Surviving a state tax audit of your business

May 11, 2011
Agenda

- Audit types
- Taxpayer selection
- Preparing for an audit
- The examination process
- Common errors
- Post-audit – Options and strategies
- Questions
Types of state audits

**Letter of inquiry** – usually questioning a specific transaction or reporting issue

**Office audit** – conducted remotely, e.g., phone, e-mail on less complicated tax returns

**Field audit** – full examination of taxpayer returns and records; portion of the auditor’s time will be spent on site

> Experience of auditors ranges from the least for office audits to the most for field audits

> Caution – Your appeal rights may be different for each type of examination
What is the primary purpose for your participation in this webinar?
Why is a business selected for audit?

> Regularly scheduled examinations – “preferred customer”
> Random selection
> Unusual item(s) on a return(s)
> Amended return/refund claim/federal RAR
> Discovery efforts e.g., nexus
> Targeted industries e.g., California and service enterprises
> Information or reports from other government entities or taxpayers
> Many businesses are scheduled for audit as part of a regular cycle e.g., every 3 or 4 years

> Candidates include:
  – Multijurisdictional corporations
  – Businesses with complex issues e.g., manufacturers, contractors, software
  – High liability retailers e.g., motor vehicle dealers
  – Taxpayers with a questionable audit history
Random audit selection

Businesses can be selected for audit randomly, as part of a state’s general compliance program.

Small enterprises are not necessarily immune.

States maintain that even though the cost of the audit might exceed any assessments, such audits are necessary just to keep taxpayers honest.
For years, the IRS has had systems to check the internal logic and interrelationship of items on returns.

States following the IRS lead with increased investment in technology.

Items, such as apportionment factors, can be compared from year to year.

Several states require disclosure of “aggressive” filing positions to avoid penalties.
Amended return, refund claims, and federal RAR reporting

> Amended returns normal get “desk audited”

> States currently trying to avoid paying refunds; large refunds are more likely to trigger an examination than in the past

> Documentation can be key to avoiding an audit resulting from a refund

> State mandates to report results of IRS examinations provide fodder for state tax audits
Discovery efforts

> Auditor “networking” – A business may come to the attention of a state tax agency during the audit of a vendor or customer

> Business activity (nexus) questionnaires – Often a precursor to an audit

> Review of company websites, news services, trade journals, corporate press releases, etc.

> Agents often gather information about affiliated companies or transactions with related parties
States periodically concentrate their audit efforts on a particular industry e.g., Wisconsin’s bank audit initiative

Can pursue known or suspected areas of noncompliance

Potentially high tax recovery for audit effort

Provides training to agents on industry characteristics – how it books certain items, tax strategies

Allows the state to pick the weakest link if the state deems tax litigation is necessary
Information sharing and referrals

- Various compacts between the states provide for the sharing of information
- Organizations like the Multistate Tax Commission often conduct audits of large taxpayers on behalf of several states
- Most states participate in an information exchange with the IRS e.g., customs data
Other state audit selection strategies

Other state audits can be based on recent legislation or litigation (e.g., New York is pursuing audits based on Amazon.com)
What taxes are most frequently audited?

- Sales and use tax – High “payback” relative to audit effort by state
- Income, franchise, and other business enterprise taxes
- Personal property taxes
- Other:
  - Payroll (unemployment)
  - Abandoned and unclaimed property
  - Credits and incentives
**Pre-audit planning**

| Proper planning and preparation for a state tax audit can significantly reduce potential assessments of tax, interest, and penalties |
| Require state taxing agency to provide written notification of an examination: including taxes, years under review, and records required |
| **Never** permit an auditor to conduct a “surprise” or “drop-in” examination; proper notification is required by law in most states |
| Consider representation by CPA or other tax advisor? Power of attorney usually required |
Other pre-audit considerations

- Is an amnesty plan available (desirable if a company has exposure)? See Michigan’s amnesty program beginning May 15, 2011.

- Does that state offer a self-audit option?

- Should the audit be handled “offsite”?

- Commencing the audit: Agree to a workable date for you and the auditor?

- Should the business request an extension of time and sign waivers?
How would you assess the pre-audit planning activities of your organization?
Steps to take before examination begins

- Gather and review required documentation; try to obtain any missing documentation (e.g., resale certificates if a sales/use tax audit)
- Prior audit history – Zero in on problem areas
- Review returns previously filed with the state
- Catalog activities or presence in the state if nexus is in question
- Research state tax statutes, rules, and cases for possible changes during the audit period
Dealing with the auditor

> If the examination is an on-site audit, place the auditor away from key business functions if possible e.g., finance, IT
  – Don’t put the auditor in the “dungeon”

> Work out a timeframe for the audit and stick to it

> Discuss approach e.g., sampling if a sales/use tax audit and suggest modifications
Dealing with the auditor

> Consider disclosing material issues to mitigate possible penalties.
> Amended returns?

> Ensure that refunds will be included in the process

> Monitor the documentation given to the auditor

> Touch base regularly with the auditor to avoid “surprises”

> If possible, do not wait under the end of the audit to bring a tax advisor
Is an outside tax expert advisable?

