Noonan's Notes on Tax Practice
State Tax Notes, Jan. 21, 2008, p. 215
47 State Tax Notes 215 (Jan. 21, 2008)

The Ins and Outs of a Sales Tax Audit

by Timothy P. Noonan

Over the past year, this column has addressed a host of state and local tax issues affecting practitioners who do this type of work on a day-to-day basis. We've looked at how to litigate a New York tax case, analyzed New York's unusual positions on stock options and temporary residency cases, and have reviewed important decisions in the personal income and corporate tax areas. To begin the new year, I thought a good old-fashioned column on sales tax audits would be in order. So in this column, I'll discuss what you should expect in a typical sales tax audit, with a focus on audits in my home state of New York.[1]

Who Gets Audited

Really, anyone can be the subject of a sales tax audit. Most often, however, persons or companies registered as sales tax vendors are prone to New York audits, for no other reason than that they're the easiest taxpayers to find. They file tax returns every month or quarter and are obviously on the Department of Taxation and Finance's radar screen. The largest 1,200 or so registered vendors are perpetually under audit, and from time to time there will be a special focus on industry targets or groups, such as doctors, the printing industry, cash businesses, and so forth.

Unregistered vendors, too, are subject to audit, and states are finding more and more ways to discover those folks as well. One common method is the "bird dog" audit. For example, suppose an auditor is conducting an audit of XYZ Co., a manufacturing company engaged in the production and sale of pencils. In going through the XYZ Co.'s purchases, the auditor notices that large purchases of taxable equipment or other services are being provided by an out-of-state company, and no sales tax is being charged. Perhaps there is some indication on the invoice or through discussions with the taxpayer suggesting that the out-of-state company came into New York to deliver the goods or provide the services. Often that leads to a brand new audit of that out-of-state company. Note also that unregistered vendors will usually face a longer audit cycle. Normally, audits of registered vendors cover three years, but no statute of limitations applies when tax returns are not filed. So unregistered vendors are usually subject to *six-year* audits under normal tax department policy.

Commencement of the Audit

The audit generally begins 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. The list of requested documents is voluminous and could itself take three years to respond to. Normally, the best approach, after the commencement of the audit, is to sit down with the auditor, go through his laundry list of required documentation, and discuss what is needed in an effort to streamline the audit process and save your client (and the tax department) lots of time and effort.

Areas of Review

Once the audit begins, auditors generally focus on four different areas.

Tax Reconciliation

First, the auditor needs to verify that every single dollar of tax collected by the vendor was remitted on the vendor's sales tax returns. Normally, the auditor can resolve that issue by reviewing the tax returns and the vendor's sales tax accrual account to determine whether the numbers match up. That initial aspect of the audit is fairly straightforward.

Review of Sales

The review of sales 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. One issue that often comes up in the sales area is whether the vendor maintains so-called adequate records. Under well-established rules, a vendor is required to maintain adequate records. And if it does, it is entitled to have those records used to complete its audit.[2] However, if a vendor does not maintain adequate records, the law permits the auditor to determine the amount of tax due based on "such information as may be available," and external indexes may be used if necessary.[3] Case law in that area also makes it clear that exactness in the method used by the tax department is not required. Instead, the department need only adopt an audit method that is reasonably calculated to determine the amount of tax due.[4] Then the burden is on the taxpayer to demonstrate, by clear and convincing evidence, that the audit method employed was unreasonable.[5]

Those rules have created nightmare situations for many vendors. The standard for keeping adequate records might be obtainable for some businesses, but for smaller businesses and those who deal with a variety of customers paying by different means, it can be much more difficult. The tax department claims its regulations require documentary proof of *every single transaction* engaged in between the vendor and its customers for *every single day* during the audit period. That creates an almost insurmountable burden for a vendor to establish that it, in fact, maintained adequate records. And without those records, vendors are left with amorphous audit standards that allow the tax department to determine the tax liability by using such information as may be available. On top of that, even if the vendor can show that the method used was flawed or that a better method is available, case law provides that that doesn't make a difference. Instead, the vendor has to establish that the audit method is *unreasonable*.[6] That is not an insurmountable standard, and many taxpayers have been able to show that methods used by auditors are unreasonable and incorrect. But those rules most definitely create an unlevel playing field.

