
Slumping Economy Means Increased Audit Activity and an Urgency To Prepare

By Don Fuga and Tom Concitis

Don Fuga and Tom Concitis provide valuable insights into the audit process and suggest best practices in preparing for an audit. They also discuss the value of automating certain processes that will assist a company in both tax preparation and responding to an audit.

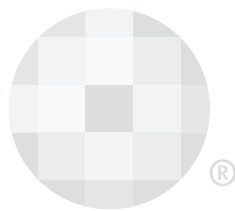
A perfect storm of macro trends are putting taxpayers, and particularly the corporate tax professional, under intense pressure. The softening economy is leading to such revenue shortfalls that some states are facing record deficits, and struggling to fund programs.

In an election year, lawmakers are reluctant to raise taxes to cover these deficits and hesitant to cut funding for popular programs. This predicament is leading many states to increase revenues by rigorously auditing taxpayers.

Since sales and use tax laws and regulations are some of the most complex and vary by state, these taxes are constantly targeted for audit by states that impose them. As many businesses are struggling to stay profitable and resources become scarce, many tax professionals find themselves in a bind. Businesses are pressured to preserve capital in a slumping economy and the tax professional is expected to contribute to this effort. Thus, a real urgency to avoid large audit assessments mandates that the tax professional be prepared to weather the audit storm.

Audit Preparation

Changes in the sales and use tax laws generally lead to new compliance needs that taxpayers must learn and adopt. Often the changes can present challenges that can swamp a tax department. For example, states adopting the provisions of the Streamlined Sales Tax Agreement are required to amend their laws to come



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into compliance with that agreement. The amendments often mean changes in the taxability of goods and services. Aggressive auditing states know this and are taking full advantage of the circumstances by increasing audit activity for large corporate taxpayers, or targeting specific industries like manufacturing or retail.

Taxpayers must prepare for audit activity to continue to rise by staying abreast of sales and use tax law changes, rate changes, and exemption rules on a state-by-state basis down to county, city, and special tax district levels. At the same time, accurate recordkeeping is increasingly paramount. Changes in corporate structure, product lines, and ownership must be carefully monitored and tracked. While this can be daunting, following certain key practices for audit preparation and management, and using automated tools, will prevent audit snafus and help taxpayers reduce risk.

One important preparation step tax professionals can take is to initiate an open dialogue with other companies in their industry. Perhaps they are also being audited or have been audited and would be willing to share their experiences. By identifying the hot button issues being examined in the industry before his or her own audit begins, a tax professional can take some corrective measures and prepare supporting research for existing processes.

Tax professionals should also be aware that before the audit actually starts, an auditor will review any past audits his or her jurisdiction performed on the company. The auditor will detail areas where it was previously out of compliance and prepare to examine them. The auditor will also review the company's Web site and look for acquisition information, product information, change in corporate structure or any area that may lend itself to other possible non-compliance issues. The tax professional should think ahead to also examine these same areas to avoid any unpleasant surprises.

It is almost certain an auditor will review fixed asset purchases in detail and test sample expense purchases for possible tax omissions, test sample exempt sales transactions for possible non-billing of tax and check to see if the exemption certificates

are up-to-date. They will also reconcile the accounting records including the accrued sales tax accounts to ensure that all the tax that was accrued has been remitted.

Internal Complications

There are also several internal factors that can hinder audit preparation and the sales and use tax function as a whole. The tax professional should be prepared to face them and plan to deal effectively with these challenges.

Staff turnover can present a major issue. In many cases there is one person in the tax department who

bears responsibility for the entire sales and use tax function, but then their un-documented institutional knowledge is lost when these employees leave. Often it can take months to replace that person, and even longer to reinstate an effective compliance process. The downtime can be disastrous, particularly if the laws change and audits

are on the horizon or in progress. The responsibility for the sales and use tax function should be spread around to several individuals if possible, in order to avoid what is often coined the "one man show." Periodically, institute a rotation of assignments to insure adequate cross training and backup in the event of staff changes.

New product lines can open up a host of issues. The tax professional must determine if the product line is taxable or exempt in the jurisdictions in which the company operates. It is also important to note whether the company's customer base has changed with the new product line, and if so whether that means exemption certificates need to be updated in some jurisdictions. Acquiring new customers may also require the tax professional to examine if nexus has been established in jurisdictions where the company is not currently registered.

Mergers and acquisitions (M&A) activity can cause disruptions even when they are well-planned and well-integrated transactions. It is essential to review the sale and purchase agreement to determine the parties responsible for potential tax liabilities. When

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acquiring a company, the tax professional should perform a reasonable amount of due diligence in order to be aware of potential liability issues. Companies that go through a period of significant M&A activity often find they are more susceptible to audits. During these times employees are often distracted by the M&A activity and attention to day-to-day details often falls by the wayside. An audit can also be triggered when companies close the affairs of a corporate entity that is no longer needed in the post-transaction era. M&A activity among customers also adds a layer of complexity to exemption certificate management. If in a merger the surviving legal entity was not your customer then this generally requires a new exemption certificate be obtained, even if the business name remains the same.

