SALES AND USE TAXES: AN OVERVIEW

The author provides a guide to this often neglected area and some strategies for contesting audits.

DANIEL M. DAVIS

Suppose there was a business tax often greater than federal and state income taxes combined, and worse yet, suppose it arose from laws and regulations for which there was little formal training. You would take it very seriously and take immediate steps to teach yourself about it, right?

Many businesses face such a tax already—namely, sales and use tax. But because the provisions seem simple, and because reimbursement generally can be collected from customers, the impact of the tax is underestimated by practitioners and clients. A tax computed as a small percentage of gross receipts may be greater than a tax computed as a much larger percentage of net income.

By familiarizing themselves with the laws and regulations, keeping sales and use tax in mind when structuring transactions, and questioning procedures used to develop assessments, practitioners can help to minimize the impact of the tax on businesses.

This article outlines general principles and common characteristics of state sales and use tax laws. It also discusses recent state attempts to tax direct market sales by out-of-state vendors, and it suggests approaches to sales and use tax audit defense.

Note: A related article on planning for state and local taxes in general appears in the sidebar on page 28.

IN GENERAL

Forty-five states and the District of Columbia now impose sales and use taxes. A breakdown of the taxes imposed by the states is shown in Exhibit 1 on page 25. Of the five states which do not, Alaska allows imposition of local sales taxes, Delaware levies a use tax on leases of tangible personal property, Montana imposes a lodgings tax, and New Hampshire taxes rooms and meals. The fifth state, Oregon, has no provision for any form of sales, use or lodgings tax.

"Sales tax" is often used as a generic term for several similar types of excise taxes. True sales taxes are either imposed directly on sales or measured by sales. Gross receipts or gross income taxes are based on revenue from all sources rather than sales alone. Occupation taxes are imposed on gross revenues from particular sources specified by each enacting state. These distinctions often become blurred within the various bodies of state law, and unless otherwise stipulated, all such taxes will be referred to as "sales taxes" in this article.

Since any given sales tax applies only to sales within the enacting state, a complementary use tax is needed to reach purchases made outside the state but intended for in-state use. Without a use tax, consumers would be able to avoid taxation by simply buying out-of-state, in person or by mail. This would reduce revenues and put local businesses at a competitive disadvantage. Thus, every state with a sales tax has enacted an accompanying use tax.

Although sales and use tax principles are similar from state to state in many respects, significant differences arise in the following areas: (1) liability for the tax, (2) persons exempt from tax, (3) types of property and services taxed, (4) types of transactions taxed, (5) exemptions allowed, and (6) tax rates. (In most bodies of sales and use tax law, the term "persons" includes individuals, partnerships, corporations, government bodies and virtually all other conceivable entities.) In addition, many state laws provide for local sales and use taxes, which are added to and collected with the state taxes. Let's take a look at these areas.

DANIEL M. DAVIS, CPA, M.B.A. (Taxation), is a partner in Davis & Davis, CPAs, in Salinas, CA. Mr. Davis was formerly a sales tax audit reviewer and supervisor with the California State Board of Equalization.

Who Is Liable

The sales tax is imposed on the consumer in 29 states and on the seller in 16 states and the District of Columbia. But regardless of who is considered the primary taxpayer, the seller is generally responsible for collecting and remitting, making the distinction seem insignificant. The distinction is important because, among other things, it fixes the right to sue for recovery. Where the sales tax falls on the consumer, for example, the seller may have the right to sue a customer for recovery of tax on transactions initially treated as tax-exempt but later determined to be taxable.

Persons Exempt from Tax

Sales to the U.S. government and its agencies are exempted by all of the state laws for constitutional reasons. All but six of the states also exempt sales to their own agencies and subdivisions, including municipalities, towns and counties. However, only seven states exempt sales to other states, and three of those restrict their exemptions severely.

Most of the states treat specified not-for-profit agencies as exempt, although the numbers and types of agencies and transactions eligible for exemption vary widely from state to state.

Property and Services Taxed

Retail sales of tangible personal property are taxable in all states imposing sales tax. Nearly all of the states also impose sales or use tax on leases or rents of tangible personal property, although most allow an exemption if the rental property is bought tax-paid and used only for rental.

