

Chicago Department of Finance

Tax Audit Process

Audit Overview

There are various ways a business gets selected for audit. The most common are referrals from another division of the Department of Finance, referral from another City Department, information obtained during another audit, referral from another business or competitor, referral from another government agency under an information exchange agreement, selection based on analysis of information contained in a filed tax return or random selection from registered taxpayers.

If a business is selected for audit, the authorized representative of the taxpayer will be contacted by an auditor and audit commencement date set. The auditor will explain generally how the business was selected for audit, however if a referral was made the specifics of the referral may not be divulged. The specific tax types and audit periods to be reviewed will be explained during this initial contact. An audit notice will also be sent denoting the taxes and periods under audit, the date, the time and the location where the audit will take place and taxpayer records and documents that maybe required at the start of the audit.

Many variables affect the time required to complete an audit. Generally, a taxpayer can expect an audit to extend over a three to four-month period with the auditor spending approximately three to four weeks at the audit site in total.

Guidelines for Retaining Records

All business records should be retained for any period for which the Department of Finance can issue a Tax Determination and Assessment, as per the Statute of Limitations outlined in section 3-4-120 of the Uniform Revenue Procedures Ordinance (URPO). Certain exceptions to this rule may apply wherein the municipal code authorizes record destruction if approval is granted by the City Comptroller.

Once selected for audit or during the course of an audit a taxpayer may be asked to sign a consent to waive the statute of limitations waiver allowing the Department additional time to conduct or complete an audit. This occurs when the date when the statute of limitations would run on the department's right to issue a tax determination and assessment is approaching or will pass before the audit is completed. The statute waiver allows the Department additional time to complete the audit and during this time period no additional interest will accrue on any tax liability.

Taxpayer Responsibilities

- **Maintaining books and records**
Every taxpayer and tax collector shall keep accurate books and records of its business or activity, including original source documents and books of entry denoting the transactions that gave rise, or may have given rise, to any tax liability, exemption or deduction. All such books and records shall be kept in the English language and, at all times during business hours of the day, shall be subject to and available for inspection by the Department.

- **Duty to produce documents**

If, during an audit or investigation, any taxpayer or tax collector fails to make its books and records available for inspection to the Department, then the Comptroller may serve written notice by United States registered or certified mail or by personal service on the person being audited or investigated to produce the requested documents within 45 days from the date the notice is received. The Comptroller may extend the 45-day time limit.

If the taxpayer or tax collector fails to provide the documents requested in subsection A of this section within the time so provided, then:

- The Comptroller may issue a tax determination and assessment based on the best estimate of the person's tax liability, or
- The Comptroller may issue a subpoena requiring the attendance of any person having personal knowledge of any relevant facts and may issue subpoenas duces tecum for the production of books, records, papers or memoranda.
- In addition, the Comptroller may issue a citation for each day beyond the 45-day time limit, or extension thereof, that the documents are not tendered and may request the City's Corporation Counsel to bring, or cause to be brought, an action to impose fines for disobeying or refusing to comply with a request made under this section. Fines shall be as provided for in Section 3-4-310 of this chapter.

Audit Process Steps

Step 1: Opening Conference

The actual audit field work begins with an opening conference with the taxpayer's representative. At this conference the auditor develops a thorough understanding of the business' activities, their accounting system and the books and records maintained by the business. The duration and detail of this conference depend in large part upon the complexity of the businesses activities and the volume of detailed records maintained. The information obtained at this meeting will directly affect the direction and extent of the audit approach.

If a business will be represented by an Attorney or Accountant not directly employed by the business, a Power of Attorney form must be executed by an authorized business representative authorizing such individual(s) before the Auditor can discuss specific details of the audit with them.

Step 2: Sampling Methods

After the opening conference the auditor will test the accounting system to ensure that procedures are in place as explained by the taxpayer and he or she will determine those areas which require further detailed testing. The auditor will use his or her best judgment in formulating the audit approach to determine the level of compliance with each tax type under review. Many factors must be considered in determining the best approach.

Factors such as the availability of complete and accurate books and records, volume and materiality of transactions, previous enforcement action with the business and accounting practices of the business all will have a notable effect on the approach. Two basic audit sampling methods used by the Department are judgmental sampling and statistical sampling. Before beginning the review of the books and records, the auditor will present the taxpayer with an Audit Method Election Form outlining the audit approach they have selected.

Judgmental Sampling:

The majority of the audits conducted by the Department are done using a form of judgmental sampling whereby the auditor identifies and reviews test periods from within the audit period and the results from these test periods are extrapolated over the remainder of the audit period. This technique involves the auditor judgmentally selecting periods or sequences for review (months, quarters, weeks, days or sequences of invoices) and reviewing all items in that sample period or sequence. This approach is slightly less accurate however the costs associated with performing this type of test are significantly less to both the taxpayer and the City than those of a statistical test. The most important factor with such a sample is to select a sample period which is representative of the entire audit period.

