

## **Streamlined Sales Tax (SST)**

### **Audit Issues: Business Taxpayer Response**

#### **I. Scope of this White Paper**

This white paper provides responses from the business taxpayer community regarding the Streamlined Sales Tax (SST) audit issues. This paper is intended to continue the business and government dialogue of these issues in the SST Business Advisory Council (BAC) and the SST State and Local Advisory Council (SLAC). Many of the SST audit issues discussed in this paper are related to long-standing issues in sales and use tax audits.

This paper is a compilation of ideas from different people in corporate tax departments, associations, and taxpayer advisory firms. The pronoun “we” in this paper refers to the opinions of one or more members of the business community. The Council On State Taxation (COST) has facilitated this compilation, but the views expressed herein are not official positions of COST or its member companies. Please email your comments and suggestions about this paper to [skranz@statetax.org](mailto:skranz@statetax.org) and [will@willyancey.com](mailto:will@willyancey.com)

#### **II. Process of Audit Policy Development**

##### ***A. Need for Public Involvement***

The SST Audit Committee began its deliberations without much public involvement. Beginning in late 2005, the Committee has been more open to the public. We hope that this more open approach will continue in the future.

Effective public involvement in public policy requires public discussion of the policy agenda, drafting of alternatives, public dissemination of comments between the public and government, and review of the implementation of regulations. Effective public involvement does not imply many closed sessions to draft audit policies followed by a brief public hearing with a few minutes of public comment before approving policy documents.

Business taxpayers do provide positive contributions to audit policy. We can recommend clarifications in the guidelines to reduce disputes about interpretation. We can identify where guidance is needed for specialized industries or situations. We can suggest methods to improve audit efficiency and effectiveness.

## ***B. Prior Evolution of Audit Policy***

### **1. Public Involvement in SSUT Agreement**

The Sales and Use Tax Agreement (SSUTA) was adopted after extensive public discussion. Drafts of amendments are circulated for public discussion prior to adoption. Taxpayer groups are allowed to submit suggestions for amendments and interpretations. SSUTA § 702 and § 804 requires that the public be given an opportunity to comment on state law and regulations before a state is admitted to SST membership. SSUTA § 807 requires open meetings of the SST Governing Board except for certain defined reasons. Opportunities for public comment before adoption of SSUTA amendments, interpretations, and definitions are required by SSUTA §§ 901, 902, and 903, respectively. At the present time there are no SST audits underway and will not be any for several years. There appears to be no confidential taxpayer information being discussed at the SST Audit committee and subcommittee meetings.

### **2. FTA EDI Working Group**

The Federation of Tax Administrators (FTA) facilitated the Task Force on Electronic Data Interchange (EDI) Audit and Legal Issues in 1995 to 2002. The Task Force published a series of white papers that are available online at <http://www.taxadmin.org/fta/ftapub.html>. Members of the public were effectively involved in planning the agenda, drafting documents, and reviewing final drafts for this Task Force. Numerous drafts were circulated and the public was present during the final revision meetings. Although we did not always agree on specific wording, the resulting white papers were better than if the government representatives had operated in a vacuum without public involvement. Some of the government and businesses participants in the EDI Task Force process are now involved in the SST process.

FTA's efforts to facilitate public involvement in the EDI Task Force had several beneficial effects. The content and scope of the white papers was improved. The process of developing those white papers created some sense of trust and shared purpose between government and the business community. We hope that the SST Audit Committee can follow the Task Force's tradition in encouraging public involvement.

### **3. California BOE**

The California Board of Equalization (BOE) Business Taxes Committee actively encouraged public involvement during its revision of its Field Audit Manual (FAM) in 1999 to 2001. BOE staff prepared position papers that were disseminated in paper or electronic format. Taxpayer groups, local government groups, and individuals submitted comments and the BOE staff prepared responses and revisions based on those comments. After hearing from the public and the BOE staff, the elected members of the BOE made their final decisions in public

meetings with public votes. Although there were some disagreements, there were many areas where consensus was reached based on the public involvement.

