Sales & Use Tax Audit Survival: Texas Focus

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Agenda

- Introduction: What is a “Successful” Audit?
- Audit Procedures Discussion
  - Audit Notice
  - Initial Preparation
  - Kickoff / General Guidelines
  - Responding and Negotiating
  - Finalizing the Audit
- Technical Overview: Texas Specifics
- Q & A
Question: What is a “Successful” Audit?

- Common Responses/Opinions:
  - No change/No tax due?
  - Minimum direct efforts & business disruption?
  - Net credit/refund?
  - Valid tax errors & assessment, but lessons learned?
  - All or part of the above?
Question: What is a “Successful” Audit? (continued)

- *Anybody But Me?*
Common Traits of a Successful Audit Outcome

- The audit result is as close to “no change” as possible, without being materially erroneous with respect to assessments OR credits/overpayments
- The audit process and result were reasonable and fair, given the facts
- The audit field work and completion were performed and completed in an acceptable timeframe and with a manageable level of effort required by the taxpayer

Conclusion: A successful audit outcome can be described many ways and with varying attributes. Inevitably, a successful audit outcome will most likely result from the following: a) good and timely compliance procedures, b) accurate, complete records, c) a good understanding of the state’s general audit processes and d) good communication and rapport with the auditor
Audit Procedures: Audit Notice
Notification & Audit Questionnaire

- All notifications of a jurisdiction’s intent to audit should be in writing
- Ensure the information on the notification is accurate
  - Correct company/taxpayer name, address, taxpayer ID number and/or FEIN
  - Are the audit reporting periods covered within statute?
- Questionnaire response – be measured, efficient and clear!
  - Focus on the facts/issues at hand – if a question is not pertinent to the tax in question, don’t focus on it or “write a book”
  - Carefully and clearly address nexus questionnaires
  - Don’t be afraid to discuss the audit and your issues with an expert
- Respond timely and document EVERYTHING
  - In most cases, the audit is not going away, so best to deal with it as quickly and efficiently as you can
  - Establish a dedicated audit file to keep track of correspondence and index all information shared with tax authorities
Audit Procedures: Initial Preparation
Work to do Before your First Meeting

- Review your prior audits
  - What was reviewed previously? What was assessed?
  - Any post-audit changes to the business - procedures, processes, recordkeeping?
- Know your records
  - Are available records electronic, paper or both? Availability and access?
  - Any system changes during the audit periods?
  - Are there any gaps in your data or records? If so, can you document/work around them? If gaps do exist, be prepared to discuss these early on
- Examples of documentation typically required:
  - Electronic accounting data – sales, fixed assets, expenses, journal entries, etc.
  - Tax returns and supporting workpapers
  - Purchase Orders, Bids, SOW’s, Contracts, Invoices, Work tickets
  - Customer resale and/or exemption certificates, if applicable
  - Other – job illustrations, photos, etc.
Work to do Before your First Meeting (continued)

- Once notified, try to identify any major issues before field work begins
  - What is your position on the taxability of a given transaction? Can you support it?
  - Proper documentation is KEY – contracts, bids, invoices, PO’s, etc.
  - Resale and exemption certificates in lieu of tax charged/collected are very important

- If available, review the tax authority’s audit manual
  - The Texas audit manual is available online: https://comptroller.texas.gov/taxes/audit/manuals/fundamentals/ch5.php
Work to do Before your First Meeting (continued)

- Be familiar with the basics of authority – applicable law, regs, letter rulings, etc.
  - You DON’T have to be a tax expert, but you DO need to know the general tax rules that apply to your business
- New Construction vs. Repair/Remodeling vs. Maintenance
- Customer/job type and potential impact on taxability – exempt entity, manufacturing, etc.,
- Contract form: Lump-sum, GMP, T&M, etc.,
- Tax paid/accrued on purchases (or not) – incorporated materials, CAPEX, software, leases, services, etc.
- Use tax accruals - purchases from non-registered OOS vendors and self-reporting use tax
- Tax Reserves – materiality, probable and estimable
Audit Procedures: Audit Kickoff and General Guidelines
Getting started with the Auditor