Fabrication labor (labor which changes the function of tangible personal property or results in the creation of a new item) is included by most states in the measure of tax. Repair and installation labor, on the other hand, is completely excluded by 23 states from transactions taxed and partly excluded by at least five others. In states where repairs or other services are taxed, the services are generally specified by law, and those

not specified may be considered exempt.

Since tangible personal property becomes real estate when incorporated into buildings and similar structures, most states treat construction materials as consumed by installing contractors. Thus, sales of building materials to construction contractors are taxable retail sales, and the tax does not apply later when contractors bill their customers. Contractors may still be considered retailers of items that retain their identity when installed (such as bathroom fixtures or installed machinery), and of property sold before installation. The laws of a few states view construction contractors as retail sellers of *all* property they install.

Most state statutes impose tax on rentals of hotel rooms and other transient accommodations. The tax generally does not apply to stays beyond 30 days or some other specified period. Twenty-eight states also tax admissions to entertainment events and/or use of amusement facilities, with varying limitations and exemptions.

Several additional activities are taxed by one or more states, including (but not limited to) telecommunications, transportation, and provision of gas and electricity.

Exemptions

Exemptions are generally specific and strictly construed. A transaction excluded from taxable measure in one state (such as installation labor) might be included but protected by an exemption in another. Some of the more common exemptions follow.

• Labor is usually treated according to its nature. In most states professional services are not included in the measure of sales taxes, but they are sometimes included in states where the measure of tax is gross receipts rather than sales. As explained above, repair and installation labor is often excluded or specifically made exempt, and fabrication labor is usually taxable.

In states where repair or installation labor is exempt, the labor must be separately stated on invoices to customers when taxable property is sold concurrently. For example, an auto repair invoice showing an installed battery would generally have to show separate totals for the installation, the selling price of the battery, and the tax on the battery.

Some states apply fixed taxable ratios to a few specified repair operations. These ratios are stipulated either in the law or regulations.

• Sales for resale are granted exemption or excluded from the measure of the tax in nearly all of the states. In order to support a deduction for sales for resale, sellers must generally obtain resale or exemption certificates from their customers. The certificates describe the property and state that the customer is engaged in business and buying the property for resale. Customers must sign and date the certificates, and may have to provide other data, such as customer permit numbers.

The impact of the sales tax is underestimated by clients and practitioners.

• Sales of food products are granted some degree of exemption by most states. The exemption is usually restricted to unprepared food that will be eaten off the premises (i.e., groceries), and the particular items granted exemption are generally spelled out in the law and/or regulations. Soft drinks, candy, alcoholic beverages and miscellaneous other items are often excluded from the definition of food products and taxed accordingly.

• Sales of prescription medicines are exempt in all states except New Mexico and Illinois. (Illinois has a special 1% tax rate for sales of unprepared food, medicines, and specified medical appliances and supplies.) Most states also exempt various medical aids and devices.

• Newspapers and/or periodicals are granted some degree of exemption in 39 states. Seventeen of those states exempt sales of newspapers only, and other limitations often apply.

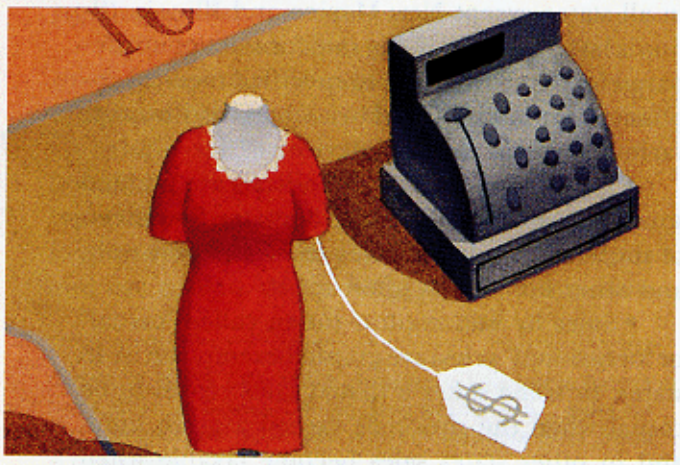
• Sales by nonretailers (often called "casual" or "occasional" sales) are granted exemption in 43 states. In some states a casual sales ceases to be casual when the proceeds exceed a given limit, and in other states sales become taxable when

there are more than a specified number of transactions within a given period. In one way or another, most states limit the exemption to persons not making regular retail sales of tangible personal property.

