# State Audit Guessing Games: When Can States Issue Estimated Assessments?

*by Eric S. Tresh and Madison J. Barnett*

*Eric S. Tresh*

*Madison J. Barnett*

There are generally three types of state tax assessments: (1) an assessment based on actual information provided by the taxpayer during an audit of a taxpayer's books and records (an audit assessment);[1] (2) an assessment based on the best available information, which may include information contained in the taxpayer's books and records as well as any other relevant source of information (an estimated assessment);[2] and (3) an assessment based on *any* information available, typically issued in extraordinary circumstances in which the state believes its ability to collect the tax may be in jeopardy (a jeopardy assessment).[3]

Most taxpayers are all too familiar with audit assessments, which are the most typical form of assessment, and we explored jeopardy assessments and the narrow circumstances justifying their use in a previous Pinch of SALT.[4] This article focuses on the third type of assessment: the estimated assessment. Although estimated assessments are perhaps most common in the sales and use tax area, taxpayers may face them for any type of tax.

> ***Many estimated assessments result in an increased tax liabilty because the assumptions used to determine estimated assessments often favor states.***

From a taxpayer's perspective, an estimated assessment often produces offensive results because it is not based on a review of actual books and records and there is a greater margin of error between the estimated assessment and the actual tax liability. Although that margin of error could favor either the taxpayer or the state, many estimated assessments result in an increased tax liabilty because the assumptions used to determine estimated assessments often favor states.

### An Analytical Framework: Adequate Information and Estimated Assessments

State tax laws vary regarding the limitations on states' authority to issue estimated assessments.

---

[1]*See, e.g.*, N.J. Stat. section 54:49-6. ("After a return or report is filed . . . , the director shall cause the same to be examined and may make such further audit or investigation as he may deem necessary, and if therefrom he shall determine that there is a deficiency . . . , he shall assess the additional taxes, penalties, if any.")

[2]*See, e.g.*, N.J. Stat. section 54:32B-19. ("If a return . . . is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by the director from such information as may be available . . . [and] may be estimated on the basis of external indices.")

[3]*See, e.g.*, N.J. Stat. section 54:49-7. ("If the commissioner finds that the taxpayer designs quickly to depart from this state or to remove therefrom his property, or any property

**(Footnote continued in next column.)**

subject to any state tax or to conceal himself or his property, or such other property, or to discontinue business, or to do any other act tending to prejudice or render wholly or partly ineffectual proceedings to assess or collect such tax, whereby it becomes important that such proceedings be brought without delay, the commissioner may immediately make an arbitrary assessment.")

[4]Marc A. Simonetti, Zachary T. Atkins, and Madison J. Barnett, "Auditors Must Not Use Jeopardy Assessments to Coerce Taxpayers," *State Tax Notes*, Apr. 11, 2011, p. 113, *Doc 2011-6563*, or *2011 STT 69-3*.

The law is often not well developed — statutorily, judicially, or through official guidance. Generally, however, a state's authority to issue an estimated assessment is governed by the interaction among several statutory provisions, including those addressing: (1) the taxpayer's duty to maintain and provide books and records; (2) the quantity and quality of records deemed to be sufficient; (3) a state's authority to issue an estimated assessment based on the best information available rather than based solely on the taxpayer's books and records; and (4) a state's authority to issue a jeopardy assessment.

Courts analyzing the validity of estimated assessments often follow a two-step analysis. First, the taxpayer must show that it maintained and provided the auditor with books and records that were sufficient to allow a determination of the tax due. If a state issues an estimated assessment to determine the amount of tax due when the taxpayer's books and records are sufficient, the use of an estimated assessment is improper.[5] If the taxpayer fails to maintain or provide adequate books and records, the inquiry shifts to whether the state's method used to calculate the estimated assessment is reasonable.[6]

### Taxpayers' Duties to Maintain and Provide Information

A tax assessment generally must be based on a taxpayer's actual books and records if the books and records are adequate to determine the tax due. Estimated assessments issued when the taxpayer provides adequate books and records are often invalidated.[7] An issue therefore arises regarding whether information available to an auditor is sufficient in both quality and quantity to meet the taxpayer's statutory obligation to maintain and provide adequate books and records. An adequacy determination is a facts and circumstances analysis with few objective criteria available to evaluate the results.

