THE ULTIMATE GUIDE TO FIGHTING YOUR SALES TAX AUDIT

The perfect resource for the beginner to advanced tax professionals looking to learn new sales tax audit defense skills or sharpen existing ones.

State Governments are Insatiable.
Sales Tax is a Major Source of
Revenue in Most States. Somethings
Gotta Give. Usually It's the Taxpayer.

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The Ultimate Guide to Fighting Your Sales Tax Audit

The Ultimate Guide to Fighting Your Sales Tax Audit is for business owners and professional tax advisors that want to minimize the total cost of a sales tax audit for themselves or their clients.

Read it now to learn how manage your sales tax audit without the false starts and missteps that come with doing it alone. When it comes to the odds of being audited for sales tax, it's not if, it's when. So it's best to be prepared for the experience.

Most executives and business leaders understand that businesses get audited for sales and use tax, but only a small percentage are aware of the material impact to their company should a state auditor come knocking on their door. Unless you've been audited in the past, you might not know why certain businesses are targeted, what the most common types of errors auditors look for, and most importantly, how much it might cost the business.

Fun Fact: The word "audit" is derived from a Latin word "audire" which means "to hear". In a certain sense, the auditor is there to give you a "hearing".







A sales tax audit occurs when a state agency inspects the books and records of a company specifically evaluating the correctness of sales tax paid on invoices and use tax accrued on invoices. Sales tax paid on invoices can occur in two areas:

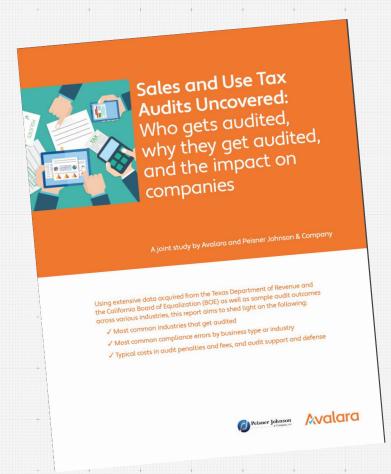
- Sales tax paid on invoices for company purchases; and
- Sales tax charged and collected on invoices for company sales.

This *Ultimate Guide* is meant to assist you in handling the audit and in keeping the assessment to a minimum. We do not advocate evading taxes that are legally due and we don't see auditors as your enemy or ours. We do understand the sales tax audit process very thoroughly and through our experience in handling hundreds and hundreds of audits, we know how state auditors work. We've worked for companies with revenues of less than \$1 Million to companies with revenues of over \$100 Billion. We've saved our clients over \$61 Million in audit assessments. That means our clients were overassessed in the first place by \$61 Million.









You can learn a lot from a joint report we did with Avalara called: "Sales and Use Tax Audits
Uncovered: Who gets audited, why they get audited, and the impact on companies".

Like:

- What companies get audited and why?
- What are the common errors by key industries?
- How costly are sales tax audits?

Here are some key findings from the Report:

What Companies Get Audited and Why?

Sometimes it's a case of bad luck, but as the data suggests, companies are most often not selected at random but evaluated by a number of factors, which include:

- Industry
- Past audit history
- Volume of sales a company reports to the state
- Volume of exempt sales claimed
- Ratio of exempt sales to total sales







Most of these factors might seem obvious. Companies with a history of negative audits usually get targeted until the audits no longer produce results for the state. High revenue companies, on the other hand, find themselves in a perennial audit whereby any number of auditors from multiple state agencies set up residence at their headquarters, even if they're meticulous with their compliance processes. It's also not surprising that companies that report a high ratio of exempt sales to total sales raise a flag, especially if that ratio isn't consistent with their industry peers.

What's less evident to most people is the first criteria: Industry. This factor seems to be accounting for more and more audit activity across the U.S. and doesn't show any signs of slowing down. Here's why.

Targeted industries – error prone or opportunity for the state?

Certain industries tend to put themselves at risk of an audit in two ways. One is based purely on how the industry operates: For example, bars, restaurants, grocery and liquor stores are all cash-based businesses, and auditors are all too aware of how cash goes unreported. However, while cash-based businesses routinely put themselves in compliance risk,







the effort to find the errors might be too high for many auditors to even bother investigating, especially if it's a small operation.



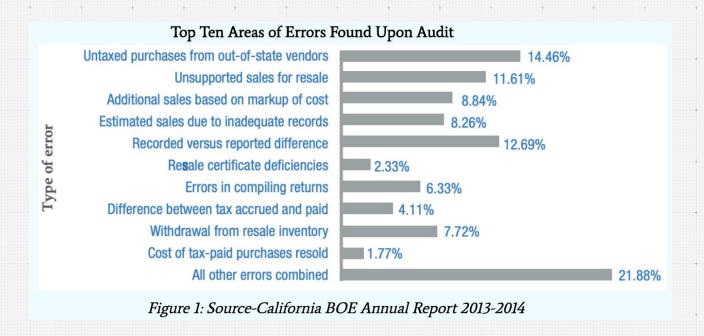
The other main reason certain industries get targeted is that historically they don't adhere to state and local sales and use tax regulations, which are complex, ever-changing, and require a lot of research, and due diligence on the part of the company's accounting, and finance teams. There are many ways a company can make a mistake in their compliance, but as the data from the California BOE indicates, the following account for the majority of errors (see Figure 1):

- Untaxed purchases from out-of-state vendors
- Unsupported sales for resale

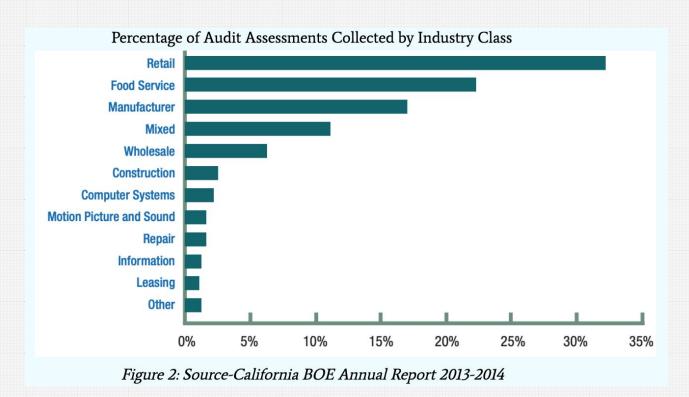








In the 2013-2014 fiscal year (according to the CA BOE report), the top three industries (see Figure 2) found to have large assessments were Retail, Food Service, and Manufacturing.



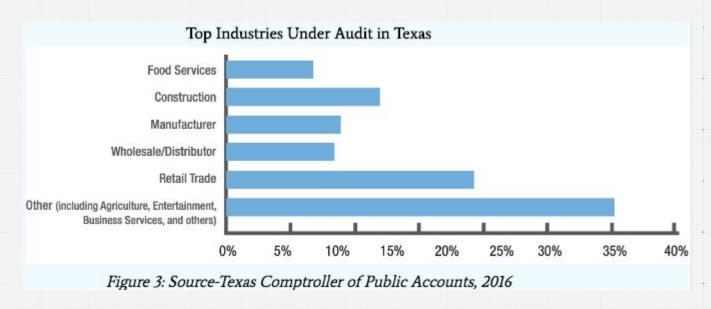
The Ultimate Guide to Fighting Your Sales Tax Audit







Interestingly, the data told a slightly different story in Texas. While retail and manufacturing remained high as in California, Texas also targeted the construction industry and wholesale/distributors (see Figure 3).



Basically, it boils down to this: the State views everything you buy as being subject to tax. In other words, you're guilty until proven innocent. We all know not everything is taxable, but you have to be able to prove all of that to an auditor. Your best bet is to keep the auditor from scheduling items in the first place. It's easier to keep> it off the auditor's schedules than to get it taken off later.

In many cases, using an expert advisor to help will ensure you get the best results. And if you decide to seek outside help, we hope you'll consider Peisner Johnson. However, it's also possible for you to handle much of this process yourself. Here's a breakdown of the chapters in this Ultimate Guide.







01

What To Expect From a Sales Tax Audit and What to Do NOW to Prepare

First, don't be shocked that you're being audited! You should expect a sales tax audit if you sell to customers in other states. You may even be audited by another state before you get audited by your own. In fact, the odds of getting audited by more than one state are pretty good. This is because of the expansion of "nexus", especially in light of the Wayfair decision by the US Supreme Court in June, 2018. States are setting up audit offices all over the U.S. to conduct audits on companies that now have nexus in their state.

Data from the Texas Comptroller also supports this claim, as one-third of their audits are conducted on businesses located outside of Texas. Research also indicates that Texas has a total of 595 auditors with 78 of those permanently based out of state.

Second, if/when you are audited, don't be surprised at how much it costs. According to information <u>published by Avalara</u> based on a survey of over 400 U.S. finance and accounting professionals across several industries, ranging from ecommerce, to retail to manufacturing, found that a sales tax audit costs on average \$114,147.







02

How Far Back Can a State Audit You (or What is the Sales Tax Audit Statute of Limitations)?

In this chapter, we will highlight the statute of limitations for various states and a corollary issue of just how long you should retain your sales tax records.

Chapter

03

Sales Tax Audit Sampling: Here's What You Need to Know

In this chapter, we will highlight the statute of limitations for various states and a corollary issue of just how long you should retain your sales tax records.

Chapter

04

The Sales Tax Audit Process: What to Do Once the Audit Fieldwork Begins

Not knowing what the process is with a sales tax can add to the stress for sure. But not knowing how (and WHEN) to deal with the auditor can lead to over-inflated assessments.







05

The Best Sales Tax Audit Defense is a Good Offense (Sales Tax Refunds)

Some people seem to get a little uncomfortable with the terminology of "fighting" an audit. Some prefer to call it "sales tax audit defense". Either way you refer to it, I can assure you the state auditor has one major objective when they audit you: get the most money out of you with the least amount of work possible. Sorry if that sounds a little too harsh, and maybe there are a few auditors out there who aren't this way, but if there are, we haven't met them.

By the time you get to this chapter, we've already talked about what the audit process is like and how to negotiate with the auditor, with tons of tips. Now we're going to talk about going on the offensive. Since the focus in many audits is on how much tax you will owe rather what refunds might be due. So it's a great idea to do a refund review to determine if there are opportunities for refunds.

You know the old saying: "sometimes the best defense is a good offense". That's where refunds and overpayments come in. Overpayments can arise in many different situations. For example, in many states there are sales and use tax exemptions for machinery and equipment directly used in the manufacturing process. That's just one area where refunds could exist, there are many others that we discuss in this chapter.







06

Protesting Your Audit Results: At Least You Should Request a Waiver of the Sales Tax Audit Penalties

If you don't agree with any aspect of the audit, there are many levels of review and appeal that you can pursue. Protest procedures vary from state to state, ranging from simple to complex. A few agencies allow only one level of administrative appeal before compelling you to pursue their cases in court. Most tax agencies provide two levels of appeal, although one is generally an optional informal conference. A few states provide three levels, and some also offer alternative dispute resolution or settlement programs outside the usual administrative appeal process.

You have to be very careful in this phase of an audit that you don't compromise your rights to sue in court at a later date, should you so choose. Some states, however, require you "to exhaust all administrative remedies" before proceeding to court. So you have to know what your "administrative remedies" are.

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Special Situation: Help With Texas

No Sales Ta

Sales Tax Audits

Data from the Texas Comptroller indicates that one-third of their 4,252 audits in progress are being conducted out of state. Research also shows that Texas has a total of 595 auditors with 78 of those permanently based out of state. Texas is one of the most aggressive states when it comes to auditing for sales tax. There are some unique aspects to audits done by Texas that you need to be prepared for. We'll discuss those in this chapter.

Chapter

Review: Sales Tax Audit Checklists

08

Here's where we put all the checklists and charts in one handy, quick reference section.

Chapter

What's Next?

09

A sales tax audit is no stroll in the park. You need to invest the proper efforts internally or seek outside help. Defending businesses against a sales tax auditor is a highly specialized area of consulting. Over the years of working with clients to minimize the tax assessed against them we have gained invaluable experience and it's our pleasure to share it with you. Whether you use this information to manage your audit completely start-to-finish or to at least gain some familiarity with the process to know how to avoid common pitfalls, then it will have been very valuable indeed.