Setting the adequate records and estimated audit method issues aside, many other issues also come up in the sales area. Often a vendor claims exempt sales, either based on the resale exclusion or some other exemption. Under New York's rules, a vendor who accepts a properly completed exemption certificate in good faith is relieved of the burden to collect the sales tax from the customer, even if it is later determined that the transaction was indeed taxable. That raises many issues. For instance, sometimes auditors take the position that a vendor's acceptance of an exemption certificate was not in good faith because the transaction was ultimately one that was subject to sales tax for one reason or another. Here, however, the rules are heavily weighted in favor of the vendor. Indeed, unless it can be shown that the vendor had actual knowledge that the exemption document issued by the purchaser was false or fraudulently presented, no tax can be assessed against the vendor.[7] Also, sometimes vendors simply fail to obtain exemption certificates (such as resale certificates) or the certificates on file are not properly completed to the satisfaction of the tax department's auditors. Even in those cases, however, the failure to have a proper resale certificate does not make an otherwise nontaxable transaction a taxable one to the vendor. The regulations still allow the vendor to prove the resale nature of the transaction by other means of evidence, such as a statement from the purchaser, shipping records, bills of lading, and so forth.[8]

Another issue that always comes up in audits of sales concerns the use of a test-period audit method. As mentioned above, vendors with adequate records have the option of forcing the auditor to use those records to determine whether sales tax was properly paid. Nonetheless, that can be an arduous and difficult process, so often vendors and auditors agree to use a test period. Choosing the test period is an important task. The focus should be on periods when the vendor believes the error rate was the smallest -- not simply on periods when sales were lowest. Choosing a method of extrapolating the results from the test period is also critical, and can greatly affect the overall tax liability. Some auditors use a straight-line method of extrapolation, simply multiplying the tax found in the test based on the remaining periods involved. Sometimes that approach works out well for the vendor, but sometimes it does not. Other methods look to extrapolation based on revenue, comparing the revenue in the test period with revenue in the other periods during the audit, or advertising expenses, or general expenses, and so on. The types of methods vary by auditor, but again it is important for taxpayers and practitioners to keep in mind that the method chosen could have a huge effect on the ultimate tax liability. Great care should be taken in determining that a proper method of extrapolation is used.

Review of Recurring Expenses

In reviewing recurring expenses, the auditor is looking to confirm that the vendor paid tax on purchases of materials, supplies, and services that recur throughout the audit period. Purchases of materials, supplies, paper, pencils, services, or anything else that a business purchases on a regular basis and does not list on its depreciation schedules normally qualify as recurring expenses. To figure out the scope of review, auditors will usually examine a vendor's chart of accounts and select some accounts for which invoices have to be reviewed. A test period is often the desirable method here, saving the auditor and the vendor a significant amount of time and effort. Here again, however, the selection of an appropriate test period must be taken into consideration.

Other issues to look out for:

- This area is designed to catch all *recurring* expenses. If, in the test period selected, an item or large purchase appears that is nonrecurring, the vendor has the right to request that that item be removed.

- The vendor doesn't have to agree to the use of a test period if an acceptable method cannot be attained (assuming the vendor has adequate records). Auditors are required to obtain a test-period consent form from the vendor before the audit is closed in the event a test period is used; without that signed form, the audit method can be thrown out.
- Be on the lookout for refunds. Often vendors will pay sales tax on nontaxable or exempt items simply because it showed up on their supplier's bill. If those issues show up in the test period, they should be added in as a negative adjustment, and one subject to the overall extrapolation.

