

Preparing for the Sales Tax Audit

By Robert Schulte

Robert Schulte provides taxpayers with practical guidance for organizing, improving and analyzing their sales and use tax records.

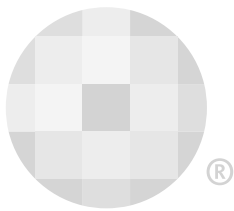
The fateful day when the call from the state agency comes requesting that your company make its records available for a sales and use tax audit. The typical responses range from sheer panic, to mild annoyance, at yet another battle with the state or local taxing authority. The auditor generally requests sales invoices, resale certificates, customer purchase orders, sales tax returns, income tax returns, general ledgers, journal vouchers, accounts payable files and documentation for fixed assets purchased and sold.

In the recent past, these records would be stacked in a conference room or on an empty desk, and the auditor would plow through the records for days, weeks, months, or in some cases, years. Due to the sheer volume of records and the inability to establish meaningful controls over individual records, the standard procedure was to test sales and purchases by using some form of judgment sampling.

Testing sales generally meant selecting one month from each year of the audit. Invoices were reviewed for the proper tax rates and to ensure that all taxable charges were being taxed correctly. Documentation was also requested to support all sales made without tax. A percentage of error was developed for each of the months tested and then applied to the corresponding year.

Purchases charged to expense accounts were usually audited by reviewing a one year period. Again an error rate was developed and applied to the other years in the audit period. Capital additions were generally audited on an actual basis.

Audit results based on these techniques *might* be correct. A year of purchases *could* represent one third of all the purchases in the audit period. While this would appear to be more than adequate coverage, it still does not guarantee accurate results. Perhaps internal controls over the purchasing cycle



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changed during the audit period or there was turnover in key personnel positions. Even if all external factors remained constant, there was still the human element involved. Imagine examining every document in every storage box representing one year's worth of purchases at your company. Contrary to opinions held in some circles, auditors are human and tend to get bored, tired, distracted and sloppy after days or weeks of looking at documents. This human error factor would also affect the tests of sales. Exemption certificates would be overlooked, errors would occur in data entry and audit procedures would be short cut or omitted.

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Today's sales and use tax audit is likely to rely on electronic financial data in lieu of hard copy records. The key variables are how adept the parties are in extracting the data and how knowledgeable they are in working with the results. In its most basic form, an "electronic" audit is conducted by providing the auditor with a pre-existing "canned" report in electronic format. This canned report will almost never contain all the information (fields of data) an auditor would need to make informed and accurate decisions. However, at a minimum, it generally will provide a way to test the subject matter using a statistical sample rather than a block sample.

Table 1: Recommended Data Fields to Perform a Thorough Analysis

Sales Transactions		Purchases Transactions	
Field	Description of Field	Field	Description of Field
Customer ID	Unique Customer Identifier	Vendor Id	Unique Vendor Identifier
Customer Name	Customer Name	Vendor Site ID	Unique Vendor Site Identifier
Customer Billing Address1	Primary Customer Billing Address1	Vendor Address Type	Description of Address (remit to or warehouse)
Customer Billing Address2	Primary Customer Billing Address2	Vendor Name	Vendor Name
Customer Billing City	Primary Customer Billing City	Vendor Address1	Vendor Ship From Address1
Customer Billing State	Primary Customer Billing State	Vendor Address2	Vendor Ship From Address2
Customer Billing Zip	Primary Customer Billing Zip	Vendor City	Vendor Ship From City
Customer Shipping Address1	Primary Customer Shipping Address1	Vendor State	Vendor Ship From State
Customer Shipping Address2	Primary Customer Shipping Address2	Vendor Zip	Vendor Ship From Zip
Customer Shipping City	Primary Customer Shipping City	Vendor Phone	Vendor Contact Phone
Customer Shipping State	Primary Customer Shipping State	Vendor PO Number	Vendor Purchase Order Number
Customer Shipping Zip	Primary Customer Shipping Zip	AP Header ID	Unique AP Header Identifier
Customer Tax Code	Taxable or Exempt?	Invoice Date	AP Invoice Date
Customer Tax Exemption Number	State Tax Exemption Number	Invoice ID	Unique AP Invoice Identifier
Customer P.O. Number	Customer Issued P.O. Number If Available	Invoice Line ID	Unique Line Identifier
Sales Header ID	Sales Header Primary Key	Item Number	Item or Part Number
Invoice Date	System Generated Invoice Date	Item Description	Item or Part Description
Invoice ID	Unique Invoice Identifier	Quantity	Quantity Invoiced
Invoice Line ID	Unique Invoice Line Identifier	Unit Price	Price per Unit
Invoice Line Type Code	Line Type (service, product, shipping, etc.)	Extended Amount	Extended Line Amount
Part Number	Internal Part Number	GL Distribution Account	GL Account Where Transaction Line is Posted
Part Description	Internal Part Description	Division	Division Where Transaction Posted
Quantity	Quantity on Invoice	Department	Dep't Where Transaction Posted
Unit Price	Unit Pricing	Cost Center	Cost Center Where Transaction Posted
Extended Amount	Extended Line Amount	Sub	Sub Account Where Transaction Posted
Taxable Flag	Is the Product or Service Taxable	Taxable Flag	Was the Line Item a Taxable Line
Freight Amount	Freight Amount	Tax ID	Tax ID Type (CA sales tax, etc.)
Tax Amount	Tax Amount	Ship to Location	Where Did the Product Land
Total Invoice Amount	Total Invoice Amount	Total Invoice Amount	Total AP Invoice Amount (all line items)
Tax Exempt Code	Tax Exempt Code	Freight Amount	Total AP Freight Amount
Tax Exempt Reason	Tax Exempt Reason (resale/U.S. Gov't)	Tax Amount	Total Tax Charged by Vendor
FOB Point	Title Transfer Clause	Invoice Type	Invoice Type
Warehouse Location	Where Was the Product Shipped From?	FOB Point	Title Transfer Clause (destination/origin)
Ship Via	Shipping service (UPS, Fedex, etc.)	Voucher Number	Voucher or Check Number Used to Pay Bill

