The Best Time to Prepare for a Sales Tax Audit: NOW!!

-by Ned Lenhart, President, Interstate Tax Strategies, P.C.

Each year, states collect about $1 billion in sales tax as a result of tax audits or other enforcement measures. That's money coming out of your businesses pocket to pay for mistakes you made for failing to know and follow the sales tax rules in the states where you operate. To be sure, some of the money collected may not be a legitimate collection. For some businesses, the cost to fight an assessment is as large as the taxes due and they just make the decision to pay the amount assessed and move on. Even though this happens, this is a very small percentage of the total amount collected. As discussed in more detail below, preparing for a sales tax audit begins long before you ever receive a notice that your business is being audited. The goal of actively preparing for a sales tax audit prior to ever receiving a notice is to give the states as little of your money as possible if they ever come knocking on your door.

The worst time to begin preparing for a sales tax audit is when you receive the notice or phone call that a state wants to review your documents. But for 90% of the businesses that are audited each year, that's exactly when it starts. The severity of the audit is often connected to whether you are registered or not. Registered businesses are usually audited for only 3 or 4 years which is the normal statute of limitations. For unregistered businesses, there is no statute of limitations and the auditor can go back many more years for their review. It's not unusual for auditors to go back 8 to 10 years if your company has had nexus in the state for that length of time. As such, companies can significantly reduce the audit look back period by periodically reviewing their nexus footprint in the states where they conduct business and taking the initiative to be properly registered where necessary.

The majority of sales tax assessments normally occur for one or more the following reasons: missing certificates to support exempt sales, misapplication of tax to taxable sales, and unpaid use tax on taxable purchases. To be properly prepared for a sales tax audit, you must periodically review your company's procedures in each of these areas. As mentioned in a previous article, missing exemption certificates create a tax liability for your business. Some process should be in place to review the sufficiency of the exemption certificates you have and to obtain any missing certificates. This one process will keep a lot of money in your pocket if you are audited.

If you routinely charge and collect tax on the sales you make, you should periodically validate the tax rules you use. The laws are constantly changing and unless you have a systematic process to keep your tax rules current, you may be creating a hidden tax time bomb for your business. Also, the way invoices are constructed significantly impacts the taxation of the transactions you make. If your invoices "bundle" taxable and nontaxable items for a single price, you must charge tax on the full amount you receive. This area is complex so get the right help. Don't assume the rules of your "home" state apply to other states.

The last item auditors look at is use tax. This is the tax due on the taxable purchases your company makes. Just because your vendors do not charge you tax does not necessarily mean that the transaction is not taxable. If the product or service would be taxable if you purchased it from a local supplier, then the odds are high that the transaction is subject to use tax. Use tax compliance is difficult to perfect because the process is often manual and relies heavily on the knowledge of the AP department to determine what the purchases are, where they were consumed, and whether the activity is taxable. Despite these challenges, the states are aggressive at finding untaxed purchases. If you don't have some type of use tax process in place, now is the time to start.

Preparing for and managing sales tax audits can be a very time consuming and elaborate process. For large businesses, there may be entire teams of professionals that manage these processes from start to finish. For small to mid-sized businesses, the task usually falls to the CFO, Controller, or Accounting manager. If you are uncomfortable about what an auditor might find, get help. Even after you have received a notice of an audit, having a "pre-audit" review can be helpful to identify areas that an auditor might find and will allow you to take some defensive positions before they arrive. Remember, it's not just the tax that you are saving; it's the 12% interest and the 25% penalties too.

A note about the author: Prior to starting Interstate Tax Strategies, P.C., Ned Lenhart served as Director of Multistate Tax Services for Deloitte's Atlanta office. He served as Director of the Missouri Department of Revenue's Compliance Division and led civil and criminal tax enforcement efforts; and served as Deputy Director of the Missouri Division of Taxation. He is a licensed CPA in multiple states and an active member in AICPA and GSCPA.

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