What triggers a sales tax audit?

A joint study by Avalara and Peisner Johnson & Company

Using extensive data acquired from the Texas Department of Revenue and the California Board of Equalization (BOE), this report aims to shed light on:

- ✓ the most common industries that get audited
- ✓ the most common compliance errors by business type or industry
- ✓ the typical costs in audit penalties and fees, and audit support and defense

Peisner Johnson & Company, LLP

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It's safe to say that most executives and business leaders understand that businesses get audited for sales and use tax, but only a small percentage are aware of the material impact to their company should a state auditor come knocking on their door. Unless you've been audited in the past, you might not know why certain businesses are targeted, what the most common types of errors auditors look for, and most importantly, how much it will cost the business should the audit outcome not weigh in your favor.

Note on the data used for the report:
Through a request of information from the Texas Department of Revenue, Peisner Johnson & Company and Avalara received sales and use tax audit data spanning 1989–2016. The analysis includes a breakdown of approximately 64,000 audits with 4,252 currently in progress. This report also uses supplemental findings from the California State Board of Equalization (BOE) Annual Report, which details the state's sales and use tax audit revenue and supporting demographic findings.

KEY FINDINGS

- NEARLY 60% OF AUDITS ARE SPREAD AMONG JUST 4 INDUSTRIES.
- ONE-THIRD OF AUDITS WERE AIMED AT COMPANIES THAT ARE HEADQUARTERED OUT OF STATE.
- THE TWO PRIMARY TAX COMPLIANCE ERRORS ARE UNSUPPORTED SALES FOR RESALE AND FAILURE TO PAY USE TAX ON PURCHASES FROM OUT-OF-STATE VENDORS.
- AVERAGE COST OF AN AUDIT IS APPROXIMATELY $114,000 INCLUDING PENALTIES, FEES, AND PROFESSIONAL COUNSEL.

What companies get audited and why?

It should come as no surprise that state audit divisions aren't looking for companies that are managing their taxes correctly. After all, audit penalties and assessments provide enormous revenue and help shore up budget deficits. According to the California State Board of Equalization (BOE) 2013–2014 report, **the state generated over $21 million in revenue from their managed audit program.**

Why do some companies get selected while others don't? Sometimes, it's a case of bad luck, but as data suggests, companies are most often not selected at random but evaluated by a number of factors, which include:

- Industry
- Past audit history
- Volume of sales a company reports to the state
- Volume of exempt sales claimed
- Ratio of exempt sales to total sales

Most of these factors might seem obvious. Companies with a history of negative audits usually get targeted until they get their act together. High-revenue companies, on the other hand, find themselves in a perennial audit whereby any number of auditors from multiple state agencies set up residence at their headquarters, even if they're meticulous with their compliance processes. It's also not surprising that companies that report a high ratio of exempt sales to total sales raise a flag, especially if that ratio isn't consistent with their industry peers.

What's less evident to most people is the first criteria: industry. This factor is accounting for more and more audit activity across the U.S. and doesn't show any signs of slowing down. Here's why.

Target industries – error prone or opportunity for the state?

Certain industries tend to put themselves at risk in two ways. One is based purely on how the industry operates: bars, restaurants, grocery stores, and liquor stores are all cash-based businesses, and auditors are all too aware of how cash goes unreported. However, while cash-based businesses routinely put themselves in compliance risk, the effort to find the errors might be too high for many auditors to even bother investigating, especially if it's a small operation.

The other main reason certain industries get targeted is that historically they don't adhere to state and local sales and use tax regulations, which are complex, ever-changing, and require a lot of research and due diligence on the part of the company's accounting and finance teams. There are many ways a company can make a mistake in their compliance, but as the data from the California BOE indicates, the following account for the majority of errors (see **Figure 1**):