Chapter One

What To Expect From a Sales Tax Audit and What to Do NOW to Prepare







What to Do NOW to Prepare



First, don't be shocked that you're being audited! You should expect a sales tax audit if you sell to customers in other states. You may even be audited by another state before you get audited by your own. In fact, the odds of getting audited by more than one state are pretty good. This is because of the expansion of "nexus", especially in light of the Wayfair decision by the US Supreme Court in June, 2018.

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PRE-Audit Process

First of all, let's review the PRE-audit process: The audit actually starts before the fieldwork begins.

Notification Letter

This will be your first contact with an auditor. The letter says you have been selected for an audit. Accompanying the letter will be a questionnaire requesting information about the company.

This is a standard part of the process. It will not do you any good to delay responding or to be incomplete in your answers.

TIP ► We recommend you respond completely and accurately within a reasonable period of time. There is no need to rush, however.







Appoint your "Audit Coordinator"

The more pre-audit review and planning you do, the better the prospects for a favorable outcome. No one likes audit surprises and they should be minimized wherever possible. As soon as you are notified of an impending audit, you should appoint your "Audit Coordinator" (AC). This person should have a strong knowledge of sales and use tax laws and procedures. If nobody within the company qualifies, you should consider engaging an outside sales and use tax advisor to manage the audit process.

The AC's first task will generally be to obtain and review any previous sales tax audit reports and work papers. Unless state procedures have changed, or the business processes have changed significantly, the current auditor will probably follow the same approach as was used in the prior audits. This knowledge will help the AC to identify the necessary supporting data, alert relevant company personnel, and, if necessary, begin locating documentation from vendors and customers.

If there have been significant changes, or there was no previous audit, the AC must assess potential exposure based on his or her knowledge and experience. This may be accomplished by investigating the areas where significant errors are most likely to have occurred.







This is where a "pre-audit investigation" comes in. Such an investigation generally should include discussions with appropriate company personnel along with review and spot tests of records and supporting documents. This will help the AC as they negotiate audit parameters and test procedures before the audit begins.

FAQ ► Why should we do a self-audit before the audit begins?

It's better to find and correct errors before the audit even starts. You shouldn't think of a sales tax audit as the opportunity to correct errors. By correcting such items internally, the company saves money in interest, penalties, consulting fees and time. The quicker an audit is resolved and closed out and the fewer mistakes found, the better for the company.

FAQ ► What are the 4 most important areas to review in a self-audit?

In a self-audit, the emphasis of your review is to identify lapses and breakdowns in procedures that could result in additional assessments by an auditor. On the next page are the four areas you should review before the audit starts.







- **Nexus.** (Make sure you know where your company had nexus, that's the first step.)
- ☐ **Fixed Assets.** (Review your fixed assets to determine if tax has already been paid on items delivered and used in the state auditing you. Make sure you have the documents to prove tax was paid. Consider creating a fixed asset folder with copies of all invoices, journal entries, project requests and approvals. Keep all documentation that will support a tax exemption if one was taken.)
- Use Tax Accruals and Sales Tax Payable Account. (Make sure that you can easily reconcile your sales/use tax payable accounts. It's very simple for a sales tax auditor to simply say that any unexplained debits to this account are automatically assessed unless you can prove that they shouldn't be. It's best to keep the accounts reconciled on a regular basis because years down the road when the auditor is in the building, reconciliation can be nearly impossible.)
- Exemption Certificates. (For each non-taxed sale you make, a valid exemption certificate from your customer must be on file. You should do a sample review of non-taxed sales transactions in a prior period just to see where you stand. You may find that you're in good shape, or you may also find that immediate attention is necessary in preparation for an audit.)







FAQ ► What is a good, on-going tax system we should have in place to minimize future sales tax audit assessments?

Ideally you have designed, implemented, and documented (in your company tax manual) a good system for identifying, recording, and processing any tax liabilities.

Your system should be regularly tested and adjusted where necessary to accommodate business, technology, and tax law changes. That's the ideal world, your results may vary, but this is what you're striving for. In any sales tax audit, documentation is critical. A company tax manual can serve not only to remind your team of the periodic tests that need to be done, but also help the team remember to document audit trails, record retention policies, and as a training aid for new staff. In addition to a reliable and dependable tax system, there are specific tasks that should be done periodically.

For example, you should have a plan and schedule to:

Regularly review the minutes of the Board of Directors and executive committee meetings to identify and plan for significant plant expansions, purchases, contractions, or company reorganizations;







- Periodically review of exempt and resale exemption certificates to ensure that they are complete and in proper form.
- Periodically review company depreciation schedules for any "big-ticket" items will ensure that sales/use tax was either paid or use tax accrued on the purchase (assuming it was taxable).
- ❖ Document tax positions taken on gray or ambiguous areas of the law while memories are fresh. The memos and supporting statutes, regulations, and cases should be stored in a permanent file.

In your permanent files, you should keep a company tax audit log that tracks the following information:

- Legal entity being audited
- Audit period
- The state that is being audited
- Auditor name and contact information
- Initial audit assessment
- Final audit assessment
- Notes discussing the largest items identified under audit and other areas in which improvement is needed to reduce future tax liabilities







FAQ > Should we do a refund/tax credit review before an audit, and if so, how do we go about it?

Many companies perform refund reviews and self-audits in anticipation of a state audit. In a refund review, the focus is upon identifying overpayments of tax. It is your responsibility to make sure all refund claims are claimed; you can't count on the auditor to do this for you. By performing a refund review, you will be in a position to offset any audit deficiency with a refund claim. (We discuss this more in detail in Chapter 5.)

More on Your Audit Coordinator

The AC should not only understand the business but they should also know who to go to in the company for information. The purpose of having a single contact person is not to mislead the auditor, not at all. Rather, it is to facilitate the information gathering process so that the auditor is satisfied they are seeing everything they need to see to make their judgments. Many times a well-meaning AC says the wrong thing out of ignorance – ignorance of the company's business practices, and/or ignorance of how those practices could be viewed by an auditor. A company can lose credibility with an auditor by failing to give accurate information the first time. Every time the story is changed the more suspicious an auditor gets. And that suspicion could be totally unfounded. A loss of credibility translates to high assessments and lots of extra time working on an audit.







TIP ► The AC should meet frequently with the auditor to review their tentative list of errors found and to get answers taken care of as quickly as possible.

TIP ► The AC should be thoroughly familiar with particular state's sales tax law and the policies of their Department of Revenue as they relate to your company.

FAQ ► Isn't the auditor supposed to educate us about the law?

We hear this a lot. And some auditors say that's what they do, but you don't want to make this assumption. Auditor's are sometimes misinformed about their own law and many times they are not aware of recent cases that have changed how the law is applied.

TIP The auditor has deadlines and is working with other taxpayers, but they will work with you to make things convenient to your schedule. Do not feel that you have to schedule around the auditor's time. If you are busy during a particular part of the year and less busy in another, the auditor will cooperate. Auditors generally want to complete an audit in the least amount of time possible. You should also state your preference for wrapping things up. It is a good practice to ask the auditor how long they estimate this audit will take and by what date it should be completed. Then try to stick to those dates as you work with the auditor. Our experience is that auditors are much more efficient that way, and that the audit tends to be less problematic throughout.







FAQ ► What is the Audit Coordinator's (AC) agenda in the preliminary meeting with the auditor?

The AC will handle any preliminary audit investigations and all meetings with the auditor. Most audits will begin with a preliminary meeting of the auditor and the AC. This meeting occurs before the actual fieldwork is begun. It can be done over the phone or in person.

Here are some items for your agenda:

- Introductions: Introduce yourself as the audit coordinator. Provide all of your contact information. Explain that during the audit all questions should be directed to your attention. If possible, provide information for someone higher up in the corporate tax or finance department. This second contact should only be used if the auditor has an emergency and you cannot be reached.
- Establish rapport -- make yourself an ally, not an adversary. I like the approach of saying something like: "We look forward to working with you to ensure that our company is paying the correct tax that's due."
- Obtain the auditor's contact information. (phone number and email).
- Determine which taxes are under examination.







- Make sure to confirm the exact audit period under review.
- Ask the auditor to confirm which records they will need. Auditors will often ask for much more than they really need. This is an opportunity to limit the scope of the documentation and save you some time. Request that the auditor put this request in writing. Do not commit to providing anything at this time.

TIP ► Do not commit to an audit appointment until the following is known:

- The scope of the audit (one state or many, etc.)
- Whether you have the personnel available to obtain and provide the information requested
- The availability of suitable office space
- The schedule of other ongoing audits
- Audit location (where the auditor wants to perform the on-site review of documents)
- Whether a consultant should be used and their availability
- Applicable statute of limitations
- Whether the auditor is travelling (could be helpful to know how many days they've allocated for their visit)
- Whether the audit raises sensitive exposure concerns (there were large acquisitions during audit period, nexus issues, exemption certificate issues, etc.)







- Tests and sampling procedures should be discussed with the AC and agreed upon in advance.
- Copies of audit working papers should be given to the AC as each major component (such as the examination of exempt sales, or expenses, or fixed assets) of the audit is completed, along with appropriate explanations and relevant citations;
- At some point during the audit process, the auditor may wish to question other employees in order to clarify factual or procedural issues. (For example, an engineer might be needed to explain some aspect of the manufacturing process; a fixed assets accountant might be asked about criteria for capitalizing equipment.) The auditor should be instructed to request such interviews in advance. The AC then should schedule the meetings, educate the interview subjects about the tax issues beforehand, attend the meetings, and prepare internal memoranda immediately afterward.

FAQ ► How long will your audit take?

Depending upon the taxpayer and the level of activity in a particular jurisdiction, From the initial Request for Information and back and forth on audit schedules, to the assessment and potential appeal, you should expect an audit to go on from one to six months.







It's not unheard of for an audit to take years to complete. What are the factors?

- Size of the taxpayer.
- Relative size of operations in the state.
- Scope of activities in the state.

Example: Auditing a large manufacturing operation will take considerably longer than auditing a satellite administrative office simply because of the significantly greater number and complexity of potentially taxable transactions that have to be reviewed.

In audits that take the longest, a great deal of time can be spent just selecting the sample, especially in the case of a stratified or statistical sample. This is true because the auditor usually has to go to great lengths to verify the total populations so that he/she can make sure they're seeing the whole universe of transactions. (We discuss sampling in greater detail in Chapter 4.)

In a business in which most or all transactions are likely to be taxable, auditors will reconcile figures in the books and records to those reported on the sales tax returns and even federal tax returns. Next, they will test the accuracy of the amounts in the records by tracing them to original documents, such as sales invoices, for a test period. This testing and verification can be very time consuming.







From then on, the greatest amount of time is spent in reviewing actual transactions. Then the auditor will generate a preliminary assessment. This portion of the audit is time consuming because it involves the manual review of the transactions on an individual basis and the negotiation of the final taxable amounts with the auditor.

FAQ ► What official authority does an auditor have to audit your business? What are the limits?

State statutes confer broad authority on the state to audit a taxpayer's records. This is necessary because our system of taxation (both federal and state) relies heavily on voluntary compliance. As such, the state must have substantial authority to audit taxpayers so that compliance can be verified. Absent this authority, we would likely see large-scale evasion.

You might not have known that auditors even have administrative subpoena powers that give them the authority to compel taxpayers to produce information. However, we've never seen this authority exercised. It is generally reserved for extremely uncooperative taxpayers.







FAQ ► Is it best to discuss difficult audit issues early on or wait to the end?

Delaying the discussion of a difficult topic until later in the auditor's visit may be beneficial as it may result in less focus on sensitive details due to the auditor's desire and the pressure to wrap up the audit.

FAQ ► If there are overpayments/refunds due, when is the best time to bring those up?