Changes of business form or ownership, such as transfers of assets to newly formed corporations, may be exempted from tax under "occasional sale" provisions or under separately enacted provisions. The circumstances giving rise to such exemptions are usually spelled out in the law and regulations. The rules should be reviewed before structuring transfers involving significant amounts of tangible personal property. In many states, business changes can produce unexpected liabilities when sales tax law is overlooked in the rush to minimize income taxes.

• Sales in interstate commerce are generally granted exemption for constitutional reasons. Under the Constitution, states may not burden or discriminate against interstate commerce,[1] nor may they tax transactions or property beyond their borders.[2] Accordingly, when a sale is completed outside a state's border, that state may not assert sales tax on the transaction. However, if the buyer then brings the property to a location within the state where it will be used, the use tax will apply. (Storage is generally included in the definition of use under sales and use tax statutes.)

Goods ordered by mail from an out-of-state vendor and shipped by common carrier from an out-of-state location directly to the buyer (such as goods ordered through a catalog) will generally be subject to use tax but not sales tax. This distinction becomes important when an out-of-state retailer is not considered "engaged in business" within the buyer's state, because the buyer's state then cannot require the retailer to collect the use tax. Since a state cannot police the mail order purchases made by all of its residents, a large amount of use tax goes uncollected on merchandise bought from unregulated out-of-state vendors. Attempts by several states to resolve this problem are the subject of the following section.



OUT-OF-STATE SALES

The recent boom in sales by mail, telephone and television has resulted in a redefining of "engaging in business within the state" by many state legislatures. Between the beginning of 1986 and the present, at least 27 states have passed laws to try to force out-of-state direct market sellers to collect and remit use tax.

The Constitution prohibits states from taxing persons, property or transactions beyond their borders unless there is a connection, or "nexus," between the proposed taxpayer and the taxing state.[3] Without nexus, a state may not require an out-of-state vendor to collect and remit use tax on its sales to resident customers. The state may, of course, collect the use tax directly from customers, but collecting directly from every person whose buying extends beyond state borders would be an administrative impossibility.

Retailers in states with sales tax statutes have complained that unregulated outside vendors have a competitive advantage in not having to charge or absorb the tax. Such complaints and large losses of use tax revenue have prompted many states to extend their definitions of "nexus" considerably beyond the boundaries recognized by the U.S. Supreme Court to date.

Within the past few years more than half of the states have passed laws that attempt to include marketing through catalogs, direct mail and electronic media among activities with sufficient nexus to be considered "doing business in the state." The Supreme Court, however, has repeatedly held to a standard of physical presence in determining nexus. For example, the Court found nexus when a mail order seller had offices in the taxing state, even when the activities of those offices were unrelated to mail order selling.[4] The standard also was met when the seller had no office or warehouse in the state but had employees or other representatives soliciting business

there. This was true even when the "representatives" were independent contractor wholesalers who solicited orders on the seller's behalf.[5]

However, the Court has never upheld a state taxing authority when there was no physical presence. In *National Bellas Hess, Inc. v. Department of Revenue*,[6] the state of Illinois tried to require an out-of-state corporation to collect and remit use tax. The corporation had no office, warehouse or other facility in Illinois; it solicited business only by mailing catalogs and flyers to Illinois residents, who then ordered and received merchandise by mail or common carrier.

In ruling against Illinois, the Court held that the duty of use tax collection and payment could not be imposed on a seller whose only connec-

EXHIBIT 1/ STATES SALES AND USE TAXES

The following table shows general state rates, exclusive of local sales and use taxes, for each U.S. state and the District of Columbia, as of July 1, 1990. Some states impose varying rates on particular kinds of transactions or property, which are not shown. The table also shows who is liable for the tax.

