



# Reverse Audits

## An Opportunity To Recover Overpaid Sales and Use Taxes

### EHTC State and Local Tax Services

#### INCOME & FRANCHISE TAX

- Tax Minimization Studies
- Business Structure Reviews
- Allocation and Apportionment Planning
- Combined, Consolidated, & Unitary Planning
- Nexus Studies
- Amended State Tax Returns from IRS Audits
- Single Business Tax Training

#### SALES & USE TAX

- Reverse Audits
- Compliance System Review
- Direct Pay & Compliance Agreements
- Exemption Certificate Documentation
- Industrial Processing / Manufacturing Exemption
- Utility Studies
- Nexus Studies
- Sales & Use Tax Training
- Transportation Company
- Procurement Company

#### PROPERTY (AD VALOREM) TAX

- Real Property Tax Reviews
- Personal Property Tax Reviews

#### TAX AUDIT & APPEALS

- Sales & Use Tax Audit Defense & Appeals
- Income & Franchise Tax Audit Defense & Appeals
- Property Tax Audit Defense & Appeals
- State and Local Tax Litigation Support
- Merger & Acquisition Due Diligence Reviews
- Voluntary Disclosure

#### BUSINESS INCENTIVE SERVICES

- Business Relocation & Expansion Services
- Tax Credits, Exemptions, & Abatements
- Grants, Financing, & Infrastructure Assistance

The reverse sales and use tax audit is similar in many respects to the sales and use tax audits conducted by state auditors except overpayment of taxes are researched on a reverse audit. EHTC has several tax advisors on its staff. These tax professionals now perform Reverse Audits in much the same way the sales and use tax audits are performed. The following is a discussion of why a reverse audit is advisable and how EHTC approaches the reverse audit.

### Why a Reverse Audit is Needed

Several factors may cause a situation where sales and use taxes may be overpaid. In many states the field auditors have become very aggressive in assessing tax, penalty and interest. This environment has caused the retailers and suppliers to be aggressive in charging sales tax to avoid a sales tax audit deficiency. Often, sales tax is charged even when the sale would be exempt. Other times they will inappropriately charge the tax because of no exemption claim or an invalid exemption certificate was submitted. Either way the purchaser may pay tax to the supplier that is not legally due.

An inadequate sales and use tax compliance system will allow tax to be paid in error. When working efficiently, the compliance system will provide reasonable assurance that exemptions have been claimed and that all tax is properly billed and paid. However, in many companies the compliance system is not operational. Business expansion, downsizing, and employee turnover are causes of compliance system failures. A compliance system failure can result in overpaid taxes.

Normally it is the responsibility of the purchasing function to make a claim for exemption (resale, industrial processing, non-profit, and government). If this is not done either through miscommunication or negligence, the supplier will normally charge the tax. If an invoice is presented for payment that includes tax, the accounts payable department should omit the tax if the purchase is exempt.

### How a Reverse Audit is Performed

The first step in a reverse audit is to perform a complete study of the business activities of the client. It is very important to identify and understand the manufacturing, warehouse and retail locations of the business, the product lines, and how the business pays sales and use tax. It is important to determine what exemptions may apply to their business. For the manufacturing location, it is important to identify where the manufacturing process starts and ends to take advantage of the industrial processing exemption. For warehouse and retail locations, there may be exemptions for certain processes.



# Reverse Audits (Continued)

## About EHTC

Echelbarger, Himebaugh, Tamm & Co., P.C. (EHTC), a professional corporation was established in 1977 by Dennis M. Echelbarger. Since that time, our Firm has grown to become one of the largest, most successful, local accounting firms in the Greater Grand Rapids, Michigan area, and we are a recognized leader in the business community. Our success is based on building partnering relationships with our customers. We are large enough to serve a wide diversity of customers but small enough to maintain personalized attention.

EHTC's professional team is highly trained to provide technical and consulting services in the areas of accounting, taxes, and strategic planning to nonprofit, profit and service organizations and related entities.

Minimizing your tax liability requires careful, advance planning rather than preparing tax returns as deadlines near. Our tax professionals provide complete tax services and are assisted by our extensive tax library and the latest technology.

We pay careful attention to your unique circumstances such as your current requirements and your plans for the future. We then recommend a plan that best suits your needs while minimizing financial risk.

The second step is a complete study and evaluation of the sales and use tax compliance system. The sales tax compliance system is analyzed in order to be familiar with the process of issuing sales tax on the clients' invoices. The purchasing function is analyzed to obtain a deep understanding of how purchases are made and approved. A sample review of invoices is traced from the purchasing function through the payment and accounting for the acquisition. Particular attention is paid to the sales tax and use tax compliance function. The use tax compliance function is thoroughly analyzed to ensure a complete understanding of the process. During our review, we will look for weaknesses in the system that may allow for the overpayment of tax. Oftentimes a sample review of invoices will be made in order to identify adherence to company policy.

After the review of the business, the purchasing function, and the sales and use tax compliance systems are completed; a reverse audit work plan is prepared. The work plan will require the review of purchase invoices based on the compliance review where we have determined that there is a high probability for the overpayment of tax. EHTC employs the latest state of the art computer database analysis software to assist in analyzing purchases where tax may have been paid in error. The computer database analysis software can identify the entire population of purchase invoices and then stratify it by amount, account numbers, and vendors. The software can then identify invoices to be reviewed. Other invoices can be selected at random as part of a scientific statistical sample.

A review of the invoices will be completed to determine which invoices may have been erroneously remitted with sales tax. Procedures are then followed to recover the overpaid sales and use tax from the vendors and the state.

## Final Report and Recommendations

After the reverse audit is completed, a written report is provided. The report identifies the audit procedures followed to recover overpaid sales and use taxes and the findings. Weaknesses found in the sales and use tax compliance system and recommendations to improve the systems are included in the report.