



**INTERCONTINENTAL**  
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## **2005 ADVANCED SALES TAX CONFERENCE**

Audits, Samples & Appeals

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- Audit Selection Process
- Pre-Audit Preparation
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- Audit Process
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# Overview of Sales & Use Tax Audits

# Overview of Sales & Use Tax Audits

In today's economy, states are increasing their audit efforts, particularly in the area of sales and use taxes. Audits are becoming increasingly more frequent and auditors are becoming more aggressive.

Understanding how to manage the audit process can save the company both time and money, and can assist in developing policies and procedures to address items before they become an issue.

# Audit Selection Process

# Audit Selection Process

The strategies for selecting a business to audit vary. However, many businesses are selected for audit based on information obtained from the following sources:

- Information sharing programs with other states or state agencies.
- Computer-based random selection.
- State database information.
- Business publications, periodicals, journals and directories.
- Information obtained during the audit of a customer.

# Pre-Audit Preparation

# Pre-Audit Preparation

## Overview

The first contact for an audit can be made either by telephone or through written correspondence. The auditor will generally contact the taxpayer to schedule a mutually convenient time, date and location for an audit. Consideration should be given to the following:

- Location for Audit
- Scheduling
- Contact Information
- Notify Appropriate Personnel

# Pre-Audit Preparation

## Requests for Information

Also make sure that the auditor has submitted a request for information prior to the start of the audit. When such request is received, consider the reasonableness of the information requested. Information which is commonly requested includes:

- Sales and use tax returns, with related workpapers for the audit period.
- Sales and purchasing invoices.
- Exemption and resale certificates.
- Chart of accounts.
- General ledger.
- Capital asset schedules.
- Financial statements.

# Pre-Audit Preparation

## Audit Period

The audit period is usually based on the periods open under the statute of limitations. The statute of limitation varies by state, and most commonly averages three years, although there are exceptions (i.e., New Jersey's statute of limitations is four years, while Pennsylvania is three years plus the current year).

# Pre-Audit Preparation

## Waivers of Statute of Limitations

It is not uncommon at the commencement of the audit, for the auditor to request that the taxpayer sign a waiver extending the statute of limitations for assessment. The purpose of such waiver is to provide them with the time necessary to conduct the audit.

It is also not uncommon for the auditor to request an additional waiver be signed during the audit period. A taxpayer should carefully consider the following prior to signing such waivers:

- Does the waiver keep the statute open for refund as well as assessment?
- Why is a waiver being requested?
- How many waivers have been previously requested?
- What is the time period the waiver?

# Pre-Audit Preparation

## Identify Exposure for the Audit Period

Prior to the commencement of the audit, a taxpayer should determine if there is any exposure related to the audit period. In order to do so, the taxpayer should consider the following:

- Review prior audit history to determine what issues were raised in previous audits.
- Consider any unusual transactions which occurred during the audit period (i.e., major acquisitions, dispositions or mergers).
- Consider issues that have been raised during other state audits.
- Consider strength of audit documentation.
- Review publicly available information. Auditors often have clippings of stories regarding the company. It is important to understand the information the auditor has access to when conducting an audit.

# Pre-Audit Preparation

## Identify Overpayments Made During the Audit Period

A taxpayer should determine if any overpayments have been made during the audit period to offset any claim which may arise.

If overpayments are identified, the taxpayer should give serious consideration as to when to discuss such overpayments with the auditor (at the beginning or end of the audit), and how to address these overpayments during the course of the audit.

- Consider the Pennsylvania Supreme Court decision in *McNeil PPC*.

# Interactions with the Auditor

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## General

The level of knowledge, aggressiveness, experience, etc. vary from one auditor to the next. Get to know your auditors to determine the best way to interact with them. Remember, you can't do anything about an irrational auditor.

Remember, it is an auditor's job to be skeptical. During the course of an audit the burden of proof is generally on the taxpayer. An auditor's job is to find underpayments, not overpayments, and as such their questions will be geared towards such.

Work towards maintaining a good relationship with the auditor. If the auditor likes you, they will want to help you.

# Interactions with the Auditor

## Logistics

The logistics of the audit should be considered, including the following:

- Auditor's Work Space
- Notification of employees in auditor's work area.
- Document Storage of Confidential Records
- Auditor Identification and Time Keeping
- Meals

# Interactions with the Auditor

## **Point Person**

Designate one point person to interact with the auditor. With one person being the point person, it is understood what has been provided and what has not, what has been answered and what has not.

## **Information Provided**

Keep copies of everything provided to auditor. This is particularly important if the point person should become sick, should leave the company, or if the assessment is appealed.

Respond to the auditor's inquiries, don't volunteer information regarding information which has not been requested, unless it will be helpful.

If information is requested that you believe is not relevant, ask the auditor to state the relevance. If you don't think it is needed and decide not to provide the documentation, put this in writing to demonstrate that you are being responsive (i.e., California has a 25% additional penalty if they feel taxpayer has not responded to request).

