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***Sales and Use Taxes***

# Corralling the Runaway Sales Tax Auditor

  

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In the wake of the economic recession, state legislatures face huge budgetary shortfalls; slow recovery and depressed tax collections have prevented states from offsetting deficits and, as a result, states are looking to increasing tax collection as a means to generate additional revenue.

The audit climate has become very aggressive. Economic pressures have caused an uptick in audits both in terms of frequency and in scope.

***While focused on sales and use tax audits, the majority of the suggestions herein have application to all state tax audits.***

This article examines some of the challenges facing taxpayers, and sets forth practical guidelines for approaching a difficult audit and surviving an audit with an aggressive auditor. Although audit procedures vary from state to state, the following summarizes the general challenges often faced by taxpayers and suggests ways to respond to those challenges.

While focused on sales and use tax audits, the majority of the suggestions herein have application to all state tax audits.

We recognize that some audits are so small that many of the suggestions herein just would not apply. We encourage you to use this article and the recommendations contained herein as a menu of possible strategies that may be selected and adapted to the particular audit, auditor, tax authority, and taxpayer.

## Prepare in Advance

One way to assert control in a difficult audit is to prepare in advance. This preparation begins with the return compliance process. Unique transactions on the return should have already been reviewed for proper treatment in the jurisdiction(s) involved.

Company policy should be formulated and applied to properly identify and respond to potentially aggressive positions. In practice, that means asking the tough question: Will the company shift the burden of sales tax incidence to the customer on transactional facts that create an uncertain outcome?

Internal risk avoidance must be balanced with customer relationships. This may be an area where the tax group collaborates with the sales department, particularly on large or numerous transactions.

Changes in transactional positions or law and audit experience can also dictate areas of concern in preparing the return.

The key to audit preparation during the return compliance process is document, document, document. The compliance files should contain notes, research, internal conversations including emails, etc., broadcast notices from professional firms or the taxing jurisdictions themselves, and position or opinion letters.

Finally, contemporaneous internal documents such as invoices, exemption certificates, contracts, etc., should be stored and safeguarded for easy retrieval. If these internal documents are not in electronic format, consider a project to transfer the files to a searchable electronic medium.

Periodic internal audits of your business will help you both feel and be prepared. Internal audits provide an opportunity to locate your company's weaknesses, improve policies and procedures, and strategize how to defend against adjustments on those sensitive issues. Seeking assistance from tax professionals to complete periodic audits helps ensure accurate filings and readiness for eventual disclosure to a state auditor. However, internal audits can also be conducted by in-house personnel.

The more exemptions or exclusions from sales/use tax claimed by your business or its customers, the more involved the audit is likely to be. For an audit to proceed smoothly the taxpayer must know both the law and the correct exemptions and must have the documentation to back it up.

Many taxpayers are understandably reluctant to challenge customers who may be providing resale certificates or may be claiming self-assessment exemptions. There is a risk involved, and a customer relationship on the line. However, be vigilant and make sure to verify the representations of your customers to determine independently whether the sales should be subject to sales tax.

Although straining customer relations is a concern, it is important to gently remind your customers that it is you, the retailer, who will be liable for any sales tax not collected. In appropriate situations, you may want to obtain written indemnification agreements from your customer to protect your business if the exemption is not allowed.

Resale certificates taken in good faith change the balance of liability for sales tax. Where a resale certificate is taken in good faith, signed by the purchaser, stating the property is purchased for resale, the liability for the sales tax shifts from the seller to the purchaser. When accepting resale certificates, retailers walk a fine line to maintain the fragile balance between one extreme of allowing customers too much leeway and the other extreme of burdening business and potentially offending customers.

In-house tax professionals should make management aware of any cause for concern as the issues arise and let management provide guidance for how closely to scrutinize customers tendering resale certificates or claiming self-assessment. If the company's tax policies and procedures are not in writing, consider creating a manual and solicit management sign-off. That way, internal practices are never solely the tax department's oversight, but rather reflect company policy.

