

# Managing Sales and Use Tax Risk: Reviewing Nexus Activities, Procurement Processes and Policies to Minimize Exposure

TUESDAY, MAY 2, 2017, 1:00-2:50 pm Eastern

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# Managing Sales and Use Tax Risk

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May 2, 2017

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# Managing Sales and Use Tax Risk

5

## **Records and Processes to Examine in a Sales and Use Tax Compliance Review**



# Records and Processes to Examine in a Sales & Use Compliance Review

6

- What is A Compliance Review?
  - Comprehensive analysis of the sales tax compliance processes and requirements with various jurisdictions for sales of products and services and purchases for resale and consumption
  - Report provides findings of nexus, historical exposure, solutions to address historical exposure and provides recommendations for enhancing the Company's multistate sales tax compliance processes
  - Don't want to move forward without considering the past



# Records and Processes to Examine in a Sales & Use Compliance Review

7

- What is A Compliance Review?
  - Interview tax/finance, sales and operations
  - Review nexus factors through multistate nexus questionnaire
  - Rank nexus scores in each state
  - Audit sales and purchases for historical exposure
    - This can be based on sales tax decision matrix or high-level assumptions
  - Quantification of sales and use tax exposure



# Records and Processes to Examine in a Sales & Use Compliance Review

8

- What is A Compliance Review?
  - Stratification of states based on exposure and nexus analysis
  - Recommendations to address historical nexus and exposure include voluntary disclosure and available amnesty
  - Recommendations to address and enhance prospective compliance processes include registration, sales tax decision matrix, automated compliance and exemption certificate mgmt, website, collateral, contract and invoice literal changes, and record retention, and use tax accrual processes





# Records and Processes to Examine in a Sales & Use Compliance Review

9

- What processes to review
  - Nexus - Sales / Delivery / On-site Services (more on this later)
  - Contracts / Invoices - what do they say about what you sell?  
And where - delivery and transfer of title?
  - Record retention
    - Resale and Exemption Certificates
    - Audit Trail Documents - invoices and detailed reporting
  - Tax Decision Matrix - properly taxing what needs to be taxed?
  - Rates - properly rating what needs to be taxed?



# Records and Processes to Examine in a Sales & Use Compliance Review

10

- What records to review
  - Summary of sales by customer by state and listing of any resellers / exempt customers
  - Summary of monthly AND by revenue category 3 yrs
  - Detailed monthly sales by state for 3 yrs: Customer Name, Sale to Jurisdiction, Invoice Number, Invoice Date, Invoice Amount, Revenue Category, Invoice Detail/Description
  - Copies of several sample contracts and invoices for the mix of products and services
  - Access to sales invoices, contracts, certificates - sample



# Records and Processes to Examine in a Sales & Use Compliance Review

11

- What records to review
  - Fixed Asset schedule, including purchase date and location
  - Expensed Purchase report, summarizing purchase activity by account and location for 3 yrs
  - Payroll by state
  - Listing of states in which sales representatives travel, including for tradeshow for 3 years
  - A listing of any subsidiaries and affiliates operating in the US, and all information above relating to their activities
  - Existing Tax Decision Matrix

# MANAGING SALES AND USE TAX RISK

## Nexus Reviews to Ensure that the Company Identified Potential Areas of Risk

By Martin I. Eisenstein

# NEXUS REVIEWS: OUTLINE

- Background re nexus
- Why it is important to know about nexus
- Nexus Questionnaires
- Remedial Measures

# NEXUS BACKGROUND

- Nexus:
  - When a company is subject to state tax
  - Both statutory and constitutional standard
  - Different standards depending upon tax
  - Entity nexus
    - Not divided by product line, activity or division
    - Nexus of one division or activity gives nexus for the entire entity with a few exceptions

# SALES TAX NEXUS STANDARDS

- Constitutional Commerce Clause Standard Under Sales Tax: Physical Presence – *Quill* (1992)
  - Property
    - Facility
    - Tangible Personal Property -Inventory
  - Employees
    - Located in state
    - Travel to state

# SALES TAX NEXUS STANDARDS (CONT'D)

- Third Parties: Agents and Representatives
  - Solicit sales
  - Drop ships
  - Order Fulfillment-White Glove
  - Installation/Repairs
  - Fulfillment by Amazon
  - Amazon Marketplace
  - Apple contracts
- Click Through Nexus statutes