First of all, you should always look for tax credits and overpayments that might offset any assessment. Auditors do not see this as their duty and it will be up to you to find them. We usually advise waiting until the end of the field work stage to present your findings to the auditor. Providing an auditor with a refund schedule toward the end of an audit may result in a more limited review of the refund claim. A limited review is good simply because of the time and hassle savings.

Also, once the auditor has announced that they are done with the audit, they would be very unlikely to reopen their review and "sharpen their pencil" to find additional items to assess. It would be very difficult to justify to you and their supervisors why they should spend any additional time on your audit at that point.







FAQ ► Is there any flexibility in when I allow the auditor to come to our business?

Definitely. Auditors have flexibility in their schedules and if there is a conflict in your schedule that warrants delaying and rescheduling the initial meeting, then you should request it. Keep in mind that delaying cannot go on forever as the auditor will not allow periods to lapse to the statute of limitations. In such cases, the auditor may still cooperate with a delay, but he/she will require that you agree in writing to a waiver of the statute of limitations.

FAQ ► What if we are currently registered and filing in the state seeking to audit us? Are there any special considerations in this case?

Yes. If your company is not currently filing in the state that wishes to come in and audit, you should perform a comprehensive pre-audit nexus study. If the study finds that the company did not have nexus with the state for any or all of the audit period, the auditor should be contacted, and any audit appointment put on hold until the nexus issue is resolved.







FAQ ► What are some of the most common errors found in an audit?

For most sales tax audits, the auditor is looking for two things: taxable sales that were not property taxed and taxable purchases that were not taxed. The variations on this basic rule vary by business and industry. Here are a few of the common issues found in sales and use tax audits:

- Missing exemption certificates for untaxed sales
- Sales made to non-profit organizations that you believed to be exempt but are not
- Not charging tax on shipping charges are required
- Not charging tax on other taxable services
- Failure to pay use tax on untaxed purchases used by your business and not resold
- Failure to have receipts to show that purchases using credit cards were taxed by the vendor
- Operating and capital leases that are not taxed properly
- Intercompany transactions that are not properly taxed or documented
- Asset sales or business disposition that are not properly taxed







TIP We have a document you can consider sending to your auditor before they come for their initial visit. It spells out who the contact person is, what time the office is open, etc. It instructs the auditor that they need the contact person's permission to speak with others and it asks the auditor to provide a written report of proposed adjustments and a timetable for responding to it. Below is the content of the letter, feel free to use it.

To: Mr/Ms Auditor

ABC Company is providing the following information to assist you in efficiently completing the fieldwork portion of your audit. Any deviation from these guidelines should be discussed with the Audit Coordinator in advance. Should you have any concerns regarding these guidelines, please bring them to the attention of the Audit Coordinator.

Office hours

Our office hours are 8 a.m. to 5 p.m., Monday through Friday. Because of flexible work schedules in the tax department, we request that the auditor arrive no earlier than 8:30 a.m. and leave by 4:30 p.m. Observing these hours will assure that tax department personnel will be available to assist the auditor.

Sign-in procedures

Because of the proprietary nature of the information in the facility, each day, upon entering and leaving the office, all guests must sign in and sign out with the office receptionist. The Audit Coordinator should be listed as the host party. Once you have signed in, the receptionist will notify the tax department of your arrival and you will be escorted to your working location.







Audit Coordinator

The Auditor Coordinator for this audit will be:

Andrew Johnson Taxpayer, Inc. 2 Taxpayer Blvd. Any Town, USA 222-1111

All questions regarding the audit should be directed to the Audit Coordinator. To minimize disruption to our team, the auditor should not contact other employees without the contact person's permission.

Access to office areas requires escort

Auditors are allowed access to the public areas of the office such as the restrooms and the cafeteria. Auditors must obtain consent to visit other areas. Visits may be scheduled through the Audit Coordinator.

Request audit questions in writing

To facilitate completion of the audit and minimize any misunderstandings, we request that all questions regarding the audit be posed in writing. Prompt responses will be provided for all questions.

Request for concluding conference and copies of all work papers

We request that the Audit Coordinator and the auditor have a meeting at frequent intervals throughout (at least weekly) and at the conclusion of the fieldwork to discuss any proposed adjustments and establish a timetable for the resolution of any outstanding audit issues. At this meeting, copies of all audit work papers should be provided to the Audit Coordinator.







Audit Expectations

"Expectation is the root of all heartache."

- William Shakespeare

In this chapter we've laid out quite a few pages of what you can expect in your sales tax audit. But, things often do not go according to plan.

Auditors don't always follow the script. Business records or lack thereof may create hardships for you in responding to the auditor's questions.

Business goes on even while the audit proceeds. You still have to get your "real job" done. So, take all of this with a grain of salt and do your best to maintain some sense of humor throughout. It will end some day...



"I find my life is a lot easier the lower I keep my expectations."

— Bill Watterson

Chapter Two

How Far Back Can a State Audit You (or What is the Sales Tax Audit Statute of Limitations)?







The Statute of Limitations

In this chapter, we will highlight the statute of limitations for various states and a corollary issue of just how long you should retain your sales tax records.

Statute of Limitations

A statute of limitations is a law that sets forth the maximum time after an event that legal proceedings based on that event may be initiated. When applied in a sales and use tax context, there are time limits established by state laws that govern how long a taxpayer has to file a refund claim after paying tax erroneously and how long taxing jurisdictions have to assess you tax.

Most states have just adopted the federal statute of limitations meaning that they have a 3 year limitation, except in the case where the tax liability is understated by 25% or more which gives the state 6 years to go back. Other states use something different than 3 years. The most common other time limit is 4 years but some states use a 5 or 6 year statute of limitations. One interesting state is Louisiana. In Louisiana the statute of limitations is 3 years, but 3 years after December 31st.







Use <u>this link to access a chart from CCH</u> showing every state's statute of limitations for assessments.

Arizona	from later of return due date or return filing date.	Comments If base understated by more than 25%, 6 years from later of return due
Alabama :	from later of return due date or return filing date.	t base understated by more than 25%, 6 years from later of return due
Arizona	to a later of return due date or return tiling date.	
Arizona		25% 6 years from return filing date.
	4 years from later of return due date or return filing date.	If receipts understated by more than 25%, six years from the date the If receipts understated by more than 25%, six years from the date the return was filed. We recommend you reference cited authority for more return was filed.
Arkansas	3 years from later of return due date or return filing date.	return was seed. Information. 8 years from the end of the calendar month following the quarterly period if no return was filed. We recommend you reference cited authority for
2002277	3 years from later of the end of the calendar library and the return filing quarterly period for which the assessment relates, or the return filing date.	if no return was med. We receive more information.
California	the date or return filing date.	
Colorado	3 years from later of tax due date or date and a serior of tax or date and of the calendar month following the tax period, or the date the return was filed.	6 years from return filing date if tax understated by more than 25%.
Connecticut	turn data	6 years from return iming date in the
District of Columbia	years from return filing date. years from later of return due date, tax due date, or return filing date, or any time a right to a refund or credit is available to the taxpayer.	authority for more information.
Florida		We recommend you reference cited authority for more information.
Georgia	3 years from later of return due date or return filing date.	the distance of the second vou
Hawaii	3 years from later of annual return due date or filing date.	7 years from return due date if no return was filed. We recommend you reference cited authority for more information.
Idaho	3 years from later of return due date or return filing date. 3 years from the month or period in which the taxable gross receipts a years from the receipts issued on January 1 or July 1).	
Illinois	were received (assessment flips date or the end of the calendar year	r .
Indiana	containing the period for which the	from the date fraud
lowa	3 years from return filing date.	In the case of a false or fraudulent return, 2 years from the date fraud was discovered. We recommend you reference cited authority for more information.
Kansas	3 years from return filing date.	We recommend you reference cited authority for more information.
Kentucky	4 years from later of return due date or return filing date.	
Louisiana	years from later of return oue data or return which the tax payment will due.	
Maine	3 years from later of return due date or return filing date. If tax understated by 50% or more, 6 years from return filing date.	No limitations period if proof of fraud or gross negligence.
	for the date	We recommend you reference cited authority for more information.
Maryland	4 years from tax due date. 3 years from later of return due date or return filing date.	For cases involving fraud, 2 years from the date fraud was discovered.
Massachusetts	3 years from later of return due data of returning	alted authority for more information.
Michigan	4 years from later of return due date or return filing date.	We recommend you reference case addressly seems from later of return if taxes underreported by more than 25%, 6.5 years from later of return due date or return filing date.
	3.5 years from later of return due date or return filing date.	We recommend you reference cited authority for more information.

Tolling of the Statute of Limitations

Here is a concept that I frequently hear being used incorrectly. Tolling is a legal doctrine that means "paused" or "stopped" while a certain condition exists. For example, if a company does not file sales tax returns when required to do so, the statute of limitations is tolled or paused and does not run out. Frequently, people will say that the statute of limitations is NOT tolled in this scenario but that is incorrect usage that leads to confusion. Suffice it to say that however you use the tolling word, the sobering fact is, under certain conditions, a state can go back much further than the statute of limitations would seem to indicate.







Record Retention

So if a state can go back as much as 6 years the next natural question you probably have is what would be a good record retention policy? The answer to this question is: "It varies all over the board". In general, if you retain records for 6 years, you'll be in compliance with just about every state. You may not want to keep records for that long though, so if you're primarily in a state that just requires 3 years, you can get away with destroying records sooner.









Waiver of the Statute of Limitations

Invariably the audit fieldwork takes longer than the auditor initially estimated. That may be the auditor's sole fault or it may be because things got too hectic at your office and you had to ask for some more time to supply the requested records. Usually, it's the fault of both the taxpayer and the auditor. Who's at fault is not important though.

In this case, the auditor will request a waiver of the statute of limitations. The statute of limitations in many states is three (3) years and in some it's four (4) or even five (5) years. In other words, in general, for states with a four (4) year statute of limitations, tax cannot be assessed (or refunded) on items purchased more than 4 years ago.

If your company files its sales tax returns on a monthly basis, that means every month that passes, another month (48 months ago) is no longer accessible to an auditor. The immediate temptation is to attempt to delay the auditor somehow so that some purchases can fall "out of statute". However, it is important to remember that the auditor has all the power in this situation. The auditor can ask you to sign a "waiver" of the limitation statute. A statute waiver agreement is just that -- you agree to extend the statute of limitations on the earliest months in an audit to allow the auditor to complete the audit.







TIP Clients frequently ask us if they should sign this agreement. Our short answer is generally yes. If you refuse to sign the agreement, a number of things might happen and most of them are bad. The auditor will just estimate the audit using available records. Most auditors will be conservative (from their viewpoint) and not risk understating the tax liability and will usually overstate it by a significant amount. Refusing to sign a waiver may be seen as unreasonable by an auditor and will cause the auditor to spend many hours in a short time frame getting all the paperwork completed before the statute expires. This is not bad per se, but when it comes time for that auditor to make a reasonable compromise later in the process, you can be sure they will remember this part of the audit.



The Ultimate Guide to Fighting Your Sales Tax Audit







On the other hand, we have seen instances where refusing to sign a waiver actually worked in the Taxpayer's favor. In this case, records were so sparse and the client knew even if they were found it would mean bad news. In this case, the assessment calculated by the auditor was actually less than the amount projected by the client. Finally, in the interim period in which you refuse to sign a waiver extension agreement the auditor may quit or even forget about your audit. We have seen it, but it would be very difficult to predict.

TIP We generally recommend that our clients go ahead and sign the agreement to waive the statute of limitations. The auditor will usually not miss a deadline and you will have succeeded only in alienating the person who has the most leeway in whether to tax certain purchases.

TIP The waiver can also delay the audit to a more convenient time and give a taxpayer time to locate requested documentation that was not initially available. It is also beneficial to have the waiver allow for more time to find offsetting refunds or credits to reduce the assessment.







Limitations

"There's no statute of limitations on doing what's right."

- Louie Gohmert

It is often said that sales tax (as compared to income tax) is a "form over substance" tax, meaning that the form of a transaction often controls the taxation. The wording on an invoice or contract can make all the difference.

The date of a transaction can also mean the difference between being in the audit period or not. Be sure to review transactions near the beginning of the sales tax audit period, to see whether the dates on the invoices would put it outside the audit period altogether.



