



MULTISTATE TAX COMMISSION

## **Sales and Use Tax Audit Manual**

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# Multistate Tax Commission

## Sales and Use Tax Audit Manual

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# 1. Introduction

## 1.01 Multistate Tax Commission Joint Audit Program

The Joint Audit Program of the Multistate Tax Commission (Commission) was initiated in the early 1970s pursuant to Article VIII of the Multistate Tax Compact.

## 1.02 Sales and Use Tax Audit Manual

This Sales and Use Tax Audit Manual (manual) describes the procedures that Commission auditors follow in performing a joint audit on behalf of the Joint Audit Program member states that have elected to participate in a specific audit.

## 1.03 Changes in Substantive Law

The information provided in the manual 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 and does not contain all authorities that may be relevant to a Commission audit.

## 1.04 Purpose of the Manual

The sole purpose of this manual is to provide general guidance to the Commission's Joint Audit Program staff for the performance of joint audits on behalf of program states. It is the nature of tax audits that specific audit procedures are necessitated by provisions of tax law (e.g., varying taxability and exemption rules). While the manual may generally reference typical state law requirements describing certain procedures, the manual is not intended to replace applicable law or specific guidance of the states on substantive issues, nor can it be cited for that purpose. The manual does not constitute a uniform law or regulation under the Multistate Tax Compact Art. VII, but it has been approved by the Commission's *Audit Committee*. The Commission has made this manual available to the public to provide general information on the joint audit process.

## 1.05 Suggestions and Corrections

All suggestions and corrections are welcome and should be communicated to the Commission's Joint Program Audit Director (Audit Director).

## 2. Definitions

### 2.01 Introduction

This section lists terms and general definitions used extensively in multistate audits. In many cases, these terms are also statutorily defined by states and there may be differences among the states in how a term is defined. Auditors will need to develop a general working knowledge of these terms and definitions. The terms defined below appear capitalized and italicized the first time they are introduced in each chapter in this manual.

### 2.02 Assigned Auditor (Auditor)

The Commission employee to whom an audit is assigned from the audit inventory.

### 2.03 Audit Committee

The audit committee guides the Commission's Joint Audit Program. States that participate in the Joint Audit Program each have a representative on the Audit Committee.

### 2.04 Canned (Prewritten) Software

Software that is created for general sales (distribution) and not for the needs of a single customer.

### 2.05 Cloud Computing

Computer system resources (e.g., networks, servers, storage, applications, and services) that are available on demand but are not owned or possessed by the user. There are three primary service models for cloud computing: Software as a Service (SaaS), Platform as a Service (PaaS) and Infrastructure as a Service (IaaS). This definition is generally derived from the National Institute of Standards and Technology (NIST) Special Publication 800-145.

### 2.06 Custom Software

One of a kind and unique software that is written for the needs of a specific customer and has not been previously sold to other customers. Custom software does not include setup, personalization, or modification of canned (prewritten) software for a specific customer's needs.

### 2.07 Delinquency Notice

Commission correspondence that provides a taxpayer formal notification that a request for audit records has not been met by the due date.

The Delinquency Notice will identify the information previously requested which has not yet been provided and will set forth a timeframe with deadlines indicating when that information must be provided to avoid the issuance of a Demand Letter.



## 2.08 Demand Letter

Commission correspondence that provides formal notification to a taxpayer of outstanding audit records. The Demand Letter is generally issued after deadlines established in a Delinquency Notice have not been met.

The Demand Letter will require production of the previously requested documents by a deadline or deadlines that will allow the audit to be completed in a timely manner. Failure to comply may result in issuance of an *Estimated Assessment* or commencement of legal action to compel production of records.

## 2.09 Detailed Review

Detailed review refers to an audit practice of reviewing **every item** in a population. Whenever procedures are employed that allow the auditor to review less than every item in a population, the result is a sample.

## 2.10 Digital Products

Products that are delivered, transferred, or accessed by electronic means. Examples of digital products are music, video, books, periodicals, audiovisual works, artwork, or games that are streamed or downloaded by users and digital code not otherwise defined. Digital code is a process of using binary digits to represent letters, characters, and other symbols in a digital format.

## 2.11 Estimated Assessment

A tax assessment issued as the result of an audit based on best available information. This may occur when requested records are not provided by the taxpayer.

## 2.12 Information Document Request (IDR)

The Commission's standard procedure for requesting audit documentation; an IDR includes a detailed list of records requested and due dates.

## 2.13 Infrastructure as a Service (IaaS)

A cloud computing service model or arrangement that allows the consumer to remotely access processing, storage, networks, and other fundamental computing resources, thereby enabling the consumer to deploy and run software, including operating systems and applications; the consumer does not own, manage, possess, or control the underlying cloud infrastructure but has control over operating systems, storage, and deployed applications; and possibly limited control of select network components such as host firewalls. This definition is generally derived from the National Institute of Standards and Technology (NIST) Special Publication 800-145.

## 2.14 Nexus

A connection or link between a person (meaning both natural persons and entities) and a state sufficient to enable the state to impose on that person a tax or tax collection and remittance duties.

### 2.15 Platform as a Service (PaaS)

A cloud computing service model or arrangement that allows the consumer to remotely deploy the consumer's created or acquired applications on a cloud infrastructure using programming languages, libraries, services, or tools supplied by the provider. The consumer does not own, possess, or control the underlying infrastructure but has control over the deployed applications and, potentially, configuration settings for the application-hosting environment. This definition is generally derived from the National Institute of Standards and Technology (NIST) Special Publication 800-145.

### 2.16 Remotely Accessed Software

Software that remains in the possession of the service provider or the service provider's designee and is accessed remotely by the user. It includes hosted software, applications provided by ASP's (application service providers), Software-as-a-Service (SaaS), and certain other cloud computing applications.

### 2.17 Remote Seller

A seller without physical presence in a state who sells products or services for delivery into that state.

### 2.18 Sampling

Applying audit procedures to less than 100% of the entire population of items. Sampling is used to infer or make conclusions on the population based on the result of the review of selected items.

### 2.19 Software as a Service (SaaS)

A cloud computing service model or arrangement that allows the consumer to remotely access a provider's application on a cloud infrastructure via the internet or a program interface. The consumer does not own, manage, possess, or control the underlying cloud infrastructure including network, servers, operating systems, storage, or individual application capabilities. Limited user-specific application configuration settings may be permitted by the service provider. This definition is generally derived from the National Institute of Standards and Technology (NIST) Special Publication 800-145.

### 2.20 Statute of Limitations

State law that sets the time limits within which an action must be taken. States have statutes of limitations that set deadlines for the valid assessment of taxes by the tax authority and for claiming a tax refund by a taxpayer.

### 2.21 Statute Waiver (Waiver)

An agreement between a taxpayer and a state to extend the statute of limitations.

## 2.22 Streamlined Sales and Use Tax Agreement (SSUTA)

The Streamlined Sales Tax Governing Board developed an Agreement intended to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance. The Agreement has not been adopted by all Commission Joint Audit Program states.

<https://www.streamlinedsalestax.org/library?SelectedDocumentType=Agreement+Documents>

## 2.23 Tabular Data Sets

Tabular data sets are generally tables made up of rows and columns, commonly referred to as a database. Typically, columns contain data fields and rows contain data records.

## 2.24 Taxpayer

A taxpayer is any person (meaning both natural persons and entities) subject to the tax imposed under each state's tax laws. In this manual, the term "taxpayer" generally refers to a corporation, group of corporations, or other entity, subject to tax, or tax collection and remittance responsibilities, in particular states. In addition, depending on the context, the term "taxpayer" may refer to the person or persons designated by the taxpayer to handle the audit and respond to the auditor.

## 3. Audit Resources and Tools

### 3.01 Introduction

The sales tax audit landscape has changed over the last fifty years. These changes include the legal environment, how audit data is exchanged (by electronic means rather than by paper), and the tools that auditors use to do the audit (hardware and software). Further, the pace of these changes has increased which will likely continue. Therefore, the Commission expects that its auditors will have required minimum technology and software skills, and that they will maintain and improve technical competencies during their tenure with the Commission.

### 3.02 Software Tools

The Commission provides a variety of software tools the auditor will be required to learn and use. Examples include the Microsoft Office Products (Outlook, Excel, Word, Access, PowerPoint), the Commission's *Sampling* software, file sharing programs, cloud storage, VoIP, etc. Specific examples are expected to change over time as software tools are continuously changing. Auditors will use these programs regularly while performing audit work. Auditors can expect their proficiency at these programs to improve while performing specific audit tasks.

Auditors should maintain technical competency throughout employment at the Commission in the role of sales tax auditor. It is also expected that the Commission will provide the resources and training to maintain this competency. Auditors should always be seeking to improve their technical competencies and are expected to participate in relevant training opportunities offered by the Commission.

### 3.03 Computer Audit Specialist (CAS)

Typical Commission audits require the auditor to work with large files containing *Tabular Data*. From time to time, data file size or complexity exceeds the functional limits of the auditor's designated hardware or software (for example, computer processor speeds, computer memory, Microsoft Excel, Microsoft Access, etc.). In cases where the auditor is unable to independently manage the files due to size or complexity, the Commission maintains other types of specialized software that can be utilized to perform computer assisted audit techniques. Various Commission personnel are tasked with the role of CAS and are available to assist with audit data manipulation. The role of a CAS generally includes:

- Using specialized software and maintaining software licenses as needed.
- Downloading and managing large data sets.
- Developing data subsets into sizes that can be managed by the auditor.
- Communicating elements present in large data files to the auditor (function as eyes and ears for the auditor).
- Guiding the auditor in determining relevant data subsets based on data structure and elements present in the download.

The role of the CAS is to assist and guide the auditor, not to make audit decisions, perform the audit or act in a purely clerical role. In cases involving a CAS, the auditor is generally unable to view and manipulate the entire data set without assistance.

Auditors may, from time to time, request assistance from or consult with a CAS for specific tasks not related to managing large data sets. This assistance or consultation is to be used by auditors as an opportunity to enhance and improve, rather than to serve as a substitute for, their own skills.

### 3.04 Tax Research Tools

The Commission provides auditors with a subscription to a tax research tool. The auditor should become familiar with the tax research tool and utilize the features and benefits provided by the software. An example is the ability to create customized charts referencing specific tax topics that include basic tax information, state authority citations, and editorial references.

The sales and use tax audit team maintains a chart containing taxability information and authoritative citations for various tax issues. The chart is a useful tool in conducting audit research and should be used as a starting point. The auditor is responsible for investigating issues and clarifying state guidance with the state contact, when necessary.

## 4. Pre-Audit Procedures

### 4.01 Introduction

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

### 4.02 Audit Assignment

The Commission's Joint *Audit Committee* selects the audits to be included in the audit inventory by vote. The Audit Supervisor assigns audits from the Commission's inventory to individual auditors as the auditors require them to maintain an adequate workload.

### 4.03 Audit Authorizations

Following the assignment of the audit by the Audit Supervisor, the audit authorization requests will be sent along with a sales and use tax audit checklist to the states participating in the sales and use tax section of the Commission's Joint Audit Program. The audit authorization will also include an expected audit period which may be subject to change as the auditor begins the audit process.

### 4.04 Authorization Deadline for the States

The states are expected to return signed authorizations within 45 days. At the expiration of the authorization deadline, the auditor will tell the audit supervisor which states intend to participate. The Audit Supervisor or the supervisor's designee will follow up with the states which have not responded. Once field audit work has begun on the audit, states that have not returned a signed audit authorization may not participate in that audit unless specific approval has been given by the Audit Director.

### 4.05 Gathering Information Before Starting the Audit

The auditor will gather taxpayer information prior to starting the audit. The auditor will use information submitted with the sales tax nomination forms and the sales tax checklist. The auditor should also obtain copies of the taxpayer's annual report and SEC Forms 10-K. The auditor should make use of the internet to explore the taxpayer's website and other information regarding the company.

### 4.06 Initial Audit Information Package

The auditor will review the tax returns or transcripts submitted by each participating state. The auditor will also summarize pertinent data into appropriate schedules for each state. The auditor will review the returns or transcripts to identify any obvious audit issues.

#### 4.07 Prior Audits

If the Commission has previously conducted audits of the taxpayer, the Audit Supervisor will provide the auditor with information regarding those prior audits at the time the audit is assigned. If a state indicates a prior audit on the sales and use tax checklist, the auditor will request relevant information if not provided by the state in the initial audit information package.

The auditor will thoroughly review prior audits to gain any relevant knowledge about the taxpayer. Additionally, the auditor should develop the audit plan to verify correction of prior audit issues.

#### 4.08 Documenting Audit Progress

The auditor will prepare a ‘workload review’ form and an ‘audit status summary report’ at the beginning of the audit. These forms will be used and updated throughout the audit process. The auditor will provide the workload review to the Audit Supervisor monthly and the audit status summary to the Audit Supervisor upon request. The auditor will also keep and maintain a record of all audit activity. This will enable the supervisor to monitor progress and activity on the audit. These records will also give the Audit Director or any other authorized personnel access to the progress being made on any audit. The reports will also serve as documentation of work that has been performed.

#### 4.09 Audit File Organization

The auditor will maintain electronic records for all assigned audits. The auditor will create a separate file folder for each assigned audit. Within the audit folder, separate subfolders should be created for each participating state. All electronic workpapers, forms, and documents generated and used during the audit are expected to be maintained in these folders. The auditor should review and follow the Commission’s file backup guidelines. Any hard copies of tax returns, transcripts, audit authorizations, correspondence with taxpayers and states, waivers, and schedules should be maintained in accordance with the Commission’s document retention policy.

#### 4.10 Establishing the Audit Period

The auditor should endeavor to begin the audit field work within six months from the date of the initial audit assignment. The auditor should then establish the audit period beginning with the tax account period (month or quarter) after the auditor has contacted the taxpayer and include all open statutory prior periods. The auditor will have some leeway in establishing the audit period depending on the initial contact with the taxpayer. The auditor must seek approval from the audit supervisor if there is a need for an adjustment to the beginning date of the audit period.

Commission policy is to establish a six-year audit period when no *Statute of Limitations* applies, such as in situations when no returns have been filed. State policies on audit periods may vary. Refer to the *Nexus* discussion in [Chapter 7](#) and consider when nexus was established (and if nexus ceased). Special circumstances such as collecting but failing to remit tax may cause longer audit periods beyond the general policy, if directed by the state.

#### 4.11 Initial Audit Plan

The auditor will establish an initial audit plan. The plan should be discussed with the taxpayer during the initial contact or meeting. The audit plan may include the order in which information will be reviewed and may also include the order in which state audits are completed. The auditor may also decide to start with specific audit issues. The auditor has the flexibility to determine how to proceed on the audit but should work with the taxpayer and make any adjustments to the audit plan that make sense for both the auditor and the taxpayer.



## 5. Statutes of Limitations and Waivers

### 5.01 Commencement of Audit; Initial Extension of Statute of Limitations

The auditor will likely need to request an initial *Waiver* to extend the *Statute of Limitations* at the onset of the audit. If possible, the auditor should request the first waiver during an initial telephone conference with the taxpayer. The waiver should be requested no later than the commencement of the audit, whether that occurs during a field visit or remotely.

The initial waiver extension should consider the anticipated completion date. The auditor must allow adequate time for the taxpayer to provide documents and information, for the auditor to review those materials and prepare preliminary audit findings, and for the taxpayer to then review those findings prior to their submission to the state. The auditor should also anticipate that the taxpayer may request an adjustment or provide additional information that will need to be considered by the auditor.

Once final schedules have been provided to the taxpayer, time is required for the auditor to complete the audit report and for the Audit Supervisor to review it. Once the audit report is submitted to the state, the state will need time to review the findings and issue an audit report.

### 5.02 Statute of Limitations Control Procedures

The auditor will adhere to the following control procedures:

#### (a) Commission Waiver Policy

Discussions before or during the initial audit appointment will include the Commission's Waiver Policy for Joint Sales and Use Tax Audits. The auditor will provide the taxpayer with a copy of the Commission's Waiver Policy ([Exhibit A](#)) and request the taxpayer's signature on the document acknowledging the discussion. The auditor will also discuss the taxpayer's internal policy for signing waivers of statutes of limitations and request a copy of the taxpayer's written policy if one exists.

#### (b) Form of Waiver

The auditor must ensure the taxpayer, all associated tax entities, federal identification number(s), and state identification number(s) where applicable, are properly documented on the waiver. The auditor must also ensure the waiver includes all states participating in the audit. However, certain states require use of state specific forms or require a separate waiver form for each taxpayer that filed returns in the state.

The Commission Waiver Form ([Exhibit B](#)) contains a statement that the signature on the waiver is prima facie evidence that the individual signing the waiver is authorized to sign on behalf of the taxpayer.

### (c) Requesting Additional Waivers

The auditor should make every effort to complete the audit within six months of the expiration of the current statute waiver. In general, whenever a statute waiver is due to expire within six months, the auditor will assess the current status of the audit and request a waiver extension if necessary.

A possible exception to extending a waiver the full six months could occur when the auditor has all information necessary to complete audit recommendations and is confident those recommendations can be finished in time to provide an opportunity for the taxpayer to review and the state to process the audit.

### (d) Documenting Statute Expirations

The auditor will prepare a statute control document for each assigned audit identifying all audit periods and initial waiver expiration dates. Waiver expiration dates will be updated in the document as waiver extensions are executed.

### (e) Supervisor Review of Waivers

Auditors are required to provide copies of all signed waivers to their supervisor. The supervisor must maintain copies of these waivers.

## 5.03 Taxpayer Refusal to Execute Statute Waivers

If a taxpayer declines to sign a waiver, generally within 30 days of the request, or only agrees to sign a waiver that does not provide enough time for the Commission to timely and accurately complete the audit, the auditor will immediately consult with the supervisor or audit director, whereupon the matter may be referred to the general counsel.

