How to Handle a Sales Tax Audit

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Topics for Today

- Preparing for a sales tax audit;
- Identifying areas of and quantifying potential tax risks and opportunities;
- The audit process;
- Taxpayer’s rights.
Handling a Sales Tax Audit Cycle

**PRE-AUDIT**
- Amnesty
- VDA
- SOL
- Initial Document Request
- Issue Identification
- Reverse Audit

**ON-SITE AUDIT**
- Auditor
- On-Site Logistics
- Control
- Timeline

**IMPROVEMENT**
- Prevent Future Errors

**ASSESSMENT**
- Offsets?
- RAR
- Interest/Penalties
- Protest

**AUDIT REQUEST**
- Why?
- Info?
Pre-Audit

- Amnesty;
- VDA;
- Statute of Limitations Extensions;
- Initial Audit Document Request;
- Reverse Audit.
Statue of Limitations Extensions

Extend the statute of limitations? – Consider:

- Age of audit period (and with it availability of proof);
- Number of years subject to SOL in the audit period;
- Prior experience with state or locality conducting audit;
- Novel or unique positions versus recurring issues;
- Jeopardy assessments;
- Potential impact on tax reserves.
Initial Document Request

A typical sales and use tax audit begins with a request for documents including:

- sales and use tax returns;
- sales journal and supporting invoices;
- purchase/disbursement journal and supporting invoices;
- fixed asset ledger detailed depreciation schedules;
- invoices to support all assets;
- documentation to support any deduction taken on the return;
- resale, purchase exemption and other certificates;
- general ledgers; and
- any other documentation that may have a bearing on the tax liability.
Identify Issues

Position Issues:

<table>
<thead>
<tr>
<th>Position</th>
<th>Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not-Taxable</td>
<td>Extra-Jurisdictional; Subject Matter Not Taxed</td>
</tr>
<tr>
<td>Exempt</td>
<td>Property; Transaction; Entity</td>
</tr>
<tr>
<td>Credit</td>
<td>Economic Development; Incentivize Action (e.g., Recycling)</td>
</tr>
</tbody>
</table>

Fact Issues:

- Availability of Documents:
  - Invoices, Resale/Exemption Certificates, Etc.
- Tracing.
Documentation & Recordkeeping

- Sample – Type? Periods? Size?
- Treatment in past audit(s) or business conduct;
- Third parties (vendors, customers, etc.);
- Review prior audits/protests for positions previously raised.
Confidentiality and Privilege Issues

- Proprietary information and trade secrets;
- Attorney-client privileged communications;
- Accountant-client privileged communications;
- Attorney work product protections;
- Disclosure issues (e.g., HIPPA violations).
Reverse Sales Tax Audit
Evidence and Indications of Possible Tax Overpayments

• Focus on Tax Paid Sale/Purchase Transactions;
• Tax Accrual & Expense G/L Accounts:
  – List of Tax Paid Items from Financial Systems with Relevant Available Data;
  – Financial Account Information: G/L Account; Business Unit, Cost Center, Vendor, etc.;
  – G/L versus Procurement Cards;
  – Sales Tax or Use Tax Paid? Direct Pay Permit?
• Tax Matrix;
• Sales and Use Tax Returns;
Reverse Sales Tax Audit

Assemble Documentation Demonstrating Tax Paid:

• Invoices;
  – Alternatives: Purchase Orders, Contracts;
• Description of Property, Process or Use;
• Graphic Illustration (e.g., pictures or videos) of Property, Process or Use.
On-Site Audit

- Auditor;
- On-Site Logistics;
- Control;
- ADRs;
- Timeline.
Revenue Auditors Report

- Request the opportunity to resolve dispute before auditor finalizes position on matter;
- Request a meeting with field auditor’s supervisor;
- Carefully review audit report to ensure that agreed adjustments have been made AND whether there are any mathematical or other errors.
Sales Tax Assessment

- Offsets? [Reverse Sales Tax Audit];
- RAR;
- Interest/Penalties;
- Protest.
Protesting a Sales Tax Assessment

• Requirements for a Protest:
  – Timely filing and proof of timely filing;
  – Protest;
  – Supporting statement.
Sales Tax Protest

- Short form protest versus detailed protest;
- Advantages/disadvantages of filing supporting statement or supplemental supporting statement after protest;
- Use of “sunshine,” “FOIA,” or open records requests;
- Failure to protest all issues;
- Protective refunds (general versus specific), etc.
Sales Tax Protest Conference

- Request a Conference or Not?
- What to Expect at a Protest Conference;
- Effective Use of Protest Conference;
- Failure of the DOR to act on a protest (undue delay) and increased interest as a result;
- Pros/cons of face-to-face protest conferences versus telephonic or video protest conferences:
  - Cost;
  - Development of issues; and
  - Relationship issues.
- Who should participate in the protest conference?
  - Taxpayer (tax person versus non-tax person)? CPA? Attorney?
Post-Protest Conference

• Supplemental supporting statement?
  – Another “bite at the apple” (expound, clarify and/or add new issues);

• Settlement offer considerations:
  – Hazards of litigation;
  – Certainty for future audit periods;
  – Non-recurring nature of issue.
Paths to Resolution of Protest

• Concession by Taxpayer of Issue(s) or the Protest;
• Concession by Department of Issue(s) or the Protest;
• Negotiation of Settlement (all based on Hazards of Litigation):
  – Factual Issues;
  – Legal Issues;
  – Settlement by: Trading Issues? Percentage Settlement?
  – Penalties May be Waived; Interest May Not be.
• Go to Tax Tribunal?
## Process Improvement

<table>
<thead>
<tr>
<th>Error</th>
<th>Cause of Error</th>
<th>Resolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Paid or Not Paid in Error</td>
<td>No Tax Matrix</td>
<td>Create Tax Matrix</td>
</tr>
<tr>
<td>Tax Matrix Not Used</td>
<td></td>
<td>Redistribute Tax Matrix; More Training</td>
</tr>
<tr>
<td>Tax Matrix Misunderstood</td>
<td></td>
<td>Update /Revise Tax Matrix; More Training or Re-training</td>
</tr>
<tr>
<td>Exemption Read Too Narrowly or Broadly</td>
<td></td>
<td>Update Tax Matrix</td>
</tr>
</tbody>
</table>
Taxpayer’s Rights

• Explanation of procedures, remedies, and the rights and obligations of taxpayers and the Department;

• Right to be assisted or represented by an attorney, accountant, or other person in any conference, hearing, or other matter before the Department;

• Perform audits and conduct conferences and hearings only at reasonable times and places;

• Right to make audio recordings of any conference with or hearing;
Taxpayer’s Rights (Cont.)

• Relief from penalty or interest pertaining to advice in writing from the department concerning the specific facts and circumstances of the activity or transaction relied upon by the Taxpayer;

• A clear and concise description of the basis and amount of any tax, penalty, and interest assessed against the Taxpayer, and copies of the audit workpapers and narrative setting forth the grounds for the assessment;

• An installment payment agreement for the payment of delinquent taxes, penalties, and interest owed;
Taxpayer’s Rights (Cont.)

• Not evaluate individual officers or employees of the Department on the basis of taxes assessed or collected or impose or suggest tax assessment or collection quotas or goals;

• Privacy with regard to the information provided on tax returns and reports, including any attached information or documents; no information pertaining to returns, reports, or the affairs of a person’s business shall be divulged.
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Questions?

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