Surviving a Sales & Use Tax Audit:

A Guide for Manufacturers

You open the letter from the state department of revenue (DOR) with a heavy heart. Your company has been selected for another state sales tax audit for "potential risk of underreporting and/or underpaying sales, use, corporate and/or withholding taxes." Not now, you think. We don't have time for an audit with everything else going on in the business.

Take a deep breath. Creating a detailed action plan complete with negotiation points will help get the best audit outcome possible.

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Why me?

Why was my company selected for an audit?

As you prepare for the audit, it is important to know why your company was selected. There are a variety of reasons why you could have been selected – and most of them have nothing to do with mistakes on your end.

Common Sales Tax Audit Rationale

Seven Reasons you may be targeted for an audit that are outside of your control:

1. **Audit Cycle:** It's your time again. Most companies get audited on a regular, consistent basis.
2. **Industry:** Your company is in an industry that the state DOR is targeting.
3. **Automation:** A data warehouse program convinces the state that you have nexus (significant physical presence) in that state.
4. **Audit by association:** A supplier or customer was audited and your company was red flagged.
5. **Competition:** A competitor was audited and the DOR is trying to level the playing field.
6. **Random chance:** An auditor randomly noticed your business location and jotted down your name.
7. **Geography:** Believe it or not, your location can make you a target. For example, Florida locations tend to be audited during the winter, Minnesota locations during the summer.

Areas of potential error that can trigger an audit: :

- Large number of exempt sales
- Trends in filing that show inconsistency
- Refund was filed by your company

What should I expect from an audit?

The Audit Process

To start preparing, make sure you understand the audit process, the information that will need to go back and forth between your organization and the auditor, and the time required for each step in the process.

1. **Request for information:** The auditor will ask for information on various areas of business, (see below) including fixed asset purchases and expense purchases. Note that more and more states rely on computerized audits, also known as “stratified audits.” These audits require a download of all purchases during the audit period. A computer program will then statistically select the particular purchases to be reviewed.
2. **Preliminary schedules:** The external auditor will prepare the audit work papers (also called schedules) for the taxpayer to facilitate the audit. There will be different schedules, and sub-schedules for expenses, purchases, asset purchases and sales. Sales tax schedules are generally items the auditor believes are taxable, where tax has not been properly paid and collected, and where additional information is needed. The taxpayer then responds with comments and additional information.
3. **Revised schedules:** The auditor reviews your responses on the preliminary schedules and responds back with additional requests. Depending on the complexity of the audit, you may exchange multiple audit schedules, as more information is provided.
4. **Final schedules and assessment**: Once you agree or “agree to disagree” with the auditor’s findings, you will receive a final assessment called a Proposed Assessment.
5. **Appeals:** For most states, the appeal period is based on the date of mailing of the Proposed Assessment or a subsequent notice, often called an Official Assessment of Official Notice of Assessment and Demand for Payment. Each appeal period typically extends 30 days from the date of these notices. The number of days varies from state to state. Each state has its own specific appeal requirements and procedures.

Anticipate taking at least a month to prepare for the audit; the number of hours will vary, but plan to spend at least 40 to 60 hours. For small companies, an audit can generally be wrapped up in a few weeks. For mid-size companies, an audit can be open for a good 6 months. For the largest taxpayers, audits can drag on for years. There are times when as one audit period closes, it’s time to start the next audit period.

What Kind of Documentation Will the Auditor Need?

After you've negotiated the parameters in your favor, start preparing the materials required for the audit, allowing plenty of time to gather the necessary information.

Fixed Asset Purchases

Often, tax assessments from audits actually come from the "use" tax portion of sales and use tax laws. State auditors will request a report of fixed asset purchases from the audit period, along with the supporting invoices. Typically, the fixed asset portion of the audit is done on a detailed basis and not projected.

Non-Asset Expense Purchases

Auditors typically select a test period to review samples of non-asset expense invoices. The selection of the test period is important and negotiable. If your company has improved its process for monitoring taxability of purchases, request for the test period to come after you improved those processes.

