

TO: MTC Strategic Planning Steering Committee
FROM: Audit Nominations Project Team
SUBJECT: Final Report
DATE: May 15, 2013

Background

The Steering Committee assigned our team to conduct a project to streamline the MTC audit nominating process. We started that work in January 2013. This report describes our work product and outlines the next steps to be taken.

Project Description

This project involved reviewing both the steps in the nominating process and the criteria that are used to develop and consider audit nominations that are placed in inventory. Our team included representatives from participating states and MTC audit staff. The complete project proposal is attached as an appendix to this report.

Problems to be addressed: The current nominating process takes anywhere from 5-8 months to complete. There are several stages of the process that take significant amounts of time. These include: state submission of detailed data about nominees; the voting process; and the scheduling of an Audit Committee meeting to finalize the audit inventory. In addition, the current audit nominating process does not always produce audit candidates that will be of high value to a significant number of states.

Expected outcomes: We had the following goals for the project –

- Streamlined nomination process that would take no longer than 120 days to complete.
- Recommendations for improving the quality of the pool of audit nominees.
- Recommendations for quality indicators for the audit pool.
- Describe the process steps or stages that could be made more efficient by using technology, or using it differently.

Results

We revised the audit nomination process so that it should take no more than 120 days to complete. We accomplished this by eliminating the submission of data by the states, and by establishing hard deadlines for submitting nominations and ballots. The MTC Audit Committee had recently reviewed the criteria for nominating audit candidates, so we didn't add any new nominating criteria. However, we identified two criteria that must be met in order to nominate a company for the income tax audit inventory and one criterion that must be met for a sales tax nomination. We changed the process to get input on audit candidates from the MTC Audit staff. We also changed the forms so that the states can give better information to each other concerning the criteria used for nominations. Finally, we proposed that the nomination process be conducted at least once a year to allow the program to keep the highest priority audits in the current inventory.

We concluded that the greatest efficiency to be gained was in reducing the time spent by the states gathering data. We did not see that any added efficiency could be gained from using technology differently for this process.

We have attached the revised procedure and forms as appendices to this report. The forms recognize appropriate differences between income and sales tax nominating criteria.

Next Steps

The proposed audit nominating procedure and forms should be reviewed and accepted by the Audit Committee. After that, the Audit Director should begin to use the procedure. Since the process will likely be used only once a year, evaluation of the benefit from the changes should be done after three or more audit cycles have been completed. The following information should be gathered over the next several audit nominating cycles:

- Complete cycle time – how many days it takes to conduct a complete audit cycle beginning with the request for nominations and ending with the Audit Committee approval of changes to audit inventory.
- State votes on audit candidates – how many states voted on each candidate; how many states voted “1,” “2,” or “3” on each candidate (whether or not the candidate was placed in the audit inventory).
- State participation rates in audits – how many states participate in audits selected using the revised procedure. This data should be gathered in a way that will allow the MTC Audit Director to cross check with voting data on the audit candidates that were included in inventory.

After three or four cycles, the states should be surveyed about their perception of the efficiency and effectiveness of the nominating process. Finally, the project team believes that there should be a reduction in the number of audits with few or no adjustments proposed as a result of the changes to this procedure. It will probably take longer to see whether this happens.

Issues for the Future

During our discussions, we identified a few issues that were beyond the scope of this project. They should be evaluated for possible future projects:

- *Use of Technology:* Would it be possible to create an electronic repository of state and/or federal tax data to evaluate potential audit issues for nominations, and improve the pool of potential audits?
- *Nexus Issues:* The nomination forms ask the states whether a potential audit candidate is filing and whether the states have concerns about nexus for any potential audit candidate. Is there a need for a different kind of review when nexus is an issue for a number of states?
- *Linkage between MTC audits and state audits:* As we discussed the nominating and voting process, we agreed that states usually submit nominations and vote based on their evaluation of an audit candidate from a single-state perspective. There may be value in having discussion between the states and central MTC staff about the relationship between MTC audits and state audits and whether intentional alignment between them would allow more effective use of our limited resources.

Respectfully submitted,

Rick DeBano, Wisconsin
Lee Baerlocher, Montana
Harold, Jennings MTC

Randy Tilley, Idaho
Les Koenig, MTC

Appendix 1 – Project Description

Project description: Audit Nominating Process Review

This project would involve a comprehensive review of the process for nominating audit candidates.

