VERTEX® Exchange

Best Practices for Managing a Sales Tax Audit

October 24, 2022

AHEAD OF THE CURVE

Session Agenda

Time	Topic
10 minutes	Getting Audit Ready
10 minutes	Audit Policy Considerations
5 minutes	Audit Structure
5 minutes	Managing Records
5 minutes	Consumer's Use Tax Audit Concepts
15 minutes	Closing the Audit/Additional Resources/Q&A

VERTEX Exchange

Presenters

Diane Yetter

President, YETTER Tax and Sales Tax Institute

Larry Mellon

Tax Director - Chief Tax Office, Vertex

Getting Audit Ready

VERTEX® Exchange

Understanding Your Business

- In any audit, the auditor has conducted some research into your business which may not always be accurate. In a virtual audit, there is likely even less information known about your company and its processes.

- The challenge arises in when and how best to share your knowledge with the auditor.

- What the auditor knows about your business may impact what the auditor requests from you.

- Providing a consistent narrative showing how your business works and how the data fits into that sales workflow will pay dividends in making the audits run smoother. Creating this standard overview with options for state specific information allows you to provide it up front upon audit notification.

Understanding Your Systems

- The auditor may lack familiarity with your selling systems.

- Consider providing an overview of your systems
  - Maintain a log of system history which includes dates they went live and when significant changes occurred

- Be able to explain the sales tax settings and connections of your systems along with effective dates.
  - Know what reports and what data elements are available from your systems

Data and Systems

- Be sure you know the systems your company uses and what they are capable of.
  - Understand what is possible before meeting with an auditor so you can provide solutions and options that minimize effort yet provide the auditor comfort with your process and records.
- Evaluate the volume of data along with significant company growth.
- Know the categorization of data (shift to wholesale, business model changes).

Understanding Your Processes

- Know the tax types your business is filing in the state.
  - Sales tax, Seller's use tax, Consumer's use tax

- Confirm which sales tax rates are being used
  - Illinois ROT/Use, Texas Single Local Tax, Louisiana Remote Seller

- Define your consumer's use tax process
  - Who, what, where, when, how

- Map your compliance process
  - How data goes from ledger to return
  - Adjustments, credits, amended returns

Evaluate Your Records

- Review documentation to support exempt sales.

- Gather documentation prior to audits.

- Test your tax rate calculations.

- Reconcile data from General Ledger to returns.

- Ensure record retention.

VERTEX Exchange

Nexus

- States have shifted their focus to sales tax and increased tax revenue collections.
- Maintain a current list of your registration dates and regularly evaluate unregistered states for nexus activity.
- States and auditors are interpreting nexus more broadly.
  - You may need to justify when nexus was created, and if registration was not timely, why the company failed to do so.
- States are challenging that economic nexus was the company's first nexus.
  - Texas is equating downloaded software to physical nexus.
  - New York is challenging click-through nexus.
  - Be aware of states that still have click-through and/or affiliate nexus, which pre-date economic nexus.
- Watch for breaks in nexus

VERTEX Exchange

Audit Policy Considerations

VERTEX® Exchange

Virtual vs. In Person

- Most audits still occurring virtually while some request an onsite audit.
    - Determine the type of audit.
    - Consider parameters for each and limitations.
    - Agree on scope and start date.
    - Request a workplan with timelines.

VERTEX Exchange

Waivers

- Auditors may want you to sign a waiver to extend the time period for concluding the audit.
  - Know what the company policy is.
  - Evaluate your options in not signing or signing a limited number of times or for a lesser length of time.
  - Use waivers to help manage the auditor.
  - Create a waiver tracker.

VERTEX Exchange

Communication

- Determine who will be the liaison with the auditor.

- Establish the cadence of check-ins.

- Obtain audit supervisor contact information at onset.

- Agree to the primary information request format
  - Formal, informal
  - Regular email, encrypted email
  - Portal, audit room

Plant Tours

- The auditor may request a plant tour or need to see a particular process to justify exempt use.
  - Understand the security protocols of your business in advance of the audit so you can discuss alternatives early in the audit.
  - Plan with local plant personnel prior to the tour
  - Virtual tours may require creativity – videos from the plant, online videos about the process, marketing or HR department guidance/videos specific to your industry.

VERTEX Exchange

Audit Document Protocols

- Copying policy

- Sending documents vs providing access to a read only site

- Set aside exception invoices (physical or digitally)

- Company wide vs. State specific data files

VERTEX Exchange

Logistics

- Other logistical items to be aware of:
  - Statute of Limitations
  - Power of Attorney (POA)
    - Some states may require a POA even for company employees
  - Information Document Request (IDR)
    - Be aware of the timeframe
    - Illinois is being strict on this

VERTEX Exchange

Sampling Methodology

- Do you have a standard sampling methodology?

- Will you accept what the state proposes?

- Negotiate with the auditor on what method to use and for what periods.

- Have consistent defined terms (transaction date, number)

- Avoid months of system or business changes in a sample.

- Know when to detail audit transactions.

Sampling

- Types of transactions that are sampled vs detailed

- What is an isolated one-time transaction vs. recurring transactions in a sample?