"The enemy of art is the absence of limitations."

— Orson Welles

Chapter Three

Sales Tax Audit Sampling: Here's What You Need to Know







Almost all state taxing agencies use some form of sampling in their audits. Sales and use tax audits rarely span less than three years, so huge amounts of data can be subject to scrutiny. Detailed verification is neither practical nor desirable (for you or for the state), so sampling is the logical alternative.

FAQ ► Can States use sampling? Is this a good or bad thing? What specific questions should we ask about the state's sampling procedures?

In businesses that have hundreds of thousands of sales or purchases, it is simply not feasible for an auditor to examine each sale or purchase invoice. Instead, some kind of sample must be chosen. Ideally, the sample or portion of invoices to be examined will be representative of the entire invoice population. There is a risk that the sample will not be representative. The difference between statistical and non-statistical sampling is that in statistical sampling the risk is quantified. In non-statistical sampling the risk is not quantified, but is left to the professional judgment of the auditors performing the examination. Consequently, in non-statistical sampling it is impossible to know whether the sample is too large, too small, or how accurately it reflects the records as a whole.







To compensate for the uncertainty in non-statistical samples, most states select substantially more transactions than would otherwise be required to achieve an accurate statistical sample. Expanding the sample size frequently results in a more homogenous sample but at the expense of the taxpayer's and auditor's time.

Block sampling is the most commonly used example of non-statistical sampling. In block sampling, the auditor chooses a block of time (weeks, months, days) of checks, invoices, or vouchers to examine. The auditor assumes that the block of time of checks, invoices, and so on is representative of the entire population. An error rate is determined from the sample chosen and then extrapolated over the entire audit period. There is no way of measuring the accuracy of such a method.

According to our research, the following 26 states and the District of Columbia use statistical sampling on some but not all of their sales and use tax audits: Alabama, California, Colorado, Connecticut, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, New Mexico, New York, North Carolina, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Washington, and Wisconsin. All of the states continue to use non-statistical sampling in some, if not most, of their audits.







TIP ► If given a choice, in most audit situations, you should opt for statistical sampling. While statistical sampling generally involves more up-front work, it results in an assessment that is usually more reliable, because it's repeatable. Non-statistical sampling is not repeatable and may be grossly overstated (or understated also).

In any case, you should thoroughly discuss the proposed sampling methodology with the auditor until you understand what they're proposing to do. You and the auditor may be able to reach an acceptable compromise on the type of sampling done. Waiting until the audit has been completed to object to the sampling methodology is a failed strategy that has been rejected in many court appeals.

Sampling Methodology Agreements

The sampling methodologies that the auditor wishes to use are usually agreed upon very early on in the procedure. Many times the taxpayer agrees to a particular type of sampling without clearly understanding what the auditor is attempting to do and without knowing what records are available and what types of purchases were made during the time periods being sampled. If your audit is a sample audit, you should carefully evaluate the sampling methodology to be used by the auditor.







Once an audit has been completed or nearly completed it is very difficult to change the sampling methodology used. This is true because the auditor will usually have in his/her files a copy of an official notification they created for the taxpayer explaining in detail the methodologies they used in performing the sample audit. We have been successful in getting the sample thrown out and redone by a new auditor in a number of audits. Each time we were successful, it was because the sampling used was clearly egregious. In each case, the final tax assessment was greatly reduced. But it was a hard-fought battle every time to get the samples thrown out. It's best to review it carefully at the beginning.

TIP It is not always necessary or even desirable to get samples completely thrown out. There are other ways to make sure the sample does not hurt your company unduly. For example, watch out for periods being sampled that clearly do not represent an average month or day or year (depending on what unit the auditor sampled). Also, watch out for extraordinary purchases showing up in the sample. These can skew the audit against you in some cases (or for you in others). Finally, be sure the auditor gives you credit for negative transactions that appear in the sample base that relate to taxable items. If you're not confident with your experience in dealing with this type of issue, we recommend bringing in an expert on this aspect to help.







Sampling

"In ancient times they had no statistics so they had to fall back on lies."

- Stephen Leacock

Thought to some, the fact that states use sampling to perform audits seems like an affront, it's usually in the taxpayer's best interest to allow it. Usually it saves you time and if you are involved in approving the methodology, you have the best chance of a semblance of fairness.

Most states do not use pure statistical sampling. Many states use some sort of block sample because it's the easiest to administer.



"The Government is very keen on amassing statistics - they collect them, add them, raise them to the nth power, take the cube root and prepare wonderful diagrams."

Chapter Four

The Sales Tax Audit Process and What to Do Once the Audit Starts







Not knowing what the process is with a sales tax can add to the stress for sure. But not knowing how (and WHEN) to deal with the auditor can lead to over-inflated assessments.

The Audit Process

The audit process consists of 4 basic stages. We've already discussed the pre-audit phase and what you should do there. Then in Chapter 3 we discussed the next phase which is the discussion of the sampling methodology to be used. The third phase is when the actual fieldwork begins or the performance of the audit. The last phase is the post-assessment period where you decide if and how you will appeal the assessment.

Commencement of the Audit Fieldwork

The Audit Coordinator (AC) should have already had a pre-audit conference with the auditor as we discussed in Chapter 1. In that pre-audit conference you set the date for the first on-site meeting when the field work begins. The auditor will have given you a list of records he/she will need to begin the audit. The AC should be there to make sure the records are available and that the auditor's questions are answered promptly and accurately.

First On-site Meeting with Auditor

This first meeting is extremely important, as it sets the tone for the remainder of the audit. The challenge in the early stages of the audit is to take steps that will help you gain some control







over the audit process. Don't expect that you can completely control the audit process, but in communicating to the auditor that you intend to be cooperative and professional but firm and knowledgeable at the same time, it will help the process go as smoothly as possible.

Taxpayers who appear disorganized or uninformed about state laws or audit procedures at the initial meeting can create a negative impression that persists throughout the audit.

TIP ► It is a good idea to begin at an early stage of your audit to review your resale certificate situation, if it applies. In other words, if you are a seller of goods and you sell to exempt purchasers, typically you are required to bill the tax or collect a certificate in lieu of the tax. An auditor will test your sales to see if you have the proper certificates on file.

A lack of exemption certificates generally results in large assessments by tax authorities. Depending on the time period sampled, missing just one exemption certificate could result in thousands of dollars of taxes owed. Hopefully your AC has already come to an agreement with the auditor about what to do if missing exemption certificates are discovered. You should be granted a reasonable timeframe to collect the exemption certificates.







Be Careful What You Sign

Sales tax audits can mean that a lot of forms to be signed by the taxpayer. These include statute of limitation waivers, sample agreements, receipt of documents, and agreements to proposed assessments. These are legal documents and if you don't know what you are signing, get help from someone who does. In most cases, once the document is signed, it can't be rescinded. Signing a sampling agreement without knowing what it means or what the outcome could produce may end up costing you thousands of dollars in tax. The auditor will do some minimal explaining, but they don't feel it's their responsibility to tell you, nor do they even know usually all of implications and ramifications of these possible the documents. They will say it's your responsibility to get help if you don't understand.

FAQ What's a good strategy for how to deal with the sales tax auditor?

We've seen two basic extremes when it comes to dealing with auditors. Some people are overly intimidated while others are ready to battle over every adjustment, no matter how minor. The best approach is to adopt a middle-of-the-road strategy. Neither extreme will result in successful negotiations for the taxpayer.







FAQ ► Is there anything in particular that you should NOT give to the auditor?

Auditors usually request more information than they really need. There are some things you should not give them, especially at the beginning. This includes the backup to the depreciation schedule. The reason for this is that schedule usually has rounded and combined figures. The auditor doesn't need this document because they have the source documents that feed this schedule. If they get this schedule and start assessing the amounts there, it can be very difficult to get them removed later.

FAQ ► What should we allow the auditor to see?

It is up to the AC to provide alternatives or ask questions concerning the necessity of certain requested documents. Most taxpayers are usually willing for auditors to see the following without too much protest:

Federal and state income tax returns
Sales and use tax returns
Worksheets used to prepare returns (be careful
about the depreciation schedule)
Reconciliation schedules
Source documentation such as invoices, register
tapes, contracts and other records







- FAQ ► Is there anything in particular that you should NOT give to the auditor? (cont'd)
- Exemption certificates, product descriptions, contracts and other information supporting an exemption

TIP ► It is important to remember that there are other pieces of information that an auditor should not have (for example personal information about customers or proprietary information about the company). Similarly, an auditor rarely needs an entire contract; they typically only need a limited portion of the contract and as such should only be provided what they need.

Auditor Treatment

It can be tempting to treat the auditor in a certain way to get the best results. Some advocate putting them in a cold or hot room by themselves and limiting their contact with anyone at anytime. Some say that you should give them one document at a time and make them request every little thing in writing. Others go so far to suggest that the auditor be given a bright yellow name tag that says STATE TAX AUDITOR on it so people will know to avoid him/her. We say all of these things are way overblown. It comes down to what makes sense. We have handled many, many audits and have run into some







downright unreasonable auditors to be sure, but we haven't seen that any of these extreme measures have resulted in anything good.

TIP ► Don't go overboard (in either direction) in your treatment of an auditor and cause yourself a lot of extra work and tension that won't get you any improved results.



TIP ▶ Please understand: We're not advocating being soft and just letting the auditor have her/his way. You must be assertive in claiming the rights you do have. If an auditor senses you don't know the procedures, he/she is likely to cut corners in performing the audit and you won't get the best results. However, sometimes people get crossways







with an auditor over things that won't make a bit of difference to the bottom-line result, except to make matters less favorable for you in the end. There is a fine line there. Be tough about things that matter.

FAQ ► Should the auditor be given their own office?

This isn't necessary. But, in our opinion, the auditor should be assigned a specific workspace, preferably away from company employees other than the AC. Larger companies generally have office space permanently set aside for the exclusive use of various auditors. Other possibilities include the auditor's office, or the taxpayer's CPA or attorney's office. It is not unusual for larger companies to have the IRS and one or two state auditors in the office on a nearly full-time basis. Nevertheless, entertaining more than one auditor at a time should be discouraged, particularly among smaller companies that lack a large or sophisticated tax staff.







FAQ ► Should we allow the auditor to tour our facility?

The auditor may request a tour of the premises, particularly if you are a manufacturer. Plant tours often clarify technical issues and usually they are helpful, but they also can raise additional questions. If the auditor asks for a tour, the AC should schedule a time, arrange for a guide (typically a technical person, such as an engineer) and the AC should take the tour in advance. This will allow the AC to educate the employee acting as the guide on potential tax issues. The same guide, and the AC, should then accompany the auditor.

FAQ ► How often should the Audit Coordinator meet with the auditor during the audit?

The AC should have a preset schedule of meetings with the auditor. We do not advise that you position yourself as a "regularly available" person for the auditor to drop in and talk with. The AC's schedule will dictate the meeting times. Typically, a scheduled meeting in the morning,







early afternoon and end of day for 10 to 15 minutes per meeting will suffice. Important meetings, like the initial onsite meeting and audit closing meeting should be attended by two company personnel where possible. It is important to have a second person there for purposes of verifying auditor comments, and for completeness in asking questions.

FAQ ► When should the Audit Coordinator start working on the auditor's schedules?

At the initial meeting, the AC should make arrangements to review the auditor's working papers as each segment of the audit is completed. When items are scheduled by the auditor that the AC believes should be removed he/she can immediately begin gathering additional supporting documents from within and without the company.

Detailed investigations and follow-up should be assigned to people who know the applicable laws and are experienced enough to recognize the implications of their findings. You should focus your limited resources on the issues with the greatest impact.







Fieldwork Complete

Finally, the auditor will be done with the last of scheduling items on which he/she feels tax should have been paid and was not. Most likely there are many items on the schedules that are questionable if only you could find the appropriate documentation. You may be missing some resale certificates or proof that tax was paid. You will generally be given time to obtain this missing documentation before the auditor "turns in the audit for processing".

