COST
Council On State Taxation

Recommendations To Improve Multistate Joint Audit Program

Presented to
The Multistate Tax Commission

October 17, 2007

Executive Summary

On the whole, the Multistate Tax Commission ("MTC") joint audit program appears to be achieving its goals of efficient audits for multiple jurisdictions, relieving states and taxpayers of wasteful, duplicative work. The following Survey results, however, suggest that there are a few opportunities available in the procedural area. Fortunately, many of these issues can be easily addressed, tracked, and rectified with little effort. The Council On State Taxation ("COST") and its members appreciate the opportunity to help improve the MTC's joint audit program and look forward to working with the MTC in doing so.

The following is an overview of the seven recommendations that COST is making regarding the MTC joint audit program.

Issue 1: Erroneously Applying One State's Law To Other States – Efforts should be made to eliminate the possibility that one state's laws will be applied to other states included in the audit. The use of multistate templates should be eliminated; state-specific templates should be used. Improved training of the auditors to understand the intricate legal aspects of each state's law is also sought.

Issue 2: Number Of States Per Audit – The number of states included in a single audit should be reduced. From the COST Survey, the typical number of states per audit is between eleven and fifteen. Too many states in a joint audit can make the audit unmanageable for the auditor as well as the taxpayer. COST recommends that the average number of states included in an audit be reduced, on a test basis, to between six and ten states in an effort to improve audit accuracy. Additionally, in regard to sales and use tax examinations, the number of legal entities reviewed should be reduced to focus on companies with significant activities.

Issue 3: Time To Complete Audit – Audits should be concluded in one or two years. From the COST Survey, audits are currently lasting two to three years. While the MTC Joint Audit Report indicates that the audit time has decreased, additional steps should be taken to reduce that time to between one and two years. The use of binding audit plans would greatly assist the MTC joint audit program in that endeavor.

Issue 4: Auditor Access To Tax Returns – MTC auditors should obtain copies of tax returns from the participating states prior to the commencement of the audit. States should not be allowed to participate in the audit unless they provide the MTC with already-existing documentation instead of placing this burden on the taxpayer.

Issue 5: Commencing Audits At The End Of A Statute – Audits should not be commenced at or near the expiration of a statute of limitations; there must be sufficient time remaining on the statute of limitations to conclude the audit. The time necessary to complete the audit (See Issue 3, above) should guide the decision regarding which years to audit in light of the statute of limitations in participating states.

Issue 6: MTC Policy Agendas In Auditing – COST is concerned that the MTC is asserting its own tax policy positions, such as economic nexus, in the MTC conducted audits, even though a particular state that is part of the joint audit has not taken that position. Additionally, the MTC should commit to dedicating effort during the audit to detecting refunds and using statistical sampling.

Issue 7: No Re-Audits – COST is concerned that the states re-audit taxpayers after the MTC has conducted a joint audit. To achieve its goal of audit efficiency the MTC should adopt a policy refusing to conduct audits on behalf of a state unwilling to be bound by the audit results.

Background

According to a recently published report, the MTC completed 15 sales tax audits and 7 income tax audits during its most recent fiscal year (2006-2007). It also has approximately forty-five audits in process.[1]

The information in the Joint Audit Report indicates an improvement in productivity, and the MTC Audit Committee recognizes that the process of improving joint audits is continual. Per the Joint Audit Report, the MTC measures its productivity by reference to the number of auditor hours consumed per audit per state. According to this report, in 1991 an average MTC audit required one-hundred and thirteen hours of staff time per state audited. Today, the same audit takes just sixty-nine hours, representing a thirty-nine percent improvement. The Joint Audit Report stated that member states and taxpayers participating in joint audits benefited from this improved productivity since "MTC auditors spend less time completing an audit."[2] Because the MTC does not provide the information to the public, no data was available to support the notion that there exists a causal link between the reduction in MTC audit time and improved productivity (however defined).

The MTC issued the Joint Audit Report from its own perspective, using its own experience to measure audits. By definition, the joint audit program consists of two other constituencies - the member states and the taxpayers subject to audit. The Joint Audit Report appeared to be limited to the experience of the MTC and thus does not capture the views of either the states or the taxpayers subject to audit.