> When a company should consider assistance:
  > Limited or no experience with an audit and related techniques e.g., statistical sampling
  > Audit history is poor e.g., large assessments
  > Issues raised by the auditor are complex
  > Encounter problems with the auditor e.g., inexperienced, difficult personality
  > A large assessment is anticipated
  > Potential for refunds or offsets
Typically, the state is looking for tax not charged on the sale

Nexus is a common issue on audits

Audit sampling/projection issues – statistical, block, or other methods. Bias?

Are exemption certificates valid, complete, written, signed, and received in good faith

Drop shipments (seller not registered in state of delivery, but drop shipper is)
Common audit issues – sales tax

> Situs of the sale (e.g., dock sales)
> Freight, handling, insurance, fuel surcharges, reimbursed expenses, and other “receipts”
> Accounting method – accrual basis usually required
> Reported gross receipts do not tie to income tax returns or books
Common audit issues – sales tax

> Software and related consulting services
> Bundled transactions – Sales of service and tangible personal property or, taxable and nontaxable services
> Credits and overpayments
> Bad debts – normally deductible
> Local taxes – rates, situs of sale
Recent audit issues – sales tax

> “Click-through” (Amazon.com) and affiliate nexus
> Digital products e.g., books, games, and software. Treatment of phone apps?
> “Web-hosting,” “SaaS,” “cloud computing”
> Conversion to Streamlined Sales and Use Tax Agreement rules e.g., Michigan, Minnesota, Wisconsin, Ohio, and Texas
- Purchases from out-of-state, unregistered vendors
- Fixed assets, especially self-constructed
- Purchase cards
- Software and related services
- Customer samples
- Internal consumption of inventory for non-exempt use
- Contractors – real or personal property classification
- Manufacturing exemptions and credit – MPC in Illinois
Common audit issues – use tax

- R&D – Exempt in some states but taxable in others
- “Promo” materials (e.g., displays, printed advertising)
- Temporary storage exemption
- Occasional sales (e.g., sale of business)
- Titled property (planes, boats, and other vehicles)
- Utility and telecommunications exemptions and refunds
Recent audit issues – use tax

- Digital products and software (custom vs. canned)
- “Web-hosting,” “SaaS,” “cloud computing”
- Tax situs of services
- Targeting efforts – California and service providers
Income, franchise, business entity tax audit issues

> Nexus
> Right to apportion – can be contested by state
> Use of throwback or “throw out” rules for sales factor
> Business/nonbusiness income
> International issues (e.g., IC-DISCs, ETI deduction, Subpart F)
Income, franchise, business entity tax audit issues

- Depreciation – state disallowance of bonus and expanded Sec. 179 deductions
- Municipal interest and add-back (*Davis*)
- Alternative apportionment (and related elections)
- Intercompany transactions
  - Royalty
  - Interest
  - Management fees
  - Open intercompany payables and receivables
Income, franchise, business entity tax audit issues

> Treatment of flow-through entities:
  - Apportionment factors pass through?
  - Withholding on nonresident owners

> S corporations
  - Separate state election? New York, New Jersey
  - State built-in gains tax? Wisconsin
  - Entity level tax applies e.g., California

> Mergers, acquisitions, and restructurings – State treatment of IRC Sec. 338(h)(10)
Combined reporting being adopted by more states (e.g., Wisconsin, Massachusetts)

Sourcing rules for receipts from services and intangibles changing from “cost of performance” criteria to market or “benefits received” standard

Nexus standards being eroded

Non-income based entity taxes e.g., Michigan, Ohio, Washington, Texas
Personal property tax audit issues

> Usually a local tax issue but exceptions e.g., Wisconsin manufacturing property
> “Ghost” assets
> Software and capitalized intangible costs
> Manufacturing and waste treatment equipment
> Consignment inventory
> Freeport exemptions
> Compliance with PPT abatement agreements relative to jobs and investment
> Purchase price allocations and IRC 338(h)(10)
Real property tax audit issues

- Equalization ratios
- Challenges to exempt status of nonprofits
- Double counting of fixtures as real and personal property
- Rate roll-back
- Valuation

- Economic obsolescence
- Entrepreneurial profit
Other taxes – Audit issues

> State unemployment taxes
  – SUTA “dumping”

> Abandoned and unclaimed property
  – California challenge
  – Failure to report
  – Gift certificates

> Credits and incentives
  – Enterprise zone compliance
  – “Clawbacks”
What tax type do you see creating the most audit exposure for your business?
### Closing the examination process

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<th>Actively work with auditor during the examination; don’t wait until the audit report is issued</th>
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<td>Negotiate – Try to reach agreement with the agent; “horse trading” is possible</td>
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<td>If agreement cannot be reached, ask to meet with the auditor’s supervisor</td>
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<td>Ruling requests can be made during the audit</td>
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<td>Get a clear understanding of where the business stands in the process and key dates to be met</td>
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> Remedies for disputed assessments usually available – appeals to internal or external administrative bodies e.g., Pennsylvania

> Consider consulting with a tax professional before committing to extensive protests or court

> Weigh cost and risks of appeal against settlement offer that’s on the table

> Appeal requirements – “pay to play” states?

> Settlement prior to court trials is common
> Cash flow or financial condition issues? May be possible to work out a payment plan

> Consider if the same problem exists with other states: Is an analysis needed to estimate exposure?

> Develop a remediation plan quickly to correct issues in future

> Audit lag issue – Amend years outside audit period to avoid penalties in the next cycle

> FIN 48 consequences for income tax adjustments
Questions?
Contact information

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