Beware the Slippery Slope of Sales Tax

GET FIRM FOOTING WITH THESE EIGHT AUDIT-READY BEST PRACTICES.

By Shane Ratigan, J.D., LLM

Mitigating risk is a big part of running a business. It's critical to protect your company against any disruption that could adversely impact operations, productivity, or profit.

Some tactics are obvious, such as installing a security system and purchasing an insurance policy to protect against loss. You hope you never need either one, but they provide peace of mind. Can you confidently say you apply this same level of proactivity to protecting your business from a sales tax audit?

Most businesses take a *laissez-faire* attitude where sales tax is concerned, meaning they really don't think about it much. It's a necessary evil, a pass-through activity that doesn't generate revenue. "What's the big deal?" they might ask. The big deal is that the financial impact of noncompliance is much higher than most companies realize.

According to the U.S. Bureau of Justice Statistics, businesses report $4.5 billion in losses from burglaries annually. Uncollected sales tax revenue is five times that amount—roughly $24 billion—and that's just for online sales. The average loss to a small or midsize business from burglary is $2,000. For that same company, the average cost of sales tax compliance is $24,000, according to Aberdeen Group. Wakefield Research puts that cost closer to $96,000 with an audit. Which is the bigger financial risk to your business?

As the controller or accounting manager for your company, you're the first line of defense. If the CFO asked you about the possibility of a sales tax audit, you might shrug and acknowledge that there's some risk, but not to worry. You've never been audited. What's the chance that you'll show up on the state's radar now? Besides, you keep track of your sales, and you file and remit your returns on time. Exemption certificates are tucked safely away in a filing cabinet in the back room. And you've got a master spreadsheet of all the sales tax rates, rules, and jurisdictions for your state. If you needed to, you could quickly and easily produce an audit-ready sales transaction paper trail.

That's impressive. So, then, if you were notified today that you were going to be audited for sales tax in three days, you could confidently walk into the CFO's and the CEO's offices and tell them everything is handled? You're certain you didn't miss any exemptions or undercharge sales tax on any transactions or fail to collect in any states where you have nexus? No surprises, no risk, no chance that the business will get saddled with a bill for tens of thousands of dollars in unpaid taxes and fines for invalid exemption certificates? You're confident you did everything by the book—so confident that you'd bet your job on it?

A little self-doubt might be creeping in right now—for good reason. Sales tax may not be a money maker for your company, but it's a big one for states. Other than property tax and income tax, it's the largest source of tax revenue in the 45 states that collect it. (Alaska, Oregon, Montana, New Hampshire, and Delaware don't have a state sales tax.) With $55 billion in budget shortfalls last year, it's collection time. What's the easiest way to do this? You guessed it. So it's really no longer a matter of *if* you'll be audited, but *when.*

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What Can You Do?

Handling sales tax in-house takes valuable staff time to research and calculate the right tax, keep track of exemptions, file returns, and check records. That doesn't even include preparing for or complying with the requirements of an audit. Even the most organized companies are often unprepared for this level of intense scrutiny. While there's no such thing as actual "audit insurance," applying these eight best practices can make the process easier and improve success rates.

1. Know Where You Have Nexus

A landmark 1992 U.S. Supreme Court decision (*Quill Corp. v. North Dakota*) created the concept of "nexus" by determining that a business must collect sales tax on behalf of a state if it has a substantial physical presence in that state. Examples of nexus-creating activities include holding a business license, owning tangible property, or opening an office. States recently have expanded nexus rules to include distributors, independent agents, remote employees, and affiliate networks. And more changes are expected in the coming year as states continue to tap uncollected sales tax as a revenue source.

Online and remote sales are a perfect example. Currently, if businesses have no nexus-triggering presence in a state, they aren't required to collect sales tax in that state. This has raised arguments about fairness, specifically that tax-free online shopping gives an unfair advantage to out-of-state online retailers over in-state brick-and-mortar businesses.

The issue came to a head in 2013 during debates over the Marketplace Fairness Act, a federal proposal that would give states meeting certain requirements the option of placing sales tax requirements on out-of-state sellers with more than $1 million in annual remote sales revenue. No formal legislation has been put in place yet, but a decision could come down as early as summer 2014. States are also looking closely at recent court actions, such as the refusal of the U.S. Supreme Court to hear Amazon's challenge of New York's law about so-called "click-through" affiliates.