State laws imposing a duty on taxpayers to maintain books and records are often broad and ill-defined. Florida law, for example, provides that "it shall be the duty of every person [subject to tax] . . . to keep and preserve suitable records . . . as may be necessary to determine the amount of tax due."[8] Many state statutes delegate to the department of revenue the authority to establish what books and records must be maintained.[9] Florida regulations provide a particularly useful description of the factors that a department may consider in determining whether a particular taxpayer's records are sufficient:

> "Adequate records" means books, accounts, and other records sufficient to permit a reliable determination of a tax deficiency or overpayment. Incomplete records can be determined to be adequate.
>
> (a) To be sufficient to make a reliable determination, adequate records, including supporting documentation, must be: 1. *Accurate*, that is, the records must be free from material error; 2. *Inclusive*, that is, the records must capture transactions that are needed to determine a tax deficiency or overpayment; 3. *Authentic*, that is, the records must be worthy of acceptance as based on fact; and 4. *Systematic*, that is, the records must organize transactions in an orderly manner.[10]

The presence of adequate internal control procedures for a taxpayer's accounting system bolsters the position that the records produced by that system are adequate.[11]

Although a taxpayer that does not provide all information requested by a state risks receiving an estimated assessment, a taxpayer may be justified

---

[5]*See SMK LLC v. Mich. Dep't of Treasury*, Dkt. No. 409504 (Mich. Tax Trib., Sept. 26, 2011) (invalidating estimated sales tax assessment where the taxpayer's records were "suitable and adequate to determine the correct amount of tax"); *6 To 12 Store 2, Inc. v. Dep't of Revenue*, Dkt. No. DOR 08-3-FOF (Fla. Div. Admin. Hrg., July 11, 2008) (same); *Constantine v. Comm'r, Dep't of Revenue Svcs.*, 1994 WL 320293 (Conn. Super. Tax 1994) ("An honest and conscientious taxpayer who maintains required records has a right to expect that those records will be used in a complete audit."); *Chartair, Inc. v. State Tax Comm'n*, 411 N.Y.S.2d 41, 46 (N.Y. App. Div. 1978) ("if records are available from which the exact amount of tax can be determined, the estimate procedures adopted by the [department] become arbitrary and capricious and lack a rational basis").

[6]*See Petitions of Gulzar A. Khan and Ishtiaq Khan*, DTA Nos. 820701, 820702 (N.Y. Tax App. Trib., Sept. 4, 2008) (invalidating an estimated sales tax assessment when the taxpayer failed to maintain adequate records because it lacked a "rational basis"); *Charley O's Inc. v. Dir., Div. of Tax.*, 23 N.J. Tax 171 (2006) (invalidating an estimated sales tax assessment because although the taxpayer failed to maintain adequate records, the state had "no authority . . . to adopt the gross receipts as reported on the CBT returns rather than the gross receipts as reported on the sales tax returns merely because it was more convenient to do so or because . . . [it] produced a large sales tax liability").

[7]*See supra* note 5.

[8]Fla. Stat. Ann. section 212.12(6)(a).

[9]*See, e.g.*, Calif. Revenue and Taxation Code section 7053 (retailers "shall keep such records, receipts, invoices, and other pertinent papers in such form as the board may require"); Ill. Comp. Stat. ch. 35, 120/7 ("The Department may adopt rules that establish requirements, including record forms and formats, for records required to be kept and maintained by taxpayers.").

[10]Fla. Admin. Code Ann. section 12-3.0012(3)(a) (emphasis added).

[11]*See* N.J. Admin. Code section 18:24-2.15; N.Y.C.R.R. tit. 20, section 533.2(g).

in refusing to provide state tax authorities with some types of books and records. For example, a taxpayer should not be faced with an estimated assessment for withholding documents that are privileged under the attorney-client or work product privileges.