The states will be alerted, with sufficient time remaining before the expiration of any statute of limitations, to enable those states to consider taking necessary steps to expedite review of audit recommendations or issue provisional or jeopardy assessments.

Based on the discussions with the supervisor, director, and the states, the audit may be completed based on available information. Alternatively, to facilitate the timely completion of the audit, the Commission or a participating state may issue a subpoena to compel production of documents and information necessary for the joint audit.

## 6. Working with Taxpayers

### 6.01 Introduction

This chapter provides general guidelines for interactions with taxpayers. It is not meant to override auditor judgement and should not be used as a mere checklist when conducting an audit. Audit environments are dynamic, and the auditor needs to be able to make appropriate adjustments during the audit process and revise audit plans, as necessary.

The Commission serves as the representative of member states participating in the Joint Audit Program. Audit staff will:

- Abide by participating states' statutes and regulations.
- Maintain compliance with confidentiality laws of each state.
- Practice professional courtesy during the audit.
- Conduct the audit as efficiently as possible.
- Request information that is pertinent to the audit based on each state's requirements.
- Discuss all audit findings with the taxpayer.
- Make every effort to accommodate the taxpayer's schedule.
- Request *Waivers* when needed to allow sufficient time for the states to process the audit recommendations and to allow the taxpayer an opportunity to review audit findings.

Consequently, the Commission expects that taxpayers will:

- Respect the states' request to have the Commission conduct the audit on their behalf.
- Extend professional courtesy to the Commission audit staff.
- Respond to information requests in a timely manner.
- Sign reasonable waiver requests in accordance with the Commission Waiver Policy.
- Notify the Commission auditor of any contact the taxpayer has with the states pertaining to the audit while the audit is being conducted.
- Provide the Commission auditor with any amended returns filed while the audit is being conducted.

### 6.02 Initial Contact with Taxpayer

Initial contact with the taxpayer will include, but is not limited to, the following matters:

#### (a) Contact Information

Provide auditor contact information to the taxpayer and obtain contact information for all person(s) designated by the taxpayer to handle the audit.

#### (b) Commission Authority, Operations and Joint Audit Program

- (i) Describe the basic operations of the Commission and the Joint Audit Program. The Commission does not issue assessments, refund requests, or any other adjustments to

taxpayer liability. The Commission only issues recommendations to participating states as to assessments, refunds, and other adjustments to taxpayer liability. Protests and any resolution of audit results will be handled directly by each individual state participating in the audit.

- (ii) Answer any questions posed by the taxpayer regarding basic operations of the Commission. Direct the taxpayer to the Commission website for additional information.

(c) State Authorizations

Explain the state authorization process and provide a list of states electing to participate in the audit, along with any pending state authorizations.

(d) Scope of Audit

Identify all operating entities associated with the taxpayer to be addressed by the audit and their corresponding federal identification numbers. The auditor may need to obtain authorizations from the states for any additional entities that are to be included in the audit. This will allow the initial signed statute waiver(s) to include all entities to be audited.

(e) Commission Statute Waiver Policy

Discuss Commission and taxpayer waiver policies outlined in [Chapter 5](#), and request taxpayer signature on the Commission Waiver Policy for Joint Sales and Use Tax Audits form.

(f) Secure Communications

Review the Commission’s secure email policy with the taxpayer and provide the “Request and Waiver for Unsecure Electronic Transmission of Data” document, if requested by the taxpayer. ([Exhibit C](#))

It is the general practice of the Commission to communicate with audited taxpayers by phone and email, unless the taxpayer requests otherwise. Communications by email will use encryption to avoid any accidental disclosure of confidential information. If the taxpayer requests or agrees to communicate through email without encryption, the auditor must obtain the signed waiver from the taxpayer and keep it as a record of the agreement in the audit files.

(g) Audit Period and Initial Statute Waiver

Discuss planned audit period with the taxpayer and request an initial waiver with an appropriate expiration date. This topic may be reserved for the initial meeting with taxpayer when appropriate.

#### (h) Schedule Initial Meeting

Schedule an initial meeting or conference call with the taxpayer and invite the taxpayer to include all appropriate personnel. Let the taxpayer know the initial meeting includes questions about the taxpayer's business activities and discussion of the auditor's general audit plan.

#### (i) Electronic Data and *Sampling*

Inform taxpayer of the Commission's general electronic data and sampling requirements.

### 6.03 Procedures for a Non-Responsive Taxpayer

If a taxpayer does not respond in a timely or acceptable manner to attempts to make contact (either by letter, phone, or email), the assigned auditor will mail a certified letter to the taxpayer giving the taxpayer seven days to make contact with the auditor. If there is no response to the certified letter, the auditor will discuss the situation with the audit supervisor to determine the best way to proceed.

### 6.04 Confirmation Letter

The auditor will send a confirmation letter ([Exhibit D](#)) to the taxpayer after the initial telephone conversation. The confirmation letter should be modified for each individual taxpayer. Copies of signed state audit authorizations and the audit brochure ([Exhibit E](#)) should be sent with the confirmation letter, unless previously provided. An initial document request may be provided with the confirmation letter.

### 6.05 Initial Meeting

The initial meeting, or conference call, with the taxpayer should include, but is not limited to, the following matters:

- (a) Commission and taxpayer waiver policies in accordance with [Section 5.02\(a\)](#)
- (b) The preliminary audit plan and general steps of the audit process.
- (c) Discuss the Commission's standard procedures for requesting records, including the form, timing, and general expectations for *Information Document Requests* (IDRs). ([Exhibit F](#))
- (d) Discuss the Commission's IDR Enforcement Compliance Procedures (See [Section 6.06\(e\)](#))
- (e) Power of Attorney forms are required when the taxpayer wishes to include outside personnel or representatives (attorneys, accountants, or consultants) in communications with the Commission. ([Exhibit G](#))
- (f) Procedures for obtaining documentation, corresponding via email and copies of documents (paper or electronic).

(g) Safeguarding taxpayer documents at the taxpayer location.

(h) Pre-Audit Discussion Regarding Taxpayer Operations

Auditor must obtain an understanding of taxpayer operations related to general business activities, sales, purchases, sales/use tax collection, use tax accrual, and tax reporting and remittance procedures.

Examples of inquiries include, but are not limited to, the following:

- Date of Fiscal Year End
- Personnel and Reporting Procedures
- Changes in Systems, Personnel or Reporting Procedures
- Types of Business Operations and Locations (distribution centers, showrooms, administrative offices, ecommerce, etc.)
- Types of Customers (individuals, retailers, manufacturers, construction contractors, property managers, government, non-profit entities, etc.)
- Sales Process (describe the flow of transactions from beginning to end, including tax collection, reporting, and remittance)
- Types of Exempt Sales (use based or entity-based exemptions and specific types of labor, services, products, customers etc.)
- Exemption Certificate Recordkeeping (acceptance, verification, and retention)
- Purchases Process (describe the flow of transactions from beginning to end, including use tax accrual, reporting, and remittance)
- Types of Exempt Purchases
- Taxability Matrixes
- Tax Return Reporting and Remittance Processes
- Taxpayer Known Errors (prior audit issues, overpayments, underpayments, etc.)

(i) Any items listed above in [Section 6.02](#) (Initial Contact with Taxpayer) that have not yet been discussed or require further clarification.

## 6.06 Information Document Requests (IDRs)

The Commission has authority to request information pursuant to the Multistate Tax Compact in compact member states, and as an authorized representative of non-compact member states. The Commission will seek such information and documents as are necessary to conduct a complete and accurate sales and use tax audit on behalf of the participating states.

An IDR is a Commission document that should be used by auditors when making a formal request for any type of document or information relevant to the audit. This formal process to request and secure information from the taxpayer promotes efficiency.

Using IDRs promotes:

- Clear, complete, and timely requests and responses to information requests
- 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
- Awareness for all concerned parties of any outstanding information requests

Commission auditors should adhere to the following guidelines while conducting audits:

(a) Communications

The auditor and taxpayer should agree upon a realistic due date and timeline for the information being sought.

If the IDR is presented to the taxpayer while the auditor is engaged in field work at the taxpayer's location, the auditor should sign the document and seek the signature of the taxpayer or other representative acknowledging receipt. If the IDR is presented electronically, the auditor is responsible for confirming that the taxpayer received it. If taxpayer acknowledgement or signature cannot be obtained, the auditor should document the lack of response.

It is important for the auditor and the taxpayer to establish communications regarding IDRs so that the auditor is aware of any problems or issues the taxpayer may have in responding to IDRs. Even when there is sufficient time to complete the audit, an auditor should follow up on IDRs when the taxpayer has failed to provide information by the deadline. If a taxpayer fails to respond to an IDR by the response date, or fails to respond to particular requests, the auditor should contact the taxpayer as soon as possible to determine the cause of the taxpayer's failure to respond and decide whether an extension should be granted.

The auditor should communicate with the taxpayer when the response to an IDR is satisfactory.

(b) Extensions

Taxpayers may request an extension of time to comply with an IDR. The auditor should use good judgment in granting extensions of time and allow them where appropriate. The deadline to provide requested documentation will generally be 30 days from the date the IDR extension is sent, although additional time may be granted where the request is extensive, or the taxpayer has indicated that more time will be needed, and this does not pose a problem for completing the audit in a timely fashion.

Whenever an extension is granted, the auditor should send an updated written notification to the taxpayer stating the new agreed upon response date.

The auditor should monitor whether information is being received in an appropriate time to complete the audit and allow appropriate review within the statutes of limitations or waiver deadlines. The taxpayer's willingness to sign waivers does not permit indefinitely delaying the completion of the audit; extensions should be based on the taxpayer's commitment to comply by the extended deadline or on unexpected events that are beyond the taxpayer's control.

The auditor should consult with the audit supervisor before granting multiple extensions as well as before denying a taxpayer request for extension.

#### (c) Unsatisfactory Response

If the auditor determines that the taxpayer's response to an IDR is insufficient or inaccurate, the auditor should contact the taxpayer as soon as possible to explain why the auditor believes the information is unsatisfactory and to determine the reason and decide whether an extension should be granted to provide additional information.

If a taxpayer provides additional information after receiving an extension following an incomplete response, the auditor should promptly review the additional information to determine whether the requirements of the IDR have been satisfied.

#### (d) Failure to Respond

If at any point during the audit, the taxpayer states that it is not willing to provide information for any reason, the auditor must attempt to confirm this in writing with the taxpayer and must promptly contact his or her supervisor, who will inform the audit director and general counsel.

When the taxpayer does not respond by the IDR due date or provides an insufficient response, and no extension is granted for additional time to respond, the IDR Enforcement Process begins on the date the auditor communicates to the taxpayer that an extension has not been granted.

#### (e) IDR Enforcement Process

The audit supervisor will inform the audit director and general counsel of the taxpayer's failure to timely respond or to provide a sufficient response and discuss undertaking the IDR enforcement process. The Commission will prepare a plan to protect the interests of the states and ensure timely completion of the audit within the statutes of limitations. The plan may include the following steps depending on the facts and circumstances, including the overall stage of the audit.



1. In consultation with the supervisor, the audit director, and the general counsel, and unless instructed otherwise, the auditor will send the taxpayer a *Delinquency Notice*, which will identify the information previously requested which has not yet been provided and will set a timeframe with deadlines for when that information must be provided to avoid the issuance of a *Demand Letter*.
2. If the taxpayer fails to produce the information requested in the Delinquency Notice by the deadline, the auditor must notify his or her supervisor, the audit director, and the general counsel to discuss issuing a formal Demand Letter.
3. If a decision is made to issue a formal Demand Letter, the auditor will send the taxpayer the Demand Letter requiring production of the previously requested documents by a deadline or deadlines that will allow the audit to be completed in a timely manner.
4. If the taxpayer fails to produce the information requested in the Demand Letter within the timeframe established in the Demand Letter, or it is determined that it is in the Commission and affected states' interests to not issue a Demand Letter and begin formal legal proceedings, the Commission legal staff and/or one of the states participating in the audit may commence a legal process to compel the production of records, including the issuance of an administrative subpoena to compel production of documents containing the requested information. The auditor, supervisor, director, and legal staff will work together through the legal process.

### 6.07 Complex/Significant Issues

When a complex or significant issue arises, the auditor should discuss the issue with the supervisor. The state liaison may also be consulted to determine the position or direction the state wishes to take regarding the issue in question.

When appropriate, the taxpayer should be encouraged to provide a statement that supports their position.

### 6.08 Provide Taxpayer with Preliminary Schedules

The auditor should provide the taxpayer with preliminary audit schedules. The auditor should also allow the taxpayer time to review and respond to the preliminary audit schedules.

### 6.09 Concluding the Audit

The auditor should review any objections made by the taxpayer, make any necessary adjustments to the preliminary schedules, and provide final schedules to the taxpayer. In addition, the auditor should take the following additional steps:

#### (a) Closing Conference

The auditor should offer the taxpayer a closing conference. If the taxpayer declines, the auditor is still required to ensure that all recommendations are conveyed and explained to the

taxpayer. The auditor should seek to obtain the taxpayer's position regarding the recommendations and should note those positions in the audit report.

(b) Taxpayer Response

If time permits, the auditor should allow the taxpayer an opportunity to provide a written response to the positions taken in the audit and to have that response included in the audit report.

(c) State Issuance of Audit Report

The auditor will remind the taxpayer that assessments, actions on refunds, adjustments to liability, protests, and similar official actions will be handled directly by each state; the Commission only recommends actions to the states based upon its audit findings. Commission audit findings are subject to the review and approval by the state for which they are prepared. The auditor may assist during the protest process upon request by the states and may not communicate with taxpayers following submission of an audit recommendation without the state's permission to do so.

(d) Taxpayer Request for Audit Documentation

Auditors must direct taxpayers who request audit workpapers, narratives, and similar materials to the relevant state tax agency. This is in accordance with Article VII, paragraph 6, of the Multistate Tax Compact (Interstate Audits), which states in relevant part: "Information obtained by any audit . . . shall be confidential and available only for tax purposes to party States, their subdivisions or the United States. Availability of information shall be in accordance with the laws of the States or subdivisions on whose account the Commission performs the audit and only through the appropriate agencies or officers of such States or subdivisions."

## 7. Nexus

### 7.01 Introduction

*Nexus* refers to a connection or link between a person (meaning both natural persons and entities) and a state sufficient to enable the state to impose on that person a tax or tax collection and remittance duties.

State tax statutes typically describe the types of in-state activities that trigger state-imposed tax collection and remittance duties. States' authority to impose these duties, however, is limited by the U.S. Constitution (as interpreted by the U.S. Supreme Court and other courts). The Constitution's Commerce Clause requires (among other things) that a person have a substantial nexus with the taxing state in order to be subject to that state's taxing authority. The Constitution's Due Process Clause requires at least a "minimal connection" between a state and person that it seeks to subject to state tax laws. The Due Process test is satisfied if a seller purposefully directs its selling activities towards a state's residents.

It is imperative that an auditor understand the history of relevant court cases dealing with nexus as well as stay abreast of current legislation. The auditor should take advantage of updates offered by the Commission via meetings of the Nexus, Audit, and Uniformity Committees. The auditor should also participate in pertinent training sessions hosted by the Commission.

### 7.02 Physical Presence

Prior to *South Dakota v. Wayfair, Inc.*, 585 U.S. \_\_\_, 138 S.Ct. 2080 (2018), the Supreme Court interpreted the Commerce Clause to require physical presence in order to establish nexus. *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The physical presence requirement is satisfied in a variety of ways, including:

- Maintaining inventory in a state, including storage, consignment or product held by sales representatives;
- Ownership or lease of real or personal property within a state;
- Employee presence in a state including employees who perform sales, training, delivery, installation, repair, construction, or other services, etc. (including remote/virtual workers);
- Use of company owned vehicles or contract carriers (other than common carriers) for delivery of property into a state;
- Agents, representatives, subcontractors, or other third parties operating within a state;
- Affiliates operating within a state; and
- Temporary presence within a state, including trade shows.

The Supreme Court has held, moreover, that a state may require a seller to collect and remit use taxes even if the seller's only physical presence there is not related to its selling activities. *See National Geographic Society v. Board of Equalization*, 430 U.S. 551 (1977).

Public Law 86-272 (15 U.S.C. §381) is generally relevant to nexus standards for corporate income tax. The auditor should be familiar with Public Law 86-272, its application, and most importantly its limitations. Contrary to the understanding of some taxpayers, the immunity granted under P.L. 86-272 applies only to taxes based on or measured by net income. Thus, most franchise taxes, gross receipts, and sales and use taxes, are not covered by the federal law.

#### (a) Representational Nexus

A *Remote Seller* (*i.e.*, a seller without physical presence) has nexus in a state when an in-state company or individual acting as a representative or an agent on the seller's behalf establishes or maintains a market for the seller's sales of goods or services in that state. *See Tyler Pipe v. Washington Department of Revenue*, 483 U.S. 232 (1987); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

Representatives are not limited to employees. Independent contractors also create nexus for a remote seller when they act on behalf of the seller to establish and maintain a market for the seller.

Unless *de minimis*, the presence of in-state employees in the taxing state always creates nexus if they are working on behalf of the taxpayer, in any capacity. Unless its in-state activities on behalf of a seller are *de minimis*, an in-state independent contractor that establishes or maintains a market in a state for the seller creates nexus. Activities other than sales activity can establish and maintain a market.

The term "agent" carries specific legal meaning and is defined by a specific type of relationship. An agent is authorized to represent, obligate, and act on behalf of another. An agent may have more power than a person acting as a representative. A representative does not need to act as an agent to establish and maintain a market in a state.