Keep in mind that any purchases found to be taxable will be extrapolated on the assumption that the purchase occurred regularly during the audit period.

An area of negotiation would be if a one-time purchase were selected in the sample. Often times, you can work with the auditor to reduce the factor, if you can prove that it was a unique transaction.

Detail of Sale and Use Tax Returns

Another area the auditor will delve into is the sales and use tax returns you have filed. Here, the auditor will want to review the proof or backup data for the returns being reviewed. Why? The auditor's job is to ensure all tax collected was remitted and to make sure you are taxing the correct items.

Exemption Certificates

Ensure you are documenting exempt sales with Exemption Certificates. A lack of exemption certificates generally results in large assessments. Because of the sampling technique, missing one exemption certificate could result in thousands of dollars of taxes owed. Most auditors will give you a time period to collect certificates, but not much of one. If the company for which you are seeking exemption certificates is out of business, changed names or is on an extended trip to the Bahamas, you're out of luck.

How can we prepare for the audit?

Before starting the audit, be sure to negotiate the following:

1. **Start date.** You want substantial lead-time to prepare for an audit – at least a month. This allows you to research any issues you have on your end.
2. **Test period the auditor selects.** If there has been an improvement in your business practices for monitoring the taxability of purchases, press for the test period to come after the process improvements were made.
3. **Missing Documentation.** Inevitably, there will be missing documentation, such as a purchase invoice. Is the auditor going to allow you to substitute a like invoice to prove tax was paid or is it going to be assumed taxable? Likewise, if exemption certificates from your customers are missing, will you be given time to gather them?

Statute and Waiver Issues

Auditors frequently request you sign a waiver that tolls the statute of limitations for the audit period. The statute is the period of time that either the DOR or the taxpayer can make amendments to the audit. As a result, the waiver holds the statute open to allow time for the audit to be completed without losing periods to the statues. This gives companies additional time to complete the audit without jeopardizing the statute of limitations.

With a 36-month statute, any period longer than 36 months cannot normally be audited by the state or amended by you. The waiver extends the period of time to complete the audit without having to drop the oldest month as each new month passes. Often, an auditor will request additional waivers to extend the time to complete the audit. Depending on the circumstances, giving the auditor additional time might be reasonable. However, you should limit the number of waivers so audits don't drag on for years and years.

What can you do to minimize your audit assessment?

Doing a reverse audit is one of the many steps that can minimize the final assessment. Remember, the auditor selects all of the potential assessment items and the focus is always on underpayments without consideration for overpayments. Here are some tips to review as part of the reverse audit:

Note: If you do not have the staff or the time to complete this task, consider outsourcing. See *Should We Hire Help?* on page 6 for more information.

Previous Audit Documentation

If you haven't already done so, conduct an extensive review of any previous audit documentation. Having this history will help you know your prior weak spots. Hopefully, you've made steps to rectify these!

How do auditors make assessments?

Auditors make projections in several ways. For example, if the auditor uses a four-month test period for a 36-month audit, he may multiply any assessment item by nine. Alternatively, auditors can calculate the error rate based on a percentage of purchases, and then apply it to all purchases for the entire audit period. Remember that this "factor" is also negotiable if you can demonstrate the irregular purchase pattern of the assessment item.

Purchasing & Sales

The following check lists will help you identify each area that needs to be reviewed:

PURCHASING CHECKLIST

Documentation of invoices	Check for documents related to the invoices being assessed. Ensure the tax wasn't paid in a separate billing or the item wasn't returned. Also, double check to see if use tax was paid, if the vendor didn't charge tax.
Exemptions	It is important to know whether any items getting assessed are actually tax-exempt. Find out from your employees why the item was purchased. How an item is being used will explain whether it is tax exempt. For manufacturers, in particular, the taxability of a purchase can get very complicated. Having professional tax representation from an industry expert can save you time and money in this area.
Correct Figures	Be detailed! Make sure the auditor's figures are correct. You'd be surprised by the amount of typos, transferred numbers, invoice numbers written for taxable amount and other mistakes that are made by auditors.
Vendors	Did any of your suppliers get audited for the same period and get tax assessed on the same purchases? If so, you usually don't owe the tax. The general rule is that sales or use tax is only paid once.
Exemption Certificates	If the auditor questions your exemption certificates, ask for time to correct the errors. It will usually be granted. Don't just accept the auditor's initial evaluation.

