Tax Controversies in New York

By Barry Leibowicz

While it is the substance of the dispute that determines the outcome at any stage of the tax audit and adjudication process, the substance is irrelevant, and resolving the matter hopeless, unless the dispute is properly placed before a tribunal with jurisdiction to resolve it. No matter how strong the merits of the case, proper procedure must be strictly followed if a taxpayer is to have the opportunity to present a case, let alone prevail. While the procedural rules for protesting an assessment are not inherently complex, they are strict and unforgiving of mistakes. Careful consideration of the procedures and timing of requests for review of tax controversies is crucial if a taxpayer is to have the opportunity to plead his cause.

New York relies upon self-assessment and reporting and demands that "all taxpayers be forthright in the disclosure of relevant information to the taxing authorities" [*United States v. Bisceglia*, 420 U.S. 141, 146, 43 L.Ed. 2d 88, 95 S. Ct. 915 (1975)]. Self-assessment puts the onus on the taxpayer to complete returns accurately and on time. Along with the power placed in government to enforce the tax laws through audit and assessment, the system is balanced by the rights of the taxpayer to dispute the agency's findings within the administrative system and courts.

Statutes of Limitations

Whenever a taxpayer receives a notice of an audit, the first step is to determine the statute of limitations date for assessment of the tax. For a civil assessment to be valid, it must be made by a notice mailed within the statute of limitations. Criminal liability begins to run from the date the offense was committed, with many prosecutions for New York State tax crimes being made under the larceny statute with a five-year statute of limitations [NY CPL 30.10(2)(b)]. The ordinary civil statute of limitations applicable to income tax adjustments is three years after the later of the due date or filing date [IRC section 6501; NY Tax Law section 683(a)]. If the return omitted gross income equal to 25% or more of the gross income reported on the return, the limitations period is extended to six years. If the return is fraudulent, there is no statute of limitation for a civil assessment.

Corporate franchise taxes are also subject to a three-year statute of limitations, which begins to run from the later of the due date or filing date [NY Tax Law 1083(a)]. For sales and use taxes, the three-year statute also begins on the later of the due date or filing date of each required return, which depends on filing frequency—monthly, quarterly, or annually [Tax Law section 1147]. The maximum period applicable to sales and use taxes is three years, unless the return is fraudulent, in which case the statute never runs [Tax Law section 1147(b)]. There is no 25% rule for sales and use taxes.

None of these civil limitations begin to run until a return is filed. The statute is always open if the taxpayer has not—or cannot prove that he has—filed the return. Regardless of any records retention policy for the source books and records for a long-since-filed return, the return itself with proof of filing should be preserved forever to support a statute of limitations defense. If a taxpayer cannot prove a return has been filed, he can be audited and assessed at any time because the statute has not begun to run. Audit policy, as expressed in the audit manual, generally provides that an audit should not begin within 120 days of the expiration of the statute of limitations, exclusive of extensions [*Income Tax District Office Audit Manual*, 8(A)(1), November 26, 1997].

Formal Protest

Once a notice proposing an assessment is mailed, it must be formally protested in

order to preserve the taxpayer's right to present opposition to the assessment. The period within which the protest must be made is typically set forth on the face of the notice and is generally 90 days from the date of mailing of the notice (Tax Law section 170.a). Notices proposing taxes under the International Fuel Tax Agreement (IFTA) must be protested within 30 days (Tax Law section 279-a). The notice is valid if mailed to the last known address of the taxpayer, regardless of whether it is actually received [Tax Law sections 681(a) and 1081(a)]. It is therefore in a taxpayer's best interest to make the New York State Department of Taxation and Finance (DTF) aware of any change of address to prevent a default when a notice is mailed to an obsolete address.

The 90-day period is jurisdictional. Both the Bureau of Conciliation and Mediation Services (BCMS) and the Division of Tax Appeals (DTA) lack the power to hear a late-filed request or petition. For income tax, and sales tax for periods subsequent to 1996, a defaulted notice can be protested by first paying the assessment after the 90-day period lapses and then seeking a refund within two years of payment [Tax Law sections 687(a) and 1139(c)]. If the refund is denied, the taxpayer has two years from the denial to protest by request for conciliation or petition to the DTA [Tax Law sections 689(c), 1139(b)].

