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Procedure

Tax compliance has always been a necessary and integral focal point for business, but lately compliance has become harder due to retroactive enforcement of sales and use taxes. In this article, Jeffrey Katz and Christopher Young of JDKatz, P.C. discuss how these audits have become ''gotcha'' tools instead of governing devices, and how businesses can make the audit process less painful and have it result in a more favorable outcome.

Navigating the Sales and Use Tax Audit: State Tactics and Methodologies Yield Inconsistent Outcomes

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Introduction

Worldwide tax compliance has always been an important focus for businesses. Indeed, effective tax management and compliance are important aspects of good corporate governance and sound financial operation. Not only does a commitment to such compliance provide structure and oversight for many businesses, but, in theory, it also functions as a safety net in the event a business is being pursued by taxing authorities.

However, the commitment to compliance has become increasingly challenging due to state enforcement of sales and use taxes on a retroactive basis. Specifically, states are aggressively targeting businesses and utilizing questionable audit tactics. Indeed, for cashstrapped states with mounting budget deficits and struggling economies, sales and use tax audits represent viable and effective new revenue streams. As such, for many states, audits no longer serve as governing tools, ensuring that businesses remain law abiding, but are instead becoming ''gotcha'' devices. In other words, audits are now aimed at catching the non-compliant, irrespective of a business' vigilance or actual compliance or the prevailing uncertainty concerning the law or its inconsistent enforcement, resulting in disparate outcomes.

Accordingly, businesses that find themselves engaged in a sales and use tax audit often face an uphill battle to defend themselves against these draconian enforcement methods.

Risk of Error in Audit Reports Using Formula-Based Audit Methodology

Conversely, from the taxing authorities' perspective, these questionable tactics and methods are necessary from a cost-effectiveness standpoint. To illustrate, when flipping a coin, it will land on heads half of the time and tails on the other half. While statistically possible, it is extremely unlikely that the coin will ever land on its edge. Like flipping a coin, most audit reports of sales and use tax due will either overstate or understate the taxpayer's liability. Unless the auditor actually completes a physical audit of each invoice at issue over the entire length of the audit, it is improbable that the auditor will arrive with the correct liability.

In a sales and use tax audit, auditors review business purchases and sales to evaluate whether the company correctly identified them as exempt, taxable, or nontaxable. As a matter of course, businesses generate thousands of invoices, and it would be both time consuming and inefficient for auditors to review each invoice.

As such, conducting a thorough audit of a taxpayer's business activity during the course of an audit period commits (and diverts) significant government resources. Accordingly, some states permit their taxing authorities to utilize formula-based methodologies to calculate tax assessments in the most time- and cost-efficient manner available. However, due to the inherent nature of formula-based audit methodologies, they can produce an unfair and inaccurate representation of a taxpayer's actual tax liability, if one exists in the first place.

Who Gets Audited?

Predicting candidates for sales and use tax audits is best described as an exercise in futility. While businesses and other tax professionals have the ability to make educated guesses based on patterns, making accurate determinations of audit candidates is an inexact science.

Nonetheless, trends have emerged that have provided guidance for helping businesses and tax professionals to minimize the likelihood of being targeted with an ensuing audit. Accordingly, the following is a partial list of circumstances and occurrences that may tip a state tax auditor to examine a business' filings:

- Increase in exempt sales. Businesses that experience an increase of ''exempt'' sales in a short period of time encounter an increase in the likelihood of an audit.
- Large amounts of exempt sales. Entities with large numbers of exempt sales are likely to be scrutinized to ensure there is compliance. As such, small errors will likely become more apparent.
- Nexus. Entry into a new jurisdiction may unwittingly expose a business to sales and use tax liability. When nexus is created, businesses typically need to register in the jurisdiction to collect sales and use tax. When a business enters a new jurisdiction, registers to do business, or files a state income tax return for the first time, that business may be flagging their account for the tax authority.
- Late filing. Filing late may lead to a business' filings being examined more closely, thus making the business more susceptible to a potential audit.
- Having a history of audits. Once audited, that business is more likely to be audited again. Making a mistake in filings in the past generally leads auditors to believe a business may do so repeatedly.
- Being a sole proprietor. Sole proprietors are more likely to be audited than other small companies (i.e., LLCs, S-corporations, C-corporations). Thus, sole proprietors may unknowingly expose themselves to a higher likelihood of being targeted for an audit investigation merely by deciding not to incorporate or form as a limited liability entity.