# Interactions with the Auditor

## **Negotiating:**

Determining how to negotiate with an auditor should be determined on a case by case and state by state basis. In some instances, the auditor does not have the power to negotiate (but his or her supervisor may). You may want to consider getting the supervisor involved in certain issues, or going “higher up” within the state. Negotiating is easier in audit than on appeal.

## **Contract Auditors:**

Many jurisdictions are beginning to use contract auditors to conduct audits. For example, many of the localities in Alabama, who have limited staff, have contracted with a third party to manage their audit process. These contractors usually work on a contingent fee.

# Managing the Audit

# Managing the Audit

## Know your rights

Many states have enacted taxpayer bill of rights statutes, which are available on the state web sites.

It is important to understand your rights while under audit. It will give you a stronger basis for challenging an auditor, if he or she is being unreasonable.

# Managing the Audit

## Understand Your Rights

The following are typical items found on a Taxpayer Bill of Rights:

- The right to rely on prior audit determinations (at a minimum a waiver of interest and penalties based on such determination, although some states do not waive interest at any time).
- The right to rely on a private letter ruling (in the absence of a law change).
- The right to have examinations conducted during normal business hours and at a convenient time.
- The right to receive a written description and basis for preliminary assessment. Note that the taxing authority may have the right to change the basis for its assessment on its appeal.
- The right to be assisted or represented by an authorized representative in dealings with the auditor.

# Managing the Audit

## Understand Your Rights (cont.)

- The right to apply for penalty abatement (and receive penalty abatement without foregoing the right to contest the tax).
- The right to appeal an audit assessment.
- The right to offset assessments.
- The right to be treated courteously and professional by the auditor.
- The right to confidentiality of information.

# Managing the Audit

## When to Involve Consultants

Determining when to involve consultants in the audit process should be a case by case determination, depending on the issues involved, the amount of money, and the auditor.

Consultants generally have a deep level of expertise and a number of strong contacts. As such, they can often eliminate potential issues early on in the process. But remember that a consultant will not know your business better than you do.

Auditors may become intimidated by consultants, which can be both beneficial and detrimental, depending upon the situations.

If a taxpayer is going to involve consultants, it is often wiser to do so earlier in the process, rather than waiting until the assessment is issued. It is beneficial to resolve as many issues as possible at the audit level, rather than on appeal.

# Audit Process

## Entrance / Opening Conference

This conference provides the ground work for the course of the audit. Items that should be specifically addressed during this conference include the following:

- Type of Tax / Taxes to be Audited
- Audit Period
- Length of Audit

## Entrance / Opening Conference (cont.)

### *Audit Procedures*

The auditor will generally discuss the types of procedures to be used under the audit, including sampling methodologies. The sampling methodologies most commonly used are block sampling and statistical sampling.

### Block Sampling

Under block sampling, an auditor will review all transactions during a block of time (generally one month per calendar year). From this sample, the auditor will develop an error ratio to be applied to all sales, purchases, etc. during the course of the audit period.

### Statistical Sampling

Under statistical sampling, an auditor will provide a sample of transactions, derived from the populations which it will test. From these transactions, an error ratio will be developed and applied to all sales, purchases, etc. during the course of the audit period.

## Closing Conference

During this conference, held at the conclusion of the audit, the following are discussed:

- Adjustments made as a result of the audit.
- Basis for adjustments.
- How the adjustments were computed.
- Records and audit methods utilized.
- Discussions regarding taxpayer's agreement or disagreement.
- Description of taxpayer's rights and administrative remedies (appeals).
- Waiver of penalties and interest, where permitted.

# Appeals

Weigh the costs and benefits of appealing an assessment. Appealing an assessment can be costly, particularly, if it is not anticipated that relief will be granted at the administrative level. Also, consider the likelihood of settling on appeal.

Perhaps, most important, consider the prospective impact of audit adjustments.

## Choice of Forum

### ***Federal Court***

Because sales and use tax is imposed at the state level, there is generally no jurisdiction in Federal Court (unless there is no plain, speedy, and efficient remedy at state law). See 28 U.S.C. § 1341.

### ***Administrative Agency Appeal***

The process for appealing an audit assessment varies by state. Most states require a formal process, which includes the filing of a Petition or Application, along with a narrative of the taxpayers facts, the type of relief requested, and the reasons why the taxpayer is entitled to such relief. Representation is strongly recommended during the appeal process. In many states, the administrative agency is often the same taxing authority that issued the assessment. As a result, the taxpayer may be at a disadvantage.

The time permitted for filing a claim varies by state, and is often provided in statutory provisions.

## Making the Trial Record

### *Administrative Tribunal*

It is incredibly important to preserve all potential arguments at the administrative level, in the event that the matter is to be appealed to court.

**Non-Record Appeal** - A non-record appeal is informal. Witnesses may or may not be presented, depending upon the case. However, all information that is necessary to support your argument should be presented at this time.

**Record Appeal** – A record appeal is more formal. All evidence must be presented (the rules of evidence may be liberally construed), including witness, exhibits, etc. Depending upon the complexity of the case, the agency may request memoranda of law or briefs.

