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MANAGING TRANSACTION TAX AUDIT RISK

How to protect precious cash flow by proactively addressing audits.

CONTENTS

INTRODUCTION

Even in the best economic times, businesses need to be vigilant against unnecessary costs and risks. In challenging times such as these, it's even more critical to avoid missteps, protect cash flow, and derive maximum value from people and processes. But it's not just businesses that need to maximize cash flow these days — states and other tax authorities are feeling the same economic pinch. State budget deficits are mounting into the tens of billions, income tax takes are shrinking, and federal help is drying up, leading states to become more creative in targeting additional products and services to tax, and more aggressive in collecting that tax. The result is a flurry of new laws and rate changes, intensifying collaboration to catch the non-compliant, and a explosion of new tax auditors on the streets, tasked with bringing home revenue.

This is not welcome news for businesses already reeling from the recession. Not only do companies have to navigate through the current downturn, they also have to stay on top of new tax laws and trends, preserve cash in the face of proliferating audits, and figure out how to reduce operational costs while still covering all their audit risks. Tax audits require weeks of effort and distraction, and come with the potential for tens of thousands of dollars in penalties and fees biting into your company's bottom line, all at a time when you can least afford it.

This paper presents a proactive survival guide to sales and use tax audits, based on knowledge collected from real-life past and present auditors who were queried on what they look for in an audit. It provides information to help you understand your company's exposure to audits and how to avoid them right from the start, coupled with proven strategies for minimizing their affect on your bottom line. At the end of the day, the best defense against being audited is a good offense. Each new tax law change, newly taxable item or service, launch of a new product, etc. increases your odds of being audited. Passive acceptance or turning a blind eye will get you nowhere but poorer. Hence this paper concludes with techniques, tips and tools that will enable you to be proactive in managing your sales and use tax compliance, cost-effectively scale your ability to survive audits, and help you emerge successfully from the present downturn.

THE TARGET ON YOUR BACK

From the mouths of auditors: the top ten issues that will trigger a tax audit

Make no mistake: to cash-hungry tax authorities, your business represents a revenue stream, plain and simple. Their job is to maximize that stream, and a sales and use tax audit is one of their primary tools. **In a sales and use tax audit, an auditor reviews your business records over a period of days/ weeks/months to determine whether you are underreporting or underpaying taxes that are legally due. In addition to the costly time, effort and diversion of resources this takes on your part, the resulting penalties can be substantial. In a recent survey of 514 companies, the estimated annual cost of penalties due to sales and use tax mistakes was $34,000, over and above the recovered taxes.**[1] To you, that's an unexpected hit to your profits; to the state, it's "found money."

...to cash-hungry tax authorities, your business represents a revenue stream.

[1] Independent study of 500+ mid-market CFOs and senior financial executives conducted by Tallman Insights and fielded by Mindwave Research.

Given this kind of return, it's no surprise that when states need more funds, as they increasingly do today, they send out more auditors. **Case in point, Washington State's proposed 2009–2011 budget includes 28 new full-time staff and $6.5 million to invest in new resources that will improve data analysis and increase efficiency in sales and use tax audit selections and collections. The "enhancements" are estimated to generate net revenue of $31.7 million to the State of Washington and $4.8 million to local governments.** In California, meanwhile, auditors are literally going door to door to seek out businesses that aren't properly paying sales taxes. In short, they're out there looking closer, more aggressively, and with greater frequency than ever before, and the more tax jurisdictions you do business in, the greater the likelihood that you will be audited.

