



Model 2 Seller Audits - Guidance and Information

Audits of Model 2 Sellers are expected to be similar to Sales and Use Tax Audits currently performed by state auditors. The SST Audit Committee has compiled this paper to provide guidance and information to state auditors during an audit of a Model 2 Seller. From our research we have identified topics of particular importance that should be considered during an audit of a Model 2 Seller.

Model 2 Seller:

A Model 2 Seller is a seller that has selected a CAS (Certified Automated System) to perform part of its sales and use tax functions, but retains responsibility for filing returns and remitting the tax. (SSUTA Section 206)

Certified Automated System (CAS):

A Certified Automated System (CAS) is software certified under the Agreement to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of tax to remit to the appropriate state, and maintain a record of the transaction. (SSUTA Section 202)

Certification included testing to ensure the CAS software could perform the following functions:

1. Determine the applicable state and local sales and use tax rates for a transaction.
 - a. Usages of appropriate rules include sourcing the transaction to the appropriate taxing jurisdiction.
2. Determine if an item is exempt from tax.
 - a. Usage of a state's taxability matrix will be used to determine the taxability of an item.
3. Determine the amount of tax to be remitted for each taxpayer for a reporting period.
4. Generate reports and returns as required by the Governing Board.
 - a. Ask your state SST Audit and/or Certification Committee Representative for a current listing of required reports.
5. Meet any other requirements set by the Governing Board.

- a. Ask your state SST Audit and/or Certification Committee Representative for any additional requirements in effect.
- If a CAS is certified, why do I need to audit?

System testing and certification took place prior to the Streamlined Sales Tax Governing Board Inc. (SSTGB) executing a contract with the CAS provider and testing is ongoing as laws and rules change.

The contract allows Model 2 Sellers liability relief in all member states for certain transactions processed using the CAS. (See Seller/CAS Liability Relief Questions and CAS Contract.) These areas may not be assessed when errors are found. However, if errors are found in the internal operation of the CAS, the CAS provider should be notified of the error. If the errors are not corrected within 10 business days and if an extension has not been granted, assessments may be made on these errors on transactions occurring after the 10 business day notice or expiration of the extension. (See Assessment section below for additional details.)

The areas covered under the liability relief and not subject to assessment are errors resulting from:

1. The use of the information in the state's Rates and Boundary Databases and product categories included in the library of definitions matrix as provided in the Agreement.
2. The use of product taxability for products not included in the library of definitions but which are reviewed and approved during the testing and certification process.
3. Acceptance of a certificate for an entity or use based exemption that your state has indicated on the certificate is available in your state, but was improperly claimed by the purchaser.
4. Tax calculations made through the seller's system using the Rates and Boundary Databases, product definitions, and rules which were reviewed and tested during the testing and certification process.

Other areas are not reviewed in the certification process and are not included in the liability relief. Errors in these areas may result in assessments against the seller. These areas are explained further in the document:

- A. Certification does not mean the company under audit has properly set up and integrated the CAS software with its system or is using the software to accomplish the above items. Many factors exist that could allow a CAS to operate improperly.

- B. CAS Certification does not include mapping. Mapping is the coding of the seller's products to the codes and tax rules in the CAS. Mapping to wrong categories may result in an incorrect exemption or taxation of a product.
- C. Certification does not review to determine if all transactions are processed through the CAS. Only transactions processed through the CAS receive relief of liability. All transactions processed outside of the CAS are subject to review and assessment if errors exist, unless the errors are covered under liability relief provided under the Agreement. For example, if the seller used an incorrect rate for a transaction processed outside the CAS and showed that it relied upon the information in the Rates and Boundary Database provided by the state which contained the incorrect rate, the seller would receive relief for the error by the state.
- D. Certification does not cover the timely application of updates. A CAS provider has no way of confirming that versions or updates to the software are properly and timely installed on the seller's system. The failure to timely install updated versions or content updates could result in errors in taxation which may result in an assessment.
- E. Certification may not cover all transactions reported on the SER. The CAS software includes a process of extracting the appropriate tax for transactions processed for the period by jurisdiction for the SER. This process was tested during certification. The Model 2 seller may add items that were not processed through the CAS to the SER and may make adjustments to the amounts reported. Examples of transactions that a Model 2 seller may not process through the CAS could include tax due on vending machine sales in the company break room or a division where the transactions are processed outside the CAS. An audit trail should be present to show the source of files included on the SER. Failure to report all tax due from the CAS may result in an assessment.

A link to a CAS contract is included in this document. The CAS contract details who and when each of the three parties (CAS provider, CAS user, or State) is liable for errors.

- How does the CAS calculate tax?

When a sale is processed the CAS will calculate the tax based upon a set of rules that have been tested as a part of the certification process. On-going testing of tax calculation continues as long as the CAS provider continues to operate under contract with the SSTGB. The CAS calculates tax based upon a code assigned to each product sold by the Model 2 seller. The code assigned to

the product determines what taxing rules the CAS uses in calculating the tax. The code is usually referred to as a Good (Product) Service Code or something similar in the CAS. The product code is associated with the Taxing Jurisdiction rules (product taxation, rates, sourcing rules, etc) for the jurisdiction where the transaction takes place to calculate the tax.