SALES CHECKLIST

Taxable Base	If the auditor makes an assessment on sales, be sure the calculations are correct and that the auditor did not compute tax on a non-taxable item.
Customer Tax	Ensure you have documented the tax paid by your customer accurately; check to see if they paid tax on a separate invoice or accrued use tax.

SHOULD WE HIRE HELP?

When Should You Hire Audit Help?

There is nothing wrong with getting outside help to prepare and represent your interests in an audit. Consider getting audit representation if any of the following 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.
- **Time is an issue.** 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.
- **Lack of staff.** If you can't divert enough high-level staff members to do a pre-audit and deal with the auditor while he or she is onsite, hire representation. A pre-audit is imperative, so that you know what you are dealing with before the audit begins.

When hiring professional tax representation, consider the following qualifications:

- **Experience.** Have they worked directly with auditors before? Which staff members will work on your audit? Are they experienced? You may be able to find a former auditor who has become a consultant to help you through the process.
- **Education.** How does your representative of choice stay abreast of the constantly changing tax laws? It is imperative that your representation understands the nuances of tax laws facing your industry.
- **Reputation.** Talk to their references. Review their social media profiles. Ask hard questions to make sure they are the right person for the job.
- **Industry expertise.** While the audit process doesn't change, the target for determining taxability of a purchase is constantly moving, especially for manufacturers. Finding a professional tax representative from someone who knows your industry is extremely helpful.

Learning from Your Mistakes: Using the Audit as a Catalyst For Change

Audits are a necessary part of business and an opportunity to examine your current processes for liabilities. Once an audit is complete, you will need to make some organizational changes to ensure you are protected in the future.

Which parts of audit preparation and defense can we outsource?

Perhaps you are comfortable handling the audit yourself, but need additional help with a few projects to prepare for the audit? Here are some of the things that make sense to outsource:

1. **Pre-Audit –** Conducting a pre-audit or reverse audit, prior to an auditor coming in, can ensure you have no nasty surprises. Outsourcing this makes sense because internal staff will try to avoid showcasing mistakes they have made or might not even be aware of those errors. You need substantial lead-time before the auditor shows up on your doorstep to do this.
2. **Exemption Certificate –** If staff has not been on top of exemption gathering, this may be a good task to outsource.
3. **Expert Advice –** If you choose to handle the audit yourself, paying for a little advice now and then can make a big difference. Consider getting a tax representative to bounce questions off of.

Using the results of your audit, evaluate your current business from a process and a people/training perspective. The following chart outlines common audit issues:

Process Issues	People/Training Issues
• Exemption Certificates • No system to accrue and pay use tax • Purchasing cards used without accounting for tax • Tax returns not completed properly • Tax decisions are not being reviewed by senior management regularly • Purchasing department employees have no input in tax decisions • Wrong tax base and incorrect rates	• Exemption Certificates • Wrong tax base & incorrect rates • Failing to recognize exempt versus taxable items • Accounts Payable employees don't have training • Purchasing employees don't know the impact of the procedure. For example, if tax is automatically calculated based on the account number, does the staff know that their account selection is important?

Exemption Certificate pitfalls:

- Assigning sales or customer service rep or under-trained individual to manage exemption certificates.
- Placing one person in charge of collecting and validating tasks, without oversight.
- Missing or misfiled exemption certificates.

What type of agreement should we work out with the auditor?

