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Litigating a New York Case From Start to Finish

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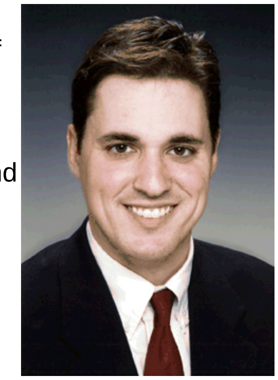

This article marks the first in what I hope will be a long-running column on practice and procedure issues arising in the everyday practice of the state and local tax practitioner. Because the focus of this monthly column will be on practice and procedure issues, I thought it would be most appropriate to begin with a nuts-and-bolts discussion of New York tax litigation. Indeed, although I will be addressing issues of multistate tax practice from time to time, my primary expertise -- and therefore the primary focus of this column -- is on issues arising in New York state, where I live and practice law.

In general, there are five stages to a New York tax case. In this article, I will review each of those stages in detail and provide practical advice and commentary about each step in the process.

The Audit Stage

New York tax audits can take one of two forms: a desk audit or a field audit. Usually, desk audits involve more basic issues or can sometimes be used as a tool for the Department of Taxation and Finance to attack perceived problem areas or common audit issues. For instance, a few years ago the tax department began a desk audit program addressing a perceived problem area in the "temporary assignment" context. Taxpayers who claimed nonresident status on their New York nonresident tax returns based on that temporary assignment exception were, for all intents and purposes, automatically subject to a desk audit if their income was under specific thresholds.[1]

However, most of the activity tax practitioners will see in their daily practice involves what are commonly known as field audits. In field audits, an auditor from one of the tax department's many district offices across the state will contact the taxpayer to schedule an appointment, review records, and so forth. Those field audits address all issues of state taxation, including personal income tax, residency issues, sales tax issues, corporate tax matters, miscellaneous tax matters, and so on, and almost always begin with a "congratulatory" letter to the taxpayer indicating that he has been selected for audit. Once the audit begins, there are no special secrets that can be imparted to help improve the client's situation. But there are a few important things to keep in mind.

Most audits begin with an exhaustive request for records and information. Sales tax auditors have for years been using a basic "records request list" that sometimes calls for information that is either too voluminous to provide or unnecessary for the audit. It is therefore usually a good idea for a taxpayer's representative to sit down with the auditors, discuss what they need and what they don't, and set a game plan for the audit. Nonetheless, it is important to be responsive to those document requests, especially in the sales tax area, because a perceived lack of adequate records will allow an auditor to use estimated methods or test periods to calculate the taxpayer's liability.

One of the more common issues that arise during field audits concerns the allowance -- or lack thereof -- of additional time to complete the audit. Generally, the tax department is constrained by a three-year statute of limitations in most tax areas, absent fraud and assuming the taxpayer has filed tax returns.[2] Often, however, either because of tax department or taxpayer delay, audits cannot be completed within the three-year period. Thus, the tax law permits agreements between the taxpayer and the tax department to extend the period of limitations for which an assessment can be made.[3] In other words, the parties can agree to extend the deadline for the end of an audit by signing a waiver. When faced with that issue -- and you will be faced with that issue in most audits -- it is important to approach it on a case-by-case basis. Often, the delay is your own fault, so granting an extension is appropriate. In other circumstances, it may not be your fault, but the failure to sign a waiver will only result in an issuance of an assessment that your client will have to appeal at further levels within the tax department. That said, there may be strategic reasons for not signing a waiver, particularly when problematic issues have been resolved or nothing further can be gained by more extensions. Again, there is no hard and fast rule here, except that each case requires its own specific analysis.

As in any typical office in corporate America, everyone in the tax department office generally is required to answer to someone else. The auditor handling the bulk of information-gathering and document review during the audit is generally referred to as an "auditor I." That auditor will have a supervisor or team leader, generally classified as an "auditor II." And the team leader and auditor answer to a section head, who answers to the manager of the district office. After that, there are further levels of supervisory review in Albany in field audit management and the commissioner's office. The bottom line: If you have a problem, there will be someone with the tax department who can address that problem. You may not like the answer, but the department is generally set up in a way that allows for the full airing of grievances.