New accounting software can also be an issue, especially for companies that hold direct pay permits. Often, systems automatically calculate use tax based on an accounting code. If during the conversion process great care was not taken in converting old account codes to the new codes, significant errors can and often do occur.

Exemption Certificate Management and Other Audit Challenges

It is imperative to have a streamlined process to gather and store exemption certificates and to manage the process effectively. Often, this is not prioritized and is a common shortfall that leads to audit assessments. In an independent study commissioned by Vertex, audit officials in 23 states and over 260 tax professionals cited missing or invalid exemption certificates as one of the major reasons for an audit assessment. Tax professionals reported that when assessing tax for missing or invalid exemption or resale certificates, the inability to produce the certificates accounted for nearly half of the total assessment. Auditors will ask for specific exemption certificates and the tax professional must have the ability to access those certificates promptly. Additionally, tax professionals should implement an automated exemption certificate system that will allow them to maintain and organize customer information by state, number and type of exemption or by any other jurisdictional requirement. In a centralized record keeping environment, record and document control is generally better controlled.

However, in a decentralized environment, remote locations may have processes that lack full control over obtaining and storing tax documents.

Unfortunately, many taxpayers are not organized in the area of exemption certificate management as they should be. In the same study, only half of the tax professionals surveyed said their companies are proactive in performing scheduled, or at a minimum sporadic, updates on their exemption certificates. The other half request certificates only upon the initial sale and have no updating process. Even minor inaccuracies such as misspellings, and mismatched tax identification numbers will cause the auditor to reject the certificate and deem the sale taxable. In the event that minor inaccuracies happen taxpayers are usually given between 30 and 90 days, depending on the jurisdiction, to obtain a corrected exemption certificate from the customer, and provide it to the auditor. If they fail to do this, the auditor's rejection stands, and the taxpayer has to pay the assessment usually with interest and penalty tacked on top of the tax.

Obtaining a corrected certificate is no easy task. Often the tax department must track down a purchasing associate of the customer and explain why a new certificate is needed. Relentless follow-up may be necessary to ensure the request is met in a timely fashion. There is also the possibility that the customer is no longer in business and no one is available to fulfill the request. The lesson to be learned is to get an accurate certificate up front and verify its accuracy. A good time to obtain exemption certificates for new customers is when they complete your company's credit application.

Also keep in mind that your company may not be complying with your suppliers with respect to exemption certificate compliance. Tax professionals should institute a policy that describes the appropriate reasons for issuing exemption certificates. The policy should also indicate the affected groups or departments that are authorized to issue certificates. It is also beneficial to create a taxability mapping tool that clearly articulates everything purchased and used in the business and provides ground rules for taxability of affected products or product classes. Meet often with other departments such as accounts payable, purchasing and those responsible for the fixed asset accounting, to review procedures and clarify taxability matters. Issuing incomplete or invalid certificates to your suppliers could lead to your company being audited.

Another recordkeeping complexity is certificate expiration dates, which vary by state. Most states require new certificates every three to five years. Once again, the burden is on tax departments to track these ever-changing rules and ensure their company is in compliance.

In addition to a formal process for exemption certificate management, it is imperative that a process be in place to accurately self-assess consumer use tax. Often this task is put on the shoulders of an accounts payable associate or a purchasing department associate who may or may not be knowledgeable about transaction tax laws. It is difficult enough for seasoned tax professionals to keep abreast of the sales and use tax laws let alone a non-tax professional. But often, due to limited resources at the disposal of the tax department, the determination to self-assess consumer use tax does become the responsibility of a non-tax professional. If the latter is the case, it is essential that the tax department provide adequate guidance in the form of a manual or tax matrix. Conducting periodic meetings with the non-tax associates in the purchasing and payables roles will ensure they are comfortable with the proper process for use tax accrual or verification. Another option is to automate the consumer use tax process using third-party software solutions that are now more robust and readily available.

Finally, there is the matter of tax law changes that can and do create additional compliance burdens. Corporate taxpayers with a presence in many jurisdictions can be sure that every year, at least one of the jurisdictions where they do business will make a change to its sales tax laws. For example, Vertex studies show an average number of 700 rate changes occurring annually over the past decade. As a result, a process for tracking these changes is essential in order to have effective control of the sales and use tax function and avoid large sales or use tax audit assessments.