Statistical Sampling

This approach requires significantly more time and effort than judgmental sampling; however, it will result in a more accurate result. Obviously a statistically valid approach is the preferred methodology. However, certain conditions must exist for this approach to be followed. Most important, complete and accurate books and records for the entire audit period must be available. For an audit to be statistically valid, every transaction must have an equal chance of being selected. Generally this presents a tremendous burden on a business and statistical sampling may not be the best method. If complete and accurate records are available the auditor should seriously consider the feasibility of performing a statistical test, particularly if a taxpayer prefers such an approach. Despite the accuracy resulting from a statistically valid test, the burdens and costs associated with such a test usually outweigh the benefit.

Step 3: Audit Method Election Form

Before beginning the review of the detailed information, the auditor will present the taxpayer with an Audit Method Election Form outlining the audit approach they have selected. The auditor will also solicit that taxpayer's opinion on the audit approach selected or any possible alternative. The taxpayer's concerns are either incorporated into the approach or reasons why they cannot be provided. The taxpayer and the auditor then sign off on the form confirming that we explained the approach. If the taxpayer refuses to sign the form, the audit supervisor must review the audit program and election form to determine what, in their judgment, is the best approach. The audit will then proceed based upon the supervisor's decision. In these cases, after the detailed audit work has been completed, the supervisor will again consider all factors influencing their decision to confirm that the approach was sound. If anything occurred which would render the test non-representative or unreasonable, further testing may need to be done. Occasionally an actual review will be the best or only way to determine the level of compliance with a tax ordinance; in these cases an audit method election form is not required.

Step 4: Closing Conference

Pursuant to section 3-4-150 F. a closing conference takes place after the audit has been completed and the audit file has been reviewed and approved by the audit supervisor. A closing conference will generally be held 20 calendar days prior to the issuance of a notice of tax determination and assessment by the Department of Finance.

At the closing conference the taxpayer will be provided with a complete copy of the audit file and a Report of Field Collection of Audit Determined Liabilities. The auditor will go over the workpapers with the taxpayer and answer any questions they may have. The only exception to this is taxpayers located out of the area where the copy of the file and Report of Field Collection are sent by certified mail. The closing discussions take place via telephone after the file has been reviewed by the taxpayer's representative.

There are two possible ways the audit file can progress:

1. The taxpayer will be given an opportunity to close the case out by signing off on a Report of Field Collection of Audit Determined Liabilities, signing all tax returns that were due during the audit period and remitting the full amount of tax and interest computed due within twenty days of the closing conference. All applicable penalties are waived under the Field Collection Report.

If a taxpayer has additional information which would impact the results of the audit or they identify an error in the file the twenty days may be extended and those adjustments will be made. At that time, revised tax returns will be generated. The taxpayer will then be expected to sign the Report of Field Collection, tax returns and make the required remittance immediately. If a taxpayer needs additional time to comply with the terms of this offer, those requests should be directed to the Audit Supervisor or Manager. When resolving any audit determined liability via the Filed Collection process two requisites must be addressed;

- i. The taxpayer must compute and file amended returns for any periods subsequent to the audit period where liability exists or provide an acceptable explanation as to why no additional liability exists for that tax type. If the taxpayer has implemented corrective procedures to address the areas of liability before this agreement, a Post-Audit Compliance Affidavit must be filed explaining those corrective measures taken.
 - ii. The taxpayer must have resolved any non-tax debts due the City of Chicago.
2. If the taxpayer disagrees with the audit findings or refuses the Report of Field Collection offer, a Notice of Tax Determination and Assessment is issued which will include all applicable tax penalties. The taxpayer then has thirty-five days from the date they receive the assessment to file a written protest and petition for hearing. A copy of the protest form, the Department Administrative Hearing rules and a taxpayer's statement of rights are provided to the taxpayer at the closing conference. The statement of rights outlines the rights of taxpayers and tax collectors as well as the obligations of the department as they relate to the tax determination and assessment that was issued.

Step 5: Settlement Process

When a protest form is filed timely, prehearing conferences and hearing dates are scheduled by the Department of Administrative Hearings. In the pre-hearing conferences, informal discussions are held on any relevant issues including any proposed corrections to the assessment, reasons for waivers or compromises and all other matters relating to the possible settlement or resolution of the assessment.

If a taxpayer is unable to pay its tax assessment in a lump sum or is experiencing financial difficulties, they can request a payment plan or file a financial hardship application with the Department of Revenue Financial Hardship Committee via the City Comptroller's Office. The standard terms of a payment plan require a 30% down payment with a 12-month term. Payment plans include the accrual of interest on the outstanding tax balance at a rate of 12% interest per annum.

Step 6: Taxpayer Audit Evaluation

At the conclusion of an audit with the Chicago Department of Finance, the taxpayer will be provided an Audit Evaluation Form and offered an opportunity to provide feedback on the audit process and Department personnel. The taxpayer comments on the Audit Evaluation Form will be utilized by the Department to evaluate its operations and will have a direct impact on future audits.