Targeted Businesses

In addition to the foregoing circumstances and occurrences, certain businesses attract the attention of state tax auditors merely given the nature of their business operations. For example, in Maryland, tax auditors are particularly drawn to commercial cleaning and janitorial companies. Specifically, because of the complexity of Maryland's sales and use tax laws in the commercial versus residential cleaning context, noncompliance is virtually assured. Thus, these businesses have become the proverbial ''canary in the coal mine'' for Maryland sales tax collectors.

To highlight such uncertainty, on one hand, Maryland exempts from sales and use tax cleanings of owner-occupied dwellings.[1] On the other hand, Maryland places a fine distinction between cleaning services performed in between a period of residential occupancy at an apartment or rental condominium, which would be considered taxable, versus fees collected for cleaning services performed in newly constructed homes prior to sale to a resident, which are non-taxable.[2] Thus, on one hand, commercial cleaning and janitorial service owners have straightforward and clear guidance as it pertains to owner-occupied dwellings. However, on the other hand, those owners must navigate a nuanced distinction between services rendered during periods of unoccupancy versus the period prior to initial ownership. While such a distinction may appear uncompli-

[1] Md. Code Ann., Tax-Gen §11-219(a)(1); *see* Md. Code Ann., Tax-Gen §11-101(m); *see* Md. Code Ann., Tax-Gen §11-101(c). *See also* Comptroller of Md., http://taxes.marylandtaxes.com/Business_Taxes/Business_Tax_Types/Sales_and_Use_Tax/Tax_Information/Special_Situations/Janitorial_Services.shtml.

[2] *Id.*

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cated at first glance, for businesses performing these services hundreds and even thousands of times in a given tax year, producing hundreds and thousands of invoices and work orders, that distinction can become confusing and burdensome.

Furthermore, these distinctions can be even more complicated for commercial cleaning and janitorial service owners when a government agency is the purchaser. For example, in Maryland, while commercial cleaning performed for a government agency is exempt, commercial cleaning performed for a contractor of a government agency is not.[3]

Accordingly, government contracting is another business area attracted by state tax auditors. Indeed, many government contractors are misguided in their assumptions that any and all transactions with government or government-related agencies are tax-exempt. Unfortunately for these unwary taxpayers, the ultimate issue of whether a contract is taxable depends on the nature of the relationship with the agency and the products or services being provided to the agencies.

To illustrate, under most procurement contracts in which a contractor provides tangible personal property to or for the benefit of a governmental agency, no sales tax should be charged (a resale certificate must still be obtained). But, when the contractor makes use of the product after it has been delivered to the agency, it must still accrue the tax.

Example: In Maryland, the National Security Agency (NSA) is a federal facility that operates a signals intelligence (''SIGINT'') operation near Fort Meade. A contractor's SIGINT procurement contract with the NSA for the provision of computer equipment would be an exempt sale. However, if the NSA provides the computers back to the contractor to operate the contract, the contractor would then be utilizing consumables (i.e., paper, toner, etc.) pursuant to the contact. Maryland could take the position that the use of these consumables in the provision of the contract was not exempt.

In addition to commercial cleaning services and government contractors, subtle distinctions and nuances in the application of sales and use tax of software has led state tax auditors to target software vendors. Specifically, in states that impose sales and use tax on software, the application of the tax on canned software varies depending on the type of software purchased and the form of its delivery. In targeting software vendors, state auditors are trained to look for weak records retention policies, physical deliveries, and on-site trainings with respect to the purchase and delivery of software.