- Why am I being audited?
  - Random Selection – most common reason for audit generation
  - Priority 1 Audit - large taxpayer
    - Large revenues and/or significant taxable sales reported
  - Audit Leads
    - Authorities were alerted by another entity; your customer or vendor has been audited – typical ways your company has been identified
  - Reporting History
    - Variances in reporting, delinquent returns, extraordinary items, M&A activity can lead to notice and audit
  - Prior Assessments
    - It goes without saying, if you were assessed a material amount previously, the tax authorities will likely be paying you another visit
Getting started with the Auditor (continued)

- Request copies of your prior audits
  - If you don’t have a copy of a prior audit, you may ask for it

- Statute waivers
  - A waiver keeps reporting periods open (“tolling”) that would otherwise close with normal SOL for both assessments and credits/overpayments
  - Allows time to prepare for the audit and to schedule around business needs, schedules/deadlines and resource limitations
  - An initial statute waiver may be requested by the auditor right away
  - Beware of waiver and auditor “disappearing acts”; the auditor should keep on schedule and properly adjudicate the audit within an acceptable timeframe
  - Time is money – the longer the audit takes to complete, the more interest will accrue on any proposed assessment – waivers should be used judiciously
  - Waivers may be necessary and favorable or unnecessary/unfavorable – let facts and requirements determine their use
“Management 101”: Who within your organization will handle the audit?
- Assign a dedicated point of contact for the auditor and maintain consistent control of the auditor’s access to your office(s), personnel and business records

Be prepared to discuss the business in some detail
- Sales – overview of customers, project types, contracts and billing formats
- Receipt and maintenance of exemption certificates (if applicable)
- Purchases – record format(s), availability, handling of tax decisions, use tax
- Other items – Pcard transactions, etc.
- Rely on your colleagues and other experts when needed
- Auditor experience varies greatly: Do not assume the auditor knows your business, the industry or applicable tax authority better than you!
Getting started with the Auditor (continued)

- Worth repeating: Auditor office visits
  - Auditors should be provided a (reasonably comfortable) work space away from other employees, if possible
  - Auditors should have a single point of contact within the company
  - Auditors should be escorted and have controlled/monitored access while on site
  - Brief your employees ahead of time: Other than pleasantries, employees should not communicate with the auditor; all questions should be referred to the assigned point of contact
Getting started with the Auditor (continued)

- Audit Scope and Methodology
  - Audit Sampling
    - Discuss sampling in advance (random, block, stratified/statistical)
    - How best to handle credits – materiality, detail, mirror sample, other?
    - If any business changes or limitations (M&A, new accounting systems, gaps in records, etc.), make sure these are addressed; different record groups and formats and/or missing records may necessitate separate populations and possibly separate auditing methods
    - If the audit requires a statistical sampling methodology (CAMS, etc.), a sample evaluation is recommended; outside advisors may help with this
    - Sampling notification should be IN WRITING and provided prior to both sample development and beginning the review – review this carefully!
    - Make sure you address any questions/issues/concerns regarding audit approach and sampling BEFORE you agree/sign-off on the notification
Getting started with the Auditor (continued)

▪ Send confirmation emails as follow-up to all in-person meetings
  ▪ ALL communications should be memorialized in writing with return receipt confirmation
▪ Establish a rapport with the auditor to the best of your ability
  ▪ Preparation, good facts and good documentation are paramount, but successfully completing the audit is also heavily influenced by how you communicate with and manage your relationship with the auditor
Audit Procedures: Responding and Negotiating
Audit Data and Records

- Sales and purchase data populations required for the audit are always generated and handled by the taxpayer; auditors should under no circumstances be provided direct access to your systems to gather source data.

- Data generated will be in accordance with agreed upon scope and procedures per the audit plan:
  - Periods covered
  - Accounts of interest
  - Groups/populations

- It is best if the person handling the audit also generate the data.

- Data should be reconciled to internal control totals prior to hand-off.
Audit Data and Records (continued)

- Field Work: If possible, the auditor should review records on-site and under controlled circumstances, particularly sales and fixed assets
  - No surprises – review your jobs/contracts and fixed asset purchase records in advance and have a reasonable idea of where you stand
    - What jobs/types of work are being reviewed?
    - What is the contract form?
    - Who is the customer and what is their tax status?
- Manage access to and duplication/copying of customer contracts and fixed asset purchase documentation
- If you are missing resale or exemption certificates from customers – get them as soon as you can! You can put forth a “good faith” argument if the certificates are facially complete, correct and timely with respect to the transactions they cover. However, if any of these elements are missing, no “good faith” exists. Auditors vary greatly in their approach and acceptance of certificates
Responding and Negotiating

