What CFOs Need to Know About Weathering a Sales and Use Tax Audit

FINANCE CHIEFS ARE TURNING TO AUTOMATION TO ENSURE SALES TAX COMPLIANCE AS ENFORCEMENT EFFORTS ESCALATE

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INTRODUCTION

Time to Take Action in the Face of Aggressive Sales Tax Audits

When it comes to sales and use tax audits, state and local jurisdictions are getting more aggressive, which means that CFOs and finance teams must be prepared for the inevitable audit. The number of audits in this area is increasing, so it's no longer a matter of if, but when, your company will face an audit.

Some organizations are so concerned about steering clear of a sales and use tax audit that they overpay. While this can help keep auditors at bay, overpaying sales and use taxes is not a smart or sustainable fiscal strategy.

The reality is that businesses are fearful of incurring penalties for not paying or incorrectly calculating the sales tax. Large companies that operate complex businesses face huge risks by not properly calculating sales tax. Sales tax compliance is especially challenging for organizations with both online and bricks-and-mortar operations.

While most companies have been diligent about calculating, collecting, and remitting sales tax, they must

also get up to speed on complying with consumer use tax rules. This can all be a heavy burden, especially for those companies that try to manage this process internally.

With all of these sales tax issues weighing on corporations, it is imperative for finance chiefs to get ahead of sales and use tax compliance issues before they have a serious impact on the company's bottom line and reputation.

Topics explored in this eBook include:

- Establishing best practices to avoid a sales and use tax audit — with input from various departments, including accounts receivable and accounts payable — and reviewing the processes at least annually;
- Assessing the benefits of working with a third-party provider to help navigate sales tax compliance at the state and local levels;
- Understanding the role of automation in ensuring that sales taxes are paid accurately and promptly, integrating tax data and documentation, and keeping your company in compliance while avoiding over/under payment;
- Considering cloud-based technology that integrates directly with ERPs;
- Determining the appropriate response when your company is audited for sales tax compliance, including establishing a central point of contact, streamlining information gathering, and having a plan for quickly remediating problems.

Start by Avoiding the Audit

To borrow a sports analogy, the best offense is a good defense when it comes to sales tax audits. While auditors are becoming more aggressive in enforcing sales and use tax compliance, the best strategy is to put the people, processes, and systems in place to minimize your chances of an audit.

While there are a number of challenges for finance chiefs when it comes to sales tax compliance, they can take steps to minimize the risk of an audit.

The finance team should have a detailed understanding of where their company is doing business. It is critical to determine your company's nexus — or "sufficient physical presence" — a legal term that refers to the requirement for companies doing business in a state to collect and pay tax on sales in that state. Fully understanding your company's nexus footprint determines where you need to register and collect sales or sellers use tax.

"As the financial leader in charge of minimizing risk, the CFO has the responsibility to ensure that the company is charging the correct sales tax in all states and localities where they have nexus in addition to having a system in place to track and report consumer's use tax," said Craig Cookle, partner, Wipfli LLP, an accounting and business consulting firm.

If your company does have nexus, there are other steps to review regarding your sales tax compliance, including:

- Is the correct form being filed?
- Are the proper state and local tax rates being charged?

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- Are exemption certificates being appropriately maintained and updated?
- Is the taxability of products or services being properly determined?
- Is all sales tax that is charged and collected remitted to the proper authorities?