Be certain you understand where you're required to collect tax under nexus laws, and keep up to date on changes in these requirements to protect your company against noncompliance penalties and undercollected taxes for which your company will be liable.

2. Keep Up with Product and Service Taxability Changes

Most sales of tangible personal property (TPP)—physical property that can be moved, such as furniture, office equipment, and tools—are subject to sales tax. This has begun to shift to include intangibles such as professional services and installation services. Many states now routinely apply sales taxes to services, including specialized training, experience, or project-related staff hours.

It's important to determine how your business is required to collect sales tax and on what items and to capture variations arising from the location of the sale. For example, many states don't collect sales tax on grocery items but do tax processed foods that contain certain ingredients. Service taxability varies greatly from state to state. Digital goods, downloadable software, and cloud services also have become subject to taxability discussions. Therefore, it's imperative to update product and service taxability as rules evolve. Be aware of these changes, and adjust your accounting systems and taxing practices accordingly.

3. Use the Right Tools to Get the Right Rates

It's common for businesses to shortcut researching sales tax rates by using ZIP code tools, assuming this will give them accurate information. Unfortunately, it doesn't. Taxing jurisdictions don't always follow ZIP codes. Individual counties and municipalities can levy sales taxes in addition to state rates, and tax rates can vary even within an individual ZIP code.

Greenwood, Colo., is a great example. If you're a business with a taxable sale in Greenwood Village and use a generic ZIP code lookup tool to find the correct sales tax rate, you'd enter the address and get the rate of 7.72%. But while Greenwood Village has one ZIP code, it has four different sales tax rates. So there's a high likelihood that you could use the wrong rate—risky odds if you're facing an auditor's scrutiny.

When an imprecise method like ZIP codes is employed to determine sales tax rates and boundaries, calculation mistakes are almost guaranteed, leading otherwise savvy financial managers to conclude that they've handled sales tax compliance correctly when, in fact, they're using the wrong rates much of the time. A more accurate method of determining sales tax rates is geospatial mapping, which pinpoints each location against each relevant taxing jurisdiction. Geolocation technology calculates the sales tax rate "down to the rooftop" with exact longitude and latitude for each taxable transaction.

4. Track Sales Tax Holidays

Sales tax holidays are specific days when sales tax isn't charged on certain products and services, giving consumers an opportunity to purchase goods tax-free. For example, "Back to School" holidays exempt clothing purchases from sales tax on specific days or below certain dollar amounts. At least 17 states offered sales tax holidays in 2013.

By their very nature, these tax holidays are ad hoc and unpredictable. They can vary by type of goods, time of year, or length of time, with no consistency from state to state. It's so haphazard that there's little chance of getting it right consistently. Yet states—and auditors—still expect you to manage all the tax rules and rates for the portion of your sales that tracks to these holidays. Incorrect application of holiday tax breaks can lead to overcharging sales tax and ultimately incur additional cost to you in time and effort to correct the errors and refund the overcollected amount to your customers.

The futility of keeping these holidays straight may seem deserving of a "pass" during an audit. But that isn't the case. The burden still falls on you to track these dates and sales correctly—no matter how daunting the task.

5. Manage Exemption Certificates Efficiently

Not all customers are required to pay sales tax. Depending on the rules in a taxing jurisdiction, certain businesses and individuals may be exempt. If your business is the seller, you must collect and keep on file a valid exemption certificate for each business, organization, or individual with an exemption. It's also up to you to ensure that each certificate is valid for each sales transaction. This requires you to keep copies of all certificates as well as track their expiration and renewal dates.

To make the accounting for sales taxes easier, I recommend that you keep a database or spreadsheet of exemption certificates that you can access easily for reporting purposes. Choose a solution that ties directly into your business management or point-of-sale system so it will be easy to verify that exemption certificates are current, valid, and on file. The inability to quickly generate a summary report—and inaccurate, incomplete, missing, or expired certificates—can be huge handicaps should you ever face an audit.

If your business manages a large number of exemption certificates, you may find it challenging to link specific certificates with specific transactions for an audit—in other words, to prove that tax wasn't due on a particular sale. Certificates also expire or may be invalid, which potentially leaves your business liable for paying uncollected tax.

6. Know Where and How to Remit Sales Tax

When it comes to remitting sales tax, businesses must meet filing deadlines and provide timely remittance using correct forms and formats for each taxing jurisdiction. This sounds fairly straightforward, especially for businesses with just one location and no remote sales, since the business is only responsible for collecting sales tax at the rate applied in its home city.