TIP ► An auditor is usually highly motivated to get the audit in for processing. It may be that the State's fiscal year-end is approaching or his manager or supervisor is requiring that it be turned in very soon. Sometimes deadlines are good in that an auditor may be willing to accept less documentation if she/he feels that it would help to get everything resolved now as opposed to later.

TIP ► If you need extra time to get documentation, be sure to ask for it. An auditor will always tell you about the appeals procedure and will usually try to "just agree to disagree" on the remaining items. However, it is our experience that it's best to get things solved before the audit is turned in.







The Audit Process

"I believe in process. I believe in four seasons. I believe that winter's tough, but spring's coming. I believe that there's a growing season. And I think that you realize that in life, you grow.

You get better." - Steve Southerland

There is a method to what can seem to be an auditor's madness in performing an audit. Basically, it usually comes down to this: how can the auditor get the most money from your business with the least amount of work or effort on his/her part. Seems harsh, maybe, but that's how it usually goes. So instead of fighting against that notion, learn how to work with the auditor towards a mutually agreeable outcome.



"There is no end to education. It is not that you read a book, pass an examination, and finish with education. The whole of life, from the moment you are born to the moment you die, is a process of learning."

Chapter Five

The Best Sales Tax Audit Defense is a Good Offense (Tax Overpayments)







Some people seem to get a little uncomfortable with the terminology of "fighting" an audit. They may prefer to call it "sales tax audit defense". Either way you refer to it, I can assure you the state auditor has one major objective when they audit you: get the most money out of you with the least amount of work possible. Sorry if that sounds a little too harsh, and maybe there are a few auditors out there who aren't this way, but if there are, we haven't met them.

By the time you get to this Chapter, we've already talked about what the audit process is and how to negotiate with the auditor, with tons of tips. Now we're going to talk about going on the offensive. Since the focus in many audits is on underpayments of tax rather than overpayments, it's a great idea to do a refund review to determine if there are opportunities for refunds.

You know the old saying: "sometimes the best defense is a good offense". That's where refunds and overpayments come in. Every state with a sales tax also provides for either a refund or credit of the tax due for overpayments in the case of bad debts, repossessions, returned goods, or simple errors with regard to taxable and exempt transactions. Since sales tax is due on a sale, it stands to reason that when the product is returned and the moneys







are refunded, the sale is undone and the tax collected and remitted should therefore be returned to the vendor. Where there is no sale, there should be no tax. The same theory applies when it comes to repossessions and bad debts (there was no legitimate sale).

Overpayments of sales and use taxes are actually fairly common, especially in larger businesses. When an overpayment is discovered, the taxpayer is responsible for organizing, documenting, and presenting the claim for recovery. The auditor's role is limited to reviewing the evidence, weighing the legal and procedural arguments, and deciding whether the claim is justified.

Refunds and credits may be requested in various ways, including offsetting assessments in an audit, filing amended sales and use tax returns, taking credits against liabilities on current tax returns, or filing stand-alone claims for refund. Some of these methods are not available for every state; for example, some states have no provisions for amended returns, and some do not allow credits against current liabilities unless the overpayments also occurred in the current period.









We generally recommend that if you discover any overpayments, and the state allows it, to first offset any audit deficiencies first before getting a cash refund from the state.

The primary reason for this is that although many states pay interest on refunds, the amount of interest on overpayments is usually less than the interest rate you are charged on underpayments in an audit. Therefore, you get a bigger bang for the buck if you the auditor will simply enter the overpayments identified as credits in your sales/use tax audit.

Regardless of the state's system, the taxpayer should prepare a report and document packet. The auditor will review any credits and approve/reject them as they deem appropriate. Having the refund claim report and packet organized in this way gives you the best chance for the review process to go smoothly.







Overpayments can arise in many different situations. Common reasons for overpayments include the following:

- Use tax self-assessed on exempt transactions
- Unclaimed deductions or credits for bad debts
- Refunds not pursued because the whole process was deemed too difficult
- Clerical errors in reporting or recording
- Inventory bought tax-paid and resold without an intervening use

FAQ > Should we do a refund/tax credit review before an audit, and if so, how do we go about it?

Many companies perform refund reviews and self-audits in anticipation of a state audit. In a refund review, the focus is upon identifying overpayments of tax. It is your responsibility to make sure all refund claims are claimed; you can't count on the auditor to do this for you. By performing a refund review, you will be in a position to offset any audit deficiency with a refund claim. In a refund review, you review all tax-paid purchases in the same manner that the auditor reviews purchases where no tax is paid. Then you look for situations where tax has been paid in error. That's where a refund review differs from the pre-audit self check described elsewhere. In a pre-audit self check, the emphasis is upon lapses and breakdowns in procedures that could result in additional assessments by an auditor.







FAQ ► If we find tax overpayments, how do we prepare our refund claim?

If you find some overpayments of tax, you should treat each category of overpayment separately in the refund claim report packet and should provide the following elements for each category:

- Copies of original documents: These documents might include sales invoices, purchases invoices, purchase orders, exemption certificates, shipping documents, or similar supporting detail. Each document copy should be indexed to the appropriate line of the summary schedule.
- Summary and supporting schedules: Unless there are only a few transactions, each transaction should be listed and categorized on a summary schedule. Supporting schedules (such as ratio computations) should be cross-indexed to related worksheets, summary schedules, and source documents. No particular system is required, but the indexing should make the flow of transactions and documents easy to understand and trace. We try to make our reports ridiculously simple to follow.







FAQ ► If we find tax overpayments, how do we prepare our refund claim? (cont'd)

- Citations: If several legal issues are involved, an abbreviated list of citations should be included as an exhibit. Each issue should be assigned a number or letter that will serve as a cross reference to the applicable transaction(s) on the summary sheet.
- Narrative description: The taxpayer should provide a detailed analysis of each aspect of the claim, including an introduction, an explanation of the facts and issues, the legal justification (including legal citations), detailed arguments, and a conclusion that ties the report together.
- Cover letter: If the taxpayer is requesting the refund in a stand-alone claim, he should write a cover letter to the taxing agency. The letter should be signed and dated and state that a refund is being requested pursuant to the state law permitting such claims. (The specific state law should be cited.)









Some states require a particular format for the claim, and others require specific claim forms. If the state mandates use of a particular form, the taxpayer may submit that form in lieu of a cover letter or file it in conjunction with the letter.

Even if the refund is claimed through an amended return or as an offset against a current liability, the taxpayer still should prepare and retain the document copies, summary schedules, citations, and narrative description for reference by the auditor.



Helpful Charts on Taxability

FAQ ► What charts will help us the most in identifying credits and/or reducing any audit assessment?

Here are the charts we know will be the most helpful to you:

- Manufacturing Equipment
- Cloud Computing
- Construction Contractor Purchases
- Various Services
- Statute of Limitations on Refunds







PLEASE READ THIS Important Taxability Charts Disclaimer

Taxability varies by state. How each state interprets or defines each of these products &/or services is critical to any determination of taxability. Remember that charts like this can oversimplify the rules and should only be used as a start to your research process. The charts are valid as of the date listed at the bottom of the chart.

The following chart(s) are provided as a service of Peisner Johnson. The chart(s) are based on information provided by various resources we subscribe to. Charts are a starting point for your research but should NOT be solely relied upon for final decisions. Peisner Johnson or its affiliates have not independently verified the accuracy of the summaries provided in each chart. This chart was produced on the date indicated at the bottom of each page and laws and policies may have changed in the interim.

Furthermore, the answers provided in these charts are based on certain facts and circumstances and any variation, however slight, in your particular circumstances or fact pattern may mean that the correct answer is totally different from the answer given. Therefore, the recipient of this agrees that Peisner Johnson and its affiliates cannot be held liable for any damages resulting from the recipient's reliance on this chart. We urge you to seek additional guidance from a qualified state tax professional on any material transaction.







FAQ ► How do states tax manufacturing equipment?

Check out <u>this chart</u> from CCH that summarizes the taxation of manufacturing machinery across the US.

Are you a manufacturer? Then, there may be significant exemptions available to you, depending on where you have manufacturing operations. But even if you aren't a "manufacturer" per se, there may be some exemptions available to you if you perform some "manufacturing" activities. For example, in some states, cooking food is considered manufacturing. Therefore, convenience stores who make food, or even use soda machines, would qualify for that state's manufacturing exemption.



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FAQ ► How do states tax manufacturing equipment? (cont'd) -- Check out this chart from CCH that summarizes the taxation of manufacturing machinery across the US.

The first thing you need to think about in determining if certain manufacturing equipment can be purchased tax free is what is manufacturing? I'm sure that it comes as no surprise that the definition of the term "manufacturing" varies from state to state. For example, all manufacturing probably includes some processing and/or fabrication, but not all fabrication or processing is manufacturing. Similar questions arise over refining, assembly, and construction. This is where the confusion arises: trying to distinguish between what is fabrication, processing, refining, assembly, etc.

Not only are there disputes over the definition of manufacturing, there is also usually a question of when the "manufacturing process" begins or ends. Machinery used either before or after the manufacturing process begins or ends usually does not qualify for a state's sales tax exemption for machinery used in manufacturing. In general, the manufacturing process begins when the raw materials are removed from their first point of storage







How do states tax manufacturing equipment? (cont'd) -- Check out <u>this chart</u> from CCH that summarizes the taxation of manufacturing machinery across the US.

and ends when the completed product is taken off the line and placed in storage. Some of the more typical areas not qualifying for the manufacturing exemption include receiving, inspection, shipping, intraplant transportation, and finished goods warehousing equipment. The key is usually whether the activity or equipment contributes to a change in the product being produced or is an essential step in the manufacturing process.

Then comes the question of whether a state's manufacturing exemption applies strictly to "manufacturers" as that term is defined by the state (usually by reference to an SIC code) or if the exemption is for equipment used in "manufacturing". Equipment that is only exempt if it is used by a "manufacturer" in the "manufacturing process" is less broad than if the exemption is for equipment that is simply used in the "manufacturing process".

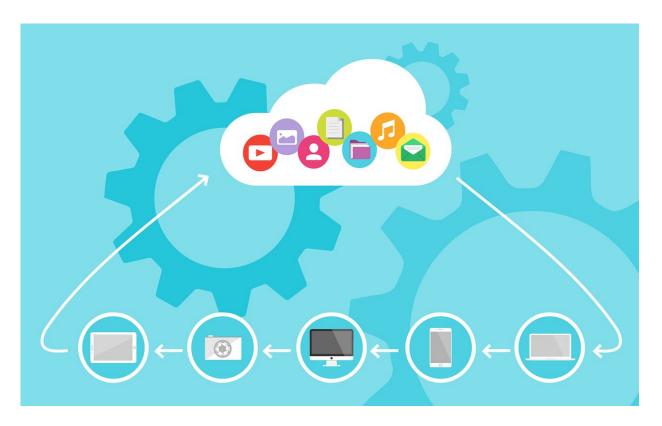






FAQ Mow do states tax cloud computing including application service providers (ASPs) and software as a service (SaaS)? Check out this chart from CCH that summarizes the taxation of Cloud Computing across the US.

Do you purchase software? If so, you may be due a refund of sales tax. SaaS and ASP (AKA "Cloud Computing,") are now a very, and perhaps the most, common model for software delivery. Cloud Computing means that customers access specific software applications over the internet through third-party providers rather than through a single purchase loaded on a single computer.



The Ultimate Guide to Fighting Your Sales Tax Audit







FAQ ► How do states tax cloud computing including application service providers (ASPs) and software as a service (SaaS)? (cont'd) -- Check out this chart from CCH that summarizes the taxation of Cloud Computing across the US.

The sales and use tax implications of Cloud Computing are far reaching and prompt many questions including:

- Does the ASP or SaaS provider have nexus in the jurisdiction in which it is providing its product or services? Quick answer: "probably, yes, especially in light of Wayfair."
- ❖ Is the ASP or SaaS involved in the sale or license of software or the performance of a service?
- Is Cloud Computing considered the sale of a service, and if so, are those services taxable?







FAQ Mow do states tax cloud computing including application service providers (ASPs) and software as a service (SaaS)? (cont'd)-- Check out this chart from CCH that summarizes the taxation of Cloud Computing across the US.