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 a "no change," and a "no change letter" will be issued. If there are audit issues or adjustments that have been agreed to, a taxpayer can agree to close out the audit by signing a statement of audit changes, which permits the department to close out the audit and assess the tax without having to formally assess the taxpayer. Generally, 60 days after that document is signed, the department is prohibited from making further changes and the audit results are "fixed and final."[4] Or, 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 most significant difference between a closing agreement and a statement of audit changes is that generally taxpayers can seek a refund of money paid under an informal statement of audit changes within two years of payment. However, refunds are generally not permitted under a closing agreement. Also, closing agreements can be used to formally resolve specific tax issues, such as the exact date of a domicile change from New York, the taxable status of particular purchases for sales tax purposes, and so on.

If the audit is not resolved, the case will be closed and the department will issue its notice of proposed assessment, which will take the form of a notice of deficiency (in corporate franchise or personal income tax cases) or a notice of determination (in sales tax cases). The importance of that statutory notice cannot be understated. In the case of either notice, the tax law requires that an appeal be filed within 90 days of the notice date.[5] There are few exceptions to that rule, and taxpayers consistently lose even if they are one day late.[6] However, issues often arise regarding the mailing of the notice, particularly when the tax department is not using a taxpayer's last-known address. When the department fails to do that within the time limitations for issuing an assessment, taxpayers might be able to win on procedural grounds.[7] And at the 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.[8]

The BCMS Process

After the audit stage, the taxpayer has the option to proceed to a conciliation conference through the Bureau of Conciliation and Mediation Services (BCMS), which is a separate division within the tax department. That process, initiated through the filing of a request for conciliation conference within the 90-day period following the issuance of a statutory notice, basically gives the taxpayer an opportunity to sit down with the auditor and a tax department mediator (known as a conciliation conferee) to refine the issues in the case and bring it to a resolution.

Because BCMS is a voluntary procedure, practitioners have varying views on its usefulness in the tax appeals process. Some practitioners believe that, because the conciliation conferees are employed by the tax department and are often former auditors themselves, the process is biased and generally a waste of time. Other practitioners see it as a mandatory step in the appeals process and as something that should always be requested no matter what facts or issues arise. However, the right answer is probably somewhere in the middle. The opportunity always exists for a conferee to rule in the taxpayer's favor, and that is something our firm has experienced on several occasions. Moreover, the discussion of issues and the presentation of additional facts at a conciliation conference can lead the Audit Division to reconsider its position or, in the alternative, lead to a favorable resolution that all parties can deal with. A conciliation conferee often can be helpful in facilitating those settlement discussions. And finally, even if you fall flat on your face, at the very least the conciliation conference allows you the ability to further develop your arguments, further understand the department's arguments, and further prepare for an upcoming administrative law judge hearing. Thus, in most cases, taxpayers are well advised to use the conciliation conference process.

But that's not to say that is an all-or-nothing rule. Sometimes going to a conciliation conference might not be necessary, either because of the nature of the issue or because of the basis for the department's position. If the department has stated its position in a Technical Services Bureau memorandum or in an opinion of counsel, generally conciliation conferees are bound by that.[9] And in some cases in which advisory opinions are issued in similar factual situations, conferees may be unwilling or unable to take a different position, even though an advisory opinion is supposed to be binding on only the taxpayer to whom it was issued.[10] Thus, before making the decision to proceed to BCMS, make sure you understand the basis for the department's position and evaluate whether that position could be modified or overruled by a conferee.

Hearings Before an ALJ

If the taxpayer is not satisfied with the result of the BCMS, or if the taxpayer decides to skip BCMS altogether, the next step is for the taxpayer to proceed to the Division of Tax Appeals. The first step within a Division of Tax Appeals proceeding is a hearing before an ALJ. That process is initiated by the filing of a petition for administrative hearing with the Division of Tax Appeals, and ultimately results in a written decision from the ALJ after a trial-type hearing and the submission of written legal briefs by both parties. In between, however, there are many opportunities for continued settlement negotiations, case development, procedural maneuvering, and so forth. There are a few things to keep in mind.