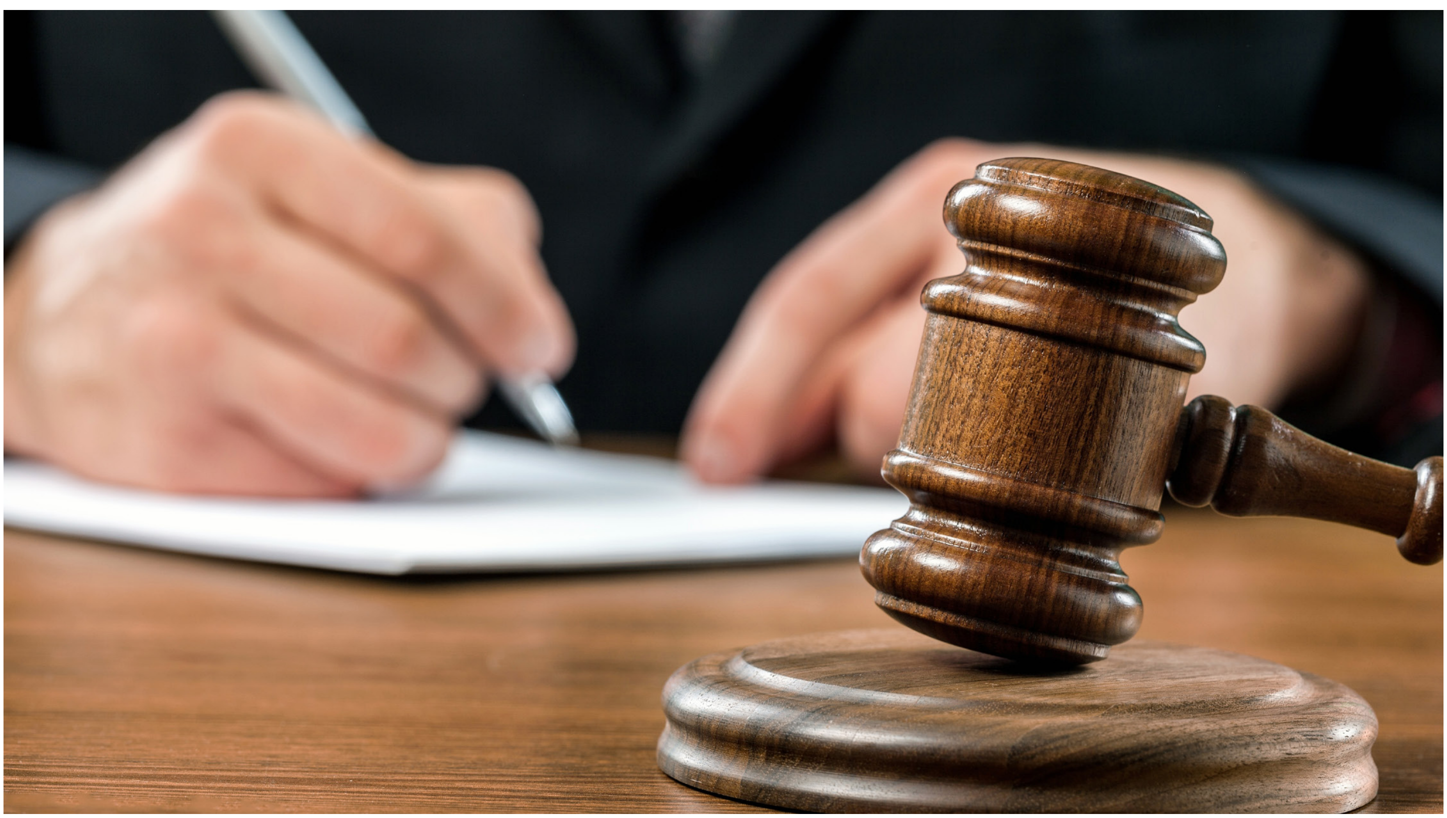
The Severe Impact of Non-Compliance, and How Third Parties Can Help

Once you have established your sales and use tax management processes, it is imperative to review them at least annually, if not more frequently, as non-compliance or incorrect remittance of tax can be subject to substantial penalties and interest charges. Also, a very aggressive state may consider non-compliance to be fraud. In addition, once a tax audit uncovers an issue, it can spark auditors to broaden their scope and look for other instances of non-compliance.

As for liability with regard to previous tax periods, many states offer Voluntary Disclosure Agreements, also known as VDAs. VDAs allow a company to enter into a settlement agreement with a state. At times, states may offer amnesty programs where taxpayers can pay prior taxes owed and have interest and/or penalties abated.

The bottom line is that sales tax non-compliance can potentially cripple your company. “You don’t want to be caught on the wrong side when it comes to sales tax compliance,” said Chris Livingston, Director of Operations and Product Management, Vertex Inc., a provider of tax compliance solutions. “Not only could non-compliance significantly affect cash flow, it is considered fraud by some states.”

While incurring fines and penalties for non-compliance can hurt the



bottom line, sales tax issues can also negatively impact the customer experience and hurt cash flow. "If you are not taxing customers correctly, they will short pay their invoice which creates a collection issue and will affect your company's cash flow," said Peggi Rockefeller, Chief Tax Officer-Transaction Tax, Vertex Inc.

Depending on the size of their operations, some organizations may have in-house resources to manage sales tax compliance issues. "While you can manage handling manually if you're doing business in one or two states, once you start expanding into more states and localities, you will really need to consider automation," Rockefeller said.

As a result, many companies are turning to third-party providers to help navigate the complexities of sales tax compliance.

Because third-party providers are keenly aware of the changes to state and local sales tax laws, they can provide timely updates to help avoid errors such as overcharging and undercharging customers if a rate has changed.

