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Best Practices for Managing a Sales Tax Audit

A **YETTER** and **Sales Tax Institute** White Paper

READ THIS WHITEPAPER TO DISCOVER:

- How to prepare for the audit before the auditor arrives
- The best practices to use throughout the audit process
- Helpful information for audit negotiations
- How to review the audit workpapers and conduct the final audit review
- What steps you should take post-audit, and more!

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INTRODUCTION

If you are registered for sales tax, an audit is likely in your future. They aren't fun but they don't have to be scary. Being prepared for the audit – understanding what to expect, how to manage it and what you don't have to do can reduce the uncertainty and also result in a better audit experience. With some expert guidance and preparation, you can go into an audit confident that you're ready to take on any issues or challenges that the auditor brings to the table.

In this helpful whitepaper, we will teach you the best practices you need to know to better navigate and take more control of the audit process. You'll learn how to prepare for the audit before it begins, the best practices to use throughout the audit process, pointers on audit negotiations, how to review the audit workpapers and conduct the final audit review, and what steps you should take once the audit is completed.

PREPARING FOR THE AUDIT

Once you've received notice that you'll be undergoing a sales tax audit, you'll want to start preparations immediately. Preparing for the audit is your first line of defense and is crucial to your success in audit negotiations.

Records Review

The first step in pre-audit preparation is to review your records before the auditor arrives. If you know where your issues (or skeletons are) you can prepare to defend against them. You won't do the full audit – but you do want to review what has been done and identify if there may be any significant exposure areas. Another benefit of this step is to determine if there are any missing records. Make sure to notify management of any issues you uncover in advance of the audit so management knows what to expect and is not surprised by the auditor's findings.

With some expert guidance and preparation, you can go into an audit confident that you're ready to take on any issues or challenges that the auditor brings to the table

One of the records the auditor always requests is the sales and use tax returns that have been filed. Pull and review all of your returns filed during the audit period and all supporting documentation. Review what is included in the returns – did you include use tax on your purchases, were any filed late, any periods with unusually large or small activity? You'll want to track your business activity and any filing changes that occurred within the audit period. In addition, look at what is included in the supporting documentation. If there are notes, comments or other extraneous items, you do not have to provide those to the auditor. But you will want to provide them reports that support the amounts on the return.

If there is missing information, you can attempt to audit around it. Although it is advisable to try to audit around problems, you should never lie or withhold requested information from the auditor. If a block sample will be used, if there is a period that is missing you can try to suggest alternative periods. But, sometimes you can't always do that. Often discussing the potential for missing records with the auditor at the beginning of the audit can result in a better outcome. If you appear to be helping the auditor, he or she will often accept suggestions on the areas to be reviewed and be willing to accept alternative support if needed.

The pre-audit preparation period is when you'll need to get familiar with the record-keeping process in your company, if you aren't already. You'll want to know how records are maintained, by whom they are processed, and where they are stored. Know whether any electronic business filings methodologies (EDI, EFT, ERS or p-cards) are being utilized and when that practice began. Also be aware of any computer system changes made over the course of the audit period. All documents should be reviewed by you before they are submitted to the auditor.

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The Audit Space

Thinking about where the auditor will conduct the audit is also important. If you are not experienced in managing audits and will rely on an advisor to help you, consider having the auditor work at their location. This can provide benefits as the advisor can be the auditor's point of contact rather than any of the company employees. The advisor also will be able to more closely monitor the issues the auditor is finding. However, the records will have to be provided to the advisor. Many companies maintain electronic records so that typically isn't a problem.

If however, the auditor will work in your offices, two things should happen first. An audit liaison should be selected to be the point person on the audit. This person should have the initial conversations with the auditor as well as participate in all on-site meetings. This person ideally should be personable, have good communication and organization skills and have a basic understanding of not only the business but also sales tax. They might not be the one to evaluate all the technical issues – that can be someone else. But, they need to know enough to be alert to issues that may arise.

