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Anatomy of a Sales Tax VDA: Organizing and strategizing a multi-state Sales Tax Voluntary compliance project

By Raymond Chang, CPA

(Part 1 of 3)

Navigating the ever-evolving state Nexus and sales tax nuances is never a simple process. Adding to the complexities presented by the significant variance in states' tax codes, the sheer logistics of maintaining the necessary due diligence can seem overwhelming.

For those reasons, businesses are understandably reticent to execute an exhaustive multi-state sales tax compliance review. The upside for businesses, however, are substantial. The confidence and relief that accompanies the knowledge of being in full compliance is immeasurable, and the knowledge gained from going through such an exercise paves the way for subsequent future reviews to ensure compliance is maintained.

It was with such upsides in mind that we recently completed a comprehensive Nexus and sales tax review of a client of ours – a manufacturer operating and filing in three states. The overall goal: to make sure they were aware and confident in their understanding of the impact their expanding market base was having in their Nexus footprint for sales tax.

Each state looks at Nexus differently, and they constantly refine it to meet the changing business strategies of the day. The old "physical" Nexus concept of the past, where a company needed to be physically present in a state in order to be taxed in that state, has now expanded to include "Click-Thru" or "Affiliated" Nexus. These days, a company does not need to be physically present in state via a "brick and mortar" to trigger Nexus. If the company hires third party sales reps in the state and they solicit new business there, states can and often will claim that this is enough to establish Nexus.

We first sought to familiarize ourselves with our client's new markets and identify the possible states where their sales tax exposure is of a greater concern. Using our client's sales-by-state information, our State and Local Tax team summarized and quantified the exposures by state, assuming everything was taxable. We then interviewed their management team to further understand their marketing and sales strategies and how they contribute into new business. Combined with our knowledge of how each state defines a taxpayer's Nexus footprint (physical, click-thru and affiliated Nexus) for sales and use tax and income tax purposes, we identified a handful of states where exposures could exist.

Following this exercise, we then encouraged our client to also be proactive to come forward and alert those states through a VDA Program. A voluntary disclosure agreement (VDA) is a program that enables taxpayers to receive certain benefits from a state when they proactively disclose prior period tax liabilities in accordance with a binding agreement. A VDA is generally welcomed by states, and helps companies avoid any penalties that could arise if they had not preemptively filed.

Filing and submitting a VDA usually means paying back taxes with a minimum three-year look-back plus interest. Companies take a hit, but doing nothing and hoping states never knock on their door is a dangerous alternative. If the states contacted our client first instead of the other way around, the look-back period could be as long as 10 years, with interest and penalties tacked on. And our client would have little control over the assessment process.

How We Tackled It – The Devil is in the Details

Each state has its own VDA process and look-back period (look-back periods vary by state regardless of whether our client goes through the VDA process or not.). Using the applicable look-back periods and sales tax rates, we computed the estimated tax exposure for these states in two ways – assuming a VDA is filed and assuming a VDA is not filed.

This exercise helped us establish a maximum and minimum range of exposure. If all sales were taxable, then the computation and the legwork would be straightforward. But, some of the sales were taxable and some were exempt. The question then became: does the company have all the proper resale or exemption certificates on file to support the exempt status of their customers? We knew it would be a problem if our analysis showed that their certificates were incomplete, improper or possibly outdated, even if the sales were rightfully exempt for sales tax as the states may not see it the same way.

Next, we dove deep into the company's sales order process, noting how customer information (i.e. exemption certificates) was obtained, retained and maintained. This deep dive was a critical step in determining the extent of work that we will need to do as well as identifying the control gaps early in the process to mitigate any deficiencies going forward. We then did a walkthrough of their system based on their description to see the process for ourselves.

In the next piece in the series, we will take a detailed look at the issues that we found in this particular case study. We'll also lay the groundwork for how businesses in a similar situation can begin to make sense of the obligations that they may have under state Nexus laws.

About Raymond Chang, CPA
As a Senior Audit Manager with more than 15 years of industry experience, Raymond's practice focuses on providing assurance and advisory services to privately-and publically-held clients in the middle market. He is particularly skilled at working with companies in the manufacturing, distribution and real estate sectors.

Highly analytical, Raymond is skilled at analyzing extensive data and identifying areas for improvement. He enjoys working with clients to find solutions to their problems and advises them in all aspects of business and financial management, including operational and internal control matters and financing. He is involved in the planning and supervision of various corporate, partnership and individual tax returns.

Raymond is a member of the Chinese American Society of CPAs and an active member of the firm's Best Practices and CPE committees. He often takes a leadership role in many of the firm's training and staff development programs. Raymond graduated from St. John's University with a Bachelor of Science degree in Accounting. Raymond can be reached at **rchang@mwellp.com.**

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