Sales & Use Tax Audit Manual

Rev. May 2010

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Multistate Tax Commission
Sales & Use Tax Audit Manual

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1. Introduction

1.01 The Joint Audit Program of the Multistate Tax Commission ("MTC" or "Commission") was initiated in the early 1970s under the auspices of Article VIII of the Multistate Tax Compact.

1.02 This Sales & Use Tax Audit Manual ("SUTAM" or "manual") sets forth the procedures that Commission auditors follow in performing a joint audit on behalf of the Joint Audit Program member states who have elected to participate in a specific audit.

1.03 The information provided in the MTC SUTAM does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted by Joint Audit Program member states since the manual was last updated.

1.04 The SUTAM is provided for the guidance of the Commission's joint audit staff and are not authoritative, and may neither be cited to support an audit position nor relied upon by a taxpayer. The laws of the states for which a joint audit is being conducted govern audit positions with respect each state. The manual merely reflects the Commission's internal joint audit procedures and guidelines.

1.05 Suggestions, corrections, or other comments are welcomed; please provide them to the director of the Joint Audit Program or the deputy director of the Commission.

2. [Reserved]

2.01 [Reserved]

3. Pre-Audit Procedures

3.01 This section will explain how an auditor should prepare to conduct an audit. It will explain how an audit is assigned and time frames for responses from the states in the audit program. It will also detail what sources auditors should use to investigate the taxpayers' activities. This section will also explain how an auditor determines the audit period, develops an audit plan, and organizes the audit file.

3.02 *Audit Assignment.* The audit supervisor will assign audits from the Commission's inventory to individual auditors within six months from the time the audit was selected by the Audit Committee. The individual auditor assigned becomes the lead auditor.

3.03 *Request for audit authorizations from the states.* The audit supervisor is responsible for sending audit authorizations (See Exhibit 3.1) to the states participating in the sales tax audit program. The supervisor is also responsible for insuring that the sales and use tax checklist is sent with the audit authorizations and will also maintain a list of the appropriate state contacts for audit authorizations.

3.04 *Authorization deadline for the states.* The states should return signed authorizations within 30 days. At the expiration of the authorization deadline, the lead auditor will inform the audit supervisor which states intend to participate. The audit supervisor will follow up with the states who have not responded. Once field audit work has begun on a particular audit, states that have not returned a signed audit authorization may not participate in that audit unless specific approval has been given by the director of the Joint Audit Program, after the director has obtained the consent of the taxpayer.

3.05 *Gathering information before starting the audit.* The auditor should use various resources to gather taxpayer information prior to starting the audit. The auditor should use information submitted with the sales tax audit nomination forms and the sales and use tax checklist.

> 3.05(a) The auditor should obtain a copy of the Annual Report and 10-K for each year under audit from the taxpayer or, in the alternative, from the U.S. Securities and Exchange Commission (SEC). A thorough review of these documents should assist the auditor in understanding the taxpayer's operations and industry.
>
> In addition to understanding the taxpayer's overall operations, the auditor should understand what the operations are within each state participating in the audit. For example, does the taxpayer maintain sales offices, warehouses, or manufacturing facilities, etc. in a participating state? The auditor should also obtain names of affiliated companies and what their operations are within each participating state.

Any relevant information should be obtained and any questions that arise from this review should be recorded by the auditor. The auditor can follow up with questions later at either the initial telephone contact with the taxpayer, the opening conference, or with an information request, as appropriate.

Any potential issues identified in this initial review should be followed up by additional review of individual state statutes, regulations, policies, and relevant court cases.

3.05(b) The auditor should make extensive use of the Internet as a research tool. Most taxpayers maintain a web page, and if one is available the auditor should visit the taxpayer's web page and research there. A great deal of information about the taxpayer's business operations can be obtained.

If the taxpayer does not maintain a web page, the auditor may still be able to do research about the taxpayer or expand the research by doing a general search on the Internet about the taxpayer and the taxpayer's industry by using available search sites (e.g., Google, Yahoo, or others).

3.05(c) The auditor will determine if the Commission has a prior audit on the taxpayer and, if so, a thorough review of it should be made. The auditor should review the prior issues in that audit. Often, prior audit issues will still exist in a subsequent audit. Review of the prior audit will also assist the auditor in understanding the taxpayers operations.

3.05(d) If not provided with an initial audit information package (see 3.06), the auditor should contact each state in the audit and determine whether they have a prior audit on the taxpayer. If they do, the auditor should request a copy of it to include in their review.

3.06 *Initial Audit Information Package.* The auditor will review the tax returns or transcripts submitted by each participating state. The auditor will also input pertinent data to appropriate schedules for each state. The auditor will review the returns and any prior audits to determine any obvious audit issues.

3.07 *Work Load Review Form and Daily Log File*. The auditor will set up the work load review form which will be used throughout the audit (See Exhibit 3.2). This form will be updated and given to the audit supervisor at the end of each month. This will enable the supervisor to monitor progress and activity on the audit.

The auditor will also open and maintain a daily log file (See Exhibit 3.3) for any newly assigned audits. The purpose of the log file is to maintain a daily record of any worked performed on the audit. It will give the audit supervisor, Joint Audit Program director, states, or any other authorized Commission employee access to the progress being made on any audit. It will also serve as documentation of work that has been performed by date.

If properly maintained and used with the audit plan, the auditor should be able to track what has been completed and what still remains to be completed on the audit. Dates of all phone contacts and all information requests sent and received should be logged in the daily log file. The daily log will be maintained as an electronic document. The auditor will record the date and number of hours worked each day on each audit and a brief explanation of the worked performed on the audit. The total hours in the daily log for the month should match the total hours assigned to the audit on the auditor's monthly timesheet.

3.08 *Audit File Organization.* The auditor will maintain a separate binder for each state that is participating in the audit. These binders will be used to accumulate and maintain all hard copy documentation the auditor generates or receives, such as correspondence, information requests, waivers, audit authorizations, responses from information requests, or any other relevant information pertaining to the taxpayer for each particular state.

In addition to the binders, the auditor will maintain electronic records for each audit organized, at minimum, through use of separate subfolders for each state participating in the audit. Each auditor is expected to review the Commission's current electronic data back-up guidelines and adhere to them without exception.

> 3.08(a) The "Documents" folder (called "My Documents" in earlier versions of Windows) is the recommended central folder for maintaining electronic records on the auditor's computer, given its relevance within the Windows operating system.
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> 3.08(b) An "Audits" subfolder within the Documents folder is recommended.
>
> 3.08(c) Each audit in the auditor's inventory should have its own folder, identified at least by the name of the taxpayer. The Audits subfolder in the My Documents folder is the recommended location for this folder.
>
> 3.08(d) A subfolder within each specific audit folder for each state participating in the audit will be used. The name of the subfolder will either be the name of the state or its appropriate two letter abbreviation. Each state subfolder will be used to maintain all electronic records pertaining to that state that the auditor accumulates during the course of the audit.

3.09 *Determination of audit period.* Prior to contacting the taxpayer, the auditor will consider an appropriate starting date of the audit. The auditor should attempt to establish the start of the audit period beginning with the filing month after the auditor has contacted the taxpayer and include thirty six months worth of returns. The auditor will have some leeway in establishing the audit period depending on the initial contact with the taxpayer. The auditor will get approval from the audit supervisor if there is a need for an adjustment to the starting date of audit period.

3.10 *Initial Audit Plan.* The auditor will develop an initial audit plan in writing. The audit plan will be based on all relevant information the auditor has obtained up to this point. Though there will be many similarities in all audit plans, each will be unique to a particular audit.

The audit plan will be the auditor's guide to follow in the conduct of the audit from start to finish. The audit plan will be a key focus of the auditor's early contact with the taxpayer, and the auditor will be working with the taxpayer to adapt and tailor the plan in an effort to develop a workable plan that is mutually agreeable. During the course of the audit, the audit plan will need to be changed and updated based on audit progress, intervening circumstances, and information obtained.

4. Statutes of Limitation & Waivers

4.01 *General*

The statute of limitation (SOL) defines the time period during which a refund claim may be filed, an assessment may be initiated, or a collection activity may occur. The statute of limitations limits the time during which an action can be brought by the states for an audit and the time for state tax collection activities. Statutes of limitation vary by state.

A statute of limitation typically begins running when a tax return is filed, or the due date of the return, whichever is later. In most states, the statute of limitation for sales and use tax can be extended beyond the normal time frame if there is an omission or under reporting of the taxes totaling a certain percentage over the reported amount.

Statutes of limitation can be extended by executing the Commission's waiver form (See Exhibit 4.1). If a state is not authorized to use the Commission's waiver form, a separate waiver form will need to be executed as prescribed by the individual state. The following states currently require the use of their waiver form: Georgia (See Exhibit 4.2), Louisiana (See Exhibit 4.3), and Washington (See Exhibit 4.4).

4.02 *Timely Completion of Audit, Extension of SOL*

The auditor must make every effort to complete the audit before the expiration of the current statute of limitation period expires. When waivers are required to extend the time period, the auditor will make every effort to estimate accurately the completion date of the audit, and will request that the taxpayer extend the time period in accordance with our waiver policy.

It is the auditor's responsibility to monitor and maintain waivers. The auditor will give the audit supervisor a copy of each waiver for each audit in their inventory. If a taxpayer refuses to sign waivers at six months prior to expiration, the audit supervisor will be notified by the auditor and in turn the supervisor will alert the states.

If waivers still have not been obtained within three months of the statute expiring, the auditor with the assistance of the supervisor will estimate the liability for the periods in jeopardy. The Joint Audit Program director will then review the audit and if in agreement will have the audit forwarded to the states.

The auditor will discuss the Commission's waiver policy (see 4.03) with the taxpayer at the start of the audit.

4.03 *Waiver Policy*

4.03(a) The auditor should explain that at the direction of the audit committee the Commission's policy is to obtained waivers six months prior to the statute expiring. This is to insure the state as sufficient time to review and process the audit file.

4.03(b) The auditor should discuss with the taxpayer the need in establishing an audit completion date so that waivers can be obtained that allow for the audit to be completed and allow for the six month review and processing period by the states.

4.03(c) The auditor should explain and discuss with that taxpayer that if waivers are not obtained at a minimum of three months prior to the statute expiring that the audit period(s) in jeopardy will be closed and submitted to the states with the best information available.

4.04 *Statutes of Limitation in Joint Audit Program Sales & Use Tax Member States*

A chart that will be routinely updated of the current statutes of limitation in Joint Audit Program sales and use tax member states can be found at Exhibit 4.5.

5. Working with Taxpayers

5.01 The Commission serves as an operating arm of the member states through its Joint Audit Program. Joint Audit Program audits must be conducted in a professional and timely manner. The audit staff must adhere to the laws and regulations of the participating states. The audit staff shall:

- Practice professional courtesy during the audit.
- Request information that is pertinent to the audit based on each state's requirements.
- Conduct the audit as efficiently as possible.
- Discuss all audit findings with the taxpayer.
- Make every effort to accommodate the taxpayer's schedule.
- Ask for waivers when needed to allow sufficient time for the states and taxpayer to review the audit findings.
- Know and obey the confidentiality laws of each participating state.

Consequently, the Commission expects that taxpayers will:

- Respect the Commission's role as representative of the states to conduct the audit.
- Extend professional courtesy to the Commission audit staff.
- Respond to the information requests in a timely manner.
- Sign reasonable waiver requests.

5.02 *Initial Contact with Taxpayer*. When making initial contact with the appropriate taxpayer representative, the auditor should discuss the following items and any other items the auditor deems befitting.

5.02(a) The general process and Commission procedures for conducting the audit should be explained, including the auditor's initial audit plan.

5.02(b) The states that have authorized the Commission to conduct the audit should be disclosed.

5.02 (c) The auditor is obligated to discuss audit appointment dates with the taxpayer. If the auditor cannot secure a timely appointment and the statute is a problem, then the need to obtain waivers should to be discussed. Once appointment dates have been agreed upon, the auditor records them in the workload review given to the supervisor. (See Exhibit 3.2). These dates will be identified in the engagement letter sent to the taxpayer (See Exhibit 5.1).