Although regulations setting forth the Division of Tax Appeals' rules and procedures under 20 NYCRR section 3000 allow for accountants and nonlawyers to represent taxpayers before the division, nonlawyers should proceed with caution. Unlike a BCMS conference, in which issues and arguments can be raised during the conference, before the conference, after the conference, and so on, and in which procedural rules are nonexistent, the hearing process within the division has various deadlines, allows for motion practice, and requires conformity to specific procedural rules. Moreover, the submission of evidence into the record, direct and cross-examination of witnesses, and the overall rules of evidentiary practice and procedure are best handled by a representative with legal-type training and, ideally, trial-type experience.

After the filing of the ALJ petition, several months will elapse before the scheduling of the actual hearing. During that time, after the formal "answer" to the petition is received from the department's attorney, opportunities exist for continued negotiations and potential settlement. However, keep in mind that once the department's attorney submits the answer, communication with the auditors or other department personnel is generally prohibited. That is because, once an attorney is assigned, the auditor is represented by counsel. Therefore, at least for attorneys, ethical rules prohibit communication directly with the client (in this case, the auditor) without the consent of opposing counsel.

Also, during the prehearing process there are many opportunities to take procedural steps to further the case, develop evidence, or foster settlement. Parties can agree on stipulations designed to cover nonessential facts that the taxpayer would otherwise have to prove with evidence at the hearing, such as the filing date of a tax return, specific days in/days out of the state in a residency case, and so on. The use of stipulations can be a positive tool and can go a long way toward expediting what otherwise can be a lengthy hearing process. Also, if the department's attorney has denied allegations that you can prove or have already proven to be true, a taxpayer can issue a "notice to admit" requesting that the department admit to or deny particular facts. Finally, the regulations permit the issuance of subpoenas through the Division of Tax Appeals or, in the alternative, by an attorney consistent with the rules of New York's Civil Practice Law and Rules.[11] That subpoena power, which taxpayers generally lack during the audit and BCMS process, can be a useful tool to discover new evidence or to compel the presence of witnesses from the department who otherwise would not be forced to attend. In previous cases handled by our firm, subpoenas have been used effectively to build a case and develop legal arguments.[12]

If the case is still alive, the next step is to proceed to the ALJ hearing. In some cases, in which only legal issues are involved and facts are not in dispute, the possibility exists to have the hearing "on submission" without live testimony, witnesses, and so on. In those cases, both the taxpayer and the tax department must agree to waive the hearing, but permission of the Division of Tax Appeals is not required. Keep in mind, however, that taxpayers should proceed on submission only when it is clear that no facts are in dispute and only legal issues are involved. Because taxpayers generally have the burden of proof in those proceedings, it is critical that any and all facts be developed and proven.

Following the hearing, both parties are allowed time to submit legal briefs summarizing the facts and legal issues developed at the hearing. Six months after the final brief is filed, the ALJ is required to issue a determination. Those determinations, which generally contain findings of fact and conclusions of law, are published decisions but under Tax Law section 2010(5), cannot be cited or used as precedent. That is an important issue to keep in mind when researching tax issues for your client or when trying to buttress legal arguments during an audit. If you attempt to cite ALJ decisions, the department will likely claim that the decision should be ignored because it is nonprecendential.

The Tax Appeals Tribunal

If either the taxpayer or the department is dissatisfied with the ALJ's determination, one or both can file an exception (that is, an appeal) to the Tax Appeals Tribunal, seeking review of the ALJ's determination. That appeal must be filed within 30 days of the determination and, like the 90-day deadline applicable to appeals from a statutory notice, the deadline is hard and fast, and should be respected. Following the filing of the exception, the parties have the option to file legal briefs to the tribunal disputing or supporting the ALJ's determination, and oral argument before the three-member tribunal is sometimes allowed. The decision of the tribunal, which *is* precedential and essentially results in the "law of the land" for tax cases, is required to be issued six months after the filing of the last brief or the hearing of the oral argument.[13]

For the department, the tribunal's decision is the last word. For taxpayers, however, the tribunal's decision is theoretically not as final. Taxpayers disagreeing with a decision of the tribunal are permitted to request review of the decision by the Appellate Division, Third Department Appeals Court in Albany.[14] That appeal must be filed within four months of the tribunal's adverse determination.[15] Moreover, taxpayers are required to pay the tax before proceeding or file a bond, and the standard of review is so high (decisions will only be overturned if the court finds that the tribunal's decision was arbitrary and capricious) that taxpayers should proceed with caution and only after a full review of the costs and benefits of proceeding.