#### **4. IFTA**

Multistate sales tax audits of highway fuel taxes are conducted by the International Fuel Tax Association (IFTA). IFTA audits highway fuel taxes imposed by US states and Canadian provinces. Each state can have its own rates and exemptions. Because the major highway fuel users are interstate freight carriers, the IFTA attempts to conduct audits of those carriers on behalf of all IFTA members. Often the revenue department of the state where the carrier has its major headquarters audits all the highway fuel taxes for that carrier on both its in-state and out-of-state highway fuel. Each IFTA jurisdiction that participates in an IFTA audit bears a share of the audit cost and receives a copy of the audit report. For more information on IFTA see <http://www.iftach.org/>

SST and IFTA may bear some similarities in that an auditor is auditing a business on behalf of more than one state. Each state may have differing tax rates, exemptions, and interpretations of the audit report. If the joint audit approach is successful a business does not face audits by many separate jurisdictions on similar issues.

Some business taxpayers have experienced problems with IFTA audits. The IFTA auditors may be familiar with the law and regulations in their home state, but not other states. After the IFTA report is prepared, additional dispute resolution may occur at the state level.

Some business taxpayers are concerned that the problems with IFTA audits may be repeated or could be even worse with SST audits. The variety of highway fuels and exemptions for interstate commerce is not as complicated as the variety of goods and services that could be taxed with SST. Thus, understanding how to resolve problems with IFTA audits may be useful to understanding how to reduce those problems with SST audits.

#### **C. MTC and SST**

Substantial overlap exists between the governmental representatives participating in the Streamlined Sales Tax (SST) and the Multistate Tax Commission (MTC). Nearly all of the current member states of SST are also MTC members or observers. MTC professional staff is deeply involved in preparing materials for SST committees.

Some members of the business community have had policy disputes with MTC in the past and are concerned similar disputes will occur with SST committees. We

acknowledge there will always be some disagreements between business taxpayers and government taxation agencies. We hope that SST provides a new forum and process for resolving disputes more effectively.

The MTC continues to engage in some initiatives on sales and use tax audits including training auditors, drafting a model regulation and audit guidelines on statistical sampling, and others. The MTC staff auditors are continuing to conduct sales and use tax audits on behalf of MTC member states.

The business community maintains a dialogue with several different governmental and quasi-governmental organizations that are recommending guidelines for sales and use tax audits. These organizations include Streamlined Sales Tax (SST), Multistate Tax Commission (MTC), Federation of Tax Administrators (FTA), International Fuel Tax Association (IFTA), regional associations of state tax administrators, regional state compacts, and individual state revenue departments. It is not clear whether the SST will become the leadership organization in setting consistent sales and use tax audit policy or merely one of several competing organizations. Will the SST member states agree on a single audit policy for sales and use tax or will they continue to have numerous differences? Apparently the business community needs to monitor the activities of all these groups and to engage in policy discussions at all levels.

### **III. Issue Paper Coordination**

Many issue papers are being developed by various SST working groups and committees with input from the business community. We suggest that the SST Audit Committee monitor the activity of those working groups. Taxpayers and government representatives need to volunteer to work on drafting papers and responses. To the extent possible, the other working groups will take the lead on tax policy issues, and the SST Audit Committee will consider how to implement those policies in SST audits.

#### **A. Purchaser Use Tax Issues**

The Purchaser Use Tax Issues white paper discusses the purchasers' ability to rely on SST compliance of the vendor. The business community has proposed that if a purchaser buys from a seller that is compliant with SST, then that purchaser can rely on the sales tax being properly collected.

The outcome of the Purchaser Use Tax issue paper will have implications for the SST Audit committee papers. The business community wants to reduce overlapping audit situations where the states assess both the purchaser and seller for the same transactions. States that participate in the SST audit of the seller should not assess additional tax on the purchaser. As a separate private

matter between the parties, the seller may or may not seek indemnification of the tax deficiency from the purchaser.

