EDI Audit Task Force Releases Report on Sales and Use Tax Compliance

The Task Force on EDI Audit and Legal Issues for Tax Administration was formed to coordinate efforts between the business community and tax administrators in analyzing and addressing the issues posed for tax administration by electronic commerce and related business processes. The Task Force is comprised of representatives of the Council On State Taxation (COST), Institute for Professionals in Taxation (IPT), Tax Executives Institute (TEI), Multistate Tax Commission (MTC) and Federation of Tax Administrators (FTA). This report is the seventh in a series of Task Force reports on issues relating to electronic commerce, emerging business processes and tax administration.

As part of the Task Force, a working group was formed to examine the tax administration and compliance issues associated with sampling. Sampling for sales and use tax compliance may be necessary for various reasons. Although most states employ sampling in some form, the sampling methodologies vary from state to state. Both taxpayers and taxing authorities agree that greater education is needed in this area. For this reason, the Task Force developed an educational document that is intended to identify the underlying reasons for sampling, review the typical steps involved in the compliance audit when sampling is used, and identify supplemental issues that may arise from the use of sampling in a sales and use tax environment.

The report is intended solely as an educational document for taxpayers and tax administration agencies; it makes no recommendations on sampling methods or strategies. Each taxing authority develops its own policies on acceptable sampling practices. Businesses are encouraged to work with individual taxing authorities to acquire an understanding of the sampling practices and methodologies employed for sales and use tax compliance.

Sampling for Sales and Use Tax Compliance is available from the Federation of Tax Administrators web site: http://www.taxadmin.org. Following is a brief summary of other Task Force reports, also available from the FTA web site.

Model Recordkeeping and Retention Regulation is intended to govern taxpayer retention of books and records, particularly electronically generated and retained records, for tax administration purposes. To date, Alabama, Arizona, Arkansas, California State Board of Equalization, Connecticut, Florida, Georgia, Illinois, Iowa, Maryland, Michigan, New Hampshire, New Mexico, New Jersey, City of New York, North Dakota,

(Continued on page 5)
At the start of a new year, it is natural to think in terms of change, of endings and beginnings. So it is fitting that, on the cusp of this new year, FTA is pleased to unveil the “new” Tax Administrators News.

The newsletter is now completely electronic; we will no longer be sending out paper copies. This move gives us much more freedom to experiment with the possibilities of new technologies and stretch TAN’s boundaries.

Because TAN, if anything, is an evolving creature. A recent project afforded me the opportunity to rummage through decades of back issues of the newsletter. It was fascinating to flip back in time from the comfort of my own desk. Since the publication of Volume 1, Number 1, in October of 1937, Tax Administrators News (and the world around it) has changed almost more than we can get our little brains around.

But one thing hasn’t changed: that you can depend on TAN to provide accurate, fair and timely information on matters of concern to state tax administrators. That precedent was set 65 years ago, and no new format, fancy look or technological whizz-bang will change that.

It’s the man who makes the clothes, not the other way around.

Enjoy the newsletter!

The Editor

---

From the Editor . . .

The Franchise Tax Board has voted unanimously to authorize the state to develop fully functional Internet-based tax return filing system. The most common individual return will be available at www.ftb.ca.gov in time for the upcoming filing season, and the state’s more complex individual forms will be available to extension filers by June.

Four straight quarters of decline in the recent fiscal year were at last followed by a slight increase in state revenue collections in the first quarter of this fiscal year. The quarterly report by the Nelson A. Rockefeller Institute of Government showed sales tax revenues up by 3.9 percent and corporate revenues increased by 5.4 percent. However, personal income tax revenues continued their decline, this time dropping by 1.6 percent, compared to a year earlier.

New York State, New York City and the IRS have signed a agreement necessary to allow the three agencies to conduct joint income tax audits of foreign banking corporations.

Louisiana has discontinued its TeleFile program (filing simple returns by phone) because participation has been declining as other non-paper options become available.

More than 400,000 individuals applied for bankruptcy in the final quarter of the federal fiscal year, up 12 percent over last year. Numbers were just as high in the third quarter, which has officials worried because bankruptcies typically drop in late summer.

The IRS has created an electronic newsletter to help state and local governments deal with their federal tax obligations. The quarterly publication will provide information on tax issues relating to benefits, Social Security and Medicare coverage for public employers. The newsletter is available at http://www.irs.gov/govts.

Wisconsin just found out that a checkoff on the tax return soon to be in taxpayer hands has been invalidated by a court ruling. A federal judge overturned the state’s campaign finance reform law. The decision invalidates a $20 checkoff to the state campaign fund. However, the previous $1 political contribution checkoff was automatically reinstated because of the ruling. Two million paper forms are ready to be mailed. Tax officials say they can update their free Internet filing program and they are considering whether to automatically count any $20 checkoff chosen by taxpayers as a $1 contribution.