- Untaxed purchases from out-of-state vendors
- Unsupported sales for resale

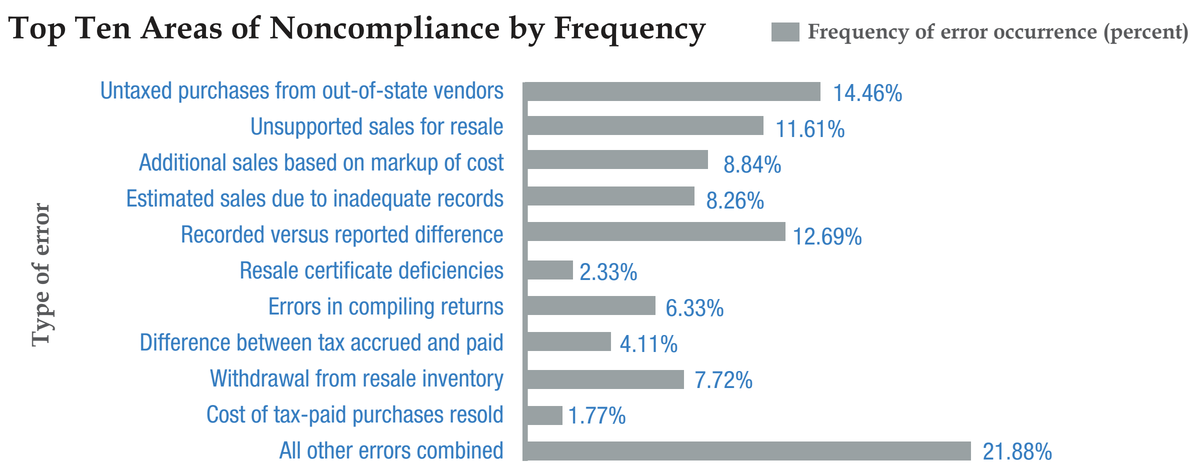

Figure 1: Source-California BOE Annual Report 2013-2014

In the 2013–2014 fiscal year (according to the California BOE), the top three industries (see Figure 2) found to have large assessments were retail, food service, and manufacturing.

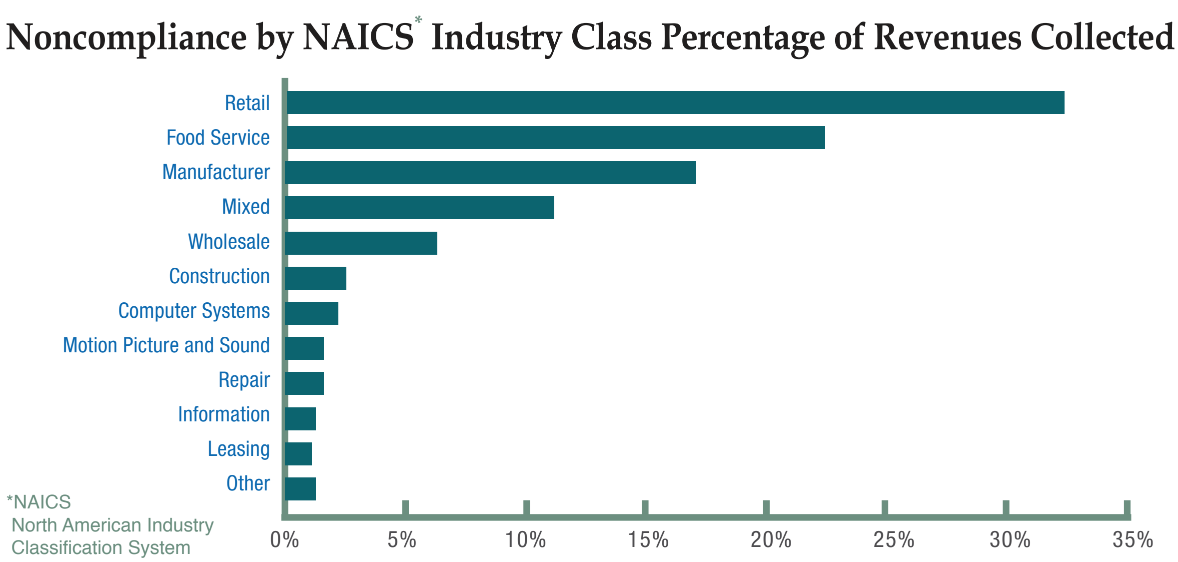

Figure 2: Source-California BOE Annual Report 2013-2014

Conversely, the State of Texas varied slightly in their top industries under audit. While retail and manufacturing remained high like in California, auditors also targeted the construction industry and wholesale/distributors (see Figure 3)

