

BE PREPARED FOR NEW YORK STATE TAX AUDITS

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The New York State Department of Taxation and Finance is now focused on tax enforcement. More taxpayers are undergoing civil audits and more civil audits are being referred for criminal investigation. Consequently, many taxpayers (including both businesses and individuals) can expect that at some point they will be the subject of a New York State tax audit.

Despite that reality, many taxpayers do not appreciate the value of preparing in advance for a tax audit. Preparation is frequently the single most effective way to reduce an assessment of additional tax liability and avoid a charge of criminal wrongdoing. Therefore, it is advisable to give thorough consideration to the following issues before any contact with the government.

1. Organize Tax Documents

First and foremost, taxpayers should maintain an orderly record-keeping system that segregates tax records from all other documents, especially those that may be privileged or confidential. Depending on the type of tax return that is under review, auditors may need to review business records related to income, sales, expenses, deductions, and credits. In other audits, taxpayers will need to document, with exemption certificates or otherwise, why a particular transaction should be deemed exempted or excluded from tax. Some audits will even require the taxpayer to produce for review some personal records, such as appointment calendars, telephone and mobile phone records, EZ Pass records, credit card and bank statements, frequent flyer records, and other travel documentation.

Under New York's Tax Law, there is generally a three-year statute of limitations on tax audits, though in some cases (such as when fraud exists or when a substantial understatement has been made on an income tax return), the statute of limitations can last for as long as six years. And if the taxpayer has failed to file any return, the statute of limitations typically stays open indefinitely. Consequently, tax documents from at least the preceding three years should be kept on-site for ease of access. If you are a business or corporation, at least one individual should have a thorough understanding of the filing system, and that person should be prepared to act as a

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custodian of records during a government audit. The more organized the records are, the more confidence the auditors will have in the accuracy of the company's tax returns.

2. Establish a Government Liaison

Business taxpayers should establish a point of contact for government officials who either call or appear on-site to conduct an audit. That employee should be considered the government liaison for all such matters. Moreover, all employees, including support staff, should know who the government liaison is and how to reach that person at all times. Auditors are used to dealing with liaisons and generally appreciate that type of professional response to their inquiries.

Taxpayers should note that they are, under the Tax Law, entitled at all times to be represented by counsel during a tax audit or investigation. Moreover, when representation has been obtained, taxpayers may insist that all requests for records and other communications from the tax department be made directly to their counsel. And perhaps most importantly, taxpayers are entitled to have their attorney present should the tax department want to interview the taxpayer or any officer or employer, or if it should seek to conduct an on-site investigation of the business or other premises. Indeed, we strongly recommend that taxpayers obtain counsel before permitting the tax department to undertake anything of the sort.

3. Establish a Document Retention Policy

Many tax audits and investigations result in the assessment of additional liability, and at times criminal charges, solely because the taxpayer is unable to locate the appropriate documentation. That is sometimes the result of a simple misunderstanding about the legal and practical consequences for document destruction. Therefore, it is advisable that business taxpayers document a process for record disposal and preservation that sets forth the types of records to be retained and how long they should be kept. A well-delineated policy will enhance the taxpayer's ability to maintain control over documents that are necessary to support its tax position. Also, employees should understand that the improper destruction of documents may result in criminal penalties.

4. Establish a Protocol for Responding to Auditors

Business taxpayers should establish a written protocol that sets forth the business's policy for responding to auditors or investigators. It should incorporate basic guidance that reduces the likelihood that auditors inadvertently intimidate employees. For example:

- The protocol should direct the liaison to immediately contact an experienced tax attorney regarding the auditor's presence. In many cases, it is advisable for the attorney to be present during the audit, and when it is not necessary for the attorney to be present, he should remain available in the event questions or irregularities arise. From that point forward, all communications with the auditor or investigator should go through the attorney, unless it is determined that some types of minimal contact between the state and the taxpayer are appropriate.
- The protocol should advise the liaison that auditors are required to explain the purpose and scope of the audit and outline the taxpayer's rights before commencing their investigation.

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- The protocol should encourage the liaison to use the opportunity to ask questions, including the names of the auditors, the district office or division of the tax department that they represent, and their authority for conducting the audit.
- The protocol should direct the taxpayer's liaison to request, if not offered by the auditor, a complete written list of the records and audit period to be reviewed. When advance notice is given, the requested records should be compiled and reviewed by the liaison and the taxpayer's attorney to ensure that they are organized and complete.
- The protocol should make it clear that it is generally not a good practice to volunteer additional records or do anything to expand the scope of the audit. Also, the protocol should state that if the auditors ask for copies of specific company documents, the liaison should ask them to flag or otherwise identify the requested documents so that copies can be made and provided to the auditors in a timely fashion. That procedure will allow the taxpayer and its attorney an opportunity to review the documents that have been requested.
- In light of the complexities surrounding privileged communications and partial waivers, taxpayers must be extremely vigilant in ensuring that privileged and confidential documents are not disclosed. Thus, the protocol should direct the liaison to consult an attorney if there are questions about privilege.