Chain store sales were weak in November even though the weekend after Thanksgiving was strong, according to the Bank of Tokyo-Mitsubishi, Ltd. Wal-Mart and Circuit City set single-day sales records on Friday, Nov. 29. But through November, same-store sales were down 0.1 percent over last year.

A new law in Maine decouples the state from the federal bonus depreciation deduction for tax years (Continued on page 3)
As the world enters a new calendar year, states are facing the same fiscal problems that dogged them in 2002. In fact, the word “crisis” is being used more often than not to describe the condition of state finances. Two recent reports, The Fiscal Survey of States, published biannually by the National Association of State Budget Officers (NASBO) and the National Governors Association (NGA), and State Budget Update: November 2002, compiled by the National Conference of State Legislatures (NCSL), shed light on the gory details of the situation at hand.

The states have a collective $17.5 billion budget gap facing them in fiscal year 2003, according to the NCSL report. This is less than the astounding $37 billion shortfall in 2002, but still substantial enough to warrant considerable concern. Particularly worrisome to states is the fact that many of the options used to “bridge the gap” in 2002 (general funds, rainy day funds, etc.) were depleted last year. This leaves the states with fewer options of containment.

This leaves many states between a rock and a hard place. “Because most states require a balanced budget each year, these gaps must be resolved by the time state officials close their books,” explains NCSL Executive Director Bill Pound in a recent press release. “2003 certainly will be a year of tough policy decisions.”

The reasons for the across-the-continent shortfalls are simple: less money is coming in than expected, and expenditures are exceeding projected levels.

Both the NCSL and NASBO/NGA reports detail the same sad story. The NCSL Budget Update reports that 33 states brought in revenue collections below forecasted levels through October. The Fiscal Survey finds that 2002 sales tax collections were 3.2 percent lower than originally budgeted, personal income collections were 12.8 percent short, and corporate income taxes were “a staggering” 21.5 percent below projections.

29 states reported to NCSL that spending is exceeding budgeted levels. Already in fiscal year 2003, according to the NASBO/NGA report, 24 states plan to reduce their enacted budgets by more than $8.3 million. In comparison, total budget reductions for all of fiscal year 2002 were $12.8 billion. An incredible 17 states are budgeted for negative growth in fiscal year 2003.

“Spending needs are outpacing projected budget levels, particularly in the area of Medicaid and health care costs,” according to Pound. The Fiscal Survey reveals that Medicaid spending grew 13.2 percent in fiscal 2002, the fastest rate of growth since 1992.

NCSL reports that 38 states listed themselves as “concerned or pessimistic about revenue performance.” Only ten states reported a “stable or optimistic” outlook (Florida, Hawaii, New Mexico, North Dakota, Rhode Island, Tennessee, Utah, Washington, West Virginia and Wyoming).

States are looking for relief from several directions. 26 states reduced the fiscal year 2002 budget gap by enacting across-the-board cuts and using rainy day funds, while 15 states laid off employees and five states used early retirement. These trends are expected to continue in 2003, as much as they can, since these actions are one-time only and cannot be used again.

States are also looking for funds by increasing broad-based taxation, such as sales, personal and corporate income, cigarette and tobacco, motor fuels and alcohol taxes.

Throw in the fact that the country is experiencing a dramatic legislative and executive turnover, and you have a recipe for more bumps ahead. Legislators in 24 states will be working with newly-elected governors, at the same time there is a 24 percent turnover in state legislative seats. Therefore, many states face an uncertain future.

Says NCSL President Angela Monson: “Legislatures will have to make extraordinarily tough budget choices in the 2003 sessions.”

---

**One-Liners — Continued from page 2**

2003 and 2004. The state had previously decoupled for 2002; the new law extends the decoupling for two more years. Taxpayers will be allowed to recapture their disallowed deductions over a three-year period beginning two years after the initial disallowance.

• The IRS has created a special toll-free number for taxpayers whose refunds haven’t yet arrived. The Service says 96,792 taxpayers are owed $80 million in refunds that have been undeliverable. Taxpayers normally can track late or lost refunds on the IRS website, but that feature has been disabled for a few weeks in preparation for the new filing season. So taxpayers missing a refund check are now asked to call 800-829-1954.
FTA, in cooperation with the IRS, is sponsoring the 2003 Electronic Filing Symposium May 4-7 in Indianapolis at the Hyatt Regency Indianapolis.