How states determine who to audit

Like Missouri, most states will say they use "systematic methods and electronic data to evaluate and determine those taxpayers who are at potential risk for underreporting and/or underpaying sales, use, corporate, and/or withholding taxes."[2] If you know what they are looking for, you can take steps to avoid being audited. But just what are the triggers? According to current and former auditors, here are the top ten issues that, when uncovered, will prompt an audit:

1. **Nexus but no registration.** Nexus is a confluence of factors that make a business liable for sales and use tax payment and reporting. It is likely that you have nexus with a state if you are paying payroll or other taxes. If you aren't registered for sales tax, but do pay another kind of tax in that state, it is very probable that you will be contacted for an audit. All a state has to do is perform a little cross-checking.
2. **In the phone book or on the Web.** If you can't be found in the state system, a simple check of the phone book or of websites can lead an auditor to call you an inquire about your registration status and number.
3. **Issued resale certificates.** Resale certificates can be a major red flag. Using them to purchase items that will be used rather than resold can result in enormous penalties. If you have issued a resale certificate and are not registered for sales and use tax, you're an audit candidate.
4. **Use tax auditing.** If one of your vendors has not charged proper use tax, and that vendor gets audited, then you will likely get audited in turn. Current audits provide the best sources and leads for future audits.
5. **Visual inspections.** Auditors will often visit large construction projects and take note of the contractors on site. Audits can quickly follow.
6. **Whistle-blowers.** Auditors are happy to take hotline calls. Disgruntled employees, upset customers, aggressive competitors, and even neighboring businesses upset that you haven't paid taxes when they have: they can all dish out the dirt.
7. **Casual observation.** Auditors are people too, and are out there buying items and living normal lives. But that doesn't mean they turn off their professional antennae when purchasing from you.
8. **Non-remission of use tax.** Companies that file sales tax without filing use tax paint themselves with a large target.

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[2] http://www.dor.mo.gov/tax/business/faq/audit.htm

9. **High net sales.** High sales volumes can harbor high volumes of errors and omissions. Hence a successful and growing business can be fertile ground for an audit.
10. **Exempt items.** Companies that purchase or sell a lot of exempt items are another happy hunting ground for auditors as there's ample room for misinterpretation, error and fraud around what is exempt and what is not.

As you can see, there are many ways to position yourself as an audit target, and lots of ways to become a target even when you're handling tax reporting and payment correctly and taking care to be compliant. Often, auditors don't even need a particular trigger to launch an audit; you can be statistically selected. A revenue department might receive a quota to generate x dollars of revenue, so they either hit it big or scramble to audit a lot of businesses. Some local jurisdictions even pay a commission. In any event, as discussed in the next section, there are multiple pitfalls ahead, starting when the auditor makes initial contact with you, the taxpayer.

THE HUNGRY TIGER LOOSE IN YOUR COMPANY

Ten things that auditors will instinctively pounce on

Just because you've been selected for a sales and use tax audit doesn't mean you're automatically going to have to pay through the nose. Conversely, just because you've done everything right regarding these taxes doesn't mean you're not going to have to spend considerable time and money proving it. Audit procedures vary somewhat state by state, but are relatively uniform. The Department of Revenue for the State of Missouri outlines its procedure thusly:

On average, an auditor spends one week examining records for a sales/use tax audit of a medium-sized company. After examining the records, the auditor will allow you time to gather additional information, if necessary. Follow-up meetings will be scheduled to discuss the overall progress and preliminary conclusions of the audit.

A sales tax auditor will examine your federal income tax return to reconcile the gross sales between the federal return, the sales tax return, and the sales recorded in your accounting records. The depreciation schedule is also examined to determine if there were sales and purchases of fixed assets during the audit period.

The State of Nevada says:

If the business is registered for Sales and Use Tax with the department the audit will usually cover the previous 3 years. If not registered, the audit can go back as far as 8 years.

For a Sales and Use Tax audit, depending on the type of business, you will need some or all of the following business records:

- Copies of previously filed sales/use tax returns with any related reports or work papers used to fill them out.
- Detailed general ledgers and a chart of accounts.
- Monthly sales journals or registers.
- Sales invoices.
- Resale certificates and exemption letters collected.

Often, auditors don't even need a particular trigger to launch an audit; you can be statistically selected.

