Legislative Analysis

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LIMIT USE OF INDIRECT AUDIT PROCEDURES IN SALES AND USE TAX AUDITS

House Bill 4288 (Substitute H-4) ***(Enacted as PA 108 of 2014)***
Sponsor: Rep. Frank Foster

House Bill 4292 (Substitute H-4) ***(Enacted as PA 109 of 2014)***
Sponsor: Rep. Peter MacGregor

Committee: Tax Policy
Complete to 12-11-13

A REVISED SUMMARY OF HOUSE BILLS 4288 & 4292 AS REPORTED FROM COMMITTEE 12-11-13

House Bill 4288 (H-4) and House Bill 4292 (H-4) would amend the General Sales Tax Act and Use Tax Act, respectively, to limit the use of indirect audit procedures by the Department of Treasury.

The bills define "indirect audit procedure" to mean an audit method that involves the determination of tax liabilities through an analysis of a taxpayer's business activities, using information from a range of sources beyond the taxpayer's declaration and formal books and records.[1]

The acts provide that if the taxpayer fails to file a return or to maintain and preserve "proper" records, or the Department of Treasury has reason to believe that records maintained by the taxpayer are inaccurate or incomplete, the department may assess additional taxes based on the information that is available or that may become available.

The bills add that where the department believes additional taxes are due because the taxpayer has maintained inaccurate or incomplete records, the department may assess additional taxes based on an indirect audit procedure. The bills would also change records retention provisions from "proper" to "sufficient." The bills would then define

[1] In an April 2010 report published by the International Monetary Fund, "indirect" audit methods were described as methods that "involve the determination of tax liabilities through an analysis of a taxpayer's financial affairs utilizing information from a range of sources beyond the taxpayer's declaration and formal books and records. Assessments are often based on circumstantial evidence indicating a reasonable estimate of the taxpayer's correct liability." See, Edmund Biber, *Revenue Administration: Taxpayer Audit – Use of Indirect Methods*, International Monetary Fund, Fiscal Affairs Department, April 2010, http://www.imf.org/external/pubs/ft/tnm/2010/tnm1005.pdf. Additionally, Part 4 of the IRS Internal Revenue Manual describes an indirect audit method as a technique that "involves the use of circumstantial evidence to determine the tax liability based on omitted income, overstated expenses, or both. Circumstantial evidence is evidence from which more than one logical conclusion can be reached. To support adjustments for additional taxable income, both the credibility of the evidence and the reasonableness of the conclusion must be evaluated before the determination of tax liability is made." (IRM 4.10.4.2.8) The manual further notes that "[t]he formal indirect methods used to determine tax liabilities involve the development of circumstantial proof of income through the use of bank deposits, source and application of funds, ratio analyses, or changes in net worth" (IRM 4.10.4.6). See, http://www.irs.gov/irm/part4/.

"sufficient records" to mean records that meet the Department of Treasury's need to determine the tax due under the acts.

The bills provide that an indirect audit procedure used by the department would have to be conducted in accordance with the Revenue Act (1941 PA 122), including any audit standards established by the department.[2]

An indirect audit procedure utilized by the department would have to contain the following five elements.

1. A review of the taxpayer's books and records. (The department could use an indirect method to determine the accuracy of the taxpayer's books and records.)

2. Both the credibility of the evidence and the reasonableness of the conclusion must be evaluated before any determination of tax liability is made.

3. The department could use any method to reconstruct income, deductions, or expenses that is reasonable under the circumstances, including the use of third-party records.

4. The department must investigate all reasonable evidence presented by the taxpayer refuting the computation.

5. If a taxpayer has filed all required returns and maintained and preserved adequate records (as required under the act), the department would be prohibited from determining a tax deficiency or assessment based on any indirect audit procedure unless the department has a documented reason to believe that the taxpayer's records or returns are inaccurate and incomplete and that additional taxes are due.

FISCAL IMPACT:

House Bills 4288 and 4292 would have an indeterminate, but negative, overall fiscal impact on both state expenditures and revenues. According to Department of Treasury estimates, the provisions of the bill would increase administrative costs by approximately $125,000 annually. Of that amount, approximately 70% would be based on the additional audit hours incurred to document the lack of records by the taxpayer to satisfy the requirements for an indirect audit. The remaining 30% of the annual cost would be incurred through additional audit hours spent in litigation defending audits relating to the new provisions. The Department of Attorney General may also realize increased costs defending any lawsuits related to audits. Any fiscal impact related to litigation would be directly related to the number and complexity of the lawsuits.

By limiting the usage of indirect methods when conducting audits, it is estimated that fewer audits will be conducted, thereby reducing the amount of revenue received by the

[2] House Bill 4291 (Rep. Farrington) would amend the Revenue Act to require the Department of Treasury to promulgate administrative rules establishing standards in how its audits are conducted. The bill passed the House of Representatives on May 2, 2013, but is still pending before the Senate Committee on Finance.

state. No numerical estimates are available on the revenue impact to the state. Any revenue loss would be directly related to the number and size of audits foregone.

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