All individuals interested in individual income tax electronic filing are encouraged to attend. The meeting agenda will also feature sessions on electronic filing of business taxes and 2-D Barcode Standards.

WHAT WE NEED FROM YOU:
FTA wants this event to be as targeted and useful as possible for all attendees with responsibilities in the area of electronic filing. We’re what topics you would be interested in. Please take the time to share your thoughts even if you aren’t sure you will actually attend the event. Share your thoughts online at www.taxadmin.org or send an email to Stephanie.Rosenbusch@taxadmin.org.

BASIC HOTEL INFORMATION:
For those who need to plan in advance, the event will be at the Hyatt Regency Indianapolis at State Capitol, One South Capitol Avenue, Indianapolis, IN 46204. The room rate is $129 single or $149 double, plus taxes. The hotel deadline for reservations is April 3, 2003. For reservations call 1-800-233-1234 or 317-632-1234. More information is available at http://indianapolis.hyatt.com. Please make sure you tell the hotel that you are with the Federation of Tax Administrators.

WORKSHOP REGISTRATION:
Registration information will be released along with a preliminary program in early February. The registration fee will be $250. This covers the opening reception, continental breakfast Monday, Tuesday and Wednesday and a lunch on Tuesday. There may be an additional charge for related meetings that are generally set up after the close of the Symposium (e.g., 2-D Standards and/or XML Standards).

THE PROGRAM:
A preliminary program and registration form will be posted to the FTA web site in early February (http://www.taxadmin.org). The 2002 Symposium Program is also available on the FTA site.

RELATED MEETINGS:
In the past, FTA has sponsored meetings related to 2-D Barcode Standards and TIGERS/XML Standards. It is uncertain at this point whether these meetings will take place at the conclusion of the Symposium. More information will be provided with the preliminary program.

The Federation of Tax Administrators looks forward to your suggestions on, and participation in, the 2003 Electronic Filing Symposium.

The Supreme Court of Missouri has reversed an Administrative Hearing Commission ruling that the income of entities holding trademarks licensed for use in Missouri was subject to the state’s income tax. In January, the AHC determined that two Delaware trademark companies fell within the imposition statute because they were doing business in the state, by licensing their intangibles for use in Missouri and earning royalty income from the use of the marks in the state, and that the imposition of the tax did not violate any due process or Commerce Clause concerns. The state supreme court has now reversed those decisions. In a 4-3 decision that did not use the word “nexus” or mention any constitutional issue, the majority determined that, while the taxpayers had no Missouri source income because they had no sales in the state, the court stated, “The basic requirement for there to be Missouri source income is that there is some activity by the taxpayer in Missouri that justifies imposing the tax,” and, while the taxpayers were related to their in-state affiliates, “they are separate legal entities, and as such each must have its own property, payroll or sales in Missouri to be taxed in Missouri.” The court concluded that the taxpayers had “absolutely no sales – in Missouri or elsewhere – because they sell no products at all,” and that the state could not tax the income in question because the taxpayers had “no contact, and specifically no sales, within the state.” The animated dissenting opinion asserts that it “defies economic reality” to hold that income derived from the Missouri market, in which the taxpayers participated through their related manufacturing companies, was not taxable there. Acme Royalty Co. and Brick Investment Co. v. Director of Revenue, and Gore Enterprise Holdings, Inc. v. Director of Revenue, Nos. SC 84225 & SC 84226 (Mo., 11/26/02).
South Carolina and Utah have adopted the model regulation in whole or in part.

Auditing Electronic Data provides an overview of the basic framework of the tax audit and examines various issues related to auditing in an electronic environment.

Procurement Cards and Tax Compliance: Bridging the Gap discusses use tax compliance issues associated with corporate procurement cards and examines alternative methods of achieving the appropriate compliance.

Evaluated Receipts Settlement (ERS) and Tax Compliance focuses on understanding the ERS process and identifying potential solutions that would be helpful in addressing the audit and recordkeeping issues created by the use of ERS.

Model Direct Pay Permit Regulation examines the issues involved in the use of “direct pay” permits, a procedure through which certain purchasers are allowed to pay use tax on their purchases directly to the state tax administration agency, rather than to a retailer. The report also contains a model regulation to govern direct pay authority and a survey of state practices in this area.

Sales and Use Tax Compliance Agreements (SUTCAs) are agreements between taxing agencies and taxpayers that specify an agreed-upon method for calculating and remitting tax on specified purchases, and which identify alternative reporting methodologies, best practices, and recommendations for taxpayers and tax agencies to follow when entering into these agreements. This report includes a summary of state practices with respect to sales and use tax compliance agreements.

