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Your Audit Defense Toolbox

Section 1

The Sales and Use Tax Audit: From Start to Finish

This section of the manual will provide a general overview of each stage of an audit. Please keep in mind that this information is for reference purposes only. Users of this information do so at their own risk. www.SalesTaxReference.com and/or its owners are not responsible for any consequences from the use of the information contained in this document.

These stages include:

1. Initial Contact
2. The Opening Conference
3. Audit Field Work
4. The Closing Process
5. Preparation for the Next Audit

Initial Contact

Normally, a business will discover that it is subject to an audit when it receives an audit notice letter in the mail. In general, this letter will detail the formal name of the company being audited, the time period that will be reviewed in the audit ("audit period"), and a list of records that should be made available for review during the audit. The letter will also include a request that the taxpayer contact the auditor in order to set up an appointment for an opening conference. Here is an example of what an audit notice letter might look like: example audit notice.

The audit notice letter may also be preceded by a phone call from the auditor in which he or she provides the same information mentioned above. If you receive only the audit notice letter, it is good audit etiquette to call the auditor in a timely manner to acknowledge the receipt of the letter and schedule a time to talk about the audit in more detail. This is also the perfect opportunity to begin building a positive relationship with the auditor by making it clear that you are willing to work with them to complete the audit as efficiently as possible. A good relationship will go a long way in getting a break on any borderline issues that may come up during the audit. It is also important to remember that the vast majority of auditors are professionals that are just doing their job. For most auditors, it is nothing personal and if you demonstrate that you are willing to work with them, you will be treated with fairness and respect. Unfortunately, most sales tax specialists have a story or two about a “not so professional” auditor. While few and far between, these unfortunate situations do occur and tips for dealing with a “problem auditor” will be covered in the third section of the Toolbox.

Before contacting the auditor for the introductory phone call, it is a good idea to familiarize yourself with the information set out in the audit notice letter, such as the audit period and the records requested by the auditor. This will prepare you for any initial questions the auditor may have. (Remember, if you don’t immediately know the answer to a question, it is okay to tell the auditor that you will need to “look into it and follow up”.)

During the call, the auditor may give you his/her standard spiel on how the audit process works and what will be expected. Listen carefully to all of this information and make note of any points that may be a cause for concern – you can work on a plan for these items later. At this point, you should also be able to set an "opening conference" appointment for the auditor's initial visit. If the auditor is local, you can schedule the conference at your office. If the auditor is located out of state, the opening conference can usually be performed via a phone call. You may want to schedule the conference a week or two in the future, at a minimum. This gives you an opportunity to start thinking about any issues that might have occurred during the audit period. For example, that week when your billing system was down and sales tax was not being billed correctly. It is a good idea to identify these types of issues early because you can use that information as a planning tool when a sample is selected by the auditor. We will discuss this issue in greater detail in the second section of the Toolbox.

The Opening Conference

At the opening conference, the auditor should explain the audit process and procedures to you in detail, including the various portions of your business that he or she will be reviewing and the documentation that will be required. These sections will most likely include:

1. A review of your tax returns and related workpapers filed during the audit period
    a. The auditor will confirm that all returns have been calculated and filed correctly.
    b. The auditor will examine your returns for any inconsistencies, such as large fluctuations in reported sales and/or purchases.

2. A review of all sales made by your business
    a. Based on the nature and volume of your business, this may be comprised of a 'detail audit' where the auditor reviews 100% of the sales invoices during the audit period, or a "sample audit" where the auditor reviews a randomly selected sample of your sales invoices and then projects the total audit liability, if any, based on that sample. For businesses with any significant degree of sales volume, the sample method is typically used in most audits today. We will discuss the various sampling methods in greater detail in the second section of the Toolbox.

3. A review of all expense purchases made by your business
    a. In this section, the auditor will review your chart of accounts and select general ledger expense accounts he or she wishes to examine. Similar to the review of sales, this examination may be comprised of a 'detail audit' where the auditor reviews 100% of your purchases from the selected accounts during the audit period, or a "sample audit" where

the auditor reviews a randomly selected sample of your purchases from the selected accounts and then projects the total audit liability, if any, based on that sample. For businesses with any significant degree of purchasing volume, the sample method is typically used in most audits today. We will discuss the various sampling methods in greater detail in the second section of the Toolbox.

4. A review of all capital purchases made by your business
    a. In most audits, the review of capital purchases will always be performed on a "detail" basis. This means that 100% of your capital purchases will be reviewed by the auditor.

5. Any other specific issues that may apply to your business

During the opening conference, the auditor should also outline your taxpayer rights, including your right to protest and appeal any audit findings. Make note of this important information, as it may be very useful at the conclusion of the audit if you are not satisfied with the auditor's findings.