One sign that a third-party provider would be a valuable partner in managing sales tax compliance is a high turnover rate in the department responsible for tax

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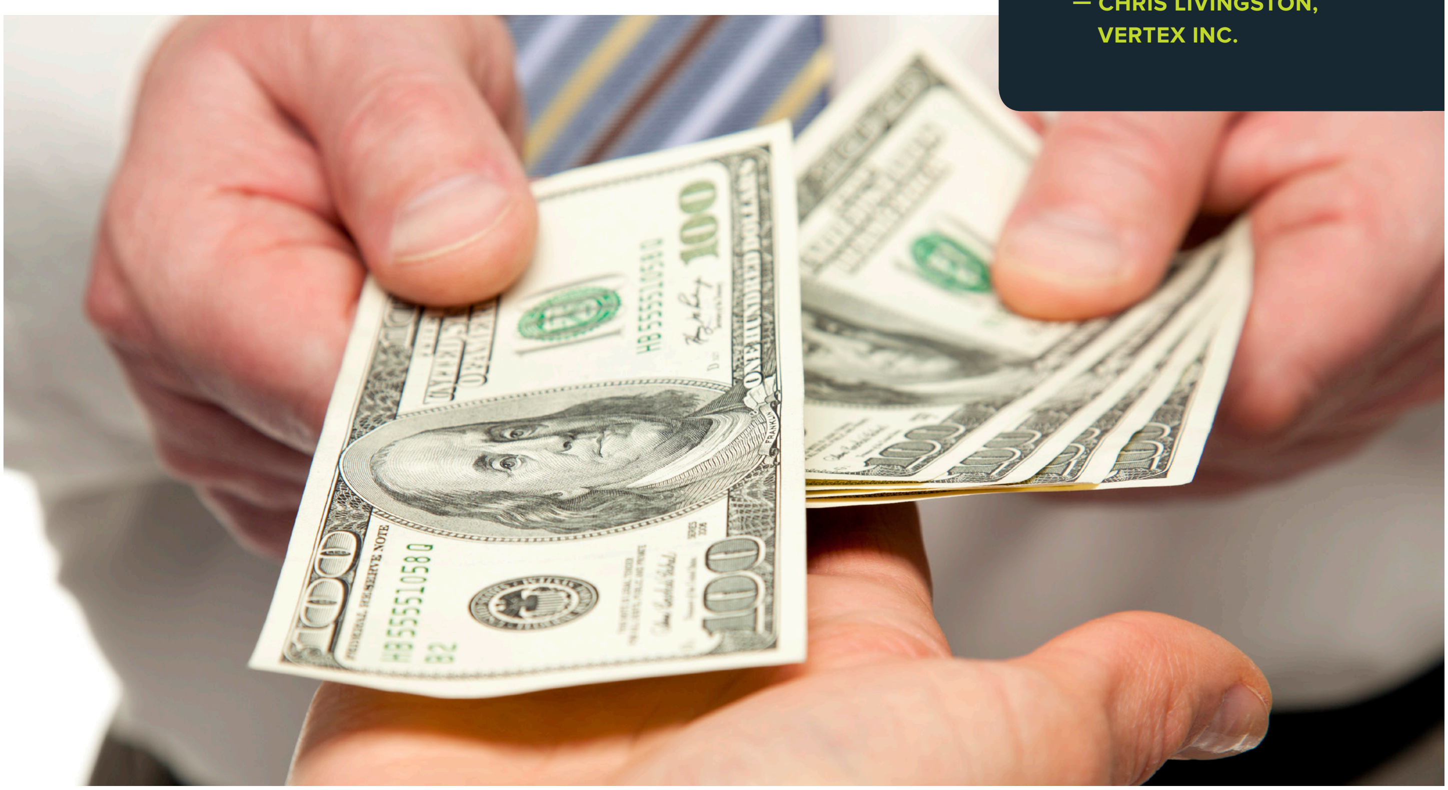

filings. "If there have been a lot of changes in the people managing the filings, things could potentially slip through the cracks," Cookle said.

Mitigating Risk Through Cloud-Based Solutions

Many of the challenges of determining sales tax rates and compliance can be eased through the use of cloud-based systems.

Automation can help with some of the key triggers of an audit — improperly taxing products and services and/or taxing them at the incorrect rate. "Technology will help accurately calculate, remit, and report sales and use taxes," Livingston said.

Automation can also assist in identifying which returns should be filed and ensure the accuracy of the returns' calculations.

State and local sales tax rates are continuously being adjusted. Relying on manual updates is subject to error and may not happen in a timely fashion, if at all. Automation ensures that the current rates are applied and reported accurately.