You'll also want to examine the room or area where the auditor will be working, along with all of the surrounding areas. It is a best practice to try to separate the auditor from areas where sensitive work occurs. Before the auditor arrives, visit the audit area and make sure that any documentation not relevant to the audit is not in the vicinity. Check bulletin boards or other posting areas since the auditor is likely to read whatever is near the audit room or what may be posted en-route to the storage areas when accessing records. Ideally locate all the records in the room or area where the auditor will be sitting to minimize walking around the facility.

It is a best practice to try to separate the auditor from areas where sensitive work occurs

It is best to locate the audit area away from congregation areas or other meeting rooms. If the auditor is working in a central area of the office, they may overhear conversations. Limit the auditor's interaction with others and bring the records to the auditor, if at all possible. Lastly, question whether the auditor is authorized to use on-site common areas (such as cafeterias) as it is difficult to monitor what he or she may hear or observe in public areas within your place of business.

Prepping your staff

Once the audit date has been set, notify office personnel as to when the auditor will be in the office so they can be aware. Instruct all individuals who may come in contact with the auditor which issues they are authorized to discuss and remind them not to volunteer any information or documentation. To exercise more control over the situation, make sure that an audit liaison is identified and is involved with all discussions with the auditor. If the liaison is unable to supervise discussions with the auditor, inform staff members that the auditor should be referred back to the liaison with any open questions or expanded topics of interest.

All responses to the auditor's questions should be reviewed. Be sure contradictory answers have not been provided. Don't rush to find answers – be sure to obtain, review and confirm before responding to the auditor. The auditor understands that it will take a reasonable amount of time to locate the appropriate information as you are contending with the work flow of a typical day in addition to any of his or her requests.

Prepping your "tour guides"

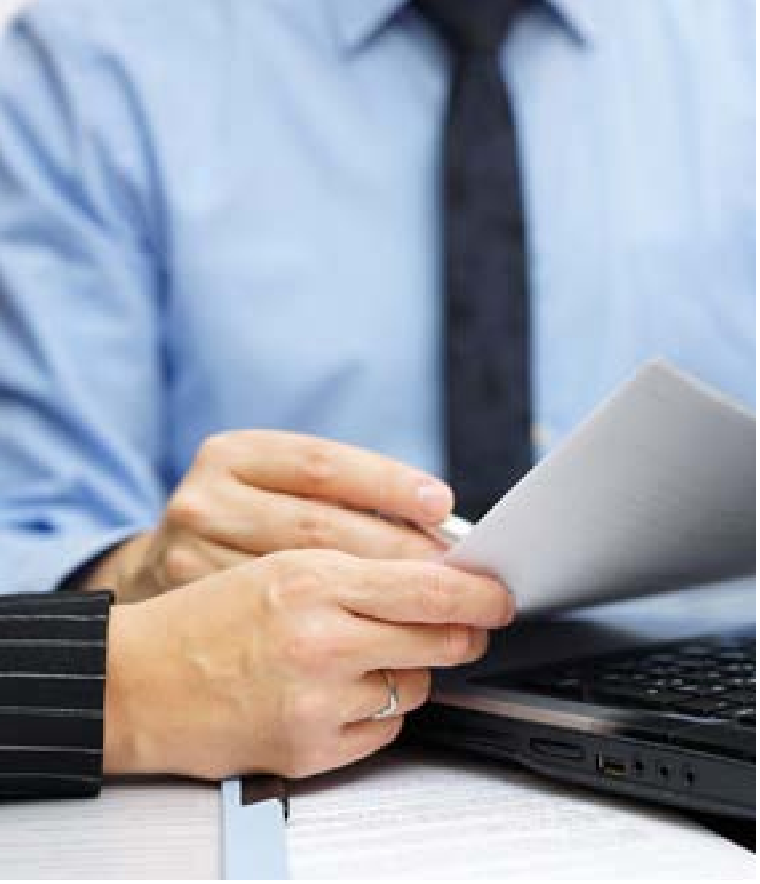
It is very likely that the audit liaison won't be able to answer every question or be the only person the auditor meets with. We refer to the other individuals in your company who may be involved as "tour guides". It is important for the tour guides to understand their role, understand what the auditor needs to learn and understand how to interact with the auditor. Tour guides include not only people like plant managers that may need to conduct an actual tour of your facility, but also accounting personnel, computer services personnel, accounts payable personnel, and others knowledgeable about business operations. The audit liaison should participate in all meetings between the tour guides and the auditor to field unplanned comments from either party and best position an issue within the context of the audit.