- Advantages of Sampling:
  - Efficient
  - Practical if large volume of transactions
  - Cost-effective (requires smaller amount of records)

- Disadvantages of Sampling:
  - Possibility of inaccurate sample
  - Additional cost if the state wants to perform a computer assisted audit sample

Audit Structure

VERTEX® Exchange

Scoping the Audit

- Depending on the audit scope and reason, it's worth seeing if the auditor will just focus on the gap period instead of a full-blown audit.
  - Example: An economic nexus challenge in which the company registered late.

- If you have easy access to data, it may be worth conducting a detailed audit instead of a sample.
  - See if you can get the auditor to work with the data from the tax engine since the information is easy to access.

VERTEX Exchange

Managed Audits

- Some states have moved to managed audits performed by the taxpayer.
    - Examples: California, Connecticut, Kansas, Ohio, Texas
- The state sets specific guidelines for the audit.
- Rarely performed by the taxpayer. Usually done by a third party.
- Benefits include:
    - Fewer interruptions by the auditor
    - Limitation of inclusion of "grey" issues
    - Reduced time for accrual of interest

VERTEX Exchange

Expert Support

- Engage with experts early.

- Bring in experts when appropriate.

- Having an expert on your side and available from the start allows you to focus in other areas and streamlines time spent on challenging or "gray" areas.

Reviewing the Audit Workpapers Regularly

- Check for math errors and taxability issues.
- Check all elements of the listed item (dates, amounts, invoice numbers, names).
- Confirm exemption certificates and coverage (received and issued).
- Sample evaluation to ensure representative.
- Make sure agreed upon deletions removed from schedules.
- Contact vendors & customers to avoid double taxation using XYZ Letter process
- Be cautious of items scheduled for in state vendors and who is responsible for the tax.

Managing Records

⁄⁄ VERTEX® Exchange

Data and Systems

- Consider a shift from auditing transactions to auditing configurations.
  - This shifts the audit focus to internal controls and tax policy with verification rather than focusing on random errors in individual transactions.

VERTEX Exchange

Using Vertex Data in the Audit

- Configuration Data
  - Tax rules and configuration identify if your taxability is set-up correctly
  - Errors can be easily identified, and a detail audit of selected configuration can refine the liability

- Exemption Certificate Data
  - Using reports may reduce need to present actual certificates
  - Scans of certificates should be sufficient to present to the auditor
  - Ability to retain expired certificates when you have replacement certificates

VERTEX Exchange

Using Vertex Data in the Audit

- Tax Journal Data
  - If you add key elements into Flex Fields, the Tax Journal may suffice as your transaction data for audits
  - Complete tax journal may reduce need to pull actual invoices
  - Evaluate ability to add Flex Fields even if implementation is complete
  - See if auditor will start with the tax journal and make exception notes on your file – it will minimize your review effort

- Systems Changes
  - Document changes as they are made over the course of an audit period
    - Configuration
    - Integration

- Access to Systems and Data
  - Evaluate ability to provide data access to auditors on a limited basis or reports/extracts of the data

Missing Documents

- Have a backup plan for if you are missing documents – such as invoices – due to a system crash/missing data files.

- Reach out to the vendor or customer to see if they have the missing document(s)

- For invoices, you could potentially pull a replacement invoice for the same item in the same time frame.

- Are you able to regenerate missing invoices?

Missing Exemption Certificates

- Be aware of states' rules for missing exemption certificates during an audit.

- Texas Rule:
  - If the seller is not in possession of resale or exemption certificates within 90 days from the date written notice requiring possession of them is given to the seller by the comptroller or a later date agreed to by the comptroller and the seller, deductions claimed by the seller that require delivery of the certificates will be disallowed (TX Sec. 151.054).

Consumer's Use Tax Audit Concepts

VERTEX® Exchange

Consumer's Use Tax Audits

- Purchases and consumer's use tax continues to be a focus of all audits – even remote seller audits

- Direct purchases are evaluated for correct tax rates and authorities as remote sellers may not be taxing correctly

- Goods movements, inventory withdrawals and intercompany transactions are being scrutinized more

- States rarely point out overpayments so these should be evaluated

Challenges with Use Tax Determination

- Items in question are unknown

- Ship-from information missing

- Location of where items will be used is unknown

- Tracking and documentation of who paid taxes and when

- Record maintenance and audit readiness

- Manual tax determination in purchasing or payables departments is dependent on non tax professionals making decisions

- Employee turnover and limited training resources contribute to the problem

Converted Inventory

- Use includes the conversion of property purchased exempt from sales tax that is used in a taxable manner

- This includes samples, donations and converted inventory for self use

- Most states impose the tax on the cost of property. Therefore, for items removed from inventory that are self-manufactured, only the material cost would be subject to tax. Before assuming the tax is due, verify that no other exemption would apply.

