

WA-AK HFMA One Day Conference “Dealing With Ambiguity”

Washington State Tax Audit – Are You Prepared?

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It's Friday At 4:00 PM



What We Will Cover Today

- State Tax Update
- You Are Being Audited – Now What
 - Common Errors
 - Before The Audit
 - During The Audit
 - After The Audit

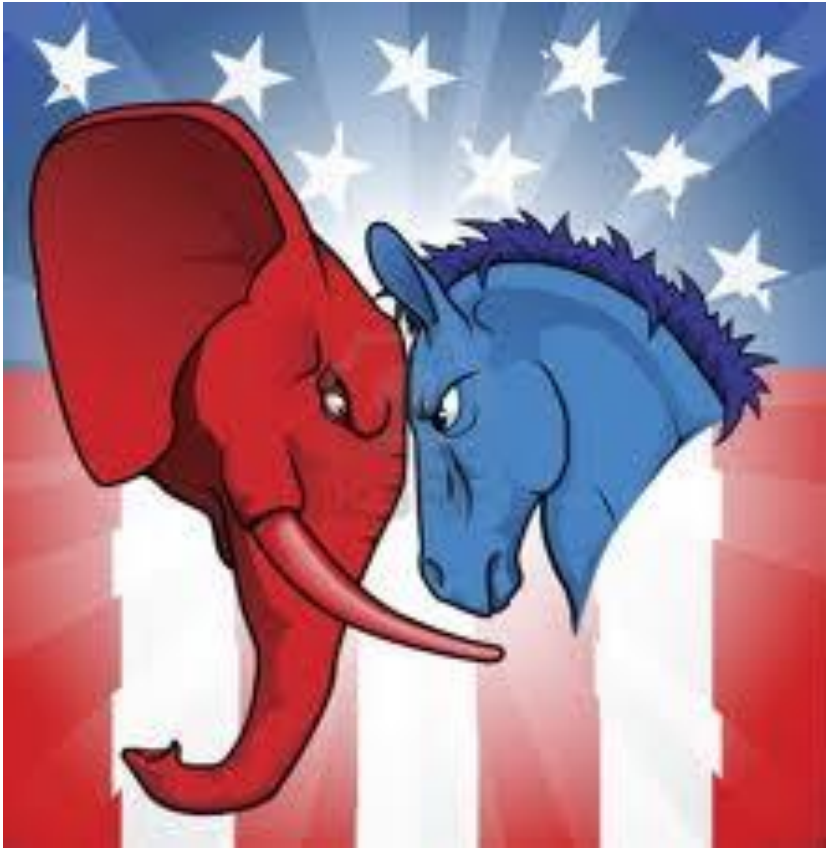


State Tax Update



- Session is scheduled to end April 28
- Washington state's legislature will likely end its regular session this weekend without approving an operating budget as the state House and Senate are at odds over tax increases, lawmakers said on Thursday - (Reuters, April 25, 2013)
- “The budget approved in the House by its majority Democrats cannot win over the Senate's Republicans or many of its Democrats because of its proposed tax increases.” (Senator Sheldon)

State Tax Update



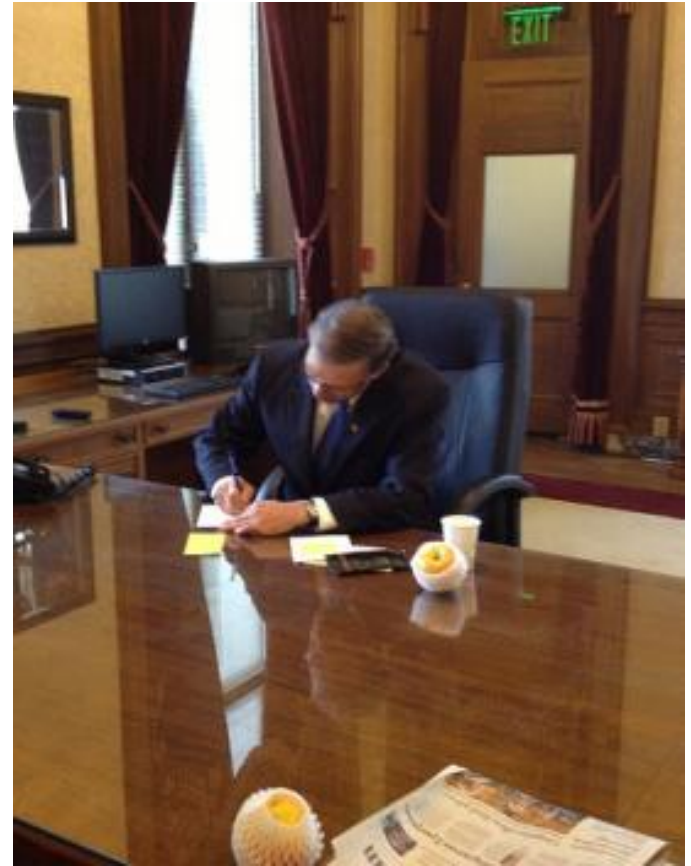
- The **Senate**, led by a coalition of minority Republicans and two Democrats, earlier this month approved a \$33.2 billion budget **without tax hikes**.
- The **House** would spend about \$1 billion more than the Senate and raise about \$900 million by **eliminating nine tax exemptions and extending a business surcharge tax** to help increase funding for schools.

