The Strategic Power of Reverse Audits

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On-Demand Webinar

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- Passionate about helping businesses minimize exposure and providing strategic solutions.

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Learning Objectives

- Understand the key steps and documentation needed to conduct a reverse audit
- Identify common sources of overpaid sales and use tax and how to recover them
- Learn how reverse audits support compliance, refund management, and audit defense
- Apply reverse audit findings to improve business practices and reduce future risk

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Overview

What Is a Reverse Audit?

A reverse audit is a review of past transactions to identify overpaid sales and use tax.

It gives businesses a chance to uncover refund opportunities or prepare for a future state audit.

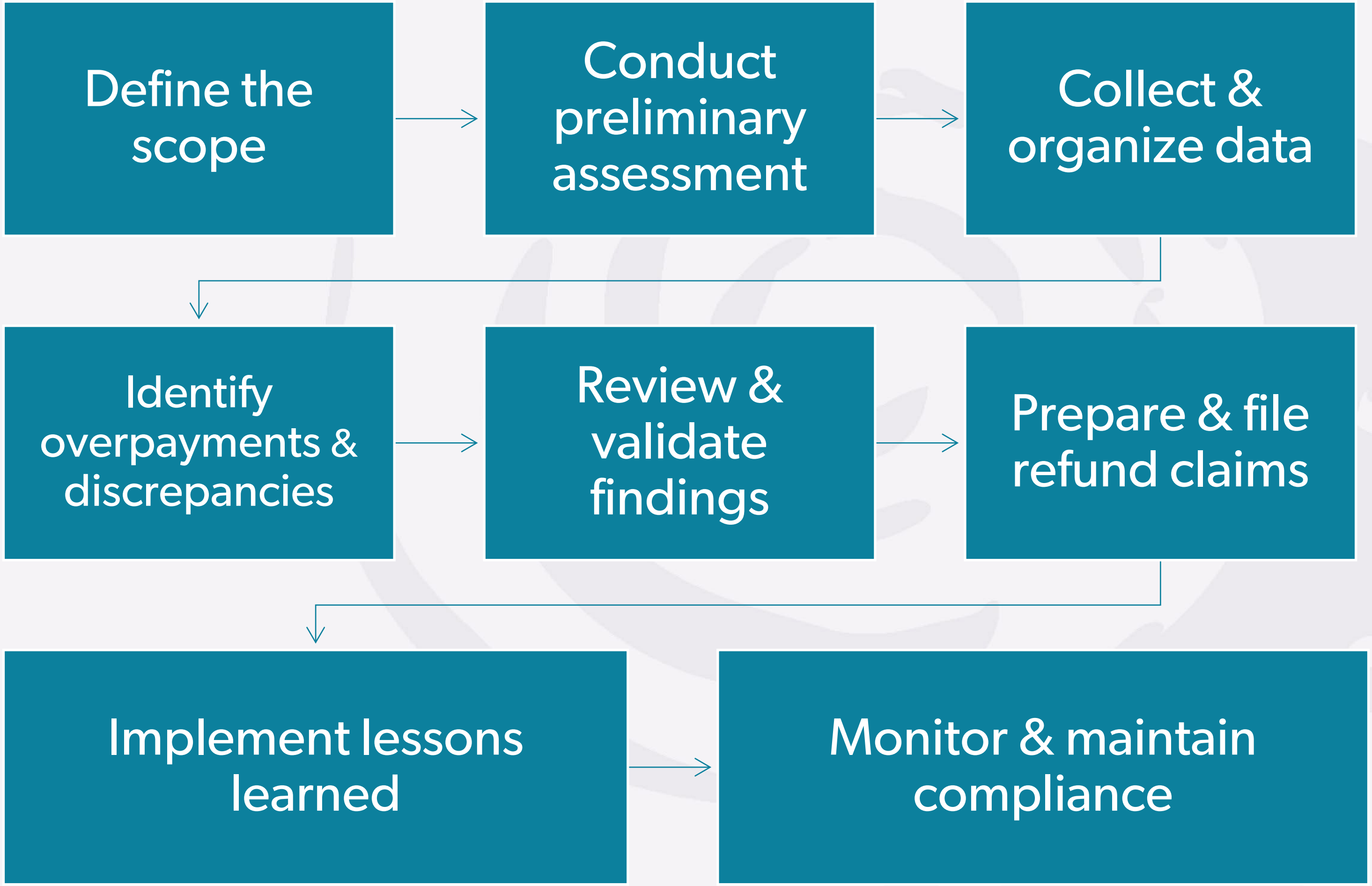
Why Perform a Reverse Audit?

- It helps correct misclassifications, vendor errors, and missed exemptions that may lead to unnecessary tax payments.
- Reverse audits strengthen compliance by revealing systemic issues and improving documentation, processes, and cross-functional collaboration.
- They shift tax from a reactive function to a strategic one, helping organizations reduce future risk and stay audit-ready.