[1] 2007 MULTISTATE TAX COMM'N REP. OF THE AUDIT COMM'EE AND AUDIT PROG. at 2 (Aug. 2007). Referred to in this article as the "Joint Audit Report".
[2] *Id.*

To assist the MTC in capturing the views of the taxpayer community, the Council On State Taxation ("COST") organized a subcommittee (the "Subcommittee") to gather the views of its member companies that have completed or are currently undergoing a MTC joint audit for sales and use, and/or income tax. The Subcommittee's first task was to gather issues encountered by member companies during their MTC audits. The Subcommittee used this information to draft a survey to solicit additional information to be used in formulating recommendations to the MTC.

Survey Results

The intent of the Survey was to gather taxpayer experiences and perceptions. For those issues demonstrating broad consensus, the Subcommittee developed recommendations that would be generally acceptable to the COST membership. The Subcommittee developed seven recommendations, detailed below. The survey methodology can be found in Appendix A, attached to this document.

Issue 1: MTC Auditors Appear to Apply One State's Laws to All Other States in the Joint Audit

After hearing from COST members that MTC auditors were applying one state's law to all others, the Subcommittee asked the Survey respondents the following question:

> *On the whole, do you feel that your MTC auditor(s) applied each state's laws independently when conducting the audit(s) of your company?*
>
> *Please give a real-world example where the MTC auditor(s) applied each state's specific law to the issue as presented OR please give an example where the MTC auditor(s) applied a general legal concept with respect to all states. Do not give an example of both circumstances.*

Two-thirds of the respondents indicated that the MTC auditors did not apply each state's law independently.

Below are some of the illustrative examples provided by respondents:

> **Company A** - *We had an auditor apply the regulations of a certain state to as many states under audit as [the auditor] could. It was as if, wherever [the auditor] could, [the auditor] contorted the regulations and or opinions of the various other states to appear similar in some degree to the first state, so that [the auditor] could impose the treatment of the first state on as many other states as she could… It was as if [the auditor] was trying to coerce all states to follow the laws enacted by the first state, because it gave a good answer for the other states, of generating revenue.*

The write-up provided to us in response to the interrog[a]tories was not state-specific with regard to the state where the assessment was made. In fact, the write-up response appeared to be a modification of a sample template write-up, where the name of the company had not even been changed from "XYZ Company," and the write-up itself referred numerous times to the "member states" in general, and to various specific state laws dealing with and building a case for the issue, instead of referring to the state where the assessment was made, and to the specific laws (for that state) that supported the assessment.

Company C - *The auditor used UDITPA section 18 to make discretionary adjustments to apply industry-specific regulations in states that did not have them. Additionally, the auditor took a case from one state and circulated it to the other states and encouraged them to take the same position even though there was no precedent for it in the other states.*

Company D - *For contractor services, the auditor tried to assess tax on materials across the board for all states. [The auditor] was not aware that in some states, the contractor is considered the consumer and tax is not due from the customer even if the materials are separately stated.*

Company H - *CA Law was used for most states.*

Company K - *When reviewing the draft audit work papers, each state's apportionment factors' denominators included exactly the same property/revenue items. In explaining to the auditor that each state has different statutes as to what is or is not included in the factors, the response was "the MTC audit template" is what determines each factor... [The auditor] also believed if it was an MTC state, they have the same laws.*

Recommendation to Issue 1: Apply Each State's Laws to the Particulars of the Situation, and Eliminate Multistate Templates

The vast majority of the responses suggest that the MTC auditors are routinely applying one state's laws to situations in other states. While it may be that the law of other states can be persuasive,[3] or that the interpretations of state laws issued by federal courts can also be persuasive,[4] when the laws of a particular state are unambiguous, the MTC should apply tax laws state-by-state, independently.

In cases where there is true uniformity among states on positions, for example with respect to certain provisions of the Uniform Division of Income for Tax Purposes Act, the application of the Act to those states should be encouraged to promote efficient audits. Multistate templates should be eliminated and state-specific templates (e.g. for the apportionment factor) should be developed, updated, and used. Over-reliance on spreadsheets, blanket positions, and other devices that reinforce efficiency at the expense

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[3] *See State v. Ball*, 471 A.2d 347 (N.H. 1983).
[4] *See Thomas v. United States*, 824 A.2d 26 (D.C. 2003).

of accuracy are counterproductive with respect to taxpayers and member states. After all, when a taxpayer detects that a state's law has been misapplied, the typical resolution mechanism is a formal administrative protest, which often involves high-cost representation. Such a process imposes greater administrative cost and delay on both the taxpayer and the taxing state – further eroding the efficiency of conducting multistate audits.