State Tax Update

| House | Count | Senate | Count |
|---------------------------------|-------|---------------------------------|-------|
| House Introduced | 1373 | Senate Introduced | 1340 |
| House Rules Review (2nd) | 104 | Senate Rules White (2nd) | 53 |
| House Rules Consideration (2nd) | 69 | Senate Rules Green (2nd) | 7 |
| All House Rules | 173 | All Senate Rules | 204 |
| House Second Reading | 9 | Senate Second Reading | 9 |
| House Rules Consideration (3rd) | 0 | SGAs in Senate Rules | 3 |
| House Third Reading | 0 | Senate Third Reading | 0 |
| House Bills on Reconsideration | 0 | Senate Bills on Reconsideration | 0 |
| Passed House | 551 | Passed Senate | 472 |
| House Passed House | 384 | Senate Passed Senate | 294 |
| House Bills Passed Senate | 178 | Senate Bills Passed House | 167 |

State Tax Update

- 80 bills have been signed by the Governor Inslee
- 228 bills have either been:
 - Delivered to the Governor
 - Signed by the Speaker of the House
 - Signed by the Senate
 - Filed with the Secretary of State
- What is going to happen with taxes is anyone's best guess



You Are Being Audited!



Common Errors

- Duplicating deductions-review excise tax workpapers (i.e. bad debt taken on a contractual adjustment/returns & allowances)
- Deducting co-pays for Medicare/Medicaid (Inpatient/Outpatient are different amounts)
- Not deducting government income for public/nonprofit hospitals
- Mishandling subcontracted departments (i.e. subcontract emergency room receipts)
- Including self-insured (worker's comp.) payments on L&I deduction - this is private \$, not government

Common Errors

- Not deducting Champus/Tricare payments
- Not reporting Use/Deferred Sales Tax on capital assets (look for computer systems)
- Deduction of amounts received from an employee benefit plan as defined in WAC 458-20-168 (3)(e)
- Deduction of government income by remote clinics operated by public or nonprofit hospitals that are not an integral part of the hospital (not on-site, refer to definition of hospital), although income from Washington basic health plans are deductible
- Reporting under incorrect classification (service vs. public/nonprofit), must reclassify due to funding implications. Public/nonprofit B&O tax is earmarked for specific health programs.

Before The Audit

- Availability of supporting documents is your best defense in any audit
- Do a preliminary investigation before the auditors arrive.
 - Conduct a “walk-through” to discover and document what supporting documents are available and retrievable.
 - Include electronic and paper files
 - Identify potential exposure areas

Before The Audit - Documents Available?

Classified by availability of supporting documents

| | | |
|----------------------------|---------------------------------|--------------------------------------|
| Dark Period None | Cloudy Period Partial | Light Period All available |
|----------------------------|---------------------------------|--------------------------------------|

Before The Audit - Dark Period

- The Dark Period includes the older years where no supporting documentation can be located. (Current statute of limitations goes back to 2009)
- All that may be known about the Dark Period is total revenue by year, total purchases, or some other total \$.