Business purchasers should be able to rely on the results of an SST audit of the seller or CSP. If the SST has audited the seller or CSP for a particular period and the purchaser did not submit an exemption certificate for that SST audit period, then the purchaser should not be audited again on those purchases. To enable the purchaser to know if the seller has been audited, the purchaser can contact the seller's corporate tax department or ask the SST auditor to determine if it was audited.

The confidentiality rules for CSP's should allow the SST auditor to notify the CSP of an information request from a purchaser. The SST auditor should be allowed to discuss with the purchaser which of the purchaser's purchases were included in the sales audit of the CSP.

### ***B. Exemptions and Direct Pay Permits***

The SST Audit Committee will coordinate with other working groups on many issues related to sales tax exemptions and direct pay permits. A "Simplified Exemption Administration" working paper was issued by the SST Project on April 13, 2005. SST Audit Committee members have been involved in developing the SST Certificate of Exemption and SST Exemption Certificate Instructions that deal with exemptions based on the customer. Exemptions based on the product should be part of the Taxability Matrix project. Exemptions based on how a customer uses a particular product are the subject of numerous state laws, such as sales tax exemptions for specified manufacturing, Medicare patients, and qualified enterprise zones. These exemptions based on customer usage might or might not be addressed by the SSUTA.

Since the exemption administration provisions in SSUTA section 317 allow businesses to obtain the data elements rather than paper certificates, businesses are interested in understanding the audit requirements related to the data elements. The SST Audit Committee should invite business taxpayers, consultants, and tax software publishers to discuss the data elements required for exemptions.

Connecting a particular sales invoice to a particular customer exemption certificate is easier for some businesses than for others. Some businesses include a customer number on every invoice. Other businesses with "walk-in" customers may accept payments and record no customer identification on their sales register receipts. For businesses with a high volume of walk-in customers and exempt sales, such as building supply retailers, maintaining the

documentation may be difficult. The SST audit procedures should allow sampling and other procedures to connect exemptions with sales invoices.

### **C. Sourcing**

States will be changing their sales sourcing rules to conform to the SSUTA sections 309 through 315. SST audits will deal with implementation of the sourcing rules.

A chronic problem for businesses is identifying the correct address for a sale. Depending on the type of product or service the customer may have a delivery address ("ship-to"), billing address ("bill-to"), and place where the product or service is used. Customer addresses at the time of sale ("historical address") may be different than the address in the customer master file ("current address") when the auditor requests customer addresses. Sometimes one invoice will include deliveries to several different addresses. Some customers have no street address and provide only a postal box as an address.

The SST auditors will have to deal with the practical problems of sourcing every sale. The objective should be to seek a high level of compliance with the sourcing rules. However, the auditors need to understand a small number of sourcing errors are inevitable given the difficulty of getting accurate addresses from customers.

### **D. Multiple Points of Use (MPU)**

Multiple Points of Use (MPU) is defined in SSUTA section 312. If a seller chooses to collect the tax by working with the customer, sellers will be dependent on accurate information provided by the purchaser.

The audit of the apportionment methodology will also be an important audit consideration. Since the MPU provision applies to information available at the time of sale, the selected apportionment methodology, if reasonable based such information, should be honored upon audit. The audit policy should be to ensure that the method selected was consistently applied. Businesses are concerned that an audit could result in changing them from one "reasonable method" to another "reasonable method." Auditors will need practical guidelines on the evidence sufficient to support an MPU.

In addition, a business may not have "information available at the time of sale." Past discussions have indicated that a business would not be required to create documentation to support apportionment if the information wasn't otherwise available. Information that becomes available after the purchase is reported for use tax purposes should not be required, but allowed if a taxpayer chooses to

retroactively adjust its sales tax returns. These concepts should be supported in the audit process.

### ***E. Tax Rates and Boundaries***

Tax rates and boundaries are discussed in several SST issue papers and SSUTA sections 304 through 308. The CSP, CAS, and proprietary software systems are dependent on getting accurate rate and boundary information from the states. In the discussion of the Rates and Boundaries paper and the Purchaser Use Tax Issues paper, the business community has emphasized that taxpayers should not be penalized for relying on incorrect information provided by the states.