- ❖ Is Cloud Computing considered the sale of software, and if so, is it canned or custom software?
- If Cloud Computing considered the sale of software, is an exemption available?

The basic problem in taxing Cloud Computing is that it's not clear what is being sold. Is it considered tangible personal property or a service? It is not always clear whether anything has been delivered, or where it has been delivered, or whether the concept of delivery even applies.

Adding to the confusion, the distinctions between software, digital goods, and SaaS have become blurred. As a consequence, some states, like Colorado, that do not tax software delivered electronically will tax digital goods. Other states, such as New Jersey, taxes personal use software delivered electronically and digital goods, but does not tax SaaS.









FAQ Mow do states tax cloud computing including application service providers (ASPs) and software as a service (SaaS)? (cont'd)

Not surprisingly, the answers states have taken varying and inconsistent positions on these questions. In some states, Cloud Computing may not be taxable because they do not tax the sale of software delivered electronically or because there is no sale of tangible personal property (such as California).

Other states may not tax Cloud Computing because they consider it to be a nontaxable service. Still other states tax Cloud Computing as an information or data processing service (like Texas).









Check out this chart from CCH that indicates whether a contractor's purchases of materials or equipment are subject to tax when used in performing a construction contract that is billed on a lump sum basis. Special rules may apply when construction is performed for government or not-for-profit entities.

Are you a construction contractor by chance? If so, we feel your sales tax pain! In most states, if a contractor is performing work on real property, the contractor is deemed to be the final consumer, or the end user of the tangible personal property used to build the real property and,







accordingly, must pay sales tax upon those purchases. Accordingly, in most states, as a purchaser of construction services, you would not owe any sales/use tax on the contract price.

In the beginning days of sales tax, states applied the tax to tangible personal property (because real property was already taxed with property taxes). Services were not taxed in the early days. Therefore, construction historically has generally not been taxed because it was deemed a service. However, for construction and other service providers, they still owe sales or use tax on the tangible personal property used in performing those services.

This seems rather clear on its surface. A contractor is the end user of the tangible personal property because when the contractor finishes the job, the tangible personal property (the nails, sheet rock, lumber, cement, iron, etc.) has transformed into real property.







Unfortunately though, just paying sales tax on purchases does not begin to cover all the multitude of activities performed by contractors. In addition to contract jobs on real property, contractors sometimes act as retailers of fixtures or other tangible personal property such as furnaces, water heaters, cabinets, and air conditioners. Construction contractors will usually have questions over the different sales tax treatment depending on the types of contracts, such as cost-plus, fixed-price, time and materials. There are further complexities regarding contract work with federal and state governments, churches, and not-for-profit organizations. And then the distinction between real property and tangible personal property contracts is not always clear.

Construction contractors face some of the most complicated sales tax questions of any industry especially if they do business in different states. A contractor must always consider the impact of sales tax on its purchases when making a bid. They can be caught between a rock and a hard place because they face constant competition and the bid price is a major criteria for who gets the contract. But they also have to be very careful to accurately estimate the tax cost of the materials incorporated in the job so they don't end up losing money on a job. For sure they need to be careful to bill the sales tax on the overall job, if state law requires it.







<u>Gross receipts taxes and contractors</u>

While the guidelines just provided are applicable to the majority of states, it is important to remember that there are always exceptions. Arizona is one of those exceptions. Arizona has a gross receipts tax called the Transaction Privilege Tax. In many ways, it operates like a sales tax in that it is billed separately. But technically speaking it is a tax on the seller, not the buyer. The differences become very apparent when it comes to construction. In Arizona "Prime Contractors," who modify real property, which includes construction, improvement, removal, wreckage, or demolition activities, purchase their construction materials free of tax. Why? Because the Prime Contractor must pay a "Transaction Privilege Tax" (TPT) on 65% of the gross receipts on their contracts, a tax that is passed on to the building owner in much the same way a sales tax is passed on to a purchaser.







At first glance, the TPT on contractors may seem simple enough, but if a contractor performs maintenance, repair, replacement, or alterations (MRRA) work for the owner of real property, or the owners of improvements to real property, that contractor becomes a service contractor, not a prime contractor. As a consequence, instead of buying their building supplies free of tax like a prime contractor and paying tax on 65% of their gross receipts, a service contractor pays tax on the building materials when they buy them.

You can quickly see how this could be confusing. First, a contractor has to know what is included in MRRA and what is still modifications that are prime contracting. Second, contractors could be a prime contractor, or subcontractor to a prime, on one job and a service contractor on another job. In these cases, the prime contractor inventory and service contractor inventory must be accounted for separately.

Other states imposing special taxes upon contractors in addition to a general sales tax include Mississippi and South Dakota.







FAQ ► How do states tax the most common services?

Check out <u>this chart</u> that shows what states tax certain key services that most companies would purchase in their business. The chart shows if sales tax applies to:

- Data Processing
- Debt Collection Services
- Heating and Cooling System Repair Commercial Real Property
- Information Services
- Installation Services Separately Stated
- Janitorial Services
- Landscaping Services
- Mandatory Equipment Maintenance Agreement
- Optional Equipment Maintenance Agreement
- Repair of Tangible Personal Property; Labor Only
- Security Services
- Temporary Staffing Services Personnel Perform a Non-Taxable Service
- Temporary Staffing Services Personnel Perform a Taxable Service
- Waste Removal







FAQ ► How do states tax the most common services?(cont'd)

Most states tax only a few services. On the other hand, Hawaii, New Mexico, and South Dakota tax almost all services. Connecticut and Texas tax many services.

Many vendors tend to err on the side of taxing a service, if they're not sure. Also, in many instances, vendors tax services based on the bill-to address, when it should be taxed at where the service is performed. So there may be a refund opportunity for you if you purchase a service that is only partially consumed in your home state.









FAQ Mow far back can you go back in seeking a refund of sales taxes? (Or, what is the statute of limitations for sales tax refunds?)

Check out <u>this chart</u> from CCH that shows all the states and how far you can go back with a refund claim. Keep in mind that Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose sales and use tax, so they are not listed in <u>this chart</u>.

A state's sales and use tax statute of limitations applies as a limit to how far back a state can go when they audit you -- that is assuming your company has been registered and filing sales tax returns in that state. Some states have different limitations for audit assessments than they do for refunds.







FAQ ► What methods do states allow for obtaining sale tax refunds and credits?

Check out <u>this chart</u> from CCH that summarizes the alternatives that each state has indicated that it will accept (keep in mind that other options may be also be available).

The steps for claiming a sales tax refund or credit vary greatly by state, but the most common procedures include:

- Adjusting the sales reported or tax due (or taking a credit) on a following return
- Amending the original return(s)
- Filing a separate refund claim either by letter or specific form

The easiest and quickest way to get a "refund" of taxes overpaid is by taking a credit on the return you'll be filing next month. But, be careful here, just because a state allows this method as one mechanism does not mean that it's allowed in all situations. For example, do not assume you can take a credit on next month's tax return for tax you paid to a vendor in error. If a state allows you to do this, it's usually only in the case where you paid tax in error on inventory for resale.







The Best Defense is a Good Offense

"Attack is the secret of defense; defense is the planning of an attack." – Sun Tzu, The Art of War

The auditor, if they're any good, will find all the tax you or your client owes. If they don't find it all, then so much the better. But they won't purposefully miss anything that you owe because they want to cut you a break.

What they don't do as a general practice is find areas that vendors overcharged you and you're due a refund. That's up to you.

So you can wait around for the auditor to assess you tax and then react to that, or you can proactively look for areas where you overpaid the tax, and ask the auditor to give you credit against the audit assessment.



"Everyone must be proactive and do all they can to help themselves to stay employed." — Stephen Covey Chapter Six

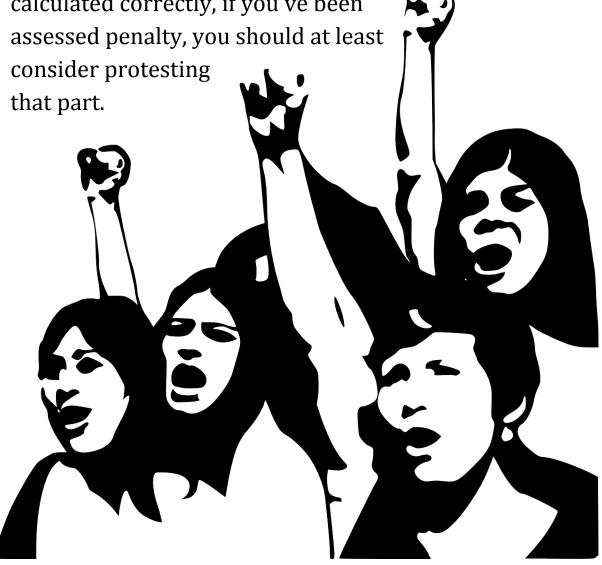
Protesting Your Audit Results: At Least You Should Request a Waiver of the Sales Tax Audit Penalties







Many auditors like to view themselves as the final authority on the audit results. As a result, they often push taxpayers to pay the tax assessment, interest, and penalties. But this is not true. You have rights. Before making any protest decisions, you should verify that the assessment is correct. And even if you don't disagree with the items assessed in the audit and everything seems to be calculated correctly, if you've been



The Ultimate Guide to Fighting Your Sales Tax Audit







At the completion of the fieldwork, you should have already receive copies of all audit work papers and schedules. These documents should be reviewed to verify that they're correct and that they properly reflect any agreements reached in your negotiations.

Any errors in the assessment should be brought to the auditor's attention immediately. Pay particular attention to any last-minute adjustments that were agreed upon to make sure they were carried forward to the auditor's final worksheets.

After all required adjustments have been made, some states will issue a preliminary assessment while others will issue a final assessment. An assessment is a formal request for payment that imposes certain obligations on the taxpayer for payment or appeal of the audit results.

FAQ ► How long does it take the State to issue the formal assessment?

It can take anywhere from four to twelve weeks after the fieldwork is completed to issue either a preliminary or final assessment. Most states issue their assessments six to eight weeks after the auditor turns in the necessary papers. It takes this long because the auditors work has to go through a review







process before the formal assessment can be issued. Most states rely upon the auditor's supervisor to perform the review; however, some states have a formal committee or department that reviews and processes all assessments. The level of review can vary with the amount of the assessment—larger assessments generally receive closer scrutiny.

TIP States often allow the taxpayer to make a payment from the preliminary assessment to avoid incurring additional interest costs. If the audit is agreed upon, the taxpayer may wish to consider this alternative. In some states, if the audit is only partially agreed upon, the taxpayer may pay that portion to reduce interest costs on the overall settlement.

Check the Interest and Penalty Calculations

You should also verify the accuracy of the interest or penalty calculations. Many states use simple interest, which makes the verification process relatively easy. If a penalty has been included in the assessment, you should consider asking for a waiver.

The deadline is usually thirty or sixty days after the date the notice was mailed or received. If the taxpayer fails to file an appeal or protest by the deadline, the assessment becomes final and the results cannot be appealed. If the taxpayer does not make payment or file an appeal by the deadline, additional penalty may be assessed and additional interest will be assessed.







Checklist of What to Do As the Audit is Finalized

Meet with auditor at a concluding conference and verify the timetable and tasks to be completed to finalize the audit. Discuss the assessment process and clarify your rights and responsibilities. Take particular note of your appeal rights if you are planning to appeal. Confirm your appeal and payment rights through analysis of the state's law. If the auditor provides you with copies of the audit work papers, verify that all agreed-upon adjustments are reflected in the final work papers. When the assessment is received, verify all amounts against the final work sheets provided by the auditor. Note deadlines for payment or appeal and plan accordingly so they are not missed. If an appeal or litigation is contemplated, discuss the probability of success with outside counsel. Verify that the interest calculation is correct. If the state allows partial payment on agreed-upon issues, consider paying that portion of the assessment to reduce interest costs during an appeal. Make sure the audit deficiency is properly accounted for on the company's books. Promptly notify the auditor of any errors or discrepancies in the final audit work papers or assessment.







