact results. One method that auditors use is the direct observation of sales at your business. The auditor will observe a sample period, and then extrapolate the totals across the audit period. Another method auditors may use is to request information from your third-party vendors, and then calculate total sales using standard “mark-ups” from your cost of sales.

In short, this is an area where auditors have a good deal of discretion, and it can be difficult to challenge the method chosen.

5. *Why have I received a “responsible person” questionnaire?*

In addition to the liability of the business itself for any unpaid sales tax (in the case of businesses conducted through entities such as corporations and limited liability companies), New York also imposes liability on those who are deemed “responsible persons” under the law. A responsible person is generally someone that was in charge of collecting the sales tax or who signed the tax returns – for example, a manager, an owner, or an officer, etc. The responsible person questionnaire is designed to help the auditors identify those individuals.

In many cases there are multiple “responsible persons.” The Tax Department can, and usually will, try to collect any deficiencies from any or all of them if the business is unable to pay. If you could potentially be a responsible person, consult your tax advisor immediately regarding your rights and potential liabilities.

6. *Will this lead to an income tax audit next?*

It certainly could. Remember that the amount of sales tax due is a percentage assessed on the basis of your gross sales. Gross sales are of course used in determining your net income and any related income tax. Thus, for example, if the applicable sales tax rate is 8%, and it is determined that there is a \$10,000 sales tax deficiency, depending on the circumstances, this might indicate that there is \$125,000 in associated income that may not have been reported on your income tax returns.

Accordingly, where the potential for unreported income is significant, a referral to the income tax auditors is likely. However, to our knowledge there is no publicly disclosed threshold for referral. We note that the Tax Department has recently released a decision involving a referral based on a deficiency similar to the amount indicated in Question 5 above.

7. *If the auditors claim that I owe additional taxes, will there be interest and penalties?*

Yes. Depending on the amount of the underpayment and the year in which it occurred, the penalties and interest can be significant – often 50% or more of the tax due. In some circumstances, penalties can be waived. An interest charge, however, is mandatory.

8. *Will the case be closed forever if I pay the tax that the auditor claims is due?*

Most of the time, if you make a payment in satisfaction of an audit adjustment (or receive a “no change” letter), that will be the end of the matter. However, if the statute of limitations has not run with respect to a year that was previously the subject of an audit, the Tax Department retains the right to assess additional taxes if it becomes aware of information that indicates that additional taxes should have been paid.

9. *When will I be audited again?*

The frequency and pattern of audits is an administrative and policy matter at the Tax Department. Although we are not aware of any publicly available policy statement on the issue, our experience indicates that if you were audited this year and a deficiency was found, there is a strong potential that you could be audited again soon.

10. *Where can I find more information?*

As discussed above, there are significant legal issues in every sales tax audit. These include, among other things, whether: 1) “responsible person” liability will apply to you or others in connection with your business; 2) sufficient records have been maintained as required by New York State regulations; and 3) there is a potential for criminal charges to be brought. These issues must be confronted from the moment the audit notice is received to preserve your rights and to allow your advisors to develop appropriate strategies to minimize taxes and penalties and protect the business. Sales tax audits also involve complex factual issues. All of your relevant business records should be reviewed and analyzed by your advisor prior to their disclosure to the Tax Department to understand the strengths and weaknesses of your case, and to prepare accordingly. You should consult with a qualified attorney about these issues.

The Tax Department (its official name is the New York State Department of Taxation and Finance, and it is often referred to as “DTF”) publishes a lot of useful general information on its website. Relevant information is provided at the following link: <http://www.tax.state.ny.us/nyshome/stidx.htm>. You can also search for “sales tax audit,” and specific topics (such as “responsible person liability”) in the search engine on the upper-right-hand corner of the page.