- Federal Income Tax returns for the years under audit.
- All purchase invoices.
- Cash disbursement journals or check registers.
- Asset depreciation schedule or fixed asset schedule.
- Bank statements and cancelled checks
- Cash register "Z" tapes.
- Other records the auditor may identify as the audit is performed.

The most common pitfalls

If these procedures seem straightforward — aside from the burdensome requirement to produce all that documentation — just remember that much falls between the cup and the lip. As an audit proceeds, there are numerous items and conditions that an auditor will commonly look for in order to catch you. Here are the top ten pitfalls that are most likely to trip you up, and what you need to do to avoid them:

1. **Use tax.** This is an easy and substantial "hit" for an auditor. Use tax applies to the routine purchase of such items as consumables and office supply, as well as to the purchase of large fixed assets. Thus there is the potential for the state to assess a very large fee. Unfortunately, most people don't know this until it's too late — i.e., when the auditor has come in, looked at a certain period of time, and then assessed back taxes and penalties retroactively. **The only way to fight this is to maintain domain expertise in determining use tax applicability. But that is traditionally an expensive proposition for businesses of all sizes.**
2. **Exemption and resale certificates.** If you don't possess proper exemption certificates, some auditors will let you go back and try to get them retroactively, but that's not something you want to count on. As for resale certificates, if they're not on file, the auditor will typically determine an error rate and project backwards to assess tax and penalties. If it's proven that a resale certificate has been used improperly, the penalties can be substantial. In California, for example, it's a 10% penalty of the tax due for each purchase and/or a 25% penalty for intent to evade tax. **To avoid these situations, companies need an automated process to enforce exemption and resale certificate compliance for each tax jurisdiction in which they do business.**
3. **Unreported sales.** Mistakes happen and certain sales can go unreported. Sometimes even entire divisions get left out in error. **The remedy is to rely on systems, not people — i.e., let automated systems determine and calculate tax.**
4. **Charging wrong rates.** In 2008, there were over 1,100 tax rate changes across the US. Staying on top of these changes and instituting new rates at the right time is extremely difficult, especially when districts get re-aligned. **The only good answer is to have real-time rates applied automatically from the day they are effective.**
5. **History of audits and assessments.** Bureaucracies have the memory of an elephant. Once flagged, you're under the microscope for life and can expect repeated audits. Most auditors will cite an error, and you might not have the time, energy or resources to address it going forward. Then, upon the return audit, auditors can easily find the exact same infraction and assess penalties on it. **The defense here is to have iron-**

The only good answer is to have real-time rates applied automatically from the day they are effective.

clad processes and procedures and good documentation. Adequate documentation makes an audit go much more smoothly, while poor record keeping will prolong an audit and ultimately sink you. Lacking documentation, an auditor will try to get a visual sample — which for a retailer just might end up being the day after Thanksgiving or the week before school starts — and then extrapolate that sample across your business year, potentially to your disadvantage.

