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Streamlined Sales Tax Project Issue Paper

Certification and Audit Standards

The Audit Sub-committee has the task of developing recommended procedures or standards for the “Certification” of Models 1, 2 and 3 and for the audit of entities responsible for collecting the sales/use tax under Models 1, 2 and 3. In addition we were asked to make recommendations about who would perform the certification or audit.

Starting with the “certification”, the first question to be answered was what could or should the project certify. This was discussed at many meetings and teleconferences held over the last year and one half including the entire Technology, Audit, Privacy and Paying for the System Committee, as well as the Audit Sub-Committee. Many of these meetings included retailers, service providers and other interested parties. After much discussion, and after fully considering all the suggestions and commentary, the Audit Sub-Committee has agreed on a group of recommendations that we feel, if accepted, will allow for substantial reduction in the burden on a retailer in making the correct determination of the taxability of a good or service. In addition, the Sub-Committee has determined that it does not place any state in a situation, from an audit perspective, that it could not accept. The Committee further believes the certification can be accomplished, in most cases, with a reasonable allocation of resources.

The Audit Sub-Committee considered suggestions that were appealing from some perspectives but were unacceptable to many states for various reasons. One suggestion was to allow an accuracy standard of less than 100% (this was primarily discussed in connection with Model 3) in determining the correct amount of sales tax as an incentive for retailers to join the project. This proposal was inconsistent with most state’s audit policies and ultimately found to be unacceptable. Another proposal that was considered was to certify not only the operation of a Model 1 or Model 2 system but the mapping of the products or services sold as well. It soon became apparent that this was an undertaking so large that it was beyond the ability of the states to perform. (Perhaps in the future the states will be able to provide a centralized list mapping most products and services similar to our recommendation for sourcing.)

Even though the Committee concluded that some suggestions could not be included, the Committee believes that if the following recommendations are accepted, together with the uniform definitions and other project simplifications, the accuracy of the process for Models 1 and 2 can be insured, and significant simplification and resources made available to all models. (It should be noted that these recommendations only apply to sales. Purchases will remain subject to use tax compliance audits.)

Following the recommendations are discussions of audit procedures and certification standards.

Audit Sub-Committee Recommendations

1. The Governing States should form an Audit Committee. The Audit Committee should be comprised of representatives from tax administration agencies of the Governing States. The Audit Committee should have the following responsibilities:
 - Selecting audits using a uniform selection methodology. A process similar to that employed by the MTC is recommended. That is, based on requests from states and the availability of resources. Vendors selected by the committee for audit could not be audited for sales tax by individual Governing States.
 - Maintaining a database of qualified auditors. What constitutes a qualified auditor, should be determined by the committee.
 - Assigning audits
 - Developing uniform audit procedures
 - Developing standard audit work papers, etc. To achieve the desired level of uniformity, standardized work papers, audit reports, forms, etc., should be developed and used by the audit teams. Work papers, reports, etc. should be simple, thorough, and easy for the taxpayer to read and comprehend. This type of standardization provides the added benefit of enhancing the efficient use of the audit team's time. Standardization of work papers will still allow auditors to adopt an audit approach based on the particular circumstances found in each audit. In addition, any computer or audit software used by audit teams should ideally be the same, or at least substantially similar. Such standardization promotes ease of data compilation and increases the efficiency of the audit teams.
 - Maintaining statistical records of findings
 - Coordinating audit related activities and communications

- Distributing as appropriate, the finding to each Governing State. When errors in tax calculations, reporting or remittance are discovered, the information will be provided to each state participating in the audit. Each State will determine whether or not an assessment or refund is required, determine the amount of underpayment or overpayment, and handle all billing or refund functions. States shall issue assessments or refunds within 90 days of the completion of the audit.
 - Developing and implementing auditor training. All auditors participating in a joint or team audit process should be required to participate in a standardized audit training program. Training would be required on an ongoing basis. Standardized training could include; instruction on SSTP rules, regulations and interpretations relating to audits; audit processes; audit procedures and programs; sampling techniques; confidentiality provisions; ethics; public relations, etc.
2. 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.
 3. The states should offer a multi-jurisdiction audit option to agents or retailers, subject to the limits of an auditor's ability to adequately represent the number of states that wish to audit the taxpayer. However, Model IIA and Model III may elect to have audits performed by states individually.
 4. States will be responsible to provide the needed audit resource, be it personnel or funding relative to the number of audits that they participate in. To the extent that states provide adequate resources, the restriction mentioned above would have less impact.
 5. Agents and retailers will be held harmless for all errors caused by incorrect information provided by the states and will not be responsible for changes in taxability until timely informed by the states.
 6. Audits under the agreement generally will cover a maximum four-year audit period. Agents and retailers will not be precluded from extending the audit period to cover returns due in periods subsequent to the original audit period. States with lesser statutes of limitations can apply the results based on their state's statute. The four year limit applies to filed tax returns. Limits for unfiled returns will apply on a state by state basis. Generally there is no limit for audit of unfiled returns.