At the other end of the electronic audit spectrum, the auditor is provided with the data in table format just as it is stored in the company's underlying database. Since all accounting documents are populated *via* these tables, theoretically the auditor is able to build custom reports containing the precise information needed. For example, when testing sales it is critical to know not only where the customer is located but also the F.O.B. point and the method of delivery. The "Ship To" address may be in Arizona but if the method of delivery is "will call" at the seller's place of business in California, then the transaction is a taxable sale subject to California sales tax and not an exempt sale in interstate commerce.

While some may question the sanity of any company providing the auditor with this kind of information, there are real advantages to the company if managed properly. Instead of waiting for the "audit appointment" call, taxpayers can begin the process of reviewing their records electronically much in the same way that the state agency would. Working closely with the Information Technology (IT) Department, the state and local tax manager can extract meaningful sales and purchases data from the Enterprise Resource Planning (ERP) System without significant complications. Communicating the required fields and format of the data is the most important step in this process. I always recommend having the pertinent fields from sales and purchases extracted into a pipe | delimited text file with the field names contained as the header row and imported into Microsoft Access (see Table 1: Recommended Data Fields to Perform a Thorough Analysis). Having the data in an Access database will allow for in-depth analysis in a relatively easy and straightforward manner.

The sales analysis should consist of segregating sales into three distinct populations: 1) taxable invoices, 2) exempt invoices, and 3) mixed invoices. This is easily accomplished by placing a criteria of "< >0" in the tax field for taxable invoices and the criteria of "=0" for the exempt invoices. The goal of the sales analysis should be to determine how accurately the company taxes the taxable sales and what types of exempt sales the company makes.

Examining the taxable invoices consists of calculating the effective tax rate on the invoice by taking the tax charged and dividing it by the taxable sale amount to ensure that the percentage is equivalent,

or pretty close, to the tax rate in that jurisdiction. The most common error typically encountered is a difference in the tax rate charged compared to the legal tax rate in effect, and generally speaking this will have a minimal impact on the audit results.

Nontaxed sales may be exempt because the product line is statutorily exempt in a particular jurisdiction or it may be exempt because the customer is considered exempt. This is an area of great exposure to most companies and considerable effort should be spent in this analysis. Generally, I like to take the exempt sales population and group it by customer—counting the number of invoices and summing the total dollars of exempt sales made to each customer. The result of this query provides the exact names of each exempt customer, the number of invoice transactions to that customer in the examining period, and most importantly, the dollar amount of transactions that customer made. Next, I usually determine how many exempt customers make up levels of sales. For instance, I determine the number of customers that make up 90 percent of all exempt sales. I repeat this process for 80 percent, 70 percent, *etc.*, until I have determined the precise number of customers for each of the total sales levels. Knowing the number of customers for each level provides a realistic view of how much work will be necessary to examine the customers representing a certain percentage of the total exempt sales.

Armed with the names of the exempt customers, the next step would be to verify that the proper documentation supporting the exempt sale is in place and valid. I generally recommend obtaining documentation for the population of exempt customers that comprise 90 percent of the total exempt sales. This may be a tedious task, but you have identified the customers and have their addresses and other pertinent biographical data. The results of this task will provide an accurate portrayal of the exposure to assessment the company faces and remedial action can be recommended and put into place. For instance, now that you know the exempt customers that should have been classified as taxable, you can take the necessary steps to change their taxing classification, in addition to attempting to collect past taxes due. Additionally, the company is now armed with the knowledge of precisely where the system is flawed. Internal controls can be implemented to close these loopholes and reduce exposure in fu-

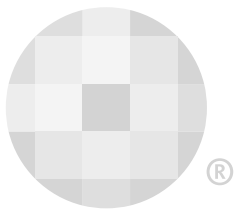
ture audits. The company may also employ the same audit techniques as a tool for conducting periodic internal audits of their transactions.

While the techniques described above are intended to serve as a comprehensive analysis of the exempt sales, they are by no means intended to

be the only methodology utilized. Be creative and analyze the data for trends. By becoming familiar with the data, you will gain an insightful look into the areas where your business is most vulnerable and be prepared for the methodology that best manages your next sales and use tax audit.

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