# CURRENT DEVELOPMENTS: AFFILIATE STATUTES

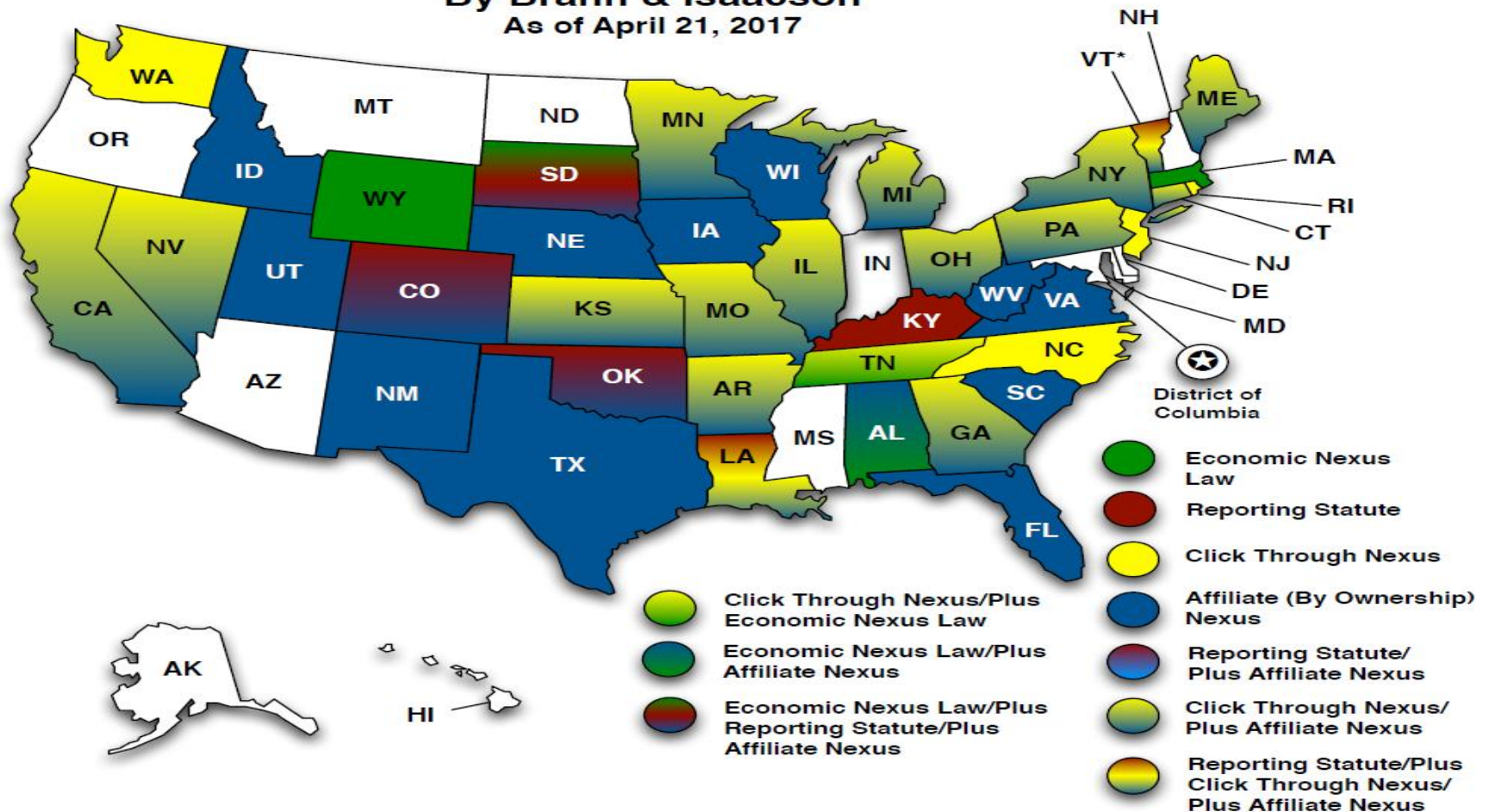
- Member of commonly controlled group of companies:  
Affiliate Nexus
  - E.g. CO, OK, UT
- Out of state retailer uses in-state affiliate to distribute goods or service products.
  - E.g. TX statute
- Affiliate sells under same trademark
  - E.g PA regulation
  - *New Mexico Taxation and Revenue Department v. Barnesandnoble.com LLC*, 303 P.3d 824 (2013)
  - *St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F.Supp2d 575 (EDLa. 2007)

# ANTI-QUILL STATE LEGISLATION

## Anti-Quill Laws

By Brann & Isaacson

As of April 21, 2017



# SAFE HARBORS REGARDING NEXUS

- Use of Servers in State
  - CA/TX/WA statutes and rulings in other states
- Trade Shows
  - CA
  - MA
  - FL
- Printers
  - States include CT, FL, GA, IL, IN, KY, ME, MN, OH, OK, PA, SC, UT, VA, WV and WI
    - Storage of paper
    - Visits by personnel

# INCOME TAX NEXUS

- Constitutional standard may be different than sales tax standard
- PL 86-272: federal statutory exemption for out-of-state company if:
  - Employees or agents merely solicit sales;
  - Orders are approved outside of state;
  - Delivery of products from inventory outside of state; and
  - Sales are only of tangible personal property.