6. **Unique rules and regulations.** Each state has its own special twists to its sales and use taxes. Auditors are highly tuned into these, particularly when the rules are new, and are quick to spot non-compliance. Tax authorities often have special taxes that apply to specific goods. There are many food/beverage, gambling, cigarette/tobacco, soft drink, timber, and fuel taxes that can be uncovered during an audit. Tax authorities will also audit specifically for these types of taxes from time to time, which can open you up to a full-blown sales tax audit if it appears there is weak recordkeeping. **As with the issues above, adequate documentation and automated processes are necessary to keep you out of trouble. Specialized domain expertise in determining taxability for specific items is also requisite.**
7. **Sales tax accruals.** Many companies don't properly remit the sales taxes they've collected. An auditor will look at federal tax returns, the general ledgers, invoice register, actual invoices, sales journals and summaries of sales by state to identify and reconcile disparities, and will then use the number that provides the best assessment. **The best advice here, obviously, is to do the same thing yourself — exhaustively and comprehensively — before you report and remit.**
8. **Acquisitions.** A business acquisition can really roil the waters when it comes to sales and use tax compliance. For one thing, if an acquisition brings you into new markets, you can be creating nexus and thus opening the door to new tax liabilities and an increased number of audits. Then there is the issue of previous liability: when you acquire a company, you must immediately notify all states where the new combined company is doing business; if you don't do this, you automatically assume all previous tax liabilities. **Specialized expertise is required to ensure that you are properly reporting pre- and post-acquisition taxes. After all, you are dealing with the potential for new nexus as well as material changes to your business.**
9. **Internet sales.** Yes, federal protection is still in place regarding out-of-state sales tax on e-commerce purchases. But that isn't stopping some states from eyeing this potentially huge revenue source. New York, for example, has raised the spector of affiliate nexus in regards to e-commerce. i.e., XYZ Corp and its e-commerce XYZ.com affiliate can currently be set up as separate entities to avoid tax, but New York is working to close that loophole.
10. **Business Activity Questionnaires.** These questionnaires are issued by Tax Discovery Auditors. The audit world's version of the Marines, they are much tougher than your normal tax auditors as they are tasked with uncovering unregistered businesses and businesses engaged in fraudulent activities. As with other Informational Document Requests (IDRs), it's easy to check the "yes" box next to the general questions on these questionnaires, but doing so may well create nexus. **Hence, be sure to seek counsel before filling out these or other IDRs.**

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A cure worse than the disease?

The recommendations for avoiding these top ten pitfalls are commonsensical: **deep domain expertise; automated processes; relying on systems, not people; real-time tax rate and rules tracking; thorough documentation; and specialized expertise and counsel** will all ensure you get sales and use tax compliance correct up front. But for companies operating in a challenging economy, following through on these recommendations is not always economically feasible. For example, building and maintaining domain expertise in house may once have been an option, at least for large companies, but how many businesses can justify that today? Similarly, a huge percentage of companies still rely on manual tax processes, which are intrinsically expensive and error-prone. And while they may be attracted to the traditional enterprise software solutions, these solutions are prohibitively costly for most companies to install and maintain.

Yet despite these economic realities, businesses don't have to simply roll over and let the auditors eat them alive. It is possible to protect your business from non-compliance and audits without breaking the bank. The following section discusses strategies that enable companies to be both cost-effective and proactive in their ongoing tax management activities.

THE BEST DEFENSE IS A GOOD OFFENSE

A cost-effective path to proactive sales and use tax management

Even when you are doing everything right, you have to pay to prove it. Yet there are ways for companies to reduce the risk of being audited, minimize the economic impact of audits, and cut the costs of compliance and defending themselves.

As always, the best defense is a good offense. There are hundreds of tax law changes each year, even when tax authorities are operating in a strong economy, and researching these changes enables you to apply the latest rules and rates the moment they become effective. Preparing and simplifying your documentation in advance simplifies and streamlines the audit process, and helps you avoid audit sampling methods that may be to your disadvantage. Understanding the ins and outs of use tax applicability, exemptions and resale certificate usage can shrink the target on your back and keep you out of trouble. Replacing manual processes with automation minimizes the potential for human error and omission and ultimately reduces operating costs. And having expert counsel on hand, and on demand, reduces a myriad of potential risks.

The question is, how does a company construct this type of proactive defense, cost-effectively and quickly?

When to leverage outsourcing

Outsourcing key business processes, especially those requiring specialized domain expertise, has become an accepted and highly effective way for companies to achieve back-office efficiencies while avoiding large capital expenditures. The selling points of business process outsourcing are reduced costs (both upfront and ongoing), lower risk, and rapid implementation — plus the benefit of enabling companies to focus on their core business and not specialized functions such as payroll processing, HR and tax.

...despite these economic realities, businesses don't have to simply roll over and let the auditors eat them alive.

Given the mounting pressures and substantial penalties for noncompliance, sales and use tax compliance is a logical candidate for outsourcing. An outsourced service can enable you to operate with a complete, expert and on-demand tax compliance resource base, without the expense and resource consumption of having to "care for and feed it" in house. The outsource provider makes all the investments in tax infrastructure, technology and people, while you focus on company growth. And as you grow, enter new markets, add new products, etc., your entire tax resource base is able to scale cost-effectively with your company's needs. So where do you turn for this advantage?