5.02(d) The Commission's preference in auditing through use of electronic data and statistical sampling procedures needs to be explained.

A conference call should be arranged that includes the auditor, taxpayer, a computer audit specialist and a representative from the taxpayer's IT department. The purpose of the call would be to determine the feasibility of conducting a computer assisted audit. In the interim the auditor should provide the taxpayer with a copy of Computer Assisted Audit Description for Taxpayers (Exhibit 5.3)

5.02(e) The Commission's policy regarding the use of secure e-mail should be explained. The auditor should inform the taxpayer that our preference is to use our secure messaging system in order to preserve the confidentiality of taxpayer information. If the taxpayer cannot or does not wish to use it then they will be asked to sign a waiver form (See Exhibit 5.2). The auditor should explain that if the taxpayer chooses not to use secure e-mail or sign the waiver form that the auditor will not be able to communicate with them by e-mail and will not be able to exchange any data electronically with them using the Internet.

5.02(f) Any questions from the taxpayer about the basic operations of the Commission should be answered. The Commission website, *www.mtc.gov*, should be provided to the representative for additional information.

5.03 *Procedures for a Non-Responsive taxpayer*. If a taxpayer does not respond to repeated attempts to make contact (either by letter, phone, or e-mail), the assigned auditor will send a certified letter to the taxpayer giving the taxpayer a seven day response window to make contact with the auditor. If there is still no response within two weeks of the certified letter, the audit supervisor shall be informed.

5.04 *Initial Written Correspondence with Taxpayer.* After the initial telephone conversation with the taxpayer, the auditor will send the taxpayer an engagement letter (See Exhibit 5.1). The engagement letter can be modified to suit the particular audit of any individual taxpayer.

The auditor should include the authorizations from each participating state, Commission's procedures for conducting a computer assisted audit and a copy of the Commission's sampling guidelines and policy as attachments to the engagement letter.

5.05 *Initial Meeting.* The following should be discussed at the initial meeting with the taxpayer:

5.05(a) Waiver policies of both Commission (Chapter 4.03) and taxpayer

5.05(b) The initial audit plan, including any modifications and obtaining the taxpayers agreement to the plan

5.05(c) IDR policy (See 5.06(b))

5.05(d) Steps of the audit process

5.05(e) Additional people who may be involved in the audit such as a computer audit specialist

5.05(f) Taxpayer personnel including any third party representatives (non-company personnel, including outside attorneys, accountants, or consultants)

5.05(g) The taxpayer policy relating to corresponding via e-mail and copies of documents.

5.05(h) Safeguarding taxpayer's documents at the taxpayer's location

5.06 *Conducting the Audit*.

5.06(a) The auditor should discuss major audit issues as they arise.

5.06(b) Information Document Request (IDR). An IDR is an official Commission document that should be used by auditors when making a request for any type of document or information relevant to the audit. This formal process to request and secure information from the taxpayer promotes cost effectiveness and quality audits. The importance of timely responses is emphasized, as it will improve the audit cycle time and help focus on early resolution of issues.

Use of IDRs promote —

- More complete and timely responses to information request
- Open and meaningful communication between the auditor and taxpayer
- Consistent treatment of taxpayers
- Taxpayer understanding of expectations
- Improved timeliness and quality of documentation received
- A foundation for issue development and earlier resolution of issues
- More clear and complete information requests
- Awareness for all concerned parties of any outstanding information request

To help ensure that responses to an IDR address the specific needs of the audit it might be useful to have a meeting with the taxpayer. The auditor and taxpayer should discuss and specifically identify the records needed to eliminate or avoid any ambiguity. The auditor and taxpayer should agree upon a realistic due date and timeline for the information being sought.

The document should be signed by the auditor. If the IDR is presented to the taxpayer while engaged in field work at the taxpayer's location, the auditor should also seek to gain the signature of the taxpayer or other assigned representative acknowledging receipt. If a taxpayer signature cannot be obtained, the auditor should document the request and provide the taxpayer with a copy.

If the IDR was sent by mail and a signed copy is not returned in seven days, then the IDR should be sent using a delivery method whereby receipt can be confirmed, such as certified mail or other third party delivery service.

5.06(c) Additional IDR Procedures —

(1) A copy of any IDR given to the taxpayer during the course of the audit should be included in the audit file along with an explanation of the circumstances surrounding the request.

(2) If an IDR has more then one request for information, the response date for each request should be indicated.

(3) Taxpayers may from time to time request an extension of time to respond to an IDR. The auditor should use good judgment in granting extensions of time and allow them where appropriate. Any time an extension is granted an updated written notification should be sent to the taxpayer with the new agreed upon response date.

(4) If the auditor determines that an extension is not justified; written notification will be sent to the taxpayer stating the reason for denial. Should the taxpayer fail to respond, the auditor will immediately notify their supervisor.

(5) If the taxpayer fails to provide information by the due date or provides incomplete information, the auditor, should contact the taxpayer and determine the cause. If warranted, the auditor may allow for an extension of time with a new agreed upon response date. Should the auditor determine that an extension is not warranted, See (3) above.

(6) If the taxpayer request a second extension or fails to respond to the first extension, the auditor should immediately notify their supervisor and discuss the problem.

(7) The supervisor should contact the taxpayer to determine the cause for either not responding or needing another extension. If the supervisor determines the taxpayer is being non-responsive a demand letter should be sent immediately. If another extension is not warranted the supervisor should immediately send a demand letter and the reason for denial.

(8) The supervisor should be reasonable in granting an extension if the taxpayer provides sufficient cause. If the supervisor

determines an extension is warranted then a letter granting the extension should be sent to the taxpayer which clearly indicates the mutually agreed upon response date.

(9) If the taxpayer fails to respond to the supervisor’s 14-day demand letter, or to the extension granted by the supervisor or request a second extension from the supervisor, the supervisor will notify the audit director of the problem and seek further guidance.

5.06(d) When a complex issue arises, the auditor should:

(1) Encourage the taxpayer to provide a statement that supports their position.

(2) Inform the Commission supervisor and the state liaison, if necessary.

5.06(e) Preliminary audit schedules will be issued.

5.06(f) Allow the taxpayer ample time to review and respond to the preliminary audit schedules unless the taxpayer refuses to extend a short statute date.

5.07 *Concluding the Audit*.

5.07(a) Any necessary adjustments to the preliminary schedules will be made.

5.07(b) The auditor should offer the taxpayer a closing conference. If the taxpayer declines, the auditor should insure that all recommendations are conveyed and understood by the taxpayer. The auditor should know the taxpayer’s position regarding the recommendations and should note it in the report.

5.07(c) If a request for a copy of the narrative is made by the taxpayer, the auditor should inform the taxpayer they are not permitted to do so and that such request should be made to the state.

5.07(d) The auditor will inform the taxpayer that billings and protests will be handled directly by each individual state.

5.07(e) The auditor may assist the taxpayer and states during the protest process.

6. Nexus

6.01 Nexus is a measure of the connection that a taxpayer has with a particular state. Once a taxpayer has established sufficient nexus, it is subject to tax by that state.

Each new auditor will be expected to attend the MTC Nexus School as soon as possible. The auditor will receive Nexus School materials which contain a description of all U.S. Supreme Court cases which deal with sales tax nexus. Also included in the materials will be numerous state court cases which deal with sales tax nexus. The auditor will retain this material and refer to it when investigating nexus issues for sales tax purposes.

6.02 Nexus Creating Activity for Sales Tax

6.02(a) *In-State Property or Payroll*. Generally, if a company has either property or payroll in a particular state, this company would have nexus for sales tax purposes. At times a company will have no property in a state but may have employees who travel into the state to perform business activities on behalf of the company. In most instances this activity would create nexus for sales tax.

See appropriate section of the Nexus School materials for detail of state tax court cases and US Supreme Court cases that address this issue.

6.02(b) *Representative Nexus*. Nexus can be established where one company or a group of individuals are present in a state acting as representatives of an out-of-state company with no other presence in the state. The representative's presence is attributed to the out-of-state company to establish the required nexus between the state and the nonresident company.

See appropriate section of the Nexus School materials for detail of state tax court cases and US Supreme Court cases that address this issue.

6.02(c) *Affiliate Nexus*. Corporations are carving out separate companies to sell via the Internet or catalogs. The companies are taking the position that the Internet companies have no nexus for sales tax purposes. Many states have taken the position that the brick and mortar company located in its state creates nexus for the Internet affiliate if the brick and mortar company acts on behalf of the Internet company.

See appropriate section of the Nexus School materials for state cases that address this issue.

6.02(d) *Temporary Presence.* Companies that send personnel into a state for a "significant" number of days in each year may create nexus in that state. States have varied positions regarding the number of days and specific activities that may create nexus.

See appropriate section of the Nexus School materials for state cases that deal with this issue.

6.03 Audit Procedures for Nexus Investigations

For any audit assigned, the auditor should endeavor to understand the company's business activities and how they conduct business, both as a whole and in a particular state. If needed, the auditor should obtain a state by state analysis of property, payroll, and sales to determine whether there are sufficient activities in a particular participating state to initiate a nexus investigation.

6.03(a) *Use of MTC Nexus Questionnaire.* Initially, the auditor should obtain from the taxpayer a completed "Multistate Tax Commission Nexus Questionnaire" (or version adapted for the particular audit) for each state participating in the joint audit for the tax years during which any affiliate of the taxpayer did not file returns in any participating state (See Exhibit 6.1).

6.03(b) *Follow-up Investigation.* After receiving the completed MTC Nexus Questionnaire, the auditor should compare the responses to the questionnaire with previous information obtained regarding the conduct of the affiliate's business. To verify the accuracy of the responses, the auditor may, if necessary, coordinate the following with the taxpayer:

- Review of procedural manuals for sales representatives
- Review of instructional manuals for sales representatives
- Interview in-state employees or representatives
- Interview appropriate district, regional managers, or vice presidents familiar with the affiliate's sales operations
- Interview in-state customers of the affiliate
- Chart of Accounts

6.04 Document Requests for Nexus Audits

The following documents, if not already obtained by the auditor (see 3.05 & 3.06), should be requested if appropriate or useful in conducting a nexus audit:

6.04(a) *Annual Report & 10K.* This information will give significant information regarding the operations of the company and any affiliates.

6.04(b) *Federal Consolidated 1120 Return.* This information will give information concerning any company owned in the corporate group and the general business activity of each of the companies. The affiliates will be found on Schedule 851.

6.04(c) *State Apportionment Factors.* This information will give the location of sales by destination, property by state, and payroll by state for each state participating in the audit. Property should include fixed assets, inventory, land, and rent expense.

6.04(d) *Job Descriptions for Salesmen.* This information will describe the salesmen activities and territories.

6.04(e) *Expense Reports for Salesmen.* Expense reports are very important to discover what the salesmen are actually doing. It is important to get the description of the salesmen daily activities when obtaining the expense reports.

6.04(f) *Warranty Contracts*. It is important to determine how warranty work is conducted. The auditor needs to determine if any warranty work is conducted in the state. The auditor needs to determine if warranty work is provided by third parties. The auditor must also determine if the cost for repairs is included in the price of the product being sold.

6.04(g) *Independent Contractor Agreements.* The auditor should determine whether of not the company uses independent contractors for sales activity. The auditor should ask for any contracts with independent contractors. The auditor should determine if the independent contractor creates nexus for the company. The auditor should also request copies of federal 1099 for any independent agent that worked for company.

6.04(h) *Company Policy or Procedure Manuals.* These are important documents to discover how the company operates.

6.04(i) *Delivery Records*. These records will help determine if products are delivered by company owned vehicles, which may create nexus in a state.

6.04(j) *In House Publications or Newsletters*. Often these documents may contain information that may be helpful in determining nexus. Many such items can be found in the taxpayer's lobby.

6.04(k) *CPA Consolidating Workpapers.* The company may be required to provide for potential state tax liabilities. These are often detailed in the Tax Provision Account. The companies are often reluctant to release this information.

6.05 Determination of Nexus

After completing the nexus investigation, the auditor with permission from the audit supervisor, should contact the Commission's legal staff to discuss the facts and circumstances and determine if any additional information should be sought. Upon completion of the fact gathering process, the decision as to whether nexus exists as to any participating state for any tax year should be arrived at jointly among the auditor, supervisor and the legal staff.