Top Industries under audit

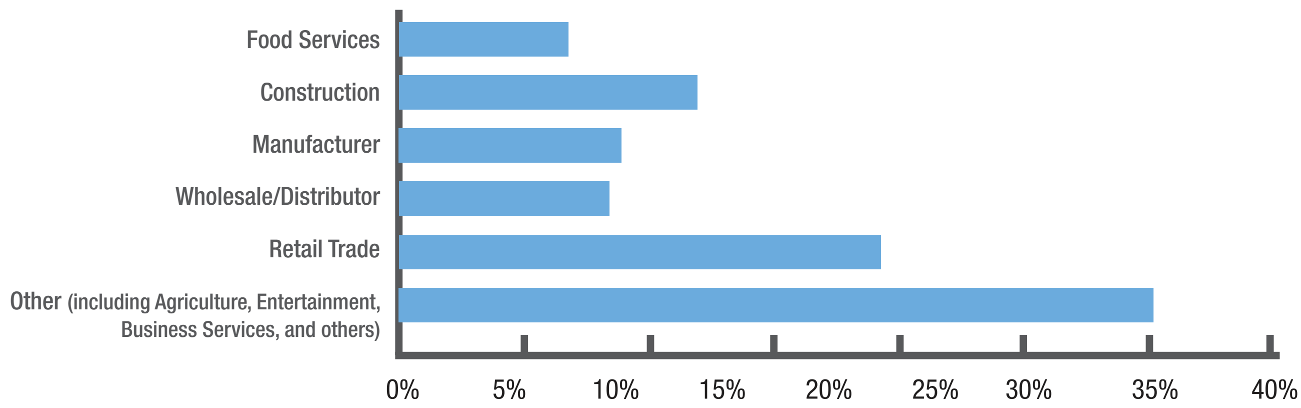

***Figure 3:** Source-Texas State Department of Revenue, 2016*

Ecommerce Retailer*
Company size: Approximately 40 employees
Revenue: Approximately $125 million

» Conducts business in all 50 states with offices located in 1 state and warehouses in 2 states.

» Audited by Minnesota Department of Revenue

Note: Company based in California with nexus in Minnesota and not registered or collecting sales tax on taxable sales.

Reason selected for audit: A customer of the ecommerce retailer was audited by the Minnesota Department of Revenue (MNDOR). The auditor noted no tax collected on a purchase invoice by the California based ecommerce retailer. The MNDOR sent a nexus questionnaire to the ecommerce retailer. Nexus was confirmed and the audit was initiated.

The MNDOR assessed 289K in tax plus interest and penalty.

Challenge: no significant challenges

Lookback period: 6 months

Compliance errors by key industries

Let's take a closer look at some of the compliance challenges these industries face and what an auditor might look for in his or her assessment.

***Note:** This information applies to large industry segments and generalizes compliance challenges. Each company is different and may face a different audit experience.*

Retail

Audit Triggers: errors in product taxability, failing to remit in states where nexus is established

It's not surprising that auditors target the retail industry. From a revenue perspective, they are a primary source of recovery, as state deficits have dramatically increased due to the explosion of ecommerce. According to eMarketer and Forrester projections (see Figure 4), online sales will account for $385 billion to $440 billion in the U.S. by the end of 2017 and are projected to reach $414 billion by 2018. States have felt the brunt of the wholesale shift from brick-and-mortar to online buying.

**The following examples are detailed accounts of actual audits that took place by the State of California (DOR) between the years of 2006-2014. Company names and other confidential information have been removed to protect those parties involved.*

U.S. E-Commerce Sales, 2014-2018

E-commerce sales will reach nearly $500 billion by 2018. Sales (in billions)

