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How to survive sales tax audits and live to tell about it!

By Brent Watson, CPA

Some dangers in life are not apparent until they suddenly pose an immediate danger or, worse yet, result in a terrible event, which has painful or even tragic consequences. For example, high-blood pressure is an oft undetected condition, but it can result in a heart attack or stroke. Undetected sales tax exposure also poses a detrimental risk: It can damage or ruin a business. The purpose of this article is twofold: 1) To help readers minimize this risk before an audit occurs, and (2) help them deal with audits that occur.

Minimizing risk - recognizing and rectifying sales tax exposures

Factors that increase the risk of audit assessments:

- **Multi-state sales**
  Because of the "sales tax tsunami," the United States (U.S.) Supreme Court released in its 2018 *Wayfair v. South Dakota* case, sellers who sell remotely into states in which they have no physical presence may potentially be subject to sales tax in those states based on "economic nexus." The threshold for economic nexus is based on sales over a one-year period in all states that impose sales tax. However, the similarity ends here. States vary in the following factors:
  - *Nexus trigger sales value*
    In all but seven states, the threshold is $100,000. However, in other states, the threshold is more—up to $500,000 in California, New York and Texas.
  - *Nexus trigger sales transaction count*
    In some states, the number of sales is irrelevant as far as nexus, as it should be. Unfortunately, in about half of the states, an "or" test applies, with nexus created either by 200 or more annual transactions or by value of sales.
  - *Sales counted in the measure*
    States vary in which sales transactions must be included in the value to be considered for their threshold. Some include all sales of goods and services; others allow exclusion of non-taxable services or exempt sales of goods—either for resale or of all exempt sales.
  - *Definition of the one-year period*
    For most states, the period is measured by calendar year, past complete years or the current calendar year. For others, the measure is by rolling four quarters, or even rolling 12-month periods.
  - *Time allowed to begin compliance*
    Some states allow a period to register and begin collecting tax, but the period can be very short—even the very next month beginning after the threshold is triggered. For a few, no buffer period at all is provided.
- **Not collecting tax in states where physical presence occurs**
  If a seller has employees working in a state where sales occur, even if it is temporary—including repairmen, installers, etc.—nexus exists for sales tax. Additionally, delivery in company vehicles, inventory or leased property located in a state creates nexus.
- **Not taxing services or goods correctly**
  Sellers of services may not be aware that some services are taxable in certain states.

For example, a window washing vendor in one state was unaware that state's tax on janitorial services extended to window washing. A proposed assessment for tax over a multi-year period would have destroyed the business. Other common errors include not correctly taxing freight, or other charges added to sales (depending on state laws), and collecting incorrect state and/or local taxes.

- **Not having valid exemption certificates**
  The largest source of tax assessment is due to missing or invalid exemption certificates. Without fail, auditors examining sellers who have made exempted sales will request exemption certificates. Sellers may have collected some documentation, but often the certificates have been lost, were invalid or, for Oklahoma purchasers, the certificate is invalid because the buyer's permit expired.

- **Poor billing practices**
  Sales tax is a form-driven tax. Presentation of sales on invoices matter! For example, if sales made include both non-taxable services and taxable items, separately stating those elements can avoid unnecessary audit assessments or unnecessary collection of tax from customers. When taxable and non-taxable elements are bundled, the taxable items normally taint the entire transaction. This is what we refer to as the "omelet principal"—adding one bad egg ruins the entire omelet. Audits often result from an audit of the seller's customers. In this scenario, auditors may notice invoices that appear to not include correct taxes. Depending on how the invoice looks and what it says, the audit of the customer could lead to an audit of the seller.

- **Claiming exemptions of purchases improperly**
  Just as an audit can result from an audit of customers when an auditor believes taxes may have been under-collected, audits of vendors to whom purchases appear to be improperly claiming exemptions often create audit leads. Proper control over issuance of exemption certificates for purchasers can avoid such exposure.

