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Pitfalls of a Sales Tax Observation Audit

By Eric L. Morgenthal

Have any of your small business clients ever hoped and prayed for a really bad day, a day when no one comes to their store or place of business? Not a single customer. Chances are if they have, then they were likely undergoing a Sales Tax observation audit by the New York State Tax Department.

Everyone seems to have heard about these audits. They imagine two auditors in suits sitting in a Ford sedan discreetly counting pizza boxes as the customers leave the restaurant. Has this happened before? Sure, but it's a bit more complicated than that and the results span long past that day.

Adequacy of Records

Pursuant to the NYS Tax Law, taxpayer's are required to maintain records of every sale they've conducted during the audit period.¹ The auditor must request them and in turn they must be provided. It becomes a shock to clients when they are informed that they didn't maintain the records required by NYS Tax Regulations. The consequences that result can be harsh.

Business records serve as the initial line of demarcation. In the absence of adequate books and records, the Tax Department can then utilize any or many



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of several estimated audit techniques to establish the tax due.² Once the records are deemed inadequate, the burden is shifted to the taxpayer to now disprove the auditor's determinations. Pursuant to the NYS Tax Regulations, the Tax Department may use "any information available," even if not derived from the taxpayer's place of business. Mark-ups, error-rates or external indices can then be utilized as the basis for an assessment. By the way, the method doesn't have to be perfect or even the best of the methods available.³ The statute only requires that the methodology used

to arrive at it be reasonable.

Perhaps the most highly contested method is the observation audit. During these audits, tax field auditors observe one or two days of sales activity at the business premises. The audit results are then extrapolated (sometimes through the application of an error rate) and then projected throughout the audit period. This is where it starts to get ugly. Take a restaurant on the east-end of Long Island observed in summer or a luncheonette located in a business district observed mid-week and the projected results aren't pleasant. The auditor may provide a "concession" or an "allowance" for those factors but they oftentimes fail to com-

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pensate for the circumstances. A common question asked by clients is, “is this legal?” The answer is yes and in fact, observation audit results have been sustained in the courts.

Who says a flat tax is simple?

The New York State Sales/Use Tax is a flat-tax structure. And how often have we heard that instituting a flat tax would make everything less complicated? However, with a closer look at the New York State Sales Tax, one could see that even a flat tax can create a huge mess. Take a bagel store for example. A customer purchasing a roll with butter and bottled water would be subjected to NYS Sales Tax on the entire purchase despite the contents resembling prison food (or mere sustenance). Yet the customer behind him in line purchasing a Snapple Iced Tea with chocolate cake would pay no sales tax at all because tea and baked goods are considered exempt. Based on this example, you can see that logic often fails to dictate the expected sales tax treatment and that business owners can easily

find trouble if each sale is not reflected properly during the audit period and the observation audit.

Penalty abatement

At a car dealership, it’s best to negotiate the price of the new vehicle before ascertaining the value of the one you are trading-in. This isolates the variables and makes it easier to understand how much each component costs. Audits are often structured the same way. After the tax is negotiated, the final hand played in the card game is the abatement of penalties. In the past, “first-timers” were often allowed penalty abatement as a matter of grace. However, it is no longer a sure thing. It should be noted that there are two components to a traditional Sales Tax Penalty; the penalty itself and the increase in the interest rate on the underlying assessment. If abated, the penalty is removed and the interest rate is reduced from 14 to 9 percent statutory interest.

Bear in mind that the penalties aren’t just set aside without a little *quid pro quo* expected from the taxpayer. The depart-

ment typically requires the execution of a *Waiver and Consent* in exchange for the favorable penalty reduction. The signed consent ends the audit but prevents the taxpayer from further protesting the audit results.

The Tax Department’s new policy

For quite some time, this procedure resolved and ended the Sales Tax Audit. After the representatives had negotiated the tax as low as they could get it, they would seek penalty abatement and then the parties would move forward with their lives. However, the policy in the NYS Tax Department has recently changed and it has impacted the way that these audits should be addressed. Because of the current economic climate, New York State needs money. As a result, Tax Department employees have searched for and found a steady source for new tax audits... namely...existing audits. Although not citable as precedent, a recent case demonstrates the new Department policy. In the recent ALJ Decision⁴ it was held that because the “taxpayer signed the consent to the *Statement of Proposed Audit Adjustments*,” the Tax Department’s use of the figures to subsequently “determine the amount of additional unreported income for income tax purposes was clearly proper and appropriate.” Therefore an executed consent could constitute an admission. Adding insult to injury, the business owner was not even allowed to provide offsetting expenses (i.e. cash inventory or cash payroll) against the additional income imposed by New York State. These are liabilities that are typically here to stay. Sales taxes are considered trust funds and are not dischargeable in Bankruptcy.

It doesn’t stop there

A high observation audit result can lead to the ultimate *parade of horrors*. The IRS has an information sharing program with the NYS Department of Taxation and Finance. A single day observance of sales can resonate into state franchise and federal corporate/individual income tax assessments as well. Due to the potential for a resulting multi-tiered institution of additional taxes, the sales tax audit has obtained a heightened importance and must be addressed cautiously from inception. It doesn’t stop there. Many sales tax audits trigger follow-up audits to insure continued compliance from the time the last audit was completed.

In light of the personal liability of these entity-level deficiencies and the resulting 20-year renewable collection statute against personal property of the parties ‘responsible’ to remit the tax, a successful day of business could end up being the worst day of your client’s life.

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¹ NYS Tax Law Sections 1135 and 1142(5)

² NYS Tax Law Section 1138(a)(1)

³ *Matter of Vebole Edibles v. Tax Appeals Tribunal*, 162 A.D.2d 765

⁴ *The Matter of the Petitions of Bok Hui Nam*, DTA Nos. 821515 and 822016