***State auditors should not be permitted to coerce a taxpayer by using an overly broad or out-of-control IDR process.***

More frequently, a taxpayer risks receiving an estimated assessment when it refuses to comply with overly broad information document requests (IDRs). The use of an estimated assessment is inappropriate, in our view, when a taxpayer refuses to provide documents irrelevant to determining the proper amount of tax due. Those fishing expedition IDRs are burdensome and may be motivated in part by a desire to dissuade a taxpayer from protesting an adjustment. State auditors should not be permitted to coerce a taxpayer by using an overly broad or out-of-control IDR process.[12]

A taxpayer should also not be required to *create* books and records that are not maintained in the taxpayer's ordinary course of business. It is not uncommon for a state tax auditor to request that a taxpayer create audit schedules or workpapers. Although many taxpayers oblige under the theory that creating documents will lead to a more efficient and fair audit, it is often inappropriate for an auditor to require a taxpayer to create a document when none exists. As one New York court said regarding a related issue:

> [The Department alleged that a] complete audit would have been very time consuming . . . [and] a costly venture on the Department as well as the taxpayer. We are not aware of any authority that would support an economic feasibility test as the basis for determining when [an estimated assessment] may be utilized. The honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability.[13]

There is absolutely no justification for demanding that taxpayers generate documents to satisfy an auditor.

### The Reasonableness of an Estimated Assessment

If a taxpayer fails to maintain or provide adequate books and records, most states are authorized to issue estimated assessments using the best information available. Taxpayers may challenge the basis and method of an estimated assessment, and those assessments are subject to a form of reasonable basis review, under which the assessment will be upheld to the extent it is reasonably determined. In New York, for example, the method used to calculate an estimated assessment must be "reasonable" or "rational."[14] Estimated sales tax assessments using test period or sampling methods typically are upheld as reasonable, as are markup methods for retail sales businesses when the only available information is purchase order records and the auditor adds a profit margin markup to the wholesale price to estimate the taxable retail price.[15]

States are afforded a degree of latitude in the method they use to calculate an estimated assessment. States are not required to show, for example, that the estimated assessment was calculated using the *most* reasonable method, just that the method chosen by the state is reasonable.[16] The state is generally "given wide latitude to establish the tax due from such information as may be available," as

---

[12]*See Evergreen Lawn Svc., Inc. v. Dir. of Revenue*, Dkt. No. RS-80-0187 (Mo. Admin. Hrg. Comm'n, July 13, 1987) (invalidating an estimated sales tax assessment when the taxpayer could no longer provide books and records destroyed after the statutorily prescribed retention period, because "[the state's] power . . . to issue estimated assessments is not *carte blanche* to arbitrarily impose tax liability upon taxpayers based upon irrelevant data and computed by undisclosed formulae"); *Brown v. N.Y. State Tax Comm'n*, 99 N.Y.S.2d 73, 78 (N.Y. Sup. 1950), *aff'd*, 109 N.Y.S.2d 626 (N.Y. App. Div. 1952), *aff'd*, 107 N.E.2d 510 (N.Y. 1952) (invalidating an estimated assessment issued solely for the improper purpose of holding open the statute of limitations).

[13]*Chartair, Inc. v. State Tax Comm'n*, 411 N.Y.S.2d 41, 47 (N.Y. App. Div. 1978).

[14]*See Meyer v. State Tax Comm'n*, 402 N.Y.S.2d 74, 77 (N.Y. App. Div. 1978) ("We must . . . determine whether the audit procedures were reasonable under the circumstances."); *Petitions of Gulzar A. Khan and Ishtiaq Khan*, DTA Nos. 820701, 820702 (N.Y. Tax App. Trib., Sept. 4, 2008) (invalidating an estimated sales tax assessment because it lacked a rational basis).

[15]*See, e.g.*, *Markowitz v. State Tax Comm'n*, 388 N.Y.S.2d 176, 177 (N.Y. App. Div. 1976), *aff'd,* 376 N.E.2d 927 (N.Y. 1978) (the sample period of a single day was reasonable); *Meyer*, 402 N.Y.S.2d at 76-77 (the markup method was reasonable despite flaws).