The Audit Investigation

For businesses that have been selected for an audit investigation, several aspects of the process bear mentioning and should be retained while navigating the often lengthy and protracted process.

1. The hiring criteria for auditors varies from state to state. Thus, the quality of the auditor will likely vary markedly based on his/her experience, educational background, and prior auditing practice. Generally, the position requires functional knowledge of accounting and bookkeeping concepts, but in some states, the position does not require a CPA certification.

2. An auditor's assumptions based on their investigation will vary, and a business should not assume the auditor's calculations are correct. Thus, a business should request all work papers, calculations, and methodologies that the auditor used to reach his/her conclusions throughout the audit and at the termination of the audit.

3. State sales and use tax auditors not only review a business' sales, but also its purchases. Out-of-state consumables are generally not tax-free even though the selling firm has not collected a sales tax. Most states impose an offsetting use tax on the importation of tangible and otherwise taxable goods into the state.

4. Auditors tend to resolve ambiguities in the state's favor. Auditors will view payments for purchases without invoices as taxable, resulting in a determination that a business owes tax on that purchase. Accordingly, the strength of a business' bookkeeping records and the auditor's methodology heavily influence the amount of tax assessed.

5. An auditor's initial report is almost always wrong. Audit methodologies may have systemic flaws—block sampling errors, misapplied apportionment formulas, straight line growth formulas, and basic math errors, to name a few—are common mistakes made during an audit investigation.

One such methodology that is particularly troubling and popular is projection methodology.

Projection Methodology of Sales and Use Tax Audits, the Sample Period Problem

Projection methodology attempts to prognosticate a business' sales and use tax liability by applying a series of formulas to a sample of the business' operating history. Thus, this methodology routinely either overstates or understates a taxpayer's true tax liability, resulting in an expensive exercise to correct inaccuracies—a cost borne by the taxpayer.

The methodology functions by first identifying a sample period. A sample period is a number of months, days, or years that the auditor selects to base his/her calculations. Sampling provides a baseline for computations, without requiring the auditor to inspect the entirety of the taxpayer's records.

To illustrate, Maryland currently utilizes this methodology when conducting its sales and use tax audits. Once the sample period has been identified, Maryland auditors will calculate an error factor based on the business' total reported taxable purchases/sales and the total purchases/sales made during the sample period. Auditors will then add the total number of purchases/sales made during the audit periods and multiply it by the error factor to determine the perceived taxable amount during the entire audit period. The amount is then multiplied by the applicable tax rate and an assessment is issued.

In other words, to calculate the foregoing assessment, auditors will scrutinize all sales and purchases made during that sample period. Auditors will isolate instances during the sample period where they determine that the business failed to collect and remit sales tax or instances where the business failed to report and

[3] *See* Md. Code Ann., Tax-Gen §11-220(a).

pay use tax. Accordingly, this methodology magnifies small bookkeeping mistakes made during the sample period. Those findings are then used to calculate the error factor, which is then applied uniformly to the taxpayer's business activity during all audit periods, irrespective of the business's compliance, or lack thereof. When the sample period is a period of months, auditors will extrapolate their findings over a year by multiplying the error factor by the remaining number of quarters.

As such, the sample period may or may not bear any relationship to the taxpayer's natural business year, busy or slow periods, or third party interferences in the taxpayer's business operations. For taxpayers operating seasonal businesses, (i.e., snow removal, florists, candy manufacturers, life guard services, professional sports teams, golf courses, swim clubs) sampling periods of less than one year can be particularly inaccurate and misrepresentative of a taxpayer's annual business operations.