If needed, the auditor or legal staff should discuss the findings with the applicable state(s) to obtain their feedback whether there is a strong basis for asserting nexus based on that state(s) laws, statutes, regulations, or policy.

6.06 Documentation

The auditor should be aware that in most cases the taxpayer will likely contest a nexus finding. The auditor should insure that all records used in making a decision should be documented. This would either be by obtaining a copy of records used or noting what documents were reviewed and information contained in the documents.

6.07 Audit Years

Generally, an audit will cover the latest 3 years. Many states will request that the auditor look back 6 years for any nexus audit, however. The auditor will determine when nexus creating activity first occurred. The auditor will confer with the audit supervisor and appropriate state personnel to determine how far back the audit should go.

6.08 State Request for Nexus Audit

Any audit participating state may participate in an audit of a taxpayer authorized by the Audit Committee in which the company has not filed returns for any of the tax years under audit. Prior to the initiating of the nexus audit, the state should agree to assist by gathering information located within its borders.

6.09 Audits Referred by the MTC Nexus Program

The National Nexus Program may refer a nexus audit to the Audit Committee. The Audit Committee will vote on whether to add this audit to the MTC audit inventory. See separate policy on this procedure.

7. General Audit & Verification Procedures

7.01 Introduction

This chapter is designed to introduce the auditor to common sales and use tax audit procedures. It is impractical to list all possible procedures required during a course of an audit. Therefore, the auditor should be prepared to handle situations not addressed within this manual. There are procedures that are common to most audits. But each audit will present the auditor with a unique set of circumstances that will require the auditor to use good judgment.

7.02 Objective of a Sales and Use Tax Audit

The objective of any tax audit is to determine the correct measure of tax in the most efficient manner for the Commission and taxpayer. Oftentimes the auditor may be confronted with more then one alternative on how to audit a particular issue. In choosing an appropriate alternative there could be a trade-off between efficiency and accuracy. Even though a procedure may be deemed more accurate, after careful analysis, the auditor may determine that the best alternative is the more efficient one, possibly for materiality reasons.

7.03 Taxpayer Agreement and Disclosure

In developing an audit plan for review of sales and purchases, the auditor will be making decisions that obviously impact the taxpayer. Therefore, the Commission recommends that the auditor utilize or consider any reasonable suggestion or request made by the taxpayer with regard to the development of an audit plan of sales and purchases. This presupposes that the auditor has made a good faith effort to disclose or communicate important decisions made, and the taxpayer is similarly acting in good faith toward the audit. Discussing this before the plan is executed will be in most cases beneficial to both the Commission and the taxpayer. Where agreement cannot be reached, the taxpayer has the right to discuss these matters with the audit supervisor, where appropriate. Similarly it is incumbent on the auditor to communicate areas of possible disagreement to audit supervisor and within the audit report.

Although taxpayer agreement is encouraged, the form and execution of the audit plan is ultimately the responsibility of the Commission, and given the amount of time and work usually involved with purchase examinations, the auditor should not delay the audit of the transactions at the detail level where it is deemed that areas of disagreement cannot be reasonably resolved, or where the areas of disagreement do not appear to be genuine. Unduly delaying the audit of transactions, particularly with respect to large taxpayers, even when sampled, can be problematic and infringe on the state’s interest — the Commission is responsible for preserving and protecting the state’s right to audit and make corrections for errors within the statutory period open for audit.

7.04 Test vs. Detailed Audit

Whenever possible, a detailed examination of the taxpayer's records is the preferred method of determining the correct measure of tax. Realistically, this is usually the least practical method because of the number of records encountered in most audit cases. Tests used to replace detailed examinations can be either quite simple or very complex.

In some cases, an examination of only a few invoices may be needed to make a determination or provide enough substantiation to support a position. A simple test, depending on the findings, may later require a more complex test which might include the design of a more substantial sample, such as statistical sampling.

There are many types of tests that an auditor could perform, but the auditor has to determine the test that best fits the needs. The auditor may even be confronted with an issue that may require a specially designed test.

Some things to consider when selecting or designing a test include: (1) the volume of records, (2) the probability that an error exists, and (3) the materiality of any possible error.

7.05 Compilation and Review of Tax Reporting

Establish the amounts reported for taxes due from income producing activities. The purpose of this procedure is primarily for purposes of reconciliation of reported amounts with actual amounts found to be due. In some cases, reported amounts can be used for a basis of projection of tax reporting errors found in sampling.

7.05(a) For each tax classification covered under the scope of the MTC audit that arises from the income producing activities of the taxpayer, typically collected retail sales tax, establish a summary of the tax reported for the entire audit period, generally referred to as a transcript.

(1) Wherever possible, request copies of tax returns directly from the states.

(2) For those returns not supplied by the state, obtain copies from the taxpayer. Indicate in the audit report which returns were summarized using taxpayer supplied copies.

(3) The transcript and related audit work papers should summarize gross amounts, exemptions taken, taxable amounts (tax measures), and taxes paid.

7.05(b) In preparing tax returns, taxpayers usually produce a set of supporting papers, or tax worksheets, that arrive at the reported amounts on the return. These tax worksheets often identify the sources of the amounts by reporting division, activity, and source.

(1) Request all copies of tax worksheets from the taxpayer applicable for the audit period.

(2) Identify the sources of these amounts used in the tax worksheets from within the taxpayer's records, if that information is available in the tax worksheets.

(3) Often the auditor will have general knowledge of the taxpayer's income producing activities from taxpayer interviews, review of SEC filings, financial reports, or other sources. Identify those reporting areas in the tax worksheet that account for taxes due for those income producing activities.

(4) Review the methods by which the taxpayer produces or generates the amounts used on the tax worksheet.

(5) If any changes in this methodology exist during the audit period, investigate these changes (missing or added divisions, changes to sources of the numbers, changes as a result of personnel producing the returns, and so on).

(6) Where changes in methods exist, make sure that no gap in reporting exist (for example, the taxpayer changes computer accounting software, but there could be time period not captured by the tax worksheet that possibly exists as a result of the change).

(7) As necessary, create summaries of the tax worksheets for purposes of reconciling. These summaries often will further breakdown the numbers generated from the transcript.

7.06 Gross Income Reconciliation

7.06(a) For the audit period, reconcile gross sales per sales tax returns using transcript and related work papers with gross sales per the taxpayer's records.

7.06(b) Taxpayer records include financial reports, general ledgers, federal tax returns, and apportionment reports created for state income tax reporting.

7.06(c) Where comparison is made to apportionment reports created for state income tax reporting, additional audit steps are required. You will need to request information about the apportionments made to all states from the taxpayer in order to verify that the total apportioned income ties to other summary sources, such as general ledger accounts, federal tax returns, or financial statements. If the taxpayer refuses to provide the apportionment information, consult your audit supervisor.

7.07 Audit of Tax Collection and Accruals

7.07(a) Review of Sales Tax Collected vs. Gross Tax Reported.

(1) Prepare a monthly comparison of sales tax collected to gross tax reported for the entire audit period. Investigate material differences. Ordinarily, a difference will not in itself result in an adjustment; but it may lead to one.

(2) Trace sales tax collected to the general ledger.

(3) Identify sources that increase (credits) and decrease (debits) balances in tax accrual accounts, if they exist in the general ledger. Perform any necessary reviews of these sources.

(4) Where necessary and appropriate, reconcile any sales tax accrual accounts contained in the general ledger.

(5) Determine whether unexplained material balances exist between reporting periods (that is, amounts that represent tax collected and in the tax accrual account that does not get reported).

7.07(b). Tax Charged Sales

(1) *Tracing to Original Documents*. Verify the fact that tax charged has been remitted to the state by tracing invoices or other sales transactions on a test or detailed basis.

(2) *Checking Rates*. Verify that tax rates used by taxpayer are correct.

(3) *Scheduling.* Prepare a schedule of any differences, errors or omission on Schedule 1-A (See Exhibit 7.1).

7.07(c) *Review Use Tax Accruals*. Similar reviews of use tax accruals should also be made as needed. The auditor should make sure any accrued use tax in the general ledgers makes it to the tax returns.

7.08 Audit of Exemptions

7.08(a) Examine the taxpayer's claimed exempt sales.

7.08(b) Determine what types of exemptions the taxpayer is asserting (resale, exempt product, exempt purchaser such as the federal government, or other).

7.08(c) For each type of exemption claimed, determine whether such an exemption exists under the laws of the state.

7.08(d) Determine the total exempt amount, for all reporting periods for each type of exemption that is claimed exempt, and then compare (reconcile) these to amounts deducted (as established in procedures outlined).

7.08(d) As required under the audit, either on a test, spot check, or through a complete examination of source documents and any applicable exemption certificates, determine whether the exemption transactions are allowable.

7.08(e) Where exemptions are claimed though certificates, such as resale certificates, make sure that —

(1) The certificate used is applicable to claimed exemption

(2) Certificates are properly completed or satisfactorily filled out under the state's requirements

(3) That the certificate is not expired at the time of the transaction if the state has specific rules covering the dating of certificates

(4) Disallow any invalid claimed exemptions as applicable

7.09 Auditing Purchases – Use Tax Examination

7.09(a) In the audit of purchases, the auditor is verifying whether, taken together, the sales tax paid to vendors, the self-accrued use tax, and exempt purchases, has been paid correctly for items consumed during the period under audit. Purchases examinations entail auditing procedures (such as tracing totals to the tax returns and verifying use tax accrual procedures) and an examination of purchases at the transaction level. To develop a proper audit plan, various questions and considerations should be investigated before performing the examination on detail transactions:

(1) Are the purchase transactions available electronically?

(2) Has the taxpayer paid use tax for periods under audit?

(3) Does the taxpayer maintain a use tax accrual system?

(4) Is there an audit trail for use tax accrued to the individual purchase transactions allowing for an audit on a difference/error basis? (Is it possible to trace use tax reported to the individual transactions, tracking the error amounts made with respect to each transaction audited?)

(5) Is it more practical to determine (or estimate) a total use tax liability (initially disregarding any use tax accruals actually made - possibly because that information is not available at a detail level) and comparing that to total actual use tax amounts reported rather than tracking tax differences (as in #4 above)?

(6) Can the auditor give credit for sales tax paid in error to a vendor? (Many states will not refund sales tax paid in error through the tax audit but require the taxpayer to seek a credit through the vendor that received the tax from the taxpayer audited.)

(7) Can the taxpayer segregate transactions to the various states by use of cost centers or other sourcing data?

(8) Are there few enough transactions to do a detailed audit (preferred audit method)?

(9) If a detail examination is not practical, are there enough transactions to justify statistical sampling (the preferred sampling method)?

(10) Fixed assets and other capitalized purchases may be audited separately, that is apart from transactions that are expensed or are of a recurring nature. On the other hand, they may be audited within a single procedure, and sampled — together with the expenses — if there are sufficient numbers to justify sampling.

7.09(b) Other Important Procedures to Consider in a Use Tax Examination

The auditor should trace some of the accruals, and if possible, before auditing, determine what type of transactions tax was accrued upon. Note the procedure for reporting use tax from the accrual account, and any unusual transactions. Frequently, the taxpayer will have an internal control procedure that differs depending on the nature and size of the transaction. It is often useful to know these procedures in advance when developing an audit plan.

The auditor is responsible for verifying electronic purchase populations to the books and records (that is, make assurances that all pertinent records are received from the taxpayer — see Chapter 8, Computer Assisted Audits). Optimally, a download of purchases should be traced to general ledger accounts and reconciled to their balances.

Because the tax is predicated on the consumption of property (and taxable services depending on state law), knowledge of the business and those specific activities performed in the states audited is crucial. Therefore the auditor should obtain information about these activities before auditing the detail records, as well as understand the various nuances specific to the law in the states included in the audit.

A review of the type of general ledger accounts, costing codes, cost centers should be made prior to auditing the detail to help in determination of an audit conclusion. Inclusion of this information in electronic audit populations, or investigating these matters in non-electronic audits will often be useful. This could be done concurrently in the electronic sampling methods which use "account of interest" approaches.