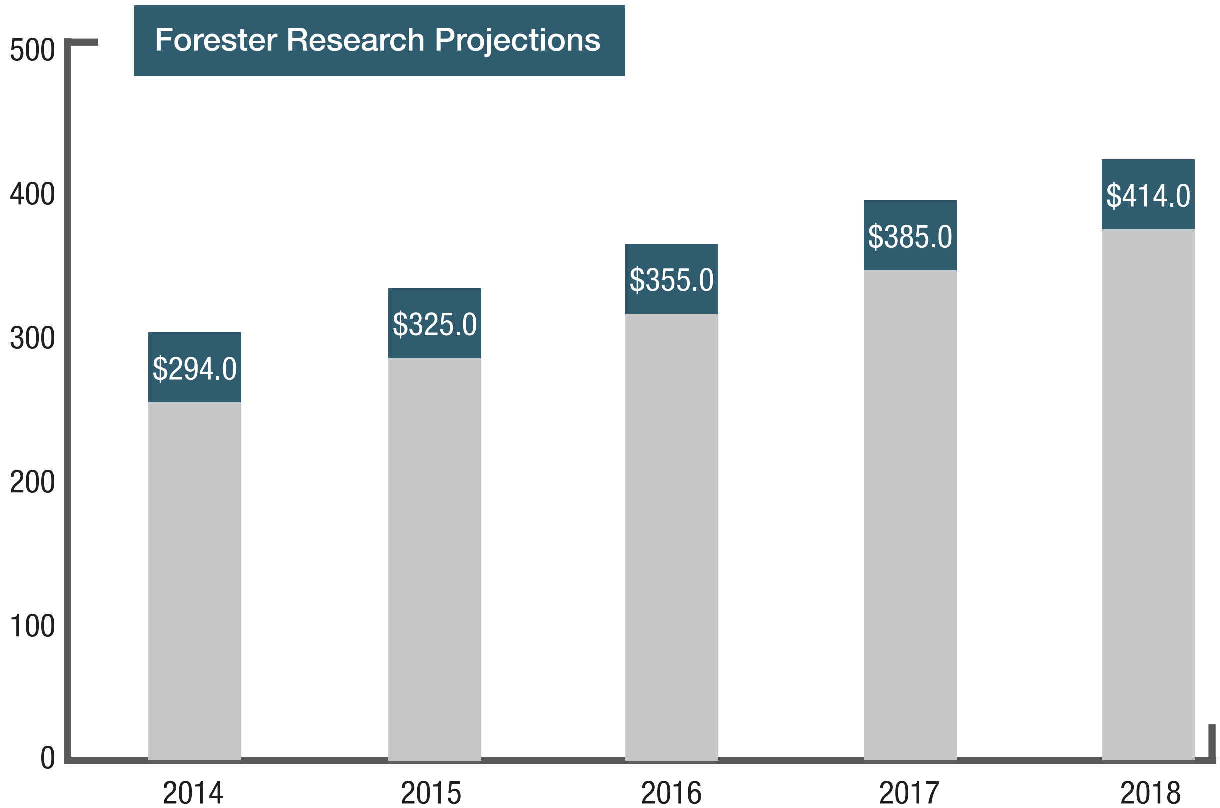

***Figure 4**: Source-Forrester Research, 2016*

To give this shift perspective, the California BOE outlined statistics from the U.S. Census Bureau (see Figure 5). Their annual report highlights the loss in millions that states are facing due to ecommerce.