For more information on the Task Force and its reports, contact Stephanie Rosenbusch at Stephanie.Rosenbusch@taxadmin.org.

Excerpt from Sampling for Sales and Use Tax Compliance (December 2002)

Below is an excerpt from the Task Force on EDI Audit and Legal Issues for Tax Administration report, Sampling for Sales and Use Tax Compliance (December 2002). For a copy of the full report, visit the FTA website at www.taxadmin.org.

The Sample Plan
A well-developed sampling plan will set appropriate expectations, resolve some taxpayer concerns, and reduce the time to resolve disputes at later stages of the compliance examination. Agreement in the steps and methods to be used will be the overall goal; however, this may not always be possible. The following subsections provide suggestions on the details of sample planning.

The sample plan, which is part of the overall audit plan, is the design that guides the process of sampling. The intent of the parties involved in the sample is described in the sample plan. The development of the sample plan is an ongoing process. Like all plans, some details may be decided upon or changed during the sampling process. However, at the outset, a sampling plan may include the following:

• Objective of the sample;
• Identification of the population being sampled, the sampling unit, the sampling technique to be used, and the source of the random numbers and random seed numbers;
• Description of the procedures to be followed in identifying the units to be examined, who should locate the records, and how and where the records will be presented for review;
• Outline of any special procedures to be utilized (for example, a description of a strategy to deal with missing items); and
• Description on how and what kind of evaluation and projection procedures will be applied to the sample results. In statistical sampling, this may include a statement of the desired confidence level that will be used in calculations.

An audit may consist of several tests that each address a different area of interest and population (e.g., a paid bills test, a fixed assets test, a resale test, an exempt sales test, etc.). Some of the tests conducted may involve the use of sampling, while others may not. The sampling techniques applied may also vary among the different tests in which sampling is used; such as, a unique sampling plan (written or oral) may be needed for each area sampled.

Stratification
Stratification is the process of sectioning, dividing or segmenting a population into individual strata or homogeneous groups. Each group must be structured in such a way that no unit can belong to more than one stratum. Often a sample is stratified based on an attribute of the population (e.g., assets vs. expenses) and then further stratified by dollar amounts within each attribute subpopulation.

Stratifying the population and taking samples from each stratum generally improves the overall precision of the
Excerpt — Continued from page 5

sample. This can be done in several ways and requires auditor and taxpayer judgment and mutual agreement. Stratification almost always requires the use of computerized records. Some examples of stratification are:

- **Dollar ranges:** Used to divide the population into two or more segments based on characteristics of dollar amounts.
- **Accounts:** Used for those instances when a particular account, or group of accounts, has special attributes associated with it.
- **Time periods:** Typically used for significant law changes or changes in a taxpayer’s computer system.
- **Locations:** Generally used when one location significantly differs from another such as headquarters vs. manufacturing.
- **Vendors:** Used when the value associated with a particular vendor is significantly different from the remaining vendors and the errors associated with that vendor are expected to be different.

**Define Sample Unit**
The sampling unit is the basic unit that will be sampled. The desired sample unit is one that will provide an accurate assessment of its intended use and can be traced back to the source document. The sampling unit may be a line item, invoice, voucher, batch number, purchase order, time period, contract, location, or customer. Line items provide the greatest detail and are often easiest to tie to the general ledger. The format of computerized data will generally determine the sample unit. In a noncomputerized audit, the method in which records are filed may control the determination of the sample unit.

**Select the Sampling Technique**
A sample, by definition, is when part of the population is reviewed for the purpose of obtaining a conclusion about the population as a whole. How this is done, or the choice of sample selection method, is crucial to the overall process. When the records are not suitable or complete, the sample can be subjectively selected. Samples drawn subjectively are judgmental samples. In any judgmental sample, the probability of selection of the sampling units cannot be measured.

To obtain an objective evaluation of the sample results, more sophisticated sampling methods must be used. Therefore, some sort of random selection process is generally the method of selecting the sample. Random selection, which requires removal of selection bias, is fundamental to any methodology that can be objectively evaluated. What is meant here by “random” is any selection procedure where the probability of selection is known (“probabilistic” sampling would be a more accurate description of this class of sampling).

1. **Judgmental Selection Techniques**
   Individual sampling units in a judgmental sample are usually not drawn from throughout the population. Judgmental techniques may be necessary due to the method in which records are stored. One example of judgmental selection is Block Sampling in which the audit team selects blocks of contiguous transactions, usually grouped together on a time basis (e.g., records batched on a specific date).