7. Each participating state will be responsible to provide a matrix of all definitions (including uniform definitions and definitions specific to each state's statutes) of tangible personal property and services and the taxability of each definition. Each state will be responsible to update the matrix as required. Agents and businesses using this matrix will be held harmless for errors made by the states. Agents and others using the matrix are responsible for reviewing each state's matrix monthly and making the required changes within 30 days of the end of the month the change is reported or the effective date of the change, whichever is later.
8. Each state should have staff available to answer questions from retailers or service providers asking for clarification or help in correctly identifying the nature of a product or service defined in a state's statute that is not covered by uniform definitions. The goal for answering inquiries should be 1 to 2 business days. Retailers will be held harmless for related errors from the time of inquiry until 48 hours after a response is provided by email or fax. If additional information is required the states will request it and the retailer or service provider will answer by email, each within 48 hours. (A committee member from business is preparing a recommendation for a default rule).
9. The project will be responsible to provide a resource for uniform definitions as described in recommendation 9.
10. Each state will be responsible to provide audit resources. The resources will be required to be trained for multi-state auditing based on the policies of the Governing States. It is expected that the audits will be performed by the state or states located closest to the records. In the case where a state is disproportionately burdened, a method of compensation will be developed.
11. Exemption certificates will be considered to be accepted in good faith when all the information contained on the uniform exemption certificate has been provided. Retailers and CSPs will be required to maintain certificates, whether paper or electronic for at least four years.

Audit Procedures

Regardless of the Model used by a retailer, the goal of a sales/use tax audit of sales is to determine whether or not the correct amount of sales tax has been charged, collected and remitted to the correct jurisdiction. As such, the same general audit procedures apply in each situation. The entity to be audited depends upon the model being used by the retailer.

The purpose of this paper is not to set forth the details of how an audit will be conducted. The specific procedures to be used will vary according to the model and the specifics of each system. Rather, this document presents the current recommendations of the Audit Sub-Committee and offers a general overview of the audit approach. Details of how to perform a sales tax audit are documented

in the audit manuals of most states and the M.T.C. and need not be recreated here.

The following is a list of the main areas of focus for an audit for any of the three models. The attached matrix indicates which entity has the responsibility for maintaining the documentation required for audit in each area. The responsibility for errors in tax collection and remittance of sales (and use tax on sales) tax is on the agent in Model 1, varies in the two variants of Model 2, and the retailer in Model 3.

Audit Functions

- I. Verify accuracy of:
 - A) Data used to determine location
 - B) Identification of item sold (mapping)
 - C) Identity of purchaser if exemption is claimed
 - D) Reason for exemption if claimed – ie-was the information on the certificate accurately reported.

- II. Check accuracy of Tax Calculation
 - A) Verify tax jurisdiction was properly determined based on approved information provided by states.
 - B) Verify tax rate used is correct for the jurisdiction based on approved information provided by states.
 - C) Verify taxability of goods and services are properly determined based on matrix of taxability of tangible personal property and services provided by states.
 - D) Determine error rate and amount if appropriate.

- III. Verify tax charged is recorded in the proper jurisdiction.

- IV. Verify Accuracy of Reporting
 - A) Verify amount of tax recorded is remitted.
 - B) Verify figures as reported (gross receipts and deductions)
 - C) Verify accuracy and completeness of exempt sales reports.
 - D) Verify accuracy of credits, returns and other adjustments.

(Attached is a matrix of responsibility to maintain records subject to audit for each model and audit function.)