Finally, a review of purchase documentation of the taxpayer should ultimately determine the auditor's conclusion on most transactions. This is time consuming and expensive process for both the Commission and the taxpayer. As such, the auditor is encouraged to use sampling methods in purchase examinations wherever and whenever appropriate.

7.10 General Audit Approaches on Purchases

7.10 (a) The audit report should summarize the approach taken with regard to purchases, and the conclusions reached, particularly to those stated in 7.09(a). If a sample approach has been taken, the sample must be adequately documented (see the sampling manual and Chapter 9).

7.10 (b) Because use tax is ultimately based the facts surrounding purchase transactions, the auditor must have sufficient information in the audit workpapers concerning facts about specific purchases whenever any adjustments are recommended in consideration of a review of individual transactions, whether this is on sample or detail basis. Such facts would normally include, but not necessarily be limited to the following:

(1) Date of the transaction (such as an invoice or book date).

(2) Specific numbers assigned to the transaction, such invoice number, voucher number, general ledger accounts that the purchase is accounted under and/or other identifying numbers.

(3) Information identifying the purchase source, such as vendor number or name.

(4) Description of the item purchased, if necessary.

(5) Amounts of each transaction, including any book values, difference values (error values), taxable values, and tax paid or accrued values.

(6) Point of use information, such as the state. If the state has local taxes, further information is often required that documents the proper local tax rate and jurisdiction.

(7) Point of sale, vendor locations to determine if purchases are made from out of state vendors.

(8) Information documenting the audit conclusion with respect to the difference (error) amount or taxable amount

7.10 (c) According to 7.10(b)(7) above, the auditor must come to some conclusion about the transaction if auditing on a tax difference (tax error) basis:

(1) No tax was due, and no tax was paid (no error).

(2) No tax was due, but sales tax was paid in error to the vendor (credit for this depends on state law or policy).

(3) No tax was due, but use tax was accrued in error.

(4) Tax was due, and use tax correctly accrued (no error).

(5) Tax was due, and sales tax was correctly paid to the vendor (no error).

(6) Tax was due, and no sales tax or use tax has been paid (the transaction is in error).

7.10 (d) On the other hand, the auditor may not be able to audit on a tax difference (error) basis, but must determine (or estimate) the total amount subject to use tax and compare that total to the amounts reported. In that event, the audit conclusions possible are as follows with respect to each transaction:

(1) No tax was due, and no tax was paid.

(2) Tax is due, and sales tax was paid to the vendor.

(3) Tax is due, and no sales tax was paid to the vendor.

Regardless of audit approach, that is the tax difference (error) method or where the auditor determines the reportable total for use tax, the audit conclusions expressed above should be recorded in the workpapers with respect to each transaction within the workpapers. When using sampling methods, allocation methods are usually required to distribute liability between time periods or locations or both. Interest and tax rate considerations usually require some apportionments or allocations. Where allocations are made distributing tax or taxable amounts, the audit workpapers should adequately detail and describe these methods.

7.10(e) Examine supporting invoices or other documents for asset transactions within your scope. Determine the tax status of the transaction and indicate it on the schedule by using the letters which appear in parenthesis:

(1) Tax charged by vendor.

(2) Consumer's use tax reported or self assessed. Trace through to tax return workpapers.

(3) No tax due — e.g., paid by contractor, purchased for out-of-state delivery, freight charges, etc. State the reason on the schedule.

(4) Amount taxable.

7.10(f) *Sales Samples, Inventory Withdrawals, and Promotional Items*. Many taxpayers audited by the Commission will possibly have use tax liability for these items. Sometimes verifying the existence of this liability, or the amount of this liability, may not be possible through a routine examination of expenses. Where it is expected that a liability for these could exist, it is recommended that the Commission auditor make a separate examination to review whether in fact a material liability for these items exists. Oftentimes accounting for such items is not consistent; therefore it is difficult to recommend specific procedures that can be used in every case. Sometimes the best that can be done is to establish that the taxpayer has a liability, but the true amount is difficult to establish due to the lack of detailed records regarding the use of such items. Some suggested procedures to establish the existence of the liability include, but are not limited to:

(1) Whether the taxpayer is reporting use tax specifically for such items.

(2) Review internal controls concerning sales inventory to see if there is an accounting for withdrawals.

(3) Verify whether the sales staff makes withdrawals to inventory.

(4) Verify whether the taxpayer withdraws inventory and then later reinserts inventory at a reduced price due to intervening use.

(5) The taxpayer may maintain a separate inventory for samples – verify and review this accounting where it exists.

(6) Review unusual or credit entries to inventory accounts.

(7) If the taxpayer maintains special expense accounts for these items, a review of those accounts can be made.

(8) Review sales expense, promotional expense, and/or advertising accounts to see if inventory items (or other specially purchased promotional items) are accounted for in these accounts.

In many cases, the point of use for such items is not available or not perfectly apportioned between taxing jurisdictions. In those cases where the taxpayer is not reporting the liability, the value may be estimated using other information, such as sales factors or other information. Where the taxpayer reports a liability for such items, but uses self-established or pre-existing estimation procedures due to lack of detailed point of use records, the auditor should review these for reasonableness, or adjust and update this reporting where the auditor finds more accurate apportionments.

While the auditor should strive to make as accurate of an assessment as possible, the auditor should not avoid a review of such items due to the taxpayer's lack of accounting. Ultimately, it is the taxpayer's responsibility to have adequate records to establish any tax liability. Where detailed records do not exist, the auditor may use estimates that approximate the liability.

7.11 *Refund Claims*. Request copies of any refund claims *filed* pertaining to the period under audit that are made outside tax return reporting procedures.

7.11 (a) Determine if the claim has been *granted* by the state within and before the time of the field work conducted by the MTC auditor.[1]

7.11 (b) For any claims granted by the state, make sure the transcript reflects these.

[1] Claims for refund can be *filed* but not necessarily *granted* by the state. For obvious reasons, any outstanding claims granted by the state after field work concludes will not be within the scope of the audit conducted by the Commission. It is therefore a good practice to note in the audit report whether any refund claims were presented to the auditor.

7.11(c) Verify that the amounts claimed have not already been deducted or otherwise taken through normal reporting procedures used by the taxpayer.

7.11 (d) Notify the state of any outstanding claims and request instructions from the state as to:

(1) Whether the claim is to be within the scope of the MTC audit.

(2) If the claim is within the scope of the audit, the necessary audit procedures required.

(3) Audit the claims, as instructed by the state.

7.11 (e) The auditor should make a statement in the report whether sufficient records were provided by the taxpayer to determine the proper tax reporting.

7.11 (f) If certain requested accounting records were withheld or not provided for whatever reason, the auditor should identify those records within the audit report.

7.11 (g) Where the auditor uses electronic records in the audit examination, audit steps should be taken to determine whether electronic download of records are complete and do not contain transmission errors.

8. Computer Assisted Audit

8.01 Introduction

In an effort to increase the efficiency and accuracy of our audit program, the Commission has implemented a Computer Assisted Audit unit. Advances in computer hardware and software provide our audit program with the ability to be more efficient than ever before. This section will describe the Commission's policy in conducting computer assisted audits, the techniques to be used by and the responsibilities of the auditor and computer audit specialist (CAS) in conducting such audits.

8.02 Computer Assisted Audit (CAA) [2]

A computer assisted audit is any audit where the auditor is able to obtain the taxpayers records or some portion in an acceptable electronic format which will be used to assist the auditor in conducting the audit.

8.03 Purpose

CAA is an accelerated and sophisticated method of reviewing taxpayer data in an electronic format. It can also utilize statistical methods in the analysis of taxpayer data, which produces more reliable results.

8.04 Benefits of a Computer Assisted Audit

8.04(a) *Decreased Audit Hours*. Participation in a CAA will reduce the amount of time that the auditor spends on site at the taxpayer's location. A CAA will normally reduce the total audit hours devoted to the audit by the taxpayer and the auditor.

8.04(b) *Greater Efficiency*. Using CAA, electronic records can be processed and examined more quickly when compared to conventional methods. A more thorough analysis of the data can also be done. The reduction in field time by the auditor will free taxpayer resources for other uses.

8.04(c) *Increased Reliability*. Using statistical sampling in a CAA will increase the reliability of the results. These results can be evaluated mathematically with a greater degree of certainty. This assurance cannot be obtained using traditional sampling methods.

[2] Note that CAA can mean either "Computer Assisted Audit" or "Computer Assisted Auditing"

8.05 CAA Audit Process

8.05(a) *Pre-audit Evaluation.* The auditor should try to apply CAA on every audit, and should start the pre-audit work with that assumption. In fact, it is presumed that every MTC audit is a good candidate for a CAA.

When assigning an audit to an auditor the supervisor also notifies the CAS supervisor. Upon notification, the CAS supervisor will assign the audit to a CAS and inform the auditor and audit supervisor which CAS has been assigned to assist in the audit. It is the responsibility of the auditor to contact and include the CAS the process. Ideally this should be done before making contact with the taxpayer. An experienced auditor who is comfortable with conducting a CAA may choose to by-pass this step.

The key issue to determine is whether the taxpayer maintains their records in an electronic format. This may be difficult to do before actually contacting the taxpayer if the Commission has not previously performed a CAA on the taxpayer. However with the assistance of the CAS, member states in the audit program that have a CAAP should be contacted to see if they have performed a CAA on the taxpayer.

8.05(b) *Initial Taxpayer Contact.* Under normal circumstances, in the initial contact, the auditor notifies the taxpayer that the account has been selected for audit and should also discuss a CAA with the taxpayer's representative. Depending experience level, the auditor may want to include the CAS during this initial contact.

At a minimum, the auditor should explain to the taxpayer that the CAS will be contacting them. The taxpayer should be given the name of the CAS who has been assigned to the audit. In the interim the auditor should send the taxpayer written information on CAA, which includes the "CAA Description for Taxpayers" along with the cover letter. See Exhibits 8.1 and 8.2.

8.05(c) *Determining the Feasibility of CAA.* Before any field works begins on the audit, a determination as to whether a CAA will be performed should be made by the auditor and the CAS. In some instances it may be necessary for a CAS to attend the opening conference before this decision can be made. When it becomes necessary for a CAS to attend an opening conference the auditor and CAS should request that the necessary personnel from the taxpayer be present at the meeting such as personnel from the taxpayers IT/IS department present.

The final decision to rule out the possibility of conducting a CAA will be made jointly by the auditor and CAS assigned to the case. An explanation will be included in the audit narrative to support their conclusion as to why a CAA could not be conducted. The taxpayer's unwillingness to provide the data is not a valid or acceptable reason.

8.05(d) *Requesting Electronic Download from the Taxpayer*. Before any download is requested there should be an agreement between the taxpayer and auditor as to the format of the data and which medium will be used to exchange the data.

(1) Data Formats. For all downloads, totals for amount fields and record counts should be requested, if this is not supplied directly within the download itself. Data can be supplied in numerous data formats, although some formats are preferred. The following table details acceptable data formats, in order of preference:

Data Format	**Comment**
PC Compatible plain ASCII fixed width (flat file)	Please request record layout
PC Compatible delimited text	Please request record layout
dBase	Please request a data dictionary to explain columns
Mainframe ASCII	Please request record layout – flat file preferred
Mainframe EBCDIC	Please request record layout – flat file preferred
PC Compatible Text Reports	Commonly outputted from programs such as VERTEX, SAP, and other accounting programs – please discourage Excel files converted from text reports – often the conversion process to Excel by Excel's data import wizards will not make uniform decisions in the importation process, often rendering the results useless!
Microsoft Access Files / FoxPro	
Excel Files	Excel files are the least preferred, and if the data can be provided in plain text, this is best. Most importantly, Excel files that were manually created from an intermediate from text output often will be highly problematic, or even useless.

Data provided in PDF format will often not be acceptable, due to problems in the conversion process.

(2) Medium. The Commission has some tape drive capabilities. Before accepting data on tape, the auditor or CAS should verify that the media type is acceptable. Otherwise, data transferred by CD-ROM or DVD is preferred. Iomega zip disks and email attachments are acceptable; however email files should be discouraged, generally due to size limitations and security concerns.