Plan for Audit Offsets

When conducting the pre-audit review, look for potential offsets to the audit liability. These may include bad debt deductions, math errors, missing credits, and tax paid on exempt purchases. If you find potential offsets, research the relevant state regulations on how to claim them and be prepared to negotiate with the auditor. Some states will require a separate refund claim to be filed and audited separately. However, in many cases these items can be incorporated into the audit. The taxpayer will likely have to prepare the documentation for the refund items. If there are items that qualify, it is advisable to discuss this with the auditor early in the audit. There may be an opportunity for inclusion in sample projections in lieu of detail actual refund reviews.

Waiver Strategies

Most audits require more than a few days to conduct the audit. Depending on when the state initiates the audit notification in relation to the expiration of the statute of limitation of the earliest period, a waiver may be necessary. This extends the period within which the audit can be completed and the assessment notice or refund claim can be filed. The auditor will generally request a waiver near the beginning of the audit, and they often have a "standard" period of time that the waiver will extend the period. The taxpayer doesn't have to agree to the waiver but needs to be aware of the risks for not signing one. It is important to know the rules for when the audit must be completed based on the statute of limitation. If you refuse to sign a waiver, the auditor may issue a jeopardy assessment – basically a "guess" as to your liability. It would then be the taxpayer's burden to prove the number is wrong. We will typically agree to signing waivers, but with conditions.



If you decide to agree to a waiver, the audit period should start based on the start date of the audit, not the initial contact date from the auditor unless you have to delay the start date for your convenience. Be sure the waivers extend both assessments and refunds for the same period with the same benefits. Understand your work load and space availability when negotiating the length of waiver. Also ask the auditor how much processing time is required once the field work is completed. Some states require 30 to 90 days to process the assessment and allow for informal hearing requests before the statute expires. A best practice to help keep the audit moving is to set the initial waiver based on your workload and knowledge of how long it should take the auditor to do the field work and for your review of the proposed assessment. If there is a need to extend the waiver, only extend it for the amount of additional time needed – even if the auditor claims it is "policy" to do a longer extension. Be sure to document why the additional extension is needed – was it due to auditor delays or additional time needed by the taxpayer. You should also understand interest rules for over- or under-payments to evaluate all the costs of signing the waiver. Also evaluate all open and potential audits to determine which ones are best not extended.

THE AUDIT PROCESS

The opening meeting of the audit is when you need to set the ground rules for the audit. Remember: it's your job to protect your company from the auditor while providing the auditor with the records that support the tax due. Here are some of the key items when setting the ground rules for the audit:

- Create a sign-in/sign-out sheet for the auditor. Notify the auditor that they'll need to sign in whenever they are on premises and sign out whenever they leave the premises. Doing this provides you with documentation that the auditor was actually on premises and working on your audit. It can support you if you find that the auditor has not been on your premises working on your audit in dealing with waivers of statute of limitations.

- Have an audit liaison for your company. Having only one person that the auditor communicates with during the audit ensures that the correct information and no contradictory information are being delivered to the auditor.

- Be specific on what information the auditor will need to include in their requests. The auditor will setup a workpaper to list items of potential assessment. Request that the auditor include information that will save you time in addressing not only the auditor's questions but reducing the company's liability. Include things like dates, batch numbers, vendor numbers, customer numbers or other identifying information needed to locate and retrieve information.

- Request that the auditor provide the law or rule that applies for any exception found. This will help you during the review of the exceptions and understand the cause of the exception.