Appeals Procedures and Process

If you don't agree with any aspect of the audit, there are many levels of review and appeal that you can pursue. As you would expect, protest procedures vary from state to state. A few agencies allow only one level of administrative appeal before requiring taxpayers to pursue their cases in court.

Most tax agencies provide two levels of appeal, although one is generally an optional informal conference. A few states provide three levels (again including an initial informal conference), and some also offer alternative dispute



resolution or settlement programs outside the usual administrative appeal process.

If you don't agree with any aspect of the audit, there are many levels of review and appeal that you can pursue. As you would expect, protest procedures vary from state to state. A few agencies allow only one level of administrative appeal before requiring taxpayers to pursue their cases in court.







You need to be careful in this phase of an audit that you don't compromise your rights to sue in court at a later date, should you so choose. Many states require you "to exhaust all administrative remedies" before proceeding to court. So you have to know what your "administrative remedies" are.

Typically the auditor will hold an "Exit Conference" with you at the end of an audit. You may not be aware that this meeting is an exit conference because the auditors don't usually don't call it anything specific. In that meeting, they tell you your options as far as appealing the audit. These can become quite involved depending on how things go and we won't discuss all the available options, but several avenues are quite commonly used and these we will discuss.

Meeting with the Audit Supervisor/Manager

It is usually advisable to meet with the auditor's supervisor or manager to resolve disputed items. Auditors (especially new ones) will sometimes schedule certain nontaxable purchases as taxable and then cling to them like their life depended on it. No amount of logic seems to sink in and they'll want you to appeal it right to the state DOR, when a bit of common sense would do. This is when a good supervisor or manager can help.







Official Protest/Redetermination

In some states, an audit is referred to as a "Determination" of your tax liability. If you believe the tax assessed your company is overstated as a result of this "Determination" and you haven't been able to persuade the auditor or his supervisor, then you must appeal it or request a "Redetermination" if you want to appeal the matter further. This is usually an appeal to the State Department of Revenue. To request a redetermination you are usually required to file for one within 30 days of being notified of the official audit results. Typically, the request/appeal must contain a complete statement of the facts and the legal reasoning behind it. The deadline is critical.

TIP ► At this point, a state attorney is usually assigned and will attempt to get the audit resolved (usually in favor of the auditor/State). At this point there are many different avenues the appeals procedure could take depending on the circumstances. It is possible to handle it on your own but it is highly recommended that you utilize an attorney or CPA experienced in these specific types of actions to make sure you get the best results.







Penalty Appeals Done Right

If you were assessed a penalty in any material amount, you should consider appealing it. Not only is the penalty an additional amount out of your pocket, but it carries a double whammy of not being deductible for federal income tax purposes.

First, make sure you understand why the penalty was assessed and how it was calculated.

Next, assuming you get a satisfactory explanation of the penalty, you will formulate your arguments and assemble your evidence for waiving the penalty. Generally the penalty imposition laws state that penalties are imposed because the taxpayer failed to exercise "reasonable care". So this is what you will be attempting to refute in your protest.

If the penalty relates to self-assessments of tax on fixed assets, you might want to explain your self-assessment procedure. Be sure to cite the dollar amounts self-assessed, the number of transactions reviewed, and any other material fact that supports your argument for abatement of penalty on this area. You might also want to review department regulations, court cases, and department of revenue publications to determine if there are any guidelines that support the state's position.







Penalty Appeals Done Right (cont'd)

The state may not always be specific in its reasons for assessing a penalty. In many instances, the state will merely indicate that you may have made errors in prior audits with self-assessments and that similar errors were found in the current audit. Or the state may cite the amount of the assessment or the number of errors in the audit as being greater than in the previous audit.

When the state provides general reasons for the imposition of penalty, you should also be prepared to respond in a broad manner. There are a number of general defenses we usually bring up to justify a penalty waiver. These are listed below, and you should use them if/when applicable.

- The complexity of the tax law.
- ❖ The unsettled nature of the issues involved.
- ❖ Your demonstrated level of self-compliance. (You were correct on 99% of the transactions, for instance.)
- How much tax you voluntarily collected and paid compared to the audit deficiency.
- Your prior audit history and compliance record (if favorable).
- The staffing issues and turnover you've endured during the audit period.
- The degree of cooperation you exhibited with the auditor.







Sample Penalty Abatement Letter

December 10, 2018

State Department of Revenue 123 State Capitol Street Capitol City, USA 77777

RE: Penalty Abatement for ABC Company Taxpayer ID 123-45-6789

Dear Madam or Sir:

We have completed our review of the audit and are in general agreement with the results. However, we are not in agreement with the penalty imposed. Per state statute, penalty is imposed in cases where the taxpayer failed to exercise "reasonable care". We feel that a penalty on this audit is inappropriate for the following reasons:

- A review of tax remittances during our audit period shows that the audit deficiency comprises less than 10% of the total tax due for the period, when compared to voluntary self-assessments and payment of tax to vendors. The tax deficiency is \$50,000, while the amount of self-assessments during the audit period totals \$250,000, and the tax paid to vendors equals another \$300,000. These figures indicate that we have made a diligent effort to comply.
- \$40,000 of the audit deficiency is related to the sale of SaaS services which is a complicated area of the tax law that we did not fully understand until now.
- Our prior audit history of a less that 3% overall error rate shows that we have been diligent taxpayers over a long period of time.
- Throughout the entire audit period, all returns and payments were made in a timely manner. We accomplished this despite the fact that there was a 25% turnover of compliance personnel during the period.
- We cooperated fully with the auditor during the audit engagement and extended every courtesy to make the audit as efficient as possible for the state.

Based upon the facts presented above, we believe that we have established that we exercised the "reasonable care" required under the statute and as such, it would be inappropriate to impose a penalty. Therefore, we respectfully request a full abatement of penalty on the audit.

Please contact me if you have any questions.

Sincerely, The Taxpayer







Protesting the Sales Tax Audit

"Nothing strengthens authority so much as silence." – Leonardo da Vinci

If you've been over assessed sales tax in your audit in any material amount, then you should strongly consider protesting the assessment. Don't be overly intimidated by the process and don't be put off by the auditor who has a strong motivation to avoid the protest phase.

Every state has a defined process for protest starting with trying to resolve it with the auditor and the supervisor and going all the way to an administrative law judge.

In our experience, it's easiest and least costly when you try to get everything possible resolved before ever going to the official protest route.



"Get up, stand up, Stand up for your rights."
Get up, stand up, Don't give up the fight."
— Bob Marley

Chapter Seven Special Situation: Help With Texas Sales Tax Audits







Data from the Texas Comptroller indicates that one-third of their 4,252 audits in progress are being conducted out of state. Research also shows that Texas has a total of 595 auditors with 78 of those permanently based out of state.

The Statute of Limitations in Texas is four years. That means that your audit period will most likely look back four years.









Why am I Being Audited by Texas?

One of the first questions most business owners ask is, "Why my business?" It's common to think you did something wrong, this usually isn't the case.

Priority 1 Audits

Gross sales reported is the single biggest driving factor in the audit selection process. It is simple math: the higher your reported sales, the higher your potential tax exposure. The Comptroller knows this which is why they audit larger businesses on a more regular basis.

Audit Leads

You may have been selected for audit because someone has reported your business to the Texas Comptroller. This is called an Audit Lead. They come from former employees, competitors, and from Texas auditors directly.

Random Selection

A possible reason your business was selected for audit is simply due to bad luck. In other words, your tax identification number was selected at random. It is also possible that your business is in an industry the Comptroller is targeting due to poor compliance.







Why am I Being Audited by Texas? (cont'd)

Reporting History

Some businesses are selected for audit because their reporting history throws up a "red flag".

Prior Productive Audits

If your business owes more than \$10,000 in additional taxes due to an audit then you will automatically be audited again in three to four years.

Additional Reasons for Audit Selection

- Certificate of NTD (No Tax Due) request
- Leads from newspaper articles or internet news sites
- Leads resulting from bankruptcy action
- Security Release Request
- Bankruptcy
- Insolvency Investigation
- Refund Request
- Amended Returns









Appealing Your Texas Audit Results

Preliminary Notice and Initial Discussions

Once the field work is completed, the Texas auditor is required to provide and explain the audit schedules to the taxpayer. The auditor's write-up is expected to include a sufficient explanation to allow the taxpayer to determine the legal basis for the proposed assessment. The taxpayer also may request a meeting with the auditor's supervisor.

Informal Conference

If you disagree with the proposed assessment and you desire an informal conference, you will be granted an independent review by a reviewer outside the Comptroller's Audit Division.

Important Note: This "independent reviewer" may be "outside the Audit Division" but they are still employees of the Comptroller's Office. When the review is completed, a final version of the audit will be provided to the taxpayer, and a Notification of Audit Results will be issued. If there are remaining disagreements, the taxpayer should file a written request for a Redetermination Hearing within 30 days of the date of the Notification.







Appealing Your Texas Audit Results (cont'd)

Assessment and Protest

The request for a Redetermination Hearing should include a statement of grounds that lists the protested items (either individually or by category) and explains the taxpayer's reasons for disagreeing with each. Any disagreement with the agency's interpretation of the law or regulations must be supported by legal citations. Copies of supporting documents should be included with the petition, and schedules and work papers should be provided as needed to clarify the taxpayer's position.

Agency Conference

The audit staff will schedule a pre-hearing conference on or about the 61st day after it receives the request for redetermination. The staff is expected to expedite the process, and if the taxpayer does not provide all records deemed necessary, the audit will be returned to the hearing section without adjustment.

Extensions of time may be granted in increments of 30 days or less. Requests for extension, and the staff's responses, must be in writing. If obtaining resale or other exemption certificates is required, extensions for doing so may not be granted beyond the statutory 60-day requirement.







Appealing Your Texas Audit Results (cont'd)

If the pre-hearing conference does not produce a resolution, a hearings attorney will schedule an informal meeting with the taxpayer. Following the meeting, the attorney will issue a letter explaining the state's position. The taxpayer should respond to the letter, including an explanation of any remaining disagreements and any additional documentation if applicable.

As the final step before a formal hearing, the state will offer an optional mediation with an Attorney/Mediator before proceeding to a formal hearing.

Appeal to Second Level

The State Office of Administrative Hearings (SOAH) holds all formal hearings of contested sales and use tax cases. The hearing process is quasi-judicial: the administrative law judge may examine witnesses; rule on motions and the admissibility of evidence; and determine what goes into the record. After the hearing, the ALJ will issue a proposal for decision to the Comptroller or her designee that includes findings of fact and conclusions of law, as well as a description of the judge's legal analysis and reasoning.







Appealing Your Texas Audit Results (cont'd)

Either the taxpayer or the Administrative Hearing Section may file exceptions to the SOAH's proposal for decision. Once exceptions are filed, the other side has 15 days to respond. The Comptroller or her designee must rule on the exceptions, and either side may file a Motion for Rehearing. If the Motion for Rehearing is denied, the decision becomes final on the denial date. Note that the Comptroller may change a judge's finding of fact or conclusion of law, or vacate or modify an order, if she finds specified types of errors.

Missing Resale Certificates and the 60 Day Rule in Texas

One of the unique rules in Texas sales tax audits involves how they treat missing resale certificates. Recall that if you make a sale of taxable items to a customer in Texas, you must either collect the tax, or a valid resale or other exemption certificate. If you don't have a valid certificate on file, then the Texas auditor will simply assess you the tax on the transaction. This is not unique to Texas. What is unique is that Texas gives you a specified time period to locate missing certificates, and if you can get them in that time, all is well. If not, then the assessment sticks even if you get a valid certificate later.

The Ultimate Guide to Fighting Your Sales Tax Audit







Appealing Your Texas Audit Results (cont'd)

Sixty-Day Letter

Texas law requires that properly executed resale or exemption certificates should be in the possession of the seller at the time of the nontaxable transaction. Texas auditors are required by agency policy to allow the taxpayer a reasonable amount of time (depending on the circumstances of the audit) to obtain the missing certificates relating to unsupported tax-free sales before the audit is finalized.

