

LIMIT USE OF INDIRECT AUDIT PROCEDURES

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House Bill 4288

Sponsor: Rep. Frank Foster

House Bill 4289

Sponsor: Rep. Aric Nesbitt

House Bill 4291

Sponsor: Rep. Jeff Farrington

House Bill 4290

Sponsor: Rep. Bob Genetski

House Bill 4292

Sponsor: Rep. Peter MacGregor

Committee: Tax Policy

Complete to 3-19-13

A SUMMARY OF HOUSE BILLS 4288-4292 AS INTRODUCED 2-20-13

In general, the package of bills restricts the use of "indirect methods," or sampling, during the course of an audit by the Department of Treasury to determine a taxpayer's income and expenses and, ultimately, a tax liability, or to determine a reporting entity's unclaimed property liability.¹

House Bill 4288 (General Sales Tax Act) and House Bill 4292 (Use Tax Act)

The bills 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 use of "circumstantial evidence" to determine a tax liability based on omitted income and/or overstated deductions or expenses. The term "circumstantial evidence" is defined as evidence from which more than one logical conclusion can be reached.

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.

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>.

However, the bills provide that if a taxpayer has filed all required returns and maintained and preserved adequate records (as required under the act), the Department of Treasury 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.

An indirect audit procedure utilized by the department could not be conducted in an "arbitrary fashion" and 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. A tax deficiency determination or an assessment could not be based on a projection from a sample without the written approval of the taxpayer.
3. Both the credibility of the evidence and the reasonableness of the conclusion must be evaluated before any determination of tax liability is made.
4. 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.
5. The department must investigate all reasonable evidence presented by the taxpayer refuting the computation.

House Bill 4289 – Uniform Unclaimed Property Act

House Bill 4289 would amend the Uniform Unclaimed Property Act to require unclaimed property audits to be performed using the *Government Auditing Standards* published by the U.S. Government Accountability Office (GAO)². The Department of Treasury (or its authorized agents) could determine any liability based on the facts contained in the unclaimed property report that is the subject of the audit or other information in the department's possession.

Additionally, the department (or its authorized agents) may determine liability based on a "reasonable" statistical sample or other sampling techniques consistent with the GAO standards in examining the reports and records of the reporting entity only when the entity does not have complete records of transactions or, if the reporting entity has adequate records, upon the entity's written approval. The bill provides that if the reporting entity has preserved and maintained adequate records, any unclaimed property audit must contain the following elements:

1. A review of the reporting entity's books and records.
2. Not be based on a determination of any indirect audit procedure.

² <http://www.gao.gov/yellowbook>.

3. Not extrapolate a determination based on any indirect audit procedure.

If an indirect audit procedure is used by the department during the course of an "examination" (audit), the department would have to evaluate the credibility of the evidence and the reasonableness of the conclusion before the determination of tax liability was made. The use of an indirect audit procedure during an unclaimed property audit would have to contain the following five elements:

1. The department (or agents) could use any method to establish the audit determination.
2. The department (or agents) could not be arbitrary in the use of authority.
3. An indirect method could be used to test the accuracy of the reporting entity's books and records.
4. The department (or agents) would have to investigate all reasonable evidence presented by the taxpayer refuting the computation.
5. The department (or agents) could use third-party records.

The reporting entity subject to the indirect audit procedure could challenge the accuracy of any method by providing clear and convincing evidence that the method or test is erroneous, lacks a rational basis, or produces a different result when complete records are considered.

House Bill 4290 – Revenue Act

The bill would amend the Revenue Act, which governs the administration of the several tax and revenue laws of the state, to require the Department of Treasury to publish and make available to the public (printed and electronically) all audit manuals, including training manuals, as well as all internal policy statements, bulletins, memos, and other documents.

House Bill 4291 – Revenue Act

The bill would amend the Revenue Act to require the Department of Treasury to provide a person who has been audited by the department with a complete copy of audit work papers, report findings, and any correspondence and other documentation that form the basis for any audit determinations.

The bill would also require the department audits to follow the GAO *Government Auditing Standards* and the American Institute of Certified Public Accountants' (AICPA) audit sampling guide.³

³ <http://www.aicpa.org/Publications/AccountingAuditing/KeyTopics/Pages/AuditSampling.aspx>. The AICPA website notes that the audit sampling guide "summarizes applicable requirements and practices, and delivers "how-to" advice to help auditors apply nonstatistical and statistical sampling in auditing. The Guide includes case studies illustrating the use of different sampling methods, including classical variables sampling and monetary unit sampling, in real world situations."

FISCAL IMPACT:

A fiscal analysis is in process.

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Fiscal Analyst: Jim Stansell

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.