Assessments made against business entities, such as corporations, LLCs, partnerships, and trusts for sales or payroll taxes often result in concurrent assessments issued against individual owners, officers, directors, and other "responsible persons" involved with the entity. Separate notices of deficiency or determination are sent to the entities and the responsible persons, and they should all be separately and independently protested. Nevertheless, the DTF has, in recent years, considered a protest of a corporate sales tax assessment to be a deemed protest by the responsible persons as well, but not vice versa. Note that there are often significant conflicts regarding the liability by various alleged responsible persons that can make their interests adverse and require independent representation throughout the tax appeals process. The defense of lack of responsibility is available to the individuals assessed, while it is irrelevant to the corporate entity.

Separate Notices of Determination are issued to the "bulk sale" purchaser of a business. A purchaser can use defenses that are not available to the seller. A purchaser should therefore file its own independent protest of a notice, regardless of any protest by the seller.

Conciliation

Protests of a Notice of Deficiency or Notice of Determination are made by request for conciliation to BCMS or by a petition to the DTA [Tax Law sections 170(3-a) and 170(e); 20 NYCRR sections 3000.3 and 4000.3]. If a timely request for conciliation is made to BCMS, a taxpayer will still be able to protest the assessment by a petition to the DTA filed within 90 days of the mailing of a conciliation order sustaining the assessment [Tax Law section 170(e)]. It is therefore preferable in most cases to make the request for conciliation to BCMS first, because it provides a simple and inexpensive means to resolve the dispute and still allows for a formal petition to the DTA if a taxpayer is unable to resolve the matter at BCMS. In both circumstances, the BCMS request or DTA petition must be filed within 90 days. As remarkable as it may seem, numerous cases each year revolve around whether or not the 90-day time limit for protesting the assessment to BCMS or the DTA was met. Ninety days is not three months—it is 90 days. This requirement is easily dealt with by sending the request for BCMS conference or petition to the DTA via certified mail early enough to avoid any question of timeliness.

Protesting a petition to BCMS is simple. The DTF typically includes a form request for conciliation conference along with the Notice of Deficiency or Determination with most of the identifying information already filled in. The taxpayer need only fill in her representative's name and a general statement regarding the errors in the assessment and send it in the envelope provided, along with a power of attorney (form POA-1) if the request is filed by her representative. Although the Corporate, Individual Responsible Officer, and Bulk Sales Notices of Determination or Deficiency may look alike, they are independent notices and assessments and should be protested individually.

A conciliation conference is intended to afford taxpayers a quick and inexpensive means of resolving tax disputes without the need for a formal hearing in the DTA [20 NYCRR section 4000.5(c)(1)(i)]. At a conciliation conference, the taxpayer presents his position, and representatives of the audit division in turn submit support for their determination. The conference is very informal. The conciliation conferee is expected to try to narrow or define any factual issues. Although the conferee theoretically has the power to make a determination in favor of the taxpayer over the objections of the auditor, it rarely happens.

Conciliation conferees essentially act as mediators rather than impartial arbiters. The basic thrust of conciliation conferences takes the tone of the conferee attempting to mediate the dispute, pointing out possible strengths and weaknesses in the parties' positions, but without imposing a settlement on recalcitrant auditors. It is the "can't we all get along" approach to settlement rather than an objective review designed to eliminate unnecessary litigation.

Audit Files

A taxpayer engaged in conciliation before BCMS or a formal hearing at the DTA should obtain the entire audit file and any other related documents or records prior to the first conference or hearing. Access to and review of these records will often disclose deficiencies or failures in the audit process that can be used to overturn or minimize the assessment at issue. Any mistakes made by DTF personnel often provide the best chance of success at hearing or conference, and those mistakes are usually captured in the audit file.