Problems: The current nominating process takes anywhere from 5-8 months to complete. There are several stages of the process that take significant amounts of time. These include: state submission of detailed data about nominees; the voting process; and the scheduling of an Audit Committee meeting to finalize the audit inventory. In addition, the current audit nominating process does not always produce audit candidates that will be of high value to a significant number of states.

Risks: Time delays in the nominating process create the risk of losing audit years to statutes of limitations, or at least create the need to ask taxpayers for waivers. Time delays in the nominating process can tie up audit resources and preclude spending time on other audits. Time delays can create a risk that there won't be sufficient audits in inventory to have sufficient work for audit staff until a new nomination process can be conducted. Time delays also create risks that states will not participate in audits. When audit nominations are not of high value to a significant number of states, fewer states participate and MTC auditors do not spend their time in the most productive ways.

Issues for review:

- Should the nominating process be conducted on a different time sequence?
- Would it be possible to create an electronic repository of state tax returns to evaluate potential audit issues for nominations, and improve the pool of potential audits?
- Are there any other efficiencies in the process that could be achieved using technology?
- How might information about issues that could affect large industry groups or significant taxpayers be used to improve the pool of possible audit nominees?
- How effective were the changes that were made to the nominating process within the last two years? Have there been any unexpected effects (e.g., audit inventory too small)?
- Should MTC audit staff be involved in providing information about audit candidates during the nominating process? If so, how?
- Should the nominating process or criteria be different for Sales/Use tax versus Income tax?

Expected outcomes from the project:

- Streamlined nomination process that would take no longer than 120 days to complete.
- Recommendations for improving the quality of the pool of audit nominees.
- Recommendations for quality indicators for the audit pool.
- Describe the process steps or stages that could be made more efficient by using technology, or using it differently.

Who should be involved in the project:

- Audit Committee
- MTC Audit Staff
- IT person (from MTC or the states)

Appendix 2 – Procedure

Audit Nomination Process – Final 5-14-13

Desired Process Outcomes: (from the project description)

- Streamlined nomination process that would take no longer than 120 days to complete.
- Recommendations for improving the quality of the pool of audit nominees.
- Recommendations for quality indicators for the audit pool. (TBD)
- Describe the process steps or stages that could be made more efficient by using technology, or by using it differently. (TBD)

Possible MTC Joint Audit Nomination Process (same basic steps for both income and sales tax except where noted)

Goals for the audit nominating process:

1. Maximize the MTC's unique joint audit expertise
2. Use the MTC's audit resources, both people and budget, to maximum benefit for the states
3. Choose audit candidates that have significant common audit issues that affect multiple states
4. Maximize the return on the investment of audit resources

STEP 1. 120 days before additions to inventory are needed (but at least by March 1 each year): Audit Director initiates process by asking states for audit nominations

- Step 1 materials include:
- Description of the process and nomination form
 - INCOME TAX
 - Minimum criteria for nomination
 - Suggested criteria for states to use in selecting candidates for joint income tax audits (see form for list)
 - SALES TAX
 - Minimum criteria for nomination
 - Suggested criteria for states to use in selecting candidates for joint sales tax audits (see form for list)
- States have 30 days to nominate up to 2 candidates and must include a description of the reason(s) for the nominations or they will not be included on the ballot.
- States are not required to make a nomination.
- Late submissions would be included in the next process, if the nominating state wants it to be considered at that time.
- States are free to submit nominations at any other time, to be included in the ensuing process.

STEP 2. 60 days before additions to inventory are needed (but at least by May 1 each year): Audit Director distributes nominations to the states for a vote

- Audit Director reviews current inventory of audits and identifies those that have not yet been started; these audit candidates are included in the ballot
- For each candidate, Audit Director provides comments regarding the candidate. These comments would include an indication of whether, in his opinion, the candidate would likely be a good or poor joint audit candidate
- States indicate: “1-will participate/high priority audit,” “2-will likely participate/not a high priority,” or “3- will not be likely to participate” if the candidates are selected for inventory
- States indicate the reason for a “3” vote
- States also indicate whether the nominees are filing in their states
- If any candidate is not filing in a state, the state can indicate on the ballot whether nexus is a significant concern for that candidate in that state
- States have 30 days to return their ballots

STEP 3. 30 days before additions to inventory are needed (but at least by the annual MTC Meeting date): Audit Director reviews ballot results with committee and recommends new taxpayers to include in audit inventory and which taxpayers to retain from current inventory. Audit Committee approves inventory.