### Managed Audits

When you first receive notice of an audit, consider applying for a managed audit if that is an option in your state. Managed audit programs generally allow a business to conduct a type of self-audit with instructions and guidance from an auditor.

To qualify, your business must generally have fairly straightforward tax issues without transactions subject to numerous sales tax exemptions. In addition, your business must be able to demonstrate it has the resources necessary to complete the managed audit.

### Preparation

A mistake we often see is a tax or accounting department allowing the audit to begin before the team is ready. Preparation is critical. If you receive notice of an audit and need more time to organize your business, request additional time before the audit begins.

Prepare a list of specific reasons for the requested delay and explain to the auditor why additional time would allow for a more efficient and expeditious audit. Delaying the audit to present a more organized front is worth requesting the additional time. The auditor, even if not granting the delay, will be forced to acknowledge your reasonable request.

### *Pre-Audit Checklist*

Once the audit period is confirmed, review the compliance files for that period. Note any problem areas and create a "to do" list including items for which a refund may be due.

Review the prior period audit file for issues raised and confirm that any prior issues were adequately resolved in the current period compliance. In addition, if the prior audit was handled by another person in your department, include that person in the review of the prior audit work papers. Review any tax reserves on your financial books regarding any of these issues.

In your pre-audit contact with the auditors, ask them about the areas that they will be reviewing and whether this is a routine audit or if it was initiated due to a specific transaction or incident. Gather additional information on problematic issues from your review of the compliance and audit files.

***If the company position on an issue is particularly weak, it is better to let management know the bad news earlier rather than later.***

It can be very helpful to ask colleagues at other companies about their experience with the auditing jurisdiction and the auditor that will be conducting the audit. A 10-minute phone call to trade organizations such as the Council on State Taxation, the Institute for Professionals in Taxation, Tax Executives Institute, etc., or to your peers in other companies can be very helpful in understanding the jurisdiction auditing your company.

The point is to learn all you can about this jurisdiction including checking for and reviewing the jurisdiction's online "Audit Manual."

To the extent weak points are located, consider making upfront disclosures of issues that have a high likelihood of detection.

## Keeping Management Informed

Consult with company management prior to meeting with the audit team. Discussion with management will give you the opportunity to clearly communicate the status of the audit and in the process manage expectations.

If the company position on an issue is particularly weak, it is better to let management know the bad news earlier rather than later. Take this opportunity to suggest changes to company business practices to avoid this issue in years going forward.

Talking with management will also provide insight into the company's appetite for risk (i.e., whether it is willing to pay an adjustment/take an appeal/seek an independent determination, etc.).

## Opening Conference With Auditor

Discuss with the auditor a list of pre-identified issues. Agree as to the timing, scope, and materiality of the audit. Request an audit plan.

Obtain an understanding of information that is likely to be requested. Though you need to comply with information requests, you do not necessarily have to provide information in the quantity, quality, or in a format specified by the auditor.

A sample of transactions will likely be requested by the auditor; therefore, develop a plan on what samples from what time period will be acceptable. Begin negotiating now!

## Develop a Relationship With the Auditor

With many audits, and specifically with a large multiyear audit, the auditor will be on-site and working closely with your business and your personnel. Try not to see this as a complete negative. Use the access and opportunity to get to know the auditor as a human being.

To help start the audit off on the right foot consider the following suggestions to lay the foundation for building the auditor taxpayer relationship:

- The advantages of locating the auditor in a room that is not on the company's Tax or Finance floors include avoiding the potential problem of an auditor overhearing a conversation, finding a document left behind in a copy or lunchroom, etc.

- Prepare ahead and provide a brief introduction to the business. Provide an overview of the company, its products, its customers, and its sales tax procedures and practices. Take this opportunity to put your best foot forward. First impressions matter.

