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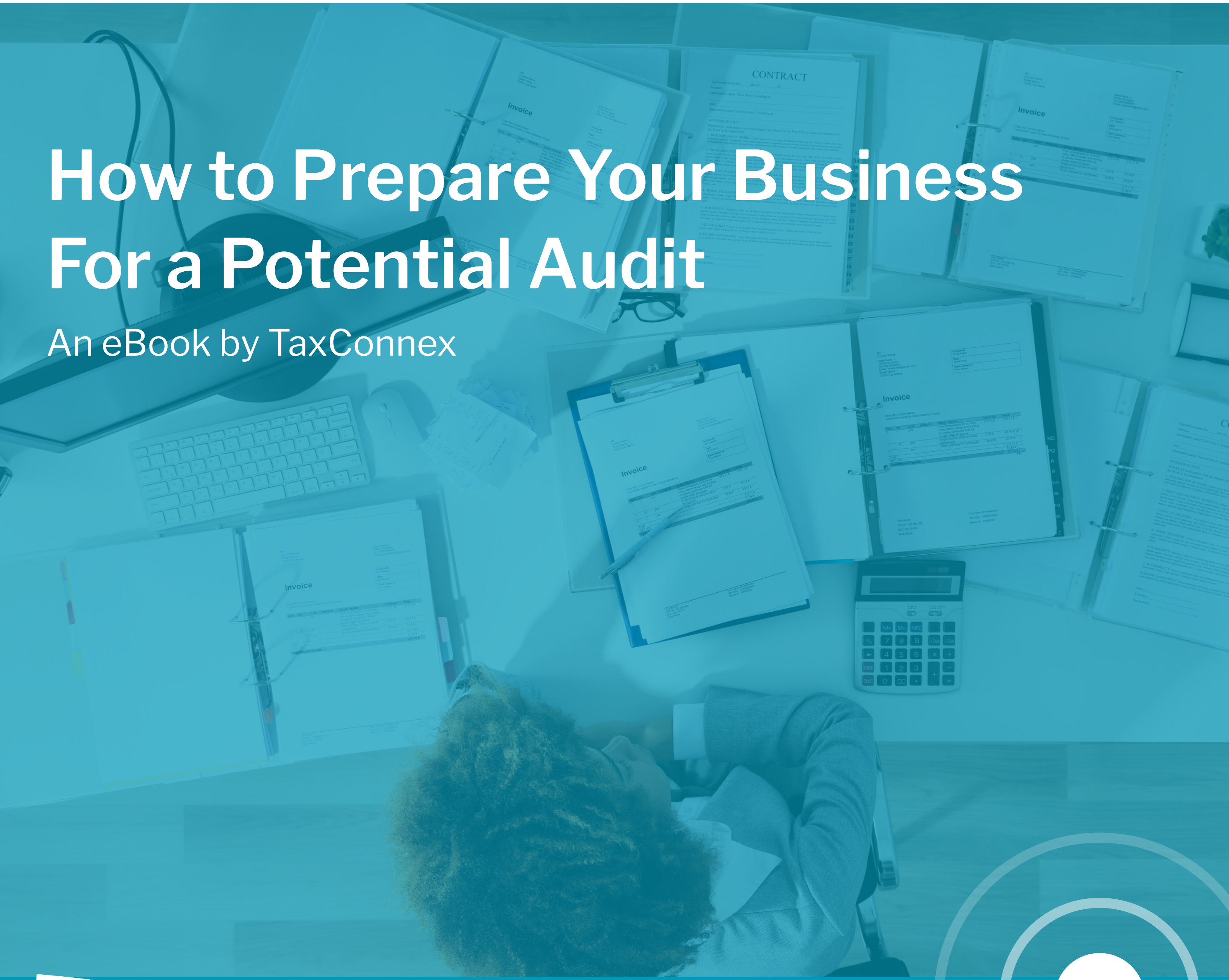

How to Prepare Your Business For a Potential Audit

An eBook by TaxConnex

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Introduction

The COVID-19 pandemic of 2020 has created economic implications that will continue to be felt across the world for years to come. States have been heavily impacted by drops in sales tax revenue due to the pandemic and are spinning their wheels to figure out how to make up for lost revenue. As of June 2020, total state tax revenues are down about $57 billion compared to 2019.

