

Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner (Ret.), Second District
Honorable John Chiang, State Controller

Date: March 14, 2014

From: Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department (MIC 43)



Subject: **Board Meeting March 25, 2014**
Item P3 - SUTD Deputy Director's Report
Audit Program Update

The memo provides an update on the Sales and Use Tax Department's (SUTD's) Audit Program functions.

SUTD is committed to meeting the needs of our customers and maximizing voluntary compliance. SUTD continues to innovate and adapt to our rapidly changing world by providing taxpayers the tools, and education and outreach to more easily comply with the tax laws. In addition to focusing on increasing voluntary compliance, SUTD also added new audit functions to reduce audit hours. The program audits one percent of active accounts each year, concentrating on those considered most likely to be inaccurate in their tax reporting. In fiscal year 2012-13, the sales and use tax audit program disclosed net deficiencies of more than \$528 million. Taxpayers received more than \$155 million in sales and use tax audit refunds. The following is a summary of the various audit efforts SUTD is employing to increase efficiency and minimize taxpayer impact.

Joint Audits

SUTD is currently partnering with the Property and Special Taxes Department (PSTD) to pilot accounts that are also registered for the Electronic Waste Recycling Fee (eWaste). This joint effort allows for staff from both SUTD and PSTD to be present at the early stages of the audit, which helps reduce the amount of time BOE staff are interacting with the taxpayer and disrupting the taxpayer's business operations. The pilot also uses the expertise of the BOE's Computer Audit Specialist and audit staff to design and develop an audit program that allows staff to make efficient use of the taxpayer's information and BOE's resources. Also, this effort helps the BOE meet the goal of improving the taxpayer experience and enhancing operational effectiveness as part of the BOE's Strategic Plan.

Managed Audit Program

The Managed Audit Program (MAP) allows certain businesses to conduct a type of self-audit with instructions and guidance from one auditor. Eligible businesses generally have: straightforward tax issues, few tax exemptions, and the resources to conduct a MAP audit.

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With a MAP audit, the taxpayer is only required to pay the interest at one-half the rate that would otherwise apply, should the audit result in a liability. In addition, a taxpayer that conducts a MAP audit is less likely to appeal the findings, becomes more knowledgeable about sales and use tax, is more likely to ensure future compliance with the areas he/she audited, and becomes more familiar with the audit process. Furthermore, the hours spent by the taxpayer to conduct the MAP audit are hours saved by BOE staff.

During the fiscal year 2012-13 there were a total of 32 MAP audits completed, which generated \$21.1 million in revenue and saved taxpayers \$1.8 million in interest. The estimated number of hours saved for this period was 5,690, which allowed staff to conduct more audits.

Prior Audit Percentage of Error

SUTD currently employs the Prior Audit Percentage of Error (PAPE) program, which allows audit staff to utilize the percentage of error calculated in the prior audit of the taxpayer and apply the same PAPE to the sales or accounts payable in the current audit of the taxpayer. This tool helps streamline the audit process by reducing the time it takes to complete an audit, and also minimizes the disruption to the taxpayer. Eligible accounts must have at least one prior audit. In addition, the prior and current audit must be similar and have consistent business operations, volume, and potential type of errors. During the fiscal year 2012-13 there were a total of 82 PAPE audits, which saved an estimated 12,350 hours and allowed staff to conduct more audits.

Desk Audit Program

Within our Desk Audit Program (DAP), third party data is compared to amounts reported by taxpayers on their sales and use tax returns. Rather than forwarding all of the discrepancies found to the district field offices for examination and follow up, the discrepancies and investigations, as well as contact with the taxpayer, is handled remotely. For example, Department of Motor Vehicles data is compared to the sales amounts reported by registered vehicle dealers and the difference is assigned to desk audit staff. For fiscal year 2012-13, this program generated \$4.1 million in revenue.

1099-K

The 1099-K information contains electronic payments from payment processing companies which is compared to the sales information reported to the BOE. The program began in fiscal year 2012-13 and had over 220 cases referred to the field for further investigation during the current fiscal year. 41 investigations are complete resulting in 13 deficiency audits generating over \$600,000 in revenue.

Digital Audits

Following the conversion of SUTD's entire audit program to digital audits in fiscal year 2011-12, we continue improving the digital audit process. Audit reports are no longer printed and are now managed, tracked, and processed electronically.

Electronic Audit Plan

In December of 2012, an electronic Audit Plan was developed and distributed to all field offices for use on non-cash based businesses. This electronic Audit Plan can be used in place

of audit plans manually prepared by auditors. This plan contains basic audit questions, identifies potential audit issue areas, and helps the auditor be more efficient. As an Audit Plan is required for all audits, having a generic Audit Plan covering key areas ensures more consistency in our audits and helps reduce audit hours. SUTD regularly reviews the Audit Plan and makes necessary updates. SUTD is currently developing an electronic Audit Plan for cash based businesses.

Electronic Sales Suppression Devices

In 2012, SUTD initiated a pilot project in an effort to determine the degree of electronic suppression affecting California tax gap. As a result of the pilot, the BOE sponsored legislation (AB 781) making it a punishable offense for any person to sell, purchase, install, transfer or possess programs that falsify reported sales. It also resulted in SUTD identifying approximately 100 cases where electronic sales suppressions occurred, developing more effective auditing techniques for point of sale recordkeeping systems, implementing statewide training, and organizing a Sales Suppression and Detection Techniques Symposium in partnership with the Federal Tax Administration (FTA) for April 28 and 29, 2014 in Pasadena, California.

Streamlining the Field Waiver and No Change Forms and Process

SUTD staff is conducting efforts to combine the BOE-596, *Report on Account Being Waived for Audit*, and the 414-C, *Report of Examination of Record – Sales and Use Taxes*, forms and processes. By combining these two forms and simplifying the process, it will result in a reduction of audit hours and less impact on taxpayers. We anticipate this process to be in place by the beginning of the 2014-15 fiscal year.

SUTD is proud of its innovative efforts to create new audit leads and streamline some of its processes, while improving our relationships with our taxpayers and stakeholders. Please let me know if you have any questions.

JLM:mwl

cc: (via email)

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