# GROSS RECEIPTS TAXES NEXUS

- Only a few states have gross receipts taxes: WA, OH, TX, TN and NV and some local jurisdictions in CA
  - WA B & O tax (except for tax on wholesalers and providers of services) requires activity conducted in the state on behalf of the company that establishes or maintains a market for the company's products
  - OH (CAT), and TN (Business Taxes) statutes provide nexus if annual sales to state exceed \$500,000; WA for wholesale and service if sales greater than \$267,000; NV (Commerce Tax): sales greater than \$4 million

# LESSONS

- *Quill* remains good law, but be careful about other state taxes.
  - Income taxes: *KFC Corp. v. Iowa Dept. of Revenue*, 792 N.W.2d 308 (Iowa 2010); *Capital Bank One v. Commr. of Revenue*, 453 Mass.1, (2009); *Geoffrey, Inc. v. South Carolina Tax Comm.*, 313 S.C. 15 (1993).
  - Gross Receipts taxes: *Crutchfield v. Testa*, Ohio Supreme Court Slip Opinion No. 2016-Ohio-7760 (November 17, 2016)
- States on a witch hunt for nexus. See MA Department of Revenue Directive 17-1.

# KNOW ABOUT NEXUS

- Exposures may be large if nexus and don't collect sales tax from customers, who are the taxpayers
- Nexus may create liability for taxes other than sales taxes
- There is no statute of limitations for failure to file tax returns; thus potential back tax liability
- Inform senior management/finance department beforehand so appropriate remedial measures can be taken

# NEXUS AUDIT: GENERAL PRINCIPLES

- Conducted by counsel and company management on behalf of counsel
  - Important to start the audit correctly to maximize attorney client privilege
    - Be careful about Company management and accountants conducting the review
- Begin with a written questionnaire
- Follow up interviews



# THE NEXUS QUESTIONNAIRE

- Gather Information Under Attorney Client Privilege
  - Location of offices
    - In-home offices
      - Company owned equipment
      - Telephone number listing on cards etc.
  - Location of employees
  - Location of fixed assets

# THE NEXUS QUESTIONNAIRE

- Gather Information Under Attorney Client Privilege
  - Location of inventory
    - Consignment Relationships (FBA)
  - Drop Ship Arrangements
  - How are goods delivered to customers
  - White Glove Service
    - Determine whether unpacking as well
  - Installation
  - Service

# THE NEXUS QUESTIONNAIRE

- Gather Information Under Attorney Client Privilege
  - How are orders obtained/customer relationships established
    - Company employees
      - Travel
      - Trade Shows: Locations and nature of activities there
      - Number of days of trade shows
    - Third party agents/representatives
      - Location
      - Travel

# THE NEXUS QUESTIONNAIRE

- Gather Information Under Attorney Client Privilege
  - PL 86-272 issues:
    - (Acceptance of orders); collection/returns
  - Return of Merchandise?
  - Repairs of Products?
  - Affiliates with nexus
    - Common activities/Common names
  - Marketplace arrangements-Amazon or Walmart
  - Sale of products through Apple

# NEXUS AUDIT-THE MANAGEMENT TOOL

- Counsel should produce a report
- The report should advise management
  - The level of nexus risk of various activities
  - Quantification of the exposures and the level of risk on a state-by-state basis
  - Consider effect on reserves: ASC 450-20
  - Advise of recommendations to reduce risks and exposures and limit nexus risk in the future

# REMEDYING THE EXPOSURES/RISKS

- Addressing risk and exposures:
  - Obtain advisory opinion or cold comfort letter for grey area activities
  - Determine whether Activities may be restructured or limited to decrease the nexus risk or fit within a safe harbor
    - Examples: Transfer of Title; Shift Activity to Another State; Change Nature of Relationship With Third Party
  - Restructure company to ring fence the nexus.
  - Determine whether to provide guidelines for future activities

# ADDRESSING CLICK THROUGH RELATIONSHIPS

- Require in T's and C's affiliate not to do in-state solicitation, including
  - Distributing flyers, coupons, newsletters and other printed promotional materials; emailing from state; verbal solicitations in state; and initiating telephone solicitations from New York.
- Obtain a certificate of compliance annually
  - Provide in T's and C's for termination of the affiliate from the retailer's affiliate program for failure to submit certificate.

# REDUCING THE EXPOSURES

- Consider Voluntary Disclosure Agreement
  - Can be done on a state-by-state basis or through the Multistate Tax Commission Voluntary Disclosure Program
  - Lookback periods vary
- Procedure for Voluntary Disclosure Agreement
  - Approach the state or MTC without identifying company
  - Describe the company's products and sales level
  - Make representations regarding whether company has been noticed for audit



# REDUCING THE EXPOSURES

- Amnesty
  - “Encouragement” for taxpayers to come forward is a waiver of some or all penalties and limitation of interest
  - Unlike VDAs, taxpayer is identified in first instance.
  - Recent examples
    - TN; OK
- Consider Silent Registration: Bright Line Event





# Managing Sales and Use Tax Risk

35

**Develop, Automate and Review a Sales Tax  
Decision Matrix**



# Develop, Automate & Review Sales Tax Decision Matrix

36

- What is a Tax Decision Matrix?
  - A tax table containing taxability determinations relating to the company's sales and purchases, which can then be automated.
  - Can be used manually, but this is inefficient and can be ineffective, creating audit exposure
  - Must be regularly reviewed / updated
- Sales and use tax compliance software
  - Automated tax decision, rating and return preparation
  - Keep accounting personnel focused on higher-value work
  - Data archived for audit purposes



# Develop, Automate & Review Sales Tax Decision Matrix

37

- Sales and use tax compliance software: Requirements
  - Must consider and ensure seamless integration with accounting/billing platforms
  - Even with automation, there is human involvement, which always leads to the potential for error.
  - Minimize humans interaction but create reviews by tax for select accounts, problem vendors, big purchases over materiality threshold.