State	Primary Taxpayer	Rate	State	Primary Taxpayer	Rate
Alabama	Seller	4%*	Montana	None	—
Alaska†	None	—	Nebraska	Consumer	5%*
Arizona	Seller	5%*	Nevada	Consumer	5.75%*
Arkansas	Consumer	4%*	New Hampshire	None	—
California	Seller	5%*	New Jersey	Consumer	7%
Colorado	Consumer	3%*	New Mexico	Seller	5%*
Connecticut	Consumer	8%	New York	Consumer	4%*
Delaware	None	—	North Carolina	Seller	3%*
Dist. of Columbia	Seller	6%	North Dakota	Consumer	5%*
Florida	Consumer	6%*	Ohio	Consumer	5%*
Georgia	Consumer	4%*	Oklahoma	Consumer	4.55%*
Hawaii	Seller	4%	Oregon	None	—
Idaho	Consumer	5%	Pennsylvania	Consumer	6%*
Illinois	Seller	6.25%*	Rhode Island	Consumer	7%
Indiana	Consumer	5%	South Carolina	Seller	5%
Iowa	Consumer	4%*	South Dakota	Seller	4%*
Kansas	Consumer	4.25%*	Tennessee	Seller	5.5%*
Kentucky	Seller	6%	Texas	Consumer	6.25%*
Louisiana	Consumer	4%*	Utah	Consumer	5%*
Maine	Consumer	5%	Vermont	Consumer	4%
Maryland	Consumer	5%	Virginia	Seller	3.5%*
Massachusetts	Consumer	5%	Washington	Consumer	6.5%*
Michigan	Seller	4%	West Virginia	Consumer	6%
Minnesota	Consumer	6%*	Wisconsin	Seller	5%*
Mississippi	Seller	6%	Wyoming	Consumer	3%*
Missouri	Seller	4.225%*			

†Alaska has no state sales or use tax, but local taxes are imposed.

*Additional local taxes are imposed. Rates vary from state to state and often vary among local taxing jurisdictions within the same state.

tion with customers in the state was by mail or common carrier.[7] When the seller has neither a facility nor a representative operating within a state, the state can expect an uphill battle establishing nexus to the Court's satisfaction.

Undaunted by the prospect of an uphill battle, several states have developed ingenious criteria for establishing nexus without physical presence. Under one theory, nexus is created if the seller accepts credit cards issued by banks within the taxing state. Another theory holds that nexus is created when resident customers place orders over an out-of-state seller's toll-free "800" number. A third theory asserts nexus if the seller is an affiliate of an in-state corporation engaged in a similar line of business.

So far dispute over these theories has been confined to state courts. Although states must generally follow the decisions of federal courts on federal issues, they are not bound by decisions of the courts of other states. Legislation has been introduced in Congress that would allow states to tax the mail order sales of sellers who regularly solicit business from state residents, but the prospects for enactment are uncertain. It appears that a clear settlement of the nexus question will not be reached any time soon.

Meanwhile, many of the states can be expected to pursue out-of-state direct mail and media sellers for uncollected use tax. Some states will agree to waive uncollected back taxes if a retailer agrees to register, collect and remit prospectively.

Practitioners may want to advise vulnerable clients to look into the possibility of securing such agreements.

CONTESTING AUDITS BY OUTSIDE STATES

A state may obtain a judgment for taxes in its own courts, which can be enforced against a taxpayer in another state. Federal courts may be used to enforce tax judgments, and many states will allow direct use of their courts to other states granting them the same privilege. States also have the authority to examine the records of taxpayers considered "doing business" in their jurisdictions, regardless of the location of the records.

Most states include audits of out-of-state sellers in their audit programs. These audits are generally lucrative, since the target companies are often unfamiliar with the laws of the taxing state and, as discussed above, may not have registered to collect the use tax at all. In the latter case, auditors may be expected to develop use tax assessments over prior periods as far back as their state statutes and operating policies will allow.

Aside from nexus issues, assessments proposed by out-of-state auditors usually hinge on questions of fact rather than law. Since sales and use tax auditors almost always use some form of sampling to develop assessments, an audit defense might take one or both of the following approaches:

1/ Develop evidence showing that individual transactions considered taxable in the sample were in fact not taxable events;

2/ Contest the *method* of sampling and/or the method of applying the sample results.

Contesting individual sample items requires a firm grasp of the distinction between sales and use tax transactions. In the simplest type of transaction, a customer in one state sends an order to a seller in another state. The seller fills the order and sends the property to the buyer by common carrier. The sale is exempt from the sales tax of the seller's state because it is a sale in interstate commerce. Sales tax does not apply in the buyer's state because the sale took place outside that state's borders. But as soon as the buyer receives and uses the property (and use generally includes storage), the buyer owes use tax.

As we have seen, an out-of-state seller can be compelled to collect use tax if that seller is considered to be "doing business" in the buyer's state. When an auditor from the buyer's state finds an applicable unreported use tax transaction, that transaction will either be taxed individually or

included in a sample used to develop a percentage of understatement.