The audit file should be obtained as soon as possible after the issuance of the notice. These files are available through a request filed under New York's Freedom of Information Law (FOIL; NY Public Officers Law section 87). While FOIL does contain some exceptions to disclosure, the vast majority of information relevant to the proposed assessment should be disclosed and can be used to prepare for the BCMS conference.

Settlement

If the parties reach an agreement with the conferee, the conferee will issue a consent which, upon execution, will finally determine the tax in the amount and on the

basis set forth in the consent. Great care must be taken to consider all of the consequences that can arise from the consent, particularly with regard to sales taxes.

Settlement of a sales tax assessment carries a significant risk that it will be used as a binding admission for the assessment of a corresponding franchise or income tax liability. Historically, taxpayers could execute a consent-to-sales-tax adjustment based simply upon their own analysis of the "hazards of litigation," or the cost of taking the matter to a formal hearing, regardless of whether they felt the proposed tax was truly owed. In the past several years, however, the DTF has taken consent–to–sales-tax adjustments and utilized them for income and franchise tax liability assessments. These "referral audit" assessments utilize any increase in gross sales agreed to in the sales tax matter.

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Although the DTF uses estimated increased sales in these referral audits, it does not typically estimate corresponding deductions. The DTF argues that the taxpayer is bound—estopped—from denying the additional sales regardless of the underlying rationale for the assessment. To make matters worse, to the extent this estoppel results in a final determination of additional state income tax, the determination will be transmitted to the IRS, which can use the New York State income tax determination as binding and conclusive against the taxpayer for federal income tax purposes [*Sunik v. Comm'r*, 321 F.3d 335, 336 (2d Cir. 2003)].

In response to criticism that taxpayers were being blindsided by income and franchise tax assessments based on consent–to–sales-tax adjustments, the possibility of the sales tax audit being used for income tax adjustments is now often included in a statement in the first letter advising a taxpayer she is under sales tax audit. Nevertheless, this notice is generally too abstract to adequately warn a taxpayer of the potential consequences of consent. The taxpayer and her accountant must consider all of the possible consequences of a proposed consent before accepting one for the sales tax alone. For example, while an assessment based on a change in taxable versus non-taxable sales ratios will not have an income tax consequence, an assessment based on an increase in gross sales, made within the income or franchise tax statute of limitations, will have an income tax effect and should be avoided. Be aware, however, that if the settlement gross receipts increase gross income by more than 25% of that reported on the income tax return, the six-year statute of limitations will apply to the income tax return, rather than the ordinary three-year statute [Tax Law section 683(d)(1)].

Timely Petitioning

If the parties cannot agree at BCMS, the conciliation conferee will issue a Conciliation Order, which, in most instances, will simply sustain the original assessment proposed in the Notice of Deficiency or Determination [Tax Law section 170(e)]. A taxpayer then has 90 days from the date of mailing of the conciliation order to file a petition with the Division of Tax Appeals for a formal hearing.

It is critical that the petition be filed within 90 days to obtain DTA review. If there is no time for a detailed formal petition, one can file a "skeleton" petition within the time limit to establish jurisdiction in the DTA and amend it thereafter. However, defects in a filed petition can fatally damage a taxpayer's case. For example, a statute of limitations defense is waived if it is not raised in the petition. (*Matter of Adamides v. Chu*, 134 AD2d 776, 521 NYS2d 826, 828, *lv denied 71 NY2d 806, 530 NYS2d 109; Matter of Convissar v. State Tax Commission*, 69 AD2d 929, 415 NYS2d 305; *Matter of Servomation Corp. v. State Tax Commission*, 60 AD2d 374, 400 NYS2d 887).

Filing a request for conciliation or petition to the DTA too early can be just as bad as filing too late. Neither BCMS nor the DTA can have jurisdiction until a notice of deficiency or determination is mailed. A request for conciliation or petition to the DTA filed *prior* to the issuance of the notice is a nullity [Tax Law section 1089(b), *Matter of Multi State Handling Corp.*, DTA, 1988]. If the taxpayer fails to file a subsequent request or petition within 90 days *after* the notice is actually issued, the taxpayer will default and the tax will become due regardless of whether a premature request or petition was filed.

