

## **Your Audit Defense Toolbox**

### **Section 3**

## **Other Audit Issues and Discussions**

### **1. The Statute of Limitations Waiver: When to Sign, When to Negotiate**

At various points in an audit the auditor may ask you to sign a statute of limitations waiver. The purpose of this document is to extend the time that the auditor has to complete the audit. This request is most commonly required when the taxpayer and auditor have not yet finished all the fieldwork and both parties mutually agree that more time is needed to do so. In general, this is a very common practice and should not cause any alarm. However, there are a few points that you should keep in mind when this issue arises:

#### **It's the Taxpayer's Fault**

The most important factor in evaluating a waiver request may be determining which party is at fault for the delay in completing the audit. In most instances, it is technically the taxpayer's fault that more time is needed to complete the audit. Perhaps you didn't have the resources immediately available to pull all the documentation that the auditor has requested. Or perhaps you requested more time in order to follow up on some taxable exceptions that the auditor had identified. In any case, it is in the best interest of the taxpayer to sign the waiver in order to continue the audit process. If the taxpayer is at fault for delaying the audit and they refuse to sign a waiver, the auditor has the power to issue a jeopardy assessment that will significantly exceed the final audit liability had the audit work continued its normal course. In addition, not signing the waiver may also create friction in the taxpayer-auditor relationship.

#### **It's the Auditor's Fault**

In cases where the delay is due to the auditor, a taxpayer has some wiggle room. Perhaps you had provided the auditor with all the requested documentation, but he or she did nothing with it and the statute of limitations was about to expire. Or perhaps the auditor hadn't even started the audit yet, despite having months to do so. The auditor then contacts you requesting a waiver so that he/she has more time to work on the audit. In this situation, the auditor is in a tough spot, as he/she doesn't want to tell his supervisor that he neglected the audit. Because of this, you may be able to negotiate a reduction in the scope or detail of the audit

fieldwork, among other items, in return for signing the waiver. By doing so, you receive more favorable audit terms and the auditor gets the time needed to complete the audit. Remember that every audit is different, so use your best judgment when dealing with this situation, or employ the assistance of a sales tax professional!

**Remember to Confirm the Details!**

Another important point to remember when dealing with statute of limitations waivers is to always examine the waiver to ensure that you agree with all the terms specified within. You should confirm that the entity name and audit periods stated on the waiver are correct. The waiver will also specify the additional time that it provides for the audit to be completed. Pay careful attention to this information! If you feel that only a few additional months are required to complete the audit, it is usually not a good idea to sign a waiver giving the auditor six months or more to do so! This may allow the auditor to “sit on” the audit and produce additional delays. It may also tack on unnecessary interest and penalty charges because the audit is drawn out longer than needed.

In closing, signing a statute of limitations waiver is a common audit practice. However, taxpayers should always closely consider the reasons the waiver is being requested and the specific terms outlined in the waiver document.

**2. Problem Auditors: “You Can’t Stop Them, You Can Only Hope to Contain Them”**

In a perfect world, you would be best friends with every auditor and after quickly agreeing to a ‘no charge’ audit, you would take the auditor by the hand and skip through a field of daisies off into the sunset!

Unfortunately, this is never the case. Most auditors are competent professionals that treat taxpayers with respect and complete the audit in an efficient and fair manner. However, if you defend enough sales tax audits, you WILL have to deal with a ‘problem auditor’. This person may be rude, overly demanding, or just plain incompetent. He may constantly demand large amounts of unrelated information, refuse to answer your inquiries, or make the audit painful for numerous other reasons. For whatever reason(s), these auditors will make your life very difficult!

Barring extreme circumstances, you won’t be able to “throw the auditor back” and request a new one. Thus, you will need to try your best to work with this person in order to complete the audit. This portion of Section Three will discuss some of the pointers for doing so.

**Professionalism**

The most important thing that a taxpayer can do when dealing with a problem auditor is to maintain your professionalism. No matter how rude or obnoxious the auditor becomes, do not reduce yourself to their level. Making it “personal” will

only exacerbate an already difficult situation. When communicating with a problem auditor, try to always stay calm and stick to the facts of the situation.

**Document Everything!**

Another tip for defeating a problem auditor is to keep a detailed record of all communications. By doing so, you can diffuse any “he said, she said” situations, by quickly whipping out an e-mail or letter copy that states what and when you discussed a certain issue. Some pointers for doing so include:

- a. Provide any questions to the auditor in writing and keep a log of when they were provided.
  - i. Many states require auditors to keep a log of their own communications with taxpayers as well.
- b. Save copies of all e-mails sent to the auditor.
  - i. Even if it is just a quick e-mail to send over a file, or confirm an appointment – Save it! You’d be surprised as to what may help down the road!
- c. If a pertinent issue was discussed with the auditor in person or via telephone, send a follow-up e-mail confirming the details of the conversation.
  - i. By doing so, you will have your side of the story on record.
- d. Save all e-mails and communications from the auditor, especially those containing file or document attachments.
  - i. If the auditor says they sent you something, but they really didn’t, ask them to tell you when they sent it!
- e. Explain to the auditor that you can only respond to questions or information requests that are provided to you in writing.
  - i. By doing so, you have a formal document trail of when and what was requested.
  - ii. You may be surprised by how few requests the auditor makes when they have to document each one – Some ‘problem auditors’ are also ‘lazy auditors’.