The number of audits kept in active inventory should be no more than can be commenced within the next 12 months given current resources and work load. If an audit cannot be commenced within 12 months after being placed in the inventory, the states should be advised and may consider withdrawing the audit from the inventory.

Appendix 3 – Income Tax Forms

Income Tax Audit Nominations

Final – 5-14-13

Goals for the audit nominating process:

5. Maximize the MTC's unique joint audit expertise
6. Use the MTC's audit resources, both people and budget, to maximum benefit for the states
7. Choose audit candidates that have significant common audit issues that affect multiple states
8. Maximize the return on the investment of audit resources

The following criteria should be considered when nominating audit candidates for MTC joint income tax audits:

1. Consolidated federal income per line 28 should exceed \$250,000,000
2. Taxpayer has substantial business activities in a number of states so that the apportionment factors are more than de minimis in most states where the taxpayer files returns
3. There would be a good chance nexus may be established in states where taxpayer is not filing
4. Proper combined reporting is an issue where states require it
5. The taxpayer reports large intercompany transactions
6. Apportionment factors fluctuate from year to year
7. A significant questionable non-business position is taken by taxpayer
8. The business is a large and fast growing company, and likely has insufficient compliance capabilities
9. A taxpayer who has undergone a major reorganization or recent major acquisitions or dispositions
10. A taxpayer that has a captive REIT or special purpose entities (example: LLCs)
11. A taxpayer in certain service oriented industries that have produced significant past audit results (for example: financial, telecommunications, entertainment)

Obviously no company will meet all of the above criteria. However, nominated companies should meet criteria #1 and #2 in all cases, unless an explanation is provided why an exception should be made, and at least one of the other criteria listed above.

Step 1

INCOME TAX NOMINATION

The MTC Joint Audit Program needs to add candidates to the income tax audit inventory. Please submit up to two (2) nominations no later than ____ [date] _____. In addition to checking the applicable boxes below, you must describe the reasons for each nomination or it will not be included on the inventory ballot. Please note that you are not required to make a nomination at this time. You may submit a nomination at any time, but if it is received after the deadline above it will be included in the next audit nomination process.

The nominations received by the due date will be submitted to the states together with a list of the audits that are currently in our inventory that have not been started. The vote results will be discussed with the Audit Committee at its meeting on ____ [date] ____.

State _____

Company _____

FEIN _____

Description of company business (to help put the specific information into context) _____

Check all boxes that apply.

<input type="checkbox"/>	*Consolidated federal income line 28 exceeds \$250,000,000.
<input type="checkbox"/>	*Company has significant business activities in a number of MTC states.
<input type="checkbox"/>	**Company is a non-filer in our state but has potential for nexus.
<input type="checkbox"/>	**Proper combined reporting is an issue in our state.
<input type="checkbox"/>	**Company reports large intercompany transactions.
<input type="checkbox"/>	**Company's apportionment factors fluctuate from year to year.
<input type="checkbox"/>	**Questionable non-business position taken by company.
<input type="checkbox"/>	**Company has undergone a major reorganization or recent major acquisition or disposition.
<input type="checkbox"/>	**This is a fast growing company.
<input type="checkbox"/>	**Company has a captive REIT or special purpose entities.
<input type="checkbox"/>	Company is in certain industries where audit results were productive (financials, telecommunications, entertainment).
<input type="checkbox"/>	**Other, please specify

* REQUIRED, unless it is explained in the Comments section below why the company should be nominated without meeting one of these criteria.

** For each of these criteria, describe facts that support your conclusion in the Comments section.

Comments

Note: This form will be distributed to all states along with the ballots for income tax inventory votes.

Step 2

Income Tax Nomination Ballot

To: State of _____

The states have submitted the nominations listed below for the current nomination cycle. This list includes any companies in our current income tax inventory for which the audit has not been started. For each company, the reasons for the nomination are indicated on the attached sheets. Please return your ballot no later than _____ [date] _____.

