10 Tips from 4 (former) State Tax Auditors

What to do and *what not to do* from the experts

Avalara

Wouldn't it be nice to get insight from a state tax auditor before you had to meet one? Most people fear the dreaded notice from the department of revenue (DOR) because sales and use tax audits are an inconvenience at best and very costly at their worst. Circumstances place you and the auditor at odds, where you can't ask for advice, pick their brain on how to avoid penalties, or seek their counsel at any time during the process.

State tax auditors have seen just about everything and can offer advice no one else can. That's why we created this guide. We found four former state tax auditors who are also sales and use tax compliance experts and asked them what advice they'd give companies to increase their chances of a quick and painless experience if and when the auditor comes knocking.

About the Authors:

Mehrdad Talaifar – Mehrdad is a recognized expert in sales, use, and value added tax compliance automation with over 30 years of Indirect Tax experience. Prior to working for Avalara, Mehrdad was a California State Auditor, in addition to holding leadership roles at Thomson Reuters and Sabrix, and managing sales and use tax for Arthur Anderson in San Francisco and Silicon Valley.

Sylvia Aguirre – Silvia is the co-founder of Avalara CertCapture and an expert on exemption certificate management. She has 20 years experience in sales and use tax compliance and was a former Texas State Auditor tax and accountant who has a passion for helping businesses achieve 100% compliance.

Clifford Turner – Clifford is a former California State Tax Auditor and an industry veteran with 25 years of sales and use tax experience. He has built and managed sales and use tax compliance operations for two of the "Big 4" accounting firms.

Steven Cabrera – Steven is a CPA and former California State Tax Auditor and has over 20 years of sales and use tax experience both in state government and the "Big 4". His experience is in Voluntary Disclosures, Tax Recovery, Registration, Audit Representation, Taxability Research, Refund Reviews, Due Diligence and more.

Here are their ten tips to consider.

Tip #1 – Determine, Calculate, and Report taxes correctly–the first time!

This may sound like a no brainer, but too often companies get in trouble or complicate the audit process when they have errors either in their calculation or reporting of sales and use tax. Whether you have minor errors in your transactions, like charging the wrong rate on a single invoice, or a severe blunder, like failing to remit taxes that were collected, the audit process changes dramatically once the auditor believes there's reason to probe. Start by assessing your tax responsibilities and don't forego the research required to do it correctly. When in doubt, conduct a Nexus Assessment with a CPA, preferably one who specializes in State and Local Taxes (SALT).

Assess your tax liabilities and know the correct rates, rules, and tax laws for each jurisdiction in which you file. Here's a couple helpful tips:

- ✓ **Understand filing requirements for each jurisdiction.** Review each state's department of revenue site to determine filing specifics. Some states require everything from electronic filing to advance payment to specific forms.
- ✓ **Know where you have nexus.** Do you have a significant presence in another state where you're not filing? Evaluate your physical and economic presence and learn about the nexus rules where you might have a connection. Each state has different requirements.
- ✓ **Forget about zip codes.** ZIP codes are the wrong tool for calculating rates. For example, some cities in Colorado have at least 5 different sales tax rates for one ZIP code! Use geolocation to pinpoint exact addresses and rates by relying on the right source.

Tip from Mehrad

Proof is in the reports. Companies don't always get in trouble because they managed sales tax wrong, but because they can't produce reports that prove they're doing it correctly. It's a good idea to retain "internal" tax return worksheets that substantiate the source of reported figures. Although worksheets are not generally furnished with the original filing, they are an extremely valuable resource in recalling audit trail, particularly after a number of years have elapsed.

Tip #2 – Find the skeletons in your closet – *conduct your own audit first*

Nobody likes surprises, unless there's a party involved. Conducting a pre-audit or reverse audit before you get a notice from the state lets you find – and correct – errors. You can conduct one on your own, but outsourcing this task to a consultant has its advantages. Your accounting team may try to avoid exposing their own mistakes or might simply overlook errors. Auditing yourself is like editing your own book. It's difficult to be objective when you're so close to the process. But even if you don't employ outside expertise, conducting an internal audit is worth the effort and will likely pay off in reduced penalties down the road.