# Develop, Automate & Review Sales Tax Decision Matrix

38

- Sales and use tax compliance software: Requirements
  - Systems must address who, what, when, where, hows
  - Map each tax decision and tax category code to
    - customer profile - are they exempt? do we have certificate?
    - product code - what is being sold?
    - invoice date and title/possession transfer - shipping terms (FOB Origin v. FOB Destination) and timing of event
    - jurisdiction - ship to, service delivery/performance
    - how being delivered - electronic



# Develop, Automate & Review Sales Tax Decision Matrix

39

- Sales and use tax compliance software: Requirements
  - Purchases - more complicated, but still address who, what, when, where, hows
  - Have to review purchase invoices and removal of goods from inventory, and multi-state use (software, promos) for proper jurisdiction, proper taxability, proper rate
  - Use tax compliance software can map purchases tax category, based on account type, vendor, jurisdiction and delivery mode
  - Ensure record-keeping for audit purposes
  - Human involvement in set-up, p.o. coding review of specific accounts and vendors minimizes audit risk



# Develop, Automate & Review Sales Tax Decision Matrix

40

- Sales and use tax compliance software: Requirements
  - More detailed, tax-centric descriptions in contracts and invoices reduce audit exposure
  - Statutory exemptions must be addressed
  - Exemption Certificate Management platforms
  - Some transactions are exempt based on interstate commerce, and consideration must be given to multiple jurisdictions and when title is transferred.





# Develop, Automate & Review Sales Tax Decision Matrix

41

- Sales and use tax compliance software: What systems are available
  - Avalara
  - Vertex
  - Taxware
  - BillSoft EZTax
  - TaxJar and Taxify for e-commerce platforms



# Develop, Automate & Review Sales Tax Decision Matrix

42

- Sales and use tax exemption certificate management:
  - Create, validate, store, manage certificates
  - Integrate with ERP, accounting, tax decision and POS systems
  - Automation Tools -
    - Avalara CertCapture, Vertex ECM, ONESOURCE TCM
    - Can implement “home grown” platform into ERP, scan and manage certs and interface with billing and tax systems

# MANAGING SALES AND USE TAX RISK

## Intra-Company Questionnaires to Discern Problem Areas

By Martin I. Eisenstein

# OUTLINE OF TOPICS

- Overlap with Following Section Re Determining Risk
- Planning
- Structuring Questionnaire
- Use Tax: Sampling

# WHY PLANNING IS IMPORTANT: CURRENT AUDIT PRACTICES

- Hungry for money because of fewer federal dollars, states have increased the number of sales and use tax audits
- Many state auditors have begun to “Assess First and Talk Later” rather than working with the taxpayer to achieve an agreed-upon result
- States have adopted new procedures to make it more difficult to defend the sales tax audit:
  - New audit “methodology” for inadequate records;
  - Completeness testing
  - Rejecting self-issued resale certificates
  - Scrutiny of Exemption Certificates

# PLANNING

- Planning should be undertaken long before an audit takes place in order to minimize exposures
- Like nexus planning, should be undertaken to maximize the confidentiality of the results
  - Consider under supervision of counsel
  - Memo from counsel requesting review to facilitate provision of legal advice
- Documents marked as confidential and subject to attorney client privilege

# PLANNING

- General business questions:
  - Understand the software/accounting systems/  
sales and expense records:
    - Software systems used
      - ☐ For financial records, such as SAP
      - ☐ For order entry
        - Different systems for different channels?
    - Does client use a third party CSP such as Avalara  
or does it prepare and file its own returns?

# PLANNING

- General business questions:
  - Understand the software/accounting systems/ sales and expense records:
    - Type of journals (sales etc.)
    - Chart of Accounts and G/L Codes of relevance
    - Type of ledgers (fixed assets/accounts payable)
  - Extent of underlying records including record retention
    - Confirm consistent with state requirements
      - Unclaimed Property-DE 10 years



# STRUCTURING THE QUESTIONNAIRE

- General business questions:
  - Nature of client's business (manufacturer, service provider, distributor, construction etc.);
    - Any special exemptions available (e.g. Data centers)
  - How your client does business—sales representatives/employees/distributors
  - Location of offices, assets and employees;
  - Type of customers: Exempt organizations

