SALES AND USE TAX AUDITS:

HOW TO PREPARE YOUR BUSINESS

Avalara

GUIDE

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Tax compliance done right

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Introduction

Expanding into new markets, adding new sales channels, and launching new products are great for growing revenue but these activities can affect sales and use tax obligations. It's important for companies to consider how changes to their business may impact their audit risk. Certain factors make a business more likely to be audited. Companies may be on the hook for paying taxes owed, plus penalties, should an audit not go in their favor.

Unfortunately, many businesses aren't fully prepared to handle an audit. This guide will help you understand your potential risks and what to expect during an audit. You'll also find strategies that may reduce the likelihood of a failed audit, make the audit process smoother, and ultimately save your company money.

The ongoing impact of economic nexus on sales tax compliance

> **State audit divisions continue to look for companies that fail to manage their taxes correctly.**

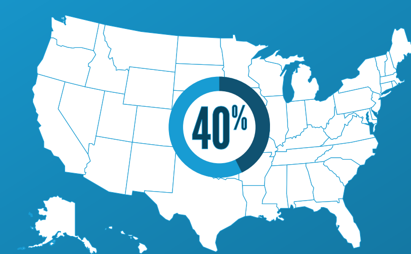
After all, sales tax accounts for more than 40% of total state and local taxes in some states and goes a long way toward filling a state's budget coffer.

The most recent annual report from the California Department of Tax and Fee Administration shows the sales and use tax audit program audited approximately 1% of active tax accounts and uncovered net deficiencies of nearly $477.3 million during fiscal year 2021–2022. Tennessee's Department of Revenue collects more than 25 different taxes and fees. The department audited 30,795 tax accounts of all types during fiscal year 2021–2022 and assessed approximately $176 million in tax.

In addition to uncovering accounting discrepancies, states may also try to track down unregistered remote sellers. All states with a general sales tax now have economic nexus laws that create a tax collection obligation based on sales or transaction volume, meaning physical nexus is no longer the only trigger.

The immediate impact of the new rules were seen in California where 2,185 retailers registered because of the Supreme Court's 2018 decision in South Dakota v. Wayfair, Inc. Those retailers initially reported more than $39 million in taxes due during fiscal year 2018–2019.

To give businesses time to adapt to these new laws, states were initially lenient when it came to enforcement. Those days are gone: States now expect remote sellers with economic nexus to register and comply with applicable sales tax laws.



Sales tax accounts for more than 40% of total state and local taxes in some states.

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Which businesses are most likely to be audited?

> You may be more likely to be audited just because of the nature of your business.

Certain industries tend to put themselves at risk in two ways. One is simply how they operate. The other reason they get targeted is because of their history of making mistakes while trying to comply with complicated and ever-changing sales and use tax regulations.

A study conducted in 2021 by Avalara and Potentiate included responses from 500 U.S. companies in software, manufacturing, retail, and other industries. Half were small and midsize businesses (SMB) with 20–499 employees and the other half were emerging small businesses (ESB) with fewer than 20 employees.

Of the key verticals measured, manufacturing companies have the highest audit rate (18%).

Aberdeen Strategy & Research surveyed more than 200 businesses making between $100,000 and $5 million per year and found 72% had been audited in the previous five years.

In addition to industry, the report also found auditors more frequently pore over the books of companies that meet these four criteria:

- **Have been audited before, especially if they have a history of negative audits**
- **Report a high sales volume**
- **Report many exempt sales**
- **Have a high ratio of exempt sales to total sales**

If your supplier is audited and you're a seller, your risk of being audited increases. The reverse is true as well.

If any of these audit red flags apply to your business, it's especially important to evaluate your sales and use tax liability and put procedures in place to reduce risk.

Which noncompliance issues do auditors most frequently catch?

While there are many reasons why a business might make errors, the Potentiate and Aberdeen studies both identified five top reasons businesses incur penalties from audits:

- Failure to register in states where they have a tax obligation (nexus)
- Missing exemption certificates
- Sales tax rate or rule errors
- Late filings
- Consumer use tax liabilities

Common exemption certificate errors include:

- Missing a signature or failure to include the signature of an accepted signer
- Missing an issue date
- Incorrect claim type or any certificate not accepted
- Document not recognized by the state authority in the form of a letter, email, or government license
- Including a name or address other than the direct buyer and seller
- Including a state tax identification number that doesn't align to the correct state

Industries like manufacturing, retail, and hospitality often face greater risks of use tax noncompliance

Failing to properly assess consumer use tax ranks as one of the most common compliance mistakes made by companies. A buyer owes consumer use tax when the seller doesn't collect or remit the full amount of tax owed on a purchase of tangible personal property, some virtual goods such as a software or digital content, or some services. [Certain industries](), like manufacturing, retail, and hospitality, often face greater risks of use tax noncompliance. Regulations for these businesses are more complex and can vary from state to state. These industries may also see more companies issuing direct pay permits to their suppliers, which allows those suppliers to forgo charging any sales tax. The purchasers then assume all responsibility to self-assess consumer use tax on purchases that should be taxed.