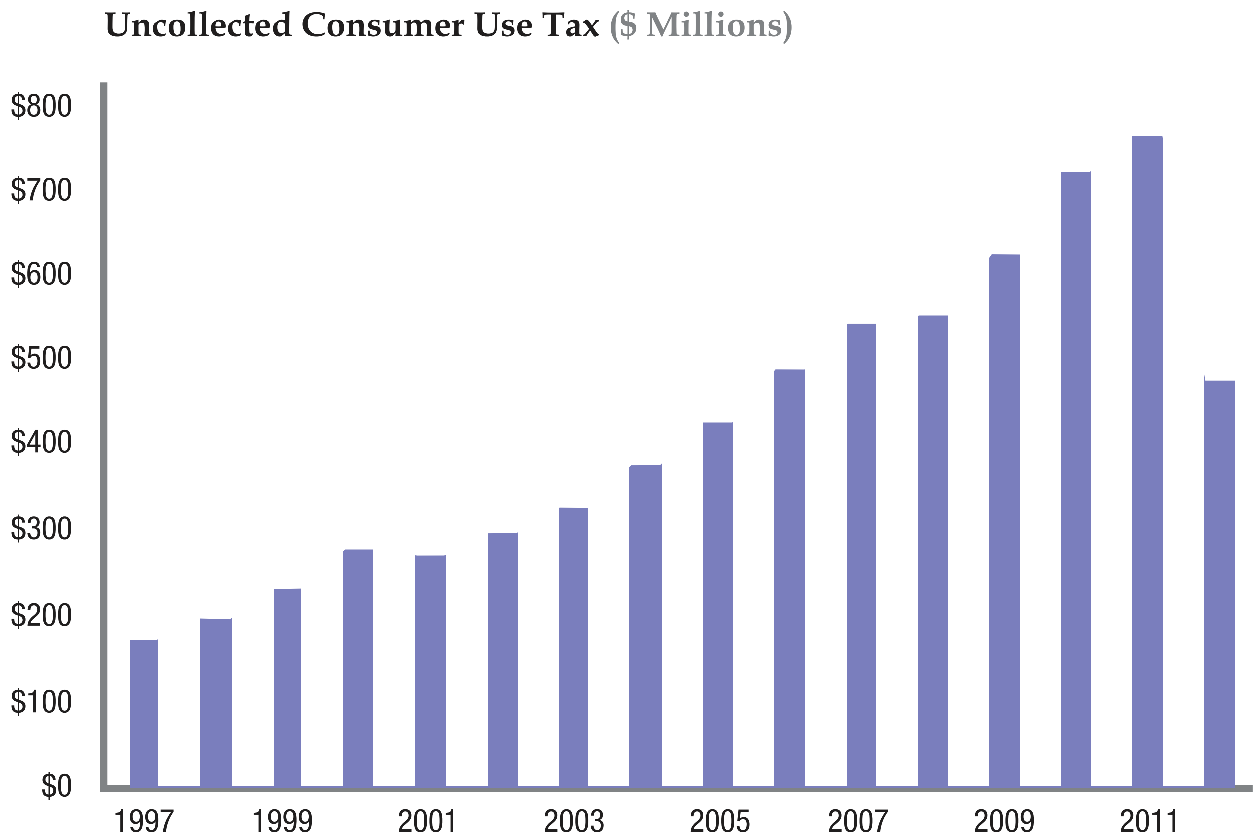

***Figure 5**: Source-California BOE Annual Report 2013-2014*

Figure 5 shows annual business-to-consumer use tax revenue losses, which rose from $171 million in 1997 to $763 million by 2011. In 2012, with the decrease in unregistered out-of-state sellers (nexus percentage) from 37 percent to 23 percent, the tax gap declined dramatically, to $477 million. This amount decreased from 2006.

Making sense of product taxability

Understanding product taxability is particularly challenging for many retailers as most tangible products are subject to sales tax in the U.S. However, product taxability rules and rates vary widely from state to state and change frequently. If that wasn't bad enough, certain goods and services fall into a nebulous category called "sometimes taxable" where use can make a difference in how an item is taxed.

As retailers grow, they're more likely to operate across state lines, which can trigger nexus, a "physical presence" in a state that creates an obligation to collect and remit sales tax. As such, they need to pay closer attention to where customers and partners are located and ensure point of sale, ecommerce systems, and shopping carts are set up to calculate the correct tax in each state and jurisdiction in which they now have nexus.

WHAT IS NEXUS?

NEXUS HAS LONG BEEN DEFINED AS THE PHYSICAL CONNECTION BETWEEN A TAXING AUTHORITY AND A BUSINESS THAT TRIGGERS A SALES AND USE TAX COLLECTION OBLIGATION. YET IN RECENT YEARS, MANY STATES HAVE STRETCHED THE DEFINITION OF NEXUS TO INCLUDE LESS CONCRETE CONNECTIONS. IN OTHER WORDS, BUSINESSES DON'T ALWAYS HAVE TO BE PHYSICALLY PRESENT IN A STATE TO CREATE A TAX OBLIGATION. HAVING REMOTE STAFF, USING A DROP SHIPPER, EVEN ATTENDING AND CONDUCTING BUSINESS AT TRADE SHOWS, CAN ESTABLISH NEXUS IN MANY STATES.

MORE THAN 20 STATES, INCLUDING ARKANSAS, CALIFORNIA, GEORGIA, ILLINOIS, MAINE, MINNESOTA, NEW YORK, PENNSYLVANIA, VIRGINIA, WEST VIRGINIA HAVE ENACTED "CLICK-THROUGH" OR AFFILIATE NEXUS LAWS, WHICH BASE NEXUS ON THE RELATIONSHIP BETWEEN AN OUT-OF-STATE RETAILER AND IN-STATE REFERRALS.

IN 2017, 13 STATES HAVE EITHER ENACTED OR ARE IN THE PROCESS OF ENACTING "ECONOMIC NEXUS" LAWS, WHEREBY COMPANIES THAT GENERATE AT LEAST $250,000 IN SALES ARE OBLIGATED TO COLLECT AND REMIT SALES TAX.

Knowing where you're obligated to remit (understanding nexus)

A growing number of states have recently expanded the definition of nexus (a company's connection to a state, whereby an obligation to collect and remit sales and use tax is established) to include activities such as employing remote staff, attending tradeshows, warehousing inventory or using drop shippers or third-party fulfilment. In fact, many states are now adopting "Economic Nexus" laws that require businesses to collect and remit tax on the basis of generating at least $250,000 worth of sales from that particular state. Other states base economic nexus on the number of transactions by its residents. These factors, and many more, can make sales tax compliance particularly difficult for affected retailers. And state auditors are all too eager to turn these challenges into opportunity. (Learn more about Nexus in the callout above.)

Manufacturing

Audit Triggers: undocumented exempt sales, failure to remit use tax, failure to remit in states where nexus is established

State auditors are all too aware that manufacturers expose themselves to risk at many points along the supply chain. Whether they're selling to retailers, directly to consumers, or supplying wholesalers and distributors, they face several compliance challenges throughout the process.

Window Blinds Manufacturer (also provides installation services and retail sales)*
Company size: Approximately 80 employees
Revenue: Approximately $75 million

» Conducts business in 40 states with offices located in 3 states
» Maintains distribution centers in 2 states
» Audited by State of California

Reason selected for audit: Taxpayer filed a claim for refund – State agreed to consider claim but wanted to examine the refund claim and check for offsetting debits.

