MTC Audit Nomination Process Description – Version 2.0 1-25-13

(NOTE: The same basic steps apply for both income and sales tax audits, substantive differences are noted)

<u>Step 1</u>: Audit Director initiates the process by sending Audit Nomination Forms to states

- Generally, the sales tax process is conducted annually, and the income tax process is every 18 months. However, if inventory is getting low at any time, the Audit Director may initiate the process.
- He will start the process with an Audit Committee meeting date in mind so that final review by the states will be timely. Typically this will be about 5-6 months ahead of a scheduled meeting.
- The Audit Director may tell the states how many audits he needs to fill inventory (example: 10), and how many nominations he would like to receive from each state (typically 2). The states are asked to respond within 60 days.
- State staff people identify nomination candidates. Criteria that may be used include: what potential the state may see for adjustments based on state-specific returns or data; does the state think that other states would be interested in the issues that might be presented; the company is one that the state might not get to because of resource constraints (travel audit); the company may already be included in an in-house audit plan (a candidate that the state is interested in already); extent of the company's business presence (reporting or doing business in a large number of states); criteria on nomination form (3+ criteria that match); companies that the state wouldn't audit (out of state) but has issues that are of interest to the state. State may have a nominations list ready either for its own use or as potential MTC audits, as a state builds its own audit plan.
- State audit programs generate leads for their own audits: supervisors assign new cases to auditors and monitor production; auditors pick up prospective audits also; leads are developed through use of computer-based discovery tools; leads may come from other tax type audits; weight may be given to different characteristics and issues in identifying potential audit candidates.
- Les generally waits 60-90 days for nominations to come in. He will typically send a reminder after 60 days.

- <u>Potential efficiencies</u> – clean up the nomination forms to get states to explain reason for the nomination, see Rick's comments. Consider starting the process earlier to have the inventory supplemented sooner. States complain about how long candidates sit in inventory; allow states to pull companies out of inventory if reasons for nomination get stale. If an issue emerged that needed attention this would allow shifting of attention. Does this indicate that some periodic status evaluation would be useful? Ask about audit history in the states; issues in prior audits from MTC; potential nexus issues (taxpayer business model/facts).

<u>Step 2:</u> Audit Director distributes to the states a list of all companies that were nominated together with another form seeking state specific information about each of those candidates for the most recent 3 tax years. (It takes about 7 days for Les to consolidate the nomination information and turn it back around to initiate this step.) There are typically 30-40 different companies nominated.

- State staff fills out information forms for each taxpayer that has been nominated. They tend to work this into their existing work load, and may not give it a high priority. Gathering the requested information is time consuming to do because it requires a taxpayer-by-taxpayer investigation. The states must look at return data for three years for each taxpayer.
- This step is a big bottleneck in the process because it is so time-consuming for the states to generate the data on all nomination candidates.
- States return information on all audit nominations within 60-90 days. Generally 70% of the states respond within 30-60 days. The Audit Director sends out a reminder and gives remaining states about 20 days to respond.
- Audit director consolidates all of the information submitted (this takes 14-21 days).
- <u>Potential efficiency:</u> don't ask for this information until the authorization for the audit is requested, if at all. It may be available from other sources, and may not be needed unless the taxpayer is included in inventory.

<u>Step 3:</u> Audit director sends out the consolidated taxpayer information to the states together with ballots for the states to indicate which audit nominations they prefer.

- Voting criteria: "1" – the taxpayer is a high priority audit for the state (the state <u>will</u> participate in an audit of this candidate); "2" - the taxpayer is not a high priority but the state is likely to participate in an audit; "3"- the state would not likely participate in an audit of this candidate.
- Typically the states take 30 – 45 days to return their ballots.

<u>Step 4:</u> Audit director summarizes the vote results and shares the results with the states.

- The Audit Director makes a recommendation for a cut off point based on how many audits are needed for inventory. He also looks for broad state representation (either a "priority" or "likely to participate" vote) in the audit list he suggests.
- <u>Important considerations:</u> Joint audits should take advantage of the MTC resource (skills and training of the auditors) and also provide equity in coverage for the states. A "2" vote may be motivated by a wide variety of reasons (see discussion under Step 3); "priority" and "not likely" are well defined. Perhaps identify the "priority" votes separately or weight them differently in order to achieve equity in coverage across the states.

- The states discuss the results of the vote, and the Audit Director's recommended list, either on a conference call or at next Audit Committee meeting. The discussion often focuses on companies that are close to the cut off line. Les might move the line to be more inclusive of the states who indicated a priority vote.
- States approve additions to MTC Audit Inventory after discussion. They usually approve the list as presented.
- Audits are assigned to MTC auditors based on their existing schedules, auditor skill and knowledge, and travel requirements. MTC supervisors look at a six-month window for initiating audits by seeking audit authorizations from the states and contacting the taxpayers for initial appointments.

<u>ISSUES AND CONCERNS WITH CURRENT NOMINATING PROCESS:</u>

Is Step 2 information too detailed? Is it the right information to evaluate nominations? Could MTC staff use this data to do an initial screen? Is all of the information needed, or used, for voting and selection? It appears that there isn't any analysis done for the voting process based on this information by the states or the MTC audit staff. Question – would it be helpful for MTC to do some preliminary analysis with the data before the states vote?