• Give the auditor a tour if appropriate. This will allow the auditor to see what you do for your customers and how you do it.

• Establish a point person for the auditor. Choose an employee who is knowledgeable about the tax issues, the company procedures, and who is willing to develop a working relationship with the auditor. This point person should be the gatekeeper for all communication to and from your business to the auditor.

• Create an open dialogue with the auditor. An open dialogue allows you to discuss the application of various rules of law as they apply to your company's business and its sales or purchases. A common mistake is waiting until the audit work papers are completed to engage the auditor in dialogue. At any time during an audit, your main goal should be to understand exactly what the auditor is currently focusing on, what he or she is writing up, and what he or she is thinking regarding those transactions. Discuss areas where you and the auditor are not in agreement as they arise.

• Depending on the auditor's schedule and the amount of time he or she will be spending on-site, set aside time weekly or biweekly for you and the point person to answer any specific questions for the auditor that may arise during the audit. Work with the designated point person to choose a time that is conducive for the point person and the auditor.

• Remember there is no need to volunteer information. Provide everything needed to respond to the auditor's reasonable questions but not more than is necessary. Use the regular meetings as your opportunity to gauge the tone and focus of the audit. Take the time, if appropriate, to voice the taxpayer's concerns regarding the audit.

• If the auditor will be working on-site, provide the auditor with a comfortable, separate work space. Make sure this work space is free from any customer files or other confidential information to which the auditor should not have access. Supply the work space with basic materials and provide access to a power outlet.

• There are two schools of thought on where to locate the on-site auditor. Many taxpayers believe that, if the facilities permit it, generally it will be preferable to locate the auditor in an isolated space. The other approach is to keep the auditor close by so as to be able to monitor his or her activities. (Remember the Chinese proverb to keep your friends close and your enemies closer.) If your company follows the latter policy, consider a room that is well marked as housing a tax auditor and send out a notice to applicable personnel that an auditor is on the floor. Though most tax professionals are well aware of the problems of loose lips, upfront knowledge of the presence of an auditor is often welcome and helpful to others in proximity to the audit process.

• In any event, make the auditor understand (and get the auditor's agreement) that company policy does not allow non-company employees access to the rest of the premises without an escort. If the auditor is to have access to the business premises (i.e., independent of a company escort), make sure the auditor's credentials (badge, company identification, etc.) are distinctive from those provided to regular employees.

• Advise your employees of when the auditor will be on the business premises. Remind your team not to discuss company business, especially tax issues, openly when the auditor could be present or overhear the conversation.

• If a request from the auditor is unduly burdensome, request a meeting with the auditor to discuss ways to reduce the burden of gathering the documentation. Try to meet soon after the request is received. Bringing the burdensome request to the auditor's attention quickly shows your involvement in the audit and good faith efforts to meet the auditor's requests.

• Find out early whether the auditor plans to provide a draft of the audit report. If no draft is planned, request that a draft be provided. In most cases, the auditor will hold an exit conference to discuss the audit report. During the exit conference, the auditor will generally provide the audit report along with an overview of the issues. If you disagree with the assessment, the auditor will often give you an opportunity to provide additional information to support your position. Compile a detailed organized list of the documents supporting your position.

Although the auditor's proper mission is to determine whether the business owes any tax, state sales tax auditors appear to be increasingly concerned with writing up a large assessment, not necessarily a correct one. During the audit, an overarching goal is to dislodge the auditor's belief that your business is trying to skirt its sales tax obligation.

**Exercise Vigilance During the Audit And Keep a Close Watch**

Maintain control of the audit. The audit cannot be conducted without access to your business's documentation and records. Make sure you exercise the appropriate level of ownership over your documentation.

If the auditor has not already provided a list of requested documents, ask the auditor to provide a list of the documents that he or she wants to have available on the first day of the audit. Before the auditor arrives, locate and copy the documents requested. Make two copies stamp them both "copy." Provide one to the auditor and keep one for your company's audit file.

