Managing sales and use tax audits

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Even in the best economic times, businesses need to be vigilant against unnecessary costs and risks.

In challenging times such as these, it's more important 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. The result is a flurry of new laws and rate changes, and intensifying collaboration to catch the noncompliant.

This is not welcome news for businesses recovering from COVID-19. Not only do companies have to navigate through the recovery, but 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 covering their audit risks. Tax audits require weeks of effort and distraction and come with the potential for audit assessments — all at a time when you can least afford them.

This article outlines a survival guide to sales and use tax audits, based on knowledge collected from real-life past auditors who were asked about 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 effect 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. In conclusion, this article provides techniques, tips, and tools that will enable you to effectively manage your sales and use tax compliance, and cost-effectively scale your ability to survive audits.

Top 10 issues that trigger audits

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, and months to determine whether you are underreporting or underpaying taxes that are legally due. In addition to the time, effort, and diversion of resources this takes on your part, the resulting penalties can be substantial.

How states determine whom to audit

Most states use systematic methods and electronic data to evaluate and determine those taxpayers who are at potential risk for underreporting or underpaying sales, use, corporate, or withholding taxes. If you know what they are looking for, you can take steps to avoid being audited. But what are the triggers? According to former auditors, here are the top 10 issues that, when uncovered, will prompt an audit:

01 — Economic nexus

If you have physical presence in a state, you are required to register for sales and use tax purposes. Many states also have economic nexus laws where remote sellers are required to collect and remit sales tax or use tax if they exceed defined thresholds. Tracking and monitoring thresholds is important to remain in compliance and have an awareness of the next sale which will cause the business to surpass the threshold creating a sales/use tax responsibility.

02 — Sales through an electronic marketplace

In many states the marketplace facilitator is required to collect and remit sales tax on sales made through the facilitator. If you have a physical presence or economic nexus in the state where sales are made, you should check to make sure that the facilitator is collecting tax correctly on your behalf. In addition, you'll still have a tax obligation for additional taxes that are due (for example, gross receipts tax, and B&O tax).

03 — 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 are an audit candidate.

04 — Use tax auditing

If one of your vendors has not charged proper sales tax, and that vendor gets audited, then you may get audited in turn. Current audits provide the best sources and leads for future audits.

05 — Visual inspections

Auditors will often visit large construction projects and take note of the contractors on site. Audits can quickly follow.

06 — Whistleblowers

Reports of suspected tax fraud and noncompliance are investigated. Your audit may be the result of an online complaint.

07 — 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.

08 — Unreported use tax

Companies that file sales tax without filing use tax paint themselves with a large target.

09 — 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 is ample room for misinterpretation, error, and fraud around what is exempt and what is not.

Thus, 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, there are multiple pitfalls ahead, starting when the auditor makes initial contact with you, the taxpayer.

What auditors look for

Just because you have been selected for a sales and use tax audit doesn't mean you are automatically going to have to pay through the nose. Conversely, just because you have 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 states: On average, an auditor spends one week examining records for a sales and 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 three years. If not registered, the audit can go back as far as eight years.

For a sales and use tax audit, depending on the type of business, you'll need some or all of the following business records:

- Copies of previously filed sales/use tax returns with any related reports or workpapers 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
- 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
- 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 — 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 common pitfalls that are most likely to trip you up, and what you need to do to avoid them:

01 — 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 supplies, as well as 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 — that is to say, 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.

02 — 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 isn't something you want to count on. As for resale certificates, if they are 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. To avoid these situations, companies should consider an automated process to ensure exemption and resale certificate compliance for each tax jurisdiction in which they do business.

03 — 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 — that is to say, let automated systems determine and calculate tax. Tracking economic nexus thresholds and marketplace facilitator sales are also critical to filing accurate and complete tax returns.

04 — Charging wrong rates

Staying on top of tax rate and tax boundary changes, and instituting new rates at the right time, is extremely difficult, especially when districts get realigned. The only good answer is to have real-time rates applied automatically from the day they are effective.

05 — History of audits and assessments

Bureaucracies have the memory of an elephant. Once flagged, you are 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 ironclad 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. For a retailer, this just might end up being the day after Thanksgiving or the week before school starts. The auditor will then extrapolate that sample across your business year, potentially to your disadvantage.

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A cure worse than the disease?

The recommendations for avoiding these 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. 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.

Despite these economic realities, businesses don't have to simply roll over and let the auditors eat them alive. It's possible to protect your business from noncompliance and audits without breaking the bank.

Outsourcing: A possible approach to sales and tax management

Even when you're 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 shortens 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 active defense, cost-effectively and quickly?

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 include reduced costs (both upfront and ongoing), lower risk, and rapid implementation — plus the benefit of enabling companies to focus on their core business versus specialized functions such as payroll processing, HR, and tax.

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. Furthermore, 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.

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