The MTC should revisit the technical resources and conditions that create this issue and make appropriate adjustments to audit procedures, manuals, and software. While lengthier procedures may increase the number of hours a MTC auditor spends auditing, the result will be more accurate audit results. The MTC should also revisit its auditor training to make sure that its auditors understand what legal issues are truly uniform and which are idiosyncratic. Improved legal research skills and/or use of technical personnel should eliminate the possibility that the wrong law is applied.

Issue 2: Number of States Per Audit

Half of Survey respondents indicated that their particular MTC audit(s) covered eleven to fifteen states. About a third of the Survey respondents indicated that their MTC audits contained more than fifteen states. Only a few of the respondents indicated that their MTC audits covered less than eleven states.

When asked the following question:

> *If the number of states per audit were changed, how would you feel the accuracy of the audit would change?*

The vast majority of the respondents indicated that audit accuracy decreased as the number of states included in the audit increased. The responses further suggest that the current number of states per audit is too high. When asked about an ideal number of states per audit, no respondent suggested that there should be more than ten states per audit and most respondents suggested that six states per audit is the appropriate figure.

Recommendation to Issue 2: Reduce the Number of States Per Audit on a Test Basis and Determine Changes in Accuracy

One goal of a MTC audit is to improve efficiency by auditing as many states as is economically and reasonably possible. Efficiency in this regard benefits the taxpayer and the tax administrator so long as the audit results remain accurate. COST members believe that the accuracy of audits would benefit from a reduction in the number of states. Obviously, this goal must be balanced with the need for the efficiency gained by conducting multistate audits. Logically, there is a natural upper and lower limit to the number of states that should be covered in a MTC audit. These limits should be driven by the resources, training and capacity of both the taxpayer and the tax administrator.

With these issues in mind, COST recommends that the MTC reduce the number of states per audit to six to ten on a test basis and compare the accuracy of the limited-size audit with the accuracy of larger audits currently being conducted. If the comparison data show a material difference, then the appropriate changes should be made permanent. This recommendation comports with the suggestions posted by the Survey respondents when asked how many states should be covered per audit:

> **Company A** - *Five or less - otherwise the overall audit becomes too complex for a particular auditor to address the various laws pertaining to the various states.*
>
> **Company B** - *As a general proposition, I think 5-6 is about right with a maximum of 8-10.*
>
> **Company J** - *I think 4-6 states would be manageable.*
>
> **Company L** - *I think a half-dozen or less is the most practical and manageable.*

Issue 3: Audits, in Absolute Terms, Are Taking Too Long To Complete

When asked about the time taken per MTC audit, the responses were too varied to concisely measure. Respondents were asked to "measure time in days from the date the audit began (meaning, the date you were given notice of a pending MTC audit), to the date you were issued an assessment (or the date you received a no-change notification)."

The average responses indicated about two to three years per audit (the audits included in these responses included an average of 11 states). The respondents spent approximately 200 to 300 man-hours per year to conclude an audit, or 400 to 900 man-hours over the average life of an audit. Although the responses vary based upon the size of the company and the number of states audited, the Survey suggests that MTC audits are taking too long.

The free-form Survey responses to this question suggest that were the joint audits conducted concurrently by the individual states the process would be completed in no more than one to two years, as opposed to the two-to-three currently encountered in a joint audit. When asked how long the audits should take, the Survey respondents answered:

> **Company A** - *I have been able to complete six to eight concurrent [non-MTC] state audits within eight to twelve months.*
>
> **Company F** - *365 days.*
>
> **Company G** - *We believe separate state audits should take no more than 180 days to complete.*

> **Company I** - *Each of the audits would likely have taken 12-18 months, but would have occurred simultaneously [if done by individual states], and would have concluded within the statute of limitations, had they started early enough.*

Recommendation to Issue 3: Use a Binding Audit Plan to Shorten Audits

The Joint Audit Report states that the time the MTC spends per audit per state has decreased over time. This report only measures the length of time in hours spent, and does not measure (or at least did not report) how many years passed during the course of the audit, and if that metric has improved. The Joint Audit Report does not draw any conclusions as to whether the current state of affairs represents an optimal figure.