## Judicial Review

### ***Trial Court***

The trial court is only relevant if you have a non-record administrative appeal. The trial court could be a court of general jurisdiction, a state tax court, or an appellate court with special original jurisdiction in relation to tax cases.

This is a very formal proceeding, governed by state rules, including rules of evidence. Also, the corporate taxpayer **must** be represented by counsel; whereas an unincorporated taxpayer may appear *pro se*.

### ***Appellate review***

Appellate review is before a state appellate court, based upon the record made before either the trial court or record administrative tribunal. Appellate review involves briefing the legal issues raised below and oral argument before the court. It is extremely important to understand that the only issues raised on appeal are issues which were raised below. Appellate review follows the state's rules of appellate procedure through to the state supreme court. The court will give extreme deference to the findings of fact at the lower level. There should be a disputed issue of law.

## Trial Process

### *Pre-Trial Preparation*

Pre-trial preparation involves a variety of things, including:

- Identification of legal issues.
- Legal research.
- Determine facts needed to prove case.
- Interview client.
- Identify witnesses.
- Discovery (Formal or Informal)
- Preparation of witnesses.

## Trial Process (cont.)

### *Trial*

Significant considerations during the trial are:

**Fact witnesses** – These witnesses include those that have factual information related to the case, such as employees, vendors, customers, etc.

**Expert witnesses** – These witnesses include those that have a specific expertise related to an issue of the case. For example, (Utility study engineer).

**Burden of proof** – Generally on the taxpayer.

**Burden of persuasion** – Generally on the taxpayer.

# Other Considerations

# Other Considerations

## Managed Audits

Many states now provide taxpayers with the opportunity to perform managed audits. Managed audits, are in a general sense, a self audit of taxpayer records. Depending upon the state, taxpayers may be able to obtain automatic penalty waiver, and reduced interest.

For example, Florida has the Certified Audit Program, which is a cooperative effort between the Florida Department of Revenue and the Florida Institute of Certified Public Accountants. This program gives taxpayers the opportunity to hire, at their own expense, qualified CPA firms to review their tax compliance. As an incentive to incur the cost of a certified audit, penalties are waived and interest abated if tax is owed as a result of the audit. Additionally, except in cases of fraud or misrepresentation, the Department will not audit taxpayers for the same period or tax covered by the certified audit period.

# Other Considerations

## E-Auditing

Electronic auditing, or E-Auditing, is computer assisted auditing that uses electronic records to complete all or part of the audit. If you use a computer to record your business activity and maintain this data electronically, you are a candidate for an electronic audit.

During an electronic audit, you provide electronic (machine-sensible) records and the Department uses computer software programs to analyze the data. If the data is available electronically, it may eliminate the need for sampling, and thus a detail audit can be performed.

# Voluntary Disclosure & Amnesty

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## Voluntary Disclosure Agreements (“VDA’s”)

Voluntary disclosure programs are offered by many states to business taxpayers who are not in compliance with state tax laws. While the requirements differ by state, a requirement that is fairly standard from state to state is that the company must not have been previously notified by the state or an agent thereof in relation to any outstanding liability. Some states also hold their programs open only to those companies that are not registered for sales and use tax purposes in the state. The company is required to pay the outstanding taxes plus interest, and is generally required to register and file on a prospective basis.

# Voluntary Disclosure & Amnesty

## Voluntary Disclosure Agreements (cont.)

The advantages of a company entering into a VDA with a state is that:

- The state will often limit the lookback period (the period in which they will go back and assess tax) to a limited period, such as three or four years.
- The state will also generally waive penalties associated with any outstanding tax liability. It is rare that a state will waive interest on outstanding liabilities.
- The State generally agrees not to audit periods prior to those negotiated under the agreement.

# Voluntary Disclosure & Amnesty

## Amnesty

On occasion, in addition to the voluntary disclosure programs, states will offer companies the opportunity to voluntarily pay back taxes by offering an amnesty program. Tax amnesty is an opportunity for companies to pay taxes owed to the state without penalties, and often at reduced interest rates. Amnesty programs are generally only offered for a limited period of time (i.e., one month, four months, etc.), but often cover all open years for taxes. As with voluntary disclosure programs, the requirements are different by state, and should be closely reviewed.

# Voluntary Disclosure & Amnesty

## Amnesty

Amnesty programs can be differentiated from voluntary disclosure programs as follows:

- Amnesty programs often offer reduced interest rates on payment of taxes, whereas voluntary disclosure programs often charge interest at the statutory interest rate.
- Amnesty programs may often include taxes, which have been previously assessed by the State, whereas in order to participate in a voluntary disclosure program, a company must not have been previously notified by the State of an outstanding liability.
- Amnesty programs often do not have a limited lookback period, whereas voluntary disclosure agreements do.
- Amnesty agreements sometimes require a taxpayer to waive their rights to protest a tax assessment or to apply for refunds of taxes for the period included in the agreement.

# Voluntary Disclosure & Amnesty

## Current Amnesty Programs

Amnesty programs that are upcoming or are underway are:

- California (Ends 3/31/05)

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