#### (b) Transient or Temporary Presence

The in-state presence of transient employees or representatives of a company creates nexus if the presence rises above a *de minimis* level. Salespeople and transportation industry workers are examples of transient or temporary employees or representatives. States have varied positions regarding the number of days that an employee or representative must be in the state, and the nature of their activities that may create nexus.

Telecommuters who work in the taxing state create nexus for their employer even if they do not engage in any activity related to "establishing or maintaining a market" in the state. Few

states specifically exempt telecommuting from nexus creating activity. De minimis allowances may apply to occasional telecommuting.

During the COVID-19 pandemic in 2020-21, some states adopted through law or agency policy exceptions to the general rule that employees telecommunicating in a state create nexus. The exceptions in some of these states apply only to corporate income tax.

#### (c) Affiliate Nexus

Many states have enacted legislation providing that the in-state physical presence of a parent or affiliate causes an out-of-state seller to have nexus with the state. Click-through nexus is also considered a form of affiliate nexus (see subsection 7.02(d)).

Some courts have found affiliate nexus in the absence of affiliate nexus legislation. *See, e.g., New Mexico Taxation and Revenue Dept. v. Barnesandnoble.com LLC*, 303 P.2d 824 (2013). These courts, however, generally have rejected the contention that the out-of-state seller has nexus with the state solely because it is related to an in-state parent or affiliate. Rather, the parent or affiliate must perform activities that “establish or maintain a market” on behalf of the online seller in the state. Common support activities include accepting returns on behalf of the online seller, offering discounts or promotions involving the seller, joint advertising or common promotional activity, similar logos and trademarks.

In some jurisdictions, activities performed on behalf of the seller that might create nexus include fulfillment, delivery, shipment, installation, repair, and even financial activities such as those provided by a franchisor or multi-level marketing company to franchisees or independent sales representatives. Other examples include utilizing a common financial accounting, order, or billing system.

#### (d) Click-Through Nexus

What is often called click-through nexus has been enacted by some states. Here, an out-of-state retailer or service provider contracts with a third party located in the state who refers potential customers to the retailer through internet web links. The third party earns a commission or fee whenever the referral results in a sale. The third party’s activities establish nexus between the state and the retailer or service provider.

Some states repealed click-through legislation subsequent to the *Wayfair* decision. At least one of these states has reenacted legislation pertaining to click-through nexus. Generally, thresholds related to sales volume are included in the legislation.

#### (e) Cookie Nexus

The term cookie nexus is derived from reference to internet cookies and is generally considered to be a component of physical presence. Some states define internet cookies as a tangible item that establishes physical presence nexus. Typically, cookie nexus is defined in

thresholds of sales or transactions, similar to economic nexus (See [Section 7.03](#)). Some states that previously enacted cookie nexus legislation have since repealed that legislation.

### 7.03 Economic Nexus

The Supreme Court altered nexus jurisprudence in a fundamental way on June 21, 2018. On that day, the Court ruled in *South Dakota v. Wayfair, Inc.*, 585 U.S. \_\_\_\_, 138 S.Ct. 2080 (2018), that a state may impose tax collection and remittance duties on sellers that do not have a physical presence within its borders. *Wayfair* negated the physical presence requirements set forth in *Quill v. North Dakota* and *National Bellas Hess*. The Court also stated in its opinion that certain provisions of the South Dakota sales tax statute likely ensured that the Constitution's Commerce Clause nexus requirements were satisfied. Most significant is the provision that out-of-state sellers must collect and remit tax if their annual sales into the state are at least \$100,000 or if they make at least 200 sales transactions into the state each year.

Since *Wayfair*, every state that imposes sales/use taxes has amended its law to adopt sales thresholds. These thresholds are not all identical to the South Dakota thresholds, but none are lower. In a limited number of cases, states have altered the thresholds they initially adopted shortly after the Court's decision.

When no clear physical presence exists, an auditor examining sales/use tax compliance of an unregistered out-of-state seller for periods after June 21, 2018, must determine if the seller's sales exceed applicable statutory thresholds in each state according to the date each state's law is effective. Except perhaps in extraordinary circumstances, if sales exceed a state's thresholds, then the seller has nexus with that state.

If a seller's sales into a state exceed applicable thresholds, the auditor must also determine when that occurred and when the seller was obligated to register in that state. Some states require registration and reporting the day after meeting a threshold, others wait until the first day of the month that begins at least 30 days after the date the threshold was met, others allow 60, 90 or 120 days to pass after the date the threshold was met.

State statutes and regulations contain thresholds and definitions of sales volume or transactions to be used in determining if thresholds have been met. Note that sales dollar volume definitions vary by state and may be based on any or a combination of gross sales, taxable sales, direct sales, or marketplace sales. In most states, transaction counts are based upon invoice values rather than individual invoice line items.

Nexus questions may arise relating to periods following the *Wayfair* decision but before a state revised its sales tax statute to adopt thresholds. In such cases, the auditor should first determine the statutory requirements that were in place during those periods. If the statute does not appear to provide sufficient guidance, the auditor should speak to the audit supervisor or Commission legal staff.

Both before and after *Wayfair*, an out-of-state seller has nexus in a state even if its sales do not exceed the state's thresholds if it has more than a de minimis physical presence in that state or if another party acting on its behalf has physical presence there. Consequently, the physical presence discussion in [Section 7.02](#) will be relevant in the case of some post-*Wayfair* audits undertaken by Commission auditors. Nexus investigation discussion begins in [Section 7.06](#) and should be reviewed when auditing a taxpayer not registered in a state participating in the audit.

#### 7.04 Marketplace Facilitators

Beginning in 2017, many states started enacting legislation requiring marketplace facilitators to collect sales and use tax and/or report sales shipped into a state. All states that impose sales tax have since enacted marketplace facilitator tax collection requirements.

A marketplace facilitator is a business that contracts with marketplace sellers to facilitate the sale of the marketplace seller's goods and services using its infrastructure and provides such services as listing the products, marketing, payment processing and collection, tax collection, and shipping. The Commission Uniformity Committee established a Wayfair Implementation and Marketplace Facilitator Work Group. Refer to the Commission website, the Commission Uniformity Committee Wayfair Implementation and Marketplace Facilitator Work Group and the Work Group's July 2021 White Paper. The White Paper provides additional information including narrow and broad definitions of marketplace facilitators that have been enacted by different states.

Generally, the marketplace facilitator is the "responsible party" for sales or use tax collection and remittance and is the party subject to audit. A marketplace facilitator may avoid assessment when it can show the marketplace seller provided erroneous information or failed to provide the information that would have enabled the marketplace facilitator to correctly collect the tax. A marketplace seller is subject to audit on all activity that is not administered by a marketplace facilitator.

#### 7.05 Use Tax Notice and Reporting Requirements

Prior to *Wayfair*, some states enacted notice and reporting requirements. Notice refers to a retailer's requirement to notify buyers of potential use tax liability. Reporting refers to a retailer's obligation to provide purchasers and the state with an annual report including all sales to the customer in a calendar year. In most (but not all) of these states, these requirements either have been repealed or have ceased to apply to retailers that comply with post-*Wayfair* tax collection and remittance requirements.

#### 7.06 Nexus Investigations

A nexus investigation determines whether (and for what time period) a state has a legal right to require a taxpayer to collect and report taxes. There are generally two instances where the auditor will be required to conduct a nexus investigation:

- (a) When conducting a sales tax audit, if a taxpayer is not registered or filing in a state participating in a joint audit. The applicable state(s) should agree to assist the auditor in gathering information about the taxpayer's activities and operations within the state(s).
- (b) The Commission's National Nexus Program member states can authorize the Commission to conduct a nexus investigation on their behalf. The findings of the nexus investigation are presented to the participating Nexus Program member states and an audit nomination may be presented to the *Audit Committee*. When a nomination occurs, the Audit Committee will include the referral in the routine audit selection process.

### 7.07 Nexus Investigation Procedures

For pre-*Wayfair* periods, the auditor must determine whether physical presence exists. For post-*Wayfair* periods, if the seller does not have an obvious physical presence in the taxing state, it generally will be most efficient for the auditor to first investigate whether economic nexus thresholds have been met. If economic thresholds are not met for a sufficient portion of an audit period, the auditor should discuss with the Audit Supervisor and the applicable state contact to determine whether a more in-depth investigation of physical presence makes sense.

The auditor must understand a taxpayer's business activities and how the taxpayer conducts business, both as a whole and in a particular state. The following documentation may be used to determine whether nexus exists:

- Annual Reports and 10-K's
- Consolidated Federal Income Tax Form 1120
- Form 1120, Schedule 851 (Schedule of Affiliates)
- State apportionment factor schedules
- Consolidating workpapers
- Deferred tax workpapers

When the nexus investigation is conducted within the context of a sales and use tax audit, much of the documentation listed above will have been previously obtained from the taxpayer (refer to [Sections 9.02](#), [9.03](#), [10.01](#) and [11.01](#)).

The auditor should request completion of the Commission's Nexus Questionnaire, as adapted to the taxpayer, for each participating state for tax years during which the taxpayer, or affiliate, did not file returns in the state subject to the audit period as determined in [Section 7.10](#).

The auditor should compare the taxpayer's responses to the questionnaire with all other information available regarding the taxpayer's business activities. The auditor may consider reviewing or requesting the following information and/or conducting the following activities, subject to confidentiality requirements:

- Company website
- Location listings for all types of locations
- Employee payroll records (W-2's, state unemployment returns, etc.)



- Employment ads
- Job descriptions for sales reps
- Expense reports for sales reps
- Warranty contracts
- Independent contractor agreements
- 1099-NEC and 1099-MISC forms issued to independent contractors.
- Company policy or procedure manuals
- Delivery records
- In-house publications or newsletters and company news releases
- Review of procedural and/or instructional manuals for sales representatives
- Company contacts e-mail/phone listing, including job titles
- Interview of in-state employees or representatives
- Interview of officers, district or regional managers, or other personnel familiar with the taxpayer's or affiliate's sales and other operations
- Interview in-state customers of the taxpayer or affiliate
- Advertising activities in a state

#### 7.08 Determination of Nexus

The auditor will discuss nexus investigation findings with the audit supervisor, who will discuss the matter with the audit director and/or Commission legal staff, if necessary. The auditor may need to make further inquiries, if directed to do so by the audit supervisor, audit director or legal staff. Additionally, the auditor may need to consult with state contacts for guidance on state specific nexus matters. The auditor is responsible for determining when nexus begins and ends (if applicable) in each state in question.

#### 7.09 Documentation

The auditor should maintain documentation including all records used in making the nexus determination.

#### 7.10 Audit Period

An audit period generally includes three or four years, depending on state statutes of limitations. Most states do not have a *Statute of Limitations* when no returns have been filed. When no statute of limitations exists, Commission policy is to establish a six-year audit period.

State policies on audit periods vary widely and could extend as far back as the date nexus creating activities first occurred. The concept of trailing nexus is also an important consideration. Once nexus is established in a state, it can continue beyond the date presence in a state ended, sometimes for a year or longer. The auditor should consult with the audit supervisor and state contacts to determine the appropriate audit period, including any trailing nexus period. Discussion of establishing the audit period appears in [Section 4.10](#) in more detail.

## 8. Conducting the Audit – General Audit Procedures

### 8.01 Introduction

This chapter is designed to introduce general sales and use tax audit procedures. It is impossible to list all necessary procedures that might be required during the course of an audit. Therefore, the auditor should be prepared to handle situations not addressed within this manual. Each audit will present a unique set of circumstances requiring the auditor to exercise good judgment.

### 8.02 Objective of a Joint Sales and Use Tax Audit

The objective of a joint sales and use tax audit is to determine the correct amount of tax in the most efficient manner possible. The auditor may be confronted with more than one alternative to audit a particular issue. The auditor must make decisions balancing efficiency and accuracy.

### 8.03 Specific State Laws, Statutes, Regulations and Policies - Consulting with Member States

State tax statutes, regulations, and policies around the country share many common features. However, differences exist among states in how certain transactions are treated, items included or excluded from the basic definition of selling price, allowances for exemptions, etc. The auditor must remain cognizant of these differences when conducting audits on behalf of participating states.

There are key differences between those states that have adopted the *Streamlined Sales and Use Tax Agreement* (SSUTA) and those that have not. The auditor must be familiar with relevant aspects of the Agreement and how SSUTA Member States interpret definitions and apply various audit procedures.

Fundamental differences exist in how states impose transaction taxes, namely through sales, use, gross receipts, transaction privilege, and general excise taxes. Additionally, some states allow localities to establish and administer their own sales and use taxes, which is known as “home rule.”

The auditor must consult with member states whenever confronted with unique circumstances which make it difficult to determine proper application of statutes, regulations, and policies.

### 8.04 Communication with Taxpayers

When developing an audit plan, the auditor will be making decisions that impact the taxpayer. Therefore, the Commission recommends the auditor consider any reasonable suggestion or request made by the taxpayer regarding the audit plan. This presumes the auditor has made a

good faith effort to disclose and communicate important audit decisions, and the taxpayer is acting in good faith during the audit.

When disagreement occurs, or is anticipated by the auditor, the audit supervisor should be notified. If the auditor and taxpayer cannot agree on the audit plan, the taxpayer can discuss the matter with the audit supervisor. In addition, it is incumbent upon the auditor to describe areas of disagreement within the audit report.

Although taxpayer agreement is encouraged, the form and execution of the audit plan is ultimately the responsibility of the Commission. The auditor should not delay the audit, particularly review of transactions at the detail level when areas of disagreement cannot be reasonably resolved. Unduly delaying the audit of transactions, even when sampled, can be problematic. The Commission is responsible for preserving and protecting the state's authority to audit and making corrections for errors within the statutory period open for audit.

### 8.05 Electronic Data

Auditors generally receive two types of electronic data when conducting audits. *Tabular Data Sets*, which are long data lists in row and column format, and electronic images of documents such as invoices and tax returns.

Auditors can obtain tabular data in a variety of formats. The Commission provides audit staff with proper tools for conversion of various types of data formats, such as text or database downloads. Portable Document Format (PDF) is not ideal for tabular data as it is difficult or impossible to convert to a usable format.

Electronic images can be provided using PDF, TIFF, JPEG, or other formats as long they can be viewed without the need to rearrange the data.

The Commission hosts a secure file sharing site allowing taxpayers to upload data files via the internet. Alternatively, files may be provided on media such as USB Drives or CD/DVDs. Files may be provided via e-mail, subject to space limitations and firewall security protocols.

The auditor is responsible for performing analytical and/or other audit tests to ensure that the data is sufficient for audit purposes. Procedures required to reconcile and verify data downloads are described in [Chapter 9](#).

### 8.06 Sampling

A *Detailed Review* (100% review of all records) will provide the most accurate results but is generally impossible due to volume of records and time constraints. Therefore, in nearly every case, *Sampling* will be required to conduct an efficient audit.

The auditor should develop an audit plan for sampling based upon discussions with the taxpayer and review of the tabular electronic data provided by the taxpayer. Sampling methods may vary, and multiple samples of varying methods may be utilized in a single audit.

The Commission's audit preference is to use statistical sampling whenever possible and to avoid detailed review unless the transaction volume requires it. Sampling methodologies other than statistical sampling are judgmental and therefore less defensible. However, statistical sampling is not always practical, and auditors must exercise sound judgement when planning samples. Refer to the Commission's Sampling Policy and Guideline Manual.

## 9. Conducting the Audit – Verifications and Clerical Testing

### 9.01 Introduction

The auditor is responsible for ensuring the audit plan includes procedures necessary to verify completeness. Completeness means the taxpayer has provided all relevant data for the audit and omissions have not occurred. Completeness is determined using a variety of analytical processes such as tests of controls, substantive tests, and *Sampling*. The auditor must exercise judgement when conducting tests of completeness, as each audit is unique. Basic analyses should include identification of all reporting units, sources of revenue, and completeness of data provided for the audit.

### 9.02 Revenue Producing Activities

The auditor must understand all the taxpayer's various sources of revenue and lines of business. The auditor should consider the industry in which the taxpayer operates to ensure the information gathered is reasonable and complete.

Global economies have evolved over time so many companies operate in the ecommerce environment. The auditor must have a full understanding of the entity structure, operations, and presence and nature of intercompany transactions.

### 9.03 Gross Receipts Reconciliation

The auditor must compare gross receipts per the taxpayer's records, which may include a variety of sources, to sales per sales tax returns and/or reports used to prepare sales tax returns.

Taxpayer records may include items such as closing trial balances, financial statements, general ledgers, federal income tax returns, proforma tax returns, state income tax return apportionment schedules, or alternative documents that provide sufficient evidence of gross receipts.

The auditor should seek an independent source of information for verification. For example, simply comparing data provided for the audit to sales tax returns is insufficient, since the auditor has not verified whether the data provided represents all reporting units or total company activity.

In cases where the auditor uses state income tax apportionment schedules to reconcile gross receipts, the auditor must ensure the state income tax apportionment schedules, as a whole, tie, within reasonable variances, to the federal income tax return. Accordingly, the auditor must obtain state income tax apportionment schedules that include totals for all states and not just the states included in the audit.

While a reconciliation is the preferred method to verify that the correct amounts of gross receipts have been reported for sales tax purposes, specific audit circumstances may make it difficult or impossible to complete a reconciliation. In these cases, the auditor should use alternative methods to ensure the taxpayer's system is capturing the correct amounts and that those amounts

have been properly reported. When an auditor encounters a situation that causes uncertainty as to the adequacy of alternative procedures, the audit supervisor should be consulted.

#### 9.04 Tax Return Transcripts

Participating states provide tax return transcript data in summary form. The auditor might need to request location specific or local jurisdiction tax return transcript data from the states.

#### 9.05 Tax Reporting Procedures and Documents

The auditor should request copies of returns and supporting documents, such as worksheets or reports used to prepare returns, from the taxpayer. The auditor should obtain an understanding of how the taxpayer accumulates sales, exemptions, deductions, and tax collected information used in tax return filings.