The Wayfair decision increased the administrative burden for consumer use tax. In many cases, economic nexus rules require remote sellers to collect only the state portion of the tax and not local tax, which is also due. Yet purchasing companies bear the burden to prove that all tax has been correctly paid on everything they buy.

A company can be tripped up in a variety of ways when it comes to consumer use tax. For example, a manufacturer that buys a forklift in Oregon, then moves it to Washington to replace broken equipment, may owe consumer use tax in Washington against the original or fair market value. Or a New York business that buys 50,000 bolts from an out-of-state seller for resale and manufacturing, then uses 2,000 of those bolts to build displays for its own use, may owe consumer use tax in New York. Those are just a couple of scenarios; there are many more.

Senergy Medical Group
Medical equipment

Senergy Medical Group, a provider for devices and nutrition products to manage chronic pain and cellular health, discovered during an audit that it hadn't been assessing consumer use tax properly.

The company knew automating with Avalara would provide a smarter way than maintaining complicated spreadsheets or creating expensive custom solutions.

"We're prepared now because we can show them that we're making a good-faith effort to make sure we approach use tax correctly. We also have our receipts in the system, and we can pull them up at a moment's notice without a lot of digging," says former company CFO Linda Taylor.

Read the full story

The true cost of an audit: It's more than money

Audit penalties can vary widely depending on the size of the business. The Potentiate study found that 62% of audited businesses surveyed incurred penalties. Penalties were higher among certain industries. Manufacturers incurred penalties most frequently.

Considering how expensive an audit can be, it's wise to assess your potential exposure before it happens to you. Ask yourself these three questions:

- **What are your average total annual sales in a state?**
- **What percentage of your total sales is exempt?**
- **What percentage or dollar amount of your exempt sales isn't covered by a valid certificate?**

One way to estimate sales tax liability is to take that amount that isn't covered by a valid certificate and multiply it by the average sales tax rate, interest rate, and penalty rate.

This figure won't account for the loss of time you'll spend responding to an audit, however. According to responses from the Aberdeen study, 64% of audits take between one and four weeks, although a small percentage stretched out for longer than four months.

The Potentiate survey found that the SMBs surveyed spent an average of $4,679 in estimated staff wages responding to and managing an audit while the ESBs spent an average of $1,471. Businesses dedicated an average of 35 hours responding to and managing the audit process.

Preparing for an audit upfront can save you the headache of filing appeals, the results of which could still end up cutting into your bottom line. California's audit department settled 487 sales and use tax cases during fiscal year 2021–2022 for a combined $193.4 million.

Boy Scouts of America
Nonprofit

Trying to collect and reconcile tax data was a burden for Boy Scouts of America, who used two different tax compliance systems before the organization found Avalara.

Since implementing Avalara solutions, participating in audits has become much easier.

"The reports I need are saved, so I just pull the periods needed," explains Marnie Harris, who leads the organization's tax team. *"All of our certificates are online. Everything is in one place."*

In an audit, BSA didn't owe a penny.

"Month in and month out, I'm saving tons of time," Harris says.

Read the full story

What to expect (and avoid) during an audit

Even if you think you've done everything correctly, audits can be intimidating. The best way to weather a sales and use tax audit is to prepare.

Conducting your own audit before you get a notice from the state can help you to find and correct errors before they result in penalties. During a sales tax audit, the auditor will typically take a sample of your purchase transactions, including invoices, credit card charges, etc., from a four-year period and determine the percentage out of compliance. If you lack proper documentation to show you've paid sales tax, self-assessed use tax, or are tax-exempt, an auditor may find that you owe penalties and fees on a greater number of transactions than those that are incorrect.

Auditors often start by examining sales tax exemption certificates. If you don't know how many certificates you have on file, what percentage will expire in the next month, or how many are missing – or if your staff spends a lot of time manually updating expired or invalid certificates – it may be time to reform your process.