Audit period: 2006-2008

Cost: State initially denied refund claim of $198,000 and instead assessed $1.2 million of tax due. Case entered appeals and the state ruled in favor of issuing the refund to the taxpayer.
Challenge: no significant challenges

Lookback period: 6 months

There are three primary activities that pose sales tax risk:

- Managing exempt sales when selling to retailers
- Managing taxability rules when selling directly to consumers
- Remitting use tax

Managing exempt sales when selling to retailers

For manufacturers selling directly to retailers, the main challenge is effective management of exemption certificates. Errors managing exemption certificates are one of the primary issues an auditor looks for. Common mistakes include simple things, like a missing signature, or incorrect name or address. Or, more significantly, filling out the wrong certificate and filing with the wrong state, or using expired certificates. Adding to the complexity, requirements for managing exempt sales vary from state to state.

Managing taxability rules when selling directly to consumers

When a manufacturer sells directly to a consumer or end user, the sale is subject to the raft of sales tax rates, rules, and boundaries that apply to any retailer. One problematic area is determining the correct tax rate and provisions on the products it sells and complying with nexus, the connection between a seller and a taxing jurisdiction that results in a sales tax obligation. This is particularly problematic for multistate manufacturing operations.

Every time a manufacturer makes sales into a state in which it does not have a physical presence, it might face additional sales tax responsibilities. Lacking a federal mandate, many states have instituted rules broadening definitions of nexus to include remote sellers, such as manufacturers selling into a particular state, even when they don't have a physical presence within that location.

Remitting use tax

Use tax is tricky for companies. How you "consume" certain items in your business often determines if use tax is owed. Common triggers may include:

- Inventory transfers
- Equipment purchases
- Charitable donations
- Fixed assets purchasing

Auto Parts Wholesaler (also provides retail sales)*
Company size: Approximately 125 employees
Revenue: Approximately $200 million

» Conducts business in 18 states with offices located in 18 states
» Maintains distribution centers in 6 states
» Audited by State of Washington

Reason selected for audit: Random selection of audit.

Audit period: 2008-2010
Taxpayer did not collect resale certificates from customers who claimed to be for resale. The sales were now subject to tax unless proof of resale occurred. The tax representative argued that although a resale certificate or affidavit from reseller could not be obtained, the state searched the reseller in their database and found them to be a registered business that sells this merchandise. Many unsupported resales were accepted on reasonableness on the basis of auto parts distributor selling to a front end auto parts retailer.

Cost: Tax reduced from $328k to $89k as not all resales could be fully supported.

Challenge: Tracking down old resellers from 1-3 years in the past that were unresponsive or out of business

Lookback period: 2 years

If these items were intended for resale and the company didn't pay sales tax at the time of purchase, then it is now obligated to pay use tax. Or, if the company bought equipment or furniture for its office and then moved locations, and the tax rate is higher in the new location, then it may owe the difference in use tax. This is where most auditors spend their time – checking that expenses, fixed assets, and inventory transfers have been properly taxed. It's also where most mistakes occur. As the audit data suggests, use tax errors are the number one audit risk and the bulk of assessments come from use tax not being paid.

Wholesale/Distribution

Audit Triggers: failing to remit in states where nexus is established, errors in product taxability, failure to follow correct drop shipping rules

For wholesalers and distributors, the first thing auditors look for are missing or incomplete records and certificates on exempt sales. For exempt purchases to be documented properly, a distributor must maintain exemption certificate information for each state or locality where the reseller receives product. Distributors must also ensure their own tax-exempt status is maintained and exemption certificate information is provided to each manufacturer or supplier with which they work. After all, they're considered a reseller in a manufacturer or supplier's eyes.

Direct sales to consumers include sales of spare parts, updates, replacement wear items, and a lot more. It is the distributor's obligation to ensure that accurate and current sales tax rates, taxability rules, and boundaries are applied for each taxable sale.

Working with a drop shipper

Distributors or wholesalers will sometimes request the manufacturer to drop ship their product to either their location or sometimes to their customer's location. If an item is being shipped directly to the distributor, and the product is considered tax-exempt for resale, then no tax is required – only resale documentation. However, if shipping is done on behalf of the customer, the transaction may be taxable. Knowing what documentation you need to maintain for which states becomes a major challenge – especially as ship-to destinations may vary widely if your customer, the distributor, has you ship to their customers in numerous states.

