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New York Case Highlights Pitfalls of Consenting to Sampling Methodology in Tax Audit

The New York Division of Tax Appeals ("Division") in *In the Matter of Top Drawer Custom Cabinetry Corp.*, DTA No. 825588, recently held that a taxpayer who signed a consent to use a test period audit methodology was bound by the consent and waived its right to a detailed audit of the entire period. In November 2010, New York began a sales and use tax audit of Top Drawer Custom Cabinetry Corp. ("Top Drawer"). During the audit, New York determined the sales records provided by Top Drawer were adequate to conduct the audit. In December 2010, Top Drawer's president entered into a test period agreement with New York, which provided in part:

> When my records are complete and available for the entire audit period, the Tax Department may not determine my tax based upon a test period audit without my consent. However, if I find that it may be practical to use the test period method audit, I may agree to use such method by comp[l]eting this form. [...]
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> The Tax Department representative has explained to me the various audit methods listed above. If the auditor determines that my books and records are both complete and adequate, I agree the audit should be conducted using a **test period method audit**. It is understood that this agreement is contingent upon the adequacy of my records and pertains to the audit method to be used. It does not preclude my protest of the audit results on grounds such as the particular test period selected, the inclusion of certain transactions within the test, the taxability of certain transactions, or the method of projecting the results of the test period findings. The Commissioner of Taxation and Finance enters into this agreement on the assumption that my books and records, including computer files, are complete and adequate. [Emphasis in original]

The agreement contained boxes that had been checked to show that the parties had agreed the test period method could be used for the audit of sales and recurring expense purchases. The Division used the test period method to audit the sales and expense purchases for a three-month test period and asserted $67,447.20 of tax, plus interest, due for the three-year audit period. Top Drawer appealed the determination. It argued that despite the signed consent, New York should have conducted a detailed audit because adequate books and records were available to the auditors. It believed a detailed audit would have resulted in decreased tax liability.

The Administrative Law Judge found for New York. He stated that the use of the test period method was not based on Tax Law??1138(a)(1), which permits New York under certain circumstances to estimate a taxpayer's tax liability, but rather on the written consent of Top Drawer. Top Drawer knowingly entered into a valid agreement, consenting to a test period audit in lieu of a detailed audit. Therefore, it could not argue that a different methodology should have been used after conclusion of the audit.

The *Top Drawer* appeal highlights the pitfalls of entering into an audit methodology agreement in a state tax audit. Before entering into such an agreement, the taxpayer must assess the test period methodology being proposed to make sure it will fairly reflect the tax compliance and exposure for the entire audit period. This often requires the taxpayer to do some sampling of its own to determine whether there are any unusual situations that might skew a test period audit. Although it often is impractical to insist on a full actual audit, it often is possible to pre-negotiate how anomalous transactions might be dealt with in a test period audit.