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TAX LITIGATION MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
Shirlee Aminoff, Esq.

DATE: April 2, 2010

RE: Winning a Sales Tax Dispute in the NYS Division of Tax Appeals

With the lure of interest, penalties, and large revenues upon which the sales tax is based, the Department of Taxation aggressively pursues sales tax revenue through audit. To emerge victorious in a sales tax dispute, the taxpayer should be conversant with some important principles involving sales tax litigation. First, auditors often attack the adequacy of the taxpayer's books and records. Should the Division find these records inadequate, it may resort to "external indices," one of which is a "test period" audit, in which an extrapolation could be made over a lengthy term. Since penalties will also be extrapolated, this is a dangerous position for the taxpayer to be in.

The first question is whether the Division was justified in resorting to external indices. The Division must make an explicit request for books and records for the entire audit period. If only a "weak and casual" request is made for records (Matter of Christ Cella, 477 NYS2d 858), the taxpayer may be excused from having failed to provide records. If the auditor failed to conduct a

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sufficient examination of the records, the use of a test period audit has been held improper. Does the audit report actually document a finding of inadequacy of records? Matter of King Crab, 522 N.Y.S.2d 978. If not, the Division may be unable to establish inadequacy of records. Resort to a test period audit is not justified unless it is “virtually impossible” to determine tax based upon available records. Matter of Chartair, 411 NYS2d 41. Did the auditors fail to review books and records because they were “too voluminous”? Matter of Names in the News, 429 NYS2d 755. The Division may not employ an “economic feasibility” test in resorting to a test period audit. The taxpayer has a right to a detailed audit under Tax Law §1138. Matter of Chartair, *supra*.

Did the taxpayer or his representative actually consent to a test period audit? Merely complying with a request to provide records for a test period does not, without more, evidence a waiver of the taxpayer’s right to a complete audit. Matter of James G. Kennedy, 509 NYS2d 199. Did the Division “deliberately overlook” records which were helpful to the taxpayer? Matter of Merrick Discount Center, DTA No. 800362. Was there a change in auditors? Did the original auditor appear at the hearing or at least provide an affidavit? If not, the evidence may not be sufficient to justify resort to external indices. Matter of Kenneth Schuck Trucking, DTA No. 816129. If the audit period was extended, were those records requested? Was an independent review of records relating to the extended audit period made? If adequate records exist for the extended audit period, the Division “cannot ignore them.” Matter of Adamides, 521 NYS2d 826.

Even if the taxpayer failed to comply with the Division’s record keeping regulations, it may not “prescribe the type of proof that a taxpayer must provide at hearing” in order to prevail. Matter of John G. Avildsen, DTA No. 809722. If the amount of tax paid was “easily ascertainable” from records provided, a denial of credit by the Division was held to constitute the “mindless elevation of form over substance” and could not be considered “anything other than an arbitrary and capricious exercise of power.” Matter of Riluc, 565 NYS2d 265. Did the Division request records not typically kept by persons involved in the taxpayer’s line of business? If so, the taxpayer has the right to substantiate the proper collection of tax due through supporting documents. Matter of Raemart Drugs, 555 NYS2d 458.

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Assuming resort to estimate procedures was warranted, did those procedures lack a “rational basis,” or did an extrapolation yield a grossly inaccurate estimate the tax liability? Matter of Yonkers Plumbing, 403 NYS2d 792. Was the Division’s method “reasonably calculated” to reflect the taxes due? Matter of W.T. Grant Company, 2 NY2d 196, cert denied 355 US 869. Was the audit methodology founded upon the auditor’s “experience” without any indication that the experience relates to the present audit? Matter of Grecian Square, 119 AD2d 948. Was the method chosen by the Division to estimate sales arbitrary and capricious? Matter of King Crab, *supra*.

Was the imposition of penalties proper? Did the taxpayer make a “reasonable effort” to ascertain tax liability? Matter of Northern States Contracting, Inc., DTA 806161. Was any understatement of tax unintentional? Matter of G & R Machinery, DTA 804590. As these cases demonstrate, knowledge of the taxpayer’s substantive rights constitutes the best insurance against an unfavorable result. Having a meritorious case may unfortunately be insufficient to prevail at hearing unless the proper legal arguments are advanced.

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