# STRUCTURING THE QUESTIONNAIRE

- Additional general business questions:
  - Type of products and services client sells.
    - Review relevant contracts/promotional materials/website to determine product/service tax characterization of products client sells
  - Is there a tax matrix?
    - How often is the matrix updated to address changes in client's product/service line?
    - Integration of tax matrix with order system

# STRUCTURING THE QUESTIONNAIRE

- Additional general business questions:
  - Where client sells products and services
    - Estimation of sales by state?
    - Can client's data base be used to estimate sales by state and type of product?
  - Billing question issues
    - Determine whether client's billing/order system assesses sales tax and the reliability of such system.
    - Confirm states for which tax collected and client's registration in the state
    - Confirm remittance of the tax with the return

# STRUCTURING THE QUESTIONNAIRE

- General business questions
  - Billing question issues
    - Determine if there are any instances where tax has not been remitted and rectify as soon as possible
      - Registration
      - Refund of tax collected to customer if not registered
      - Filing amended returns if registered

# STRUCTURING THE QUESTIONNAIRE

- Resale/exemption certificates
  - Determine whether obtained?
  - Determine how often updated?
  - Determine where maintained?
  - Test to determine whether have prepared properly
- Direct Payment Permits?
  - Determine if obtained from customers?
  - Test to determine if satisfies applicable state standard.

# STRUCTURING THE QUESTIONNAIRE

- Other Issues
  - Significant accounting changes within the audit period
  - Business model changes within the audit period
    - New service lines
    - New cost centers and/or general ledger accounts
    - New business segments (mergers & acquisitions)

# STRUCTURING THE QUESTIONNAIRE

- Other Issues
  - Sales Journals don't identify TPP destination/benefit received for services
    - Invoices: Identify billing address but not destination or benefit of services location
    - Many companies lack invoices but simply have billing data without address information

# USE TAX ISSUES

- Use Tax: Determining Taxable Purchases and Tax Due
  - Expenses: Accounts Payable Ledger & Journals
  - Fixed Assets: Fixed Asset Subledger
- Challenges
  - Accrual entries
  - Control Accounts (Assets not put into service)
  - Determining location of use
  - General ledger accounts do not identify taxable expense
  - Fixed Asset Register may not identify location of Asset



# USE TAX ISSUES

- Goal: All tax paid on taxable purchases either to vendor or accrued and paid with the return.
- How determine?
  - Most realistic way is by sampling (i.e. to do a reverse audit)
- Sampling of expenses;
  - Select relevant expense accounts from chart of accounts
    - Review accounts payable records for accounts selected
      - Pull relevant invoices and accrual records
      - Determine deficiencies and remediate

# USE TAX ISSUES

- Determining the population from which to determine fixed asset purchases
  - Fixed Asset Register or Subledger
  - Determine location of fixed assets
  - Review invoices/accounting entries to determine if tax paid
    - Determine state of tax paid
    - Determine deficiencies and remediate





# Managing Sales and Use Tax Risk

60

## **Develop Audit Best Practices and Protocol**



# Develop Audit Best Practices and Protocol

61

- Taxpayers are audited by state auditors who are:
  - Often inexperienced and poorly trained
  - Don't understand sampling methods
  - Don't understand the taxpayer's business
- This often leads to assessments that are vastly overstated
- Audits Focus on
  - Taxable Purchases (Use Tax vs. Sales Tax)
  - Then Taxable Sales
  - Reconcile Sales & Use Tax accounts
  - Other unique transactions



# Develop Audit Best Practices and Protocol

62

- Audit Process Only Begins with a Notice of Intent to Audit
- Audit Actually Began 3-4 years ago
- Pre-Audit: Audit Thyself!
  - Review the Items to be Audited
  - Certificates & Documentation
  - Determination & Positions
  - Review Compliance and Audit History

**PRACTICAL TIP:** Control the Flow of Information - taxpayers are often intimidated but they should not turn over information without agreeing to its use and implications prior to releasing



# Develop Audit Best Practices and Protocol

63

- Initial Meeting & Workplan: Set the Tone
  - Introduce auditor to your Company and record-keeping / compliance processes
  - Manage expectations
    - Discuss what information you can provide and if unavailable, suggest alternatives
    - Discuss timing of information
  - Set milestones and a date for the audit to conclude
  - Set site ground rules for when / where audit may work on-site



# Develop Audit Best Practices and Protocol

64

- Initial Meeting & Workplan (cont' d)
  - Discuss how to handle Missing or Insufficient Documentation
    - Company purchasing cards and electronic transactions
    - Bundled services
    - Exemption certificates
  - Discuss how to handle overpayments, then get to work
  - Document all communications and Request that the Auditor issue all Request for Information in Writing as well





# Develop Audit Best Practices and Protocol

65

- Initial Meeting & Workplan (cont' d)
  - Sampling - pros and cons
  - Statistical vs. Nonstatistical
  - Discuss, but avoid written sample agmts
  - Discuss if you can select the sample - Recommend any sample periods that you have previously reviewed and with which you are comfortable
  - Discuss treatment of large, non-recurring items - isolate
  - Discuss whether overpayments can be included in the sample results



