

## Surviving a Sales Tax Audit

Part One of a Two-Part Series

By: *Randolph P. Johnston, MCS, MCP*

### Sales and Use Tax Fast Facts

In the United States

- 45 States,
  - 4,696 Cities,
  - 1,602 Counties, and
  - 1,113 Other Jurisdictions
- impose some form of sales and/or use tax.

In 2008, according to University of Tennessee research, \$21.5 billion in sales and use taxes are expected to be lost due to Internet sales.

According to PricewaterhouseCoopers, LLP, for businesses with less than \$1 million in annual revenue, cost of compliance is 13.47% for each sales tax dollar collected

In softening economy with state, county, and municipal budget shortfalls, expect more aggressive sales and use tax collection efforts, including increased audit activity.

What are appropriate steps and strategies you can use to survive the dreaded sales tax audit? Make no mistake, in a softening economy with governmental budget shortfalls, you should expect sales and use tax collection efforts to become more aggressive, including stepped-up sales and use tax audit efforts. In this two-part series, we will discuss strategies for surviving sales and use tax audits and how to minimize your exposure in the future. We will also address the topic of tax amnesty, including a discussion of which states currently offer some amnesty programs and whether you should consider participating in such a program.

### Why Was Your Company Selected?

Perhaps the first issue to address is why your company was selected for audit. Knowing the answer to this question is the starting point to developing an appropriate strategy for surviving the sales tax audit. Though your company's selection could have been random, it is possible that there was a "trigger" for the audit, based on your company's sales and use tax history. Characteristics that can lead to sales tax audits include:

- No reporting of sales and use tax or consistent late reporting/filing of sales and use tax returns,
- Reporting a large volume of exempt sales,
- Having nexus in a jurisdiction but not registering with that jurisdiction,
- Internal whistle-blower activity, and
- Trickle-down effect from other sales tax audits.

For example, if your company consistently reports a large volume of exempt sales, it is quite likely that the auditor will want to focus on the nature of those sales; as such, you should begin accumulating all of the documentation to support your position that the sales are in fact exempt from taxation. Included in this documentation would be verifying that you have current reseller's certificates on files for all customers claiming to be exempt from sales taxes.

Likewise, if you suspect that your company was selected for audit because one of your vendors was recently audited and you claim tax-

exempt status on purchases from that vendor, then you should begin documenting your position that those purchases are indeed exempt from sales tax. If you are in doubt as to why your company was selected for a

sales tax audit, contact the auditor in advance of the audit and ask. Knowing the answer to this critical question can provide you with a valuable head start in building a case that supports your company's position.

As a prevention strategy, perhaps a "pre-emptive" strike is in order. Maybe you have reviewed the above listing of characteristics that increase the likelihood that your company will be audited and determined that your company meets one or more of these characteristics. If that's the case, begin addressing the issue now, so as to minimize any exposure if and when a sales tax audit notice arrives. For instance, maybe your company has recently established nexus in a jurisdiction, but has not yet registered with that jurisdiction for purposes of collecting sales taxes. Now is the time to rectify that deficiency, before it ends up costing your company unnecessary penalties and interest in a sales tax audit.

### **What Questions will the Auditor Ask?**

In addition to knowing why your company was selected for audit, it is also helpful to know in advance what types of questions the auditor will ask and what types of documentation will be examined. Keep in mind that the auditor's job is to find more revenue and therefore the questions will be focused in the areas of order-to-cash cycle for sales taxes and purchases-to-payments cycle for use taxes. On the sales tax side, expect the auditor to perform a high-level review of items such as:

- Sales per books compared to sales per sales tax returns,
- Deposits per bank statements compared to sales per sales tax returns,
- Sales per income tax returns compared to sales per sales tax returns, and
- An analysis of the sales tax payable account to sales tax actually remitted.

With respect to use taxes, look for the auditor to focus on such items as:

- Purchases from out-of-state vendors of items that were not re-sold to customers,
- Purchases of fixed assets and fixed asset additions, and
- Internet-based purchases.

Expect the auditor to perform detailed tests such as tracing individual transactions involving sales and use taxes to the company's books of account, validating that tax rates billed on transactions are correct at the time of the billing, and verifying that current reseller's certificates are on hand for customers claiming exempt status.

From a documentation standpoint, the auditor is likely to start with some form of questionnaire to obtain general information about the business, its ownership structure, and the markets it serves. In addition, the auditor is likely to want to have access to and inspect documents such as:

- The company's income tax returns for the period under audit,
- Trial balances and general ledgers,
- Sales journals,
- Invoices, receipts, and credit memos supporting sales transactions,
- Exemption certificates for customers,
- Purchase journals and records,
- Cash disbursement journals,
- Bank statements, and

- Fixed asset registers and depreciation calculations.

One proven strategy for bringing a sales and use tax audit to conclusion as quickly as possible is to have all of the documents the auditor requests available when the auditor arrives. This provides a clear signal to the auditor that you are cooperating with the auditor and are anxious to bring the audit to closure as quickly as possible.

### **Summary**

In Part One of this two-part series, we have addressed the issues of why your company was selected for a sales tax audit and what types of questions the auditor might ask and documentation the auditor may request to see. Knowing why your company was selected for audit, the types of questions the auditor will ask, and the documentation the auditor will need to examine provides you with a great start on surviving the audit. In Part Two, issues such as handling proposed adjustments, sales tax amnesty, and sales tax management systems will be discussed as strategies to help you survive a sales tax audit.

### **About the Author**

Mr. Johnston is a shareholder in K2 Enterprises, where he develops and presents technology-related continuing professional education programs to accounting and finance professionals across the United States. You may reach him at [randy@k2e.com](mailto:randy@k2e.com).