- Deal with audit issues while the auditor is on the premises. It is easier to remove items while the auditor is still on the premises than to move the audit into the protest stage.

- Challenge every line item. In a sample audit, a small item can become a very large one.

- If there's a disagreement with the auditor over an item, request a supervisor or manager's involvement.

- Request that if the auditor identifies an overpayment that they are included in the audit.

Remember: it's your job to protect your company from the auditor while providing the auditor with the records that support the tax due

Throughout the audit, it is key for the liaison to be involved in selecting which records are to be examined by the auditor. Make sure that there is appropriate stratification of the various classes of records and transactions. The auditor will typically want to review items where tax may have been under-paid (such as office supplies and computers). Bring the auditor's attention to transactions that may have tax over-payments (such as items for resale and manufacturing equipment). If certain periods may be beneficial to your situation, recommend them to the auditor - if the auditor accepts, you are better off. If the auditor rejects, there is no additional risk. If there are electronic records, evaluate how the system should be audited.

Schedule regular status meetings throughout the audit so you can monitor the auditor's progress. It's in your best interest to not let the auditor work uninterrupted. Visit the audit room regularly so you can make sure you know what he or she is finding. Let your participation help guide the auditor's analysis.

Respond to the auditor's inquiries and provide timely responses. This can help avoid requiring "formal" information or document requests by the auditor. In some states these carry strict time limits for responses and become an official part of the audit workpapers. Informal and even verbal requests allow you more flexibility.

Request interim workpapers or exception and issue lists from the auditor. Don't wait until the audit is completed to see the issues that have been identified. Do not let exceptions go un-reviewed or they may get in the auditor's final workpapers and lead to additional questions from the audit supervisor. In some jurisdictions, exceptions remain on the workpapers, with explanations included to explain why there is no tax due. It is easier for the auditor to explain and discuss noted exceptions during the audit rather than waiting to address them when it is time for the audit report to be written.

Also make sure to monitor which documents are being copied by the auditor for his or her files. Discuss copying procedures at the pre-audit conference. All copies should be made and provided by the audit liaison. It should not be necessary for the auditor to make his or her own copies. Unplanned copies typically document questionable records or procedures

It is very important that your answers to the auditor remain consistent throughout the audit process. Make sure that explanations to similar questions remain consistent. State the facts and only the facts. If you are uncertain of an answer, ask for additional time to research the issue. It is better to take the time to seek out the correct answer and report back to the auditor rather than to state a probability that may not be correct. If you make a statement that is later discovered to be incorrect, be willing to admit your error. It is important to demonstrate your expertise and gain the trust of the auditor. Your relationship with the auditor will be damaged if you act in a manner that causes mistrust or a loss of confidence. Poor relations with the auditor can negatively affect later negotiations.

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AUDIT NEGOTIATIONS – THE PLAYERS

When it comes to audit negotiations, the auditor is your first point of contact. Present your argument to him/her first, using enough substantiation for the auditor to reach a decision. If the auditor feels comfortable with you, he/she will typically work with you and more readily accept your explanations.

The second player in audit negotiations is the audit supervisor. At the opening conference, ask for the audit supervisor's name and contact information. With this information at the onset, you will not have to ask for it, or defend your reasons for needing it, should a conflict arise with the auditor. Make sure that you don't abuse the privilege though. Call the supervisor when necessary, but be sure not to "cry wolf." Be prepared to present your case when the supervisor arrives, make specific arguments and ask for determinations, and follow up with the supervisor as necessary.

Outside of the auditor and the audit supervisor, remember that you can bring in experts as needed at any point during the audit. If necessary, bring in experts from your business or experts from the tax field (i.e. attorneys, consultants, etc.). Business experts may be from within your company or an expert in a specific technical field from outside the company. But it is important to bring in the right people at the right time, and not too late. Do not wait until the audit report is issued to bring in experts. In some cases, experts will be able to resolve issues before the audit report is issued.