Benefits

- Builds the reputation and strategic value of the tax department while delivering measurable financial results
- Creates stronger engagement with leadership and other departments
- Provides cash refunds and reduces future audit liability
- Uncovers opportunities for long-term savings and cost recovery
- Helps resolve vendor discrepancies and improve vendor relationships
- Reveals process improvements that strengthen compliance and efficiency
- Educates internal teams and promotes cross-functional tax awareness

Reverse Audit Process



Initial Scoping & Assessment

Define the Scope

- Establish objectives (refunds, process improvements, risk reduction)
- Review statute of limitations in each state where you operate.
  - Determine if you are examining:
    - Maximum allowable period?
    - Specific years with higher spend or risk of errors?
- Identify entities to be included.
- Pinpoint which states/jurisdictions are in scope.

Define the Scope (cont.)

- Focus on areas prone to error:
  - Utilities
  - Office supplies and equipment (multi-state usage)
  - IT/Software and SaaS
  - Construction or capital improvements
  - Shipping and delivery charges
- Consider exemptions
- Consider law changes during period

Conduct a Preliminary Assessment

- Does the system and internal process calculate tax properly?
- How easily can data be retrieved and what is the quality of the data?
- Are web-based applications utilized in the tax process?
- Are there any security concerns related to data access or storage?
- Is the relevant data available electronically?
- Are invoices imaged and retrievable in bulk?
- How much time and effort will be required to conduct the reverse audit?
    - Consider internal + external resources

Consider Timing

- When should you plan your reverse audit?
  - Prior to an audit
    - Opportunity to include in audit
    - Opportunity to identify issues in advance to better prepare
  - During an audit
    - Opportunity to include in audit
  - Post audit
    - Reduced risk of triggering an audit

Leveraging Internal Resources

- Importance of interaction with other departments is critical to support reverse audit process
  - Tax Department
  - Information Technology
  - Accounts Payable
  - Purchasing/Supply
  - Manufacturing
  - Research & Development
  - Location Personnel

Leveraging External Resources

- External help has several benefits, including:
  - Acting as a buffer between tax jurisdictions and clients
  - Preexisting relationships and/or contacts with tax authorities
  - Outside perspective
  - Ideas from experiences with other clients
  - Minimizing impact on internal resources
  - Expertise from professionals with valuable knowledge

Qualifications for External Resources

- Specialized tax and jurisdiction knowledge
- Understand process and documentation
- Sensitivity to related issues
- Maintain relationships with jurisdictions

Data Collection & Organization

Reviewing State Taxability

- Sales and use tax rules differ widely by state.
- Knowing exemptions, special rates, and definitions helps uncover overpayments in a reverse audit.
- Focus areas: tangible personal property, digital goods, services, and industry-specific exemptions.

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Common State Variations

- Digital Goods: Some states tax SaaS, streaming, and downloads (e.g., WA, TX, NY); others exempt.
- Services: Personal, professional, and repair services are taxed inconsistently.
- Manufacturing/Processing: Machinery exemptions vary by scope and definition.
- Delivery & Fees: Retail delivery fees (e.g., CO, MN) treated differently than shipping charges.
- Tax Holidays: Certain states offer periodic exemptions (e.g., holiday shopping, back-to-school). Do these apply for business use?

Refund Process Differences

- Each state also has its own statutes and administrative rules for claiming refunds.
- Variations impact success, timing, and cost of reverse audits.
- Key areas to consider:
  - Statutes of limitations
  - If state requires vendors to apply or if purchaser is allowed to file directly
  - Not all states pay interest on refunds, some only after a threshold period
  - Different levels of documentation required
  - Can retailer retain sales tax collected in error?

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Examples of State Differences

- Texas
  - 4-year statute begins on the date the tax is due/payable
  - Purchaser may file directly with state
  - Detailed schedules are required

Examples of State Differences

- New York
  - 3-year statute from the later of the return due date or the return filing date
  - Refunds are often tied to exemption certificate validation
  - Purchaser who overpaid sales tax to vendor may file directly with state for sales tax credit
  - Provide certificates and invoices

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Examples of State Differences

- Illinois:
  - 3-year statute from the month or period when taxable gross receipts were received
  - Requires purchaser to file with supporting schedules
  - Tax refund claim filed with who tax was paid to (vendor or state)
  - State has 90 days to issue refund, interest accrues if refund is delayed

Collect and Organize Your Data

- Focus on high-risk areas where overpayments are most likely to occur
- Review transactions involving complex supply chains or multi-jurisdictional activity
- Evaluate vendor-charged tax rates for accuracy and consistency
- Identify purchases where tax decisions were left solely to vendors
- Prioritize categories with frequent exemptions or special tax treatment or recent law changes
- Cross-check internal records against vendor invoices for discrepancies
- Consider departments /systems that handle large volumes of taxable purchases

Collect and Organize Your Data (cont.)