In summary, preparation for an audit includes: 1) Knowing whether goods or services sold are taxable, 2) establishing where the seller has nexus and 3) collecting the correct tax or valid exemption certificates on all sales where tax is imposed into those states. The complexity of the final task may require usage of sales tax software. If past significant exposure is discovered, measures to cure the exposure may be needed, including potential usage of voluntary disclosure agreements.

Minimizing damage - how to deal with audits

Immediately upon notification of an impending audit, taxpayers should begin preparation for the audit. Sellers making substantial amounts of exempted sales should reconcile the exempted customers against exemption certificates, noting also whether certificates are valid, as well as collecting missing or invalid certificates. Auditors will often immediately ask for agreements to use sampling agreements or extend the statute of limitations. While it is wise to always treat auditors with respect and fairness, that does not mean taxpayers should automatically agree to these requests exactly as presented. Doing so is often not in your best interest.

For sampling, Oklahoma normally relies on block sampling. This sampling method is not a mathematically reliable technique and often produces skewed results. Because we have seen negative consequences for doing so, we normally advise clients to not sign such agreements. Rather, we will informally agree to sampling—pending the results are fair and representative. While states that use statistically valid auditing sampling techniques—such as random, stratified, statistical sampling (including Texas)—can require taxpayers to accept this type of sampling, agreeing to block sampling is never required.

Regarding statute of limitations waivers, our opinion is: Although these can be reasonable, we believe it is unreasonable for an auditor to expect the extension to begin with the immediately expiring period. Rather, we request such extensions begin with a period that would expire three months after. Additionally, immediately asking for a one-year waiver is unreasonable, and the period should be shortened. However, the following factors should be considered: 1) Existing exposures, 2) lengthened audit periods and 3) potential bad will with the auditor.

The Oklahoma Tax Commission (OTC) actively audits in two non-traditional ways: 1) Regarding sales reported on IRS Form 4797 for gain or loss on disposition of assets and 2) one-month mini-audits of sales and exemption certificates. Because Oklahoma lacks an exemption for isolated sales, sales of business tangible personal property (TPP) assets are potentially taxable. In fact, sales of real property or intangibles are never taxable.

Tax should not apply to many sales of TPP, including:

- Sales outside the state;
- Sales of inventory to a buyer who holds—or have applied for—a sales tax permit (resale) at the date of the sale;
- Sales of manufacturing equipment to holds for those who have applied for a manufacturer's sales tax exemption permit (MSEP) at the date of the sale.

For mini-audits of exempt sales, it is very important to aggressively provide valid certificates because these are essentially "fishing expeditions," and an assessment for the one-month will likely be a precursor to a full audit.

For audits regarding purchases of manufacturers and others with many potentially exempt purchases, the selection of accounts to be reviewed is important. Auditors generally know what accounts to review to find exposures and what accounts to avoid because they often reveal overpaid taxes. Manufacturers and others with many potentially exempt purchases should be careful to have the credit-prone accounts included in the population to be examined.

Remember, you are the expert at your business. Auditors audit a variety of businesses, and they may not accurately understand your business. Often, a bit of education—wisely done—can help avoid misunderstandings. Of course, this must be done with caution considering your particular facts and circumstances. A tour of a manufacturing facility can help an auditor understand why certain types of purchases are exempt. Generally, maintaining a cooperative relationship with the auditor is beneficial.

When an audit assessment is issued, taxpayers who lack sales tax expertise should obtain a review by an expert. This can produce dramatic savings in some cases. We have seen many audits reduced from correcting law misinterpretations by collecting and presenting exemption certificates, correcting incorrect sampling methods and extrapolation and including credits for overpaid tax.

Summary

As the old saying goes, "An ounce of prevention is worth a pound of cure." This also applies to sales tax audits. If measures in this article are implemented, exposure can be greatly reduced. Additionally, when an audit occurs, wisdom in dealing with the auditor can often greatly impact the final cost of an audit.

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