Only Sabrix can cover your complete compliance lifecycle

With sales and use tax management, it is possible to take each of the major components of your defense on a piecemeal basis to one or more third party providers, including:

- Tax research
- Tax determination, calculation and reporting
- Professional tax services and counsel

Until now, however, no single vendor has offered a comprehensive outsourced solution that covers the complete sales and use tax compliance cycle, end to end — starting with expert research and automatic determinations and extending to full documentation and professional audit support from CPAs, tax analysts, former auditors, and tax attorneys when you have to prove your compliance. It is this advantage that Sabrix now brings to companies regardless of size, so you can have a truly proactive defense that eliminates the hassle, reduces the cost and limits the audit exposure of sales and use tax compliance.

The Sabrix Managed Tax Service encompasses:

- **An on-demand version of Sabrix's proven tax calculation and determination engine, used by many of the world's largest enterprises.** The Sabrix on-demand engine integrates quickly, seamless and securely with your back-office ERP and other systems and leverages Sabrix's automatic tax research updates for 13,253 tax jurisdictions to automatically eliminate errors in tax decision making. As each and every transaction occurs, it is accurately taxed for both sales and use tax.
- **Automatic preparation of monthly tax audit data and signature-ready tax returns.** You have the thorough documentation you need for audit defense coupled with accurate returns that all you have to do is sign.
- **On-demand access to a dedicated team of tax experts.** This team of experts, including CPAs and former auditors, provides oversight and continuity to ensure the highest degree of transaction tax compliance as your business grows and evolves.

An outsourced service can enable you to operate with a complete, expert and on-demand tax compliance resource base, without the expense and resource consumption of having to "care for and feed it" in house.

CONCLUSION: EXTEND YOUR DEFENSE WITH A STRONG OFFENSE

At a time when tax authorities are becoming more aggressive than ever, the Sabrix Managed Tax Service functions as an extension of your finance team and systems, giving you the expertise and automated processes you need for tax compliance at the fraction of the cost of building and maintaining them in house.

Functionally, you gain a proactive shield against audits in the form of accurate calculation and determination and, when they do occur, you are equipped with the documentation and expert counsel required minimize their impact in terms of penalties, time and effort, and diversion of internal resources. Economically, you avoid large CapEx investments, enjoy a solution that is perpetually "right-sized" for your business, and are able to focus valuable resources on what really counts in a challenging economy: sustaining and growing your business.

ABOUT SABRIX

Sabrix, Inc. is a leading provider of transaction tax management for companies of all sizes, enabling finance, tax, and IT professionals to achieve accurate, timely, and cost-effective compliance for sales tax, use tax, Value Added Tax (VAT), excise tax and industry-specific taxes and fees. The Sabrix Solution combines the Sabrix Application Suite software for sales tax, use tax and value-added tax automation with Sabrix Tax Research, delivering SAS 70 certified tax rates and rules for the U.S. and 170 countries. The company also offers the Sabrix Managed Tax Service™ (MTS), an outsourced transaction tax compliance service that helps finance departments of small-and-medium-sized businesses eliminate the hassle, control their audit exposure, and reduce the total cost of compliance. Sabrix MTS seamlessly integrates with a company's existing accounting and e-commerce systems, and, similar to outsourced payroll services, operates as a trusted extension of a company's finance department to address tax compliance from start to finish: address validation, tax rate maintenance, tax determination and calculation, returns preparation and filing as well as audit research and documentation. To learn more about Sabrix MTS contact us at inforequest@sabrix.com, 866.472.2749.

SALES CONTACT
sales@sabrix.com
P. 1.866.4SABRIX

Sabrix – part of Thomson Reuters
12647 Alcosta Blvd, Ste. 155
San Ramon, CA. 94583-5180
USA

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