Responsible Entity

Audit Function	Documentation Required	Model 1	Model 2	Model 2	Model 3	
		Agent Model	Tax Calc. by Agent	Tax Calc by Cert. Software	Proprietary Model	
Receive and Input Information	Verify data used to determine location	electronic or paper invoice	Agent	Retailer	Retailer	Retailer
	Verify mapping of item sold	electronic or paper invoice	Agent	Retailer	Retailer	Retailer
	Verify identity of purchaser if exemption is claimed	electronic or paper invoice	Agent	Retailer	Retailer	Retailer
	Verify reason for exemption if claimed	electronic or paper exemption certificate	Agent	Agent	Software	Retailer
Calculate Tax	Verify tax jurisdiction was properly determined	jurisdiction selected and address of purchaser	Agent	Agent	Software/Retailer	Retailer
	Verify tax rate is correct for the jurisdiction	rate used	Agent	Agent	Software/Retailer	Retailer
	Verify amount of tax was properly determined	amount of tax accrued	Agent	Agent	Software/retailer	Retailer
	Determine error rate if necessary		Agent	Agent/Retailer	Software/Retailer	Retailer
Record Transaction	Verify tax charged is accurately recorded in the proper jurisdiction	paper or electronic invoice and access to liability account	Agent	Retailer	Retailer	Retailer
Report and Remit tax	Verify amount of tax recorded is remitted	access to liability account and payment verification	Agent	Retailer	Retailer	Retailer
	Verify receipts and deductions	access to books of record and supporting documentation	Agent	Retailer	Retailer	Retailer
	Verify accuracy of exemption reports	access to reports and supporting documentation	Agent	Retailer	Retailer	Retailer
	Verify credits, returns and adjustments	access to records and supporting documentation	Agent	Retailer	Retailer	Retailer

Certification – Models I and II

The attached Matrix lists the requirements for certification of Models I, II (remote determination of tax only) and IIA (a software solution to determine the correct tax to be used within a retailer's existing system). In addition, any suggested standards or areas requiring further clarification have been listed under the related requirement.

Two columns have also been added. One is a column describing at what point in the process a test or an audit will be conducted to determine if the requirement has been met and/or is continuing to be followed. PRE means before certification by the Governing States has been issued. POST means after certification and can be performed separately or as part of the audit process. No matter when the POST work is done, it is expected to require a special resource. The fifth column indicates whether or not it is expected that "experts" will be required to advise the project on the detailed requirements for this particular standard. It also indicates that experts will be required to confirm compliance of the approved system to this standard.

Based on the committee's discussion to date, the certification for Models I and II would involve a review of the documentation of the system and how it supports the applicant's compliance with the system requirements and a functional test of the system.

The methodology suggested for the functional test involves each state preparing a "test deck" of transactions. This test deck should include sufficient tests of taxability of products and sourcing, thereby enabling a state to be reasonably satisfied that a system accurately determines the amount of tax due to each jurisdiction within the state. The information in the "Test Deck" should include not only the transactions to be tested, but the expected results, and return information.

In addition, CSP's and CAS vendors should provide for remote access by state for purposes of continuous testing related not only of every day transactions but statute and sourcing changes. States are responsible for continuously testing, as CSPs and CAS vendors are not responsible for errors until brought to their attention by the State. (The exception to certification and state responsibility is the mapping of the product being sold).

States should endeavor to provide test decks as soon as possible to CSPs, CASs and proprietary vendors for statutory or sourcing changes.

Model III

Model III would not involve a "certification" as for Models I and II, and IIA, but instead would require an agreement or contract. The contract would provide that to the extent their existing system or systems as modified accurately applies the state provided sourcing (zip + 4) information and taxability of tangible personal property and services matrix, they will not be held responsible for errors in the state provided information. Model III vendors will also be provided the "test deck"

information to help insure themselves that their system accurately determines the amount of tax due. (Further discussion is required to determine if the Governing States can certify proprietary systems at some future date.) Any such certification would require a proprietary system to meet all requirements of the CSPs and CASs, including providing remote access to the Governing States and aggregating exempted sales by customer.

They will also be required to meet the documentation and reporting requirements for exempt sales in order to get the reduced good faith standard. (Note – The Exemption Administration Committee is re-examining Model IIA and Model III vendors as they relate to exemption certificates and good faith relaxation. Based on their findings this requirement may be modified.)

It is recommended that each state provide a dedicated contact person(s) for retailers and CSPs to use to resolve EDP questions.