Goods Movement

- Assets moved between uses or locations could incur use tax

- Credit for tax paid on initial purchase should be allowed but documentation can be challenging

- Depreciation credit should also be allowed

- Intercompany transactions are typically not considered goods movement and will be taxed on the "sales price"

Vendor Tax Validation

- Risk of incorrect tax being charged as more vendors are required to register post-Wayfair.
    - Lack of certificate – Vendors may be charging tax because you didn't previously give them a certificate.
    - Uncertainty of taxability
    - Opportunities for refunds but also for wrong jurisdiction being charged resulting in double tax

VERTEX Exchange

Closing the Audit

VERTEX® Exchange

Negotiating with the Auditor

- Provide additional documentation.

- Disagreed upon items are usually easier to remove at the auditor level.

- You may request a meeting with the auditor's supervisor.

- Your final review of the workpapers is the last opportunity for change.

- Agreement is much easier to reach during audit than at appeal.

Protesting

- Consider the impact of the assessment on the item in principle and in dollars.

- What are the lingering effects of acceptance?

- Evaluate the cost to protest and potential outcomes.

- If protesting, understand and comply with the process and be aware of timelines.

- Determine whether outside counsel is needed or required.

- Create a plan of action for the protest.

Closing Documentation

- When closing out the audit, obtain the final workpapers and all details supporting the audit.
  - Auditor's summary
  - Exceptions report
  - Assessment

- Acknowledge agreement and conclude the audit.

- Arrange for payment and obtain confirmation.

- Prepare your own internal document of audit issues and resolutions to use for future company reference.

Implementing Corrective Actions

- Submit your analysis summary of the audit, issues, and actions needed for internal changes to systems, data, or processes.

- Make a plan for changes where needed.

- Take action now so the same issues are not repeated.

Additional Resources

VERTEX® Exchange

General Audit Manuals

- California: https://www.cdtfa.ca.gov/taxes-and-fees/staxmanuals.htm

- Idaho: https://tax.idaho.gov/pubs/EPB00750_05-01-2019.pdf

- Indiana: https://www.in.gov/dor/files/audit-manual.pdf

- Massachusetts: https://www.mass.gov/doc/field-audit-procedures-manual-0/download

- Michigan: https://www.michigan.gov/taxes/coll-audit/audit

VERTEX Exchange

General Audit Manuals

- New Jersey: https://www.state.nj.us/treasury/taxation/pdf/njmap.pdf

- Pennsylvania: https://www.revenue.pa.gov/TaxLawPoliciesBulletinsNotices/AuditManuals/Documents/sut_audit_manual.pdf

- Texas: https://comptroller.texas.gov/taxes/audit/manuals/

- Multistate Tax Commission: https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Audit_Program/Resource/MTC%20SUTAM%20PUBLIC%20DRAFT.pdf

VERTEX Exchange

Computer Audit Information

- California (Computer Assisted Audit Brochure): https://www.cdtfa.ca.gov/formspubs/pub147.pdf

- Illinois (Computer Assisted Audit): https://www2.illinois.gov/rev/research/publications/pubs/Documents/pub-107.pdf

- Louisiana (Computer Assisted Audit): http://revenue.louisiana.gov/Miscellaneous/caa%20brochure%20120108.pdf

- Missouri (Computer Assisted Audit Info): https://dor.mo.gov/taxation/business/audit/computer-assisted-audit-program.html

- New York (Computer Assisted Audit): https://www.tax.ny.gov/pdf/publications/sales/pub132.pdf

VERTEX Exchange

Q&A

VERTEX Exchange
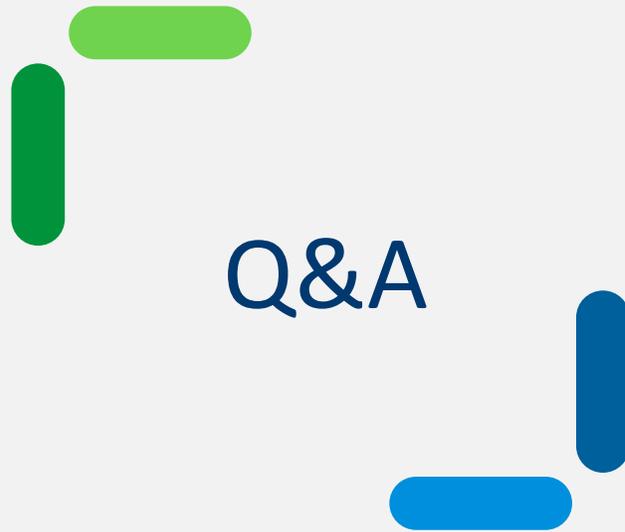
Thank You
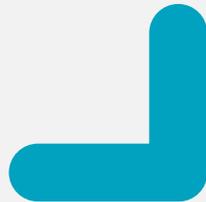
Diane Yetter, President

YETTER and Sales Tax Institute

Telephone: 312.701.1800, ext. 2

Email: diane@Yettertax.com

Twitter: @Yettertax and @salestaxinst

Larry Mellon, Tax Director, Chief Tax Office

Vertex Inc.

Telephone: 484.595.5865

Email: Larry.Mellon@vertexinc.com

Twitter: @larrymellonsr

VERTEX Exchange

VERTEX Exchange