SALES AND USE TAX AUDITS IN 2021:

HOW TO PREPARE YOUR BUSINESS

Avalara
Tax compliance done right

OASIS SOLUTIONS

GUIDE

Contents

The ongoing impact of economic nexus on sales tax compliance	3
Which businesses are most likely to be audited?	4
Which noncompliance issues do auditors most frequently catch?	6
The true cost of an audit: It's more than money	8
What to expect (and avoid) during an audit	10
Automating sales and use tax compliance can help	12

Introduction

Businesses that shifted operations due to the COVID-19 pandemic must now consider impacts on sales and use tax compliance. Closing office buildings, transitioning to a remote workforce, and moving more sales online can all impact tax obligations. It's important for companies to consider how changes to their business may affect their audit risk in 2021. Certain factors make a business more likely to be audited. Companies may be on the hook for paying taxes owed, plus penalties, should an audit not go in their favor.

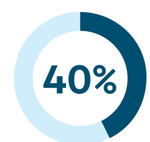
Unfortunately, many businesses aren't fully prepared to handle an audit. This guidebook will help you understand your potential risks and what to expect during an audit. You'll also find strategies that may reduce the likelihood of a negative audit, make the process smoother should the auditor pay you a visit, and ultimately save your company money.

The ongoing impact of economic nexus on sales tax compliance

State audit divisions continue to look for companies that fail to manage their taxes correctly.

After all, sales tax accounts for **more than 40%** of total state and local taxes in some states and goes a long way toward filling a state's budget coffer.

The most recent annual report from the California Department of Tax and Fee Administration shows the sales and use tax audit program audited approximately 1% of active tax accounts and uncovered net deficiencies of nearly **$553.1 million** during fiscal year 2018-2019. Tennessee's Department of Revenue collects more than 25 different taxes and fees. The department audited 27,652 tax accounts of all types during fiscal year 2019-2020 and assessed approximately **$180 million** in tax.



Sales tax accounts for more than 40% of total state and local taxes in some states.

Unregistered remote sellers

In addition to uncovering accounting discrepancies, states may also increase scrutiny on unregistered remote sellers. As of March 2021, 43 states, the District of Columbia, and some local governments in Alaska now have **economic nexus laws** that create a tax obligation based on sales or transaction volume, meaning physical nexus is no longer the only cause.

More than 43 states now have economic nexus laws that create a tax obligation

The impact of the new rules can be seen in California, where 2,185 retailers registered because of the **South Dakota v. Wayfair, Inc.,**

Supreme Court decision. Those retailers reported more than **$39 million** in taxes due during fiscal year 2018-2019.

To give businesses time to adapt to these new laws, states were initially lenient when it came to enforcement. Those days are gone. States now expect remote sellers with economic nexus to register and comply with applicable sales tax laws. And some states are even trying to collect more revenue from out-of-state businesses: **Illinois** now requires out-of-state sellers to collect and remit local sales and use taxes, and **West Virginia** is looking to institute a fee on internet sellers.

"Furthermore, state and local governments are at the forefront of the response to the pandemic in their communities and will likely need to increase their typical spending to provide crucial public health services and help communities adapt to social distancing guidelines," writes **Brookings**. Revenue departments may choose to wield a magnifying glass when it comes to remote sellers.

Which businesses are most likely to be audited?

You may be more likely to be audited just because of the nature of your business. Certain industries tend to put themselves at risk in two ways. One is simply how they operate. The other reason they get targeted is because of their history of making mistakes while trying to comply with complicated and ever-changing sales and use tax regulations. A **joint study** by Peisner Johnson & Company and Avalara found that nearly 60% of audits are spread among just four industries: retail, manufacturing, wholesale/distribution, and construction.

In addition to industry, the report also found auditors more frequently pore over the books of companies that meet these four criteria:

- **Have been audited before, especially if they have a history of negative audits**
- **Report a high sales volume**
- **Report many exempt sales**
- **Have a high ratio of exempt sales to total sales**

If your supplier is audited and you're a seller, your risk of being audited increases. The reverse is true as well. Peisner Johnson & Company and Avalara also identified compliance challenges among the top four audited industries:

RETAIL

- Product taxability errors
- Failure to remit in states where nexus has been established

MANUFACTURING

- Undocumented exempt sales or exempt sales errors
- Failure to remit use tax
- Failure to remit in states where nexus has been established

WHOLESALE/DISTRIBUTION

- Undocumented exempt sales or exempt sales errors
- Product taxability errors
- Failure to follow correct drop shipping rules
- Failure to remit in states where nexus is established

CONSTRUCTION

- Use tax remittance errors
- Product taxability errors
- Failure to remit in states where nexus is established

If you work in one of these industries, it's especially important to evaluate your sales and use tax liability and put procedures in place to reduce risk.