While maintaining this level of documentation seems tedious, it will prove to be very valuable in some situations. Keep in mind that most audits will not require such a detailed communication document trail, as you will be able to develop a certain level of trust and respect with most auditors.

If you are not able to resolve your problems directly with the auditor, it is usually time to call in the cavalry. First, you should discuss the situation with your supervisor to ensure that they are aware of the possible complications and overall effect on the business. This may also present an opportunity to bring in the auditor’s supervisor as well. If you do so, remember to stay professional and

stick to the facts when explaining the problems you are having with the auditor. (This is where your extensive documentation trail becomes vital!) In most situations, the audit supervisor will work with you to 'set boundaries and responsibilities' for the auditor that may get the audit back on track.

If the audit supervisor is not able to resolve your issues you may want to consider engaging the advice of sales tax professionals. The addition of a 'fresh face' to the situation can sometimes yield results that are satisfactory to both parties. Finally, if all else fails, the audit issues may be so extensive that they may call for a resolution at the audit appeals level.

### **3. Charge It!: The Use Tax Impact of Company Procurement Card Systems**

Many companies utilize a company purchasing card system in order to make the procurement process more efficient for those employees that make frequent purchases. However, unless properly designed, a purchasing card program (P-card) can cause problems on a sales/use tax audit.

The most common use of P-cards is by employees that are 'on the road' often, such as salespeople. The cards are used for purchases like meals and entertainment, travel and lodging, and other miscellaneous expenses. In general, all of these transactions would have the appropriate sales tax charged, as they are most likely occurring in a traditional retail setting.

However, P-cards may be issued to other employees that make frequent purchases via the internet or through other methods where sales tax is not charged by the vendor. The following paragraphs discuss two potential pitfalls that taxpayers should keep in mind regarding this issue.

#### The Vendor Does Not Charge Tax

As mentioned above, most P-card purchases will have tax charged by the vendor. For instance, your salesperson takes a potential client out for dinner and pays with their p-card. It is likely that the restaurant will charge the correct tax. However, certain types of purchases may 'slip through the cracks'. For example, employees in the marketing department may be issued P-cards. They may use the card to make purchases of materials and prizes for use in company promotions. The purchases are made via the Internet from a vendor that does not charge sales tax. If this is the case, your company will owe use tax on these purchases. Unless the proper documentation trail is available, it may be difficult for the tax department to identify these transactions and self-assess the applicable use tax. This brings us to our second issue:

#### Documenting P-Card Transactions

The key to minimizing sales and use tax exposure on a P-card program is documentation. With an effective documentation trail, the tax department will be able to identify taxable purchases and accrue the correct use tax. In addition, thorough documentation will allow an audit to breeze past any P-card issues. In contrast, if the auditor does not have any documentation other than a monthly

P-card summary from the credit card company, they may treat everything as taxable. Thus, the taxpayer would be sent on a wild goose chase to dig up relevant documentation.

So what is considered 'effective documentation'? There should be two parts to the documentation trail for P-card transactions. First, all source documents should be available, if necessary. These documents are composed of all the invoices and receipts for the purchases made with the P-card by the individual employees. For accounting purposes, most companies require that employees submit expense reports with this documentation to verify that their P-card purchases were business related. These documents are vital to an audit defense of P-card exceptions – make sure they are easily accessible, if needed!

In addition, effective documentation also includes some type of compliance report that details the p-card purchases. This report can be used by the tax department to self-assess the monthly use tax and remit it on the appropriate tax return. In some cases, the credit card issuer may be able to provide enough detail on their monthly statement (name of vendor, description of purchase, breakout of any tax charged) for it to be used. Otherwise, the taxpayer would have to work with IT to develop an in-house report that could capture this information.

In conclusion, a P-card program is an efficient tool for company purchasing. However, if the proper documentation trail is not present, it can cause use tax exposure on an audit. If your company utilizes P-cards, make sure that you evaluate possible use tax exposures and, if necessary, make the adjustments to the documentation trail procedures.