Keep a meticulous chronological log of the documentation provided. Careful records will allow you to quickly locate documents provided to the auditor if the audit escalates and you need to defend your documentation. In addition, your records will be verification of your cooperation during the audit process.

Your documentation log should include the following:

- date of the auditor's request;
- when the response was provided;
- date an extension was requested (if applicable);
- date the request for extension was granted (if granted);
- date of request for explanation (if requested); and
- date when any explanation from the auditor was received (if requested).

The log should also include how each of the foregoing was received or submitted (i.e., email, hard copy memo, verbally, etc.). If providing documents electronically, an equal level of precision and care is required.

Be diligent with your company's electronic files. Make sure all non-PDF documents are converted to PDF before transmittal. This guarantees the auditor will be able to open and read the documents regardless of software compatibility. It also ensures document integrity, preventing any inadvertent changes or edits to the documentation.

Keeping careful track of documents can increase your credibility with the auditor and any subsequent appeals officer. This is true for both the documents you provide to the auditor and for anything they provide to you.

If a document includes sensitive business information, make sure to stamp it confidential.

An auditor may not keep careful track of what has been furnished and may request documents you already gave him or her, or assert that you did not produce the requested records. Be ready to prove the auditor wrong by providing the documentation along with the date you provided it and in what form.

Make sure to provide the auditor with copies of documentation, books, records, etc., rather than allowing the auditor to view or copy originals. Generally, it is better practice not to provide original files to an auditor but copies, and then only to provide what is specifically requested. The one exception might be to volunteer additional favorable material that puts the company in a good light.

With short-staffed companies, and the growing prevalence of on-site audits, there may be a temptation to simply provide the auditor with the native files. Keep in mind that original files could give the auditor access to documents they would not otherwise request or ever see. More importantly, giving the auditor direct access to your files could send a message that the auditor is in control.

If the material the auditor wants to review is too voluminous to copy, opening original files for the auditor may be the only option. However, establish early that your point person will be responsible for all photocopying. If nothing else is learned from reading this article, it should be that the goal at all times is to send the message that you, the taxpayer, are in control.

Never underestimate the power of organization. Disorganization or a lack of consistency are red flags for auditors and can lead an auditor to write up more than otherwise would be written up.

Be careful not to offer information about years not under audit. This can lead to expanding and prolonging the audit. Instead focus exclusively on the years under review. Auditors may request tax returns or documents from later years. Resist providing tax returns for years other than those under audit unless and until the auditor demonstrates how those tax returns or documents for other years are relevant to the current audit.

> ***If an answer is not known, promise to follow up but do not speculate about the answer. Speculation only leads to additional headaches down the road.***

Establish a process for communicating with the auditor. As mentioned earlier in this article, precise communication starts with having a point person. Task the point person with creating and keeping the audit file. This person should also be responsible for maintaining a communication log. The communication log should include dates of all conversations with the auditor whether in person, over the telephone or via email correspondence.

Be brief. Provide answers to questions posed by the auditor as clearly and as succinctly as possible. If an answer is not known, promise to follow up but do not speculate about the answer. Speculation only leads to additional headaches down the road. Nothing is more difficult than re-establishing credibility after having provided an incorrect conjecture.

## Post-Assessment—Damage Control

After your business receives the audit work papers, there may be an opportunity to negotiate or discuss the issues with the tax auditor. Try to maintain objectivity as you prepare for these discussions.

### *Strategy No. 1: Negotiate the Issues, Not the Tax*

Focus on the tax issues wherever possible, rather than the amount of tax to be paid. Try to avoid an invoice-by-invoice analysis. Work with the auditor to determine the legal issues contested.

If possible, place the transactions at issue into "legal issue buckets." Knowing how much you have at risk in each bucket allows you to determine how much effort to put toward each legal issue. An issue that results in a $5 million dollar adjustment should take more of your attention than a $500 issue.