The COST Survey responses suggest that joint audits are still taking too long to complete. The Survey did not query the root of the problem, but the causes should be relatively apparent – a lack of binding deadlines, failure of the states to provide initial documents, sketchy audit plans, and broad audit scopes are likely leading both the MTC and taxpayers down wasteful audit paths. Consequently, COST recommends that the MTC institute formal audit plans, limiting the scope of the audit to specified tax type as well as tax issue. The MTC should also require the states to provide copies of existing tax return to the MTC auditor (see Issue 4, below). The plan should contain an outer time limit for completion of the audit. Such a deadline will press taxpayers and MTC auditors to work diligently and efficiently.

Following the example of the IRS, it is the recommendation of the Subcommittee that the MTC should establish a materiality threshold, identify material issues, and focus both its, and the taxpayers' resources on those issues, ignoring potentially time-consuming and immaterial adjustments.

Issue 4: Auditor Access to Tax Returns

COST members indicated that joint audits would be more efficient if the MTC auditors obtained taxpayer returns before a joint audit begins. Significant time is wasted at the outset of an audit when the MTC asks taxpayers to provide copies of information that have already been filed with the participating states.

Recommendation to Issue 4: MTC Auditors Should Obtain Taxpayer Returns Prior to the Start of a Joint Audit

The MTC, as audit agent for the State, should have access to the state's records. One respondent stated:

> **Company D** - *The state auditors don't always have copies of the tax returns but they at least usually have a report containing the taxpayer reported data. The MTC auditors should at least obtain the taxpayer reported data from the state.*

COST recommends that the MTC alter its engagement documentation with the states requiring the states to turnover taxpayer returns and other relevant documents to the MTC auditors at a date certain before the beginning of the audit.

Issue 5: Commencing Audits Towards the Expiration of a Statute of Limitation

Taxpayer reluctance to extend the statute of limitations should be considered when deciding whether, or for what tax periods, the MTC will conduct an audit. Engaging in an audit agreement on behalf of states with little or no time left on the statute of limitations should not be allowed. While taxpayers have historically been asked to extend the statute by signing a waiver, increasing pressure to close tax years for financial reporting purposes will undoubtedly exacerbate taxpayer reluctance to extend any open tax year. Three-fourths of Survey respondents indicated that they would only sign waivers of the statute of limitations given a prescribed set of circumstances; i.e. one taxpayer would only sign waivers for one year or less and another would only sign where it is perceived that the waiver would not be used to just to "stack up files."[5] The consensus amongst respondents was that taxpayers were not willing to sign waivers simply to allow the MTC time to complete an audit.

To start a joint audit at the end of a statute of limitations introduces two undesirable elements into the picture. First, if an audit is commenced under a compressed time-frame with pressure to issue an assessment before the statute of limitations expires, it is likely that the resulting assessment will contain multiple errors – a situation which is avoidable were the audit started with sufficient time on the statute. Second, it goes without saying that time works against all parties involved. Files disappear, audit trails go cold, laws change, and memories fade. Asking a taxpayer to waive the statute of limitations at the last minute simply to relieve pressure on an already delayed audit only invites an audit result burdened with evidentiary problems. This creates extra costs for taxpayers, who, at least, must maintain and track evidence for that much longer. It also creates extra cost for the states who must defend the assessment through appeal or litigation.

Recommendation to Issue 5: The MTC Should Identify a Definitive Point Beyond Which It Will Not Accept an Audit Engagement

The MTC largely controls the timing of its audits. While a MTC auditor may commence an audit at any time, the resulting assessment must be issued before the statute of limitations expires. If the MTC starts an audit late in the statutory period, it, along with the taxpayer, must work frantically to conclude the audit prior to expiration of the statute. With the MTC and taxpayer rushing to complete the audit report, it is likely that the assessment will be riddled with problems, which, in turn, must be addressed by the constituent states and the taxpayers at additional cost, extra effort and with increased delay.