Much time can be wasted in obtaining data if the data received is incorrect, incomplete, or missing some necessary information (missing fields would be an example of this). The auditor and the CAS should work together in preparing the request for data to insure the appropriate data is requested based on the audit objectives of the auditor.

(3) All requests for data should be made in writing. If a verbal request is made, it should be followed up with a letter or memo of understanding.

(4) Request a test set of the data; this usually needs to be no more then 100 items. The test data can serve many purposes that may save a great deal of time later. It can be used by the auditor to insure that it is what he/she expected the data to be. Things to look for in the test data:

- Is the data in the format requested?
- Is it possible to open and read the data?
- Does the data have all the fields requested?
- Does it appear that the audit objectives can be satisfied with the data, or is something else needed?

All records from certain accounts or transactions, even for jurisdictions not under audit, should be requested to enable the reconciliation process described later, if that verification cannot be performed in any other way. For example, a company has expense and asset purchases of two different plants in general ledger accounts. One plant is in a jurisdiction under audit, the other is in a jurisdiction not under audit. To ensure that the Commission has received a complete download, reconciliation to the account balances must be made.

Because it is impossible to do this reconciliation without the transactions from the plant in the jurisdiction not under audit, all purchase transactions for both plants need to be in the download. Later, to perform the audit examination, the purchases for the plant not under audit can be ignored. Alternatively, if it is possible to reconcile to the books of account from the download of only the one plant of interest, only purchase transactions from that plant need to be requested in the download.

Another example would be a report that details a deduction taken on the tax return. If an electronic report is supplied that explains the deduction, it should be complete for the period examined, and tied to the totals for the deduction taken on the return. Reconciling the report totals to the returns satisfies the reconciliation/verification requirement. If the totals do not reconcile, an incomplete download may have occurred. In this case, the electronic data received should be presumed inadequate for audit purposes.

8.05(e) *Reconciliation and Verification.* Verification and reconciliation are the basic audit functions that the audit conclusions depend upon. Failure to properly verify totals or at least make a reasonable attempt do so may cause more serious problems later in the audit process, if not call into question whether the auditor's conclusions can be relied upon.

Similarly, any download of data must be verified for completeness and correctness. There is no single approach that can be described that accomplishes this in all cases because of the many different accounting systems found in taxpayer record keeping systems.

The reconciliation/verification process for CAA audits is no different then reconciliation/verification processes that should also be applied in a traditional audit without electronic records; see Chapter 7. It is the responsibility of the auditor to insure that the download has been reconciled to the appropriate books and records, if it is possible to do this from the taxpayer's records.

Part of any reconciliation should begin with the sales and use tax returns filed. The auditor should understand where the numbers come from that flow into the tax return. If the download is coming from the GL and the tax returns are prepared using the GL the two should reconcile. If they do not, something is missing and the auditor should ascertain what it is before going any further in the audit process.

In many instances the source for the preparation of the tax returns might be different from the source of the download provided by the taxpayer for audit purposes. In these situations, there may be additional steps in the reconciliation process. An example of this might be where sales reported on sales tax returns of various states based on the sales destination field recorded by the Accounts Receivable billing system. The A/R billings then are separately posted to the Sales accounts in the GL based on profit centers responsible for the sales. The GL is a different system altogether, and an audit download may available only at the GL level. The entries of the GL and A/R systems differ slightly because of things like bad debts, accruals reversing sales (rather than credit memos), and other timing differences on recognition of sales. In order to reconcile the differences, these issues need to be understood.

However the auditor's biggest problem with the example above is the fact that profit center distribution and totals will not tie out to or reconcile to the sales destinations distributed by state because the download it is on a by-state basis.

In these kinds of instances the auditor will need to request the apportionment factor for sales which is detailed by state. The apportionment factor detail should then be reconciled to the GL account for sales and to the Federal Form 1120. Any unexplainable differences the auditor cannot reconcile should be presented to the taxpayer for explanation. Any significant differences not explainable by the taxpayer should be adjusted to protect the states interest. The final step then would be to insure that the download ties to the sales apportionment factor either as reported or adjusted.

If it is not possible to perform this step, that is it is not possible to perform an adequate reconciliation or verification from the taxpayer's records to the download, then the auditor must conclude that the taxpayer's records are either inadequate, or the records provided are insufficient to perform the audit examination. Refer to Section 5.06(b) for guidance on what the auditor is to do when a determination is made that the records are inadequate, or the records provided are insufficient.

8.05(f) *Data Description*. Information describing the data download should be requested. If transaction records are held in multiple tables, the taxpayer has the option of either supplying the records outputted to a single table with no dependent tables, or providing multiple tables with an explanation as to how the tables are related. If no column headings are provided in the download, a *data dictionary* should be requested that explains the information contained in fields provided.

If the data includes *business codes* specific to the taxpayer's business or the software that an outside independent auditor would not generally know, including tax codes, separate description fields in the data or dependent tables should be requested that explain these codes. If these separate description fields or dependent fields are not available, a separate explanation of the business codes can be provided. For example, the taxpayer has location codes for various plants. These plant numbers are common company information, and as such are not included in the electronic data of the company. A separate listing of plant numbers in a Word Document was provided to the auditor to explain the plant numbers.

Most importantly, totals for amount fields and record counts should be requested for each file and table in the download along with a record layout when the data is in a basic format. Basic file formats generally have data that is separated by delimiters or is space delimited (where the field is determined by the position the data in the record).

The preferred format of the record layout:

Field Name	**Start Position**	**End Position**	**Field Length**	**Decimals**	**Data Type**
Invoice Date	1	8	8	n/a	MMDDYYYY
Invoice Number	9	13	5	n/a	Alpha-numeric
Invoice Amount	14	25	12	2	Numeric
Vendor Name	26	45	30	n/a	Alpha

8.05(g) *Receipt and Security of Data*. Regardless on which medium or in what format the auditor receives the data it must be secured and maintained in its original format. Security of the data is of the utmost importance. Any data received regardless of the medium used to transmit it should be secured at all times. Obviously the auditor should be familiar and conscious of the Commission's security requirements for the handling of taxpayer confidential information.

The auditor or the CAS should never work with the original data received from the taxpayer. Upon receipt of the data the auditor or CAS should immediately determine if the files can be opened and read. If they can be, then a copy of the data needs to be made with the original data then secured in the manner prescribed by the Commission's guidelines. From that point on all work done with the data will be done with the copies and not the original data.

If the data cannot be opened or read, the auditor or CAS will contact the taxpayer to determine if there is anything that can be done to correct the problem. If the problem cannot be corrected the data should be returned to the taxpayer or destroyed in the prescribed manner agreed upon with the taxpayer. The auditor will retain the original data until it is no longer needed and then will either be returned to the taxpayer or destroyed as agreed upon with the taxpayer.

8.05(h) *Audit Trail and Accounting Fields*. Audits on a transaction level can be generally classified into two types, purchases, or sales examinations. The accounting fields in the download must be sufficient to trace the transactions through the records, and provide information on the location of the source documents (often source documents might also be stored electronically). The following are suggested fields that can be requested.

Obviously the following is an example and is not intended to be all inclusive. The taxpayers accounting system and method of storing this data will dictate what fields might be requested. Once again it is imperative that the auditor work with the taxpayer to understand its accounting system before any data is actually requested.

(1) Sales Data

General Type	Field	Comment
Date	General Ledger Date or Period(s)	Date entered to the books of account (a minimum of posting year & month)
	Transaction Date or Period(s)	
	Posting Date or Period(s)	
	Invoice Date	
	Sales Order Date	
Customer Identification	Bill-To Name	
	Bill-To Customer #	
	Ship-To Name	
	Ship-To Customer #	
Transaction #	Invoice #	Any posting # that uniquely identifies the transaction through the books of account
	Sales Order #	
	Job (work order) #	
	Batch #	
Location Sourcing	Bill-To Ship Address	Request both bill-to and ship-to fields
	Bill-To Ship City	
	Bill-To Ship State	
	Bill-To Ship Zip	
	Ship-To Address	Ship-to fields are usually used for sourcing a transaction for tax purposes
	Ship-To Ship City	
	Ship-To Ship State	
	Ship-To Ship Zip	
Product or Service Descriptions	Sales Order Description	Line item descriptions are preferred
	Invoice Description	
	Product # (including SKU)	
Product or Service Charges	Invoice Line Charge	
	Tax Charge	At line item (or invoice level if line item unavailable)
	Discount	
	Freight/Shipping/Handling	
Sales Tax Computation Fields	State & Local Tax Split	If available and needed
	Tax Rate	
	Tax Coding	
	Line Item Tax Code	Identifies each line item as to whether it was included in the invoice tax calculation
	Tax Jurisdiction Codes	
Other	General Ledger Account Name / #	Sales are sometimes assigned to detailed G/L accounts
	Tracing #	Any field that can be used to trace the source document storage location
	?	Any field that identifies tax status if the item sold is exempted – such as the existence of a resale certificate or other certificate
	?	Any other field required for audit purposes

(2) Purchase Data

General Type	Field	Comment
Date	General Ledger Date or Period(s)	Date entered to the books of account (a minimum of posting year & month)
	Transaction Date or Period(s)	
	Posting Date or Period(s)	
	Invoice Date	
	Purchase Order Date	
	Check Date	
	Paid Date	
	Inventoried Date	Date placed into stores or inventory
	Inventory Distribution Date	Date taken out of stores or inventory
	Transfer Date	Internal company transfers
	Voucher Date	
Identification of Product/Service Provider	Vendor #	
	Vendor Name	
	Internal Transfer Source	Internally produced items or items from sales or stores inventory
Transaction #	Batch #	Any posting # that uniquely identifies the transaction through the books of account
	Check #	
	Job # (work order #)	
	Invoice #	
	Purchase Order #	
	Voucher #	
	Fixed Asset #	
Costing and/or Location Used	General Ledger Account Name / #	Identifies the location of use or the location that the cost is assigned for book purposes
	Division Name / #	
	Plant Name / #	
	Cost Center Name / #	
	Other Location Used Name / #	
Product or Service Description	Purchase Order Description	
	Invoice Description	
	Work Order Description	
	Transfer Item Description	
Transaction Costs	Invoice Line Item Amount	
	General Ledger Line Item Amount	
	Distribution Line Item Amount	
	Costed Amount	
	Voucher Amount	
	Check Amount	
	Transfer Amount	
	Sales Tax Paid	
	Use Tax Accrued	
	Shipping/Handling Amount	
	Cash Discount	
Other	Tax Accrual Coding	
	Tracing #	Any field that can be used to trace the source document storage location
	?	Any other field required for audit purposes

8.05(i) *Completing the Audit*. Upon completing the audit, the auditor should thoroughly document the process in the audit narrative. The CAS should submit to the auditor his/her explanation of any work done on the audit. The narrative should include a section titled “Computer Assisted Audit.”

It should be clear in the narrative that computer assisted audit techniques were utilized. At a minimum the section should include the following:

(1) Name of the CAS involved if appropriate

(2) Source of electronic files

(3) Format files were received in

(4) Medium by which files were transmitted

(5) Number of records in the file

(6) Totals of amount fields

(7) Explanation of how files were verified for completeness

(8) What portion of the audit period for which electronic files were received

(9) If the electronic files were not received for the entire audit period an explanation as to why not and how those periods were handled

(10) Any significant data conversion problems that might be relevant for future audits

(11) Name of any specialized software such as ACL or Monarch that were used to convert or manipulate data

A copy of the original data should be securely maintained by the Commission in accordance with the Commission’s record retention policy. Afterwards the data should be either returned or destroyed in the manner agreed upon with the taxpayer.

9. Sampling & Testing

9.01 *Sampling versus detailing – Maximizing the accuracy of the audit*

A detail audit, that is 100% review of all records, is always preferred if it can be done in a reasonable amount of time. Due to the size of the taxpayers audited by the Commission, however, an audit of that detail is rarely practical. In most cases, some sort of sampling procedure will be required. In a detailed audit, no sampling error is present. Whenever an auditor samples — regardless of sampling method — there will most likely be sampling error (this can also be referred to as the precision).