[16]*Yilmaz, Inc. v. Dir., Div. of Tax.*, 22 N.J. Tax 204, 235-236 (2005), *aff'd,* 915 A.2d 1069 (N.J. Super., App. Div. 2007) ("it is contrary to the purpose of [the estimated assessment statute] to require the Director to establish that he used the best possible method to estimate the taxpayer's [liability]"); *Markowitz*, 388 N.Y.S.2d at 177 (holding that a degree of imprecision in an estimated assessment arising from the taxpayer's own failure to maintain adequate records is reasonable).

long as the method is reasonable.[17] The rationale underlying cases upholding less-than-perfect estimated assessment methods is an implicit recognition that "where the taxpayer's own failure to maintain proper records prevents exactness in determination of [the] tax liability, exactness is not required."[18]

There are, of course, limits on the realm of reasonableness. An estimated sales tax assessment calculated on the basis of a markup method, for instance, was invalidated because the site visits to the retail store used to calculate a taxable sales ratio produced a margin of error in excess of 35 percent.[19] Similarly, the New Jersey Tax Court invalidated an estimated sales tax assessment against a restaurant when the auditor arbitrarily used the amount of receipts from the taxpayer's state corporate income tax return to calculate the amount of sales subject to sales tax rather than using a markup approach that would have resulted in a lower tax liability.[20]

An estimated assessment issued for an improper purpose may also be invalidated as being unreasonable. For example, an estimated assessment in New York arbitrarily issued for the purpose of extending the statute of limitations was reasonable and was invalidated.[21] Similarly, the premature issuance of an estimated assessment to preserve the liability of a bulk purchaser, less than a month after an audit first began and before the taxpayer had an opportunity to provide its full books and records, has been held unreasonable and invalid.[22]

### The Shifting Burdens of Proof

A state tax audit assessment based on the taxpayer's books and records carries a presumption of correctness, and the burden of proof is on the taxpayer to rebut that presumption. Some states, either by statute or case law, grant estimated assessments the same presumption of correctness as an audit assessment.[23] To rebut that presumption, the taxpayer must present evidence showing either that the method used to calculate the estimated assessment is unreasonable or that the data underlying the method do not produce a reasonably accurate assessment.[24]

> ***In states that afford estimated assessments a presumption of correctness, overcoming the presumption is not impossible, but taxpayers face an uphill battle.***

In states that afford estimated assessments a presumption of correctness, overcoming the presumption is not impossible,[25] but taxpayers face an uphill battle in doing so. In *Ragland v. Big River Sales, Inc.*, for example, a taxpayer successfully challenged an estimated sales tax assessment imposed on its interstate sales of motorcycles and ATVs.[26] Although the taxpayer fully cooperated with the auditor and made its records available for inspection, the auditor assessed all of the interstate sales because of inconsistencies in the taxpayer's records. In invalidating the assessment, the court found that the taxpayer rebutted the presumption of correctness by demonstrating that it maintained books and records sufficient to document the exempt nature of the interstate sales, and that the auditor ignored available records by making the estimated assessment.

Other states have adopted a shifting burden of proof approach for estimated assessments more favorable to taxpayers than the presumption of correctness granted audit assessments. Some New York cases, for example, have applied a shifting burden approach in which the state bears a minimal initial burden of showing the assessment has a rational basis, and then the burden shifts to the taxpayer to show that the assessment's method is invalid.[27]

---

[17] *Yilmaz*, 22 N.J. Tax at 235.

[18] *Meyer*, 402 N.Y.S.2d at 78.

[19] *6 To 12 Store 2, Inc. v. Dep't of Revenue*, Dkt. No. DOR 08-3-FOF (Fla. Div. Admin. Hrg., July 11, 2008).

[20] *Charley O's*, 23 N.J. Tax at 186-187.

[21] *See Brown*, 99 N.Y.S.2d at 78 ("No doubt wide discretion should be given [the state] in making an [estimated] assessment . . . , but it cannot be seriously contended that the Legislature ever intended to permit such action without any basis for so doing and for the sole purpose of procuring an extension of the [statute of limitations]."); *Petition of Allied Paper Products, Inc.*, N.Y. Tax Comm'n Hrg. Dec. No. TSB-H-85(115)S (Feb. 6, 1985) (same).

[22] *Petition of A & J Grand Enterprises, Inc.*, DTA Nos. 822935-37 (N.Y. Div. Tax App., Aug. 25, 2011).