When to Consider a Managed Compliance Agreement

Companies who have experienced nightmare audits tend to look for better solutions for their next audit. A managed compliance agreement (MCA) is an option. The goal of a managed compliance agreement is to improve your sales and use tax compliance, and reduce audit assessments, while reducing your administrative burden. This agreement between your company and the DOR simplifies your tax liability, based on the average tax due on an account or group of accounts. Then, an authorized percentage is applied to purchases during the agreement of the MCA, usually up to three years. Depending on the state, future audits may only change the percentages used in the future.

Like anything, MCAs have pros and cons:

MCA Pros:

Pros	Cons
• Once the agreement is reached, the process of accruing use tax moves away from the individual invoice level, thereby simplifying the process/cost of tax compliance. • Minimizing human intervention of the tax decision process at the invoice level is designed to reduce personnel costs. • With reduced human intervention, the cost of training employees on taxability concepts and procedures is eliminated. • Use tax is a budgeted expense. • Depending on the state, any future audit only changes the methodology of tax accruals on a going forward basis; the company is not assessed for prior periods, based on any changes to the MCA by a subsequent audit.	• The business and the state must reach an agreement on the percentage to be used for accruals. • There is a cost to determining percentages (either consulting cost or internal staff resources). • Where agreement cannot be reached, certain accounts may be excluded from the agreement and process going forward. This could result in a hybrid method of accounting for use tax that could increase the complexity and time requirements for compliance. • The implementation of MCAs requires training employees on the new process and tax policies change due to legislation and other factors. If this happens while operating within a MCA, the negotiated percentage will need to be readdressed.

Sales tax compliance challenges like these giving you a headache?

Take it easy and give us a call. After all, over 10,000 companies already use our highly rated cloud-based automated sales and use tax solutions.

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Managed Audits: Another Option

A Managed Audit allows the business and the state to coordinate a self-audit for sales and use tax. Both parties agree on the parameters before the agreement is signed, and the state then reviews the taxpayer's analysis and makes adjustments.

Pros	Cons
• Audit period, sample techniques and other parameters are agreed to in writing. • Your staff will already know the details of how purchases are used, eliminating the need to field questions from auditors. • You may be able to hire tax experts to minimize employee time.	• Time expended by employees is greater, since your own employees may be performing the audit. • Deadlines are normally part of the agreement, thereby creating some level of time pressure. • Often, final sample selection decisions rest with the auditor coordinating the audit.

After the Audit

No company wants to undergo an audit, but once it's done, the process and experience is a great reason to examine what's working – and what's not working – in your organization. Take this opportunity to consider whether there is a better way to do things, either through new processes, automation or outsourcing.

Ask yourself and your staff:

- How much time is currently being spent on tasks that could be automated or outsourced? What are our results? Would this time be better spent on value-added activities? For example, sales people are often responsible for collecting, updating and maintaining customer exemption certificates. Yet, they have little training, and don't know if certificates are valid. Wouldn't their time be better spent selling?
- Are sales tax returns completed properly and timely? Can your staff take the time spent filing tax returns and apply that to more proactive activities?
- Do you have the required in-house expertise on:
  - Taxability of purchases
  - Cash discounts
  - Taxability of services
  - Freight taxability
  - Finance charges
- Are you considering software to help track or automate any of these areas? The right software can simplify procedures and minimized mistakes by staff members. Be sure to work with a cloud-based provider.

Answers to these questions lead to a variety of solutions to consider, including hiring expertise in sales and use tax, finding software to track and automate processes, or outsourcing the entire function to an expert. The costs of changing these processes are frequently recouped by organizations because they will then have the time to focus on activities that help their businesses grow.

A Final Word

Sales and use tax audits are no walk in the park. Spending the time it takes up front to negotiate the best results for your organization, and prepare in advance, is worth the investment. Hiring audit representation also goes a long way in reducing the amount of time an audit takes while protecting your interests.

Good luck!

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