Audit Defense—Reverse Audits

Many would argue a good defense is a good offense. A reverse audit is a proactive way to recover taxes that were overpaid. Also, a reverse audit can ensure proper and accurate compliance before the

taxpayer is audited by a jurisdiction, and it may even be profitable. These types of audits are performed for the same statute of limitations period that is open for assessment. The desired result of a reverse audit is two-fold. The first is to identify overpaid tax and seek significant tax refunds. Second is to take corrective action on those taxable items for which no tax was paid or accrued before a formal audit begins.

To start a reverse audit the tax department should devise a game plan and determine those transactions that would likely lend themselves to overpayments or underpayments. Tax professionals must know how their company operates to narrow the scope to one that is manageable. Having knowledge of

prior audit results and the tax laws will aid in making the appropriate scope determination and getting the desired results.

A review of the details of the fixed assets purchases should be a

priority. Auditors normally review them because of the large dollar amounts involved. The tax professional should do so as well.

A sampling method should also be employed for expense purchases and exempt sales. At least one period in each of the calendar quarters open to assessment should be tested.

Another area of review where overpayments exist is the accrued consumer use tax account. Large dollar transactions should be reviewed in detail and smaller transactions should be sampled.

The details of the sales and billing transactions are summarized in the financial records of the organization. The account analysis of the accrued sales tax account is often overlooked. Ideally an accrued sales tax account is established and maintained for each jurisdiction in which a return is filed. Using this guideline makes it easier to track activity and quickly uncover errors. If only a single sales tax liability account tracks activity then this account should be reconciled every accounting cycle.

Typical errors that may exist are improper accounting for discounts for prompt filing and remitting, as well as tax rate errors that can lead to over collection. Generally, an under-collection is corrected when filing the tax return but an over collection and wrongful accounting for discounts will lead to an improper credit balance in the account. Auditors will examine the sales tax accrued account and assess

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for any credit balance that cannot be justified. If you cannot reconcile the account you may be assessed tax that you do not owe. Monthly reconciliation of this account is recommended.

In the event you discover that you have overpaid sales and use tax, a refund will have to be documented and a refund claim filed within the statutory period to recover the overpaid tax. A worksheet should be set up to enumerate each transaction by vendor, invoice number, invoice date, a description of what was bought, the dollar amount, and amount of tax overpaid. Refund claims filed with tax authorities require much more detailed documentation, such as copies of invoices and in some cases very detailed descriptions of the items and how they are used.

Manufacturing companies whose claim entails exemptions afforded the manufacturing industry should always include a schematic showing their manufacturing process indicating where production begins and ends. States that have exemptions for manufacturing equipment and supplies will scrutinize the use of such items included in the claim. A good source for a plant schematic is the insurance department or plant manager. Insurance companies often require a plant drawing be supplied before they underwrite an insurance policy. Helpful resources for explanations on how items are used in manufacturing process include the production manager, plant engineer or manufacturing maintenance manager.

Be aware that filing refund claims with a jurisdiction can invite an audit especially if large dollars are involved. Make sure you are familiar with a taxing jurisdiction's refund procedures. Filing refund claims with a vendor are not as risky unless they, in turn, file a claim with the affected taxing jurisdiction.

Sometimes it is possible to offset audit assessments with the overpayments found through a reverse audit. If the reverse audit and taxing jurisdiction audit are in the same time frame then use tax overpayments can almost always be used to offset audit liabilities. In jurisdictions that require the vendor to repay the overpaid sales tax then offsets may not be permitted. Be sure to review the refund provisions of a jurisdiction before requesting an audit off set and be careful of the constraints of the statute of limitations period.

Maintaining Vendor Relationships

Obtaining refunds from vendors does not always go smoothly. They may respond with statements such as

“I don't have the money, the state has it.” Or, “the state requires I file a refund. Are you going to pay someone to do that?” When requesting refunds from vendors, be careful that you do not create an unpleasant situation that affects the overall relationship. Always consult with the purchasing or other affected department and their tax or finance department before any action is taken. Sometimes forgoing a refund and correcting the taxability of future purchases may be the better approach.

Before embarking on a reverse audit, recognize the impact it is going to have on the tax department, the vendors, and other internal departments. Consider the resources and knowledge it is going to take to make this endeavor successful.

Bringing in a Third-Party Consultant

Reverse audits are not a task for the inexperienced or time strapped sales and use tax professional. Rather than conducting a reverse audit in-house, a tax professional may want to hire an outside consultant who knows their industry well. A consultant will usually have good insight into audit vulnerability and potential overpayments. Most outside consultants know the ins and the outs of the refund game, the state officials who handle claims, and the proper communications that are required to quickly generate the refund. They can act as a buffer between the company and either the vendor or the state.