Timely mailing is timely filing if the U.S. Postal Service is used. Certified mail, return receipt requested, is the preferred route, with a stamped receipt from the post office. Where delivery is made by courier, delivery, messenger, or similar services, the date of delivery will be deemed to be the date of filing [See Tax Appeals Tribunal Rules of Practice and Procedure section 3000.22(a), (c)].

A petition to the DTA is available to commence a protest of any written DTF notice that has advised the petitioner of: a tax deficiency; a determination of tax due; a denial of a refund or credit application; a cancellation, revocation, or suspension of a license, permit or registration; a denial of an application for a license, permit, or registration; or any other notice which gives a person the right to a hearing in the DTA.

In certain relatively rare circumstances, taxpayers have the option of bypassing New York's administrative tax review process entirely by seeking a declaratory judgment from the Supreme Court rather than submitting a petition to the DTA [CPLR section 3001]. In essence, declaratory judgment is available when the facts are not in dispute and the sole issue is a matter of law [*Allstate Insurance Co. v. State Tax Commission*, 495 NYS2d 789 (1985); *Xerox Corp. v. Department of Taxation and Finance*, 529 NYS2d 623 (1988)].

Small Claims

The DTA was created in 1986 to provide New Yorkers with an independent and impartial body for the resolution of tax and licensing disputes. Formal hearings are conducted by administrative law judges (ALJ) of the DTA who hear testimony, evaluate evidence, and prepare and issue a written determination [Tax Appeals Tribunal Rules of Practice and Procedure 3000.15(e)].

If the amount of personal income or corporate franchise tax at issue is $20,000 or less for any 12-month period (excluding

penalties and interest) or $40,000 for sales and use taxes, a taxpayer can request a small claims hearing in the DTA as an alternative. Small claims hearings are informal and conducted by a DTF employee empowered to make a binding determination. A taxpayer may change his mind at any time before the conclusion of a small claims hearing and transfer the matter to the DTA for a formal hearing before an ALJ (Tax Law section 201). In general, small claims hearings should only be requested when the amounts at issue do not warrant the effort and expense of a formal hearing.

A petitioner can represent himself, a spouse, a minor child, a partnership in which he is a general partner, or a corporation in which he is an officer or employee. A petitioner may also be represented by a New York attorney, accountant, enrolled agent, or CPA, pursuant to a power of attorney [Tax Appeals Tribunal Rules of Practice and Procedure section 3000.2, Tax Law section 2006, 2012, 2014, 2018)]. With the exception of small claims proceedings in the DTA, it is not advisable for anyone lacking in litigation experience to represent a client at hearing.

Importance of Preparation

The Tax Appeals Tribunal is the highest authority within the DTA. It is an appellate body and does not hear evidence or testimony. The tribunal bases its decisions on the record established in the formal hearing before the ALJ who issued the determination that has been appealed to it. Any failures made by the representative in the presentation of the case at the DTA cannot be corrected by hiring an attorney to appeal to the tribunal, since he will be limited to the record created at the DTA hearing. While taxpayers have rights to appeal to the tribunal, and thereafter to the courts in an Article 78 proceeding [NY Public Officers Law section 89(4)(a),(b)], it is the DTA hearing that represents the last, best chance to secure relief for the taxpayer.

A good working knowledge of the procedural rules governing tax audits and controversies does not guarantee success. It does, however, guarantee a decision on the merits, based upon every possible defense and presumption that may be available to the taxpayer. A CPA must zealously protect every appeal and petition right available to a client. Doing so requires strict adherence to the procedural rules for submitting tax disputes for adjudication, both as to form and timing. Not only does this adherence to procedural requirements benefit the taxpayer by allowing him to present a defense to assessment, it eliminates any possible claim against a CPA arising from technical omissions or failures. ❑

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