In addition, sampling further assumes that the sample period will be consistent and proportionate with all the audit periods. For example, auditors may have judgmentally selected three ''typical representative'' months in an audit period, and then they would examine all purchases and sales in those months. The auditors would then extrapolate those three months to the entire audit period. Unfortunately, this can be biased due to non-random selection of the months, fluctuations in purchasing or sales volume, and seasonal patterns in purchases. Furthermore, the bias, accuracy, and precision of estimates derived from non-random block sampling cannot be calculated. While the auditor may advise that they have picked three random months, or three average months, not even a perfectly designed non-statistical plan can provide for the measurement of sampling risk.

Auditors may also attempt to calculate a business' gross income and taxable and non-taxable sales and purchases during an audit period using a formula based on a block sampling technique. Block sampling involves reaching these numbers by dividing the annual gross by twelve and then multiplying that number with the number of months in the sample period. Thus, instead of using the actual figures from a taxpayer's books/records or bank statements, auditors will estimate their baseline computations based on a sample period rather than a tax period's worth of business activity. Unless business activity is exactly the same every day, calculations will almost never match bookkeeping records.

Navigating a Sales and Use Tax Audit

Once an audit investigation has commenced, there are tactics that can be deployed to make the process bearable and potentially result in a lower, more manageable tax assessment.

At the beginning of the audit process, a tax professional should review a taxpayer's records, business operations, and bookkeeping systems to determine whether the taxpayer has exposure for the underpayment or overpayment of sales and/or use taxes.

If it is determined that tax deficiencies exist or potentially exist in either processes or business operations, an effort to gather statements/invoices and solutions to recover missing statements/invoices should be implemented as soon as possible. Those statements/invoices will be crucial for either proving the tax was previously paid or that the transaction was exempt or nontaxable. The more organized and prepared a business is to challenge a tax assessment issued from an audit investigation, the greater the likelihood that an auditor will concede a transaction or an appeals board or judge will side with the business.

In addition, businesses must seek to minimize and limit auditor intrusion to their business operations. Eliminating or avoiding tax assessments during the audit investigation will not only be cost effective for businesses, but it will also focus the auditor's attention to the task at hand.

If the state uses a formula-based audit methodology, businesses or their representatives should scrutinize and challenge the auditor's calculations, whenever possible. Regression of analytics to their base assumptions (i.e., a comparison of the auditor's calculations to the business' actual tax filing) can be an effective tool. In addition, most audit reports contain numerous opportunities to reduce assessments through formula-based allocations of income, expense, and multi-state apportionment of revenues. In addition, there are often areas where penalties and interest can be minimized through abatement requests, creation of tax credits, and overpayments/offsets.

Conclusion

Although all businesses can potentially be subject to a sales and use tax audit, certain types of businesses are much more susceptible. While it is possible, if not probable, for taxpayers to make mistakes in their filings, it is highly probable the auditors will make mistakes in their analysis of tax liability.

Thus, businesses should take extra care in their filings and be generally aware of problem areas. When an audit is inevitable, the best way to tackle the matter is to develop a strategic approach at the onset of the audit investigation, identify weaknesses in documentation, locate missing documents, organize documents, and develop a pre-existing plan or approach prior to the auditor's visit.

Once the audit is underway, taxpayers should identify which approach the auditor is utilizing to conduct the audit and have a clear understanding of this approach. Furthermore, taxpayers should request and receive all workpapers related to calculations, analysis, and proposed liability.

Upon receiving an audit report, taxpayers should review the report with a jaundiced eye, questioning all assumptions, and they should independently evaluate the auditor's conclusions of those assumptions in the context of the actual bookkeeping, business records, and filed returns. In addition, taxpayers should not agree to any analysis until they understand the basis of the analysis and are satisfied that the sampling approach fairly represents their exposure. Unsophisticated taxpayers should engage counsel or a tax professional as early as possible in the process. Sophisticated taxpayers who do not regularly participate in sales and use tax audits should also seek outside advice regarding the audit investigation and analysis once the audit is underway and when a sampling approach has been proposed.

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