

ARIZONA'S NEW MANAGED AUDIT PROGRAM

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I. *INTRODUCTION.*

The Arizona Legislature has enacted a new program that allows taxpayers under audit to work together with the Arizona Department of Revenue to formulate an audit plan and calculate audit adjustments. The program provides substantial tax benefits to the taxpayer under audit. Managed audit agreements may apply to the entire audit or limit the “managed” portion of the audit to specific issues, transactions, business lines or other categories of potential adjustments. Managed audit agreements are available for transaction privilege taxes, use tax, state excise taxes, luxury taxes, city and county excise taxes, and, after December 31, 2006, for corporate income taxes.

Senate Bill 1171 (2005 Laws, ch. 95) enacted the managed audit program by adding a new Article 7 to Title 42, Chapter 2 of the Arizona Revised Statutes and amending A.R.S. § 42-2059.

II. *MANAGED AUDIT PROGRAM PROCEDURE.*

A. *Definitions.*

A “**managed audit**” is defined as “a review and analysis by a taxpayer or the taxpayer’s authorized representative of the invoices, checks, accounting records or other documents and information to determine a taxpayer’s liability under chapters 3, 5 or 6 of [title 42] or title 43, chapter 11.” A.R.S. § 42-2301(2). Chapter 3 covers luxury tax. Chapter 5 covers transactions privilege tax, use tax, and state excise taxes such as the rental occupancy tax and telecommunications service excise

tax. Chapter 6 covers county and city taxes. Title 43, Chapter 11 covers corporate income tax.

A “**managed audit agreement**” is defined as “a written agreement between the director and taxpayer that consists of an audit plan that requires the taxpayer to review selected revenue, expense and fact records to determine the proper filing method and to calculate the taxpayer’s liability” for the categories of taxes listed above. The term ““managed audit agreement” includes a limited managed audit agreement.” A.R.S. § 42-2301(3).

A “**limited managed audit agreement**” is defined as “a managed audit agreement that is limited in scope to certain periods, activities, lines of business, geographic areas or transactions, including tax on the receipts of certain sales, the value of certain assets, the value of certain items or services and other categories specified in the agreement.” A.R.S. § 42-2301(1). Any managed audit agreement that covers any tax under Chapter 5 (transaction privilege, use, or state excise taxes) shall also cover county excise taxes, which “piggyback” transaction privilege taxes. A.R.S. § 42-2302(D).

B. Application and Approval Process.

The taxpayer must submit an application to convert all or part of an audit to a managed audit. A managed audit agreement outlining the scope and procedure for the managed portion of the audit also must be signed by both the taxpayer and the Department. The agreement must meet all of the following requirements:

- The agreement must contain the taxpayer’s declaration “that all statements of fact in the application and the agreement are true and correct for every material matter.”
- The agreement must specify what the managed audit will cover, which requires identification of “the types of taxes, the reporting periods,” and “any limitations on the scope of the managed audit.”
- The agreement must supply the name of the taxpayer’s authorized representative, if one has been authorized.
- The agreement must contain an audit plan, which must include “procedures to perform the managed audit.”

A.R.S. § 42-2302(A). A managed audit agreement may be modified, but the modification must be in writing and must meet all four of the requirements listed above. A.R.S. § 42-2302(B).

The Department has sole discretion over whether it will enter into a managed audit agreement. It may consider any factors it deems relevant in reviewing a proposed agreement, including the taxpayer’s history of tax compliance, the time

and resources the taxpayer can devote to the audit, the availability and extent of the taxpayer's records, and the nature and scope of any legal dispute with the taxpayer. A.R.S. § 42-2302(C).

C. The Taxpayer May Give Cities and Towns an Opportunity to Participate in the Managed Audit.

If the taxpayer elects to include city and town taxes in the agreement, the Department will notify the cities or towns included in the agreement after the agreement is signed. Any city or town that declines to participate in the managed audit agreement will be prohibited from auditing that taxpayer for forty-two months after the end of the audit period covered by the managed audit. A.R.S. § 42-2302(D). The involvement of a city or town that elects to participate is likely passive in nature, as the statutes authorizing managed audit agreements only permit the Department to (i) review books and records to evaluate the taxpayer's audit findings and (ii) determine whether it will accept or reject the taxpayer's audit findings. *See* A.R.S. § 42-2303.

D. Audit and Appeal: Penalty and Interest Free.

Once the managed audit agreement is executed, the taxpayer will, per the agreement's audit plan and procedures, review its records and calculate its liability for the taxes covered in the agreement. The taxpayer must submit a written report of its findings to the Department. The Department may review the taxpayer's records or undertake other analysis and review to evaluate the accuracy of the taxpayer's findings. The Department will then issue a notice of determination stating whether it accepts or rejects the taxpayers findings. A.R.S. § 42-2303(A)-(B).

If the Department's notice of determination has accepted the taxpayer's findings, the Department will assess the additional tax or issue the refund that the taxpayer has determined is due. The assessment or refund will be made under the Department's normal procedures, except with respect to penalties and interest. A.R.S. § 42-2303(C). Limits on penalties and interest on managed audit findings are as follows:

- No penalties may be assessed on additional tax, unless the managed audit shows that the taxpayer committed wilful tax evasion or fraud or has charged and collected tax without remitting the tax to the state, city, or town. A.R.S. 42-2304(A).
- No interest may be assessed if the taxpayer pays the tax within forty-five days of its receipt of the Department's notice of determination. A.R.S. § 42-2304(B). If the taxpayer appeals, interest may not be assessed if the taxpayer pays the tax due within forty-five days of its receipt of the final decision at the highest level of appeal taken. § 42-2304(B), (D).
- The Department will not pay interest on refunds if the refund is paid within forty-five days of the taxpayer's receipt of the Department's notice of determination, or if the refund is appealed, within forty-five days of the

taxpayer's receipt of the final decision at the highest level of appeal taken. § 42-2304(C), (D).

Taxpayers enjoy the same appeal rights for assessments based on managed audit agreements as they do for any other assessment the Department may make as a result of an audit. A.R.S. § 42-2303(D). Taxpayers may appeal a notice of determination accepting the taxpayer's audit findings and may also appeal a notice of determination that rejects the taxpayer's findings. *Id.* Taxpayers may also enter into a closing agreement to resolve disputes about the propriety or accuracy of an assessment based on a managed audit. A.R.S. § 42-2303(E).

III. *IMPACT OF A MANAGED AUDIT AGREEMENT ON THE DEPARTMENT'S ABILITY TO PERFORM AN ADDITIONAL AUDIT.*

Arizona's Taxpayer Bill of Rights limits the Department's ability to conduct additional audits of the same tax period and type of tax after it completes an audit. Unless the taxpayer files a refund claim or fails to disclose material information during the audit, the only assessments the Department can make after it conducts an audit are limited to city taxes and tax due to a federal tax adjustment. Accepting the findings of a managed audit also prohibit the Department from conducting additional audits on the issues and tax periods covered by the managed audit agreement. The Department may, however, audit issues not covered by a managed audit agreement after it issues a notice of determination accepting managed audit findings. A.R.S. § 42-2059(A).

IV. *EFFECTIVE DATES FOR MANAGED AUDITS.*

Beginning January 1, 2006, taxpayers may apply for managed audit agreements covering all taxes imposed under the Title 42, Chapter 3 (luxury taxes), Chapter 5 (transaction privilege tax, use tax and other state excise taxes) and Chapter 6 (city and county excise taxes).

Beginning January 1, 2007, taxpayers may also apply for managed audit agreements covering corporate income tax.