With respect to auditing transactions for the accuracy of rates and boundaries, the auditors will need to have access to the published rate and boundary databases that are were in effect during each month included in the audit period. No assessment can result from reliance on the published database, so the audit will need to compare the rates used to the database available on the date of the transaction.

### ***F. Taxability Matrix***

States and businesses are working together to develop a taxability matrix consistent with SSUTA sections 327 and 328. Consensus on the matrix will help reduce disputes. The auditors will still have some situations where a seller's particular products do not clearly fit within a product defined on the matrix. The tax matrix is likely to need constant updating as states change the products and services they are taxing.

Similar to the rates and boundary databases, auditing transactions related to the sale/purchase of items contained on the published taxability matrix will require the auditors to have access to the matrices that were available during each month included in the audit period. No assessment can result from reliance on the published tax matrix, so the audit will need to compare the tax treatment to the matrix available at the time of sale.

### ***G. Bundling***

The bundling issue paper will clarify the bundling concepts for sales tax purposes that are defined in SSUTA section 330. Implementing the bundling rules will be challenging for the sales of combinations such as gift baskets containing nontaxable food, communication service bundles containing nontaxable services, and construction services that combine installation and materials.

Marketing departments often launch bundles of products with various discounted prices. Some companies are offering “a la carte” bundles designed by customers that could result in a very large number of possible bundles. These bundles are often launched into the market before the tax compliance systems are ready for them.

Even if the seller requests a letter ruling or technical advice from a state tax administrator, a decision on the application of the bundling rules may be determined after the bundled product has been launched. Sellers should not be penalized for making a reasonable effort at compliance that is changed by a subsequent interpretation of law.

Procedures for auditing bundled transactions should be established. Since an “itemized price” could be documented on something other than the invoice, “documentation” related to non-bundled transactions should be addressed. For example, the itemized price may be documented on a “rate card.” This gives the seller the ability to treat the transaction as “unbundled.” However, upon audit (several years later), the particular rate card may not be readily accessible. Audit procedures surrounding this type of documentation should be explored.

The bundling rules refer to the taxpayer’s ability to use “books and records” to determine the values for unbundled taxable components. This provision implies the taxpayers have discretion in how they keep those books and records. Thus if the SST auditor wants to challenge the taxpayer’s books and records, the burden of proof to overturn the taxpayer’s method should be on the auditor.

In some situations the sales invoice amount is not the same as the taxable base amount. The application of bundling rules or the sales contract terms may result in situations where the taxable base is less than the sales invoice amount. Auditors need to ask taxpayers for more information when there are product codes that appear to be partially taxable. The SST auditors will need some guidance on how to apply the SST bundling rules and the different bundling policy choices that the states adopt.

## ***H. Digital Goods***

The Digital Goods issues paper is dealing with a variety of software, entertainment, and information products that can be delivered in digital form. The taxation of digital goods will require frequent updating as states change their laws and new products are offered in the marketplace.

### ***I. Compliance Review and Interpretations Committee***

Some SST audits will require interpretations of the SSUTA. Some of the issues on a particular audit may result in requests to the SST Compliance Review and Interpretations Committee for interpretation. Waiting for the Interpretations Committee's response and concurrence from the Governing Board may delay completion of the SST audit.

## **IV. Certification, Re-certification, and Audit Standards**

### ***A. Audit Committee Papers on Certification, Re-certification, and Audit Process***

On May 25, 2004 the SST Implementing States approved the "Certification Standards" paper that has a May 17, 2004 revision date. The SST Audit Committee issued a draft document "Overview of the Re-certification and Audit Process" dated May 5, 2005. We understand the SST Audit Committee is working on revisions that will be released to the public by March 2006.