Short Circuiting the Process?

That long process, through audit, BCMS, ALJ, and so forth, is generally required of all taxpayers in tax cases. Taxpayers who want to proceed directly to court and have their case heard by a jury of their peers will generally be out of luck. That is because, under well-established rules, taxpayers are required to exhaust their administrative remedies before proceeding to court.[16] However, there are a few exceptions to that general rule. If the taxpayer is alleging that a statute or tax department action is unconstitutional, the taxpayer may proceed directly to court, as was done by the taxpayer in *Tennessee Gas Pipeline*, which our firm handled in 2000-2001.[17] In other cases, in which taxpayers allege that a statute is simply inapplicable or in which the department has no jurisdiction to proceed, direct court actions are also available.[18] Also, in cases in which the tax department is pursuing aggressive collection tactics after the docketing of a warrant, we have used direct court actions as a method to, at least temporarily, enjoin the department from pursuing collection activities while issues concerning jurisdiction, mailing, or other procedural aspects of the case are reviewed. But all of those situations are the exception to the general rule. Most of the time, taxpayers and their practitioners will be handling their case through the normal administrative processes discussed throughout this article.

Conclusion

If one thing can be learned from the New York audit and appeal process, it is that tax cases should be handled with the same care and due diligence applied to any other form of litigation. Knowledge of the law, or tax forms, or of a particular taxpayer's business is not enough. A tax case is the same as many other forms of litigation that lawyers face in their everyday practice. And no stone should be left unturned, no technique should be left unused, and no legal argument should be left undeveloped.

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FOOTNOTES

[1] For a further discussion of the temporary assignment issue in general, see "Temporary Stays in New York: A New Set of Rules in Residency Audits?" *State Tax Notes*, Feb. 21, 2005, p. 551, *2005 STT 34-17*, or *Doc 2005-2554* [**PDF**].

[2] N.Y. Tax Law sections 683(a), 1083(a), 1147(b).

[3] N.Y. Tax Law sections 683(c)(2), 1083(c)(2), 1147(c).

[4] *Matter of Toomer*, Tax Appeals Tribunal, Nov. 18, 2004.

[5] N.Y. Tax Law sections 689(b), 1138(a)(1).

[6] *See Standard Motions, Inc.*, Tax Appeals Tribunal, Feb. 23, 2006; *Phyllis Dinion*, Tax Appeals Tribunal, Mar. 30, 2006; *Zavoski*, Tax Appeals Tribunal, Mar. 18, 2004; *Salerno*, Administrative Law Judge Unit, Feb. 19, 2004.

[7] *See OfficeMax, Inc.*, Tax Appeals Tribunal, Mar. 24, 2005; *see also Matter of Rywin*, ALJ, Dec. 21, 2006.

[8] *Matter of Katz*, Tax Appeals Tribunal, Nov. 14, 1991.

[9] 20 NYCRR section 2375.4.

[10] 20 NYCRR section 2375.5.

[11] 20 NYCRR section 3000.7.

[12] *See Matter of Rawl*, ALJ, Dec. 10, 1998; *Matter of Falberg*, ALJ, Oct. 9, 2003; *Matter of Premier National Bancorp, Inc.*, ALJ, May 1, 2006.

[13] 20 NYCRR section 3000.17.

[14] N.Y. Tax Law section 2016; 20 NYCRR section 3000.20.

[15] *Id.*

[16] *Yiouti Restaurant, Inc. v. New York State Tax Com.*, 135 A.D.2d 973 (3rd Department 1987); *West Seneca Ford v. Commissioner of State Department of Taxation and Finance*, 198 A.D.2d 909 (4th Department 1993).

[17] *Matter of Tennessee Gas Pipeline Co. v. Urbach*, 96 NY2d 124 (2001).

[18] *See Hospital Television Systems v. Tax Commission*, 41 AD2d 576 (3rd Dep't 1973); *Slater v. Gallman* 38 NY2d 1.