At this point the practitioner should examine all documents generated by the transaction, keeping questions of the following type in mind.

1/ Was the property sent to the buyer's address or was it shipped to another destination? The auditor may have assumed the property was sent to the billing address when it actually went to a different state, which would remove the transaction from the auditor's tax base.

2/ Could the property have been bought for resale or for incorporation into other property that was resold? In either case the transaction would be exempt in most states, although it is important to remember that in a small minority of states incorporating property into other property for resale is in itself a taxable event.

3/ Was the buying entity an exempt person under the laws of its home state? Purchase orders, contracts and similar documents should be examined to make sure the buyer was correctly identified. If, for example, the buyer was not properly identified as an agency of the federal government, the transaction would have been included as taxable in error.

4/ Did the buying entity self-report the applicable use tax? If the buyer has reported and paid the tax, the liability should be considered extinguished.

Unless the answers to such questions are obvious on initial examination, tax auditors cannot be expected to take the time to dig them out. When reconstruction from fragmentary data or contact with outside sources is needed to properly characterize transactions, it is usually up to practitioners to do the work.

Once satisfied that any remaining audit exceptions are in fact unreported taxable events, the practitioner should determine how those events will be used to develop an assessment. Alternative approaches should be proposed if the auditor's application produces an unreasonable result. Common weaknesses in tax audit methods and procedures are discussed in the following section.

CONTESTING AUDITS BY HOME STATE

Regardless of the state of origin, sales and use tax audits often share the following characteristics:

1/ Taxable sales are often computed using indirect methods, such as markup procedures or cash deposit analyses.

Similar methods may be used to compute allowable exemptions.

2/ Audit "tests" of varying complexity often form the basis for assessment recommendations.

3/ Contracts and similar documents are strictly construed and taken at face value. A substance over form approach is rarely considered.

4/ Details included (or not included) in specialized documents, such as resale or exemption certificates, are given great weight, sometimes to the exclusion of other evidence at least as compelling.

t is not hard to imagine possible weaknesses in the home-state audit environment.

5/ Factual rather than legal issues are the basis for most recommended tax changes.

6/ Use tax assessments and disallowed sales for resale are probably the two most common areas of tax change.

7/ Auditors are usually under pressure to develop assessments and complete audits as quickly as possible.

It is not hard to imagine the possibilities for audit weaknesses inherent in such an environment. One of the most common weaknesses, the tendency to avoid examining transactions in depth, has already been discussed in the previous section. Another weakness is inadequate sampling.

Ideally, sample units are drawn at random from the universe they are expected to represent. The sample should be large enough to ensure a high probability that the characteristics examined will closely approximate those found throughout the universe. If the characteristics are taxable events, the sample findings may be used to project the occurrence of those events throughout the audit period (universe) with a reasonable degree of reliability.

JAN STEENSON CRANGLE

Lately, due mostly to the recent decrease in federal income tax rates, there has been increased emphasis on state and local tax planning. Tight federal budgets and decreases in federal support for state programs have led some states to increase audits by their taxing authorities. Thus, it has become vital for practitioners to pay more attention to state and local taxes. This article pinpoints some common issues which, if overlooked, could have a significant dollar impact on clients.

Note: The planning tips discussed here are general in nature. A full investigation of the rules that apply in your state should of course be made before applying any of these strategies.

Strategy #1: Don't Neglect Non-Income Taxes. Now that state tax planning is assuming a more prominent role, don't make the mistake of considering only state income taxes. For example, if a client is selling an entire plant, when allocating sales price between real and personal property for income tax purposes, you should also consider property and sales tax consequences. Frequently, the new basis for property tax purposes will be determined by the asset allocation used for income tax purposes. While certain states exempt the sale of plant assets from sales tax, some states assert a tax on these transfers.

Strategy #2: Keep Use Tax In Mind. This often misunderstood tax can cause big headaches for clients who are unaware of their liability. The use tax is explained in the main article. If your client makes purchases from suppliers located out of state, he probably has a use tax liability. Generally, companies will collect and remit the tax on sales made from their out-of-state offices if they also have a physical presence in the state.

Don't overlook the potential for use tax if you're analyzing the costs of a major capital project.