2. **Random (Probabilistic) Selection Techniques**
The results of any valid random sample can be objectively evaluated. The following are examples of probabilistic sampling methods that may be applied in a sales and use tax audit:

- **Simple Random Sample**
  A random sample drawn from a population that is not stratified. A random number table or random selection software can be utilized to develop a list of unique random numbers that are corresponded to individual sampling units in the population. When the population is in electronic format, random selection of the population is a much simpler and faster process.

- **Systematic with Random Start**
  Instead of corresponding a random number to each sampling unit as in simple random sampling, a random number is selected to correspond with only the first sample unit. Then, each k item is selected in the order it occurs (at the time of selection) in the population. The interval, or k, represents an integer derived by taking the population count and dividing by the desired sample size. Generally, a random number from 1 to k is utilized to start the selection process. The audit team may choose to use multiple starts to approach a more random selection method.

- **Stratified Random Sample**
  Sample units from a population are divided into individual groups or strata prior to selecting the sample. An independent random sample is taken from each stratum, similar to a nonstratified simple random sample. Within a stratum, each sample unit has an equal chance of selection. However, all sample units from the entire population do not necessarily have an equal chance of selection. Frequently, sample units are placed into strata based on dollar amounts. The larger dollar items may have a greater chance of selection when compared to sample units in other strata. Stratified random samples generally provide for more precise results when compared to simple random samples of the same size.
State tax administrators and policymakers are always interested in how the tax burden in their state compares with others. Yet there are many different methods for calculating a state's tax burden. Two methods for calculating tax burden use recently released data from the Census Bureau.

The Census Bureau conducts an annual survey of state and local governments, compiling data on revenues from many different sources. The Bureau recently published the results of the fiscal year 2000 State and Local Government Finances survey. By using the broadest measure of revenues in this survey—State and Local Own Source Revenues (revenues generated at each level from own taxing/revenue sources, without transfers), analysts can develop a measure that more accurately compares states and better represents the burden on state citizens. This minimizes differences in how states raise revenues, whether from taxes or various user/other fees. The use of State and Local revenues minimizes differences in how centralized revenue collections are in each state. For example, Hawaii collects 80 percent of government revenue at the state level, compared with New York that collects only 46 percent.

The Census Bureau reported that state and local governments generated $1.25 billion in revenues in the fiscal year ending in 2000, or $4,440 per person. Of that total, $710 million, or 57 percent, was collected by state governments while 43 percent was collected by local governments. The data is summarized in the table below, presenting state and local revenues per capita and revenues as a percent of personal income. States in the northeast had the highest tax burden.

(Continued on page 8)
averaging $5,181 per person, with the states in the southeast reported the lowest, averaging only $3,847 per person. (Note: Alaska’s high burden is largely attributed to Oil Royalties that are not paid by state citizens).

When using revenues as a percentage of personal income as the measure, states in the western region had the largest tax burden. This measure takes into account the higher personal income in the northeastern region, and includes a region’s ability to pay and differences in costs of living. The southeastern region still has the lowest tax burden at 15.6 percent of personal income. There is substantial variation among the states ranging from a high of 20.8 percent in Wyoming to 12.6 percent in New Hampshire.

The Census data includes a wealth of information on the different sources of state and local revenues. The data can be downloaded from the Census website at http://www.census.gov/govs/www/estimate.html. Additional summary tables are available on the FTA website at http://www.taxadmin.org/fta/rate/burden.html#slfinance.

FTA Annual Meeting, June 15-18, Oklahoma City, OK. Headquarters: Renaissance/Westin Contact: FTA

SEATA Annual Conference, July 13-16, Savannah, GA. Headquarters: Savannah Marriot Conference Website Contact: Caren Gibson, (404)-417-2291, clgibson@gatax.org

FTA Technology Conference, August 10-13, Pittsburgh, PA. Pittsburgh Hilton Contact: Jonathan Lyon, (202) 624-5894, jonathan.lyon@taxadmin.org

MSATA Annual Meeting, August 24-26, Indianapolis, IN. Indianapolis Marriot Downtown

FTA Tobacco Section Annual Meeting, September 7-10, Oklahoma City, OK. Headquarters: Renaissance Hotel

WSATA Annual Meeting, September 7-10, Austin, TX. Headquarters: Hyatt Regency Hotel

FTA Motor Fuels Annual Meeting, September 21-24, Charlotte, NC. Headquarters: Hilton Charlotte University Place Contact: Cindy Anders-Robb, (307) 632-4144, cindy.anders-robb@taxadmin.org

FTA Revenue Estimating Conference, September 21-24, New Orleans, LA. Hampton Inn New Orleans Convention Center Contact: Ron Alt, (202) 624-8445, ron.alt@taxadmin.org