Sales and consumer use tax compliance requires data that often resides in silos throughout the organization. Information has

to be collected from accounting, order processing, and billing, among other departments, to file timely and accurate sales tax returns. By automating the process, the real-time data can be shared seamlessly.

While manual and on-premise solutions can help avoid a sales tax audit, a cloud-based solution offers the visibility and flexibility to meet today's increasingly challenging and fast-changing demands.

"Cloud-based sales tax technology systems ultimately streamline the entire sales tax calculation and filing process," said Cookle. "They can be administered with little to no IT involvement. In addition, employees can focus on activities that benefit the bottom line and grow the business."

You're Audited. Now What?

Despite all of the systems and meticulous processes put in place to avoid a sales and use tax audit, auditors will most likely come knocking at some point. The good news is that automation can provide

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a solid audit trail. This makes it easier to address and correct any errors to avoid problematic future sales tax filings.

When you get an audit notice, here are some steps to take:

» Review documents supporting deductions taken;

» Review sales tax accrual accounts;

» Review expenses;

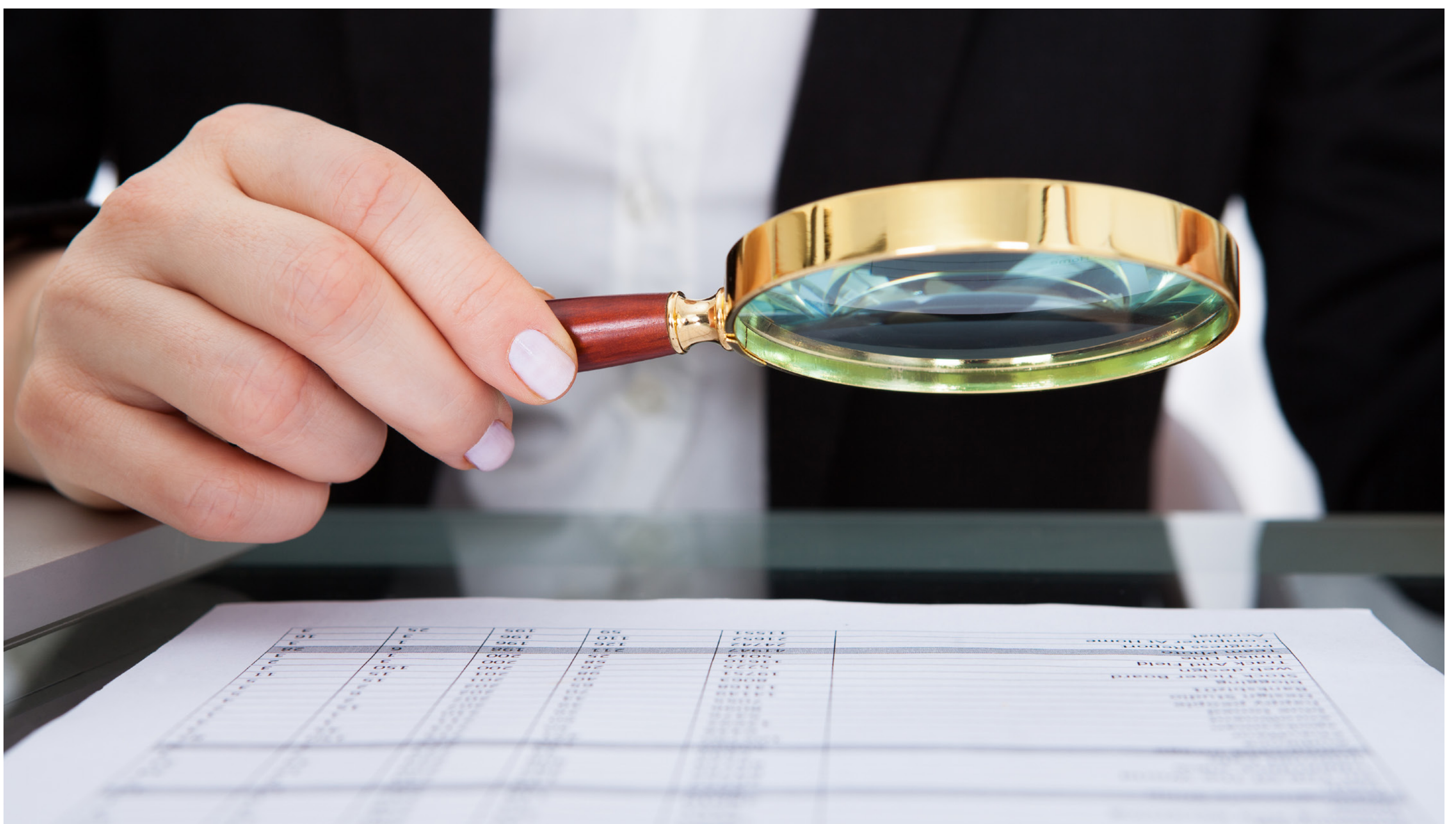
» Review use tax liability/ accrual accounts;