Clearly, the revenues are drying up, if only temporarily. A very likely way states will look to make up lost revenue early on is to increase their enforcement efforts. **Their chief tool? The audit.**

Jurisdictions may have slowed or even halted audit processes during the pandemic, but as things begin to open back up, we can expect the number of audits to rise. If you have a sales tax obligation, you need to know why you could be at risk of an audit, the implications of an audit, and how you should respond.

How Does My Business Get Flagged for an Audit?

Sales tax is a significant revenue source for a jurisdiction. In fact, according to Tax Policy Center, it can be the leading source for many departments, constituting 25%-35% of a state's revenue. Wayfair lowered the thresholds for state and local jurisdictions to assert nexus, and more businesses have started to collect. But how do companies get flagged for an audit? There may be more ways than you thought.

Jurisdictions can discover your company's non-compliance through an audit of your customer. Audits tend to beget audits. A customer undergoing its own sales tax audit might produce one of your invoices, resulting in the auditor questioning why you are not charging sales tax and potentially leading to an inquiry or nexus questionnaire being sent to your company. An audit of one of your suppliers could turn up one of your exemption certificates for something the auditor may think is taxable - resulting in a flag for an audit of your company. Auditors also know that competitors tend to have similar business models and that some industries are more susceptible than others to tax deficiencies based on the complexity of the taxation scheme. Audits of similar companies in your industry may also lead state tax authorities to run comparison data on you and your competitors, such as your percentage of taxable sales; even being off just a little bit could lead to you being audited.

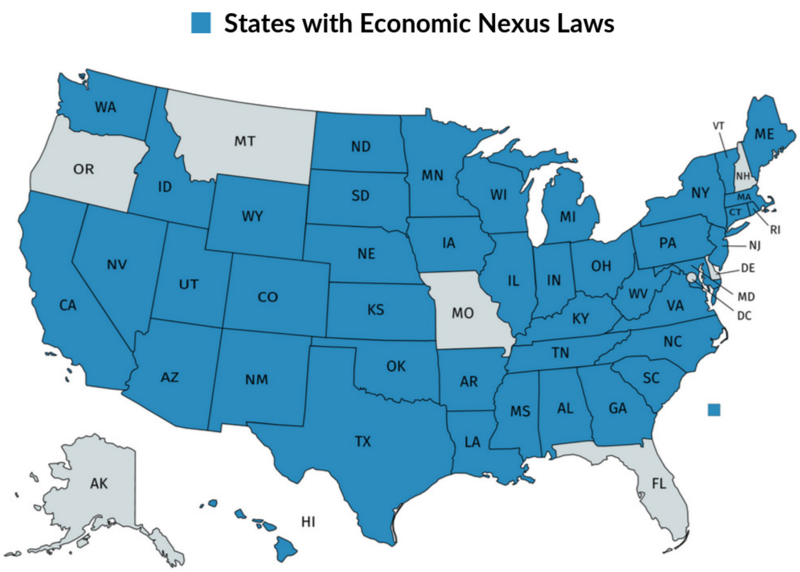
So, what happens if you do get caught? What can you expect? Slaps on the wrist?

No - assessments stemming from audits include penalties of 25% or more and above-market interest as a matter of course, and they can also result in liens, use of collection agencies or, in extreme cases, referrals for criminal action.

Preparing through Compliance

The best way to handle an audit is to avoid one in the first place.

Unfortunately, there isn't a playbook for determining the company profile a state will go after, but there are proactive measures you can take to minimize your exposure:



Understand Physical and Economic Nexus
Knowing where you have sales tax nexus is the key to determining both your liability and your defense for an audit. Understand the thresholds and qualifications in the jurisdictions where you have significant sales. Without sales tax nexus, you have no obligation to collect or remit sales tax.

Nexus is your company's connection with a state that's substantial enough for that state to impose a registration and collection obligation. This is frequently determined by a minimum number of sales or minimum dollar amount of sales, generally during a year. You can also generate nexus by traveling into states (say for a sales pitch or demo), using subcontractors in given states to fulfill contracts with customers, or even by just exhibiting at trade shows.