Something to consider: If you choose to handle the audit yourself, at the very least consider getting a tax representative to bounce questions off of. Just like most things in life, what you don't know can hurt you.

Tip from Steven

You can't change recorded history but if questioned, be able to explain "adjustments" such as credit memo's, errors, etc. You have to show proof that everything was eventually taxed correctly.

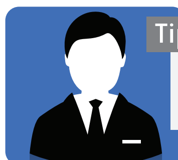
Tip #3 – Be consistent in your accounting and reporting practices

Like Tip #1, this seems obvious, but inconsistent accounting methods can creep into your business at any time. Let's say you hired a temp for six months while your Accounting Manager was on sabbatical. Your temp might have a slightly different workflow or reporting method. At face value, that's not a big deal, but an auditor will scrutinize any changes in your practice.

Another common reason why inconsistent practices creep into your business is when you make changes to your back office accounting system and technology. Do a quick audit on your transaction records shortly after you upgrade to a new system and/or purchase a new ecommerce platform, etc.

Consistency is even helpful when you've been managing sales tax incorrectly. It's far easier to correct transactions when you've identified a common mistake, rather than combing through thousands of records and assessing errors one by one.

Remember, a smooth audit is all about speed and efficiency. Inconsistent practices give auditors reason to probe further, which make the event neither quick nor efficient.



Tip from Clifford

Outliers are your enemy. Auditors don't look for how many transactions are done correctly, but for any records that stick out from the rest.

Tip #4 – Give them what they ask for–*nothing less, nothing more*

Don't withhold info or create unreasonably numerous delays when responding to data requests. You are legally bound to give certain information to the auditor if they ask for it. When they ask for info, give it to them as quickly as possible. Make sure your records are easy for them to access; you don't want to seem like you're hiding anything. This makes auditors dig deeper and try and find discrepancies and errors just a little bit harder. They will not throw up their hands in frustration and disappear. Rather, they will simply assess a large bill and you can either cooperate or fight the assessment in appeals.

On the flip side, you don't want to overshare. Don't give them records they didn't ask for; it complicates the process and opens the door for miscommunication. For example, if you have multiple business units or run separate companies, don't provide information that's not specific to the company being audited. A good rule of thumb is to have all requests in writing.

Discretion is a virtue. Don't put people in the room with an auditor, as they might speak out of turn and spark something that would make the auditor dig a little deeper.

Tip from Sylvia

More is not better. Compiling additional information doesn't give the desired effect of showing due diligence or flawless accounting. It only incites more questions.

Tip #5 – Don’t make the auditor’s life H#@!

Nobody likes getting audited, and nobody know that better than an auditor. Resist the impulse to make the auditor as uncomfortable as you probably feel. It goes without saying that you should avoid combative behavior and be cordial, but also know that even little things can have a big impact.

Here are a few recommendations:

First impressions matter. If you show up with a courteous smile and act professional, you will set a good tone for the entire audit duration. Make time for the auditor and talk through the process, so you have shared expectations.

Location, location, location . . . Don’t put the auditor where it is hard for them to work: next to the copy machine, in the staff lunchroom, on the assembly floor... you get the idea. One former California state auditor was once placed on a couch with a Great Dane that would loom over him and drool all over his paperwork. He also recounted a time when he was placed in a van on the curbside in blistering California heat.

These conditions put auditors in a bad mood, and they will often take their time and go the extra mile to find errors, request more information and dig their heels in deeper. So put them in a good location that’s well-lit and conducive for their task. Put them at ease and in a good mood and it will be as painless as possible.

True, the auditor is not your advocate and they are mindful of the interests of the Department of Revenue (i.e., collect revenue), but try and appreciate their position. A good professional rapport can go a long way when it comes to penalty assessment and any leeway they give you on errant transactions.

