



Don't Get Pinched in a SALT Audit

UNDERGOING A STATE AND LOCAL TAX AUDIT IS ONEROUS, BUT SURPRISINGLY, THERE MAY BE A SILVER LINING. BY GAIL PERRY

While nobody enjoys a tax audit. But it would be nice if you could at least expect an audit to have a clear end in sight, and that it not be repeated in future years. But that scenario is not always typical when you're faced with a state and local tax audit.

"[SALT auditors] come in one door, but they don't necessarily stop there," explained Joey Musmar, managing partner of Northern Virginia-based CPA and business advisory firm MillerMusmar. It's been his experience that it's not unusual for a SALT auditor to expand from one area of taxation to other areas.

Diane Hardt, division administrator for the Wisconsin Department of Revenue's Division of Income, Sales and Excise

Tax, explained that the majority of the SALT audits in her state are re-audits of companies, and those typically are larger concerns. However, when it comes to small and midsized businesses, the ones that deal primarily in cash are likely audit targets. "I would say cash-basis businesses are more likely to get audited, for example restaurants, taverns, even retail establishments that might be conducting transactions via cash," she said.

A LONG, DETAILED PROCESS

Europa Stone Distributors Inc., a Sterling, Va.-based importer and distributor of natural stone, was tagged for a SALT audit last year.

Owen Werthman, vice president of finance for Europa, described the experience as both lengthy and detailed. "My best advice is, if you're accepting a customer as being tax-exempt, and if your state has the ability to verify this status, you

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should do that, because even if you accept the forms that the state provides, this isn't a guarantee,” he warned.

His company found itself in the situation of having a customer who had provided them with evidence of tax-exempt status, but when it turned out the customer was not exempt, Europa was on the hook for tax that the customer should have paid. “The law says, if you receive an incomplete application, if the numbers are wrong or expired, it's your fault,” said Musmar.

Werthman also suggested organizing records so that supporting documentation is filed with the appropriate forms. For example, before the auditor came in, every single receipt was filed with the credit card bill on which it was paid, even though Europa didn't normally file receipts that way. Europa also re-organized the filing of its delivery receipts so that those receipts were filed with the invoices that were paid for those deliveries. “We had to redo our entire filing system. That became an absolute nightmare,” he said.

Werthman also recommended keeping personal items out of the workplace: “If I bring my personal computer and use it in the office, that becomes part of the office. Anyone who brought personal stuff, I told them to get it out of here. It wasn't that I had anything to hide — I just wanted to limit the length of the audit. I had other things to do.”

One thing Werthman didn't do was continue to grant the auditor extensions. As the audit approached, the statute of limitations for the time period being examined was approaching, and the auditor requested a series of extensions. After allowing several, Werthman eventually put his foot down. “Against my accountant's advice, I said, ‘I'm done, no more extensions.’”

In retrospect, that might have been a mistake.

Werthman felt that by refusing to grant additional extensions, he might have forced the auditor to assess tax at a higher amount. “It forces them to come up with their highest number, and that's pretty much what they did.” With more time for the audit, it's possible the tax amount could have been negotiated down.

Negotiation should never be ruled out as a possibility in a SALT audit. “In some cases, you'll find auditors with a great deal of latitude,” said Sean Kelley, a manager in RSM McGladrey's State and Local Tax Area Group. “That's going to vary from state to state and with the type of tax involved.” In addition, he said, “A lot of times they'll cast a very wide net for documentation, and it may not always be available. In some cases you may be able to get the auditor to back off a particular request if it's not very easy to get or if it's not really very relevant.”

But don't expect good books and records to be all you need to get past a SALT audit. Werthman pointed out that, although he had his accountant host the auditor in the accountant's office throughout the term of the audit, at one point the auditor

“insisted on actually coming out to take a tour of the facility, look at pieces of equipment, match up our items with property tax stuff, and identify receipts for those items.”

In recent years, many states have offered amnesty programs geared toward encouraging individuals and businesses to come forward and pay back taxes without penalty. Sometimes companies that have been fearing an audit take this opportunity to clear their records. “I think there are companies out there that were playing, for lack of a better term, audit roulette, and hoping their number didn't come up. When they would see an amnesty program, they would decide to cut their losses and protect themselves,” said Kelley.

AUDIT YOURSELF

Being pro-active and hiring a specialist to conduct an in-house SALT audit may prove to be a cost-saving strategy in the long run.

State and local tax experts can try to help a company structure its payroll, sales and property locations in such a way as to take advantage of lower tax rates in particular states, and to minimize the tax exposure in states with higher tax rates.

Kelley described a scenario where RSM McGladrey has been able to examine the state tax structure of certain companies and help them take advantage of some of the peculiarities of states' sales tax laws. For example, some states, including California, Texas and Illinois, have origin-based tax sourcing, as opposed to the more common destination-based tax. This somewhat-unusual tax structure provides some companies with the opportunity to create their own dedicated purchasing companies to take advantage of local tax benefits. By setting up a separate company to purchase items that a company would normally buy directly, the company can utilize discounts and also receive a lower tax rate that can be passed on to customers.

Knowing the quirks of individual state tax laws can pay off. In Virginia, for example, Musmar described a situation wherein the state tax auditors have the right to assess triple the amount of tax errors that they find. For example, “If an auditor audits you for one year and you made a mistake — let's assume you didn't charge the proper sales tax and owe \$3,000 — your bill will be \$9,000 plus penalties and interest.” Because the statute of limitations allows three years to be open for audit, the auditors have the right to assume that the error carries through all three open years, without examining the other years.

Musmar recommends that when businesses find themselves in this situation, they go back and conduct their own audit for the remaining open years, and provide proof that the error was a one-time error and did not appear in other years. By proving the error is unique, a company can save two-thirds of the tax bill. **SMB**