Which issues do auditors most frequently catch?

Exemption certificates and consumer use tax are among the most prevalent issues auditors find.

While there are many reasons why a business might make errors, California's audit program pinpoints **three noncompliance** issues that account for more than half of collected revenues:

- Unsupported sales for resale: sales claimed as exempt without supporting documentation. Generally, a seller should obtain and retain a resale certificate at the time of the transaction.
- Unreported sales: sales not reported on the sales and use tax return.
- Out-of-state vendor purchases: assessments made for purchases of tangible personal property from out-of-state vendors that did not collect use tax.

Common exemption certificate errors include:

- Missing a signature or failure to include the signature of an accepted signer
- Missing an issue date
- Incorrect claim type or any certificate not accepted
- Document not recognized by the state authority in the form of a letter, email, or government license
- Including a name or address other than the direct buyer and seller
- Including a state tax identification number that doesn't align to the correct state

Industries like manufacturing, construction, and hospitality often face greater risks of use tax noncompliance.

Failing to properly assess consumer use tax ranks as one of the most **common compliance mistakes** made by companies. A buyer owes consumer use tax when the seller doesn't collect or remit the full amount of tax owed on a purchase of tangible personal property, some virtual goods such as software or digital content, or some types of services. **Certain industries**, like manufacturing, construction, and hospitality, more frequently make errors when it comes to use tax.

Regulations for these businesses are more complex and can vary from state to state. These industries may also see more companies issuing direct pay permits to their suppliers, which allows those suppliers to forgo charging any sales tax. The purchasers then assume all responsibility to self-assess consumer use tax on purchases that should be taxed.

The Wayfair decision increased the administrative burden for consumer use tax.

In many cases, economic nexus rules require remote sellers to collect only the state portion of the tax and not local tax, which is also due. Yet purchasing companies bear the burden to prove that all tax has been correctly paid on everything they buy.

A company can be tripped up in a variety of ways when it comes to consumer use tax.

For example, a manufacturer that buys a forklift in Oregon, then moves it to Washington to replace broken equipment, may owe consumer use tax in Washington against the original or fair market value. Or a New York business that buys 50,000 bolts from an out-of-state seller for resale and manufacturing, then uses 2,000 to build displays for its own use, may owe consumer use tax in New York. Those are just a couple of scenarios; there are many more.

The true cost of an audit: It's more than money

The average audit costs a company more than $300,000, according to a report by **Wakefield Research**. Their survey received responses from 400 U.S. finance and accounting professionals across industries ranging from ecommerce and retail, software and technology, and manufacturing and distribution – all companies with annual revenues of $10 million or more.

Considering how expensive an audit can be, it's wise to assess your potential exposure before it happens to you. Ask yourself these three questions:

1. **What are your average total annual sales in a state?**
2. **What percentage of your total sales is exempt?**
3. **What percentage or dollar amount of your exempt sales isn't covered by a valid certificate?**

One way to estimate sales tax liability is to take that amount and multiply it by the average sales tax rate, interest, and penalty rate.

This figure won't account for the loss of time you'll spend responding to an audit, however. A typical sales and use tax audit can stretch over 30-45 days or longer.

Preparing for an audit up front can save you the headache of filing appeals, the results of which could still end up cutting into your bottom line. California's audit department settled 640 sales and use tax cases during fiscal year 2018-2019 for a combined **$215.9 million**.

The average audit costs a company more than $300,000.

A typical sales and use tax audit can take 30-45 days or longer.

LSI, a surgical device retailer, **described their experience** responding to audits before they had fully implemented Avalara software solutions and after.

> “It was so simple to just run some reports that showed all of the relevant data. I could print out the exemption certificates with the push of a button. It was night and day, the time it took was just so much less with the post-Avalara audit.”