Before The Audit - Light Period

- The Light Period covers the more recent years where we have access to all data:
 - Total revenue
 - Supporting documents
 - Name and address information
- The Light Period is the basis for estimation to the Dark Period
- Depending on the number of items we can:
 - Sample, or
 - Review the actual detail (also known as 100% sample, census, actual basis).

Before The Audit - Cloudy Period

- Facts and data are unclear in the Cloudy Period.
- Control totals may exist.
- Some supporting documents are missing.
 - BUT, we must make a decision on where to separate the Dark Period from the Light Period.
 - Know your records before the auditor selects the sample!

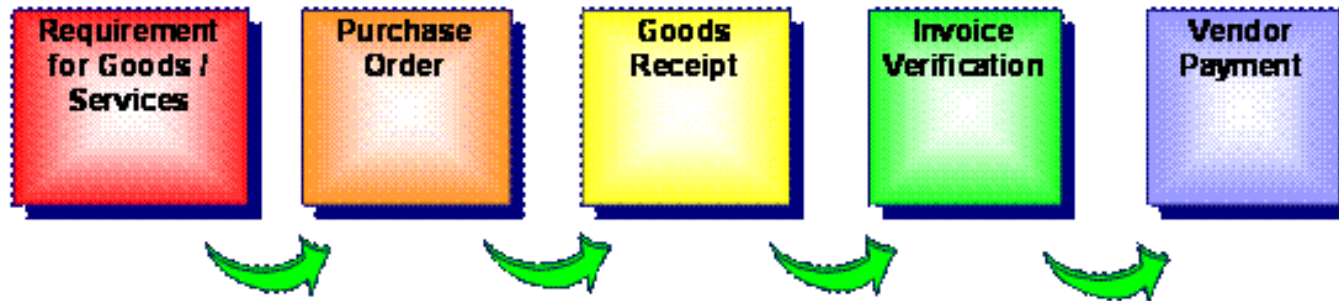
Before The Audit - Dark Period Estimation

- Estimate liability for the Dark Period.
 - Generally involves an estimated ratio of *Liability-to-Revenue* or *Liability-to-Total-Payables* from the Light Period.
 - Project that ratio onto Dark Period.
- Justification
 - The Department of Revenue will do estimates where records are unavailable.
 - If there is less than 100% error rate in the Light Period, it is reasonable to assume less than 100% error rate in the Dark Period.

Before The Audit - Purchases Data

- General Ledger (G/L) versus Accounts Payable (A/P)
 - Detail versus aggregate
- Documenting where and how used
 - Purchase orders (PO)
 - Requisitions to vendor or company stores
 - Authorization for expenditure (AFE)
 - Contracts
 - Receiving reports
 - Affidavits from operations people
- Clearing accounts
 - Work in progress (WIP)
 - Construction in progress (CIP)
 - Prepaid expenses
 - Installment payments and deposits paid

Before The Audit - Goods Received/Invoice Received (GR/IR)



In the SAP enterprise system the GR/IR system has journal entries for

1. Goods receipt: inventory received at the dock.
2. Invoice verification: vendor invoice received: a three-way match is performed internally between Purchase Order (“PO”), Goods Receipt (“GR”) and vendor invoice.
3. Vendor paid (by check or electronic funds transfer (“EFT”), or cleared. Clearing includes A/P offset against a credit or A/R.
4. If purchaser accepts evaluated receipts from the vendor, then a simultaneous Good Receipt / Invoice Verification document is generated.

Before The Audit - Fruit Salad Parable

Task is to estimate the amount of different fruits by sampling a single spoonful.

1. Fruit in four large chunks.
2. Fruit cut in many small pieces
3. Fruit crushed in a smoothie
4. Fruit floating in liquid

Before The Audit - Triage

Different strategies for different sub-populations

- Exclude: No likelihood of error
- Detail: Actual base exam of every item
- Sample: Likely to be some errors; and cost of sampling is less than cost of detail

Before The Audit - Exclude

Possible **exclusions** in a sales and use tax audit (but not all situations):

- Always pay sales tax to vendor and always taxable: non-medical equipment, durable medical equipment, diffuser tips
- Never pay sales or use tax and always exempt: charitable contributions, bandages, items sent home with patients, inventory for resale, employee benefits
- No tax consequence: some journal entries, reversals, and re-classes, etc.