Construction Contractor*
Company size: Approximately 90 employees
Revenue: Approximately $200 million

» Conducts business in 12 states with offices located in 4 states
» Maintains head office in Nevada
» Audited by State of Nevada

Reason selected for audit: Numerous errors in returns filed over the years.

Audit period: 2012-2014
Construction contractor issued resale certificates in purchasing building materials such as nails, caulking, paint, cement. Use tax was not self-reported.

Cost: Auditor assessed $475k in use tax plus penalty.

Challenge: Record keeping and purchase invoices were incomplete prompting auditor to estimate tax at $650k before documentation was provided to lower the assessment to $475.

Lookback period: 1 year

Construction

Audit Triggers: errors in use tax remittance, errors in product taxability, failing to remit in states where nexus is established

Sales and use tax compliance for the construction industry and contractors in general is no walk in the park. That's because auditors find holes in compliance throughout the supply chain, especially among companies that perform services and purchase goods in other states.

Managing use tax correctly

If a contractor does not understand or remember to accrue and remit incremental use tax due on projects, and the state audits the project, that contractor's profit margins might quickly erode.

The construction industry faces many compliance hurdles, including:

- Not registering sales tax ID number
- Not filing in states where they have nexus
- Having a large volume of exempt sales without documentation
- Failing to remit sales and use tax on equipment purchases and rentals

Cutting costs by cherry-picking the best rate

When contractors source materials from out of state, they might get a great rate on sales tax at initial purchase. But auditors look to see that in the end the contractor remitted the right amount of tax to the jurisdiction where the materials were eventually used.

Here's a simplified example: A construction firm constructs a building in Austin, Texas, but purchases materials for the project in Oklahoma and transports them across state lines. Let's say the tax rate in Texas is 9 percent compared to Oklahoma's rate of 7 percent. One might believe the contractor was smart and saved 2 percent on the purchase. Not so. In that scenario, a Texas auditor will be verifying that an additional 2 percent was remitted to the state of Texas to make up the difference.

Understanding this concept is simple, but applying the correct rates and following the right remittance process across multiple jurisdictions is complicated and hard to manage.

Rules and rates vary state to state

If a contractor is located in one state and performing work in another, where (the jurisdiction) you owe tax and how much is owed varies dramatically. Most states view contractors as the "end consumer" of materials used on a project and will typically require the contractor to pay sales tax on property at the time of purchase, or expect them to accrue and remit use tax on materials that were sourced from out-of-state vendors.

Food Services

Audit Triggers: unreported cash transactions, errors in product taxability

Food service providers are often cash-based businesses: bars, restaurants, grocery stores, liquor stores, etc. As mentioned earlier in the report, auditors are all too aware of how cash transactions can go unreported but proving noncompliance is a challenge. Nonetheless, audit data from Texas and California indicates that these businesses are carefully reviewed regardless.

Outside of unreported cash transactions, diligent tax professionals can still expose themselves to tax risk when they don't carefully evaluate the varying (and ever-changing) tax rules on the products they sell. Understanding what's taxable versus tax exempt is not straightforward. Example: candy is normally a taxable item, unless the product contains flour, in which case it's tax free. The same type of rule applies to energy drinks versus soda.

These are just minor examples, but they reflect a global challenge when you apply disparate rules across thousands of products in inventory. Charging sales tax on a packet of Oreos might not be a big deal, but when you fail to charge tax correctly on hundreds of items over the course of several years, an audit might reveal a hefty tax obligation.

Which states are the most aggressive in auditing companies?

Many states across the U.S. are getting more aggressive with sales and use tax audits because increasing budget deficits are demanding them to take action. Generating revenue through tax audits doesn't constitute new or higher taxes, rather it's a collection on what's already owed. For that reason, it's a popular strategy among legislators that's getting bipartisan support and minimal resistance from the Supreme Court as to whether states can go after businesses outside of their state.

What are the odds of getting audited by more than one state?

Odds are pretty good. If it weren't for expanding nexus, sales and use tax audits would stay local, but in recent years newly established rules are giving states greater latitude than ever before, as auditors are setting up offices all over the U.S. to conduct audits on companies that now have nexus in their home state.

Data from the Texas DOR supports this claim, as **one-third of their 4,252 audits in progress are being conducted out of state.** Research also shows that Texas has a total of 595 auditors with 78 of those permanently based out of state.

Texas has a lot at stake, as it's the 11th largest economy in the world, but it's not alone in this trend. According to Steven Walters, producer at nonprofit WisconsinEye, the Wisconsin Department of Revenue is hiring 102 new tax auditors. By increasing their audit division by one-third, many of these auditors will be based out of state in New York, Chicago, Minneapolis, and other locations "so they can focus on auditing corporations that claim a 'nexus' – or business connection – with Wisconsin."[1] The state estimates that the new auditors will generate upwards of $88 million additional revenue each year.