COST recommends that the MTC develop a bright-line rule for the commencement of audits. For example, if the MTC's experience shows that audits can be completed in just

[5] The balance of the Survey respondents indicated that they did not sign waivers as a matter of course.

one year, then the MTC should create and enforce a policy that no audit will begin within one year of the expiration of the statute of limitations. If for example, a MTC auditor finds himself delayed by his own actions, with only three months left to go from the expiration of the statute of limitations, then the equitable result is that expiring periods should be eliminated. A bright-line rule will ensure that fewer waivers are issued and that audits are not needlessly delayed to the detriment of any party.

Issue 6: MTC Audits Its Own Policy Positions

Taxpayers are concerned that MTC audits go beyond state law in an attempt to enforce policy positions supported by the MTC, but not yet adopted by its member states. MTC audits have an appropriate role in focusing on whether a taxpayer has complied with an individual state's laws. Separately, MTC policy development has an appropriate role in assisting the states in policy development. However, if a state has not expressly and publicly adopted an MTC policy position, the MTC audit should not attempt to adopt that position on behalf of a state. Going beyond existing state law inevitably forces taxpayers to seek modifications of the audit results when the results are taken up at the state level. Including these policy positions in MTC audits leads to inefficiencies, both for the taxpayer and the taxing state.

The Survey asked the following question:

> *Do you have any experience to suggest that a MTC auditor did not audit strictly for compliance (i.e. to raise revenue or to strictly issue refunds)? If so, please elaborate.*

A third of the respondents indicated that they had an experience to suggest that the MTC did not audit strictly for compliance. A number of respondents specifically referenced the MTC had taken an economic nexus position on behalf of states that had not adopted an economic nexus standard. Beyond the economic nexus issue, taxpayers expressed concern that MTC auditors often approach the audit with a goal of revenue generation rather than determining whether the taxpayer complied with a state's law. Numerous taxpayers complained that the MTC audits failed to look for credits or refunds due to taxpayers.

> **Company A -** *The MTC auditors took the approach of applying treatment of an issue in a certain state to as many of the other states represented as possible, giving me the impression that the auditors had the perception that our company was taking inappropriate positions across the board on all states, and that the only way to get even, was to apply one state's laws or treatments to all states under audit.*
>
> *[T]he impression [is] that because a treatment generates revenue in one state, it should be employed in as many states as possible so that all states generate revenues, whenever possible.*

> **Company C**- *The auditor consistently attempted to advance the MTC's policy agenda by various adjustments.*
>
> **Company D**- *Every audit conducted by the MTC auditor that had transactions where we did not properly pay… tax also had transactions where we erroneously paid the tax. However, the MTC auditor did not identify any credits; all credits were brought to [the auditor's] attention by the taxpayer.*
>
> **Company I–** *The auditor applied the theory of economic nexus to several of our subsidiaries, regardless of the existence of statutes, regulations, rules, or even department policy with respect to this issue.*

Recommendation to Issue 6: MTC Revenue-Generating Goals Have No Place In Auditing

While the MTC auditors may believe that they are in the business of identifying tax deficiencies, determining whether a taxpayer has <u>complied</u> with the law is the core of any audit function. As such, included within the scope of the audit should be a responsibility to determine whether the taxpayer has overpaid liabilities. Compliance with the law includes determining whether the taxpayer is entitled to a refund just as it includes determining deficiencies.

There is a perception that the MTC audit process has adopted an implied policy focusing on revenue generation instead of determining compliance; it should be made clear that such a policy does not exist.

COST recommends that the MTC specifically dedicate time to detecting refunds. In the following instances some MTC auditors are already apparently making this effort. The two comments below indicate that some of the MTC auditors look beyond deficiencies:

> **Company F** - *[The auditor] assisted with a capital loss carryback with [X State], and incorporated changes in our favor.*
>
> **Company G** - *[T]he auditor appears to have high ethics and wants to get the amounts correct (i.e., is not just looking for adjustments that benefit the State). However, the auditor does not seem to have extensive state specific knowledge (e.g., different state depreciation methods, state addbacks/deductions, etc.)*

Issue 7: Re-Audits After an MTC Audit

COST members indicated that one of their greatest frustrations with the MTC audit is that states will routinely re-audit the taxpayer at the conclusion of the MTC audit. Such action completely undermines the goal of the MTC audit and creates double the workload for taxpayers and tax administrators. It also further delays resolution of the issues associated with the open tax years.