- Areas to consider:
  - Purchase invoices
  - Depreciation schedule
  - Exemption certificates
  - Supporting documentation for exemptions
  - Use tax remitted on sales and use tax returns
  - List of vendors and associated products/items/services
  - Related accounting records and documents
  - Documentation from previous audits or tax authority correspondence

Overpayments & Discrepancies

Identify Overpayments and Discrepancies

- Purchases where sales tax was incorrectly charged by vendors on non-taxable items
- Transactions where tax was self-accrued to a state, but the item should have been exempt
- Mismatches in state taxability rules
  - Common areas = services and digital goods, as tax rules/exemptions vary

Identify Overpayments and Discrepancies

- Duplicate payments or misclassified transactions that resulted in overstated tax liability
- Missed exemptions on qualifying purchases
- Inconsistent tax treatment across vendors or departments
- Tax credited to customers but not refunded by states
- Bad debts

When Tax is Both Paid and Accrued

- Sometimes tax is charged by the vendor and accrued internally, leading to double payment.
- This often occurs when:
  - Vendors default to charging tax on borderline or complex items.
  - Internal systems flag the purchase as taxable and auto-accrue use tax.
- If the item is actually non-taxable or exempt, the business has paid more tax than required.

How to Spot These Transactions

- Compare vendor invoices with internal use tax accrual records.
- Look for matching dollar amounts of tax in both AP records and tax returns.
- Trace high-risk vendors or departments with history of coding errors or conservative tax treatment.
- Confirm the true taxability under each state's rules to uncover overpayments.

Purchases Taxed Incorrectly

After gathering your data, look closely for:

- Vendor-charged tax on exempt items (e.g., resale, manufacturing equipment, utilities)
- Self-accrued tax on exempt items that didn't require payment under state rules
  - Construction
  - Services
- Tax paid in the wrong jurisdiction due to sourcing errors or misapplied nexus rules or vendor charging their state tax

Review and Validate Findings

- Cross-check calculations
- Review internal coding
- Verify accurate use of exemption certificates
- Engage resources for external validation:
    - Consultants or legal/tax experts can help with large or multi-state claims

Review and Validate Findings

- Submit refund claims for overpaid taxes
  - Ensure documentation supports claim and complies with state-specific procedures/deadlines
- Address bad debts, file for applicable tax credits or deductions where applicable
- Establish or adjust reserves for potential audit liabilities to manage financial exposure
- Update tax software, train staff, and revise procedures to prevent recurring errors.

Tools & Resources

Leveraging Technology

- Artificial intelligence can analyze large volumes of transactional data quickly. It can also:
  - Identify patterns and anomalies
  - Cross-reference tax rates, jurisdictions, and exemption statuses
  - Streamline document retrieval and classification
  - Generate audit-ready reports and summaries
  - Automate repetitive tasks like invoice matching and tax validation

Resources

- General Audit Manuals
  - California: https://www.cdtfa.ca.gov/taxes-and-fees/staxmanuals.htm
  - Idaho: https://tax.idaho.gov/wp-content/uploads/pubs/EBR00230/EBR00230_06-26-2024.pdf
  - Indiana: https://www.in.gov/dor/files/audit-manual.pdf
  - Massachusetts: https://www.mass.gov/doc/field-audit-procedures-manual-0
  - Michigan: https://www.michigan.gov/taxes/coll-audit/audit
  - 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/audit/resource-documents/

Resources (cont.)

- Computer Audit Information
  - California (Computer Assisted Audit Brochure): https://www.cdtfa.ca.gov/formspubs/pub147.pdf
  - Illinois (Computer Assisted Audit) https://tax.illinois.gov/content/dam/soi/en/web/tax/research/publications/pubs/documents/pub-107.pdf
  - Louisiana (Computer Assisted Audit): https://dam.ldr.la.gov/publications/20095(11_11).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

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Building Future Resiliency

Communicating Success

- Celebrate audit recoveries as a win for the business, not just the tax department.
- Translate results into measurable outcomes: refunds recovered, penalties avoided, or compliance risks reduced.
- Use positive messaging to gain leadership support and secure future resources for tax initiatives.
- Share the spoils!
  - Reinvest in tools, training, or process improvements
  - Recognize teams that contributed

Implement Lessons Learned

- Use findings to strengthen your internal controls, documentation practices, and vendor management.
- Make necessary changes to processes or systems to prevent future errors now.
- Automate where possible:
  - Update tax engine settings
  - Ensure exemption certificate tracking
  - Digitize data collection

Monitor and Maintain Compliance

- Periodically review your systems and procedures so mistakes aren’t repeated
- Ensure future purchases are coded correctly by keeping up to date on tax rates and rules
  - Stay informed on upcoming legislative changes

Questions & Comments

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- Join the Sales Tax Institute's LinkedIn group, exclusively for Sales Tax Institute course attendees!
- Post questions, ideas, practical suggestions and news updates that you think will be relevant to other Sales Tax Institute alumni.
- We will be moderating the group, and we will remove inappropriate content posts so that this stays as a resource for our students to help them develop their sales tax expertise and ask questions.

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