#### 9.06 Reconciliation of Tax Collected or Accrued vs. Remitted

The auditor should perform a reconciliation of tax collected or accrued versus tax remitted for the entire audit period. Any discrepancies should be investigated. Discrepancies may result in audit adjustments, depending on the nature of the discrepancy.

Sales or use tax collected or accrued per the taxpayer's books and records (frequently, the general ledger detail for sales and use tax liability accounts) should be reviewed to ensure transactions are included on tax returns and to identify and investigate manual adjustments. Manual adjustments may appear as journal entries in the general ledger account detail or may be adjustments (credits) incorporated into sales and use tax returns by tax compliance staff during return preparation and filing.

## 10. Conducting the Audit – Sales

### 10.01 Introduction

The two primary objectives of a sales review are to determine if the proper rate of tax has been charged on all taxable sales and to determine the validity of untaxed sales.

The auditor should have obtained an understanding of the taxpayer's systems related to sales tax compliance. Examples of specifics to consider when developing an audit plan for sales include the following:

- Products, services, or other sources of revenue
- Types of customers
- Whether sales data contains line-item detail or invoice level detail
- Whether sales data contains sales tax amounts and jurisdiction codes or if that information is available separately
- Whether the volume of transactions, taxed and non-taxed items, allow *Detailed Review* or if *Sampling* will be required. Statistical sampling is preferred but may be substituted or combined with other sampling methodology or alternative methods. Frequently, sales data does not lend itself to statistical sampling. Statistical sampling might be possible but not practical. Refer to the Commission's Sampling Policy and Guideline Manual.

Audit workpapers should include sufficient information for each transaction reviewed to determine any taxable error, proper type of tax, jurisdiction, and amount of tax. Examples of facts that may be captured include, but are not limited to:

- Date
- Invoice or voucher number
- General ledger account code
- Customer number and/or name
- Customer location
- Description of item sold
- Amounts (book value, error value, taxable value, tax paid or accrued, etc.)
- Point of use information (state and local jurisdiction)
- Any other information documenting the audit conclusion with respect to difference (error) amount or taxable amount.

Audit workpapers should generally include comments associated with transactions reviewed indicating whether tax was properly collected from the customer, tax was not due (nontaxable transaction), or tax was due and not collected.

## 10.02 Taxed Sales

The review of taxed sales is generally focused on two main activities: verifying that tax was properly collected on individual transactions and whether the correct jurisdiction and amount of tax was applied.

Invoices, or other records of sales transactions, should be reviewed to determine if sales tax was properly applied. If parts of an invoice are not taxed, the auditor should identify the nature of the non-taxed items. Many state statutes and regulations include or exclude certain types of charges from the definition of selling price. Examples include freight or delivery, labor charges, assembly, and certain reimbursed expenses. The auditor must understand each participating state's statutes and regulations to properly review taxed sales.

The auditor should verify that the jurisdiction and tax rate applied to transactions is correct. States vary in the application of local tax to transactions. In addition, certain local jurisdictions administer tax independently from the state; these are generally referred to as "home rule" jurisdictions. Commission audits include local tax if it is administered by the state. State reporting requirements for local tax varies; tax returns may include state and local taxes on a single return, or states may require separate reporting of state and local taxes.

Verification of jurisdictions and tax rates applied to sales transactions is generally more involved than simply verifying rates in effect at each of the taxpayer's locations. Many states require destination-based sourcing of transactions.

The Commission provides sales tax rate tools for the auditor's use. The auditor should exercise care to ensure proper tax rate research is performed. Many taxpayers utilize automated systems to assign jurisdictions and rates to transactions. In some cases, these automated systems are based on high level location data, such as postal zip codes, instead of exact location data. Exclusive use of zip code data may result in errors in tax jurisdiction and rate determinations.

## 10.03 Special Taxing Situations

The auditor must be aware if a state imposes special taxes, typically excise taxes, to certain transactions including short-term rental of tangible personal property, lodging, restaurant sales, fuel, and tires. When a question regarding whether a particular type of tax is included in a Commission audit, the auditor should consult with the audit supervisor and/or the state contact.

There are states that impose tax at an increased or decreased rate on certain types of transactions. Examples include grocery/food and manufacturing machinery and equipment.

States may have sales tax rate caps at the local level (county or city) or may cap the amount of tax on single articles of certain value at the local level.

Special taxing districts exist in many states. Transactions occurring in or businesses located within the boundaries of the district may be subject to increased or decreased tax rates.



Sales tax holidays exist in many states and include various products or groups of products. Examples include school supplies and clothing, or products associated with emergency preparedness.

#### 10.04 Nontaxable Sales

The auditor must ensure products or services treated as nontaxable sales in fact are nontaxable under state law. Nontaxable sales may include a variety of products or services, depending on the state. For example, certain states do not tax groceries, freight/shipping/delivery, or charges for installations.

The auditor must be able to identify and differentiate various charges added to the sales price charged by a taxpayer. For example, the difference between assembly and installation charges or the difference between repair and installation labor can result in taxability variances.

#### 10.05 Exempt Sales

The auditor needs to determine what types of exempt sales the taxpayer is asserting and verify the exemptions exist under the laws of the state in question. Exemptions include sales for resale, sales of exempt products, and sales to exempt purchasers (commonly referred to as use-based or entity-based exemptions).

The examination of exempt sales should include review of exemption certificates and other source documents, as necessary. The auditor must be familiar with each state's policy for acceptance of exemption certificates.

Multijurisdictional certificates are commonly offered, used, and accepted by most states. The Commission offers its own "Uniform Sales & Use Tax Resale Certificate - Multijurisdiction Exemption Certificate" available on the Commission's website at [www.mtc.gov](http://www.mtc.gov) and reproduced in [Exhibit H](#). The form states a buyer who is registered in one of the states listed on the resale certificate may be able to use this certificate to make purchases of tangible property or taxable services that are for resale tax-exempt. The footnotes on the certificate include specific state guidance as to acceptance of the form. Certain states do not accept the form at all. The certificate does not identify allowable forms of alternative documentation, thus requiring the auditor to be familiar with individual state policies.

There are significant differences between those states that have adopted the *Streamlined Sales and Use Tax Agreement* and those that have not. The Streamlined Sales Tax Governing Board (SSTGB) publishes a document on its website at [www.streamlinedsalestax.org](http://www.streamlinedsalestax.org) specifically to provide training related to accepting exemption certificates. The SSTGB offers a Certificate of Exemption, also available on its website, that a purchaser may be permitted to use to claim a sale for resale exemption or other exemptions in various states. Again, state policies vary, and the auditor must be familiar with exempt sale documentation requirements in each state. The SSTGB publishes survey results on its website detailing Streamlined Sales and Use Tax

Agreement states' certificate acceptance and instructions for completing the Streamlined Certificate of Exemption.

Typical issues that arise in the process of determining validity of exemption certificates include:

- Was the certificate applicable to the claimed exemption?
- Was the certificate properly completed under the state's requirements?
- Was the certificate valid at the time of issuance (not expired)?
- Was the certificate provided within the time allowed under the state's requirements, if the state imposes any time limits?
- Are state registration numbers provided in the correct format, contain the correct number of characters, etc.?
- If the purchaser is required to be registered in the destination state, is that registration number present on the form?

State laws vary as to the type and scope of exemptions for organizations such as states, municipalities, government agencies, and non-profit organizations. For example, only some states exempt sales to other states or to municipalities in other states. Some states exempt sales to all non-profit organizations while other states exempt sales only to certain types of non-profit organizations.

Exemptions for agricultural production, industrial production, manufacturing, direct pay permits, and direct mail require the auditor to research and understand exemption qualifications applicable in each state.

## 10.06 Bad Debts

The term "bad debt" is generally defined as a loss from the worthlessness of a debt, that was created or acquired in a trade or business, when it became partly to totally worthless. Pursuant to the internal revenue code, a business may deduct bad debts, in full or in part, from gross income to determine its taxable income. See 26 U.S.C. §166 and IRS Topic No. 453 Bad Debt Deduction.

Provisions of state sales tax statutes and regulations that authorize a bad debt deduction frequently reference this federal provision. Generally, for sales and use tax purposes, the amount of bad debt excludes financing charges or interest, sales or use taxes applied to the original sale, uncollectible amounts on property that remains in the seller's possession until the full purchase price is paid, expenses incurred in attempting to collect any debt, and repossessed property.

### (a) Eligibility

It is only possible for a taxpayer to claim a bad debt deduction if they are reporting and remitting tax on the accrual basis. (Cash basis taxpayers record income when payment is received). In most states, the taxpayer must have been the original seller of the taxable goods or services and must have remitted sales or use tax on the sale that can be claimed as a

bad debt deduction. In the rare instance where the taxpayer claiming the bad debt deduction is not the original seller, the auditor should look at the specific state requirements to determine if the deduction can be claimed.

#### (b) Refund Claim or Credit on Return

Specific requirements vary by state, with some states allowing deduction of bad debts from the tax base on a tax return filing. Other states require separate refund claims to be filed related to bad debt deductions. The auditor is responsible for researching and following individual state statutes, regulations, policies, and guidelines related to bad debt deductions, recoveries, and timing of claims.

If the amount of bad debt exceeds the amount of taxable sales for the period during which the bad debt is written off, states typically require a refund claim to be filed within the applicable *Statute of Limitations* period.

#### (c) Timing of Deduction

Bad debts can generally be deducted on the return for the period during which the bad debt is written off as uncollectible in the claimant's books and records and is eligible to be charged off for income tax purposes.

Some states allow a deduction within the applicable statute of limitations following the date the accounts were charged off as uncollectible for federal income tax purposes. Other states have established specific policies related to the timing of bad debt deductions.

#### (d) Substantiation

Some states require bad debt deductions to be taken on a federal income tax return, while others specify a deduction need only be eligible to be claimed on a federal income tax return. Documentation applicable to specific states for bad debt deductions might include state income tax returns or other relevant records.

#### (e) Recovery

If a deduction is taken for a bad debt and the debt is subsequently recovered in whole or in part, the tax on the amount collected must be remitted and reported on the return filed for the period in which the collection is made. In many states, when a retailer subsequently recovers a partial payment on a previously claimed bad debt, the retailer must apply the payment first proportionally to the taxable price of the goods or services and the sales tax thereon, and then to any other charges such as interest and service charges owed on the customer's account.

#### (f) Audit Procedures

Audit procedures may include, but are not limited to, the following activities:

- Review bad debt summary reports and compare to bad debt deductions claimed on federal and state income tax returns, or other relevant documents, depending on the state.
- Examine bad debt detail schedules, along with original invoices, supporting the deductions claimed. Reconciliation procedures should be performed to verify tax was originally remitted to the state. Verification might require the auditor to obtain records for transactions occurring prior to the beginning of the audit period.
- Investigate whether any payments have been collected on previously claimed bad debts. If such payments are found, the auditor should verify remittance of applicable tax.

### 10.07 Bundled Transactions and True Object Test

Bundled transactions are those transactions that consist of multiple items, some of which are taxable, and some are not. Many states require a seller to separately state taxable and nontaxable items on invoices. Some states allow taxpayers to provide supporting documentation to substantiate the value attributable to nontaxable items. Some states apply a true object test to determine taxability of certain types of bundled transactions. The term true object test includes dominant use, primary function, incidental to service and other similar concepts.

A true object test determines whether a transaction constitutes a sale of tangible personal property or a service, either of which may or may not be taxable. A taxability determination is made based on whether the purchaser's "true object," "real object" or "dominant purpose" is to acquire the finished product or the service. Taxability often turns on whether tangible personal property is incidental to a nontaxable service or the opposite. For example, architectural drawings provided on tangible medium are generally regarded as professional services. Alternatively, an original work of art or motion picture film, both of which include artistic expressions, is generally regarded as the sale of tangible personal property.

Some states use a true object test, and some do not. Also, tax agencies and courts interpret statutes and regulations differently. Therefore, when analyzing the taxability of a transaction that involves both tangible personal property and services, the auditor should always perform adequate research and consult with state contacts and the audit supervisor, as necessary.

### 10.08 Credit Verification (Matching)

The auditor should consider various methods to identify credit memos, refunds and similar transactions in sales data provided for the audit. Credit memos are issued by a seller to a customer and may reduce the price of an item purchased by a customer or eliminate the entire cost of an item (as when an item is returned to the seller). When the seller issues a credit memo, it is applied toward the existing balance on the customer's account to reduce the total amount due from the customer. A credit memo is different from a refund in that a customer who receives a refund gets cash back from the seller.

Matching methods may vary depending upon whether electronic data allows a credit memo to be easily and affirmatively matched to the original transaction. The auditor may opt to use various data analysis methods and techniques, including the Negative Matching Excel/Access modules in the Commission’s Sampling Software. Regardless of methods used, the auditor must determine if credit memos and refunds issued to customers are treated properly by the taxpayer.

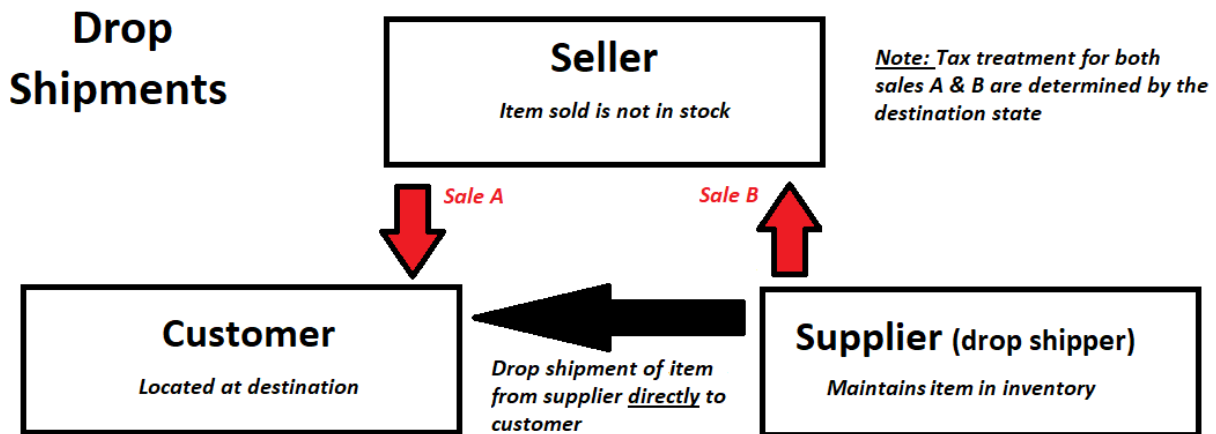
Proper treatment may depend on individual state law but at a minimum the auditor should be able to

- determine whether credit memos or refunds were issued to customers within the applicable statute of limitations,
- verify any tax credits claimed by the taxpayer were included on the correct tax reporting period return filing, and
- ensure that any credit or deduction claimed on a return, for tax credited or refunded to a customer, was originally reported and remitted to the state.

### 10.09 Drop Shipments

#### (a) Introduction

Drop shipments occur when a seller sells a product, then purchases the item and instructs the supplier to ship the product directly to the consumer. Both the seller and the supplier are required to collect and remit sales tax, based upon the state where the product is delivered (destination), unless an exemption applies.



(b) Parties to the Transaction

A drop shipment often involves a single movement from a stock of goods to a destination, but involves at least three parties as follows:

**Seller**, who receives an order from a customer for an item that it does not have in its own inventory and never takes possession,

**Supplier** (or drop shipper), who has the item in inventory, and

**Customer**, located at the destination, who buys from the seller but receives the item shipped directly from the supplier.

Note that although there is usually one physical shipment of goods, there are at least two sales:

- (A) from the seller to the customer, and
- (B) from the supplier to the seller.

Sometimes, the customer will further sell the items to others, and therefore the customer can possibly purchase either for consumption or for further resale.

Note also, for sales tax purposes, tax treatment on both sales (A) and (B) must follow the rules of the destination state.

(c) Audit Focus

Special rules, determined by the destination state, will apply to drop shipments in a Commission audit of the supplier when:

- Auditing for the destination state, and
- the supplier has *Nexus* in the destination state, and
- the seller has no nexus in the destination state, and
- the seller is not registered in the destination state.

Drop Ship Transaction Between the Supplier and the Seller			
Nexus, or Voluntary Registration, in Destination State		Sales Tax Applies to Transaction	Exemption Certificate
Supplier	Seller		
N	Not Relevant	N*	Exemption certificate not required to be provided by the seller.
Y	Y	Y	Seller is registered in destination state, so providing an exemption certificate should be simple.
Y	N	Y	Supplier must collect tax from seller unless seller provides an exemption certificate, or alternative documentation, valid in the destination state. Since seller is not registered in destination state, complexity exists and specific or alternative documentation may be required.

\*The customer is responsible for self-accruing and remitting applicable use tax.

Commission audits of sellers or customers occur but the complexity of a drop ship transaction is rarely an issue. When auditing the seller, we are focused on adequate tax collection or exempt sale documentation and when auditing the customer, we are focused on tax paid to vendors or use tax paid.

(d) Special Audit Considerations

Ordinarily, a resale certificate with a tax registration of the destination state will be sufficient to prove the exempt nature of the sale from the supplier to the seller (B). Complexity arises when the seller is not registered in the destination state, and a resale certificate cannot be provided to the supplier. Whether this transaction can be accepted as tax exempt as a wholesale sale, and/or what constitutes proper documentation to prove the exemption, differs from state to state.