Recommendation to Issue 7: MTC Audits Should Not Be Conducted for States that Are Unwilling to Be Bound By The Audit Results

The MTC, as audit agent for the State, should adopt a policy refusing to conduct audits on behalf of states if they are unwilling to be bound by the audit results. Once the MTC has finalized its audit report the participating states should not have the ability to selectively re-audit tax issues associated with the return already audited. To the extent that the taxpayer has additional adjustments that need to be resolved with the state the taxpayer and state can work together to reach resolution of those issues; the state should not be able to open up other issues that were not identified by the MTC audit. When asked:

> *Suppose that you were presented a choice between the following: 1) a single, binding MTC audit with no opportunity for re-audit by the states and 2) a non-binding MTC audit that allows states to perform second (re-)audits. Which would you prefer?*

Over eighty percent of respondents replied that they would prefer a single, binding MTC joint audit.

COST recommends that the MTC alter its engagement documentation with the states, requiring the states to elect between conducting their own audit and participating in a binding MTC joint audit.

Conclusion

Overall, the Survey suggested that MTC joint audits have their rightful place in state taxation. As indicated at the outset, the COST membership recognized the MTC joint audit program as aimed at improving audit efficiency, relieving states and taxpayers of wasteful, duplicative work. Forty years ago the COST membership challenged the MTC's authority to conduct audits. Today we are working with the MTC in an effort to gain additional efficiencies. It is COST's hope that the recommendations here will be used to revise the MTC audit process to further minimize the burden of a natural and necessary audit cycle on corporate taxpayers while at the same time assist states in improving the efficiency of the audit function.

It is important to note that a number of COST members were very positive regarding their MTC audit experience. Below are a few such comments from the Survey results:

> **Company C** - *Our auditor was very communicative. He told us about issues as they arose, he was available by cell phone or e-mail for clarification on issues, and he was receptive to information we provided to him on individual issues. (That does not mean he agreed with it, just that we tried to deal with issues as they arose.)*

> **Company E** - *The auditor is making a reasonable attempt to understand our company and has generally not issued unwarranted adjustments… Once I provided evidence of the ultimate resolution of [an] adjustment (in our favor), the auditor appears to have retracted his adjustment.*
>
> **Company H** - *[The MTC auditor] did a fine job. No ethical issues came up just like most audits. [The auditor] was able to concentrate on the main issues and get the reports done.*

Finally, we note that the Survey gathered much more data than has been analyzed in this report. Some of the other suggestions for improvement, such as staggering the issuance of audit reports so that taxpayers do not have to respond to all of them within a short 30-60 day window, also need to be addressed by the MTC. We hope that you find these suggestions helpful and we look forward to working with the MTC to create additional efficiencies in the MTC audit process.

Appendix A - Survey Methodology

In September of 2007, the Subcommittee submitted a Survey to COST members, asking them to relate their experiences with an MTC joint audit. The Subcommittee designed the Survey to cull enough data from the respondents to determine if the issues presented were endemic to the COST membership base (of all taxpayers currently participating in MTC audits), and not idiosyncratic with respect to an isolated company. Since the Survey largely consisted of the collection of normative data, the free-form response was heavily employed, allowing the respondents to relate their experiences. Some free-form questions limited responses to one example so that the respondent would answer with its highest order issue, thereby eliminating secondary, tertiary, and further, lower, order concerns. To ensure relevance and uniformity in response, questions often defined key words. For example, one question read:

> *How do you feel the quality of a MTC audit would change if there were more simultaneous or fewer simultaneous audits? "Quality" means the efficiency of the audit (meaning resources devoted to the audit in comparison to the accuracy of the audit assessment). A simultaneous audit occurs when one taxpayer is subjected to more than one audit over two or more audit cycles.*

While every definitional bias cannot be removed unless every word in a question is defined, the format of the questions was structured so as to limit variance in responses due to differing interpretations of normative phrases and words. Likert scales (e.g., a scale of one-to-five) were employed to capture some responses.