California is also proving to be just as aggressive. While data on the number of auditors and their locations isn't available, Bloomberg Business estimated that they've added approximately 100 auditors in the past few years to collect upwards of $371 million annually.

How costly is an audit?

Wakefield Research **found that a typical negative audit can cost even a small to medium sized business more than $114,000.**

For a large organization, the amount can grow exponentially. What's harder to assess than penalties and fees is the time and disruption to your business. On average, sales and use tax audits can last 30 to 45 days and auditors can be on-site for two to four weeks, during which staff and leadership are taken away from their more productive tasks.

Going alone versus hiring a tax expert

Getting outside help to prepare and represent your interests in an audit can potentially save you time and considerable costs. Consider getting audit representation if any of the following exists:.

- ✓ **You've never been audited before**. An experienced representative will help you prepare and cut down the time it takes to resolve the audit.
- ✓ **You lack staff**. If you can't divert enough high-level staff members to do a pre-audit and deal with the auditor while he or she is onsite, hire representation.

Perhaps you're comfortable handling the audit yourself, but need additional help with a few projects to prepare for the audit? Here are some of the things that make sense to outsource:

Removing the guesswork on rates and taxability: In addition to offloading the time and effort of manually managing indirect tax, tax management software ensures accurate tax collection on more than 12.7 million products in an estimated 70,000 tax jurisdictions worldwide.

Pre-Audit: Conducting a pre-audit or reverse audit, prior to an auditor coming in, can ensure you have no nasty surprises. Outsourcing this makes sense because internal staff will try to avoid showcasing mistakes they've made or might not even be aware of those errors. You need substantial lead time before the auditor shows up on your doorstep to do this.

Exemption certificate management: If staff has not been on top of exemption certificate gathering, this may be a good task to outsource.

Expert advice: If you choose to handle the audit yourself, paying for a little advice now and then can make a big difference. Consider confuring with a tax representative.

Conclusion

These simple compliance tips can go a long way toward a quick and painless audit:

Collect and remit correctly

The single best defense any business has against an audit is getting rates and product taxability right. Even the most meticulous record-keeping won't protect your business from fines and penalties if customers have been charged incorrect rates or you have been remitting less to the state than you've been collecting. Getting this complex step right can take a lot of effort – especially if you sell a wide variety of products.

Keep documentation organized

If you're filing documents manually and showing your auditor stacks of paper, it's likely that you'll be in for a long slog. Missing or expired exemption certificates are a particularly pesky problem, as many businesses don't realize that they're required to keep these certificates at the ready. Bottom line: If you can't produce the certificate, you will be assessed.

Understand the audit process

If your business receives an audit notice, it's important to know enough about the audit process to prepare adequately. These tips from former auditors can help you get ahead of the game in case you are audited with advice for what to do (and what not to do). You may also consider whether you need to bring in outside help to make your audit run more smoothly. The big takeaway? If you make things easy on your auditor, you'll make things easier on yourself. If your records and processes are in good order, you don't have anything to fear from an audit.

The bottom line: Reduce risk by automating sales and use tax

Managing transactional tax can be overwhelming, especially if you are obligated to register, collect, and report sales and use tax in several states. Just trying to keep up with different rates, rules, and regulations can keep you in survival mode. You're on the hook to get it done and held liable by states (and state auditors) if it isn't done right. Automating sales and use tax compliance in your accounting system, ERP, or ecommerce system can alleviate much of this strain and put you on a more even keel. Avalara's tax management software ensures accurate tax calculation, proper management of tax exemptions, and streamlines the remittance and filing process for sales tax returns in every U.S. jurisdiction. Make 2017 the year you rescue yourself from the hassles of sales tax and sail through compliance with ease, confidence, and Avalara sales tax automation software.

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Avalara offers more than 600 pre-built connectors into leading accounting, ERP, ecommerce and other business applications, making the integration of tax and compliance solutions easy for customers. Each year, the company processes billions of indirect tax transactions for customers and users, files more than a million tax returns, and manages millions of tax exemption certificates and other compliance documents.

Peisner Johnson & Company

Peisner Johnson & Company is a CPA firm with a clear mission: Solve clients' state tax problems. Because they focus exclusively on state and local taxes, they have developed a deep understanding of state tax issues. Their staff includes former state tax auditors and tax professionals from across the country, and their clients benefit from their extensive knowledge and experience and their client-first mentality. They have consulted with thousands of companies doing business across the United States and Canada in virtually every industry.

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