Some states require a resale exemption certificate with a tax registration of the destination state. In other states, any of the following documentation may be acceptable:

- Exemption certificate for the destination state stating the seller has no nexus
- Exemption certificate bearing state tax account registration numbers other than the state where product is delivered (destination state)
- Streamlined Sales Tax Exemption Certificate

- MTC Multijurisdiction Resale Certificate
- Copies of sales tax permits
- Affidavits stating no nexus exists in destination state
- Customer exemption certificates

(e) Tax Collection and Tax Base

When a supplier has nexus in the destination state and no valid exemption certificate, or alternative documentation, is provided by the seller, the supplier must collect tax from the seller. The amount of tax collected may be based on the supplier's price charged to the seller, the seller's retail price, if known, or the supplier's cost plus a markup percentage, depending on the destination state.

The seller is responsible for collecting tax from the customer based on the destination state's law (unless the customer provides an exemption certificate).



## 11. Conducting the Audit – Purchases

### 11.01 Introduction

The primary objective of a purchases review is to determine if products or services purchased by the taxpayer were subject to tax and if so, whether tax was either properly paid to the vendor or self-accrued and paid to the appropriate taxing authority.

The auditor should have obtained an understanding of the taxpayer's systems related to use tax compliance. Examples of specifics to consider when developing an audit plan for purchases, include the following:

- Whether the taxpayer maintains an automated accrual system
- Whether the audit data indicates use tax accrued on specific transactions, or if accruals easily match the underlying transactions
- Whether the volume of transactions, fixed assets, or purchases allow for *Detailed Review*, or if *Sampling* will be required. Statistical sampling is preferred but may be substituted or combined with other sampling methodology or alternative methods. Refer to the Commission's Sampling Policy and Guideline Manual.

Audit workpapers should include sufficient information for each transaction reviewed to determine any taxable error, the proper type of tax, jurisdiction, and amount of tax. Examples of facts that may be captured include, but are not limited to:

- Date
- Invoice or voucher number
- General ledger account code
- Vendor number and/or name
- Vendor location
- Description of item purchased
- Amounts (book value, error value, taxable value, tax paid or accrued, etc.)
- Point of use information (state and local jurisdiction)
- Any other information documenting the audit conclusion with respect to difference (error) amount or taxable amount

Audit workpapers should generally include comments associated with each transaction reviewed indicating whether tax was paid to the vendor, use tax was accrued, tax was not due (nontaxable transaction), or tax was due and not paid.

### 11.02 Use Tax Accruals

Generally, before beginning review of purchases, the auditor will trace transactions to their corresponding accruals. This may be performed on a test basis. When it is not efficient to perform matching before sampling, it will be part of the review of sample items.

If it is impossible or impractical to match use tax accruals with individual transactions or to determine which transactions upon which use tax was remitted, the auditor should consider calculating the total use tax liability and comparing that amount to total use tax remitted.

### 11.03 Fixed Assets

The auditor is responsible for performing tests to determine completeness of fixed asset data used for audit review. The auditor should ensure that the records provided by the taxpayer include all fixed assets acquired by the taxpayer during the audit period. The auditor will likely need to verify that assets in transit, construction in process, or similar account activity is included.

The auditor should always consider the volume of fixed asset transactions and whether sampling, separately or together with expenses, is appropriate. Alternative sampling methods such as vendor testing, should be considered by the auditor to ensure efficient use of audit resources. The auditor should consult with the audit supervisor and/or state contacts regarding sampling methodology when questions arise.

### 11.04 Expenses

Tax on purchases is predicated on the use, storage, or consumption of property or the receipt of services within a state. In addition to understanding business operations in each state, the auditor must understand nuances specific to the laws in each state.

Review of the type of general ledger accounts, costing codes or cost centers utilized by the taxpayer should be made before undertaking the review of purchases. The auditor must exercise good judgement and consider efficient ways to conduct the expense review. The auditor should remain flexible in designing samples or performing alternative procedures, when appropriate to do so. Appropriate alternative procedures might include activities such as reviewing high volume, recurring transactions outside of a sample, vendor testing or other types of tests.

At the outset, the auditor should consider requesting a broad download of all accounts and transactions that might be tax relevant. Accounts or transactions may ultimately be excluded from a sample after cursory review but obtaining all the data at the outset is preferred. The auditor may opt to request detail records for certain accounts of interest. When accounts of interest are used, the auditor must be aware of state specific rules regarding taxability of various types of transactions and select accounts accordingly. Whether this means account detail is requested for a standard list of accounts for all states and then refined to exclude non-tax relevant accounts for certain states or whether this means accounts of interest vary by state will depend upon the specific audit situation.

The auditor should identify accounts containing tax relevant transactions, including those accounts that contain transactions upon which the taxpayer accrues use tax. The auditor might select accounts of interest that are ultimately excluded from the target population after a cursory review is performed. The auditor may also elect to exclude certain transactions or types of

transactions from certain accounts. Regardless of methods utilized, account detail should be reviewed and refined to arrive at a target population containing tax relevant transactions. Ultimately, the auditor must strive for efficiency while identifying significant tax relevant transactions and avoiding excessive amounts of time spent on non-tax relevant transactions. In many cases, the auditor will spend more time refining the target population and documenting audit decisions than actually reviewing sample documentation.

### 11.05 Computer Hardware and Software

Generally, computer hardware is taxable, with certain exceptions for computers used in manufacturing, production, and research. Taxpayers may utilize colocation services, where taxpayer-owned hardware is physically located in third-party data centers. The auditor must apply state law to each individual audit circumstance.

*Canned (Prewritten) Software* is generally taxable, subject to similar exceptions listed in the prior paragraph. Most states have defined canned software as tangible personal property. However, in some states, the sale of any software that is digitally delivered (downloaded via the internet) is not taxable. Additionally, *Remotely Accessed Software* is not taxable in many states since the software is not delivered but is simply accessed via the internet by the user.

Many states distinguish between canned software, which can be purchased off the shelf and used in a customer's computer without any modification, and "*Custom Software*," which is created to meet a specific customer's needs. In some states, the customization of canned software is a nontaxable service, even though tax applies to the canned software itself. Definitions of "custom software" vary widely among the states; thus, the auditor must refer to state law when confronted with questions as to what qualifies as "custom software."

Computer hardware and software maintenance agreements should be reviewed carefully to determine the components of the agreement and applicable tax. For example, the auditor must consider whether a maintenance agreement provides for things such as repair labor (on site or remote), repair parts, phone support, software updates or upgrades, or software licenses. If a maintenance agreement is sold for a non-itemized price including updates, upgrades, and/or support services, the tax treatment may vary depending on the state. The auditor should also consider whether the maintenance agreements are mandatory or optional. Individual state laws apply in vastly different ways to these types of agreements.

Activities commonly referred to as "*Cloud Computing*" provide the same functionality as purchased hardware and software, but the purchaser does not acquire possession of one or the other. There are three primary service models for cloud computing. *Software as a Service* (SaaS), *Platform as a Service* (PaaS), and *Infrastructure as a Service* (IaaS). Current state laws are changing to adapt to the technology shift toward cloud computing, and the auditor should be aware of the applicable state laws when reviewing "cloud" related purchases.

## 11.06 Containers and Packaging Materials

Containers and packaging materials include pallets, drums, shrink-wrap, bags, cans, twine, gummed tape, boxes, bottles, and cartons. Containers and packaging materials are purchased by sellers for the purpose of storing, shipping, transporting, or delivering tangible personal property sold in the normal course of business. This transaction may be:

- a purchase for resale, if the seller is not considered the final user or consumer, or
- a purchase of tangible personal property used or consumed by the seller in the process of preparing product for sale and/or transporting the product to a customer.

Some states allow exemptions depending on whether the item falls within the specific definitions of containers or packaging materials. Exemption may be based on whether the container and packaging material is returnable (reusable) or non-returnable (disposable). Typically, containers and packaging materials are taxed when returnable to the seller and exempt when non-returnable. Exemptions may be subject to limitations as to a type of user, such as agriculture, or type of use, such as produce shipments. Taxable uses include such things as racks, trays, or similar devices to facilitate delivery of products, packaging materials used in providing nontaxable services.

## 11.07 Digital Products and Streaming Services

*Digital Products* are delivered, transferred, or accessed electronically. Generally, the term digital products is not used to refer to computer software, because computer software is separately defined in sales and use tax statutes. Examples of digital products are music, video, books, periodicals, audiovisual works, artwork, or games that are streamed or downloaded by users and digital code not otherwise defined.

When reviewing the purchases of digital products, the auditor needs to be aware of

- how each state defines and taxes digital products,
- whether states tax products delivered electronically differently from the corresponding product delivered physically,
- and the general sourcing rules relating to products transferred electronically.

Digital products are frequently used in advertising and marketing. Finished digital artwork, email blasts, text marketing, and digital tools associated with managing websites such as banners and videos, are examples of digital products that may be subject to tax depending on the state.

When considering whether the transfer of a digital product is taxable under a particular state's law, the auditor must often determine whether the transferee acquired the right of permanent use or if the right to use the digital product is conditioned on continued payments. Streaming services are an example of digital products that are conditioned on continued payments. States vary on whether streaming services are taxable.

State legislation in this area continues to evolve. The auditor must be aware of the provisions of state statutes and guidelines that were in place during the audit period being examined, as well as any recent changes before or after an audit period.

### 11.08 Ecommerce

Ecommerce, or electronic commerce, is the activity of electronically buying or selling products or services online over the internet. Ecommerce can include retailing, marketplaces, procurement, mobile payments, and customer service. Substantial changes have occurred and are expected to continue in the area of ecommerce and taxation. Businesses continue to develop new sales channels and many currently operate a separate sales channel for ecommerce. Ecommerce sales channels can be proprietary or provided by a marketplace facilitator, or a combination of both. [Chapter 7](#) covers *Nexus* in more detail and includes discussion of marketplace facilitators.

### 11.09 Internet Access

The Internet Tax Freedom Act (ITFA) of 1998 originally placed a moratorium on the state and local taxation of internet access services but included a grandfathering provision for states that were already taxing the service. In 2015, ITFA was made permanent, and the grandfathering provisions were repealed effective June 30, 2020. As of July 1, 2020, states are not allowed to impose sales and use tax on internet access services. The meaning of internet access continues to evolve and has been the subject of litigation in some states. The auditor should consider contacting Commission legal staff to ensure that taxation of internet access is properly addressed in an audit.

The taxability of internet access service has no bearing whatsoever on taxability of transactions.

### 11.10 Inventory Withdrawals

An auditor needs to be aware of situations involving items removed from inventory and used by the taxpayer in some manner. Examples include:

- cleaning products pulled from inventory to clean the taxpayer's own facilities
- building materials used for showroom models
- items used for demonstration to or testing by customers
- items consumed in providing a service
- inventory held for sale or demo by a sales rep (sales samples)
- promotional giveaways to customers
- charitable donations
- items used in research and development or testing
- items sold to employees

If the taxpayer sells and installs or applies tangible personal property, the taxpayer may withdraw materials and supplies from inventory for use in installation or application projects. See [Section](#)

[11.15](#) and [Section 11.17](#) for taxation of tangible personal property installed or applied by the taxpayer.

Inventory withdrawals may not be readily apparent in purchases data. Discuss issues with the taxpayer to determine whether any withdrawals exist, the manner in which the taxpayer accounts for the tax liability, if any, and what feasible methods exist to establish the taxpayer's compliance with each state's taxability laws.

Examples of considerations and procedures that might be used to verify compliance include, but are not limited to:

- Verifying whether the taxpayer reported use tax specifically for such items.
- Reviewing internal controls concerning sales inventory to see if there was an accounting for withdrawals.
- Verifying whether sales staff made withdrawals from inventory or maintained a stock of inventory. If so, determine whether items were returned to inventory.
- Inquiring if the taxpayer maintained a separate inventory for samples.
- Reviewing unusual or credit entries to inventory accounts.
- Determining whether separate expense accounts were used to track these items.
- Reviewing sales expense, promotional expense, or advertising expense accounts to see if inventory items appear in the account postings. Account postings might also include journal entries representing inventory withdrawals or specific transaction codes might identify inventory withdrawals.
- Inquiring whether samples provided to customer were sold to customers or returned by customers and if so, returned to inventory available for sale.
- Determining how inventory withdrawals for internal use are accounted for.
- Reviewing point of sale system transactions for inventory withdrawals. Many times, the withdrawals are represented by zero-dollar value transactions. If inventory withdrawals were recorded at full or reduced selling prices, was tax applied? If so, did the taxpayer make any offsetting adjustment elsewhere in their tax returns for any portion of the tax applied?
- Reviewing inventory sold to employees if such transactions were not completed using the regular sales system.
- Reviewing detail that supports the federal income tax deduction for advertising expense.

In some cases, it is not possible to determine the exact point of use for these types of items. In those cases where a taxpayer is not reporting sales or use tax that is due, the value may be estimated using some other information that reasonably allocates the amount to the proper tax jurisdictions. If the taxpayer calculates tax liability based on allocations to various tax jurisdictions, the methodology employed by the taxpayer should be reviewed for reasonableness.

The audit goal is to make an accurate determination of the tax measure. The auditor should not avoid review of these types of items due to a taxpayer's lack of accounting. Ultimately, it is the

taxpayer's responsibility to have adequate records to establish tax liability. Where detailed records do not exist, the auditor should consult with the audit supervisor to determine the use of appropriate estimates to establish tax liability.

### 11.11 Manufacturing Machinery and Equipment

Many states exempt from sales and use tax machinery and equipment that is used directly in the manufacturing or processing of tangible personal property either for sale or in the performance of taxable services. This exemption is often limited to new or expanding business facilities, businesses that are located in designated enterprise zones, or sometimes to a minimum or maximum dollar amount. Exemptions can be very broad or very narrow. Certain states apply lower tax rates to qualifying items.

Manufacturing comprises so many different activities 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 auditor must perform sufficient research related to manufacturing exemptions when the issue is present in an audit.

If a taxpayer's activity falls under the definition of manufacturing, additional questions must be addressed by the auditor:

- Where is the beginning and end of the manufacturing process?
- What equipment was involved in activities such as testing and research and development? Do the states exempt this equipment?
- What equipment was involved in quality control, pollution control, safety, and temperature control? Do the states exempt this equipment?
- Does repair and maintenance, storage, and transport (including the use of forklifts, loaders, and conveyor belts) qualify for the manufacturing exemption?

In most states, manufacturing begins when the item is withdrawn from its first point of storage and ends when the item is removed from 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.

Most joint audit program member states that exempt machinery and equipment from sales and use tax consider the shipping and receiving areas to be outside the manufacturing process. However, if some of the receiving inspection activities are undertaken after the goods have entered the manufacturing process, the activities may be considered exempt as part of the quality control function required to manufacture the product.



### 11.12 Multiple Points of Use

Multiple points of use (MPU) is a concept that some states apply to various types of transactions, including sales of canned software, remotely accessed software and related services. When allowed by a state, an exemption certificate claiming multiple points of use provided by a purchaser allows a seller to avoid collecting tax on a sale. When a purchaser claims an MPU exemption, the purchaser is obligated to remit use tax apportioned to applicable jurisdictions.

### 11.13 Overpayments of Tax

If tax was paid to the vendor and/or use tax accrued and remitted when no tax in fact was due, credit may be granted within the audit, if allowed under the specific rules and policies of each state. Some states require taxpayers to make separate refund claims rather than have them included and processed as part of an audit. Any questions regarding when it is appropriate for an auditor to allow credit for overpaid tax in an audit should be directed to the audit supervisor or state contact. See [Chapter 12](#) for discussion of refund claim review.

### 11.14 Promotional/Marketing Items and Product Samples

Examples of promotional items include free product samples, logo apparel, and logo products such as coffee mugs, key chains, calendars, and note pads. One of the key issues about promotional items is whether the items qualify as exempt purchases for resale. In many states, the key to determining this is whether the item is free with the purchase of something else by a customer or free without purchase of something else. For example, if customers who test drive an automobile receive a free beverage cooler, there is no sale component in the transaction. Therefore, the purchase of the coolers by the automobile dealer is subject to tax. The beverage coolers were purchased by the automobile dealer for their own promotional or marketing use. However, if the customer only receives the free beverage cooler with the purchase of an automobile, the beverage cooler may be purchased without tax as a resale item. State law and case law varies around the country, and the auditor must make taxability decisions subject to the state law applicable to each transaction.

Product samples might differ in size from a company's standard retail product size making it difficult, if not impossible, for a taxpayer to assert that the product samples were purchased for resale. 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 their purchase of the samples. The auditor should consider whether the product sample qualifies for another exemption, such as prescription drugs or grocery items.

Marketing items, which are generally taxable, include posters, racks, displays, banners, or signage that may be placed in retail outlets by manufacturers or distributors without charge to the retailer. Frequently, these items are produced by third parties and may be drop shipped to retail outlets or to distribution centers or warehouses for temporary storage before placement in retail outlets.



Suppliers of marketing items may offer fulfillment services that involve storage and/or drop shipping to various locations. Also, the taxpayer might store marketing items in their own warehouses or distribution centers. These activities add complexity to transactions including nexus of the suppliers and the potential for multiple layers of suppliers. Separate discussions covering drop shipping and temporary storage are included in this manual (See [Sections 10.09](#) and [11.18](#)).

In some cases, it is not possible to determine the exact point of use for promotional/marketing items and samples. In those cases where the taxpayer has not reported liability, the value may be estimated using information that reasonably allocates where the items are used among tax jurisdictions. If the taxpayer calculates tax liability based on allocations of costs applicable to various tax jurisdictions, the methodology employed by the taxpayer should be reviewed for reasonableness.

The audit goal is to make an accurate determination of the tax measure. The auditor should not avoid review of these types of items due to a taxpayer's lack of accounting. Ultimately, it is the taxpayer's responsibility to have adequate records to establish tax liability. Where detailed records do not exist, the auditor should consult with the audit supervisor to determine the use of appropriate estimates to establish tax liability.