Taxpayer name: _____

Audit Director's comments: _____

Vote: ___ 1- Our state would participate. This taxpayer is a High Priority Audit for our state

Vote: ___ 2- Our state would be likely to participate in an audit of this company, but this taxpayer is not a high priority for our state

Vote: ___ 3- Our state would not be likely to participate in an audit of this company

Reason for "3" vote:

We will do this audit ourselves _____

Other _____

This taxpayer IS ___ IS NOT ___ filing in our state

___ We believe this taxpayer may have nexus in our state because _____

Appendix 4 – Sales Tax Forms

Sales Tax Audit Nominations

Final – 5-14-13

Goals for the audit nominating process:

1. Maximize the MTC's unique joint audit expertise
2. Use the MTC's audit resources, both people and budget, to maximum benefit for the states
3. Choose audit candidates that have significant common audit issues that affect multiple states
4. Maximize the return on the investment of audit resources

The following criteria should be considered when nominating audit candidates for MTC joint sales tax audits:

1. Taxpayers with substantial physical presence in several MTC states
2. Taxpayers with nexus issues
3. Taxpayers that require a heavy reliance on promotional items involving tangible personal property for marketing their products
4. Taxpayers who sell to end users, who would not be expected to claim a large number of exempt sales, but show large deductions (\$250,000 or more) for exempt sales on their tax returns
5. Taxpayers that have had a history of poor or non-compliance in previous audits
6. Taxpayers in the health care, retail or technology industries, including consumer electronics companies

Obviously no company will meet all of the above criteria. However, nominated companies should meet criteria # 1 in all cases, unless an explanation is provided why an exception should be made, and at least one of the other criteria listed above. In addition, please avoid nominating audit candidates with the following characteristics:

- A large taxpayer with multiple operating divisions reporting combined bases under a single sales and use tax return.
- A taxpayer that requires special auditing techniques or that will require examination of a very large volume of records.
- A manufacturer or wholesaler whose products are sold for resale and who has minimal physical presence in the states.

Step 1

SALES TAX NOMINATION

The MTC Joint Audit Program needs to add candidates to the sales tax audit inventory. Please submit up to two (2) nominations no later than ____ [date] _____. In addition to checking the applicable boxes below, you must describe the reasons for each nomination or it will not be included on the inventory ballot. Please note that you are not required to make a nomination at this time. You may submit a nomination at any time, but if it is received after the deadline above it will be included in the next audit nomination process.

The nominations received by the due date will be submitted to the states together with a list of the audits that are currently in our inventory that have not been started. The vote results will be discussed with the Audit Committee at its meeting on ____ [date] ____.

State _____

Company _____

FEIN _____

Description of company business (to help put the specific information into context)

Check all boxes that apply.

<input type="checkbox"/>	* Company has significant physical presence in several MTC states
<input type="checkbox"/>	Company is a non-filer in our state but has potential for nexus
<input type="checkbox"/>	Company relies on promotional TTP for marketing its product
<input type="checkbox"/>	Company claims large number (\$250,000 monthly or more) of exempt sales to end users
<input type="checkbox"/>	Company has a history of non-compliance in our state
<input type="checkbox"/>	Company is in an industry where audit results were productive (healthcare, retail, consumer electronics or technology)
<input type="checkbox"/>	Other, please specify in comments section

* REQUIRED, unless it is explained in the Comments section below why the company should be nominated without meeting this criterion.

For each of the criteria, describe the facts that support your conclusion in the Comments section.

Comments:

Note: This form will be distributed to all states along with the ballots for sales tax inventory votes.

Step 2

Sales Tax Nomination Ballot

To: State of _____

The states have submitted the nominations listed below for the current nomination cycle. This list includes any companies in our current sales tax inventory for which the audit has not been started. For each company, the reasons for the nomination are indicated on the attached sheets. Please return your ballot no later than _____.

Taxpayer name: _____

Audit Director's comments: _____

Vote: ___ 1- Our state would participate. This taxpayer is a High Priority Audit for our state

Vote: ___ 2- Our state would be likely to participate in an audit of this company, but this taxpayer is not a high priority for our state

Vote: ___ 3- Our state would not be likely to participate in an audit of this company

Reason for "3" vote:

We will do this audit ourselves _____

Other _____

This taxpayer IS ___ IS NOT ___ filing in our state

___ We believe this taxpayer may have nexus in our state because _____