Certification Standards

Models	I	II	IIA	Cert	Expert Needed
<p>Must use state provided sourcing information.</p> <p>Format of information should be Excel spreadsheet, available on WEB-SITE and emailed to known users</p> <p>CSP and CAS (tax determine only) must update their databases within hours/days.</p> <p>For CAS (software) and Model III, must update within days of availability.</p>	✓	✓	✓	Pre	
<p>Must use state provided taxability of TPP and Services</p> <p>Format of information should be Excel spreadsheet, available on WEB-SITE and emailed to known users</p> <p>CSP and CAS (tax determine only) must update their databases within hours/days.</p> <p>For CAS (software) and Model III, must update within days of availability.</p>	✓	✓	✓	Pre	
<p>Must demonstrate back up strategy and an acceptable disaster recovery plan.</p> <p>Must have a written policy on how standards will be met.</p> <p>Separate standards for back-up and recovery. Standard For recovery will drive standard for backup. (near-line, off-Line, etc.)</p> <p>A retention of records for audit purposes must be Determined. Archive where and for how long.</p> <p>For certification, Governing States will review policy.</p> <p>Audits of the system will insure written policy is being followed.</p>	✓			Pre	Expert
<p>Must demonstrate the system's ability to capture sufficient information to make an accurate tax determination</p>	✓	✓	✓	Pre	
<p>Must demonstrate the system's ability to obtain, accumulate and report information on exempt sales.</p> <p>Must collect all information regarding purchaser claiming exemption as required by exemption certificate.</p> <p>Models I & II must accumulate exempt sales by entity.</p> <p>1) make available to states upon request or</p> <p>2) create online inquiry ability.</p>	✓	✓	✓	Pre	
<p>Must document (audit trail) all changes to system including sourcing, taxability and mapping of products (A separate report will address these requirements).</p> <p>Record all authorized and unauthorized changes.</p> <p>Record date of change</p> <p>Record changes to hardware, software, software upgrades.</p>	✓	✓	✓	Post	Expert

<p>Must be able to provide information in electronic format as required for certification and audit</p> <p>States must identify data file requirements including technical requirements and data content.</p>	✓	✓	✓	Post	Exp
<p>Must properly accumulate and account for by jurisdiction all sales/use taxes collected, reported and remitted</p>	✓			Pre	
<p>Must meet privacy standards</p>	✓	✓		Post	Expert
<p>Must properly apply rounding rules</p>	✓	✓	✓	Pre	
<p>Must demonstrate modifications cannot be made without documentation of the change.</p> <p>Must define what access and changes are to be documented and allowed related to:</p> <ul style="list-style-type: none"> • Hardware • Software versioning, upgrades distribution • Access security-electronic and physical • For both live version and back up • Data content (transmission management) • Executable code only for Model II (software for 3rd party use) • Override indicators to indicate possible fraud • Security passes to prevent code altering 	✓	✓	✓	Post	Expert
<p>Must demonstrate ability to retrieve and report recorded information</p> <p>Must meet all reporting standards</p>	✓	✓	✓	Pre	
<p>Must demonstrate the accuracy of the above by a functional test of the systems or software</p> <p>Tests may be by the Governing States as a group or by Individual States through remote access.</p>	✓	✓	✓	Pre	
<p>Must agree to any generally accepted sampling procedure including electronically applied statistical sampling and the system must be structured to provide for this functionality</p>	✓			Pre	
<p>Must apply industry-standard availability/fault tolerance (i.e. what happens if a piece of hardware goes down?)</p> <p>Two standards have been suggested:</p> <ul style="list-style-type: none"> ✓ real time - 99.999% availability ✓ batch - 99% availability 	✓	✓		Post	Expert
<p>Must apply industry-standard security protocols</p> <p>All transmitted data protected by a minimum 128 bit encryption</p> <p>Require strong authentication (eq. Client Certificated access) is required for access to transaction data, tax calculation engines and money movement</p>	✓	✓		Post	Expert

<p>Must process transactions at industry-standard speeds</p> <p>Need maximum, minimum and mean, also must define standard Deviation allowed. Suggested:</p> <ul style="list-style-type: none"> ✓ Maximum – 60 seconds allowing for network propagation and retransmission delays. ✓ Mean should be 2 seconds or less with standard deviation of 1. 	✓	✓			
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(The performance parameters will be established based on the input of the pilot project and subject experts.)

Benefits of Adopting System

- To the extent any model relies on state provided information, the user is held harmless for errors when the information is correctly applied.
- Centralized filing of returns (local jurisdiction filed with state)
- Reduced number of returns (less frequently)
- Reduced number of remittances
- Easier exemption administration – relaxed good faith standard.
- Combined audits if requested.