Note: Unknowledgeable sales representatives have sometimes represented to buyers that they can provide a lower bid, since their firm is located out of state and doesn't invoice sales tax. Obviously, in states with a sales tax, the purchaser will generally be liable for use tax on these purchases.

A simple payables program can include an analysis for accruals of use tax and prevent surprises from state audit forces. States are now becoming more aggressive in exchanging information regarding sales across state lines, and audit risk is increasing. By notifying clients of their use tax reporting responsibilities and working with them in establishing an accrual and reporting system, you'll decrease potential audit risk.

Strategy #3: Check Out-of-State Payments for Withholding Liability. If your clients have contracts with out-of-state firms, they may have to withhold on contract payments. Some states require in-state business to withhold, in order to help ensure compliance by out-of-state companies. Generally, a percentage of the payments due to the nonresident must be withheld by the in-state company from all payments made. While various exceptions to the withholding rules exist, clients are well advised to set up a screening process when making payments to nonresidents. In certain states the withholding requirement applies not only to construction contracts, but also to personal services. Are you performing auditing or accounting services across state lines? Your charges could be subject to withholding.

Strategy #4: Watch Personal Income Tax Withholding. Some practitioners believe that if you match your state personal income tax withholding with your expected tax liability, you've satisfied your responsibilities. The state withholding tables may have been established a number of years ago and may not have been updated for recent developments, resulting in built-in excess withholding. In addition, different exemption rules may apply for state and federal purposes. Make sure your clients are withholding the full amount required by the withholding statutes or you may find yourself facing stiff penalties with interest also due.

Strategy #5: New Technology Clients Require Special Attention. If you represent clients engaged in high tech communication services, software development and sales, or other new service areas, you may have special planning opportunities. Is your client's business changing from selling property to providing services? It may be time to question whether the traditional three factor formula (based on averaging the ratios of in-state sales, payroll and property to sales, payroll and property in all states) is still applicable. Perhaps a gross receipts or other special approach is available. Also, many states are becoming more aggressive in asserting sales taxes in these areas. If you have specific questions, you will

JAN STEENSON CRANGLE, CPA, M.B.A., is employed by the South Carolina Tax Commission where she serves as Manager of Audit Review and Resolution and coordinates the agency's CPA Candidate Training Program. Previously, she served as Tax Manager with a regional CPA firm. Her background also includes experience with the IRS.

find that many states will issue written rulings in areas involving new technology. In addition, some states have granted prospective relief for issues involving new technologies.

Strategy #6: Don't Overlook Consolidated Reporting. Many states allow some form of consolidated reporting. The election to file on a consolidated basis can result in significant tax savings. This is especially true where one subsidiary is operating at a loss, since filing a consolidated return allows you to offset taxable income by losses. The election may require the approval of the taxing authority; however, frequently, the election can be made simply by filing the consolidated return. For those states where you must determine the taxable income or loss of each entity and then combine the bottom line, it will generally be to the taxpayer's advantage to file on a consolidated basis rather than filing separate returns.

Caution: While it may not be difficult to elect consolidated filing, it is generally more troublesome to go from consolidated filing to separate returns. States frequently require written permission from the taxing authority, obtained in advance, to return to separate filing.

Strategy #7: Try to Use "Nexus" to Your Advantage. Nexus broadly refers to the concept under which a state can impose income or other taxes on an out-of-state entity doing business in that state without running afoul of the U.S. Constitution. A full discussion of the concept of nexus and of recent developments in this area as they affect sales and use taxes is contained in the main article. You can use the tests that courts require be met for nexus to exist to your clients' advantage. For example, if you are currently reporting all income in one state, and making substantial sales into a neighboring state with a lower income tax rate, you may want to establish nexus in that state. Establishing a branch office or maintaining inventory in the neighboring state would clearly satisfy the nexus tests; however, it could be as simple as giving the clients' sales staff who operate in that state the ability to accept orders. By apportioning income among several states, you may be able to reduce your effective income tax rate.

* * *

These are only a few of the state and local issues that deserve your attention. Careful planning on your part can turn what some might view as obstacles into opportunities.

It rarely works that way in practice. In the real world, changes are common, whether in business operations, personnel or recording systems, so that a sample drawn from one time segment often will not provide an accurate estimate of activities during a different segment. (Sales tax auditors rarely draw samples from a base that cuts across an entire audit period, since audit periods often cover several years.) Records from earlier periods are frequently misplaced. Terminology and technology change, creating confusion for auditors generally not familiar with operating details of the industries they examine. Small block samples are frequently used to develop large assessment recommendations.