Auditors may be familiar with their state's taxability matrix. Many have assumed the codes used by the state for testing are the same codes used by the CAS to apply taxing rules but this is only partially true. A CAS contains more codes (could be thousands) that were designed by the CAS provider to accommodate product categories not included in the taxability matrix. In addition, the user may have designed and implemented custom codes that were not provided by the CAS. The CAS provider or user will design codes that fit into the categories of SKUs listed in Appendix E of the SSTGB Rules and Procedures. The Model 2 Seller associates its product code for their product mix (SKU or proprietary codes) to the CAS product taxability codes. This process of matching products with codes is generally referred to as mapping. This mapping may be performed manually or in an automated manner. A Model 2 Seller could map products individually or by groups of products.

Simplified - the process is as follows:

1. Good (Product) Service Code is created by CAS provider and states confirm proper taxation of these codes for their state, except in the case of custom codes (see Custom Code section).
2. Seller product codes (SKU) are associated to Good (Product) Service Codes in the CAS.
3. When transaction takes place the CAS associates the Good (Product) Service Code to SKU.
4. CAS uses the code to determine taxability.

In some cases the CAS software is being used to calculate and report tax to non-SST states in addition to SST states. This necessitates the multitude of good service codes due to the varying and complex taxing rules of non-SST states.

- Why are Rates and Boundary Databases important?

Rates and Boundary Databases are supplied by each state to CAS providers and users at specific times throughout a year. They contain tax rates and taxing jurisdiction information for your state. A CAS must be updated with the most current Rate and Boundary Database information to calculate tax correctly. Upon notification from Testing Central, a CAS Provider is required to update the CAS with any new rate and boundary information. The updated file is provided to the Model 2 seller as a content update or a table update to be applied to their system. A log file of these updates which would include the Rate and Boundary Database updates should be available from the Model 2 Seller. Your State should be able to provide a list of Rate and Boundary Database release dates

and it may also be posted to a state's website where this information is made available to taxpayers.

- What is a committed sale transaction?

A committed sale transaction is a sale that has actually taken place. A CAS is capable of estimating tax on a potential sale (tax quote). For example, if a purchaser adds an item to their internet-shopping cart the CAS can estimate the tax that would be due on that purchase. The CAS will not add estimated taxes to the Audit Transactions File it will use to calculate and report taxes to the states. Instead the CAS waits until the sale has actually been finalized (which in most cases means it has been paid for or shipped) to mark the sale to be included in reporting to the states.

- What kind of standardized reporting capability is a CAS required to provide?
 1. Simplified Electronic Return (SER)
 2. Software version control log
- Why is the version of the CAS important?

Modifications to CAS software may be necessary to comply with changes in applicable law or policy. These changes are coordinated through Testing Central. In order for a Model 2 Seller to retain the benefits of a CAS the user must update the software timely upon receipt of a new version to retain relief of liability.

- How do I know which CAS and what version are being used by the seller?

The CAS ID can be found in the SER. In addition, the registration system contains information on sellers and whom they chose as their CAS. A log file of when a CAS version update took place should be available from the Model 2 Seller. In addition, a CAS Provider is required to provide the Model 2 Seller software upgrades and content updates which include changes to product taxability and Rates and Boundary Databases.

- Do Model 2 Sellers receive monetary compensation for using a CAS?

Compensation is allowed for Model 2 Sellers in states where the seller is determined to be a volunteer seller. The amount of compensation is 1.5% of tax collected with a maximum compensation of \$10,000 per state per year. The compensation is allowable for a period of 24 months. The criteria for determining volunteer status are the same as in the CSP contract and are also contained in the CAS contract. Compensation is retained from tax monies collected by the Model 2 Seller on behalf of your state. The CAS provider is required to complete

an Allowance Indicator Form and provide to the Executive Director's Office reflecting states where the seller is a volunteer.

- How is the CAS provider compensated?

CAS software is purchased by a Model 2 Seller from a CAS Provider. In addition to the initial purchase of the software the CAS Provider will usually require an on-going fee agreement for continued use of the CAS and access to Rates and Boundaries Database updates and software changes. The CAS Provider is required to notify Testing Central of all sellers who no longer qualify as a Model 2 Seller because of discontinued use of a CAS.

- Can other states notify my state if they find an error during their review that may also have occurred in my state?

If the nature of the error is caused by misuse of a CAS, whether in mapping or overrides, a state would probably not be able to disclose their audit findings to another state due to confidentiality statutes. However, some states have information exchange agreements with other states that allow for specific types of information to be shared if requested by another state. Check with your state for specific instructions.