Things get more complex when your business has more than one location or makes sales in other locations where you have nexus. With each new city or state, the complexity and number of guidelines you must understand in order to file and remit accurately expands exponentially. Keeping track of multiple deadlines can be daunting, and the odds of missing a file date, rate change, or certificate renewal date can increase substantially.

Compounding that complexity are more and more aggressive tactics used by the states in their auditing practices. The average company gets audited 1.5 times every five years. Your chances in the "audit lottery" can be impacted by several factors. Filing errors, such as failure to prepay where required, late payment, or payment to incorrect jurisdictions, could trigger an audit. Many states look at previous audits to see which industries had the most compliance issues and "go back to the well," so to speak. But don't assume that if you haven't made any major mistakes, you'll be okay. External factors, such as revenue shortfalls or changing tax rules, can also be outside your control.

7. Be Audit-Ready

It may not happen, but you should always be prepared in case you receive a notice that your company is being audited. Audits are much less painful when you have documentation, transaction history, exemption certificates, and other relevant information at your fingertips.

As I've emphasized throughout this article, the most critical action you can take to pass an audit is to collect sales tax properly over time and ensure that you've documented every step of the transaction properly. As most of you know, an auditor typically reviews a sample of transactions over a period of time to see that sales taxes or exemptions were applied correctly, rates are accurate, and any exemption certificates are valid and on file. Then he or she will extrapolate from that sample to determine if any taxes, penalties, or interest should be assessed. If your practices, calculations, and records are

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in good shape, you should be, too.

As the accounting arm of the business, you're ultimately in charge of compliance. It's your responsibility to track and apply sales tax law changes across every jurisdiction where your company does business and to create and maintain detailed records of sales tax activities. But the burden doesn't rest solely on your shoulders. Sales and other business activities in new locations may trigger additional sales tax compliance obligations by expanding the list of jurisdictions where you're required to comply with sales tax rules. Development of new products or service lines can alter your sales tax position by introducing new taxability questions. IT needs to maintain and update accounting systems and e-commerce systems and allocate adequate electronic storage for compliance records. This "whole business" approach is key to process integrity.

8. Streamline Your Process, and Protect Against Errors

Even though you may have been doing so with little trouble, handling sales tax compliance manually can be inefficient, error-prone, and a drain on resources. But a savvy sales tax strategy is about more than accuracy—it's a means of diverting more energy toward revenue generation. The more time you spend calculating, collecting, and remitting sales tax, the less time you have to spend on more profitable activities.

Outsourcing and automation are smart, cost-effective alternatives. Rather than creating policies, procedures, and records from scratch, thousands of companies outsource their sales tax compliance activities. Most companies outsource payroll for the same reason. Like payroll, sales tax is a pass-through activity that's time-consuming, complicated, and imperative to get right.

The key is to choose a technology vendor that ensures the transition from manual process to automation is as seamless as possible. There are both premise-based and hosted (in the cloud) solutions on the market. Cloud-hosted solutions are a more efficient and affordable option, especially for small and midsize businesses. Look for a vendor whose software can be integrated with your existing accounting, point-of-sale, enterprise resource planning (ERP), or similar technology system and that provides a full suite of transactional tax services—calculation, filing, and exemption certificate management.

Make sure you do your homework so you can make an informed decision when choosing a vendor. For example, is the company a certified provider of the Streamlined Sales Tax Project? Who are their partners and clients? Do they offer service guarantees and stand behind their product, protecting you from penalties and interest if any mistakes in sales tax remittances should occur? Do they offer robust reporting? The whole point of automation is scale. You want the experience of accessing, creating, storing, and verifying transactional data to be fast, easy, and accurate.

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Last Line of Defense

Of the eight strategies I outlined, the last one—the decision to outsource your sales tax compliance—will undoubtedly yield the greatest return on investment. That one best practice pretty much takes care of the other seven. **SF**

Shane Ratigan, J.D., LLM, is a subject matter expert in sales tax law and sales tax compliance with Avalara, a Software-as-a-Service end-to-end sales tax solution for businesses of all sizes. He began his career as a self-employed business owner and later spent several years counseling small businesses on tax and succession planning. You can reach Shane at shane.ratigan@avalara.com.