Sampling error is merely the difference between the projected results of the sample versus the true amount being estimated from the population provided non-sampling errors have not been made. That is, non-sampling errors could also be made in the sampling process (examples include an incorrect valuation of one or more of the sampling units or errors in procedure). The auditor should be concerned with both sampling error and non-sampling error, and attempt to minimize both. Statistical sampling and random selection techniques enable the Commission auditor to control sampling error. Due diligence and proper audit techniques will minimize non-sampling error.

Also note that in a detail audit, non-sampling error may also be present. In a detail audit, the auditor may spend less time reviewing each transaction, thereby increasing the chance of non-sampling error when compared to an audit using sampling techniques. The likelihood of non-sampling error increases with the number of transactions reviewed.

9.02 *Reasons to Sample*. An auditor could have several different reasons to sample, including sampling for (A) exploratory or discovery purposes and (B) as a basis for correction unpaid or overpaid tax (projection).

The auditor may design a single test that can potentially satisfy both (A) and (B). Whenever the auditor intends to use a sample as a basis for an assessment, or projects (estimates) an unpaid or overpaid tax liability from an examination of less then 100% of the transactions, the auditor should consult the Sampling Manual (B). Where the auditor wishes to use less formal procedures for preliminary testing purposes only (A), less stringent methods may be used. The auditor should document the results of any exploratory testing. Note that the auditor is encouraged to stop testing or sampling in any exploratory process when, using the auditor's judgment, it becomes obvious that no further review of the records is necessary, or any un-audited errors are likely immaterial in the auditor's opinion. Further, if the auditor is not persuaded that such a conclusion is warranted based on the evidence presented, the auditor should not be compelled to stop the examination and may extend the test or use more formal sampling procedures until the auditor is satisfied that such a conclusion is justified.

9.03 *Sampling Standard*. The Commission and the member states have adopted a Sampling Manual that contains the sampling guidelines and procedures that are to be utilized by the Commission's auditors when conducting any sample. Each auditor should read and become familiar with the Sampling Manual before attempting any type of sample. Each auditor is expected to attend the Commission's sampling courses as soon as practical after being employed. Before attempting any statistical sample the auditor will contact and involve one of the computer audit specialists (CAS).

9.04 *Deviations.* If an auditor considers it necessary to deviate from established policy and or guidelines, he or she should discuss the reason(s) for such departure with their Supervisor and with a CAS if the issue involves statistical sampling before making the final decision. The auditor should document their reasons for departing from the norm and obtain agreement from the taxpayer.

9.05 *Auditor Judgment*. An auditor is expected to use his or her professional judgment to select the best possible method of sampling. The sampling guidelines in the Sampling Manual provide recommendations concerning the preferred sampling method hierarchy. Nevertheless, auditors should also consider defensibility, accuracy, efficiency and practicality when making their sampling decisions. Convenience alone should not be the deciding factor. This sampling policy does not preclude an auditor from choosing to perform a detailed review of records as the best course of action.

9.06 *Planning, Documentation and Notification.* An auditor is required to meet with the taxpayer to plan and discuss issues concerning the sampling process prior to selection of the sample. The taxpayer should be included in the process or provided reasonable notification regarding sampling techniques to be used in the audit.

The auditor should provide the taxpayer with a copy of the Commission's "Procedures for Conducting a Computer Assisted Audit" (Exhibit 9.1) and "Sampling Procedures" (Exhibit 9.2). These two documents should be sent with the "Engagement Letter." The auditor should inform the taxpayer that a computer audit specialist will be contacting them to further discuss and answer any questions they may have about either of these documents.

In instances where a statistical sample is performed the auditor should obtain from the CAS their written explanation of the sampling process which should be included in the written narrative report to the states. If needed, the auditor will request assistance from the CAS in explaining the sampling process to the taxpayer. If the taxpayer is not in agreement with the results of the sample, the taxpayer's position and reasons for disagreement should be fully documented in the audit report.

9.07 *Efficiency and Accuracy*. The primary reason for sampling is for efficiency reasons. There is a direct relationship between the size of the sample and the accuracy of the projected findings. Therefore, an auditor should review the minimum acceptable sample units prescribed by the sampling guidelines. An auditor always has the discretion to select and review more than the stated minimum sample size.

9.08 *Sampling Preferences*

9.08(a) Obtain records electronically when possible to enable more efficient sampling techniques.

9.08(b) Use statistical sampling whenever practical, it is the Commission's preferred method of sampling. The need to use any other sampling technique should be fully explained in the audit workpapers.

9.08(c) Stratify populations when practical.

9.08(d) Select the sample from the entire period being examined regardless of the sampling unit.

9.08(e) Use random selection techniques to select the sample units even when records are not available electronically.

9.08(f) Though it is the least preferred method, time period sampling (block samples) may be used when no other method makes sense to use.

9.09 *Projection*. Sample projection should be made only into the population from which it was drawn. In other words, if an auditor is sampling sales, the projection should be against sales. If the auditor is sampling consumables, the projection should be against consumables. The auditor should refer to the Sampling Manual for a more detailed explanation.

Whether the sample results are projected or not, the sample findings should be disclosed to the taxpayer, adequately documented in the audit workpapers, and properly explained in the audit report.

10. Tax Issues & Related Audit Procedures

10.01 *Advertising Materials and Promotional Items.* Generally, the distribution of promotional and point-of-sales advertising items is subject to sales and use tax.

There has been a great deal of litigation over the application of sales and use tax to samples and promotional items. Promotional consumer items can include free product samples, T-shirts, hats, sweatshirts, sweatpants, coffee mugs, key chains, calendars, notepads, stationery, and can openers. Promotional business items are often product displays such as posters, racks, banners, signage, and other displays placed in retail outlets. Generally, these items are produced by third parties and may be drop-shipped directly to the company's distributors and retailers or to warehouses around the country for temporary storage.

There are two key issues revolved around promotional items and samples that need to be considered during the audit. First, do purchases of promotional items qualify for the resale exclusion as items purchased for resale? Or are they purchases for the vendor' own promotional or marketing use? For example, the Milwaukee Brewers gave away baseball caps, jackets, and seat cushions to spectators who attended their games. The team argued that the items were purchased for resale because they were available only to fans paying admission to the games. The court disagreed [*Wisconsin Dep't Revenue v. Milwaukee Brewers*, 111 Wis. 2d 571, 331 N.W.2d 383 (1983)]. The Minnesota Tax Court reiterated the Brewers decision recently in *Minnesota Twins Partnership v. Commissioner*, No. 6741(Minn. Tax Ct., Jan. 8 1998). The Kansas City Royals, however, appearing before the Missouri Supreme Court, successfully made the same resale argument used by the Brewers and the Twins [*Kansas City v. Director of Revenue*, No SC82554 (Mo. Dec. 5, 2000)]. Using slightly different reasoning, an Ohio Court held that bonus items included upon the purchase of a certain quantity of goods were not subject to use tax, because the items were treated as a discount to the sales price [*Electrolert Inc. v. Limbach, Tax Comm.'s of Ohio*, No. 89-J-94 (Ohio Bd. Of Tax App. Mar. 13, 1993)]. Finally, toys and prizes packaged with fast-food purchases have also been held to be exempt from sales tax as a resale item in Arizona and New York. TPR 93-45; In re *Petition of E-M Food Corp.*, DTA Nos. 809808, 809809, 809810, and 809811 (N.Y. Div. of Tax App., Admin. Law Judge Unit (Mar. 18, 1993)).

The second key issue with regard to promotional items is jurisdictional. If a third-party contractor manufactures promotional items and drop-ships them to distributors all over the United States, where is the taxable use? Is it in the state where the contractor is located? Is it in the state where the owner of the promotional items is located? Or is it in every state in which the items are drop shipped? Does the distribution by the contractor of the promotional items create nexus for the retailer for whom the goods are being made?

Summing up, absent an argument that the purchase of promotional items qualifies as an exempt sale for resale, the purchase and distribution of such items is usually subject to sales and use tax. The auditor will need to research and/or consult with his/her supervisor on various circumstances determining proper taxability of advertising and promotional items among applicable states.

Many taxpayers audited by the Commission will possibly have use tax liability for these items. Sometimes verifying the existence of this liability, or the amount of this liability, may not be possible through a routine examination of expenses. Where it is expected that a liability for these could exist, it is recommended that the Commission auditor make a separate examination to review whether in fact a material liability for these items exists. Often accounting for such items is not consistent; therefore it is difficult to recommend specific procedures that can be used in every case. Sometimes the best that can be done is to establish that the taxpayer has a liability, but the true amount is difficult to establish due to the lack of detailed records regarding the use of such items. Some suggested procedures to establish the existence of the liability include, but are not limited to:

- Whether the taxpayer is reporting use tax specifically for such items
- Review internal controls concerning sales inventory to see if there is an accounting for withdrawals
- Verify whether the sales staff makes withdrawals to inventory
- Verify whether the taxpayer withdraws inventory and then later reinserts inventory at a reduced price due to intervening use
- The taxpayer may maintain a separate inventory for samples – verify and review this accounting where it exists
- Review unusual or credit entries to inventory accounts
- If the taxpayer maintains special expense accounts for these items, a review of those accounts can be made
- Review sales expense, promotional expense, and/or advertising accounts to see if inventory items (or other specially purchased promotional items) are accounted for in these accounts
- Review the detail that supports the deduction taken on the FF1120 for advertising expense.

In many cases, the point of use for such items is not available or not perfectly apportioned between taxing jurisdictions. In those cases where the taxpayer is not reporting the liability, the value may be estimated using other information, such as sales factors or other information. Where the taxpayer reports a liability for such items, but uses self-established or pre-existing estimation procedures due to lack of detailed point of use records, the Commission auditor should review these for reasonableness, or adjust and update this reporting where the auditor finds more accurate apportionments.

While the auditor should strive to make as accurate of an assessment as possible, the auditor should not avoid a review of such items due to the taxpayer's lack of accounting. Ultimately, it is the taxpayer's responsibility to have adequate records to establish any tax liability. Where detailed records do not exist, the auditor may use estimates that approximate the liability.

10.02 *Free product samples*. The distribution of free product samples raises many of the same issues discussed in section 10.01 above. A couple of distinctions, however, need to be made. Samples that differ in size from the company's standard retail product make it difficult, if not impossible, for a sale-for-resale argument to be made. Absent the sale-for-resale argument, the company will be deemed the end user or ultimate consumer of the samples and must pay sales or use tax upon the purchase of the samples. A second distinction between samples and other promotional items is that the samples may be exempt if sales of the product itself are exempt. For example, the Kentucky Court of Appeals recently held that the free distribution of drug samples to physicians was not subject to use tax because of the stat's sales and use tax exemption for prescription drugs under Ky. Rev. Stat. Ann 139.47. [*SmithKline Beecham v. Kentucky*, No. 1998-CA-002415-MR (Ky. Ct. App. 2001); see also *Syntex Lab. v. Michigan*, 470 N.W.2d 665 (Mich. Ct. App., Apr. 2, 1991).] Other courts, however, have ruled against taxpayers in similar circumstances. For example, the Georgia Court of Appeals held that the state's sales and use tax exemption for prescription eyeglasses and contact lenses did not extend to the distribution of free samples of contact lenses. [*CIBA Vision v. Jackson*, 248 Ga. App. 688 (2001); see also *American Cyanamid v. Tracy*, 74 Ohio St. 3d 468 (19960)]

In sum, if the company distributes its standard retail product as a sample, and the sale-for-resale argument of other specific exemption is unavailable, the company will pay tax on the samples when they are withdrawn from inventory, set aside as samples, or distributed.

10.03 *Computer Software*. Generally, computer hardware is taxable, with certain exceptions for computers used in manufacturing, production, and research. Similar exceptions may exist for software that would otherwise be taxable. "Canned" or prewritten software is also taxable; however, in some states the sale of any software that is digitally delivered is not taxable.

The methods by which the states apply their sales and use taxes to sales of computer software vary greatly. Most member states impose their sales taxes on transfers of tangible personal property, but computer software is not easily classified as "tangible" or "intangible."