While maintaining good communication with the auditor is important, you shouldn't be afraid to challenge the auditor if needed. Do not just accept the auditor's explanation. Test the auditor's preliminary analysis - additional discussions often clear up questionable issues. If you're not familiar with the provisions that the auditor is citing, request copies of the relevant regulations, rulings, or administrative procedures. Be willing to make alternative arguments. Be prepared to argue not only your stance on the issue (to get the net effect of a tax over-payment), but know how the auditor will respond (in search of a net under-payment). Preparation in these matters will help achieve a fair audit.

While maintaining good communication with the auditor is important, you shouldn't be afraid to challenge the auditor if needed

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Finally, be prepared to negotiate and keep these key tenets in mind. All negotiations involve a little give and take. Be prepared to give up some small items to win one big item, but evaluate the future impact before giving in. And keep the big picture in mind: evaluate all items to make the decision that is best for your company overall.

WORKPAPER AND AUDIT REVIEW

Workpaper Review

When the auditor presents you with the audit results, your job is far from finished. Analyzing the auditor's work could reveal mistakes. Review the audit report closely and review the detail in all workpapers.

When reviewing the audit workpapers, do not assume that anything is correct without further review. Review all math calculations and totals, and know where the numbers come from. Computer-generated workpapers may contain formula errors, so you'll want to carefully review them. Review the source documents and trace all components, not just the dollar amounts. Check dates, invoice numbers, vendors and descriptions. And be sure the audit dates are consistent. Is the auditor using the invoice date, general ledger date, or date of payment? Auditors can manipulate this to their advantage. Request the electronic version of the auditor's workpapers along with all comments and documentation. This will make it easier for you to track and provide your feedback. Remember that you have the right to defend your case in order to avoid misinterpretation of the audit issues.

When reviewing the audit workpapers, do not assume that anything is correct without further review

If there are missing invoices, do not assume that these must be exceptions and errors in the audit. Suggest alternate documentation to the auditor. Review other invoices for the same vendor/customer to make sure the items are taxable. To demonstrate that tax is typically charged or paid, provide other invoices from the same vendor or issued to the same customer. You can also contact the vendor/customer to attempt to obtain a copy from their records. If necessary, make the missing invoices part of a separate projection or treat them as individual items. Look for general ledger reports or journal entry summaries to show that tax was charged (or use tax accrued) and paid.

If the auditor is projecting the exceptions, make sure that the method is valid and appropriate. Be sure the stratification is representative. Understand how the population universe, sample, and error dollar amounts were obtained, and verify that the amounts are from the same population. If alternate projection methodologies would be beneficial, suggest them to the auditor, but be sure to check the results before presenting them! The auditor's methodology may be more advantageous than other possible alternatives. And don't just review the big items: in a projection, small items can add up to a significant amount. Also check if there are any credits that should be projected. When records are unavailable and the taxpayer does not cooperate with the state to determine an appropriate liability, the state has significant latitude in estimating the taxable base. So it's in your best interest to cooperate in this matter.

When reviewing the audit workpapers, you'll want to keep an eye out for any extraordinary items included in a sample. Identify any casual sale or one-time purchase items that may be in the audit sample. Such items may be unusual in nature and could adversely affect the expense projection calculations. Auditors often refuse to remove these items, arguing that although it is specific in nature, there may be other transactions of the same magnitude in another account or category. Show the reliability of your records and note other items that were unusual in nature but accepted on the auditor's behalf.

You'll also need to ensure that credits are correctly reflected in the audit. You can negotiate whether the interest and penalty should apply to the net amount or if the credit is to be treated as a separate transaction after the under-payment amounts are settled. If the wrong tax type was applied (e.g. sales tax was collected when use tax was due), review the statutes to see if an offset can be allowed for the tax paid or collected. Any excess tax collected may need to be refunded to the customer.