The Audit Committee's Certification and Re-certification papers set forth standards that service providers must meet to qualify for certification and re-certification under the Streamlined Sales and Use Tax Agreement (SSUTA) Article II. Model 1 sellers will rely on a Certified Service Provider (CSP). Model 2 sellers will rely on a Certified Automated System (CAS). Model 3 sellers will rely on proprietary systems that are approved by the SST member states. "Model 4" sellers are those who collect and remit sales tax with systems that are not approved under SSUTA Models 1, 2, or 3.

The business taxpayer community is concerned that policies and guidelines for the Model 1 CSP and Model 2 CAS may become the basis of requirements for Model 3 and Model 4 sellers. Each business has its own unique accounting, tax, and operational issues. The comments in this white paper may be relevant to some Models, but not to others.

### ***B. Taxpayer Documentation Requirements***

The current drafts of the Certification and Re-certification papers focus too much on defining specific documentation requirements for taxpayers. Although these requirements might be feasible for some CSP or CAS systems, they will not be feasible for Model 3 and Model 4 sellers.

The SST Audit Committee should focus on defining audit objectives and then listing several alternative sources of documentation that could meet those

requirements. For example, if the audit objective is to connect a customer exemption certificate to a sales invoice, then the alternatives could include naming the customer on the face of the invoice, using a customer number to connect the customer profile to an invoice, attaching an exemption certificate to an invoice number, or maintaining a daily log of exemption certificates.

Product descriptions in the sales system may or may not be sufficiently clear to determine taxability. When auditors look at a company's product taxability tables, they may need to look at additional documentation to determine taxability. Considerable time may be required to gather the appropriate documentation and reach a conclusion on product taxability.

Some requirements detailed in the draft Certification and Re-certification papers include data requirements to be maintained within the tax software or business applications that are not required today. For some businesses the data required to be maintained in the tax databases is so voluminous that record maintenance will impose an undue burden on businesses and tax compliance services to store large amounts of electronic data. In addition, in order to potentially pass these required data elements from the business application to the tax application, significant and costly programming efforts would be required to modify existing interfaces between the systems. In many cases, these interfaces are provided not by the tax application provider but by the business application provider. It will be virtually impossible to make these vendors (many of whom are not even US corporations) modify their systems to meet the requirements of the SST Audit Committee. If a seller desires to make software modifications to meet the SST requirements, they may jeopardize their application support agreements. Rather than jeopardizing their software licenses, some sellers may decide it is not worth the bother to become an SST seller.

Auditors must understand the restrictions on accessing some business databases. There are some records and supporting documents the tax auditor may want but they are subject to strict confidentiality and security policies. For example, in health products and classified defense industries customer databases are protected by federal and state law. The internal control procedures required by the Sarbanes-Oxley Act and the Chief Information Officers (CIO) may be so restrictive that even the corporate tax professionals may not access some databases. The "Certification Standards revised May 2004, section III, paragraph 630, subparagraphs A through E, page 32 describe some protections for confidential information, but those protections may not be sufficient in some situations.

### **C. Paper versus Electronic Documentation**

In the SST environment most of the documentation will be in electronic form. Many transactions will be processed by electronic data interchange (EDI) where there are no paper invoices, no printed checks, and no printed delivery reports. The evolution from paper to electronic format may be confusing for some tax auditors who are currently working for the states. The SST Audit Committee should consider how the audit guidelines will work in a paperless environment.

### **D. SST Audit Process**

Effective SST audits will require that the auditors work cooperatively with business taxpayers. The auditors need to understand the unique features of each business and not assume that "one size fits all". More uniformity may be possible with the Model 1 CSP's. The amount of documentation for an initial audit may differ from a re-certification audit. The implementations for Models 2, 3, and 4 will be more diverse.

Data for SST audits and compliance should be determined by cooperative discussions between taxpayers and the SST auditors and committees. The SST audit issue papers should repeatedly emphasize the need to work cooperatively. The SST audit and certification field auditors should describe their audit objectives and ask the taxpayer for suggestions on how to accomplish that objective. The examiners should allow different taxpayers, particularly Model 3 and 4 sellers, some flexibility.