# Develop Audit Best Practices and Protocol

66

- Waiver of Statute of Limitations
  - Extends the time the auditor has to complete the audit beyond the statute of limitation
  - Can extend the audit timing to a more convenient time and enable taxpayer to gather information
  - Enable taxpayer to identify offsets - make sure waiver covers over and under-payments
  - Absent a waiver, auditor may issue assessment to protect period (jeopardy assessments)
  - Consider how long to extend - 3 mos / 6 mos / never more



# Develop Audit Best Practices and Protocol

67

- Based on Initial Conference, draft Audit Guidelines and provide to auditor
  - Security, access to space / records, hours
  - All questions to be in writing
  - Encourage face to face meeting for all Q&A, then document
- Request Updates and Review Workpapers at every step of process
- Review Final Workpapers and Sampling Projections
- Present Overpayments & Offsets
- Closing Conference

**PRACTICAL TIP:** The best way to reduce potential exposure is to identify it and develop a strategy to keep it off the workpapers



# Develop Audit Best Practices and Protocol

68

## ➤ Appeals

- Expert - if you have not already done so, retain an expert
- Venue - administrative versus courts: administrative hearings are typically less formal and may be more flexible in the issues put forth, but they are typically not independent tribunals
- Exhaustion - if the outcome at administrative level is not favorable, consider seeking a compromise or re-consideration before appealing to courts

## ➤ Remedial Efforts

- Make sure to address the issues in your compliance processes to avoid future liabilities on these issues



# Develop Audit Best Practices and Protocol

69

## ➤ Common Audit Issues

- Documentation - Missing / Insufficient
- Resale / Exemption Certs
- Proper rates - automation
- Digital transactions - does invoice indicate elec. delivery
- Bundled / Mixed transactions - “true object” test
- Use tax on purchases
- XYZ to ensure no double taxation
- Invoice presentation
  - what does it say / not say about what you sell
  - Bill To vs. Ship To



# Develop Audit Best Practices and Protocol

70

## ➤ Best Practices

- Your Company's audit started 3 - 4 years ago - always be auditing yourself
- Be kind to your auditor
- Manage the audit and document flow
- Manage expectations
- Reporting and Documentation - paper trail
- XYZ Letters - use them
- Exemption / Resale Certificates - get them
- Invoice presentation - separately stated and tax considered descriptives for line items
- There are sales tax experts out there

# MANAGING SALES AND USE TAX RISK

## Use of Prior Year Filings, Previous Audits and Other Documentations to Determine Sales and Use Tax

By Martin I. Eisenstein

# OUTLINE OF TOPICS

- Use of Prior Audits and Filings
- Problem Areas and Documentation
  - Drop Shipping
  - Resale Certificates
  - Exemption Certificates
  - Direct Pay Permits
  - Use Tax on Promotional Materials
  - Shipping and Handling



# USE OF PRIOR AUDITS

- Determine prior assessments/audits to prevent penalty from state in the future
- Determine prior assessments/audits from any state as a roadmap to possible areas of vulnerabilities
  - Analyze deficiencies in coding for taxability of products
    - Are changes in the tax matrix necessary because the state has a different view of the category of products
  - Analyze whether client had retained sufficient resale/exemption certificates
    - Request resale/exemption certificates

# USE OF PRIOR AUDITS

- Prior audit may be an indication that client is not properly sourcing sales
- Prior audit may show that invoices do not itemize products and services into taxable and non-taxable products and services are charged at a single price for the bundled product.
  - Consider re-invoicing and change in invoicing practice in the future
- Prior audit may be an indication that use tax is not paid on purchases of fixed assets to state where assets are maintained
  - Provide for accrual of use tax when purchase assets for delivery to a different state.

# SPECIAL AUDIT ISSUES

## DROP SHIPPING/RESALE CERTIFICATES

- Certain States Do Not Accept Resale Certificate If Issued Without State Registration Number
  - CA
    - “Deemer” Statute
    - 110% of wholesale price
  - DC
  - FL (Unless drop shipper shipping from outside FL)
  - MD
    - Wholesale Price
  - TN
- Multistate Tax Form / SSUTA Form (See Appendix)
  - Determine states that require resale certificate
  - E.g., NY/VA

# SPECIAL AUDIT ISSUES

- States That Require Customers To Complete
  - AZ
- Timeliness of Certificate
  - TX – 60 day window from notice to provide if didn't receive at time of sale
  - WA – obtain certificate within 120 days of sale; other wise must specify the sale(s) to which it applies
  - SSUTA Rule – obtain certificate within 120 days of registering
- Direct Pay Permits
  - Relieves Seller From Tax
  - But
    - Does not apply to services in some states.
    - TX: Need certificate, not registration number. See Appendix