Review of Fixed Assets

The last area of review concerns the vendor's purchase of capital items or fixed assets. Because those purchases are not of a recurring nature, an auditor will normally review each and every transaction during the audit period to determine whether the vendor correctly paid tax on its purchases of fixed assets. That's right -- every purchase over the three-year audit period will have to be examined. Generally, the vendor should have general ledger accounts for its fixed assets in different categories, and auditors will want to see the detail and invoices in those categories for the entire audit period. Normally, auditors will also request copies of the taxpayer's depreciation schedules, because normally assets listed on those schedules would constitute fixed assets. The review of the depreciation schedules also allows the auditors to double-check to make sure that all fixed asset information is being provided.

Miscellaneous Audit Issues

Here are some other general issues to keep in mind as you go along in a sales tax audit. Generally, these issues should help reduce the overall liability determined as part of the normal audit process.

The Overlapping Audit Rule

Sellers and purchasers are normally both liable when sales tax is not collected on a particular transaction. However, what if the tax department is asserting tax on an item a vendor sold to a purchaser that was already audited? The answer is that New York's overlapping audit rule should provide some relief. Under that rule, if a vendor is able to show that its customer was subject to a sales tax audit for the same period, it can request that the transactions with those purchasers be removed from the audit.

Collecting Tax From Customers

Although vendors are required to collect tax from their customers -- and can be held liable for their failure to do so -- New York law permits a vendor to seek reimbursement of the tax from its customer as if the tax was part of the original purchase price.[9] The vendor has basically a right under contract law to recover the uncollected tax, absent a special agreement with the customer to the contrary. Under New York law, the statute of limitations for contract claims is six years, so presumably a vendor has six years from the date of the transaction to recover the tax from its customer.

Penalties and Interest

Like any other tax audit, there is a potential for penalties and interest, but New York's reasonable cause exceptions can be used to seek relief from penalties. In the sales tax area, that is especially important because of the scope and extent of penalties and penalty rates of interest that apply. Often writing a detailed reasonable cause letter explaining the situation in writing for the auditor's file is a way to facilitate abatement of the penalty.

Audit Referrals

More recently, we've also seen an increase in follow-up audits on different types of taxes shortly after the conclusion of the sales tax audit. The most common situation is when an income tax audit piggybacks on a sales sax audit when the vendor has agreed to additional sales. Even in cases in which the audit was closed based on a negotiated settlement, auditors take the position (one that is subject to challenge) that that settlement can be used to form the basis of an income tax assessment. This type of multitax auditing has taken shape recently in New York, so be on the lookout whenever wrapping up a sales tax audit.

FOOTNOTES

[1] Although the focus of my analysis will be on New York sales tax audits, my firm's experiences in other states show us that many of their audits run based on the same general rules and principals. Thus, to some extent, information in this article should also be helpful for practitioners going through sales tax audits in other states.

[2] Tax Law section 1138[a]; *see, e.g., Matter of Mera Delicatessen*, Tax Appeals Tribunal, Nov. 2, 1989.

[3] Tax Law section 1138(a); *Chartair, Inc. v. State Tax Commission,* 65 A.D.2d 44.

[4] *Matter of Grant Co. v. Joseph*, 2 N.Y.2d 196; *Matter of Meyer v. State Tax Commission*, 61 A.D.2d 223.

[5] *Matter of Markowitz v. State Tax Commission*, 54 A.D.2d 1023.

[6] *Matter of Dells Mini Deli, Inc. v. Commissioner of Taxation and Finance*, 205 A.D.2d 989; *Matter of Vebole Edibles v. Tax Appeals Tribunal*, 162 A.D.2d 765.

[7] *See* 20 NYCRR section 532.4 (b)(2).

[8] *See* 20 NYCRR section 532.4 (b)(6); *Valley Stream Beverages*, Administrative Law Judge (Nov. 8, 2007).

[9] Tax Law section 1133(a).