- Monitor the auditor’s progress throughout field work; if the audit is not delayed on your end and still not progressing, inquire and push as needed
- Make every effort to resolve any issues directly with the auditor at the field level
- If you are at an impasse, request a meeting with the auditor’s supervisor or manager – you may do this at any time during the audit
- Remember – facts and documentation are key – know your records and the general tax applicability to your transactions
- Ask your advisors to assist if and when needed – a few questions and answers early may save tax, penalties and interest later
Responding and Negotiating (continued)

- Lose a Battle / Win the War, Dollars and Dimes or the Sum of the Parts?
  - You can be correct on a particular issue and still not prevail
  - Individual audit issues should be viewed against the whole audit outcome
    - How material is the issue?
    - How strong are your facts & documentation?
    - What are the costs/benefits of contesting?
    - Should I pay a partial amount on items I owe to stop interest running?
  - If you have established a tax reserve, know your settlement threshold
  - ALWAYS check the auditor’s schedules and workpapers, especially if you have battled and prevailed on a particular issue that has (reluctantly) been conceded in your favor
Audit Procedures: Audit Conclusion
Finalizing the Audit

- Review the auditor’s final schedules
  - Make sure schedules reflect what has been discussed and agreed to
  - Amounts, transactions and dates should reconcile to original data
- In addition to your acknowledgment at the exit conference, confirm your agreement (or disagreement) with proposed audit results and schedules in writing with exams/schedules properly referenced or attached with the correspondence. Again, No Surprises!
- In the exit conference, make sure you understand your protest rights and appeal deadlines if you are in disagreement with the proposed assessment
Finalizing the Audit (continued)


- Key Highlights:
  - You are entitled to speak with an auditor’s supervisor or manager at any time during the audit process.
  - You may request an informal reconciliation conference with the auditor and their supervisor/manager to try to resolve differences.
  - You can request guidance on a particular transaction and set of facts during the audit from Tax Policy via the auditor.
  - Review and familiarize yourself with your options well before the audit is finalized.
Finalizing the Audit (continued)

- Texas Notification of Audit Results
  - Covers all taxes and/or fees audited, regardless of outcome (i.e., tax due, credit/refund, etc.)
  - The notification becomes final on a specified date explicitly noted within the notification (i.e., the “final date”)
  - Payment or appeal must be completed (postmarked) on or before the final date. This is normally 30 days from the date of notification
  - Once the notification is final, appeal/redetermination cannot be accomplished without payment in full
    - Payment in full & WITHIN 6 months after final date – refund request & hearing
    - Payment in full & 6 months or longer AFTER final date – refund request for reporting periods still open under the normal SOL (4 years from the due and payable date)
Finalizing the Audit (continued)

- **Appeals Process (Audit Redetermination or Payment & Refund Request)**
  - A Petition for Redetermination must be in writing and accompanied by a statement of grounds outlining issues contested and supporting facts related to the proposed assessment or refund request (34 TAC §1.7)
  - Criteria/considerations for penalty & interest waiver: 34 TAC §3.5
  - Due date requirements: Texas Tax Code §111.009; 34 TAC §1.5
Alternative Audit Processes

- Do-It-Yourself: Texas Managed Audit Program: https://comptroller.texas.gov/taxes/audit/managed.php
  - Granted at the sole discretion of the Comptroller to qualifying taxpayers (i.e., the program is not a statutory right)
  - Allows qualifying taxpayers to self-perform portions of the sales/use tax audit, including, but not limited to audit planning/scheduling record pulls and taxability determinations
  - If you are underpaid (i.e., you will owe) and you have available internal and/or external resources to handle the day-to-day aspects of the audit, this may be a good option
  - Greater control, less intrusive
  - Penalties and part or all of interest may be waived
Tax Technical Overview - Texas
Sales/Use Tax Decision Inputs

My Business

Job Type(s)

Who is my Customer?

What is the Contract Form?
Technical Highlights: Texas

- **My Business**
  - General/prime contractor, Subcontractor, Other (engineering, supplier, etc.)