Example One: During October 1985 the client, XYZ corporation, began a new manufacturing process involving use of a chemical catalyst that does not become a component of finished goods. Under state law, property used in manufacturing but not incorporated into inventory is taxable to the manufacturer, but the suppliers of the chemical were initially given a resale certificate in error. The certificate was rescinded after several purchases of the chemical had been made without tax being charged. XYZ management tried to correct the error by reporting use tax on the untaxed purchases, but a few were overlooked.

XYZ is now being audited for the period from January 1, 1985 to December 31, 1988. The auditor has chosen the month of November 1985 to "test" consumable manufacturing supplies, since that is the first full month of the new operation. He finds that untaxed purchases of the chemical came to $20,000 for the month, and $8,000 of that amount was not self-reported. Using a separate test, the auditor estimates purchases of the chemical at $300,000 for the period between October 1985 and December 31, 1988. He computes a percentage of error of 40% ($8,000/$20,000) and applies it to the $300,000 base to arrive at unreported taxable purchases of $120,000. At a tax rate of 6%, the recommended assessment for this set of transactions will be $7,200 before interest or penalty.

The fallacy, of course, is that shortly after the test period the problem giving rise to the

assessment was corrected, so that projection of the error rate to later periods is completely inappropriate. If the XYZ employees who were present during the test period have moved on, or communications between accounting and operations are poor, or nobody takes the time to look into the auditor's procedure, the assessment might well be accepted even though it is probably about 10 times what it should be.

Example Two: Assume the same set of circumstances as in Example One, except this time there were recurring errors throughout the audit period. However, the auditor's test exceptions (which came to $8,000 as above) included one unusually large start-up purchase of $7,000.

It is probable that factoring the $7,000 start-up purchase into the test results will distort the percentage of error and result in an excessive assessment. The $7,000 should be pulled out of the test and taxed individually as a nonrecurring item, and other periods should be sampled.

Example Three: The taxpayer, ABC, is a wholesale distributor of packing materials whose sales are nearly all for resale. State regulations require sellers to obtain and keep timely resale certificates to establish a presumption of exemption. However, a confused new tax manager decided to update the files by obtaining new resale certificates from current customers and throwing away the old certificates. Two months after the new files have been set up, a sales tax auditor arrives.

After initially threatening to disallow *all* previously claimed sales for resale, the auditor agrees to test an earlier month's transactions by mailing letters requesting the customers involved to state what disposition they made of their purchases. Not all of the customers respond, since some have moved or gone out of business, some have changed ownership, some are afraid a response will get them in trouble, and some don't want to be bothered.

Based on the test results, the auditor proposes to disallow a percentage of claimed sales for resale. Transactions involving nonrespondents make up most of the percentage of error.

If left unchallenged, the audit will result in a phantom assessment based on a percentage of customers who fail to respond to correspondence rather than a percentage of sales for resale claimed in error. To remove the distortion inherent in the auditor's approach, transactions involving nonrespondents should be eliminated both from the audit exceptions and the test base. (This would only be done after every effort was made to elicit responses or to establish the nature of the transactions using other evidence.)

Another approach would be to request a test of current transactions for which resale certificates are available, even if the test period would have to be outside the audit period. Whatever the approach, it is important to realize that audit procedures need not be accepted if they produce unreasonable results, even though it may be necessary to go through several levels of appeal to achieve a satisfactory result.

CONCLUSION

Practitioners and their clients often underestimate the potential impact of sales and use tax problems. By becoming familiar with applicable laws and regulations, remembering sales and use taxes when structuring transactions, and questioning procedures used to develop assessments, accountants can make reasonably certain that their clients will avoid unpleasant surprises. PA

1. US Const. Art I, Sec 8, cl 3.
2. This is a Due Process consideration under US Const. Amend XIV, Sec 1.
3. *Complete Auto Transit, Inc. v. Brady*, 430 US 274, 97 SCt 1076 (1977).
4. *National Geographic Society v. SBE*, 430 US 551 (1977).
5. *Scripto, Inc. v. Carson*, 362 US 207 (1960).
6. *National Bellas Hess, Inc. v. Department of Revenue*, 386 US 753, 757 (1967).
7. Id. at 758.