Tip from Mehrad

Don’t make things too comfortable for the auditor. You want to make sure they have enough reason to leave.

Tip #6 – Manage use tax correctly

Tax experts often call use tax the auditors’ low hanging fruit. That’s because it’s often

neglected or managed inconsistently. As a result, more and more states are increasing audits to collect consumer use tax. In fact, mismanaging use tax ranks in the top five for costliest compliance mistakes made by companies, according to leading accounting and tax consulting firm Peisner Johnson & Company.

Use tax is tricky. How you "consume" certain items in your business is often the determining factor. Common triggers include but are not limited to:

- Inventory transfers
- Promotional giveaways to promote sales (even includes free samples to customers)
- Charitable donations
- Fixed assets purchasing where tax was not collected by the vendor
- Withdraw inventory for internal research and development (applies to certain states)

If these items were intended for resale and you didn't pay sales tax at the time of purchase, then you are now obligated to pay use tax. If you bought equipment or furniture for your office and then moved locations, and the tax rate is higher in the new location, then you may owe the difference in use tax. This is where most auditors spend their time – verifying those expenses, fixed assets, and inventory transfers have been properly taxed. It's also where most mistakes occur.

State auditors say use tax errors are the number one audit risk and the bulk of assessments come from use tax not being paid. Certain industries like manufacturing, construction and hospitality face even greater risks because the use tax rules for these businesses are more complex and aren't always consistent from state to state.

Not sure where use tax applies? This is a good area for seeking counsel.

Tip from Steven

Vendors and other parties in the supply chain cause a lot of confusion in determining who's on the hook for collecting or self-remitting tax on taxable purchases. If your supplier does not collect tax, don't assume they are doing it right. Check the purchase invoices carefully if they are subject to tax. If the purchase is subject to tax, the conservative approach is either have the seller collect the tax or self report the use tax.

Tip #7 – Verify tax exempt transactions

If an auditor was to walk through your door today, would you know:

- How many exemption certificates you have?

- Which certificates will expire soon?
- How many certificates are missing information or need updating?

Many companies can't answer yes to all of these. That's because anyone that sells multiple products and services into multiple states has an administrative nightmare when it comes to managing and storing exemption certificates.

If a tax exemption certificate is invalid, out of date, or missing, a company can be liable for the sales tax not collected. Further, many accounting professionals believe that if a company fails an audit, it's only obligated to pay back the erroneous transactions found by the auditor. Truth is, penalties and fees can be applied to all transactions over an entire year as an overall percentage. If you're missing one, you might be on the hook for many.

Tip from Sylvia

Start with exemption certificates when conducting your own audit because that's the area an auditor will likely start with. Missing or outdated exemption certificates on transactions will blow any chance of a quick and painless audit.

Tip #8 – Don't be afraid to negotiate terms

You have more control in the process than you might think. Before starting the audit, be sure to negotiate the following:

Start date. You want substantial lead-time to prepare for an audit – at least a month. This allows you to research any issues you have on your end and meet with outside help to assess your records. It also gives you time to find and clear an appropriate space for the auditor to work. Don't hesitate to ask for an extension.

Date range the auditor selects. If there have been an improvements in your business practices for monitoring the taxability of purchases, press for the test period to come after the process improvements were made.

Missing Documentation. Inevitably, there will be missing documentation, such as a purchase invoice. Is the auditor going to allow you to substitute a like invoice to prove tax was paid or is it going to be assumed taxable? Likewise, if exemption certificates from your customers are missing, will you be given time to gather them?

Tip from Clifford

Audits come with a lot of legal forms to sign, such as statute of limitation waivers, sample agreements, receipt of documents, agreements to proposed assessments, and more. If you don't know what you are signing, seek out help. Once you sign the document, it can't be rescinded.