We would like a clarification of "Certification Standards revised May 2004", section III, paragraph 700, middle of page 34, that states, "The CAS/CSP should not be in a position to control the "standards" used by the auditors. On the other hand, there may be instances that may limit the procedures that can be performed." Could you add some language that recommends auditors ask taxpayers and the CAS or CSP for the documentation that will help with a certification audit objective? If the documentation standards are too harsh, then more taxpayers will chose not to fully participate in the SST process.

When a business taxpayer is audited, the auditor should provide the audit workpapers to the taxpayer before submitting the audit report to the member states. Professional standards require that audit workpapers adequately document the procedures. For example the Multistate Tax Commission's *Basic Statistical Sampling Course*, (issued in 2000), Lesson 10, page 10.2 states, "A good rule to follow for documentation purposes is to remember that the taxpayer and their representatives have a right to determine if all proper statistical steps were followed in conducting the sampling procedure."

Some disputes can be resolved by the auditor and business. If they cannot resolve the dispute, then the taxpayer should have the right to include a response that is attached to the audit report. Many government internal audit agencies have a policy of attaching the auditee's response to the audit report.

### ***E. States' Ability to Independently Adjust SST Audit Results***

The SST audit procedures suggest that each state retains the right to apply its own policies and adjustments to the audit report. This practice is similar to the current practice of the Multistate Tax Commission joint audits where each participating jurisdiction can independently adjust the results. When the states exercise their power to make independent adjustments, resolving the audit can take a long time to resolve.

Allowing independent adjustments to the audit report defeats the purpose of streamlined administration. Business taxpayers will face more complexity if they have to deal with joint audits by SST or MTC, and then negotiate separate resolutions with each participating state. If a state does make independent adjustments, then the business taxpayer may be better off having a separate audit with that state.

### ***F. Waiver of Statute of Limitations***

If SST audits or refund claims cannot be resolved quickly, there will be a need for a waiver of the statute of limitations on audit assessments and refund claims. If the SST audit is on behalf of several participating states, it is possible the business taxpayer will dispute the results for some states but not other states. There will be situations where the taxpayer reaches a resolution with some states, but desires to continue disputing issues with some other states.

### ***G. Audit Resolution Process***

The audit resolution process must provide due process for taxpayers. Taxpayers must be allowed to submit comments and additional information. The SST audit procedures must provide a reasonable deadline for a response.

If an audit assessment is issued, the taxpayer must have the right to pay the assessment under protest to stop the accrual of penalty and interest.

## ***H. Sales Credits***

Sales data files contain both positive amounts and negative amounts. The negative amounts include refunds, voids, returns, reclassifications, rebates, discounts, price adjustments, error corrections, and other credit memos. Some credits are easily traced to a related sales invoice, but some are not.

SST auditors must understand that negative amounts are normal events in sales data files. If the auditor focuses only on the positive amounts and ignores the negative amounts, then the sales base will be overstated. When negative items are ignored, the auditor could assess tax underpayments on sales that were voided.

## ***I. Tax Overpayments***

Tax overpayments are a chronic problem in sales and use tax audits. With high volumes of transactions there will always be some situations where a customer overpaid sales tax to a vendor. There are also situations where a seller on the accrual method of collecting sales tax remits the sales tax to the state before that sales tax is collected from the customer. If the customer provides an exemption or returns the goods before paying for them, then the seller should be granted a credit for overpaying sales tax that was not collected.

The SST member states should develop a logical and consistent policy of dealing with tax overpayments. Allowing each SST member state to have its own policy on tax overpayments defeats the goal of uniformity.

## ***J. Information Sharing among Taxing Jurisdictions***

Businesses are concerned about how information provided in one tax audit can be disclosed to others. The Audit Committee's paper "Certification Standards revised May 2004", Section III, paragraph 630, subparagraph F, pages 32-33, describes how the SST does not enlarge or limit the states' authority to share information with other governmental agencies. We are concerned that information obtained by SST auditors will be passed to SST members who can share it with other parties. In an extreme case, an SST seller could provide information to an SST auditor that is passed along through several levels and into the hands of a contract auditor who is operating outside of the SST guidelines.