If the audit is a large one or has an extended time frame, it might be helpful to keep track of the decisions and agreement by meeting. One suggested approach is to make a "rainbow" of notations in the margins of the workpapers. Tie notes written in a certain color ink to a specific date of a discussion with the auditor or to a specific type of determination (taxable, resale, manufacturing, etc.). Keep a history of issues successfully negotiated during a particular meeting. The auditor may have errors in the workpapers and resolved issues may still be included. By having details of when it was discussed, your credibility will be enhanced. Always remember: organization often helps you gain credibility with the auditor and is a great carry-over reference to the final copy.

Here are a couple more tips to keep in mind during the audit review:

- Evaluate all aspects of the audit.
- Develop specific questions to reach alternative solutions.
- Keep good records to double-check what the auditor does.
- Do not throw away superseded copies until you see the final assessment.

POST-AUDIT STRATEGY

Once the audit is complete, take action on any issues uncovered throughout the audit process. While the issues are still fresh, implement corrective actions so they don't pop up again in case of a future audit. If you wait to implement corrective actions, you are probably less likely to implement them at all.

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This is also the best time to scrutinize pending state audits while preparing for the next cycle. Keeping records of what happened during the audit is your head start on the next one. Once again, organization is key and will help you greatly in the future. Develop a folder or binder to organize and record information from each audit. Tax managers can reference the folder to stay on target and make the necessary changes

When the next audit cycle begins, it is easy to document compliance with the auditor's recommended changes and get the audit off on the right foot. In addition, some states like Illinois are authorized to assess larger penalties which are not subject to relief if issues are not resolved and assessed in a subsequent audit. One of the big challenges in many audits is the turnover of audit staff either at your company or at the state. Accurate records create a clear history for subsequent audits.

Documentation regarding compliance with the Sarbanes-Oxley Act is also useful in an audit. Below are some key items:

- Proper financial accounting standards
- Effective internal controls
- Controlled scheduling of audits
- Reasonable response time to audit requests
- Documentation of standing audits and status
- Documentation of waivers per statutes of limitation
- Documentation of information requests and responses (formal and informal so you know what types of information the auditor requested during the audit)
- Review of audit schedules
- Carry-forward of points for next audit
- Organization of audit data

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Finally, you'll want to create an audit binder to document everything that took place throughout the audit. Include a post-audit recap – a short report summarizing each audit. Information you'll want to document in the audit binder includes:

- The audit period
- Audit methodologies: Was it a manual audit? Was statistical sampling used? What type of sample was used? How were the dates defined (invoice date, payment date, posting date)?
- What issues did you dispute and what were the resolutions? List the statutes and regulations that were relied upon.
- What corrective actions were taken? Did you identify a specific item as taxable? Did you change the accrual system? Did you update computer software?
- Waivers – retain a copy of each waiver obtained for the audit.
- Correspondence –document all emails, notes, phone conversation logs, and requests from auditors.
- Electronic Records – identify the types of records requested; file layout information, and contacts within the company.
- Location Listing – record each company location included in the audit, with the appropriate contact information and correspondence
- Overpayment Review – plan, schedules, and progress status.
- Consultants – document correspondence and agreements if consultants have been engaged to assist with the project
- Issues – report the audit issues and related research documentation.
- Audit Schedules – retain the final versions of all the audit schedules. If the documentation discusses the issues resolved, it is not necessary to retain the prior versions of the workpapers.
- Link taxable items noted on the auditor's report to the specific department that generated the taxable transactions. If possible, place the department head responsible for future compliance by staff. Follow-up to ensure the needed adjustments are corrected. If someone is not placed in charge of the changes, they are likely to be overlooked.

To learn more about audit defense or to get assistance with a sales tax audit, we encourage you to contact us.

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About the Sales Tax Institute

The Sales Tax Institute is a premier think tank that offers live, webinar and online courses to educate business professionals about sales and use tax.

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About YETTER

YETTER is a sales and use tax consulting firm that offers clients the highest quality sales and use tax guidance by understanding their needs, increasing awareness of current tax issues and trends, and providing effective tax-related solutions.

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