



White Paper

Tips to Survive a Sales Tax Audit



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Overview

Sales and use tax audits are performed on companies of all shapes and sizes. Just because a business is not registered for sales and use tax purposes doesn't mean they aren't a prime candidate for an audit. In fact, unregistered businesses might be a better candidate for a sales or use tax audit.

Understanding the audit process is critical to your ability to minimize your audit risk and liability. This guide will outline the steps you should take prior to an audit notification, suggest ways to manage the audit process, and explain the options available to you at the conclusion of the audit.

Audit Selection

Companies are selected for audit by states for a number of reasons, the most common of which is the result of an audit of a customer. When auditors review the vendor invoices to identify sales or use tax liability, they frequently discover invoices where sales or use tax was charged incorrectly or not at all. These vendor invoices can be the basis for the auditor's next sales and use tax audit with that particular vendor.

Other circumstances which can give rise to an audit include:

- **Refund Claims** - The larger the refund claim, the more likely you are to be audited. Under the guise of approving a refund, states will customarily conduct a full audit of a taxpayer in an effort to both validate the refund claim and reduce the amount of the claim. The economic climate within the state can be a factor in the likelihood of an audit pursuant to a refund claim. The complexity of the refund claim can also be a contributing factor. Similarly, an amended return or series of amended returns could lead to an audit.

A refund claim will not necessarily trigger an audit. The smaller the refund or the less complex the refund, the less likely an audit will ensue; i.e. a sale to an exempt government agency where tax was charged in error.

- **Industry Focus** - Some jurisdictions will identify an industry for audit. This could be the result of recent legislation, a recent ruling, or trends identified during prior audits. Examples could include:

- Jewelers/Art Dealers drop shipping product out of state
- Industry trends – i.e. software as a service (“SaaS”) where the taxing rules are complex, reusable shipping containers used in manufacturing, or mobile refrigeration units.
- Disgruntled Employee or Competitor - Most states provide “hotlines” where someone can identify a taxpayer who is in violation of the law or a regulation – on an anonymous basis. Whether or not you are fully compliant with the sales and use tax laws, a disgruntled employee, former employee, or competitor could cause an audit.
- Prior Audit History - If you’ve experienced significant liability under a previous audit, you are very likely to be selected for audit on a cyclical basis.
- State Associations – In some cases, states will share information with each other. Typically, this is done via an association or organization of states. There are at least four state associations as follows:
 - FTA – Federation of Tax Administrators
 - SEATA - Southeastern Association of Tax Administrators
 - NESTOA – North Eastern States Tax Officials Association
 - MSATA – Midwestern States Association of Tax Administrators

If you are audited, the audit period is governed by the statute of limitations in the particular state. The statute of limitations applies to a taxpayer who is registered and filing timely sales and use tax returns. In most states the statute of limitations is three years. However, some states have a four or five year statute of limitations. If you are not registered and filing sales tax returns, there is generally no limit to how many years in arrears a state can assess sales and use tax. There is no statute of limitations on sales or use taxes collected and not remitted to the state.

During the Audit

Managing an audit should start well in advance of any scheduled audit. You should establish a process and documentation protocol that will

survive turnover in compliance personnel. A lack of documentation will result in an auditor deciding how best to calculate your liability rather than the facts.

All taxpayers should maintain a thorough audit trail for all taxes charged, reported on a return, and paid to a jurisdiction. In many scenarios, sales tax is a form over substance tax – meaning, if you don't follow the required documentation protocol, an otherwise exempt transaction could become taxable under audit.

Pre-audit Planning – Once a taxpayer is contacted for audit, the taxpayer should evaluate its record availability for completeness and accuracy. Determining the potential risk prior to the audit will enable the taxpayer to address sampling/projection options with the auditor. The various sampling and projection methodologies are covered later in this document.

When a state schedules an audit of a taxpayer, there are a host of sales and use tax related records requested of the taxpayer. Examples include:

- Sales tax returns
- Federal income tax returns
- General ledger
- Fixed assets
- Sales journals
- Purchase journals

Knowing which pieces of documentation to provide and when to provide them is important. Providing a flow of information to the auditor indicates your willingness to work with them. However, you may choose to delay providing certain documentation and wait for the auditor to ask for that documentation again before providing it. Sometimes the auditor will be satisfied with what you have provided and will not ask for the documentation again.

Process Review/Outline – You should provide the auditor with a clear understanding of your sales and use tax process. Keep the audit focused on the core activities of the business where sales and use taxes are well managed. Having a prepared outline of the process will keep you focused on the core sales and use tax compliance process. The less you say, the better – stick to just the basic answers to the auditor's questions – don't elaborate.

Managing the Audit-“or” - Managing the relationship with the auditor can be as important as the documentation provided. Don't treat the auditor poorly. Align the auditor with ONE person from the organization for all questions and requests – keep the message consistent and controlled. Don't leave the auditor alone in an environment with access to other

documentation or employees. Engaging a third party to manage the audit could be beneficial in this situation if the third party is able to host the audit in their office so the auditor does not set foot in your office. Provide good data quickly, bad data in pieces or delay and hopefully the auditor will ultimately forget or find the information unnecessary. Asking the auditor questions can be a good thing – just not “whether something you didn’t charge tax on is taxable”.