» Review purchase invoices to verify that the seller's use tax has been charged or consumer's use tax has been accrued; and

» Be prepared before the audit process starts, as it will make the audit process go smoother and can aid in bringing the audit to an early conclusion.

If your company has been previously audited, revisit the previous audit documentation to ensure that any concerns noted at the time were addressed. "You want to look at what process changes were put in place and when they were put in place," Rockefeller said.

Knowing what auditors are going to find before they perform the audit will enable you to be proactive. "You don't have to go to war," Livingston noted. "Providing the auditors with the information they need and understanding what the issues are will go a long way to smoothing the process as much as possible."



CONCLUSION

Easing Headaches With Automation, People, and Processes

The reality is that finance chiefs don't want to worry about sales and use tax risk. But this "above the line" expense affects net income and must be handled correctly. With more sales tax legislation on the horizon as states face tight budgets and seek ways to increase tax revenues, CFOs need to be sure they have the right checks and balances in place.

Many states are attempting to tax retailers that sell over the Internet by enacting more aggressive sales tax laws, often called "Click-Through Nexus Laws." For remote sellers that sell over the internet, be aware of "Notice Requirement" legislation passed in a number of states as well as certain states imposing "Economic Nexus" standards.

Some states are considering bills that would impose the sales tax on services like pet grooming, haircuts, country club memberships, health clubs, funeral services, telephone landline services, cell phone services, movie tickets, cable service, and digital downloads.

The responsibility of the CFO is to manage risk, and many are implementing processes and technology to reduce errors resulting in tax over/underpayment and non-compliance issues.

Even the most diligent companies will inevitably face a sales tax audit. With the chances of being audited high, automation, along with rigorous processes and frequent internal review can help make the audit a little less painful.

Avoid These Sales Tax Audit Triggers

With extensive experience in sales tax audits, Vertex Inc. is well versed in the types of actions that can trigger an audit. Here are some things to keep in mind that can spark an inquiry:

A SIGNIFICANT PERCENTAGE OF EXEMPT SALES

The purchase or sale of a large number of exempt items or services can trigger an audit, because there can be misinterpretation of the law, taking an exemption on an item in error, and sometimes just outright noncompliance.

LARGE CHANGES (INCREASE OR DECREASE) IN SALES OR USE TAX VOLUMES

A large increase or decrease in sales or use tax reporting is a red flag.

LATE RETURNS FILINGS

Consistently filing sales and use tax returns after the due date and remitting the tax payment in a non-timely manner will trigger an audit.

INCORRECT MATH

Math errors may draw inquiry, and many times lead to a full-blown examination, particularly if the errors are very frequent in nature. A large increase in sales can increase the potential of errors and omissions.

NEXUS BUT NO REGISTRATION

Not being registered for sales tax but paying another kind of tax in a state can increase the probability of an audit. A state sales tax audit division just has to check with the other tax audit division.

NOT FILING AND REMITTING USE TAX

Filing and remitting sales tax but never filing and remitting use tax is another red flag.

CURRENT VENDOR AUDIT

If one of your vendors is being audited and that vendor has not charged you sales or use tax or has charged you incorrect tax, this will likely trigger an audit.

CURRENT CUSTOMER AUDIT

If one of your customers is being audited and you have not charged the proper sales or use tax, this can also trigger an audit.

DROP IN TAXABLE SALES

A drop in taxable sales is one of the biggest triggers for a sales tax audit.

WHISTLEBLOWERS

A whistleblower can be a disgruntled employee, an unhappy customer, a competitor, or businesses in the same location as you that know or suspect that you have not paid your fair share of taxes.

REQUESTING A REFUND

A refund request, especially a large refund request, will trigger an audit.

INDUSTRY TYPE

Companies in industries that frequently under report sales and use tax, or industries that traditionally have a high use tax liability are often targeted for an audit.

LUCK OF THE DRAW

Some states have random ways of selecting companies for audit.

NOT FOUND IN STATE SYSTEM

Companies that have a website, are listed in the phone book, or appear in a newspaper, magazine, or online news report can trigger an inquiry regarding their registration status.