Many states distinguish between "canned" or "prewritten" software, which can be purchased off the shelf and used in a customer's computer without any modification, and "custom" software, which is generally a program created to meet a specific customer's needs. In some states, a canned program modified to meet a particular customer's needs qualifies as a nontaxable custom program. Definitions of "custom" programs vary widely among the states (see *Wisconsin Department of Revenue v. Menasha Corp.*, Wisconsin Supreme Court, No. 2004AP3239, July 11, 2008).

Specific references on computer software issues for each member state can be found in the auditor's Tax Chart. When the auditor encounters computer software issue during his/her audit, the auditor should utilize the chart and/or other available researching tools to properly determine taxability of computer software issues.

10.04 *Drop Shipment*. A drop shipment is a sale in which the seller, rather than acquiring the goods and distributing them to its customer, instructs its supplier (manufacturer or wholesaler) to send the goods directly from the supplier's warehouse to the customer. A problem can arise if the supplier and customer are in a state in which the seller is not doing business and thus has no obligation to file returns. The supplier will not be able to get a resale license number from the seller because the seller is not licensed with the supplier's state. As a consequence, the state may deem the supplier's sales to be taxable retail, not exempt wholesale, sales. If the state does deem the sales to be taxable retail sales, it may assess the supplier sales tax upon (1) the supplier's price to the out-of-state seller; (2) the seller's retail price, if available; or (3) the supplier's price plus an arbitrary percentage markup.

Absent a resale certificate or other specific exemption, all 18 member states with a sales tax will tax drop shipments of retail sales of tangible personal property. The following 16 states require the supplier to receive a copy of the resale certificate from the vendor; Alabama, Arkansas, Colorado, District of Columbia, Georgia, Idaho, Illinois, Kansas, Kentucky, Michigan, Minnesota, New Jersey, North Dakota, Utah, and Washington. Of the states requiring a resale certificate, 12 states will accept either a multijurisdictional or other state's resale license. These states are Alabama, Arkansas, Colorado, Georgia, Idaho, Illinois, Kansas, Kentucky, Michigan, Minnesota, New Jersey, North Dakota, and Utah. A few states will accept other support, such as an affidavit, in lieu of a license or resale certificate. Those states are Alabama, Idaho, and Louisiana.

With respect to goods drop-shipped into the District of Columbia by a D.C.-registered supplier on behalf of an out-of-state wholesaler, the supplier must collect the D.C. sales or use tax from the wholesaler and report the tax to the District unless the wholesaler provides the supplier with a valid D.C. certificate of resale by the date of sale. The wholesaler cannot use a resale certificate from its home state or its D.C. customer's resale or exemption certificate to exempt the sale.

With respect to goods drop-shipped into the Wisconsin by an Wisconsin registered supplier based on an order received from an unregistered out-of-state seller, who had received the original order from the Wisconsin purchaser, the supplier shall report the Wisconsin tax measured by the retail selling price. However, the supplier may drop ship an item to a purchaser in Wisconsin without the tax being applicable, if the purchaser is entitled to purchase the property without tax and gives the manufacturer a properly completed exemption certificate.

With respect to goods drop-shipped into the Hawaii by a Hawaii registered supplier, the supplier liable to pay the tax, but allows for the tax to be passed to the distributor (see Hawaii Tax Information Release No 98-8/Application of Act 247 to Drop Shipments).

10.05 *Machinery and Equipment.* All sales tax member states except the five states described below provide a sale and use tax exemption for machinery and equipment used directly and exclusively in manufacturing or processing tangible personal property for sale or profit. The exemption is often limited to new or expanding business facilities, businesses in designated enterprise zones, or sometimes to a minimal or maximum dollar amount.

Alabama taxes production machinery and equipment at a reduced rate. Minnesota refunds tax paid on certain capital equipment purchased by manufacturing companies. Hawaii, Louisiana, and the District of Columbia tax production machinery at their standard sales and use tax rates.

10.05(a) What constitutes manufacturing?

Manufacturing comprises so many different activities that it is no surprise that the definition, interpretation, and application of the term varies from state to state. For example, all manufacturing probably includes some processing and/or fabrication, but not all fabrication or processing is manufacturing. Similar questions arise over refining, assembly, and construction.

The lodestone for most states' definitions of the term manufacturing is the U.S. Supreme Court's statement that "manufacturing implies a change … there must be a transformation; a new and different article must emerge, having a distinctive name, character, or use." [*East Tex. Motor Freight Lines v. Frozen Foods Express*, 351 U.S. 49 (1956)] As can be seen from the following examples, there has been little agreement in interpreting the Court's definition of manufacturing.

10.05(b) What is a machine used in manufacturing?

Once a taxpayer's activity meets the definition of manufacturing, there remain additional questions, including identifying the beginning and end of the manufacturing process, and determining whether equipment involved in activities such as testing, research and development, quality control, pollution control, safety, temperature control, repair and maintenance, storage, and transport (including the use of forklifts, loaders, and conveyor belts) qualifies as machinery and equipment used in manufacturing. Needless to say, the answers vary from state to state.

In most states, manufacturing begins when the item is withdrawn from its first point of storage and ends when the item is removed at the end of the manufacturing process and placed in finished goods storage. In some states, if an activity occurs at the first point of storage, such as heating, cooling, or mixing the raw materials, then the manufacturing process may be considered underway at that point. Engaging in these activities could make the equipment and/or supplies consumed in that part of the process tax-exempt in states with a manufacturing exemption. All sales tax member states providing a sales and use tax exemption for machinery and equipment consider the shipping and receiving areas to be outside the manufacturing process. However, if some of the receiving inspection activities can be undertaken after the goods have entered into the manufacturing process, the activities may be considered exempt as part of the quality control function required to manufacture the product.

Specific references on manufacturing machinery and equipment issues for each member state can be found in the auditor's Tax Chart. When the auditor encounters manufacturing machinery and equipment issues during his/her audit, the auditor should utilize the chart and/or other available researching tools to properly determine taxability/exemption of machinery and equipment.

10.06 *Repairs and Maintenance Service*. In nine sales tax member states (Alabama, Colorado, Georgia, Idaho, Illinois, Kentucky, Michigan, Minnesota, and North Dakota), repairs of a taxpayer's tangible personal property billed on a time and materials basis are taxable only on the property provided in the repair if labor and materials are separately stated on the bill. If labor is not separately stated, then the total amount for labor and materials is taxable.

For example, an automobile repair shop replacing a front bumper is usually only required to charge sales tax on the selling price of the bumper where the sales invoice bills time and materials separately. Variations exist in those states that specifically tax repair labor (Arkansas, D.C., Hawaii, Kansas, Louisiana, New Jersey, Utah, Washington, and Wisconsin), where the materials cost is inconsequential to the sale, or whether or not the repair and maintenance is covered under a warranty.

In Hawaii repairs and maintenance are subject to tax regardless of how they are billed since the state tax services. In many states, a shoe repair shop may purchase its materials tax-free because the shop is reselling the materials and charging tax accordingly. However, in an early court ruling in Utah, the materials provided in the shoe repair were deemed inconsequential. That was really being sold was a service, and the soles, heels, and leather were simply the wherewithal by which the service was provided. Accordingly, the shoe shop was forced to pay sales tax on its purchases of materials. [*Western Leather & Finding v. State Tax Comm'n*, 48 P.2d 526 (Utah 1935)]

Specific references on repairs and maintenance service issues for each member state can be found in the auditor's tax chart. When the auditor encounters repair and maintenance service issues during his/her audit, the auditor should utilize the chart and/or other available researching tools to properly determine taxability of material and service provided during the course of repair and maintenance service.

10.07 *Containers and Packing Materials*. Purchases of containers and packing materials are usually exempt under either a state's sale-for-resale exemption or by specific statute or regulation. All sales tax member states except Hawaii exempt some combination of non-returnable containers and packing materials, including shrink-wrap, bags, cans, twine, gummed tape, boxes, bottles, drums, and cartons, that are sold with the products to the final consumer. Careful attention must be paid to the scope and precise nature of each state's definition of qualifying containers and packing materials. For example, Idaho and Louisiana exempt containers but not wrapping, packing, and packaging. Other states limit their exemption to only containers and packaging used to deliver the product to the end user. Sometimes taxability is dependent upon whether the materials are returned. If not returned, the items may qualify for exemption, not as packing material, but as ingredient or component parts of the property being sold. Kansas recently ruled that pallets, labels, wrapping, tape, and perhaps even ice if not returned, would be exempt from tax as ingredients. [Kan. Dept. of Rev., Ltr. Rul. P-2002-001 (Jan. 7, 2002)] Pallets and shipping materials used to deliver the product from wholesaler or manufacturer to retailer often do not qualify. Court decisions in different states but ruling on identical or similar language have reached inconsistent positions. [For a good summary of two theoretically distinct approaches to the issue of taxing containers and packaging, see *American Molasses v. McGoldrick & Sterling Bag*, 22 N.E.2d 369 (N.Y. 1939); and *District of Columbia v. Seven-Up*, 214 F.2d 197(D.C. Cir. 1954), cert. denied, 347 U.S. 989 (1954)]

The auditor will need to research or consult with his or her supervisor on various circumstances determining proper taxability and exemption of containers and packing materials among applicable states.

10.08 *Other Tax Issues.* Among tax issues not addressed in this chapter, following issues are one of the most frequent topics Commission auditors may encounter during the course of an audit:

- Multistate Certificates
- Direct Pay Permits
- Installation Charges
- Shipping & Handling Charges
- Contractor - Real & Personal Property
- Exempt organizations such as government agencies, non-profit organizations
- Lease & rental
- Healthcare
- Transportation

All of these issues are included in the auditor's tax chart. When the auditor encounters these issues during an audit, the auditor should utilize the chart and other available researching tools to properly determine taxability with respect to these issues.

11. Narrative

11.01 *Full Disclosure*. The narrative should fully disclose the entire audit process. The description of the audit process should also include an explanation of steps the auditor did not take that under normal circumstances would have been performed. In describing the audit process the auditor should write in a clear and concise manner and should remember there may be many interested parties who have a need to read the narrative, such as supervisors, state review sections, attorneys, the taxpayer, and other auditors.

In preparing a properly written narrative the auditor should anticipate what questions each of the potential readers might ask and then be sure the narrative answers them. The narrative should follow the logical flow of the audit process from start to finish and also the normal sequence as laid out in this manual. Any unusual circumstances that do not fit into the adopted format need to be explained in the narrative. The auditor should use their best judgment as to where any special language should be placed.

There may be instances when the auditor is required to explain highly technical issues or complex calculations. Sometimes it is inefficient to explain these within the narrative itself. Where this is true, rather then explaining these in the body of the narrative, the auditor may use properly referenced appendices or worksheets that fully explain the technical issues, show the complex calculations, or both.

11.02 *General and State Narrative*. The narrative will consist of two parts, the general narrative and the state narrative. Each part of the narrative has a specific purpose and is required to have specific information. Each state will receive a copy of the general narrative in addition to their specific state narrative.

11.03 *General Narrative*

11.03(a) Scope of audit. The scope of audit should include the following paragraph:

> *The Multistate Tax Commission has audited the books and records of [Insert Taxpayer's Name] to determine whether the sales and use (or excise) tax liability as filed for your state accurately represents the taxes due. We have conducted the audit in accordance with uniform audit procedures for all states in accordance with the Multistate Tax Commission directives.*

Detail any variations from these procedures which have been followed. For example, a standard audit procedure would require the auditor to verify that an electronic download of the taxpayer's sales were tied back to the books and records of the taxpayer for its accuracy. If the accuracy of the download could not be determined because the taxpayers records were unavailable, the auditor should state that the procedure was not performed and should clearly state that the auditor makes no statement to the accuracy of the records provided and the reasons why.

11.03(b) Auditor information. The following information should be provided about the lead auditor (the auditor to whom the audit is assigned):

AUDITOR INFORMATION

Auditor Name		Title
Auditor Number		Auditor's Office
Street Address		
City	State	Zip
Telephone	Fax	email

11.03(c) Taxpayer and taxpayer's contact information. The auditor should provide pertinent information about the taxpayer and the contact. If the contact is someone other than an employee of the taxpayer, the auditor must have a Power of Attorney signed and included with the audit file.