Wholesale Auto Supply
Distribution

Wholesale Auto Supply, a cooperative owned by a group of about 200 automobile dealers, struggled with tax complexity. Items it sells might be taxable in one state and exempt in an adjacent state. Within the same jurisdiction, the same items might be taxable for one use and exempt for another.

With Avalara, managing exemption certificates and finding the right documents for audits is easy.

"I interact with quite a few accountants, and I always recommend this automated process for their clients, especially in case of an audit. With all the information Avalara puts at our fingertips, and the many resources that the company provides, I feel comfort," says company CEO Andrea Karsian.

Read the full story

Exemption certificates

The combination of economic nexus laws and expanding omnichannel B2B sales are driving the need for businesses to gather certificates in near real time online. It's crucial to have reliable procedures in place to manage certificates, especially if any of your vendors are teetering on shutting their doors. Once a company goes out of business, you may find it difficult or impossible to get documentation requested during an audit. Should that happen, your business will likely be stuck with sales tax liability.

Consumer use tax

The audit process is a little different on the consumer use tax side. All fixed assets, such as computers and equipment, are scrutinized and the auditor will expect you to show invoices.

Use tax auditors zero in on companies with high purchasing power, such as manufacturers, retail stores, and medical facilities. And compared to sales tax penalties, which can be reduced, use tax liabilities can be more difficult to appeal and audit processes can vary between states. According to a former auditor, consumer use tax liability is usually bigger than sales tax liability.

In most cases, you'll have a period of time to gather requested information before the auditor shows up. Avoid having too many people involved in the audit process to prevent miscommunication between staff and the auditor. Lastly, be professional. A positive rapport can be the deciding factor in avoiding stiff penalties.

Remember, Avalara doesn't provide legal or accounting advice. If you find yourself confronted with an audit, please contact a qualified professional.

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Automating sales and use tax compliance can help

Manually managing exemption certificates and consumer use self-audits is labor intensive, inefficient, and prone to errors. Yet, a study by Hanover Research found that just 10% of global businesses surveyed have mostly or fully automated audit management and only 3% have fully automated exemption certificate management. Nearly 400 finance and tax professionals at SMB and enterprise companies based in Canada, United States, U.K., and five other European countries responded to the survey.

Automating your company's sales and use tax compliance process can go a long way toward reducing your audit risk. For example, should the auditor knock on your door, you'll have an easier time providing the necessary documents to prove your case.

Diamondback Branding
Retail and ecommerce

Based in Austin, Texas, Diamondback Branding supplies promotional products such as printed and engraved drinkware, coolers, and earbuds. The company's rapid growth brought additional tax complexity and scrutiny.

"*We hit the point where everybody was looking at us. ... We were breaking nexus thresholds in dozens of states. It quickly became a nightmare,*" says Diamondback founder and Chief Executive Officer William Lovelace.

The company turned to Avalara to make tax compliance easier and reduce risk.

"*We wanted to get ahead of the game,*" *Lovelace confirms.* "*We preemptively took action to avoid a bad audit.*"

With Avalara, Lovelace says that Diamondback feels secure.

Read the full story

AvaTax for Accounts Payable

AvaTax for Accounts Payable provides a reliable, automated process for consumer use self-assessment. AvaTax for Accounts Payable seamlessly integrates with Avalara AvaTax, Avalara's tax calculation software, and Avalara Returns to prepare and file sales and use tax returns.

If you're treading to keep your head above water when it comes to exemption certificates, Avalara Exemption Certificate Management can be a lifesaver. Like AvaTax for Accounts Payable, Avalara Exemption Certificate Management works in harmony with Avalara AvaTax.

With AvaTax for Accounts Payable, you can:

- Quickly detect overpaid or underpaid taxes on vendor invoices
- Easily review how and where your purchases are used so you can more accurately self-assess use tax to reduce audit liability
- Consolidate all your taxable transaction data across your business so you're ready to demonstrate a best effort to be compliant
- Reduce costs and time spent managing tax compliance, lifting the burden from your finance team

Avalara Exemption Certificate Management enables you to:

- Easily collect, verify, store, and access certificates and respond to audit requests in seconds
- Track upcoming renewals, expirations, and missing documents with automatic updates, reducing your audit risk
- Convert paper documents into digital documents at the time of transaction
- Automatically distribute personalized letters, emails, and faxes to request new customer forms – and collect completed forms – saving time and resources

Tax compliance done right

Be audit ready

Find out how AvaTax for Accounts Payable and Avalara Exemption Certificate Management can help make sales and use tax compliance easier and reduce audit risk. Contact your account manager or call 877-780-4848.

More information at avalara.com