### 11.15 Real Property Services

Construction materials typically stop being personal property once they are installed and become a component part of real property. Generally, most states treat contractors as the final consumer of materials used to perform construction contracts. Therefore, construction contractors typically owe tax on the materials and supplies they purchase. If the contractor maintains a stock of goods upon which tax has not been paid, tax is generally due when goods are removed from inventory. Other circumstances that affect taxability of construction services are too numerous to cover in this manual.

Labor services performed on real property, including application of tangible personal property, are taxable in some states. For example, taxability might vary depending on whether the project is deemed to be an upgrade or improvement versus a repair or whether the building or facility is being remodeled versus originally constructed.

Direct purchases of materials made by a building owner or tenant are generally subject to tax. Sometimes, a contractor is hired to perform installation or construction using materials provided by the building owner or tenant. In these cases, the auditor should ensure applicable tax has been paid at the time of purchase of the materials and supplies.

Mixed contracts, consisting of the sale of tangible personal property and installation services, add complexity to taxability determinations. Examples of mixed contracts include audio-visual, theatre, sound systems, signage, etc. Taxability of the separate components of a mixed contract

require the auditor to consider both the sale of tangible personal property and services and not as either one or the other.

### 11.16 Reciprocity – Credit for Tax Paid to Other Taxing Jurisdictions

Many states allow credit for tax paid to another state but limit that credit to tax that was legally due and paid to another state. Other states limit credit to only those taxes paid that are of similar type (sales or use) or similar jurisdiction (state or local). It is important for the auditor to verify that the tax paid to other states was legally due. If the tax rate is lower in the other state, then the taxpayer may owe additional tax after the credit is applied.

If tax is paid on items stored in centralized distribution centers or warehouses, the auditor should verify tax was legally due at the distribution center or warehouse location. For example, if a temporary storage exemption exists in the state where a distribution center or warehouse is located, any tax paid to that state may not have been legally due. This situation could require the auditor to research state law in states not participating in the audit. See [Section 11.18](#).

### 11.17 Tangible Personal Property Installation, Repairs and Maintenance

Taxation of such services as assembly, installation, repairs, and maintenance of tangible personal property vary. When services fall within the definitions of construction services, contractor services, performance contracts or similar activities, refer to [Section 11.15](#) Real Property Services.

Assembly and installation charges may accompany the sale of tangible personal property. A retailer may be engaged in two separate transactions: the retail sale of specific tangible personal property and installation. Whether installation charges are stated separately from tangible personal property or other charges on an invoice or other billing document affects taxability in most states. The auditor should remain alert to identifying activities, such as assembly, that are included in the definition of sales price of tangible personal property in many states.

Repair and maintenance services frequently include parts and labor charges. Parts and labor charges are often separately stated on invoices or other billing documents; tax may apply to either or both depending on state law. Taxability may vary upon whether tangible personal property is repaired on site or if property is transported off site for repair.

Labor services performed under maintenance contracts and warranties may require the auditor to investigate whether the original sale of the maintenance contract or warranty was subject to tax.

### 11.18 Temporary Storage – Meaning of Used, Stored, or Consumed in a State

When a taxpayer uses a centralized warehouse or distribution center to temporarily store fixed assets or supplies purchased from outside the state where the warehouse or distribution center is located, temporary storage issues may be a factor in the audit (some states exclude from the definition of “use, storage, or consumption” the temporary storage of goods in-state before the goods are shipped to a location outside the state). Temporary storage is typically a use tax

provision in statutes or regulations and may not appear separately or use the specific words “temporary storage.” Because temporary storage is typically a use tax provision, the exemption frequently applies only to property shipped into a state from outside the state.

Some state statutes define a specific period of time that constitutes “temporary,” while other statutes are more vague and simply reference ultimate shipment or use outside the state. In most states, the temporary storage exemption may not be claimed if the property is used in any way before it is shipped outside the state. Therefore, activities such as testing or configuration of products (e.g., computer hardware) likely negate the possibility of asserting a temporary storage exemption. State laws vary widely and something as simple as opening and repackaging items in smaller quantities might constitute taxable use in a state.

Although a temporary storage exemption may exempt the taxation of an item in one jurisdiction, this does not mean that tax is not due in another jurisdiction. Assuming the item purchased is taxable, tax is due in the state where the ultimate use or consumption occurs.

The tax due in the state where ultimate use or consumption occurs might be reduced or offset by tax due and paid in a jurisdiction where an item is stored, a concept which is addressed in [Section 11.16](#).

## 12. Conducting the Audit – Refund Claims

### 12.01 Introduction

A state may refer refund claims related to an audit to the Commission for review. If a taxpayer submits a refund claim directly to the Commission auditor, the auditor must contact the audit supervisor and consult with the state for guidance.

Claims for credit or refunds that arise during an audit may be required to be submitted to a state in a separate refund claim. Alternatively, some states allow certain types of credits or overpayments to offset audit assessments. See [Section 11.13](#) for additional guidance.

If the audit period and the refund period are not the same, the Commission will determine the scope of the refund review.

Certain states require refund claims to be handled internally at the tax agency.

### 12.02 Refund Review

Refund review varies dramatically depending upon the issues present in the claim. An audit plan for review of the claim should be developed based on discussions with the audit supervisor. The auditor must verify that the amounts claimed have not already been deducted or otherwise taken through normal reporting procedures used by the taxpayer. In addition, the auditor must perform sufficient procedures to verify the claim. Narratives for refund claims must include discussion of all relevant issues. Certain states require a separate narrative pertaining only to the refund claim.

Some of the refund claims related to Commission audits contain detail so voluminous that a *Detailed Review* is not feasible. If a state policy requires a detailed review, then the auditor and audit supervisor will discuss the feasibility of reviewing the refund claim. The Commission auditor may use *Sampling* techniques to perform refund review if approved by the state. Refer to the Commission's Sampling Policy and Guideline Manual for discussion of sampling.

## 13. Narrative

### 13.01 Introduction

The narrative will consist of two parts: general and state specific. Each part has an intended purpose and is required to contain certain information. Each state receives a copy of the general information along with the applicable state specific narrative.

### 13.02 Overall Expectations

Audit narratives should be written in a formal manner, using the generally accepted “business/professional” style of writing commonly used in academic, business, or professional settings allowing the facts to objectively speak for themselves.

Clear, concise, and consistent language is required. The narrative must speak objectively to all interested parties such as supervisors, state audit review staff, attorneys, the taxpayer, and other auditors. The auditor should strive to provide a general overview that is informative but not overly lengthy.

The narrative should present the entire audit process in a transparent way. 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. The auditor must document deviations from the guidelines provided in this manual and the Commission Sampling Policy and Guidelines Manual.

In preparing a properly written narrative the auditor should anticipate what questions each of the potential readers might ask and be sure the narrative answers them. The narrative should follow the logical flow of the audit process from start to finish.

Highly technical issues or complex calculations might require detailed explanations. Sometimes it is inefficient to explain these within the narrative itself. Where this is true, properly referenced appendices or exhibits that fully explain the technical issues, show the complex calculations, or both, might be the best option. The auditor should use their best judgment as to where any supplemental information, special language or description of unusual circumstances should be placed in the report.

### 13.03 General Narrative

The general narrative is the portion of the audit narrative containing general information about the audit and the company being audited which is not specific to any state. The general narrative template includes the following components:

(a) Scope of Audit

The narrative should contain 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.*

(b) Auditor and Taxpayer Contact Information

Include auditor contact information as well as contact information for taxpayer contacts, both internal and external. Applicable Power of Attorney authorizations must be included in the audit file.

(c) General History of the Company

Provide a brief history from the date of incorporation to the present, including information relevant to the audit, to provide meaningful context to the reviewer. Restructuring, mergers, acquisitions, and other major changes should be included. If the information is copied from a document such as the 10-K, reference the source.

(d) Description of the Business and Business Activities

Provide a description of the taxpayer's domestic and worldwide operations. The description should include information such as:

- Type of business, such as retailer, manufacturer, contractor, etc.
- Types of products the taxpayer sells or manufactures and how those products are sold (retail, wholesale, ecommerce, etc.)
- Types of customers (wholesalers, retailers, construction contractors, individual consumers, etc.)
- Summary of business locations including headquarters, distribution centers, warehouses and retail or other locations
- Additional information relevant to the audit should be included when appropriate.

### 13.04 State Specific Narrative

The state portion of the narrative is unique to each state participating in the audit. Components include:

(a) Audit Period and *Statute of Limitations* Expiration Date

Identify the audit period and statute of limitations expiration date. Include copies of executed *Waivers* with the report.

(b) *Nexus*

This section should include basic information documenting the taxpayer's nexus in the state. If a nexus investigation occurs, the auditor must state the reasons for conducting a nexus investigation, describe procedures used to determine nexus and provide sufficient evidential matter to support the determination. The auditor should also include the taxpayer's position on a nexus determination. See [Chapter 7](#) – Nexus for additional discussion regarding nexus investigations and documentation.

(c) In State Locations

Provide a list of all in-state locations for the taxpayer. Include type of location, such as retail store, showroom, warehouse, distribution center, etc. When warehouse or distribution centers exist, it is helpful to note whether the locations are used exclusively for inventory items, contain marketing/promotional materials, and/or supplies for the taxpayer's own use.

(d) Sales Tax and Use Tax

The narrative should include a section for sales tax, followed by a section for use tax, and followed by a section for local tax. Each audit is as unique as each taxpayer. Therefore, there is no single, rigid approach for describing records examined, procedures performed, and audit adjustments. The auditor should expand discussions to include all relevant information for each audit.

The sales tax and use tax sections must include discussion of method of reporting, records examined, audit procedures performed, audit adjustments (including description of supporting schedules), and any relevant auditor comments.

(1.) Method of Reporting

Fully describe the taxpayer's return preparation process.

(2.) Records Examined

Describe records used to conduct the audit. Explain any unique records or records for which the titles do not adequately describe the content. There may be circumstances where the auditor needs to describe records examined in the audit in detail. When appropriate to do so, the auditor should consider including copies of pertinent records or examples of transactions with the audit narrative.

The audit narrative should include a statement as to whether sufficient records were provided by the taxpayer to determine the proper tax reporting. If certain requested records were withheld or not provided by the taxpayer, the report should identify those records.

### (3.) Audit Procedures

Audit procedure discussions must include full disclosure of audit steps including explanations of testing, *Sampling*, and detail review procedures performed. Include an explanation as to why an item was a potential issue, what steps were taken to determine the appropriate taxability, and the basis for any adjustment. If the auditor made any assumptions, they should be disclosed. If issues were omitted because the auditor determined they were immaterial, disclosure of the basis for determining materiality should be described.

Main components of audit procedure discussions include tests of completeness of records, reconciliation of tax collected/accrued versus tax remitted, review of taxed, nontaxed, or exempt sales transactions, fixed asset purchases, and expenses.

The narrative must describe deviations from Commission audit procedures including any circumstances that result in the inability to perform required procedures.

When applicable, include an explicit comment indicating the auditor makes no statement as to the completeness of records provided, including the reasons why.

Audit narratives should describe sampling methods used in conducting the audit. Factors contributing to the auditor's decision to use a particular type of sample should be described. When a statistical sample is used, a separate document should be attached to the narrative that includes the following information:

Objective – a general statement such as “investigate the proper application of retailers’ sales tax to sales transactions” or whatever the case may be is sufficient.

Target Population – describe the data in the original download as well as steps the auditor performed when refining the data to arrive at the target population. Examples include removal of appropriately taxed transactions and credit memos. When accounts of interest are used in a purchases sample, the auditor should include a list of the accounts of interest. Include a summary of the sampling frame.

Sampling Procedures – describe the sample (number of strata, floor, and ceiling values) and include a summary of the strata.

Sample Evaluation and Projection – describe the evaluation result and any state specific guidelines that may apply.



#### (4.) Audit Adjustments

The audit adjustment discussion should include a description of each supporting schedule. The description should provide adequate information for the reader to understand the purpose of the schedule. Detailed information should also be provided on the schedule itself; workpapers and schedules should always stand alone.

#### (5.) Local Tax

The local tax narrative varies widely depending on the state. Include relevant information regarding local tax rate structure (combined or separate rates and reporting). A basic description of how local tax is allocated, and the audit schedules used to calculate local tax should be included. A simple notation of “not applicable” should be made when the audit report is issued for a state where local taxes are not included in the audit.

#### (6.) Audit Recommendations

Include the date that final schedules were provided to taxpayer, taxpayer agreement (or disagreement) with audit findings and Commission recommendation for assessment, refund, or no change.

If the taxpayer has expressed disagreement with any portion of the audit recommendation, include relevant discussion of the disagreement.

For any items expected to be appealed by the taxpayer, include the taxpayer’s position on the disputed items and the taxpayer’s interpretation of statutes, regulations, or state guidance. If the taxpayer provided a written document supporting their position, it must be included in the audit report.

Include any information the state may need in the future to audit the taxpayer, such as system deficiencies and observations that might be relevant to the state.

## 14. Audit Report

The audit report is the formal disclosure of the audit findings provided to each state at the conclusion of the audit. The report includes the narrative, schedules and all other relevant documents related to the audit.

The audit report as a whole (narrative and schedules) must be appropriately indexed and referenced. Bookmarks, hyperlinks, and other similar functionality available in software used to complete the audit report (Adobe, Word, Excel) must be incorporated into documents. There is an expectation that a user of the finished report will be able to navigate to a granular level quickly and easily within the index, narrative, and schedules.

A template is provided to auditors for use as a model. It is a general guideline for structuring audit schedules. Because each audit is unique, leeway in presenting the information is allowed. However, the auditor must adhere to certain elements of the template. Section A is always used to illustrate sales adjustments, Section B is always used to illustrate purchases adjustments, Section C is always used to illustrate local tax adjustments, and Section D is always used to provide supplemental information. Within each section, the auditor may exercise discretion if the schedules are clearly described and maintain a logical flow.

Schedules are referenced numerically within each section. Schedules A1, A2, A3, etc. are used to present sales schedules. Schedule B1 is generally reserved for fixed asset schedules. Schedules B2, B3, etc. are used to present expense schedules. Additional schedules presenting items such as sample error rates, sample projections, and statistical sample evaluations should be included when applicable. Allocation of tax types, allocations to tax jurisdictions, etc. may be required depending on the state.

The audit report includes the following components in a single .pdf document:

- Audit Report Cover Sheet
- Transmittal Letter
- MTC Audit Evaluation
- Index to Audit Report
- State Authorization
- *Waivers*
- General and State Specific Narrative
- Additional Narratives or Attachments (notes, exhibits, or appendices regarding statistical samples, technical issues, etc.)
- Transcript of Returns Filed (TRN)
- Summary of Deficiencies/Refund (SD)

- Summary of All Sales Adjustments (A)
  - Monthly Projection of Sales Issue #1 (A1)
  - Error Rate Computations for Sales Issue #1 (A1-P)
  - List of Sales Exceptions (A1-E)
  - Monthly Projection of Sales Issue #2 (when relevant) (A2)
  - Error Rate Computations of Sales Issue #2 (A2-P)
  - List of Sales Exceptions (A2-E)
- Reconciliation Tax Collected vs. Tax Remitted (A3)
- Summary of All Purchases Adjustments (B)
  - Monthly Summary of Fixed Assets (B1)
  - Error Rate Computations for Fixed Assets (when relevant) (B1-P)
  - List of Fixed Asset Exceptions (B1-E)
  - Monthly Summary of Purchase/Expense Items Issue #1 (B2)
  - Error Rate Computations for Purchases Issue #1 (B2-P)
  - List of Purchases Exceptions (B2-E)
  - Monthly Summary of Purchase/Expense Items Issue #2 (B3)
  - Error Rate Computations for Purchases Issue #2 (B3-P)
  - List of Purchases Exceptions (B3-E)
  - Reconciliation Tax Accrued vs. Tax Remitted (B4)
- Computation of Local Tax (C)
- Exhibits or Other Attachments (D)

## 15. Review of Audit

### 15.01 Supervisor Review

The supervisor will review each audit to accomplish the following objectives:

- Determine the appropriateness of the audit conclusions.
- Ensure that the audit has been conducted in a professional and accurate manner.
- Control the efficiency of the audit program and to identify timing delays and other significant factors which affected the audit.
- Verify the audit has been performed in compliance with Commission procedures.
- Confirm the report is complete and of high quality.

The review must ensure that the documentation, narrative, schedules, and exhibits are sufficient to support the findings in the event of a taxpayer protest or of derivative litigation. Careful attention to those areas in which the taxpayer has indicated disagreement or that a protest will be filed is required.

### 15.02 Taxpayer Satisfaction Survey

When all state audit reports have been submitted to the participating states, the supervisor will send an Audit Satisfaction Survey ([Exhibit I](#)) to the taxpayer.

## 16. Transmittal of Audit to Participating States

### 16.01 Transmittal

The auditor will send the following information to each participating state and the audit supervisor (via cc of the e-mail to the state):

- Audit Report (See [Chapter 14](#)) in .pdf format
- General and State Specific Narrative in Word format
- Additional Narratives or Attachments, if any, in Word format
- MTC Audit Evaluation in Word format
- Audit Template (including Index, TRN, SD, and all Schedules) in Excel format

The Audit Report in .pdf format must include bookmarks and hyperlinks. The document should be set to open with the bookmarks panel and pages visible (currently accomplished using Adobe, File\Properties\Initial View\Navigation tab: Bookmarks Panel and Page). Word and Excel files should also contain indexes and hyperlinks.

The auditor must confirm receipt of information by the state's contact. When email transmission is affected by file size limitations and/or security issues, use of the Commission's secure file transfer portal is required. Currently, when using the secure file transfer portal, the auditor must zip all documents into a single file to upload for the state.

The auditor will send the audit adjustment summary to the audit director and the audit supervisor (via cc of the email to the director).