If the taxpayer did not acquire all certificates needed within the time period allowed by the auditor, Texas Tax Code §151.0054(e) allow taxpayers sixty days to obtain the missing certificates from the date the Comptroller gives written notification requiring them. A sixty-day letter will be sent by the Audit Processing Section of Audit HQ in Austin. All certificates acquired during this time are subject to verification by the auditor.

The Sixty-Day Letter does not apply to:

- The United States government (Sec. §151.309(1)(2)(3)
- The State of Texas and its political subdivisions (Sec. §151.309(4)(5)
- Sales which are exempt by statute; e.g., water
- Sales which by their nature qualify for a resale or other exemption; e.g., bales of cotton







Appealing Your Texas Audit Results (cont'd)

One key thing to remember is that if you are missing resale certificates and haven't been able to get them for the auditor by the time he/she submits the audit, all is not lost, yet. But you must protest the audit by requesting a redetermination hearing. Once you make that request, the state will issue the "60-day Letter". The 60-day deadline is fixed and unchangeable. You must absolutely furnish any missing certificates by that deadline, and that's it.

That's another reason why Texas is fond of it's famous statement:

Don't Mess With Texas!







Sample Sixty-Day Letter

COMPTROLLER OF PUBLIC ACCOUNTS STATE OF TEXAS AUSTIN, 78774 September 25, 2006 Mr. Allen B. Clark, President ABC Services, Inc. P. O. Box 2468 Houston, Texas 77043-2468

Dear Mr. Clark:

I have received your request for a redetermination hearing on the limited sales, excise, and use tax audit performed on ABC Services, Inc., Taxpayer No. 12345678903, for the audit period April 1, 2004 through March 31, 2006. You have sixty (60) days from the date of this letter in which to submit any additional documentation to support your statement of grounds. An Auditor from Houston South Audit will contact you to make arrangements to review this documentation on the 61st day.

Your case will be reviewed by Houston South Audit, and if any relief can be granted at this initial stage you will be advised.

If we determine the issues in dispute cannot resolved by the audit office, you have the right to meet with an Independent Audit Reviewer (IAR), if you have not met with one previously. This can be initiated by notifying the auditor on or before the 61st day. If you previously met with a IAR or choose not to exercise this option, your request will be forwarded to the Comptroller's General Counsel Division. You will be notified by letter of the name and telephone number of the hearings attorney assigned to your case.

Please do not hesitate to call Jennifer Hernandez in the Houston South Audit Office if your have any questions. You can contact the audit office by calling 713/314-5700.

Sincerely,

James Jefferson Audit Processing 512.936.5872, 1.800.531.5441-Ext. 65872 James.jefferson@cpa.texas.gov







Texas Sales Tax Audits

"If a man's from Texas, he'll tell you. If he's not, why embarrass him by asking?" - John Gunther

Texas is a very business-friendly state, that is unless your business is under a sales tax audit in Texas. Texas tax rules are notoriously complicated already, so the chance for making errors is high enough. But sales tax auditors in Texas have a reputation for being very aggressive.

If you're under audit by Texas, join the crowd. The state conducts thousands of sales tax audits every year. You need to be on the top of your game to protect your company when a Texas sales tax auditor comes to town.



"If I owned Texas and Hell, I would rent out Texas and live in Hell."

— Philip Sheridan, Civil War Memoirs

Chapter Eight

Review: Sales Tax Audit Checklists







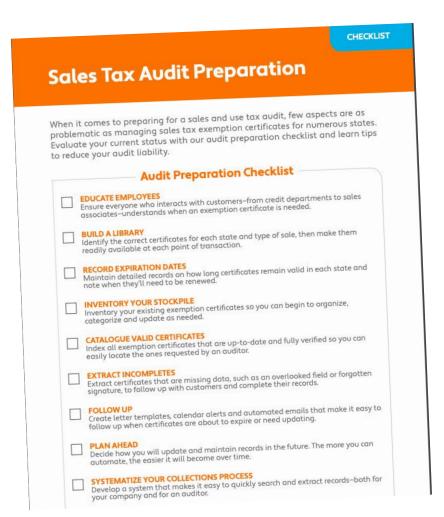
Checklist of 4 Areas to Review in Your Pre-Audit

ш	Review (See Chapter 1 for more details)
	Nexus.
	Fixed Assets
	Use Tax Accruals and Sales Tax Payable Account

■ Exemption Certificates

Checklist for Reviewing Your Exemption Certificates

Here's a handy checklist you can download created by Avalara to assist you in evaluating your readiness for an audit of your exemption certificates.









Checklist of Regular Items to Review as Part of Your Company Tax System (See Chapter 1 for more details)

- ☐ Regularly review the minutes of the Board of Directors and executive committee meetings to identify and plan for significant plant expansions, purchases, contractions, or company reorganizations;
- Periodically review of exempt and resale exemption certificates to ensure that they are complete and in proper form.
- Periodically review company depreciation schedules for any "big-ticket" items will ensure that sales/use tax was either paid or use tax accrued on the purchase (assuming it was taxable).
- Document tax positions taken on gray or ambiguous areas of the law while memories are fresh. The memos and supporting statutes, regulations, and cases should be stored in a permanent file.







Checklist of Items to Keep In Your Permanent Files (See Chapter 1 for more details)

- Legal entity being audited
- Audit period
- ☐ The state that is being audited
- Auditor name and contact information
- Initial audit assessment
- Final audit assessment
- Notes discussing the largest items identified under audit and other areas in which improvement is needed to reduce future tax liabilities









Checklist of Things You Should Know Before You Ever Commit to an Audit Start Date (See Chapter 1 for more details)

The scope of the audit (one state or many, etc.)
Whether you have the personnel available to obtain
and provide the information requested
The availability of suitable office space
The schedule of other ongoing audits
Audit location (where the auditor wants to perform
the on-site review of documents)
Whether a consultant will be used and their
availability
Applicable statute of limitations
Whether the auditor is travelling (could be helpful
to know how many days they've allocated for their
visit)
Whether the audit raises sensitive exposure
concerns (there were large acquisitions during
audit period, nexus issues, exemption certificate
issues, etc.)
What the sampling procedures will be
Who your Audit Coordinator will be







<u>Chart: How Far Back Can States Go</u> When They Audit You For Sales Tax? (or, What is the Statute of Limitations for Sales Tax Audits?)

A state's sales and use tax statute of limitations applies as a limit to how far back a state can go when they audit you -- that is assuming your company has been registered and filing sales tax returns in that state. Some states have different limitations for audit assessments than they do for refunds. Remember this: If a taxpayer fails to file a return, the statute of limitations in most states never runs. Check out this chart from CCH that shows all the states and how far they can go back.

Checklist of Items Most Taxpayers Are Usually Willing for Auditors to Review (See Chapter 4 for more details)

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	Federal and state income tax returns	
	Sales and use tax returns	
	Worksheets used to prepare returns (be careful about the	
	depreciation schedule)	
	Sales tax payable account reconciliation schedules	
	Source documentation such as invoices, register tapes,	
	contracts and other records	
	Exemption certificates, product descriptions, contracts and	
	other information supporting an exemption	

The Ultimate Guide to Fighting Your Sales Tax Audit







Sales Tax Audit Checklists

"No matter how expert you may be, well-designed checklists can improve outcomes." - Steven Levitt

This chapter contains a menagerie of different charts that we thought would be helpful. It's impossible to remember everything you should be thinking about when your company gets audited. These checklists will help guide the way in some critical aspects.



"I watch a lot of astronaut movies....Mostly Star Wars. And even Han and Chewie use a checklist." — Jon Stewart

Chapter Nine What's Next?







What's next?

We hope this guide has been helpful to you in managing your sales and use tax audit. A sales tax audit is no stroll in the park. You need to invest the proper efforts internally or seek outside help.

Defending businesses against a sales tax auditor is a highly specialized area of consulting. Over the years of working with clients to minimize the tax assessed against them we have gained invaluable experience and it's our pleasure to share it with you.

Whether you use this information to manage your audit completely start-to-finish or to at least gain some familiarity with the process to know how to avoid common pitfalls, then it will have been very valuable indeed.







Should We Bring In Outside Consultants to Help with this Sales Tax Audit?

We can't answer that without knowing your particular situation, but we can give you some points to consider.

Consider getting audit representation if any of the following conditions exists:

- ❖ You've never been audited before. An experienced representative will help you prepare and cut down the time it takes to resolve the audit.
- The timeline is advancing quickly. Should the state provide an aggressive timeline to begin the audit (less than a month), you will need help preparing for it. Outsourcing will save you time and money in the long run.
- ❖ Staff is already busy. If you don't have a person internally who can be your Audit Coordinator and/or can't spare enough competent staff members to do a pre-audit review and deal with the auditor while he or she is onsite, you should consider hiring outside consultants. A pre-audit review is highly recommended, so that you know what you are dealing with before the audit begins.







Thinking of Hiring Outside Help? Do This, Not That

Do This ► If you opt to use a third party for the preparation and actual audit, make sure you understand the scope of their work and how they will be compensated.

Not That ► Do not engage in contingent fee arrangements on questioned items by the auditor unless you have already made the first pass. Otherwise, you may be paying a contingent fee on reductions for errors made by the auditor or obvious exempt transactions.

Do This ► The fee should always be based on offsets actually granted by the state. Payment should be made at the end of the audit, or a provision should be included to reverse any offsets not allowed.

Not That ▶ Pay the fee until you have written documentation from the state audit division.

Do This ► Understand whether their services are included only at the audit level or whether services related to appeals or tax court are included.

Not That Do not give them the power to make a settlement offer without your consent.







Thinking of Hiring Outside Help? Do This, Not That (cont'd)

Do This ► Understand the consultants' specific experience with your state and your industry. Ask for references.

Not That ▶ Hire someone whose primary working experience is as a former state sales tax auditor. Get someone who has 10 or more years working on behalf of the taxpaying businesses. From our experience, it can be difficult for a former state tax auditor to change hats and think in terms of the business' interests.



The Ultimate Guide to Fighting Your Sales Tax Audit







How to Learn More About Potential Consultants Without Feeling Like You're At a Used Car Lot



Nobody wants to be pressured into a decision and no one wants to be "sold". Sorry to say, but there is an undesirable element of high pressure salespeople in the world of state tax audit consultants. You may have already experienced it.

I'm not against sales consultants whose primary role is to give you information you need to make an informed decision, but if all they're doing is heaping on the pressure, I'd stay away from them.

So how to decide? One way you can assess the experience and knowledge of a consultant is to read their material and listen to them speak. The benefit of

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After all, you only want to do business with someone you feel like you know and you believe this person knows what they're talking about. But it goes deeper than that. This consultant is going to be representing you in a very important audit situation that may have dire implications for your company. You need to be able to trust them. And we shouldn't understate the importance of liking your consultant. We have choices in this world, and we should like the people we work with.

Look your consultants up on the internet. See what they've written in blogs, on LinkedIn. If you're lucky to find that they've given speeches or webinars on fighting sales tax audits, check them out there. See what they're all about by listening to their presentations. Then, you will have a better idea if you'd like to invest some time to meet with them. Just make sure they are willing to invest their time in you before they ask you to invest your hard-earned money with them.







FREE Webinar on How to Avoid Sales Tax Audit Mistakes

We do webinars almost every week on various sales tax topics including one on How to Avoid the 5 Most Common Mistakes in a Sales Tax Audit. You can check it out here.

Under Audit?

Are you (or your client) under audit right now and need to meet with us (AT NO CHARGE) to get some advice from us on what to do next? You can request a meeting with us using this link.







What's next?

"An expert is a man who has made all the mistakes which can be made, in a narrow field." - Niels Bohr

It may be a great idea to bring in some outside help to at least review your sales tax audit assessment. An experienced, competent third party can shed some light on your situation and give you an idea of what you should do next.

This should be a no-cost, no-obligation review just to give you some direction on what your next move should be. It could save you thousands of dollars on your current or upcoming sales tax audit.



"In the beginner's mind there are many possibilities, in the expert's mind there are few." — Shunryu Suzuki