Issues to consider when planning the audit:

Electronic Records - Upon a request by a state auditor, CAS Records are required to be provided by a Model 2 Seller to a state auditor in compliance with Appendix F of the Streamlined Sales Tax Governing Board, Inc. Rules and Procedures. Appendix F is a standardized file layout developed to provide state auditors the majority of information needed to verify that tax is being calculated at the correct rate, sales are sourced to the correct taxing jurisdiction and products are coded correctly for taxability. Applicable entity and product exemption information may or may not be present within the file. In addition, Appendix F was designed to provide as much simplification and as little inconvenience as possible to the Model 2 Seller. **(Refer to APPENDIX F)**

Integration and Set Up— The initial integration and set up of the CAS to the seller's ERP (Enterprise Resource Planning) system are critical for proper functioning. During the initial integration a Model 2 seller may engage a third party technology integrator to perform or assist with the integration. The integration consists of numerous steps. These steps vary in terminology among providers but include steps such as: Planning, Design/Adaptor Development, Configuration, Testing and Go Live.

Total Sales - The CAS and ERP system(s) should be set up to account for 100% of the Seller's sales and return transactions. All of these transactions should then be reported on a SER. The CAS may have been set up to process only part of the Seller's sales for a particular division(s) or sales channel(s). The criteria the CAS system uses to determine when a sale is committed will determine if the Model 2 Seller's transactions are reported on a SER for a particular month. Auditors can perform reconciliation between the ERP system and the CAS to confirm that all transactions processed through the CAS and any additional transactions are reported on the SER.

Mapping - The Goods Service Codes (Taxability Decisions) are prepared by the CAS provider and the Certification Committee does not verify that the Codes prepared by the CAS provider are accurate. The Certification Committee developed a method for each state to accomplish this verification through the submission of test decks and on-line testing. A set of SKUs are provided in Appendix E of Article V of the Streamlined Sales Tax Governing Board, Inc. Rules and Procedures. A state is allowed to use any or none of these during their testing. It is up to each individual state to determine the amount of testing they perform. If additional Goods (Product) Service Codes are needed, the state usually works with the CAS to make the testing of the code available. These tests are also run quarterly or as requested by a state on the CAS provider. The test records are created by each state. The auditor should find the individual in their state responsible for maintaining these test decks and reviewing the results when received from the CAS provider.

The CAS user is responsible for mapping their products to the Goods Service Codes Category. Mapping needs to be verified to ensure that the individual products of the seller are associated with the proper categories that have been tested and provided by the CAS.

Custom Codes - A Model 2 seller might sell a product that is not included in the taxability matrix or the expanded matrix of products provided in the CAS. If this is the case, a Model 2 seller might create a custom code for the product. The Model 2 seller may get the CAS provider to help with the development of the custom code. Custom codes are outside of certification unless the CAS provider adds the code to its matrix and has the taxability approved by the states. Transactions using unapproved custom codes which provide incorrect taxation are not covered under liability relief. The Model 2 seller should be able to provide a report showing the Goods (Product) Service Codes and Custom Codes in use.

Tax Calculation - Tax calculation requires product mapping, product taxability, information from Rates and Boundary Databases, sourcing rules and accurate mathematical calculations. If questions occur during the examination an auditor may need to verify that data bases, product taxability and CAS versions are updated timely and that the product mapping is accurate.

Exemption Certificates - SSUTA Section 317: Administration of Exemptions governs what constitutes a valid exemption certificate, the acceptance of the certificate by a Model 2 Seller, and with whom the liability exists for an invalid exemption certificate.

Absent fraud, if the Model 2 Seller captures all exemption elements required under the agreement, whether in electronic or paper form, the liability for an invalid certificate rests with the presenter of the certificate. If the required elements were not captured at the time of sale, the Model 2 Seller is allowed additional time to obtain the required elements.

System overrides – Overrides are the exception, but could occur. An example of a system override would be if the seller created a custom code and bypassed the code in the CAS. This should be detected by reviewing the report of codes used by the seller. An override at the transaction level generally depends upon the set up of the system. If the seller can alter the amount of tax at checkout, this could result in an override. If the seller determines that the purchaser is entitled to a lower tax or to resolve a customer service issue and charges less than the CAS calculates, the taxpayer could send through a credit transaction which would provide an audit trail for the auditor to review and confirm the validity of the transaction. If the seller charges less than the CAS calculated, it may be discovered on audit as an under calculation. Sellers that use a CAS system generally have an ERP system that provides the seller controls over these types of situations and generally have an audit trail of any changes made to the calculated tax.

Liability for errors - States, CAS Providers, Model 2 CAS users and Purchasers can all be liable for errors depending upon the error and the cause of the error. Criteria for liability listed in the CAS Provider contract and SSUTA should be researched to determine with whom the liability exists.

Compensation retained - Compensation may be verified during your review. Any compensation taken by a Model 2 Seller for use of a CAS is subject to review to verify applicability and accuracy. If during the course of performing the review it is determined that compensation had been taken in error, the Model 2 Seller may be subject to assessment including penalties and interest according to applicable state statutes.

Assessment - If a determination is made that the CAS Provider is liable after consideration of all liability relief provided under the contract, the state may assess the Seller for the CAS Provider's liabilities according to section E.1 of the CAS Provider contract.

Where to find additional information -

- CAS Provider contract.

- CAS company web-sites.
- SSTGB Web-site.
- Testing Central.
- SST Audit Committee.
- SST Certification Committee.
- Executive Director's Office of SSTGB.
- Streamlined Sales and Use Tax Agreement and Rules