We recommend that the SST Audit committee adopt strict guidelines on the use of taxpayer information. If the SST auditors receive requests for taxpayer information from other parties, then that request should be disclosed to the taxpayer and the taxpayer should have a right to protest the disclosure.

Litigation and appeals about disclosure to third parties would be handled by the appropriate state and local courts with the rights of due process.

## **V. Staffing Alternatives**

### **A. Audit Committee Paper on Staffing Alternatives**

The Staffing Sub-Committee of the SST Audit Committee issued a draft document titled, "Audit Staffing Alternatives" with a draft dated December 28, 2004. We understand that further revisions of this paper are deferred while the Audit Committee deals with other issues.

### **B. Problems with Audit Contractors**

The business community is pleased that the Staffing Alternatives paper specifically discourages the use of audit contractors who are not government employees. The business community has had numerous problems with non-governmental employees conducting tax audits so we are encouraged that the SST Audit Committee is not recommending the use of contract auditors. Some of these employees are explicitly paid contingent fees based on the amount of additional taxes assessed. Other employees are *implicitly* paid contingent fees when the number of hours paid is related to the amount of taxes assessed. The audit contractors have a great temptation to use confidential information gained from auditing on behalf of one taxing jurisdiction to market their services to other taxing jurisdictions.

### **C. Audit Staff Training**

SST audits may be large and complex. A continuing challenge for SST audits will be training auditors for complex audits. Effective SST audits will require auditors who understand large businesses and complex accounting. Auditors will need to understand enterprise resource planning (ERP) systems such as SAP, Oracle, PeopleSoft, JD Edwards, and others. Some large businesses, business associations, business advisors, or software publishers may be willing to provide suggestions and training materials for SST auditors.

### **D. Removing Experienced Auditors from State Audits to SST Audits**

Taking experienced multistate auditors from state revenue departments and assigning them to SST audits presents other problems. Many sales and use tax

audits will continue to be done at the state level for many years because the statute of limitations on old law will remain open for many years. States will audit some businesses within their state that the SST auditors do not have time for. State revenue department audit administrators will have to decide how to release some of their experienced auditors to work on SST audits.

## **VI. Audit Selection**

### ***A. Audit Committee Paper on Audit Selection***

The SST Audit Committee is developing a paper on Audit Selection. No draft of this paper has yet been made available to the public. We understand this paper will include recommendations on selecting businesses for SST audit based on how their sales and exemption mixture compares to other businesses in their industry.

### ***B. Public Involvement in Audit Selection Paper***

We understand the sensitivity of state tax administrators in releasing details about audit selection criteria. While there may be a fear that businesses could use knowledge of the audit selection criteria to manipulate their reported results, orchestrating such a scheme would be difficult.

We respectfully suggest that constructive public comments on audit selection would improve the perceived fairness of SST audits. For example, the business community may be able to suggest the types of fluctuations that are not indicators of misreported taxes.

We suggest the SST Audit Committee allow public involvement in reviewing the paper that describes audit selection in general. We do understand that confidentiality rules limit disclosure of the names of particular taxpayers undergoing SST audits.

## **VII. Audit Manual**

### ***A. Audit Committee Paper on SST Audit Manual***

The SST Audit Committee has begun drafting an outline of the SST Audit Manual, but the draft has not been publicly disclosed. We understand this manual will include guidelines on audit procedures including notification, sampling, documentation, and appeals. We understand that these procedures

will be based on concepts contained in the audit manuals and guidelines of the MTC and SST member states.

### ***B. Public Involvement in SST Audit Manual***

We believe that public involvement in development of the SST Manual is in the best interests of sellers, purchasers, and government. Part of SST's success should be reduction of audit disputes. A successful audit occurs when the auditor and auditee understand the audit objectives and work cooperatively toward gathering the evidence needed to meet the audit objectives. The business community can provide practical suggestions on audit procedures that improve SST audits. We ask that the SST Audit Committee listen to our suggestions and then make its own recommendations. Most states do allow public comment on proposed regulations and do have open records laws that allow public access to state rulemaking proceedings. If the SST Audit Committee adopts an Audit Manual that is subsequently challenged at the state level, then SST audits will be delayed.