TAXPAYER and CONTACT INFORMATION

Taxpayer Name	FEIN	
Contact Name		Title
Street Address		
City	State	Zip
Telephone	Fax	email

11.03(d) Participating states, audit period and statute. The auditor should provide a list of participating states with the audit period and when the statute expires for each state.

11.03(e) General history. Provide a brief history of the company from the date of incorporation until the present.

11.03(f) Business type and general activity. Provide a description of the taxpayer's operations both domestically and worldwide. The description should include such things as whether the taxpayer is a retailer, manufacturer, contractor, etc. Include a brief description of what type of products the taxpayer sells or manufacturers and how those products are sold such as to retailers, wholesalers, or using the Internet.

11.04 *State Narrative*

State of [Insert participating state name]

NOTE: Sections 11.05 through 11.09 identify items that must be specifically detailed as they apply to each state participating in the audit; prepare a separate state narrative for each state.

11.05 *Nexus.* There are generally two reasons that may require an auditor to investigate nexus. The first instance is when an audit is assigned to the Commission inventory which comes from the nexus program rather then the audit committee. When the auditor is assigned such an audit a statement should be made indicating this.

The more common reason for performing a nexus investigation is when the audit committee assigns an audit to the Commission inventory and states participate in the audit authorizing the auditor to perform a nexus investigation for a taxpayer is not registered or filing returns in the state.

In either case the auditor should state the reasons for the nexus investigation. The auditor should also state the procedures used to determine if the taxpayer does or does not have nexus. The auditor should also include the taxpayer's position on a finding of nexus.

The auditor should provide sufficient evidential matter with it properly referenced to support their position on a determination of nexus.

Even if the audit for a specific state does not warrant a nexus investigation the auditor should make a brief state to that effect such as "Not Applicable."

11.06 *In-state locations.* The auditor should a listing all in-state locations with appropriate addresses. A description of each location should be provided such as warehouses, sales offices, distribution centers, and manufacturing facilities, etc.

11.07 *Sales Tax*

11.07(a) Method of reporting. The auditor should provide a detailed description of how sales are reported and under which account number(s).

11.07(b) Records examined. Over the course of sales examination the auditor may review many types of records provided by the taxpayer and sometimes records provided by third parties. Records could include state returns and or supporting schedules, federal returns, account balances, worksheets, exemption certificates or any other type of documentation provided by that taxpayer.

In properly documenting the audit process the auditor should identify which records were examined and describe what aspect of the audit they were used for. If practical and when appropriate, the auditor should consider making copies of records and including them as part of the audit package.

11.07(c) Audit Procedures. The auditor should pay particular attention to writing up this section of the report. Since each audit is as unique as each taxpayer there is no single approach to writing up this section because the audit procedures will vary from audit to audit.

The auditor should make a full disclosure of all audit procedures in the examination of sales. Full disclosure includes what the auditor examined in detail, tested or even sampled to properly determine the appropriate taxable amount. The auditor should explain why the item was a potential issue, what steps were taken to determine the appropriate taxability and what the basis was for any adjustment. If the auditor made any assumptions they should be disclosed. If issues were ignored because the auditor determined they were immaterial, a disclosure of such facts should be generally described.

In the examination of sales, the auditor would verify that taxes charged have been remitted to the state. Full disclosure would require the auditor to state whether this procedure was completed or not. The auditor must state the reasons why it was not performed or why the auditor was unable to make a proper determination.

Normally, an auditor will verify that the taxpayer has properly executed resale certificates for sales claimed as exempt for resale. The auditor should fully disclose what type of testing, sampling or any other procedure used to determine whether the taxpayer is properly charging sales tax. If the auditor performed a block sample or statistical sample then the details of the sample should be disclosed. If the auditor based the test on customers then this should be disclosed as well as any other details of the examination such as sales to customers below a certain dollar range were ignored and state the reasons why they were ignored.

To assist the reader, the auditor should make use of subsections. The reader may wish to focus their attention to a particular aspect and should not be required to read the entire section to find what they are looking for, suggested sub-sections that the auditor might use where appropriate.

(1) Electronic Records. The auditor should indicate if the taxpayer provided electronic records and if so what was the source of the records. The auditor should also indicate the format the records were provided in, the total dollar amount and the number of records received. Any refinements made to the records should be fully explained.

(2) Sampling. The auditor should fully disclose any sampling procedures that were used such as block samples, random samples or statistical samples. For a detailed explanation of sampling procedures used, the auditor may wish to refer the reader to the final sampling plan that was used. The auditor may also wish to seek the assistance of a computer audit specialist in writing this or the prior section up if one was used during the audit.

(3) Gross sales verification. State whether gross sales were verified or not and how this was accomplished any related worksheets showing calculations should be properly referenced.

(4) Verification of exempt sales. State whether exempt sales were verified or not and any test or sampling procedures that were used in making a determination.

(5) Verification of sales tax remitted. Indicate whether the taxpayer properly remitted all sales tax collected and what procedures were used in making a determination.

(6) Appropriate tax rates. The auditor should indicate whether appropriate tax rates were charged on sales and disclose any tests that were used in making a determination.

The above sub-sections should not be construed as an all inclusive list but only as a guide. The auditor should use good judgment in determining how many and what types of subsections should be used in writing up the report.

11.07(d) Audit adjustments. The auditor should fully disclose and explain any adjustment that was made in the audit. A detailed explanation of what the issue was and what basis was used in making the adjustment. Any assumptions the auditor had to make should also be disclosed. Worksheets or other documentation used by the auditor should be properly referenced that would assist the reader in their understanding of what the auditor did and why it was done.

The auditor should clearly indicate the taxpayer's position on any adjustment that was made. The auditor should make every attempt to obtain a written position on the issues from the taxpayer and attach them as part of the audit file and properly referenced here.

11.07(e) Auditor comments. This section should be used to explain any unusual circumstances that may have occurred during the audit. Any difficulties or delays in obtaining records or any other documents from the taxpayer should be fully disclosed and explained. If there are numerous issues the auditor wishes to address in this section then the use of sub-sections should be considered.

11.08 *Use Tax*

11.08(a) Method of reporting. The auditor should provide a detailed description of how the use tax was reported and under which account number(s).

11.08(b) Records examined. After reviewing the chart of accounts the auditor should provide a listing of which accounts by name and number that were examined. Provide information on any other records that were used during the course of the use tax examination.

11.08(c) Audit procedures. Much of what was stated in 11.07(d) is just as applicable for use tax as it is for sales tax. The obvious difference is that the auditor should discuss the procedures used in the examination of the use tax.

11.08(d) Audit adjustments. The auditor should fully disclose and explain any adjustment that was made in the audit. A detailed explanation of what the issue was and what basis was used in making the adjustment. Any assumptions the auditor had to make should also be disclosed. Worksheets or other documentation used by the auditor should be properly referenced that would assist the reader in their understanding of what the auditor did and why it was done.

The auditor should clearly indicate the taxpayer's position on any adjustment that was made. The auditor should make every attempt to obtain a written position on the issues from the taxpayer and attach them as part of the audit file and properly referenced here.

11.08(e) Auditor comments. This section should be used to explain any unusual circumstances that may have occurred during the audit. Any difficulties or delays in obtaining records or any other documents from the taxpayer should be fully disclosed and explained. If there are numerous issues the auditor wishes to address in this section then the use of sub-sections should be considered.

11.09 *Local Tax*. If the state administers the local tax and if additional local tax is disclosed by audit, describe the method used in arriving at the local tax recommendation. If the local tax is not administered by the state then the auditor should make a statement to that effect. Remember it may not be obvious to all readers that the state does not administer the local tax.

11.09(a) Combined or separate rate. If the local tax is applicable indicate whether a separate or combined rate is used. If the separate rate is used, reference the schedule used to compute the tax.

11.09(b) Projection. Where a projection of a single statewide number is made or where information is lacking concerning local taxing jurisdiction, the procedures to allocate or estimate local tax liability should be explained. If the local tax projection is made based on a sample an explanation should be given explaining how such a projection was made and the appropriate schedules making the calculations should be properly referenced.

11.09(c) Other issues. The auditor should discuss any issue that affects local tax differently from other elements of tax such as caps, or where local use tax does apply.

11.10 *Audit Recommendations*. The audit recommendation should summarize the audit finding. The auditor states whether or not the taxpayer agrees or disagrees with the audit finding and make an appropriate recommendation to the state.

11.11 *Audit Narrative Template*. Exhibit 11.1 is a copy of the electronic audit narrative template that each auditor is required to use.

12. Assembly of Audit Report

12.01 The assembly of each state's package, top to bottom, is to be in the following sequence:

1. Audit Report Cover Sheet and Privacy Statement
2. Audit Report Index
3. Authorizations
4. Waivers
5. Narrative
6. Transcript of Tax Returns
7. Audit Schedules

   The assembly of Audit Schedules is to be in the following sequence:

   A. Summary of Deficiencies / Refund (SD)

   B. Monthly State and Local Sales Tax Summery (A)

   C. Monthly Projection of Exempt Taxable Sales (A1)

   D. Error Rate Computation of Sales (A1-PRJ)

   E. Questioned Exempt Sales (A1-Exh)

   F. State and Local Use Tax Summary (B)

   G. Monthly Fixed Assets Tax Summary (B1)

   H. Fixed Assets Exception List (B1-Exh)

   I. Monthly Projection of Expense Items (B2)

   J. Error Rate Computation of Expense Items (B2-PRJ)

   K. List of Expense Exception (B2-Exh)

8. Exhibits
9. Other Attachments

13. Review & Transmittal of Completed Audit

13.01 Internal Audit Review

13.01(a) A review of the completed audit (much of which may have been done during the course of the audit) is to be made by the audit supervisor. This review has the following objectives:

(1) To determine the appropriateness of the audit conclusions;

(2) To make sure that the audit has been conducted in a professional and accurate manner;

(3) To control the efficiency of the audit program and to identify timing delays and other significant factors which affected the audit; and

(4) To ensure that the audit has been performed in compliance with SUTAM procedures, that the report is complete, and that it is of high quality.

13.01(b) The overall objective of the review is to ensure that the documentation, exhibits, narrative, and schedules are sufficient to support the findings in the event of a taxpayer protest or of derivative litigation. Pay particular attention to those areas as to which the taxpayer has indicated that they do not agree or that a protest will be filed.

13.01(c) The reviewer should begin with the final recommendations and work backward to each supporting document and narrative. The reviewer must pay particular attention to those areas of the narrative which pertain to unity, state adjustments, business vs. non business income and the recommendations; and should make sure that the auditor has attached applicable taxpayer source documents as exhibits or has identified them for further reference.

13.01(d) The reviewer and the auditor will cooperate to make any additions, deletions, or modifications which will improve the quality of the audit.

13.02 Taxpayer Review

At the conclusion of the audit review, the auditor will submit a complete hardcopy set of audit schedules to the taxpayer along with a cover letter explaining the audit adjustments. The narrative and electronic copies of the audit are not to be sent to the taxpayer in accordance with the Commission's policy. The auditor will make any changes, corrections, or adjustments in the workpapers which he or she may consider desirable on the basis of requests or information submitted by the taxpayer, provided that the reviewer agrees that they should be made.

13.03 Distribution to States

The auditor with support from the audit program administrative assistant will arrange for the preparation, for each state, of a report which contains complete recommendations plus supporting materials, including copies of all supporting documents; and will then transmit the report to the state. This distribution will include a hard and electronic record of the schedules and narrative.

13.04 Retention of Master Copy of Audit Report

The MTC audit offices will retain an electronic master copy of the audit report. Printed copies of the report and supporting documents will be destroyed in accordance with the Commission's record retention policy.

13.05 Responsibility of the States

Upon receipt of the audit report, a state will be responsible to review the audit and the recommendations and to issue whatever assessments it deems to be appropriate. It should at that time prepare and then send to the MTC's Joint Audit Program an Audit Evaluation (Exhibit 13.1). The state will issue any final assessments or refunds to the company. The state will then be responsible for obtaining any waivers of applicable statutes of limitations.

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