Be willing to explain the company's position to the auditor or, if necessary, the auditor's supervisor. Although it may not be possible to reach an agreement with a genuine runaway auditor, a good strategy is to try to settle at the lowest possible level in the process. If you can convince your auditor of the facts, you may be able to reach a more favorable resolution at the audit level rather than needing to move on to the next level in the process.

Check the auditor's level of authority. It may be the case that your auditor does not have the authority to negotiate or settle any issues. Consider your auditor's years of experience, knowledge, and facility with the audit issues. If necessary, ask to bring in the auditor's supervisor.

Bringing in the auditor's supervisor is not something to take lightly. Make sure to convey your request personally to the auditor and try to dampen the potential negative impact of your request.

### *Strategy No. 2: Offset the Tax Assessed*

Work with your internal team to locate additional exemptions, exclusions, or credits to offset the tax imposed. Most states allow a credit for sales/use tax paid to other states. Other exemptions and exclusions include occasional sales and sales for resale.

Confer with customers to locate any potential self-assessment on the part of the customer for use tax. Carefully review invoices for potential instances of overpayment or double payment. Check to make sure there were no canceled invoices, returned merchandise, or other reasons why the invoiced transactions written up by the auditor may not actually represent completed transactions.

***Strategy No. 3:***
***Consider Future Years***

You have the advantage of knowing your business better than the auditor. Consider whether issues raised in the current audit will be at issue in future years. Once an issue is flagged it will be the target of subsequent audits. If you are subject to a large adjustment, the state likely will have you on a short list for the next audit cycle. Consider undiscovered exposure, and the potential that the issues in later years will result in a larger adjustment. Make sure policies change and systems are implemented to rectify errors in assessment and collection.

## Settlement

After your company receives the proposed adjustment, evaluate whether settlement may be an option. Prior to entering audit, you should have a firm grasp of your company's tax reserves. Approach settlement with as little baggage as possible and know beforehand how far the company is willing to legally pursue specific issues and at what cost it will settle those issues.

The sales tax audit may have been protracted and painful. At this point in the audit, you may have an unabashed distaste for your state tax auditor. Try to leave hard feelings at the door and approach the settlement process as objectively as possible.

Consider the scope of the settlement, and whether your offer (or counteroffer) should involve future periods. You may consider giving up more in this audit period by limiting issues that bleed into other periods.

Whether a settlement may include future audit years likely depends on whether your settlement involves a legal issue or merely settlement of tax. Future tax settlement is unlikely without audit, however it may be possible to agree to legal issues going forward. Find out what the auditor's department policy is regarding future audit years.

Agreeing to legal issues in future periods has advantages for both the taxpayer and the state. Resolving issues for future periods can save the state time and money and can alleviate the burden on the taxpayer. However, taxpayers must be careful not to blindly agree to settlement of future years. Consider potential changes in the industry, amendments to current law, or new legislation that may change your company's position.

If settlement terms are reached, make sure to memorialize at least an outline of the terms on paper and obtain the auditor's affirmation of the terms. Drafting an informal outline of the settlement and obtaining the auditor's sign-off on the outline prevents any subsequent attempts by the auditor to distance himself or herself from the agreement.

## Audits by Multistate Tax Commission Auditors

The Multistate Tax Commission (MTC) poses unique challenges to taxpayers. The MTC, as an intragovernmental state tax agency, currently claims affiliation with almost every state in the United States in some capacity.

Although primarily tasked with facilitating uniform administration of state and local tax laws, for member states, the Multistate Tax Compact provides the MTC with authority to conduct audits of taxpayers on behalf of those states specifically authorizing such action. If your audit is being run by an MTC auditor, you must be especially aware of the audit, since the ramifications have consequences much larger in scope than a general state sales tax audit.

Like any state tax audit, an MTC audit may present challenges that require careful decisions and strategy.