The business taxpayer community asks that the SST Audit Committee post drafts of its Audit Manual on the SST web site for public comment. Putting drafts on the web site will allow for effective public involvement.

### ***C. Statistical Sampling***

The Audit Committee's "Audit Standards" paper revised July 28, 2004 specifically refers to the use of audit sampling in SST audits. That white paper states,

Audits will be conducted (where practicable from the states' perspective) using statistical sampling techniques in accordance with generally accepted auditing standards as published by the American Institute of Certified Public Accountants in their publication entitled 'Statements of Auditing Standards'. The certification process for all models will include acceptance of statistical sampling as a valid audit approach.

The draft SST Audit Standards do not clearly distinguish among the types of sampling used in sales tax audits. There are three types:

*Block sampling* where a sample of months, weeks, or days are selected from the sampling frame. Every sale in the selected months, weeks, or days are examined. The sales outside the selected blocks have no possibility of selection.

Block sampling has the disadvantage that the particular months, weeks, or days selected may miss some of the seasonal patterns in the population.

In *nonstatistical stratified random sampling* the sampling frame is divided into strata (also known as sub-populations, groups or categories) based on dollar range, type of customer, type of exemption claimed, or other attribute. A random sample is drawn within each stratum. In nonstatistical sampling no precision or confidence level is presented with the sample results. When state revenue departments such as the Texas Comptroller of Public Accounts perform stratified random sampling without computing the precision at a specified confidence level, they are doing nonstatistical stratified random sampling.

*Statistical sampling* requires the reporting of a quantitative estimate of the sampling risk in the sample results. For example, a statistical sample may report the results as a 95 percent confidence that the estimated unreported taxable sales are in the range \$460,000 to \$540,000 (also shown as \$500,000 ± \$40,000). The Internal Revenue Service and some states do statistical sampling.

The Federation of Tax Administrators Task Force on EDI Audit and Legal Issues for Tax Administration's *Sampling for Sales and Use Tax Compliance*, (December 2002), [www.taxadmin.org/fta/pub/sample.pdf](http://www.taxadmin.org/fta/pub/sample.pdf) specifically cited the definition of statistical sampling in the International Standards of Auditing (ISA). ISA 530 defines "statistical sampling" and "non-statistical sampling" as follows:

*"Statistical sampling" means any approach to sampling that has the following characteristics:*

*(a) random selection of a sample; and*

*(b) use of probability theory to evaluate sample results, including measurement of sampling risk.*

*A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.*

If the SST Audit Committee wishes to adopt statistical sampling for the purposes of SST audits, then how will SST deal with states that currently use block sampling or nonstatistical stratified random sampling? Perhaps the SST Audit Committee intends to use statistical sampling in SST audits, but some SST member states may chose to ignore the statistical confidence intervals reported for the sample results.

Adoption of statistical sampling guidelines involves a number of technical issues that have been discussed in various audit sampling guides and conferences. These include the required confidence level, required precision, number of strata,

upper threshold for comprehensive review, lower threshold (“basement”) where no sample will be drawn, minimum sample size per stratum, minimum number of errors required for a projection, treatment of tax overpayments and underpayments, treatment of credits and other negative items in the sampling frame, verification of sampling frame completeness, and others.

As the SST Audit Committee moves forward with developing its Audit Manual, the sampling issues should be explicitly discussed. In general the Audit Manual should avoid mandating a single bright-line requirement for all samples. Instead the Audit Manual should present some alternatives that should be discussed between the auditor and taxpayer.

We expect that the Multistate Tax Commission Audit Manual will be a starting point for the SST Audit Manual. The MTC has worked on drafting an Audit Manual for several years, but that Manual has not yet been formally adopted. Some drafts and chapters of the MTC Audit Manual have circulated at various conferences, but the complete draft of the MTC Audit Manual has not been put on the MTC web site for public comment.