Comment: states are most likely to use their own state-specific data to vote – based on the interest of the state, whether the state has or will likely audit the company. Comment: it appears that there is a disconnect between the information collected in 2nd step and the decision on what audits are finally selected – this needs to be lined up or changed.

What information is important to the states to vote? Prior audit information is more likely to be of interest, but not the data from the other states. States would benefit from an understanding of why other states have nominated certain companies: possible nexus? Specific audit issues? Prior experience with the taxpayer or the industry group? The team may want to get feedback from the states on the usefulness of the information for voting to validate their preliminary conclusion that the information isn't used. Could this step be skipped, go directly to balloting if Step 1 includes a detailed explanation of WHY the taxpayer was nominated?

Selecting the next best audit is what the states try to do in-house. Question – do you select the next MTC audit for the same reason? Should the standards be different – two separate criteria for the state audits versus the MTC joint audits. Some issues may be more complicated or state specific and more readily handled by the state staff; travel audits are more likely to be suggested for MTC. Les is looking for the next best audit for MTC.

For sales tax audits the detailed information requested in Step 2 may not be the most useful. Sales tax audits: one issue is that each state looks at its own criteria to determine whether the audit will be good for that state. We may need a new way to analyze the overall data. If a taxpayer has only a few physical locations, it may not be a good audit for a large group of states. Is there a way to apply a quality filter before asking the states to vote? If we stay with

the same list – other states will sign on because that is all there is to choose from. A state may conclude that there may be a hope of nexus or something that will justify participation. States that nominate may be frustrated if the companies they nominate don't get audited due to the small number of states affected.
Guidelines were given to the states after the process was reworked – criteria for a good MTC audit rather than a good state audit. There hasn't been an income tax selection process since the guidelines were developed. We will need to check whether the new guidelines will work well, and whether the states have begun to use them in making nominations.

MTC can see the national picture that sometimes the states individually don't see. The inventory nominating cycle gets stretched out when states are asked for more nominations.

Consider the possibility of MTC preparing an initial list based on Audit Committee criteria; carry over from prior lists; central data base; or other sources.
**Consider the philosophical views of the states concerning their relationship with the MTC audit program – as an extension of their own audit resources, or as a nexus finder. Small states with lower levels of business activity may see sales tax audits primarily as nexus tools. The group may want to consider whether the process should explicitly offer an initial nexus probe before conducting a complete audit for one of these states.

Some states consider MTC as an extension of resources – to pick up where state can't reach; some states look at MTC as a nexus finder (need to ask the states how they use the audit program). Need to be clear about criteria, and most valuable use of the time of the auditors. In sales tax audits this is the key issue, if a company has a large presence in a lot of states the states want to do individual audits because of use tax issues. Use tax is most significant with manufacturing (self assessed use tax); if records are kept in a central location, that company would be a good MTC audit, particularly national retail chains.

Rather than trying to find an audit for 10-12 states, where states are participating only because the inventory is fixed, maybe look at smaller audits (6-7 states) to hit the sweet spot more frequently. Audits should be less time consuming and more likely to add value. Could more audits be done if this were the case? Could they be started more quickly after being selected by the states?

If a taxpayer shows minimal presence in half the states in an audit, perhaps the auditor could use the "early no change" process that is being developed by the other project team. This could reduce the demands on taxpayers' time. As we move forward, we can look for the intersection between nomination filtering, audit selection and early no change process.

See whether states are willing to share taxpayer populations, and do some filtering to develop an initial list of companies for consideration.

What to do if a state gives a “non-filer” response in the audit process – check for nexus first?

Les has a list of nomination lists that were voted on. He doesn’t keep the backup data after a vote has been taken. The team may want to recommend retaining some kind of a list of prior nominees.

This may be an area where a data base would be helpful to keep track of the number of audits by tax type that were nominated by a state and voted in. There are some states that don’t appear to put a lot of thought into making nominations of initial candidates. The team recognized that there is turnover in staff, and that the states need to be kept aware of their overall results.

Voting criteria: consider asking why a state is voting the way it is. This could help the selection criteria be refined. Reasons for a nomination will also likely influence a state’s vote: does the taxpayer do business in my state; preliminary review of the taxpayer indicates audit potential for the state; is it in the audit stream for periodic re-audit (this might result in a “3” vote). The states also may weigh the value of having state staff audit a particular taxpayer versus MTC doing the audit: economies of scale – state recovery might be low and not worth doing independently (cost of performance; combination; nexus) but would be cost effective if MTC does the audit; potentially uncooperative taxpayers because MTC has more impact (subpoena power, multiple states behind the audit); issues that are currently hot; large presence in a lot of states, which is the state going to benefit the best from. [Comment: it is very important to know why a taxpayer was nominated – to make a good decision on voting. This likely affects votes significantly.]

Nominating info from MTC to the states: Income tax: industry behavior, identify issues, give the states some ideas to think about.

Sales tax: leads can come from “spin off” audits – a particular taxpayer (or industry) pattern of misapplication of codes, inappropriate exemption certificates, other behavior that indicates there could be improper reporting. [MTC might note in an audit narrative to flag for other states.] This could be helpful in future nominations – is the issue potentially applicable to an industry or a group of taxpayers – call to the attention of the states for them to consider in offering nominations.

Types of audits that would be good audits: one or more of the check boxes in the criteria from Step 1.