Tip #9 – Avoid being a target

States generally have a system for selecting businesses to audit but predicting whether you'll be chosen is not easy. Sometimes, it's a matter of (bad) luck, but there are a number of factors that make some companies more vulnerable than others.

Some businesses are targeted every year because of their size, sales volume, or the complexity of their returns. Others may be chosen because of a specific event, like filing chapter 11 or acquiring a company. But one of the biggest factors states look at is whether the company has been audited before and the outcome of that audit. It should come as no surprise that if you've been audited in the past, you'll probably get audited again, especially if the past audit didn't go so well.

Companies have little control in this area, but here are a few things to consider:

- **High volume of exempt sales**. Companies with a high volume of exempt sales are targeted because of the discretionary nature of the transactions. In other words, it's easy to make a mistake. Also claiming frequent refunds or large tax credits can be a red flag.
- **Errors on filed returns.** Continous filing errors generally trigger notices of inquiry and potential estimated assessments. These are red flags and could trigger an audit.
- **Late filing.** Taxpayers that continually file late will be scrutinized and eventually audited.
- **Sole proprietors are audited more frequently than small business corporations** (including C corporations, S corporations, and limited liability companies) because sole proprietorships historically have more errors in their self-prepared returns.
- **Whistleblowers.** Competitors and disgruntled employees have been known to contact state tax departments. While this occurrence is rare, states might follow up on leads of underreported taxes.
- **Audits of customers.** Not properly collecting tax from customers may be detected in an audit of the customer. The auditor potentially will take note of the sellers invoice and initiate an audit of the seller or question if the seller has nexus in the customer's state or other non-compliance considerations.

Tip from Steven

Your best offense is a good defense. When you manage sales tax correctly, such as employing internal controls, and conducting periodic self audits before you get audited, you have less to worry about when your name comes up. If you have had prior audits, ensure that you have corrected errors found in that audit.

Tip #10 – Automate the process

Relying on knowledge and manual processing often creates errors, which are further compounded by staff turnover. Inaccurate record-keeping in turn attracts tax auditors.

Technology does more than just automate the laborious task of sales and use tax management. It safeguards your business by removing risk. Small- and medium-sized companies especially stand to benefit from automation, as the average cost of an audit ($114,147 according to Wakefield Research) can eat away at profit margins and turn an organization on its head.

Automated sales tax solutions dramatically improve efficiency by assessing, calculating, and accruing sales and use tax when invoices are originally processed.

Geo-spatial technology determines sales tax rates at the invoice level, and a tax calculation engine (a vast online database) holds tax information for every state and for more than 12,000 local tax jurisdictions in the U.S. Imagine trying to remember this information! For this reason, automated solutions dramatically increase remittance accuracy, which discourages the need for audits.

Most software solutions also offer tools that quickly deliver the reports necessary to prove compliance. In this way, accounting staff can generate reports at a moment's notice without having to build them from scratch. Also, the best sales tax solutions integrate seamlessly with a business' existing accounting system, ERP, POS, or e-commerce applications.

LEARN MORE.

Note:
The above tips are a generalization of common audit occurrence and are not intended to be an all-inclusive list. Audit policies vary by state and a number of the states publish the sales and use tax audit manuals on their website and are available to the public.

Get Started.

To learn more about pricing, view online demonstrations, or chat about AvaTax's capabilities, visit:

www.avalara.com/

or call

877.780.4848 today.

About Avalara

A privately held company, Avalara was founded by a team of tax and software industry veterans to fulfill a vision of delivering an affordable, scalable sales tax solution. Thus making what was not economically feasible in the past for mid-sized business not only affordable, but more accurate as well – all with the latest and most innovative technology available. From Bainbridge Island, close to Seattle, Avalara's knowledgeable staff works tirelessly to help customers put the hassles of sales tax compliance out of mind. Avalara's mission is to transform the tax process for customers by creating cost-effective state-of-the-art solutions. The company does so through integrated on-demand, Web-based software services that provide transparent transactions, accurate tax compliance, painless administration and effortless reporting.