Preparing for a Successful New York State Audit Defense

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A client walks into your office with an audit notice from New York State. If you are not familiar with state audits, you may be wondering how similar they are to an IRS audit. Although the strategies are alike in many ways, there are also significant differences, particularly with residency and sales tax audits. At the 2021 NYSSCPA, New York and Tri-State Taxation Conference in December, our panel discussion on New York State Audit Defense and Alternative Strategies outlined the essential steps tax professionals should take to prepare for and resolve state tax audits as effectively as possible.

General Practice Tips

In any New York State audit, there are a few general rules that will help you keep the process moving forward. These include:

- **Develop an audit timeline.** Have a calendar that outlines tasks that must be completed and their relevant due dates to ensure nothing is missed.
- **Track Information and Document Request (IDR) responses.** Monitor what documents have been requested from auditors, when and how you sent them to the State and cross-reference responses to avoid duplicates. Also, keep auditors focused, question when there are broad or vague requests for documentation, and keep the scope limited whenever possible.
- **Provide clients with instructions.** Warn clients that they should not be in contact with agents.
- **Request penalty abatement.** Make an early request to have penalties abated.
- **Work with the auditor.** Be courteous and responsive to build goodwill and look for opportunities to negotiate with the auditor.

New York State Residency Audit Procedures

The purpose of a New York residency audit is to establish whether a taxpayer accurately filed a New York personal income tax return as a nonresident, part-year resident, or resident, or when no tax return was filed. Typically, it begins with a Nonresident Audit Questionnaire, which asks the taxpayer for proof of his address during a specified period, whether living quarters were maintained in New York during the audit period, among other inquiries; thereafter, there may be several rounds of IDRs. The type of documentation sought depends on whether the State is seeking to establish that the taxpayer is domiciled in New York or a statutory resident.

The domicile test looks at various factors to determine where the taxpayer's true home lies. These include a comparison of the taxpayer's homes and lives in different states (such as the size and use of the respective residences), lifestyle pattern, location of family members and items of sentimental or monetary value, business activities, and time spent in both states, among other factors. Note, that the burden of proof is on the party seeking to show a change of domicile. In most audits, the taxpayer is the one claiming to have changed his domicile from New York to another state. Therefore, the taxpayer has to satisfy the factors by clear and convincing evidence to show that he gave up his New York domicile and moved to a new one.

Taxpayers may be deemed to be state residents even if they are not domiciled in New York. The statutory residency test provides that a taxpayer will be treated as a resident of New York if he or she maintains a “permanent place of abode” in New York for substantially all of the year and spends more than 183 days of the tax year in New York. If there is a question as to whether the New York residence is a permanent place of abode, such evidence should be presented upfront to avoid an analysis of how many days the taxpayer spent in the state. For example, perhaps the home is not suitable for year-round use because it, for example, has no heat or is under construction.

Where the number of days in New York is at issue, IDRs are likely to ask for documentation such as:

- Cellphone and landline call logs
- Credit card transactions
- E-Z Pass records
- Data from security or swipe cards
- Bank records (ATM, deposits)
- Utility bills
- Travel documents
- Credible testimony

It is important in challenging an audit to present the strongest case possible and explain evidence that may not appear to be in your favor. For example, cell phone data may incorrectly indicate that a taxpayer was in New York rather than in New Jersey or Connecticut because a New York cell phone tower had a stronger signal. If evidence is misleading, be prepared to offer other proof of where the taxpayer was actually located, such as credit card statements or calendar entries.

New York State has updated its Nonresident Audit Guidelines effective January 1, 2022.

New York Sales Tax Audit Procedure
Any New York business can be subject to a sales tax audit and should be properly prepared to defend itself. Sales tax audits typically begin with a letter stating the taxpayer has been selected for an audit and an introduction of the audit team as well as the audit procedure. Next, an examination questionnaire is provided, which includes questions about the business operations, including contact information, who the possible “responsible persons” are, locations of the business and product information.

The initial IDR is sent requesting various business records, including copies of sales tax returns, Federal tax returns, NYS income tax returns, general ledger, sales invoices, and bank statements. In further IDRs, the taxpayer will be asked to provide sales records including sales slips, invoices, receipts, contracts, cashier register tapes, guest checks and exemption certificates for any tax-exempt sales.

The taxpayer will be asked to reconcile the amount of tax collected to what was remitted on the sales tax return. When documentation is voluminous, the auditor can establish a test period audit method election, which limits the auditor to reviewing sales for a specific period of time. The results are then extrapolated to the entire audit period. It is important to ensure that the period selected is representative of the audit period as a whole, or the industry of the taxpayer (i.e., whether it is a seasonal business or there are unusual transactions in the selected test period).

Although taxpayers are required to maintain adequate books and records, many do not. When there are insufficient records, auditors may use indirect audit methodologies (e.g., observation days, indices). Again, it is imperative to ensure that the correct observation date or index is being used.

A significant concern in many sales tax audits is personal liability. New York State law allows the State to collect taxes owed from certain "responsible persons." A responsible person generally includes anyone who is actively involved in operating the business on a daily basis, is involved in deciding which financial obligations are paid, is involved in personnel activity (such as hiring or firing employees), has check signing authority, prepares tax returns, has authority over business decisions, or is a tax manager or general manager. In addition, certain owners, officers, partners, and members of limited liability companies (LLCs) are automatically considered responsible persons. It is important to remember that more than one person may be treated as a responsible person and New York State may pursue all responsible persons as well as the entity, jointly and severally, for the payment of unpaid sales tax.

Taxpayers can challenge a sales tax audit with evidence that the assessment is incorrect, the taxpayer is not a responsible person, the statute of limitations has expired, or other procedural errors have occurred.

Closing the Audit
Typically, an audit will end with the taxpayer receiving one of the following: (1) a letter stating the acceptance of the tax return as filed, (2) a Proposed Statement of Audit Changes or (3) a Closing Agreement. (Note that these are usually done with settlements.)

Formal Protest Rights
To contest the audit results, the taxpayer has 90 days to file a request for a Bureau of Conciliation and Mediation Services (BCMS) Conciliation Conference or an Administrative Law Judge (ALJ) hearing. A "conciliation conference" allows the taxpayer to resolve the audit through a mediator appointed by the State. Decisions can be appealed to the Division of Tax Appeals (DTA).

Taxpayers may also request an informal courtesy conference, where they may be able to present extenuating circumstances or other evidence on their behalf. The State has discretion to examine the substantive merits of an assessed liability.

Voluntary Disclosure and Compliance Program
The Voluntary Disclosure and Compliance Program may be a good option for some taxpayers to resolve their tax debts. To qualify, taxpayers must not yet have been contacted by the State with respect to the tax type and period being disclosed and the State must not have already started an investigation. If the State accepts the taxpayer's application, the taxpayer must file and pay the tax and interest for the relevant periods, but all penalties are waived. As an added incentive, the taxpayer may qualify for a three or six-year limited look-back period and protection from criminal referral.

Conclusion
Best practice in an audit is to understand the procedure, respect deadlines, and work with the auditor. Look for opportunities to negotiate to reduce your client's liability particularly if you do not have a strong case or it would be more expensive to prove your case than settle it.

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