### 16.02 Subsequent Responsibilities of the States

Each state will then be responsible to do the following:

- Confirm receipt of the audit report.
- Review the audit report and recommendations.
- Issue tax notices or assessments as it deems appropriate.
- Complete the audit evaluation ([Exhibit J](#)) provided and submit the evaluation to the audit director.
- Obtain any *Waivers* of any applicable statutes of limitations which it may find necessary to protect its right to issue assessments.

## 17. Retention of Audit Reports and Taxpayer Requests for Information

### 17.01 Retention of Master Copy of Audit Report

The retention of audit files is coordinated with the Network Administrator and will be done consistent with the Commission's document retention policy.

### 17.02 Taxpayer Requests for Audit Information

Chapter 6, [Section 6.09\(d\)](#) of this manual includes the Multistate Tax Compact provision for handling taxpayer requests for audit workpapers, narratives, and similar materials. This information may be provided only by the relevant state tax agency and never by the Commission auditor.

## Exhibits

### Exhibit A: Waiver Policy – Joint Sales and Use Tax Audits



#### Waiver Policy – Joint Sales and Use Tax Audits July 2021

Statutes of limitations typically set a deadline for the valid assessment of taxes by the tax authority and the time in which a refund may be claimed. A waiver is an agreement between the taxpayer and the state to extend the statute of limitations. Multistate Tax Commission (MTC) audits are unique because multiple states simultaneously participate in the audit.

MTC auditors are responsible for ensuring no statute of limitations expires without sufficiently notifying the affected states. MTC auditors will make every effort to complete the audit in a timely manner after the beginning of the audit. MTC auditors often request a waiver to facilitate a more accurate and complete audit.

*Discuss Waiver Policy with Taxpayer.* The auditor will provide the taxpayer with a copy of this waiver policy at the initial audit meeting. The auditor will discuss the taxpayer's waiver policy with the taxpayer representative. If the taxpayer has a written waiver policy, the auditor will request a copy of it.

*Requesting a Waiver.* It is MTC policy that sales and use tax auditors establish audit periods beginning with the period after the first contact with the taxpayer and including all open statutory periods. Therefore, it will likely be necessary for the auditor to request a waiver of the statute of limitations shortly after the initial contact is made and no later than the commencement of the audit, whether that occurs during a field visit or remotely, in order to preserve the audit period. Various circumstances, including the complexity of the issues, the need for information, and the taxpayer's availability, commonly necessitate that the states' statutes of limitations be extended by additional waivers to fully address all the audit issues.

The auditor should make every effort to complete the audit within six months of the expiration of the current statute waiver. In general, whenever a statute waiver is due to expire within six months, the auditor will assess the current status of the audit and request a waiver extension if necessary.

*Form of Waiver.* Unless a state requires that its own waiver form be used, the auditor will prepare one MTC Waiver Form for all states participating in the audit. The waiver contains a statement that the signature on the waiver is *prima facie* evidence that the individual signing the waiver is authorized to sign on behalf of the taxpayer.

*Completeness of Waiver.* The auditor will ensure that a waiver is completed for all participating states with respect to the taxpayer and all associated tax entities, as applicable, that are included in the audit.

*Taxpayer Refusal to Sign Waivers.* If a taxpayer does not sign a waiver within 30 days of the request, the auditor will immediately consult with the audit supervisor or audit director, and MTC legal staff. Based on these discussions:

- the audit may be completed to the best of the auditor’s ability based on available information;
- an assessment based on the best available information may be issued by the state; or
- to facilitate the timely completion of the audit, the MTC or a participating state may issue a subpoena to compel production of documents and information.

By signing below, you certify that you have been provided a copy of the MTC Waiver Policy and have been given an opportunity to discuss the policy with the MTC auditor for all entities included in the audit.

\_\_\_\_\_  
Printed Name of Authorized Employee or Agent of Taxpayer

\_\_\_\_\_  
Signature of Authorized Employee or Agent of Taxpayer

\_\_\_\_\_  
Title

\_\_\_\_\_  
Date





**Multistate Tax Commission Sales and Use Tax Waiver  
and Extension of Statute of Limitations**

<b>Taxpayer</b>	<b>Tax Categories:</b> <input type="checkbox"/> Sales and/or Use Tax (includes state meals and/or room occupancy tax when relevant)  <input type="checkbox"/> Excise Tax  <input type="checkbox"/> Other
<b>Address</b>	
<b>City, State, Zip</b>	

**A. States Adopting this Form**

The following states have adopted and approved the provisions of this form:

Alabama, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Iowa, Kansas, Kentucky, Maryland, New Jersey, North Dakota, Tennessee, and Utah.

**B. Terms and Conditions; Entities and Periods Covered**

1. In order to permit the States identified in Section A. to perform audits of Taxpayer through the Multistate Tax Commission ("MTC"), acting as agent or independent contractor as applicable, and to make all appropriate deficiency determinations or assessments regarding the tax liability of Taxpayer, including applicable interest and/or penalties, Taxpayer agrees to waive the applicable statutes of limitations for the states and periods identified below.
2. The extension periods agreed to in this waiver will not shorten the statute of limitations for any tax periods within the audit that remain unexpired as of the date Taxpayer signs this waiver.
3. Taxpayer agrees to retain for audit purposes all records and supporting data pertaining to the taxable periods covered by this waiver.
4. By signing and initialing this waiver Taxpayer agrees to extend the statute of limitations for any amended returns that are accepted by the States for any of the audit periods identified.

Taxpayer Authorized Employee or Agent Initials \_\_\_\_\_

MTC Authorized Employee Initials \_\_\_\_\_

5. Taxpayer agrees that this waiver tolls all applicable statutes of limitations relating to any and all local or regional government taxes administered by the States identified in Section A. when these taxes are based upon, dependent upon, or affected in any manner by the results of this audit.

State	FEIN	State ID Number	Entire Audit Period <sup>1</sup>	Period Extended Through
Alabama				
Arkansas				
Colorado				
District of Columbia				
Hawaii				
Idaho				
Iowa				
Kansas				
Kentucky				
Maryland				
Michigan				
New Jersey				
North Dakota				
Tennessee				
Utah				
Wisconsin				

**C. Refunds**

1. Except for the States noted in 2. and 3. of this section, the States identified in section A. agree that the signing, initialing, and filing of this waiver also extends the statutory periods identified in section B., for the States listed in Section B., during which Taxpayer may file a claim for refund if the statutory periods have not already expired prior to the signing, initialing, and filing of this waiver to the extent permitted by the laws of each State. The filing of this waiver constitutes the filing of a refund claim for the extended periods as to amounts determined by the States to be due and owing the Taxpayer if the statutory periods for filing refund claims have not already expired prior to the filing of this waiver.
2. The law of Alabama requires a written petition for refund be filed in accordance with § 40-2A-7(c), Code of Alabama 1975. However, in some instances the Alabama Department of Revenue may issue an automatic refund in accordance with § 40-29-71. For additional information, contact the Alabama Department of Revenue.

<sup>1</sup> Entire Audit Period means any tax periods beginning or ending within the date range listed.

Taxpayer Authorized Employee or Agent Initials \_\_\_\_\_

MTC Authorized Employee Initials \_\_\_\_\_

3. The laws of North Dakota and Tennessee do not provide that the signing of this waiver constitutes the filing of a refund claim but do provide that signing this waiver extends the period of time a taxpayer has to file a refund claim.

**[This Space Intentionally Left Blank]**

3

Taxpayer Authorized Employee or Agent Initials \_\_\_\_\_

MTC Authorized Employee Initials \_\_\_\_\_

---

**D. Signatures and Filing**

1. This waiver must be signed and initialed by an authorized employee or agent of Taxpayer. The signature will be *prima facie* evidence that the individual is authorized to sign this waiver on behalf of Taxpayer. If signed by a Taxpayer's agent, this waiver must be accompanied by a power of attorney authorizing the signature.
2. The authorized employee or agent of Taxpayer and the MTC must both sign and initial any attachments to this waiver.
3. This waiver will be deemed filed on the date it is signed and initialed by the authorized employee or agent of Taxpayer and the MTC.

\_\_\_\_\_  
**Printed Name of Authorized Employee or Agent of Taxpayer**

\_\_\_\_\_  
**Signature of Authorized Employee or Agent of Taxpayer**

\_\_\_\_\_  
**Title**

\_\_\_\_\_  
**Date**

\_\_\_\_\_  
**Printed Name of Authorized Employee of Multistate Tax Commission**

\_\_\_\_\_  
**Signature of Authorized Employee of Multistate Tax Commission**

\_\_\_\_\_  
**Title**

\_\_\_\_\_  
**Date**

Exhibit C: Request and Waiver for Unsecure Electronic Transmission of Data



**REQUEST AND WAIVER FOR UNSECURE ELECTRONIC TRANSMISSION OF DATA**

NAME OF TAXPAYER(S):	TAXPAYER'S E-MAIL ADDRESS:
	FEIN Number:
TAXPAYER'S REPRESENTATIVE(S): <sup>1</sup>	TAXPAYER'S REPRESENTATIVE'S E-MAIL ADDRESS: <sup>2</sup>

Pursuant to its Multistate Audit Program, the Multistate Tax Commission (MTC) collects and stores confidential taxpayer information and has a responsibility to protect this information from unauthorized access, use, and disclosure. The MTC has a policy and practice of using a secure e-mail system whenever electronically transmitting confidential taxpayer information. However, a taxpayer may request the MTC to electronically transmit confidential information via unsecure electronic transmission by providing a written request and waiver to the MTC.

The following statement will be included at the top of each transmission:

*This e-mail may contain confidential information – unauthorized use or disclosure is strictly prohibited by law. If you receive this e-mail in error, please immediately notify the MTC by return e-mail and delete this message from your computer, without printing the message, and without disclosing its contents to any person. Persons who copy or disclose confidential information may be subject to legal penalties.*

<sup>1</sup> Taxpayer must list all individuals to whom the MTC is authorized to send confidential information via unsecure electronic transmission. If an individual is not listed, the MTC will NOT send confidential information to that individual unless the taxpayer first files a revised Request and Waiver that includes that individual.

<sup>2</sup> Taxpayer must provide the specific, direct e-mail address for all representatives authorized to receive confidential information from the MTC via unsecure electronic transmission. Taxpayer should not provide generic corporate e-mail addresses that would be accessible to personnel who are not so authorized.

To authorize the transmission of confidential information to you and/or your representative via unsecure electronic transmission, please sign this *Request and Waiver for Unsecure Electronic Transmission of Data*. This authorization will remain in effect until rescinded in writing.

**By signing, you acknowledge the following statement and waiver with respect to the account noted above:**

*I request the transmission of confidential information via unsecure electronic transmission, including unsecure e-mail and unsecure facsimile. I understand that transmission via unsecure electronic transmission is not a secure transmission and the MTC, its member states and their employees and representatives, are not responsible if confidential information sent via unsecure electronic transmission is accessed by third parties. By signing, taxpayer(s) hereby waives any and all claims or causes of action that may accrue as a result of the transmission of confidential or sensitive information via unsecure electronic transmission. Furthermore, by signing taxpayer(s) hereby releases the MTC, its member states and their employees and representatives from any and all liability as a result of the transmission of confidential or sensitive information via unsecure electronic transmission.*

SIGNED BY* ( <i>taxpayer, corporate officer or representative with a power of attorney</i> )	DATE SIGNED
PRINT NAME OF SIGNATORY	CONTACT PERSON ( <i>if other than signatory</i> )
TITLE OR POSITION	TELEPHONE NUMBER AND EMAIL ADDRESS
TITLE OR POSITION OF CONTACT PERSON	TELEPHONE NUMBER AND EMAIL ADDRESS
<i>*Signatory, if not a corporate officer, partner or owner, certifies under penalty of perjury that he or she holds a power of attorney to execute this document.</i>	

Exhibit D: Audit Confirmation Letter



Working together since 1967 to preserve federalism and tax fairness

[Insert Date]

[Taxpayer Manager Name]  
[Corporate Taxpayer Name]  
[Corporate Address]

RE: The Multistate Tax Commission Sales/Use Tax Audit of: [Taxpayer Name and FEIN]

Dear Mr. [Manager's Name]:

As discussed in our initial conversation, the Multistate Tax Commission has been directed by its member states to conduct a sales/use tax audit of your operations. We are writing to confirm the appointment date of [Insert beginning and ending date of appointment or appointments if more than one visit has been scheduled] to commence the audit.

To date, the following states have authorized us to perform the audit on their behalf. Should additional states authorize the Commission to perform an audit on their behalf, we will inform you and provide a copy of all authorizations at our scheduled audit appointment.

State	Audit Period	State	Audit Period
<input type="checkbox"/> AL	mm/dd/yyyy – mm/dd/yyyy	<input type="checkbox"/> LA	mm/dd/yyyy – mm/dd/yyyy
<input type="checkbox"/> AR		<input type="checkbox"/> MD	
<input type="checkbox"/> CO		<input type="checkbox"/> ND	
<input type="checkbox"/> DC		<input type="checkbox"/> TN	
<input type="checkbox"/> GA		<input type="checkbox"/> UT	
<input type="checkbox"/> HI		<input type="checkbox"/>	
<input type="checkbox"/> ID		<input type="checkbox"/>	
<input type="checkbox"/> IA		<input type="checkbox"/>	
<input type="checkbox"/> KS		<input type="checkbox"/>	
<input type="checkbox"/> KY		<input type="checkbox"/>	

Should you have any questions regarding this matter please do not hesitate to contact me, [Insert auditor's name], the Auditor-in-Charge.



Sincerely yours,

---

[Insert auditor's name and title]

Multistate Tax Commission

[Insert Contact Information]

**Instructions**

1. The electronic template should be used when preparing the Confirmation Letter
2. The basic format of the letter should not be changed
3. All letters should be prepared using MTC letterhead
4. Insert an "X" in the box if the state is participating in the audit or the auditor may choose to just list the states that are participating.
5. This is the basic format of the confirmation letter which has the minimum information that should be present. The auditor should add any additional content that was discussed during the initial contact with the taxpayer.



**MULTISTATE TAX COMMISSION  
JOINT AUDIT PROGRAM**

**444 North Capitol Street, N.W., Suite 425  
Washington, DC 20001  
(202) 650-0300**

**Holly Coon-Director**

**Contact Information: email:[hcoon@mtc.gov](mailto:hcoon@mtc.gov), phone: 334-513-8808**

**PROGRAM AUTHORITY**

- MTC Joint Audit Program operates under authority of the Multistate Tax Compact as upheld by the U.S. Supreme Court in U.S. Steel Corp. v. Multistate Tax Commission.
- MTC auditors are agents of States for conducting an audit and work at the direction of the States.
- MTC does not have assessment authority. States are responsible for making assessments after MTC issues recommendations.
- MTC Joint Audit Program is funded by the states in the program. Each state pays a fee established annually by the MTC Executive Committee.
- The MTC auditors are bound by the confidentiality laws of the states in the program.

**MULTISTATE TAX COMMISSION**

**26 INCOME TAX PARTICIPATING STATES**

ALABAMA	MISSOURI
ALASKA	MONTANA
ARKANSAS	NEBRASKA
COLORADO	NEW HAMPSHIRE
DELAWARE	NEW JERSEY
DISTRICT OF COLUMBIA	NEW MEXICO
HAWAII	NORTH DAKOTA
IDAHO	OREGON
IOWA	PENNSYLVANIA
KANSAS	RHODE ISLAND
KENTUCKY	TENNESSEE
LOUISIANA	UTAH
MARYLAND	WEST VIRGINIA

**MULTISTATE TAX COMMISSION**

**15 SALES TAX PARTICIPATING STATES**

ALABAMA	KENTUCKY
ARKANSAS	LOUISIANA
COLORADO	MARYLAND
DISTRICT OF COLUMBIA	NEW JERSEY
HAWAII	NORTH DAKOTA
IDAHO	TENNESSEE
IOWA	UTAH
KANSAS	

## MTC AUDIT COMMITTEE

### AUDIT SELECTION PROCESS

#### PRIMARY PROCESS:

- Step 1: Audit Director sends out audit nomination forms.
- Step 2 : States return audit nomination candidates.
- Step 3: Audit Director distributes summarization of audit candidates.
- Step 4: States supply information on all audit candidates.
- Step 5: States select MTC audit inventory by a voting process.

#### SECONDARY PROCESS:

- MTC National Nexus Program refers audits to MTC Audit Committee for approval.
- Taxpayers may request an MTC joint audit through the MTC Audit Committee.

### MTC AUDIT COMMITTEE MEETINGS

- The MTC Audit Committee typically meets in-person three times a year. For more information about upcoming MTC meetings, see <http://www.mtc.gov/Events-Training>. The Audit Committee may also meet via teleconference, as needed.
- In accordance with the MTC's "Public Participation Policy," public notice will be given for meetings of the Audit Committee. To protect taxpayer confidentiality, some Audit Committee meetings, or portions of meetings, may be closed to public participation.
- To receive email updates regarding MTC hearings, meetings, and teleconferences, sign up on <http://www.mtc.gov/The-Commission/Email-Updates>.
- Prior to each committee meeting, MTC staff prepares and circulates an audit packet to Joint Audit Program member states. Each packet contains confidential updates and reports on current and recently completed audits conducted by the MTC, including a staff-prepared audit narrative for each ongoing audit.
- Beginning at the Audit Committee meeting scheduled for July 2020, taxpayers under audit may submit a narrative to be included in this audit packet. Narratives must be received at least three weeks before the scheduled Audit Committee meeting and may not exceed two pages in length.