It's a good idea to review your sales tax nexus footprint periodically to make sure nothing has changed in the business to establish nexus with a state or local jurisdiction in which the business is not registered, collecting tax, and filing returns.

Evaluate the Taxability of Your Products/Services
Not all goods and services are taxable in all jurisdictions. For some businesses, the taxability of their products/services does not have a lot of variability. For example, tangible personal property (TPP) will be taxable unless the specific type of TPP you are selling is identified as non-taxable by statute. Or perhaps the TPP is being sold to another business for resale purposes or some other tax exempt reason.

Other products/services tend to have disparate tax rules across states and tend to change over time as well. The technology field comes to mind - specifically SaaS, electronically delivered software, data processing, digital downloads and telecommunications services. The statutes and guidance around these types of products are in constant flux, and your business should review the taxability of your tractions periodically to ensure you are calculating tax properly.

Make Sure You've Complied
Backtrack to make certain your company hasn't neglected to file sales and use tax returns in the past. Have you collected sales tax and failed to remit it? This failure to remit collected tax is very serious and requires immediate efforts to identify and remit all collected amounts, often with interest. Have you received notices from a jurisdiction? If you have received notices and then continued non-compliance, you could trigger an audit or potentially an arbitrary assessment that you'll need to defend yourself against.

If a state does reach out to you in some capacity, keep careful records on correspondence with tax jurisdictions, and don't assume the problem will simply go away.

Awareness is one thing, but effective, pre-emptive preparedness is another. What can you do to gauge right now how vulnerable you might be to an audit?

Maintain Compliance Documentation

Compliance documentation should be maintained in a fashion that is easy for an auditor to interpret. Many businesses find themselves in an audit without the appropriate documentation. When this happens, auditors will assume transactions to be taxable and in situations where you don't have appropriate invoices or sales data, the auditor will make historical projections or an arbitrary assessment of taxable sales.

Documentation typically required by an auditor to conduct a proper review includes the following:

- **Sales tax accruals** - Sales tax should be stated in your general ledger as a separate GL account number.
- **Invoices** - Both from a sales perspective and a purchase perspective.
- **Returns/credits** - Be sure these are clearly identified in your accounting system and appropriately invoiced.
- **Exemption certificates** - Maintain accurate and complete exemption certificates for each exempt customer.
- **Bad debt** - Most states allow a deduction for bad debts that have been written off for Federal income tax purposes. Again, be sure this is clearly identified/ documented in your accounting system.
- **Miscellaneous adjustments** - Any adjustments taken on your return should have supporting documentation. Most companies keep this documentation with a copy of the return filed.
- **Consumer use tax accruals** - These should tie to specific purchase invoices.
- **Summary reports** - Summary financials and tax reports should reconcile to the tax returns filed.
- **Returns** - All audits begin with a review of the sales and use tax returns but most auditors will request income tax returns as well. Gross receipts should reconcile between income tax and sales and use tax returns.

Conclusion

It's important to prepare your business for the unexpected, and that includes audits. But in the event an audit notice does land on your desk, we're here to help. At TaxConnex, we act as the intermediary between you and the auditor and can assist you throughout the audit. Contact us to learn more.

About the Author

Robert Dumas, Managing Partner, Founder, & CEO

Accountant, consultant and entrepreneur, Robert Dumas began his public accounting career on the tax staff at Arthur Young & Co., followed by a brief stint at Grant Thornton. In 1998, Robert founded Tax Partners, which became the largest sales tax compliance service bureau in the country, and later sold it to Thomson Corporation. Robert founded TaxConnex in 2011 on the principle that the sales tax industry needed more than automation to truly help clients, thus building within TaxConnex a proprietary platform and network of sales tax experts to truly take sales tax off client's plates.

About TaxConnex™

TaxConnex ™ is how businesses finally get sales tax off their plate – no matter how many states they're in or how often regulations change. Sales tax is more complicated than ever, especially in a post-Wayfair world. Yet the providers who claim to simplify sales tax often still leave the hardest parts – and the liability – up to you. When you work with TaxConnex, it's all on us. This means you get all the know-how, all the backup, and none of the risk. It's only possible because of our proprietary platform and network of sales tax experts. That's why large to mid-sized corporations, including accounting firms, turn to TaxConnex.

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