Alex Morris-Bouza
Senior Accountant, LSI

What to expect (and avoid) during an audit

Even if you think you've done everything correctly, audits can be intimidating. The best way to weather a sales and use tax audit is to prepare.

Conducting your own audit before you get a notice from the state can help you to find and correct errors before they result in penalties. During a sales tax audit, the auditor will typically take a sample of your purchase transactions, including invoices, credit card charges, etc., from a four-year period and determine the percentage out of compliance. Next, they'll use that percentage to extrapolate the total number of purchase transactions you have out of compliance and assess penalties and fees according to that number. If you lack proper documentation to show you've paid sales tax, self-assessed use tax, or are tax-exempt, an auditor may find that you owe penalties and fees on a greater number of transactions than those that are incorrect.

Auditors often start by examining sales tax exemption certificates. If you don't know how many certificates you have on file, what percentage will expire in the next month, or how many are missing – or if your staff spends a lot of time manually updating expired or invalid certificates – it may be time to reform your process.

Without evidence you've paid sales tax or self-assessed use tax, or collected proper tax-exempt documentation, you may end up paying penalties and fees on many transactions - not just the incorrect ones.

Exemption certificates

The combination of economic nexus laws and expanding multichannel B2B sales are driving the need for businesses to **gather certificates in near real-time** online. COVID-19 has also created an environment where it's crucial to have reliable procedures in place to manage certificates, especially if any of your vendors are teetering on shutting their doors. Once a company goes out of business, you may find it difficult or impossible to get documentation requested during an audit. Should that happen, your business will likely be stuck with the sales tax liability.

Consumer use tax

The audit process is a little different on the consumer use tax side. All fixed assets, such as computers and equipment, are scrutinized and the auditor will expect you to show invoices.

Use tax auditors hone in on companies with high purchasing power, such as manufacturers, retail stores, and medical facilities. And compared to sales tax penalties, which can be reduced, use tax liabilities can be more difficult to appeal and audit processes can vary between states. According to a former auditor, consumer use tax liability is usually bigger than sales tax liability.

In most cases, you'll have a period of time to gather requested information before the auditor shows up. Avoid having too many people involved in the audit process to prevent miscommunication between staff and the auditor. Lastly, be professional. A positive rapport can be the deciding factor in avoiding stiff penalties.

Tips for preparing for an audit

Only gather the records requested

Avoid too many people present during the audit

Be professional

Remember, Avalara doesn't provide legal or accounting advice. If you find yourself confronted with an audit, please contact a qualified professional.

Automating sales and use tax compliance can help

Manually managing exemption certificates and consumer use self-audits is labor-intensive, inefficient, and prone to errors. Automating your company's sales and use tax compliance process can go a long way toward reducing your audit risk. For example, should the auditor knock on your door, you'll have an easier time providing the necessary documents to prove your case.

Avalara Consumer Use provides a reliable, automated process for consumer use self-assessment. Avalara Consumer Use seamlessly integrates with **AvaTax**, Avalara's tax calculation system, and **Avalara Returns** to prepare and file sales and use tax returns.

If you're treading to keep your head above water when it comes to exemption certificates, **Avalara CertCapture** can be a lifesaver. Like Avalara Consumer Use, Avalara CertCapture works in harmony with AvaTax.

With Avalara Consumer Use, you can:

- Quickly detect overpaid or underpaid taxes on vendor invoices
- Easily review how and where your purchases are used so you can accurately self-assess use tax to reduce audit liability
- Consolidate all your taxable transaction data across your business so you're ready to demonstrate a best effort to be compliant
- Reduce costs and time spent managing tax compliance, lifting the burden from your finance team

Avalara CertCapture enables you to:

- Easily collect, verify, store, and access certificates, and respond to audit requests in seconds
- Track upcoming renewals, expirations, and missing documents with automatic updates, reducing your audit risks
- Convert paper documents into digital documents at the time of transaction
- Automatically distribute personalized letters, emails, and faxes to request new customer forms – and collect completed forms – saving time and resources

Be audit ready.

Find out how Avalara Consumer Use and Avalara CertCapture can make sales and use tax compliance easier and reduce risks.

Contact your account manager, Jody Patterson at jody@oasisky.com or call 502.429.6902.