Before The Audit - Detail

Possible **detail** in a sales and use tax audit (but not all situations):

- High dollar items.
 - High threshold somewhere between \$5,000 and \$500,000, depending on population.
- Select vendors or customers where always in error.
- Construction in progress (CIP)
- Information Technology (IT) purchases that include taxable and nontaxable components

Before The Audit - Reversals

- Reversals (“negative amounts”) occur because of reclassifications, error corrections, returns, voids, etc.
- The negative amounts are offset to the positive amounts.
 - Matched pair = one positive \$ offset one negative \$ to the exact amount
 - Multiple rows or partial offsets

Before The Audit - Strategies for Reversals

- Chose a combination of these:
 - Match and extract
 - Sort by descending absolute value \$
 - Detail the largest negative items
 - Sample some negative items
 - Apply error rate from positive \$ onto negative \$
 - Ignore the negatives if very small % of total positive population base \$
- Does the auditor need to see supporting documentation for every reversal?

The Audit Has Begun!



Computer Assisted Audit Program

- The Computer Assisted Audit Program (CAAP) provides a method of gathering and reviewing data in electronic format rather than paper.
- Effective March 2007, taxpayers with electronic records are required to provide the electronic records to the Department of Revenue upon request. (WAC 458-20-254).



Managed Audit Program

- **If you qualify for a managed audit**
- You and the Department's auditor sign a contract that obligates you to perform specific audit functions in an agreed period of time, usually 60 days. The contract provides:
 - Work performed by the business is subject to verification by the auditor.
 - DOR will waive the first \$5,000 of interest on a tax assessment, net of credits.
 - DOR will not add assessment penalties, including the 5 percent assessment issuance penalty.
- **Note:** The audit results are subject to an internal review process.

Managed Audit Program

- **If you owe tax:**

- The payment of the tax must be made at the time a resolution agreement is signed. This agreement acknowledges the procedures have been performed as agreed between the business owner and the auditor.

- **Note:** In the case of a tax overpayment, interest will be calculated and refunded at the statutory rate.

- **If you don't owe tax:**

- The Department will send you a confirmation letter.

Sampling

Sampling in a sales and use tax audit

(but not all situations):

- Likely to be some error
- Cost of sampling is less than detail exam.
- Mix of many different vendors.
- Taxpayer and auditor can agree on sampling plan.

Population and Sample

Data Download Universe
(all data available anywhere in any system)

Target Population
(population of audit (e.g., outstanding checks, AR credits))

Sampling Frame
(list of possible sample items)

Sample Base
(selected items)

Sample Results
(error ratio or taxability ratio)

*Estimate with
statistical or
nonstatistical
evaluation of
sampling risk*

Projection

Statistical *versus* Non-statistical

Statistical sampling requires that:

- Every sample item is selected with some known probability of selection.
- Results are evaluated using mathematical statistics.
- Confidence interval is presented.

Non-statistical sampling does not meet above.

- Time period or block sampling is non-statistical.

During The Audit – Almost Done!

- Draft audit
 - Items in dispute
 - Missing documents
- Supervisor's Conference
- Regional Audit Manager Conference (RAM)

During The Audit – Almost Done!

- “The trick with the supervisors conference is that it can only be done when we are starting the appeal process. In order to start the appeal process, we would have to have the audit submitted. The reason that they do this is so the audit can be finalized and narrowed in scope as much as possible to issues that actually need to be appealed. Thus, if you have further adjustments or concerns please let me know either by phone or email so that we can figure out how to proceed. I am not saying we can't do a supervisor's conference we just have to follow the routine first.” (New DOR auditor on third audit)

During The Audit – Almost Done!



After The Audit

- Zero or minor adjustments
 - Count your lucks stars and move on!
 - But – did the auditor miss anything?
- Audit results in an assessment
 - You really owe it.
 - You may owe it.
 - You don't owe it.
- Audit results in a refund
 - Yeah!
 - Why did you get a refund?

After The Audit

- Do you want to appeal?
 - 30 days
 - Do you want an advisor?
 - How far are you willing to go – to the Supreme Court?

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Go ahead and "appeal to a higher authority". But you know Mommy rarely overrules me.

It's 5:00 PM - And We're Done



Questions

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