The auditor will also most likely confirm with you the type of audit that will take place. A "field audit" is one where the auditor travels to your business and reviews all the related documentation on site. A "desk audit" is where you gather all of the applicable documentation and mail it to the auditor. In a desk audit, the auditor will review said documentation at his/her location and correspond with you regarding the results via telephone, mail, and/or e-mail. Due to the volume of documentation involved with a sales/use tax audit, field audits are most common in today's business environment.

Another facet of an audit that usually occurs during the opening conference is setting an appointment for the auditor to begin their "field work". This is where the auditor actually sits down and examines all of the requested documentation related to the audit. Depending on the business and its volume, this process could take one day or many months to complete. Keep in mind that most auditors understand that you are busy and may not be able to immediately schedule an appointment. At a minimum, it is usually a good idea to schedule the start of field work a few months in the future, if possible. This allows you plenty of time to collect and organize all of the relevant documentation for the auditor. It also allows you sufficient time to build a game plan to defend your business!

Depending on the start date that you schedule with the auditor, he or she may also request that you sign a statute of limitations waiver. This is a document stating that you agree to extend the time the auditor has to complete the audit and assess tax because you need more time to prepare for the audit. This is standard audit procedure and should be completed unless there are special circumstances involved. We will discuss this issue and situations where it may not be wise to immediately sign a waiver, in the third section of the Toolbox.

Audit Field Work

The audit field work portion is the "meat and potatoes" of the audit. This is where you will present the auditor with all the relevant documentation to defend the tax returns that were filed during the audit period. The auditor will then examine this documentation and begin building workpapers that will list all of the items that he or she feels are taxable exceptions. At the conclusion of the auditor's fieldwork he or she should present you with the aforementioned workpapers and explain to you why additional tax is due on the listed exceptions. You will then have the opportunity to research the exceptions and provide additional information to prove why they should not be taxed.

One important item during this stage is establishing a location for the auditor to work. The old school of thought was to make the auditor as uncomfortable as possible in order to force him or her to rush through the audit and leave your business. This meant placing them in a cramped work space, with poor lighting, limited access to restrooms, etc. While this method may have some degree of effectiveness, it is generally considered a bad idea and unprofessional by today's sales tax specialists. Instead, you should provide the auditor with a clean and comfortable work space where they can efficiently and effectively process the audit. There is no need to pamper the auditor, but let them know where they can find the restrooms, how they should go about entering and leaving the building, and other common courtesies. Once again, this will go a long way in establishing a positive working relationship with the auditor. In addition, you should take measures to make sure the auditor's access to "extraneous information" is limited. For example, do not place the auditor in an open cubicle in the tax or accounting departments where they can overhear pertinent company information. If possible, locate the auditor in an area away from any related business activity. Finally, it is a good idea to inform all surrounding employees that an auditor will be on the premises and they should keep that in mind when discussing business near the area where he/she will be working.

As mentioned above, the auditor's goal during field work is to examine all of the related tax returns, invoices, and other documentation. For most businesses, this will mean that a great deal of documentation will need to be provided. Obviously, it can require a substantial amount of time and resources to gather all of this information. One method many taxpayers use to minimize this problem is to let the auditor search through the business' Accounts Payable and Sales files to locate the applicable invoices. While this may seem like a great time saver, it is not recommended for the following reasons:

1. The auditor may have access to other records not applicable to the audit issues at hand. This may create 'red flags' for your business that leads to additional audit liability.
2. Most states have information sharing agreements with other states and the Federal government. Thus, the auditor may locate information that is eventually shared with other governmental entities and this could trigger additional audits of your business.
3. While this process may save your business some time in preparing for the audit, it may lead to the audit field work continuing for much longer than necessary. If the auditor has "free reign" to your records, he or she may proceed slowly and browse all the additional records in search of unrelated issues.

In order to avoid these problems, most sales tax professionals prefer to collect all the relevant documentation and organize it before the auditor arrives, if possible. In addition to avoiding the aforementioned issues, it allows you to identify any problems that may be present in the documentation and plan accordingly to defend said issues. It also corresponds with the Cardinal Rule of Audits: "Give the auditor the minimum amount of information they need to complete the audit, and nothing more." Providing additional information only invites the auditor to look for new issues and new tax liabilities!

Depending on the size of your business, you may need to work with numerous individuals inside your company in order to gather all of the required information. This may include people from the following groups:

1. Accounts Payable:
    a. For copies of invoices and checks related to expense and/or fixed asset purchases.
2. Accounts Receivable/Sales:
    a. For copies of sales invoices and related documentation.
3. Fixed Assets:
    a. For information related to fixed asset purchases
4. Legal:
    a. For copies of customer contracts, software license contracts, etc.
5. Accounting:
    a. For general ledger information and reports.
6. Information Technology:
    a. For help in running custom reports, pulling data from computer systems, etc.