[23] *See* Ark. Code Ann. section 26-18-506 ("The burden of proof of refuting [an] estimated assessment is upon the taxpayer."); *Murphy*, 2011 WL 6412125; *Cusumano v. Mich.*

**(Footnote continued in next column.)**

*Dep't of Treasury*, Dkt. Nos. 338269, 343698 (Mich. Tax Trib., June 24, 2010); *Edmondson Mgt. Svc., Inc. v. Woods*, 603 S.W.2d 716 (Tenn. 1980).

[24] *Yilmaz*, 22 N.J. Tax at 236.

[25] Taxpayers can and do successfully challenge the reasonableness of an estimated assessment's method. *See, e.g., Charley O's*, 23 N.J. Tax at 185-187; *Wylie Steel Fabricators, Inc. v. Johnson*, 179 S.W.3d 509 (Tenn. App. 2005); *Suprenant v. Comm'r of Revenue*, Dkt. No. 156519 (Mass. App. Tax Bd., Oct. 25, 1991).

[26] 1989 WL 111648 (Ark. App. 1989) (unpublished).

[27] *See Matter of Grecian Sq. v N.Y. State Tax Comm'n*, 119 A.D.2d 948, 950 (N.Y. App. Div. 1986) (state must show that the estimated assessment method is reasonable, then burden shifts to taxpayer); *Petitions of Gulzar A. Khan and Ishtiaq Khan*, DTA Nos. 820701, 820702 (N.Y. Tax App. Trib., Sept. 4, 2008) ("Once the Division shows that it has a rational basis for the assessment, [which may be satisfied by the face of the estimated assessment itself if reasonable,] the taxpayer then

**(Footnote continued on next page.)**

Florida has applied a similar shifting burden approach to reviewing estimated assessments.[28]

***Estimated assessments should not be afforded the same presumption of correctness as an audit assessment determined based on a review of the taxpayer's books and records.***

In our view, estimated assessments should not be afforded the same presumption of correctness as an audit assessment determined based on a review of the taxpayer's books and records. The shifting burden approach can be an effective means of implementing that preference for a "real" audit. Audit assessments often are produced after a long and labor-intensive examination of the taxpayer's records. Estimated assessments, in contrast, are by definition educated guesses at what the taxpayer's actual tax liability may be, based on whatever information and assumptions are available to the state. The rationale of applying a presumption of correctness to audit assessments — that they are carefully calculated based on actual books and records — simply does not apply with the same force to estimated assessments. Further, estimated assessments are the exception rather than the rule, and therefore removing the presumption of correctness for estimated assessments is less likely to disrupt the state's interest in efficient tax administration. The shifting burden approach adopted by some states can provide some limited protection to taxpayers while still respecting the states' interest.

## Conclusion

Estimated assessments are an appropriate state tax assessment mechanism in limited circumstances — namely, when a taxpayer fails to maintain or provide adequate books and records. However, an estimated assessment or the threat of an estimated assessment should not be used to compel taxpayers to provide records that are irrelevant or privileged, or the provision of which would be burdensome, or created solely for an audit. In those circumstances, taxpayers faced with an estimated assessment should consider challenging it as inappropriate and invalid. ✰

*Eric S. Tresh is a partner and Madison J. Barnett is an associate with Sutherland Asbill & Brennan LLP's State and Local Tax Practice. Sutherland's SALT Practice is composed of 29 attorneys who focus on planning and controversy associated with income, franchise, sales and use, and property tax matters, as well as unclaimed property matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.*

---

has the burden to show by clear and convincing evidence that the method was unreasonable or that the amount assessed was erroneous.").

[28]*See SNS Lakeland, Inc. v. Dep't of Revenue*, Dkt. No. DOR 2012-001-FOF (Fla. Div. Admin. Hrg., Jan. 4, 2012) ("DOR must show by a preponderance of evidence that the audit results and the [estimated] assessment . . . should be upheld"); *6 To 12 Store 2, Inc. v. Dep't of Revenue*, Dkt. No. DOR 08-3-FOF (Fla. Div. Admin. Hrg., July 11, 2008) (invalidating an estimated assessment because the department failed to meet its initial burden of proof).