Consultants can maximize reverse audit efforts, as well as their returns, but it is strongly suggested that you require a consultant to provide references before you engage them. Have your law department or outside counsel review any engagement contract. Also, just like with any audit engagement, certain protocols should be spelled out in the contract in order to avoid unpleasant situations. The last situation that is desired is to hire an advocate that turns out to be an adversary because the engagement contract was not clear as to what both parties wanted.

Reserves

Companies may develop a reserve for potential or contingent liabilities related to their transaction tax activities. The reserve may reflect an estimate or professional opinion of possible future taxes that could occur based on results of previous audits or contingent liability studies. Complex issues may surface in

a current audit situation and the expected resolution may span several financial reporting periods.

In March 1975, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. This standard provides the guidance for the creation and maintenance of reserve balances for financial purposes. Several years ago, FASB issued Financial Interpretation Number 48 (FIN 48) to Account for Uncertainty in Income Taxes. This interpretation provides additional guidance for FASB Statement No. 109, Accounting for Income Tax. It is possible that more stringent requirements may be necessary for reserves of transaction taxes as more data is gathered in the income tax arena. It would be worthwhile for transaction tax professionals to stay informed for further developments.

Best Practices

Timeless principles developed from practical experiences in managing audits throughout the years have led to some best practices and processes. These best practices have reduced audit exposure and facilitated control over the issues raised in a variety of audit settings.

One of the most important things to remember is that the audit process needs to be handled right from the beginning. Do not take shortcuts in your audit preparation, starting with instituting processes and procedures to ensure tax administration and compliance. Automate as many compliance processes as possible in order to avoid human error and complacency.

Make sure that you are in contact with everyone who needs to be involved in the audit. When notified by a jurisdiction that they want to commence an audit, communicate this information to the appropriate departments. Solicit the help of the Internal Audit (IA) department if your company has one. IA can be a very valuable resource, especially if your records are decentralized. The tax professional should write an audit plan for the IA associates, who in turn can be of great help in reducing audit assessments.

Create a good working relationship with the auditor. Avoid an adversarial relationship at all costs and never get personal. If possible set up a pre-audit conference. The meeting can serve many purposes such as: determining the scope of the audit, ground rules the auditor must follow, the audit period, who the auditor may contact, the amount of records that need to be provided, and the audit plan the auditor will follow.

Do not share more than you are required to. Only answer specific questions and provide documents that are specifically requested. Isolate the auditor to certain areas of a facility and limit their contacts to a few associates to avoid confusion and speed up the audit process.

Once the audit is over, remember that your work is not done. Always set up a post audit conference with the auditor. It may be your last chance to negotiate issues and avoid the appeal process. Once the process is complete, immediately have the errors corrected that were found in the audit and communicate the necessary procedural changes that have to be made to the appropriate parties.

Closing Summary/Automation Reduces Exposure

Advances in technology have seen the development of tax automation solutions that can help a taxpayer with sales and use tax compliance and administration. These software applications maintain tax rates, rules, and correctly identify tax areas so the proper situs is obtained. For the most part, object-oriented software contains a series of Java programs and XML schemas, databases and programming tools that, when combined with your financial system, can be used to create a comprehensive tax compliance system. The financial system and the tax automation system can be integrated using direct Java calls or Web service technologies.

Tax automation systems contain databases that are consistently updated, usually monthly, by the software vendor. In addition, most tax automation systems allow a user to customize data to meet spe-

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cific needs. Typical user-customized data includes information such as registration requirements, jurisdictions that require a special rate, tracking of direct pay permits and exemption certificates information. They also can record asset and inventory movement, identify purchases and how they are used, verify the tax charged by vendors on those purchases, and identify purchases that are exempt. In essence, there are tax automation systems that can be utilized to perform automated reverse audits and thereby quickly identify issues that must be corrected long before the auditor begins an examination.

Tax automation systems also contain sophisticated reporting databases and create a record for every line item passed through the tax calculation process. These reporting databases are excellent tools for automated return and remittance preparation. They also provide detailed information for audits and allow the tax professional to better manage the sales and use tax function.

The previously mentioned Vertex study indicated that while most companies still rely on some manual processes for tax management, the majority of tax professionals agreed that they could greatly improve their sales and use tax compliance by increasing the automation of the sales and use tax function. At the same time, 78 percent of state audit officials indicated that an automated system had a positive impact for the taxpayer when examining their records in an audit.

The economy will inevitably improve and audit pressure may decrease as a result. However, it is extremely important to set processes and best practices in place, as there will always be new regulations impacting the industry, corporate changes taking place, and other activities creating new challenges and audit risks in the tax process. The more a company plans ahead, the more effectively they can deal with these challenges when presented. When audits do occur, remember that the process starts before the auditor enters your facility, and does not end when he leaves.

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