#### **4. Promo/Marketing Items and Use Tax**

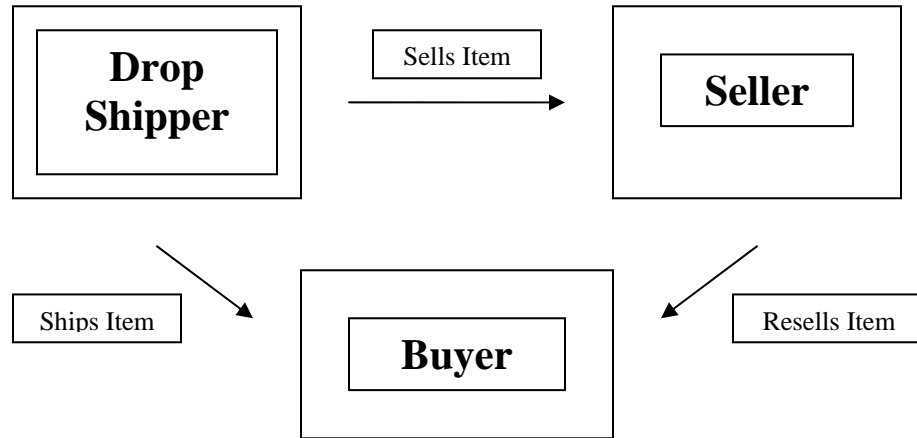
Similar to the P-card issue discussed above, taxpayers that give away tangible personal property as part of promotional and/or marketing programs should be aware of the possible use tax implications.

Use tax is due on merchandise that is pulled from inventory and given away as part of a sweepstakes or other contest. In addition, items that are pulled from inventory and used internally by employees are also subject to the use tax. If procedures to assess use tax on these items are not in place, this type of issue can create headaches on an audit. One solution is to identify and work with the employees that are in charge of such programs and develop report(s) to track such items. By doing so, you will be able to quantify the use tax exposure, if any, and accrue the appropriate use tax on your tax returns.

#### **5. Drop Shipment Headaches**

A final issue that may affect your sales and use tax audit function is drop shipments. A drop shipment is a sale in which an out-of-state seller sells an item to an in-state

customer, then buys the item from an in-state third party (such as a manufacturer or wholesaler), and directs the third party to ship the merchandise directly to the customer in order to complete the original sale. This diagram provides another reference point for this situation:



In this example, the Seller agrees to sell the Buyer 100 widgets. Instead of shipping the widgets directly, the Seller contracts to buy them from the Drop Shipper and instructs the Drop Shipper to ship them directly to the Buyer. Thus, there are really two transactions here:

- a. The Seller purchases 100 widgets from the Drop Shipper
- b. The Seller resells the same 100 widgets to the buyer and has the Drop Shipper ship them directly to the Buyer.

The sales tax issue lies with the Drop Shipper. Since the Seller is buying the widgets from the Drop Shipper as a 'sale for resale', they would normally give the Drop Shipper their resale certificate for the state the goods are shipped to. This would indemnify the Drop Shipper and they would not have to charge any sales tax. However, in many drop shipment cases the Seller will not be registered in the state where the goods are shipped to, thus they will not be able to provide a resale certificate. Because of this, the Drop Shipper will have to charge sales tax. If they do not, they will be liable for the tax on audit. In these situations, each state may offer other options to exempt the transaction:

- The Seller can provide their 'home state' certificate.
  - The "ship to" state will accept the Seller's home state resale certificate to certify that the transaction is a sale for resale. Keep in mind that the 'bill to' state on the invoice from the Drop Shipper should match the state of the Seller's certificate.
    - Currently the following states accept a 'home state' resale certificate: AL, AR, AZ, CO, GA, IL, KS, MI, MN, NC, ND, NE, NJ, RI, SC, SD, UT, VA, VT, WA, WV, WY.

- **Remember!** This list could change at any time. Do not rely on this document to confirm an exemption! Be sure to confirm with your state dept of revenue before accepting a “home state’ certificate from a customer.
- The Seller can provide the ‘ship to’ state’s resale certificate and write in their ‘home state’ registration number or check the box for ‘out-of-state vendor’, if applicable.
  - States that allow this include IA, IN, KY, MO, NJ, NM, NY, OH, PA, TX, VA
    - Once again, be sure to confirm with your state department of revenue before accepting this method from a customer.
- The Seller can provide a letter to the Drop Shipper stating that they are not registered in the ‘ship to’ State, they do not have nexus with the ‘ship to’ state, and they are purchasing the item for resale.
  - This is a much less common method that only a few states will accept.
    - Taxpayers have been successful using this method in ID and LA.
      - Once again, be sure to confirm with your state department of revenue before accepting this from a customer.
- The Buyer can provide an exemption certificate or other proof showing that they are an exempt entity, the purchase was exempt from tax, or they were buying for resale.
  - States that allow some version of this are CA, CT, FL, HI, MA, MS, RI, TN, WI.
    - Once again, be sure to confirm with your state department of revenue before accepting this from a customer.

Drop shipment issues can be very frustrating for most retailers. However, as described above, there may be various methods for exempting a drop shipment sale from state sales tax.

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