# SPECIAL AUDIT ISSUES

- Multiple State Use
  - Certificate of Multistate Points of Use
  - Available only in certain states; e.g. NY, TX
    - See attached.
- Shipping and Handling: Not taxable in some states
  - Traditional Requirements for Exemption
    - Shipped by Common Carrier
    - Charges Separately Stated
    - Delivery After Sale

# SPECIAL AUDIT ISSUES

- Invoicing of taxable and non-taxable products.
  - A price for a bundle of separate products and services in which one product is taxable and another product/service is not taxable means that the entire charge is taxable
    - NY cheeseboard rule. *N.Y. Comp. Codes R & Regs. Tit. 20, section 527.1(B)*
  - Cardinal Principle: Separately price and invoice separate charges for different services/products

# SPECIAL ISSUES

- NY Cheeseboard Rule followed in most states, with some exceptions:
  - Internet Tax Freedom Act: Combination of telecom services with Internet services may be separated into taxable and non-taxable Internet access *ITFA*, § 1106, 47 *U.S.C. 151 note*.
  - Most state laws permit a provider of telecom services to separate taxable telecom charges from non-taxable telecom charges based on its books and records.
  - Section 330 of SSUTA provides for “unbundling” of certain services (based on costs), including telecom services, ancillary service, Internet access and audio/video programming services

# SOURCING

- Common sourcing of sales of products/services:
  - The cascade approach for sales: Advance to the next tier only if prior tier does not apply
    - First tier: Product received at seller's business (or first use of taxable service made)
    - Second : Location of purchaser's receipt, if known to seller
    - Third : Address of purchaser from seller's records determined in good faith
    - Fourth: Address obtained from transaction or from payment instrument, determined in good faith
    - Fifth tier: Location of shipping point for goods, where made available for transmission of digital products or from where service provided



# SPECIAL ISSUES

- Use Tax On Promotional Materials
  - Several States Provide Exemptions
    - E.g. CA, MA OH, PA, NY, IL, VA, WI
    - Typical Requirements
      - Materials Free of Charge to Recipient
      - Promotional Materials Such as Catalogs and Other Advertising Literature
      - Distribute by U.S. Postal Service (PA) and Common Carrier (other states)

# EXAMPLES OF WHAT WENT WRONG

- FL “New methodology” for re-situsing of communications services taxes to local jurisdictions
  - Use of simple average of local addresses without weighing by dollar amounts and offsets for overpayments
- Taxpayer supplied multiple lines of sales data, one showing state tax and one showing local tax, but taxpayer did not appreciate it was the same sales, but different taxes assessed.
  - Audit assessed both sets of sales.
  - Uncovered once taxpayer’s representative reviewed detail.

# EXAMPLES OF WHAT WENT WRONG

- Taxpayer failed to provide sales data from sales journals that tied to state income tax returns
  - Audit assessed based on sales factor of state income tax returns
    - Some sales not taxable
    - Some sales not properly sourced to assessing state.
- Taxpayer took network equipment exemption in VA
  - VA statute must measure non-exempt use
  - Taxpayer did not provide information
  - State tax agency used industry average
  - At protest able to use current usage as proxy for usage during audit period

# EXAMPLES OF WHAT WENT WRONG

- Auditor devised a sampling plan that attempted to measure taxable expenses, fixed assets and taxable purchases per construction contracts on leased facilities
  - Auditor did not test population: some assets in fixed assets were also part of the leasehold improvements as part of the construction contracts
- Detailed analysis of four G/L expense accounts
  - Application to other G/L accounts
    - Proof that four G/L accounts are not representative.

# EXAMPLES OF WHAT WENT WRONG

- Auditor tested taxability based on GL entries
  - Failure to account for accrual entries
  - Failure to account for non-taxable transactions
  - Failure to adequately source: use of population statistics is not necessarily a good proxy for use in the state
- Fixed Assets
  - Fixed Assets ledger shows only assets still owned at the end of the audit period.
    - Proof of those assets that were purchased and disposed of during audit period.
    - Auditor arbitrarily doubled for five year audit period.
    - Proof of few disposals during the audit period

# EXAMPLES OF WHAT WENT WRONG

- Determining taxable sales for a long audit period
  - Use of current measure to project for prior period without accounting for differences in types of products sold.
- Auditor determined the taxable percentage for fixed assets. Client also had a control account. Auditor applied taxable percentage to control account
  - Duplicate assets in control account and in fixed assets
  - Differences in control assets—software—vs all fixed assets
  - Taxable error rate did not take into account clearly not taxable assets

# CASE STUDIES

## Case Study # 1 – Use tax audit by home state of non-filer

- Factual Background: Provider of non-taxable services so no sales tax liability/failed to file use tax returns/significant purchase of taxable services and products and out-of-state purchases/contacted by home state three weeks before audit.
- What didn't work: Failure to contact knowledgeable adviser before audit visit.
- What worked: (i) self-audit once notice helped see skeletons and structure sampling; (ii) cooperation with audit team to provide information requested on a timely basis; (iii) documentation of audit interactions; (iv) development of legal position memos re issues; and (v) jawboning with auditor.