Many sales and use tax audits involve a sample and projection. You should understand your sales and use tax history before agreeing to any sampling method. In conjunction with the sampling method, you should also agree on the projection method. States are historically good at selecting the sample but often unfairly and unintentionally project the results of the sample. A statistical sample can be just as effective as a “block” sample (a block sample is typically the selection of a single month or quarter of activity) depending on the nature of the business/sales.

In some states you are required to sign an agreement to the sample and projection method prior to a review of the records. If you are not experienced with sampling and projection techniques, you should engage a third party resource to review the method or methods proposed by the auditor.

Audit Mitigation

Depending on the state and the auditor, you will likely be presented with work papers reflecting the initial results of the audit. It is very common for this initial set of work papers to include a significant number of items which are exempt from sales or use tax. Once presented, the auditor will typically provide the taxpayer with a period of time to review and present arguments to mitigate the items assessed. This period of time can be negotiated but is usually two to four weeks.

In addition to taxable sales or purchases on which sales or use tax was not paid, a typical set of work papers will include items that are exempt or excluded from sales or use tax. The exempt status of these items might not be evident to the auditor based on the documentation available to him or her during their review. These items can include:

- Sales for resale – where a resale exemption certificate was not available to the auditor

- Sales in interstate commerce – shipped by common carrier to a customer in another state
- Sales or purchases of services (which are excluded from sales or use tax)
- Purchases of raw materials – to be incorporated into products for resale

Documentation supporting a transaction which is exempt or excluded from tax should be provided to the auditor during this work paper review period. Supporting documentation can include:

- Resale certificates
- Shipping documents/bills of lading
- Description/explanation of item sold or purchased

In some cases, taxable sales are assessed where the customer has already paid the sales or use tax directly to the state either voluntarily or under audit. In these circumstances, a signed affidavit (sometimes referred to as an “XYZ Letter”) from the purchaser can be provided to the auditor in order to have the item removed from the work papers.

The audit can be somewhat of a negotiation – meaning that there are usually gray areas which can be negotiated out of the audit. Negotiating with auditors is something that starts at the beginning of the audit. Establishing a rapport with the auditor during the initial audit conference and managing the audit relationship throughout the document review process can be beneficial at the end of the audit when there are items which aren’t clearly taxable or exempt.

Once the audit is deemed complete by the auditor, a final assessment is presented to the taxpayer. Penalties and interest are assessed on any tax due. In some states the auditor makes the recommendation on whether or not to waive or reduce the penalties. In most states, the taxpayer is required to request in writing an abatement of penalties. Whether or not penalties are abated will depend on a few factors as follows:

- Did reasonable cause exist (this can be a lofty standard in some states – i.e. the death of an employee responsible for sales and use taxes)
- Audit history
- Perceived level of negligence
- Size of the assessment
- Complexity of the issues

Once the final assessment is issued, the taxpayer has a few options depending on the state. Options in response to final assessment can include:

- Request an meeting with Supervisor
- Informal protest letter to the Department
- Informal hearing with the Department
- Formal hearing with the Department (this may require legal representation)
- Appeal to the Courts
- Payment/settlement options (offers in compromise)

Depending on your level of comfort and knowledge specific to the sales and use tax process, you may want to consider engaging third party representation for any audit. Engaging a resource could include getting advice during the course of the audit as needed, having the work papers reviewed, protesting the audit findings or outsourcing management of the entire audit process.

Furthermore, if you find you have undisclosed sales or use tax liability, there are options for coming into compliance rather than waiting for an audit. Most states offer a Voluntary Disclosure Agreement (VDA) which allows an unregistered taxpayer to disclose prior period liability in exchange for a waiver of penalty and a limited look back period.

Regardless of whether you enter into a VDA or not, the best strategy related to managing a sales tax audit is that you should expect one to occur. Expecting an audit to occur will lead you down the path of being prepared by documenting the process, establishing an audit trail, and securing exemption certificates when appropriate.

About the Author

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Sales and use tax is a passion for Jeff Meigs, and has been a key component of every stage in his career. Jeff graduated from North Carolina State University and started his career with the North Carolina Department of Revenue. Soon after, he honed his state and local tax skills as a manager for Ernst & Young, and later as a Senior Manager for KPMG. Jeff was a key leader in GE's sales and use tax department where he helped provide direction in one of the most unique sales and use tax environments in the country. Eventually, Jeff was recruited by Tax Partners where he was the VP of Client Services, and later ran their Consulting activity after the Thomson Reuters acquisition. Jeff was recruited by TaxConnex in 2010 to lead the consulting practice, while also helping to provide world class sales and use tax advice to the emerging mid-market client base.

About TaxConnex

TaxConnex is a sales, use, and telecommunications tax consulting, advisory and outsourcing firm. We provide our services to businesses of all sizes with a focus on small to mid-market companies, telecommunications firms, and companies that are underserved by a one-size fits all sales tax outsourcing arrangement. Our services are customized for each client and delivered by our skilled and expertly trained practitioners.



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