If you will need to rely on assistance from other departments, it is a good idea to communicate with these groups as early as possible to let them know what you will need from them. By building a good relationship with these groups, you will be able to efficiently prepare for your audit, and have the contacts in place for any future audits!

As mentioned above, the auditor will review the information and provide you with workpapers that detail any taxable exceptions. He or she may also have numerous questions that you will need to follow up on. If there aren't any exceptions, the auditor will begin to formally close the audit and the vast majority of your work is done!

If there are taxable exceptions, the auditor should give you an opportunity to review the items and provide additional proof to explain why the items are exempt. Use this time wisely and try to apply the techniques discussed in the next section of the Toolbox: *Your Audit Defense Techniques.* Depending on the number of exceptions and the timing of the audit, this back and forth process may repeat a few times until you and the auditor have agreed on all of the taxable items. At that point, it is time to move on to the audit closing process.

The Closing Process

If you are able to reach an agreement with the auditor on the taxable exceptions, the closing process becomes fairly simple. After reaching said agreement, the auditor will complete the formal audit schedules and calculate the total tax liability, interest, and any applicable penalty. He or she should then explain how the tax was calculated and answer any questions that you may have regarding the schedules. Make sure that you review these formal schedules and ask the auditor any questions that you may have. This is an important point, as unintentional calculation errors in the audit workpapers can occur!

At this point, the auditor needs your formal approval of the schedules to send the audit in for processing. In many states, you get 30 days from the issuance of the formal schedules to "review" them. Be sure to confirm with your auditor the rules for your state! Most taxpayers only need a short portion of this period, as they had already agreed upon all the exceptions with the auditor. As mentioned above, it is a good idea to use this time to verify that no calculation errors or unauthorized changes were made in the formal schedules.

After approval of the formal schedules, the auditor will submit the audit for processing. You can then generally pay the audit liability immediately or wait until you receive a formal bill from the state in the mail. It is a good idea to pay any liability as soon as it is finalized, if possible, as this stops the accrual of additional interest.

If you are not able to reach an agreement with the auditor on certain issues, you have options to pursue your case. First, you can request to meet with the audit supervisor. In many cases, getting the supervisor involved can result in a quick resolution to any open issue(s). Remember to keep it professional! Present your position to the supervisor and any evidence to back up the position in an organized manner and be prepared to answer any questions the supervisor may have.

If speaking with the supervisor does not produce the desired results, the next step is to file a formal audit protest with the state audit appeals board, or equivalent entity. In this action, you must follow the state specific rules for filing an appeal. Some states require that you pay the liability before you are allowed to appeal, others allow an immediate appeal. In general, an appeal will involve the composition of a formal letter detailing why the auditor's position is wrong and yours is right. Any evidence you have to support your position should also be included. The appeal board or appeal officer will then review your case and make a decision. Depending on the rules in your state, you or your representative may be required to attend a formal hearing or provide additional information.

If the audit appeal decision still does not meet your with your approval, you have the option of litigating your issue in the state judicial system. Most audits do not reach this level, as this process can prove to be very expensive. If you get to this point, assistance from your internal Legal Department and/or outside Counsel is highly recommended.

Preparation for the Next Audit

The final step in the audit process is the examination of the audit results and the effective application of said results to prepare for future audits. A taxpayer's ultimate audit goal should be to make improvements that reduce the tax liability on each successive audit until you achieve a “zero find” audit. By doing so, you greatly increase the odds that the auditor will not be making another visit to you for some time (it’s not worth their time if they can’t squeeze any additional money from you)!

The main preparation step is to review the major items that were taxable exceptions on the audit and make the necessary corrections. Was your computer system applying an incorrect local tax rate? Did you have a taxable product or service set up as exempt? Did you have a customer set up as exempt, but no resale or exemption certificate on file? Was the system treating shipping charges as exempt when they should have been taxed? These are all issues that can be quickly corrected with a few tweaks to your systems. Doing so will ensure that the next audit will yield much better results.

If your audit revealed much larger procedural issues, this is also the time to start planning ways to correct them. For example, if your business never self-assessed use tax on purchases from out-of-state vendors, this is the perfect time to start working with Accounts Payable to develop procedures to apply the use tax on purchases going forward. Fixing problems immediately after the audit is the most important tool you have in your arsenal, as everything is fresh in your mind!

This section of the Toolbox has provided you with a general overview of the various stages of an audit. The next section, *Your Audit Defense Techniques,* will detail the most common methods used by tax professionals to limit sales/use tax audit liability.
