

PP-2008-19

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STATEMENT OF AUDIT PROCEDURE

ALL UNITS

Procedure for Imposition of Civil Penalties

I. BACKGROUND

During the course of an audit, an auditor may discover information that leads him or her to conclude that a taxpayer has not complied with certain legal requirements found in the Administrative Code. As a result, the Department may impose civil penalties.

In some situations, if the taxpayer can demonstrate that its failure to comply with the tax law was due to reasonable cause and not willful neglect, the assertion of civil penalties may not be appropriate.

II. SCOPE

The criteria for imposing and abating penalties for specific New York City taxes can be found in the following sections of the Administrative Code:

- Unincorporated Business Tax Section 11-525
- General Corporation Tax Section 11-676
- Banking Corporation Tax Section 11-676
- Real Property Transfer Tax Section 11-2114
- Commercial Rent Tax Section 11-715
- Utility Tax Section 11-1114
- Hotel Room Occupancy Tax Section 11-2515

This Statement of Audit Procedure ("SAP") explains how an auditor should let a taxpayer know about potential penalties identified during an audit, and how a taxpayer may try to demonstrate that its conduct was excusable due to reasonable cause.

The SAP will outline the general procedure, and will then provide more detailed guidance about how to impose penalties for substantial understatement of tax and for negligence.

The SAP is limited to the process of imposing penalties and will not specify the legal criteria for applying particular penalties. In addition, penalties asserted by other Divisions, for example as part of the returns processing function, will not be addressed in this SAP because the Audit Division does not generally re-evaluate the taxpayer's responsibility for these penalties during the audit process. Taxpayers wishing to dispute such penalties should contact those other Divisions directly.

III. PROCEDURE

A. Proposing the Imposition of Penalties

When an auditor prepares the Notice of Proposed Tax Adjustments ("NOPTA"), an automatic calculation of penalties may be prepared by the FAIRTAX systems. The auditor must review each penalty to assure that asserting that penalty is appropriate given his or her knowledge of the specific information gathered during the audit.

After the auditor's evaluation, any penalties the auditor determines to be appropriate under the Administrative Code will be included in the NOPTA. The NOPTA will specify the Administrative Code section that applies to each penalty, explain why each penalty has been imposed, and describe how the amount of each penalty has been computed.

B. Taxpayer's Response

The taxpayer has the opportunity to explain why penalties specified in the NOPTA should not become part of a final assessment.

If a taxpayer wishes to show that a proposed penalty was asserted based upon incorrect information, or that a penalty was not properly calculated, the taxpayer need not respond in writing. In these situations, the taxpayer may discuss the proposed penalty with the auditor, either during an exit conference as provided for in SAP PP 2008-3 or otherwise.

However, if a taxpayer wishes to demonstrate that it should be excused from an otherwise appropriate penalty because its failure to comply with the tax law was excusable due to reasonable cause, the taxpayer must do so in writing. The taxpayer must prepare a letter that outlines the facts and circumstances surrounding its conduct, and explains why its actions or failures to act should be considered reasonable cause.

If a taxpayer does not respond to the proposed assertion of penalties in the NOPTA, or if the facts and explanations offered by the taxpayer do not provide a basis for abating or avoiding proposed penalties, those penalties will be included in the Notice of Determination.

C. Additional Guidelines - Substantial Understatement of Tax and the Negligence Penalties

Substantial Understatement of Tax and Negligence penalties require an auditor to evaluate whether and to what extent penalties authorized by the Administrative Code for non-compliance are called for in a particular situation. Filing positions taken by a taxpayer must be evaluated, and analyzing the taxpayer's conduct is more complicated than verifying a straightforward fact like late filing of a tax return.

Auditors deciding whether to propose either of these two penalties, and taxpayers seeking to show that they should not be asserted, should consider how the following questions apply to the particular facts and circumstances of an audit:

Substantial Understatement of Tax

- Was the understatement actually substantial – 10% of the total tax due or more?
- Did the understatement result from the taxpayer taking a filing position or selecting to treat an item of income, expense in a way for which there existed some authority?
- Did the taxpayer adequately disclose in the return, or in a statement attached to the return, relevant facts affecting a disputed item's tax treatment?
- Is the proposed audit change that results in the understatement based upon something other than a discretionary adjustment by the Commissioner?
- Did the taxpayer have reasonable cause for the understatement (or part thereof) and did the taxpayer act in good faith?

Negligence

- Can the auditor clearly identify the specific circumstances that led him or her to conclude that the taxpayer has been negligent in its failure to comply with the tax law?
- Can the auditor specify particular acts or failures to act on the taxpayer's part that constitute negligence?

Generally, negligence and substantial understatement of tax penalties are not appropriate if an understatement arises as a result of an exercise of the Commissioner's discretion unless the taxpayer knew at the time of filing its return that the Commissioner would exercise discretion in that situation.