- **Job Type – what type of work am I performing?**
  - New Construction Labor
    - Excluded from tax (i.e., a non-enumerated service)
    - Materials are taxable to the contractor and/or the customer, depending on contract form
  - Repair/Remodeling Services
    - Taxable, depending on the customer and/or type of work
  - Maintenance of Real Property
    - Generally non-taxable; specific requirements must be met
  - Engineering, project management, design, etc., are generally non-taxable/non-enumerated services
Technical Highlights: Texas (continued)

▪ Who is My Customer?
  ▪ Non-Exempt Commercial
    ▪ Repair, remodel or restoration services to non-residential customers are taxable
  ▪ Non-Exempt Residential
    ▪ Repair, remodel or restoration services to residential customers are not subject to tax
  ▪ Exempt Entities (gov’t., not-for-profit, etc.)
    ▪ Federal and State government and instrumentalities are always exempt
    ▪ Not-for-profit (501(c)(3), etc.) exempt but must provide exemption certificate
  ▪ Other (manufacturer, etc.)
    ▪ Portions of labor & materials may be exempt but will require exemption certificate
Technical Highlights: Texas (continued)

- New Construction: Contract form “in a vacuum”
  - If you are performing new construction services and your customer/owner is claiming an exemption, the contract between the parties MUST be a valid separated (i.e., T&M) contract!

- Lump-sum vs. separated new construction contracts
  - Lump: Contractor is a consumer and pays tax on all materials (incorporated, supplies/consumables, rentals and taxable services)
    - Contractor should generally not issue a resale certificate to vendors; if a tax-free inventory is maintained, use tax accrual & remittance when items are pulled from inventory & used/consumed
  - Status of your customer has no bearing on tax treatment of materials
  - Separated: Labor charges are separated from incorporated materials
    - Contractor may issue a resale certificate for incorporated materials
    - A contractor must pay tax on non-incorporated materials (supplies/consumables, rentals, etc.)
Technical Highlights: Texas (continued)

- Repair & Remodeling: Contract form is generally not determinative of tax charged to the customer/owner
  - An exemption claimed by the customer/owner must be validly documented with an exemption certificate (unless gov’t / “always exempt” status applies)
  - Better safe than sorry! ALWAYS request, obtain and review exemption certificates when customer/owner claims an exemption
- Residential vs. non-residential determines if tax is charged to the customer/owner (or not); Non-residential/commercial R&R is taxable; Residential R&R is non-taxable
  - Tax base is “total sales price” minus separately stated charges for unrelated services. If the services are a) non-taxable/non-enumerated, b) separately stated, and c) normally provided on a stand-alone basis, they may be excluded from tax base
Technical Highlights: Texas (continued)

▪ Repair & Remodeling: Material purchases
  ▪ Contractor must pay tax on all machinery, equipment, unincorporated materials and supplies used but not incorporated into the realty. No credit for tax paid is allowed
  ▪ Contractor may issue a resale certificate for a) purchases of materials incorporated into customer/owner’s realty
  ▪ Taxable services may also be purchased tax-free for resale if the services are essential to the performance of the R&R service. Examples include, but are not limited to, landscaping and surveying services
  ▪ Materials used in R&R services performed for certain exempt entities (gov’t., religious, education, public service organizations) have special guidelines. See 34 TAC §3.357(b)(5).
Technical Highlights: Texas (continued)

- **Exemption & Resale Certificates**
  - All certificates must be completed, signed and dated by the person issuing them
  - Best practice: Certificate acceptance and review should be part of customer acceptance / contract review / closing processes
  - Certificates should be organized and on-hand before an audit occurs
- **What is “Good Faith” acceptance?**
  - Certificates are facially complete, correct and timely
  - 34 TAC §3.287(d)(2): A sale is exempt if the exemption certificate is accepted in good faith at the time of the transaction and the seller lacks actual knowledge that the claimed exemption is invalid
Technical Highlights: Texas (continued)

• Exemption & Resale Certificates
Texas Statutes & Regulations

- Statutory and Regulatory Authority
  - Property Consumed in Improvement to Real Property:
    - Texas Tax Code §151.056
  - Real Property Services
    - Texas Tax Code §151.0048
  - Contractors
    - 34 TAC §3.291
  - Nonresidential Real Property Repair, Remodeling and Maintenance
    - 34 TAC §3.357
  - Exempt Entities:
    - 34 TAC §3.322
  - Resale and Exemption Certificates
    - 34 TAC §3.285; 34 TAC §3.287
    - [https://comptroller.texas.gov/taxes/sales/forms/](https://comptroller.texas.gov/taxes/sales/forms/)
Questions
The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.
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