## INCOME TAX JOINT AUDIT PROCESS

- MTC Audit Director assigns an audit to an MTC auditor from audit inventory.
- States decide whether to participate in the audit and return signed audit authorization.
- Auditor contacts the taxpayer and arranges an audit appointment.
- Auditor conducts field audit work at taxpayer's location.
- MTC staff may contact states to determine how to handle a specific issue.
- Auditor completes field work and supplies taxpayer with audit schedules.
- Auditor discusses any proposed audit adjustments with taxpayer.
- Taxpayer reviews proposed audit adjustment.
- Taxpayer may request meeting with MTC audit supervisor, MTC audit director, or MTC Audit Committee at any point during the audit process.
- Audit supervisor reviews audit schedules and report.
- Individual state audit report sent to corresponding state as a recommended audit finding.
- Each state reviews its own completed audit conducted by the MTC.
- Each state will contact MTC if there is an error in the audit report.
- Each state may contact the taxpayer to discuss audit results.
- Each state determines action to take from audit (accept or change).
- Each state sends out notice of assessment (refund) to taxpayers.
- Taxpayer may protest the audit results directly with states or request Multistate Alternative Dispute Resolution (project developed jointly by states and COST).
- MTC does not negotiate audit results.

## SALES TAX JOINT AUDIT PROCESS

The Process is basically the same as the Income Tax Process with the Following Additional Procedures.

- A Computer Audit Specialist (CAS) is assigned to the audit.
- The CAS will assist the auditor in an initial conference call with the taxpayer to discuss the use of electronic records and statistical sampling.
- The CAS provides the taxpayer with a copy of the Commission's computer assisted audit description
- The CAS provides the taxpayer with a copy of the Commission's statistical sampling procedures document
- If appropriate, the CAS and auditor will request electronic records
- If appropriate, the CAS and auditor will perform statistical sample(s).
- When necessary, the CAS will accompany the auditor on field visits.

## MULTISTATE TAX COMMISSION

### PROFESSIONAL AUDIT PROCESS GUIDELINES

The MTC Audit Program pledges to conduct its audits in a professional and timely manner. The Program considers itself to be a representative of each state in the Audit Program. The MTC Staff endeavors to adhere to each state's laws and regulations for both income and sales tax. As a representative of each state, the MTC Staff is bound by the confidentiality laws of each state. The MTC Audit Staff will endeavor to meet this pledge by adhering to the following actions:

- Practice professional courtesy during the audit.
- Request only information that is pertinent to the audit based on each state's requirements.
- Conduct the audit as efficiently as is possible.
- Discuss all audit findings with the taxpayer.
- Make every effort to accommodate taxpayer's schedule.
- Request waivers only when needed to give auditor a reasonable time to complete audit and for states and taxpayers to review audit findings.

The MTC audit states and audit program expect that taxpayers will:

- Respect the states' request to have the MTC conduct the audit on their behalf.
- Extend professional courtesy to the MTC audit staff.
- Supply the information requested to conduct the audit in a timely manner.
- Sign reasonable waiver requests.
- Notify the MTC auditor of any contact the taxpayer has with the states while the audit is being conducted.
- Provide the MTC auditor with any amended returns filed while the MTC audit is being conducted.
- Inform the MTC of any IRS audits completed during the audit.

MTC Audit Manuals are made available on the MTC website.

# Exhibit F: Information Document Request (IDR) Template



Working together since 1967 to preserve federalism and tax fairness

## Information Document Request

Taxpayer Name: _____	FEIN: _____	
Contact Name: _____	Tel: _____	
Auditor Name: _____	Tel: _____	
IDR Date: _____	IDR #: _____	
Request Number	Request Description	Response Date

\_\_\_\_\_  
Auditor's Signature

\_\_\_\_\_  
Taxpayer Representative Signature

Exhibit G: Power of Attorney Form



Power of Attorney

<i>Check below to indicate the appropriate tax</i>		<i>Check below to indicate legal entity form</i>		
<input type="checkbox"/> Income Tax <input type="checkbox"/> Sales & Use Tax		<input type="checkbox"/> Corporation <input type="checkbox"/> Limited Liability Company <input type="checkbox"/> Partnership		
Taxpayer's Name	Federal Employer Identification Number	Telephone Number	Fax Number	
Mailing Address <i>(street and number, city, state, zip code)</i>				

As owner, officer, receiver, administrator, or trustee for the taxpayer, or as party to the audit being conducted by the Multistate Tax Commission.

I hereby appoint: *[enter below the individual appointee(s) name(s), address(es) (including zip code), telephone number(s) and Fax number(s) Do not enter names of accounting or law firms, partnerships, corporations, etc., as the appointee name]*

Appointee Name		Appointee Name	
Appointee Business Name <i>(if applicable)</i>		Appointee Business Name <i>(if applicable)</i>	
Appointee Address <i>(street and number)</i>		Appointee Address <i>(street and number)</i>	
City, State, and Zip Code		City, State, and Zip Code	
Telephone Number	Fax Number	Telephone Number	Fax Number

As attorney(s)-in-fact to represent the taxpayer(s) for the following tax:

Income Tax     Sales & Use Tax     Other: \_\_\_\_\_

Specify the tax year(s) or period(s)

The attorney(s)-in-fact (or any them) are authorized, subject to revocation, to receive confidential tax information and to perform on behalf of the taxpayer(s) the following acts for the tax(es) described above: *[check the box(es) for the powers granted]*

General Authorization (including all acts described below).       Specific Authorization (selected acts described below).

- To confer and resolve any assessment, claim or collection of a deficiency or other tax or fee pending before the Multistate Tax Commission and to attend any meetings or hearings thereto for the specified law identified above.
- To execute petitions, claims for refund and/or amendments thereto.
- To execute consents extending the statutory period for assessment or determination of taxes.
- To delegate authority or to substitute another representative.
- Other acts *(specify)*: \_\_\_\_\_

(The second page of this form must be completed)



This power of attorney revokes all earlier Power(s) of Attorney on file with the Multistate Tax Commission, as identified above for the same matters and years or periods covered by this form, except for the following: *[specify to whom granted, date and address]*

Name	Date
Address (street and number, city, state, zip code)	

Unless limited, this Power of Attorney will remain in effect until the final resolution of all tax matters specified herein.  
*[specify expiration date if limited term]*

Time Limit/Expiration Date

Signature of Taxpayer(s) - If you are an owner, corporate officer, receiver, administrator, or trustee on behalf of the taxpayer, by signing this Power of Attorney you are certifying that you have the authority to execute this form.

**Warning: If this Power of Attorney is not Signed and Dated by an authorized individual, it will be returned as invalid.**

Signature	Title (if applicable)	Date
Print Name		Telephone (    )
Signature	Title (if applicable)	Date
Print Name		Telephone (    )

Exhibit H: Uniform Sales & Use Tax Resale Certificate – Multijurisdiction (rev. 12/9/20)

**UNIFORM SALES & USE TAX RESALE CERTIFICATE — MULTIJURISDICTION**

The below-listed states have indicated that this certificate is acceptable as a resale/exemption certificate for sales/use tax, subject to the instructions and notes on pages 2–6. The issuing Buyer and the recipient Seller have the responsibility to determine the proper use of this certificate under applicable laws in each state, as these may change from time to time. This form was revised as of December 9, 2020.

Issued to Seller: \_\_\_\_\_

Address: \_\_\_\_\_

I certify that:  
 Name of Firm (Buyer): \_\_\_\_\_  
 Address: \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

is engaged or is registered as a  
 Wholesaler  
 Retailer  
 Manufacturer  
 Seller  
 Lessor (see notes on pages 2–4)  
 Other (Specify) \_\_\_\_\_

and is registered for sales/use tax with the below-listed states and cities within which Seller would deliver purchases to Buyer and that any such purchases are for wholesale, resale, or ingredients or components of a new product or service to be resold, leased, or rented in the normal course of business. Buyer is in the business of wholesaling, retailing, manufacturing, leasing (renting), or selling the following:

Description of Business: \_\_\_\_\_

General description of tangible property or taxable services to be purchased from the Seller: \_\_\_\_\_

\_\_\_\_\_

State	State Registration, Seller's Permit, or ID Number of Purchaser	State	State Registration, Seller's Permit, or ID Number of Purchaser
AL <sup>1</sup>		NE	
AR		NJ	
AZ <sup>2</sup>		NM <sup>19</sup>	
CA <sup>3</sup>		NC <sup>20</sup>	
CO <sup>4,5</sup>		ND	
CT <sup>6</sup>		OH <sup>21</sup>	
FL <sup>7</sup>		OK <sup>22</sup>	
GA <sup>8</sup>		PA <sup>23</sup>	
HI <sup>9</sup>		RI <sup>24</sup>	
ID <sup>10</sup>		SC	
IL <sup>11</sup>		SD <sup>25</sup>	
IA		TN <sup>26</sup>	
KS <sup>12</sup>		TX <sup>27</sup>	
KY <sup>13</sup>		UT	
ME <sup>14</sup>		VT <sup>28</sup>	
MD <sup>15</sup>		WA <sup>29</sup>	
MI <sup>16</sup>		WI <sup>30</sup>	
MN <sup>17</sup>			
MO <sup>18</sup>			

I further certify that if any property or service so purchased tax-free is used or consumed by Buyer so as to make it subject to sales/use tax, Buyer will pay the tax due directly to the proper taxing authority when state law so provides or inform the Seller for added tax billing. This certificate shall be a part of each order that Buyer may hereafter give to Seller, unless otherwise specified, and shall be valid until canceled by Buyer in writing or revoked by the city or state.

Under penalties of perjury, I swear or affirm that the information on this form is true and correct as to every material matter.

Authorized Signature: \_\_\_\_\_  
 (Owner, Partner, or Corporate Officer, or other authorized signer of Buyer)

Title: \_\_\_\_\_

Date: \_\_\_\_\_

## INSTRUCTIONS

In order to comply with state and local sales tax law requirements, the Seller must have in its files a properly ~~completed~~ exemption certificate from all of its customers (Buyers) who claim a sales/use tax exemption. If the Seller does not have this certificate, it is obliged to collect the tax for the state in which the property or service is delivered.

Generally, a Buyer must be registered as a retailer for sales/use tax in states where the Buyer has sales/use tax nexus. The sales/use tax registration number(s) should be entered on this certificate. A Buyer has sales/use tax nexus in a state if the Buyer has physical presence in that state or has made sufficient sales to customers in that state to have sales/use tax economic nexus. The threshold of sales activity needed to establish sales/use tax economic nexus may differ by state. If the Buyer is entitled to claim a resale sales tax exemption or exclusion, the Buyer should complete the certificate and send it to the Seller at the time of purchase or as soon thereafter as possible. If the Buyer purchases tax free for a reason other than resale, ingredient or component exemption, the Buyer cannot use this form and must provide to the Seller the proper state exemption certificate for that specific exemption.

### Caution:

Misuse of this certificate by Buyer, Seller, lessor, lessee, or the representative thereof may be punishable by fine, imprisonment or loss of right to issue or accept a certificate in some states or cities.

### Notes:

1. Alabama: Each retailer shall be responsible for determining the validity of a purchaser's claim for exemption.
2. Arizona: This certificate may be used only when making purchases of tangible personal property for resale in the ordinary course of business, and not for any other statutory deduction or exemption. It is valid as a resale certificate only if it contains the purchaser's name, address, signature, and Arizona transaction privilege tax (or other state sales tax) license number, as required by Arizona Revised Statutes § 42-5022, *Burden of proving sales not at retail*.
3. California:
  - a) This certificate is not valid as an exemption certificate. Its use is limited to use as a resale certificate subject to the provisions of Title 18, California Code of Regulations, Section 1668 (Sales and Use Tax Regulation 1668, Resale Certificate).
  - b) By use of this certificate, the purchaser certifies that the property is purchased for resale in the regular course of business in the form of tangible personal property, which includes property incorporated as an ingredient or component of an item manufactured for resale in the regular course of business.
  - c) When the applicable tax would be sales tax, it is the Seller who owes that tax unless the Seller takes a timely and valid resale certificate in good faith.
  - d) A valid resale certificate is effective until the issuer revokes the certificate.
4. Colorado, Hawaii, Illinois, and New Mexico: these states do not permit the use of this certificate to claim a resale exemption for the purchase of a taxable service for resale.
5. Colorado: Sellers should review 1 Code Colo. Regs. 201-1, Rule 39-26-105-3 (Documenting Exempt Sales) prior to accepting this form. The Colorado Department of Revenue collects and administers the state sales and use taxes and the sales and use taxes of certain cities, counties, and special districts (see department publication DR 1002). Use of this form (along with the other documentation required by department rule) is acceptable for taxes administered by the Colorado Department of Revenue. This form may not be accepted by self-collecting Colorado home-rule cities. Sellers are advised to contact those cities directly for further instruction.
6. Connecticut: This certificate is not valid as an exemption certificate. Its use is limited to use as a resale certificate subject to Conn. Gen. State §§12-410(5) and 12-411(14) and regulations and administrative pronouncements pertaining to resale certificates. The good faith of the seller will be questioned if it has knowledge of facts which give rise to a reasonable inference that the purchaser does not intend to resell the property, as, for example, knowledge that the purchaser of particular merchandise (or service) is not engaged in the business of selling that kind of merchandise (or service).
7. Florida: Allows the Multistate Tax Commission's Uniform Sales and Use Tax Resale Certificate – Multijurisdiction for tax-exempt purchases for resale; however, the selling dealer must also obtain a resale authorization number from the Florida Department of Revenue at [floridarevenue.com/taxes/certificates](http://floridarevenue.com/taxes/certificates), or by calling 877-357-3725, and entering the purchaser's Florida *Annual Resale Certificate* number.

Exhibit I: Audit Satisfaction Survey



Taxpayer, and Subsidiaries

**AUDIT SATISFACTION SURVEY**

**Thank you for taking a few moments to complete this survey to relay your experience of your recent MTC audit. Your feedback is important to us and will help us improve our audit process and procedures and enhance the overall MTC audit experience. Please send your completed survey to Holly Coon, Director of the Joint Audit Program- [hcoon@mtc.gov](mailto:hcoon@mtc.gov).**

For each item identified below, circle the number to the right that best fits your judgment of its quality. Use the following scale to select the quality number

1-far below expectations, 2-below expectations, 3-met expectations, 4-exceeded expectations, 5-far exceeded expectations

Based upon your recent MTC audit, please rate each of the following, if applicable:					
	1	2	3	4	5
1. The auditor's courtesy, professionalism, and knowledge	1	2	3	4	5
2. The auditor's responsiveness to telephone calls, written requests, and e-mails	1	2	3	4	5
3. The auditor's explanation and presentation of the MTC audit procedures and audit manual	1	2	3	4	5
4. The explanation of the information and records requested to complete the audit	1	2	3	4	5
5. Appropriate length of time to conduct the audit	1	2	3	4	5
6. The auditor's knowledge of tax and audit issues	1	2	3	4	5
7. The auditor's explanation of the audit findings upon completion of the audit	1	2	3	4	5
8. Your overall audit experience	1	2	3	4	5

Do you have any specific comments about your audit experience?

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Do you have any suggestions to improve our audit process?

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May we contact you about your responses? If so, please provide the following information:

Name:

Telephone Number:

e-mail address:

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Exhibit J: Audit Evaluation Form



MULTISTATE TAX COMMISSION

**MTC AUDIT EVALUATION**

TAXPAYER:  
 TYPE OF TAX:  
 AUDIT PERIOD:  
 YOUR STATE:  
 YOUR PHONE NUMBER:

DATE:  
 DATE REPORT RECEIVED:  
 OFFICE:                      HOURS:  
 MTC AUDITOR:  
 YOUR NAME:

Please complete this questionnaire after your review of the Multistate Tax Commission's audit for the taxpayer named above. The following questions are designed to encourage constructive feedback from states who have participated in this audit. Your responses and those of other participating states will be used to make the MTC audit program more effective and more responsive to your needs. Please mail the completed questionnaire to:

Holly Coon, Audit Director  
 Multistate Tax Commission  
 444 North Capital St NW Suite 425  
 Washington DC 20001-1538

1. Did the auditor properly interpret and apply your state's law, regulations and policies? Rating: \_\_\_\_\_  
 Comments: \_\_\_\_\_  
 \_\_\_\_\_
2. A) Were the audit narrative and schedules complete and clearly presented? \_\_\_\_\_ Rating: \_\_\_\_\_  
 B) Did it adequately support the auditor's recommendation? \_\_\_\_\_ Rating: \_\_\_\_\_  
 C) Your overall rating of the quality of this audit? \_\_\_\_\_ Rating: \_\_\_\_\_  
 Comments: \_\_\_\_\_  
 \_\_\_\_\_
3. What changes would you suggest to improve the quality of the Multistate Tax Commission's audits? \_\_\_\_\_  
 \_\_\_\_\_
4. Was the MTC audit report corrected or changed? \_\_\_\_\_  
 If yes, has the corrected report been submitted to the MTC program coordinator? \_\_\_\_\_  
 Is the correction a result of out-dated or incorrect information in the MTC audit manual? \_\_\_\_\_  
 If yes, please submit correct information for incorporation into the MTC audit manual.
5. What portions of the audit did you consider were well done? \_\_\_\_\_  
 \_\_\_\_\_
6. Did you receive the audit results in sufficient time to issue your adjustments? \_\_\_\_\_ Rating: \_\_\_\_\_  
 Comments: \_\_\_\_\_
7. If your state recommended this case for audit, did the results meet your expectations? \_\_\_\_\_ Rating: \_\_\_\_\_  
 If so, why? Why not? \_\_\_\_\_  
 \_\_\_\_\_
8. Do you have any suggestions for improving the selection of companies the MTC audits, or specific recommendations for audit?  
 \_\_\_\_\_

(Please attach additional explanation if necessary)

\*\* Please use the following guidelines when making your ratings for the designated rating areas.  
 1.0 to 1.9 = Poor                                      2.0 to 2.6 = Average  
 2.7 to 3.3 = Better than average                3.4 to 4.0 = Excellent

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