

Tell Your Clients What They Need to Know about Sales Tax Audits

By Brent Watson, CPA

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Oklahoma businesses can expect sales tax audit activity to be multiplied in the near future. Until recently, compliance enforcement by the Oklahoma Tax Commission (OTC) was limited due to a small staff of auditors — at one point less than 30 auditors for the state. In contrast, Arkansas, which has about 25 percent less population than Oklahoma, had nearly 140 auditors!

Because of this deficiency, the City of Tulsa and other cities believed they were not receiving their share of local sales taxes and began pursuing the usage of contract auditors to conduct city sales tax audits. In order to regulate this activity, to maintain uniformity of state administration of sales taxes and to maintain Oklahoma's participation in the Streamlined Sales Tax ("SST") initiative, the 2010 legislature passed HB 2359. A portion of which states:

... upon the request of the municipality, ..., the Commission shall enter into contractual agreements with the municipality or group of municipalities whereby <they> are authorized to ... augment the Commission's enforcement through a contract with a private auditor(s) The auditor(s) or audit firm(s) shall first be approved by the Commission and once approved shall be appointed as an agent of the Oklahoma Tax Commission for purposes of the audit.

Taxpayers should be thankful for such provisions — otherwise taxpayers in multiple locations could have been subject to multiple city tax audits, with a separate state audit of state and county taxes. This would clearly be administratively burdensome.

According to the City Sales & Use Tax Contract posted on the OTC's website (www.oktax.state.ok.us), such audits are subject to key limitations to maintain uniformity and state oversight:

- Auditors can only audit taxpayers who are located in cities who agree to participate in the audit;
- Auditors/audit firms' cities that wish to engage must be accepted and appointed agents of the OTC; and
- Audit results must be reported to the OTC, which will issue assessments of state, county and city sales tax.

These provisions seem to leave open the question as to whether a taxpayer with locations in two cities could be audited separately for each location for the same period. Fortunately, the SST initiative (of which, Oklahoma is a member) states that a taxpayer can only be subjected to one audit for a tax period.

In addition to contract auditors, the legislature significantly augmented the OTC's field auditor staff. According to the Jan. 4, 2011 issue of the *Tulsa World*, as a result of this increased staffing, Tulsa received an additional \$1.6 million in delinquent sales taxes from July through October 2010.

Cities are beginning to use contract auditors. The City of Tulsa signed a contract in July 2010, with Revenue Discovery Systems of Birmingham, Ala. That contract calls for contract auditors to be paid \$85 per hour, not on a contingency basis.

Many factors increase the risk of audit assessments:

- Increasingly, companies are using the power of the e-commerce to market. Selling over the Internet into multiple locations multiplies the number of applicable state and local taxes. Such sales are easy to see by anyone — including auditors — who searches the web. Many states, like New York, are enacting "click-through nexus" or "Amazon laws" that base nexus of an out-of-state seller on the use of an in-state agent's web site to direct sales via a link to the out-of-state's website.

- Being registered for payroll or income taxes in a state while not being registered for sales taxes often results in audits or questionnaires when taxing authorities use a simple matching process.
- As an increased number of customers are audited, auditors note sellers that are not charging taxes. This often leads to an audit of such sellers.
- States are aggressively pushing lower thresholds for claiming that out-of-state sellers have nexus. Prominent sales tax cases, such as the 1992 Quill case, have made it clear that a taxpayer is required to collect sales taxes in a state only if they have physical presence in the state. Obviously, having property or employees in a state is physical presence. But what about temporary presence in a state, such as occasional sales visits by employees or commissioned agents, deliveries using company vehicles or service calls by third-party agents to repair items? States are continually asserting claims to collect sales taxes on the slightest of such presence.

Voluntary disclosure agreements (VDAs) can help taxpayers who discover that they have exposure for either uncollected sales taxes or unaccrued use taxes on purchases. States usually limit their look-back period to the normal statute of limitations (three years in Oklahoma), penalties are normally waived, and interest may be fully or partially waived (one-half in Oklahoma).

CPAs can act on a no-name basis on behalf of their clients to request VDA agreements from taxing authorities. Once the state sends a preliminary contract, the delinquent taxpayer discloses their identity and liability in exchange for abbreviated assessment periods and waived interest and penalties. In the case of long-term under-collections, such arrangements can reduce the taxpayer's exposure by 50 percent or more.

Tracking local tax rates and manually calculating sales taxes is an overwhelming burden for companies with widely distributed sales. In 2010 alone, 555 rate changes were made by the nearly 10,000 U.S. jurisdictions that impose a sales tax, according to Vertex Inc.'s website, which points out that "Managing the volume of new tax rates presents many challenges for retailers who need to focus on other areas..."

When tax under-collections are discovered upon audit, the taxpayer foots the bill for the tax, penalty and interest. Rebilling customers is costly in time consumption and customer relations. It's ineffective in collecting tax and rarely covers interest or penalty. Automating the sales tax function may be an economical solution. Depending on the taxpayer's accounting software used, costs of sales tax computation software can be as low as \$1,000 annually for up to 1,000 transactions or \$5,000 for up to 12,000 transactions.

Filing tax returns in states with locally imposed taxes, especially those with locally administered taxes, like Alabama, creates a second layer of time consuming demands. Returns preparation software can be as inexpensive as \$2,000 for up to 75 returns annually or \$10,000 for up to 450 returns annually.

Additionally, for retailers, management of exemption certificates is vital. According to Vertex, Inc.'s survey in its white paper, "Limiting Your Sales and Use Tax Exposure Through Automation," 54 percent of state auditors stated that not having an automated sales and use tax exemption certificate system has at least a medium impact on audit assessments, and 77 percent of auditors and tax professionals indicated that when errors are found on exemption certificates, the companies were considered likely future audit targets (www.vertexinc.com).

Clients often believe their accountants are advising them on all tax related matters, whether or not such services are contemplated in engagement letters. Therefore, it behooves CPAs to advise their clients to make sure their sales tax matters are in order before the state or a city sends someone to examine them.