# CASE STUDIES

## Case Study # 2 – Large multi-state seller of taxable services; audit by home state.

- Factual Background: Had filed monthly sales and use tax returns but had a series of tax managers; counsel not contacted until after first meeting with auditor; auditor did not understand client's business.
- What didn't work: Information provided to auditor by tax manager without review by outside professional.
- What worked: (1) Limited audit to three year period of limitations, despite a potential 6 year period by restricting information produced to three year period; (2) demand for audit work papers at an early stage and creating paper record of the same so that could appeal to the auditor's supervisor; (3) reduced potential sales tax assessed by demonstrating faulty legal positions taken by auditor by appealing to auditor's boss; (4) demonstration of incorrect calculation of error rates by faulty logic; and (5) description of client's services in a clear fashion to avoid taxation of same.



# CASE STUDIES

## Case Study # 3 – Large multi-state seller; audit by state with nexus but where client not headquartered.

- Factual Background: Audit initially handled by outside public accountant that were not familiar with sales tax issues for client's business; outside counsel consulted after notice of proposed assessment.
- What didn't work: (1) resisting information requests; (2) failure to document audit requests and responsiveness to show that auditor at fault, and not client at fault; and (3) outside advisor not reviewing and analyzing information to be provided to auditor.
- What worked: : (1) discussion with auditors as to how to satisfy information request; (2) persuading client to provide information; and (3) demonstration that positions taken by auditor were not grounded in fact.

# Martin Eisenstein

For more than thirty years, Mr. Eisenstein has regularly advised, counseled, negotiated and handled litigation and transactions regarding state and local tax issues and unclaimed property matters, including compliance, audits, and litigation. His current areas of focus include state and local taxes on retailers and providers of IT products and services.

Mr. Eisenstein has represented the Direct Marketing Association (“DMA”) as amicus curiae in the U.S. Supreme Court cases of *Quill v. North Dakota*, 504 U.S. 298 (1992) and *D.H. Holmes Company, LTD*, 486 U.S. 24 (1988), and has also represented Newegg and the DMA as amicus curiae in the petition for certiorari filed in the U.S. Supreme Court in the Amazon.com and Overstock.com New York litigation. Among the cases in which Mr. Eisenstein has handled are: *AOL Inc. v. Department of Revenue*, Washington Superior Court, No. 12-2-012005, July 26, 2013; *AOL LLC v. Iowa Dep’t of Revenue*, 771 N.W. 2d 404 (Iowa 2009); *Random House, Inc. v. Div. of Taxation*, 23 N.J. Tax 291 (2006); and *L.L. Bean, Inc. v. Tax Assessor*, 649 A.2d 331 (Me. 1994).

Mr. Eisenstein and his firm have represented Performance Marketing Association in *Performance Marketing Association v. Hamer*, 998 N.E.2d 54 (2013); the DMA in *Direct Marketing Association v. Brohl*, 135 S.Ct. 1124 (2015); Newegg, Inc., Crutchfield Corporation, and Mason Companies Inc. in the cases in the Ohio Supreme Court that challenged the constitutionality under the Commerce Clause of the Commercial Activity Tax based on sales alone. In a 5-2 decision the Ohio Supreme Court determined that the CAT economic presence test does not violate the Commerce Clause. The cases were settled prior to filing of a petition for *certiorari*; and Newegg, Overstock, and Wayfair in cases in South Dakota, Newegg in Alabama, and ACMA/NetChoice in Tennessee regarding the three states’ adoption of legislation and rules to test the continued viability of *Quill* in the sales tax area.

Mr. Eisenstein is the author of several publications, including several articles in *State Tax Notes* for his firm’s quarterly column entitled Eyes on E-Commerce Law. The articles have included *Where’s Waldo: Sourcing IT and Cloud Services* (8/8/16); *Taxing Thin Air: Cloud Computing Meets Limitless Jurisdiction* (2/8/16); *Transaction Taxes on Information Technologies: The Threat* (12/22/14); *Let the Sunshine In: The Age of Cloud Computing* (11/28/11). Mr. Eisenstein has also been selected by his peers to appear in The Best Lawyers in America (2007 – 2017), the New England “Super Lawyers” List (2007-2017). Mr. Eisenstein co-authors a regular column on state taxes for the American Catalog Mailers Association.



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Mr. Dillon is an attorney specializing in multistate sales and use tax matters for multistate and multinational businesses. For more than 20 years, as leader of his firm, practice leader for global accounting firms and in-house for two publicly-traded technology companies, Mike has successfully helped companies identify multistate nexus, negotiate settlements of historical exposure, register and automate sales tax compliance processes, and address risk during M&A activity. Mike has successfully represented taxpayers in over 200 sales tax audits, often coming in when “all hope is lost” to beneficially resolve the matter. Mike is a member of the State and Local Tax Advisory Board for Strafford Publications. He is highly sought to lecture and author articles on sales tax matters for organizations such as AICPA, Strafford, BNA, CCH and the Center for Professional Education.