The concern with an MTC audit is that though the MTC auditors are seasoned professionals, they are not trained in the intricacies of each member state's laws. The MTC auditors are provided guidance by the MTC but the state's laws should control. Consequently, significant work may be required to educate an MTC auditor on any given state's laws, and even when the statutes appear to be clear, the MTC auditor may follow deviating guidance from the MTC on the issue.

In one case, an MTC auditor was auditing a client on behalf of more than a dozen states and requested permission to tap into the client's electronic database. When the client declined to give unfettered electronic access, the MTC auditor conducted a long and far-reaching examination of the taxpayer's operations and ultimately wrote up a huge assessment in each state without regard to specific state statutes and based on a purported "confidential informant" with supposed information regarding company operations.

It took more than five years for the client to straighten out the improper assessment in more than a dozen different states. In the end, the taxpayer settled the audits in each state by paying well under 5 percent of the tax proposed by the MTC auditor. Even the nominal settlement amount was largely unjustified but the company paid as it was cheaper to pay a nominal settlement than to pursue the more expensive complete victory.

One state commissioner stated that if the taxpayer had prepared the filed returns in the same manner that the audit was conducted that the state would have brought up the taxpayer on criminal charges. The taxpayer now directly contacts any state involved in a group audit to request that the state conduct the audit itself.

The foregoing example raises issues concerning the legal and practical reasons to restrict auditor access to data processing systems. As a legal matter, you need not provide direct access to computer systems. Despite auditor protests, taxpayers generally have the right to object to direct access to data systems, except in the case of a search warrant. However as a practical matter, depending on the type of audit and the ease in generating copies of records and documents, providing electronic access may be a viable option.

In many states, computer-assisted audits are an option. A computer-assisted audit generally involves software used to design a testing plan and to prepare a sample of the electronic records from which to extrapolate to the larger tax base. Although a computer-assisted audit may reduce the audit burden, there remain risks that could result in erroneous audit conclusions. Common errors include data file records not matching documentation, intermediate work file records dropped before being completely processed, software malfunctions, incorrect calculations or selection routines, and incorrect application logic.

## Post-Audit Options—Appeal and Forum

Although focused on the state tax audit, we could not complete the article without a brief discussion of the opportunities presented by an appeals hearing and how to handle the appeal. If you disagree with a decision made by your auditor regarding your company's liability for taxes, you can usually contest that decision by filing a timely appeal.

The appeals officer is tasked with the role of impartial reviewer. During the hearing with the appeals officer, take advantage of the opportunity to present your issues. Even if the appeals officer is part of the same state tax department as the auditor, he or she is a fresh face, not filled with the auditor's history and day-to-day audit detail. Prepare and present your case as if to someone who knows nothing about the case, since in many instances this will be the reality.

Make the appeals conference as productive as possible by submitting all facts, law, arguments, and other information to support your position in an organized package. If it is necessary to submit material in multiple different submissions, provide the appeals officer with an index to help the appeals officer review the materials and the case file as easily as possible.

## The Danger of Contingent Or 'Recovery-Based' Auditors

States using third parties to conduct audits on cost-recovery or contingent fee bases are becoming increasingly common, especially with sales and use tax cases.

Because audits on cost-recovery bases have been challenged, a number of states have grown more sophisticated and are paying a flat fee to the third-party outside auditors. However the unspoken understanding is that future employment of these "flat fee" auditors is dependent on recovery.

These developments are cause for concern. Cost-recovery audits encourage the auditor to push the limits of the law in order to reap the most financial gain for both the self-interested auditor and the state.

Allowing auditors to increase their personal compensation by increasing the tax assessment calls into question both the principles behind the audit process and the results. Cost-recovery auditors have the authority to write up huge assessments and shift the burden of proof to the taxpayer to disprove the application of tax.

***Cost-recovery audits encourage the auditor to push the limits of the law in order to reap the most financial gain for***

An additional concern, even beyond a large assessment, is increased multistate tax exposure. Taxpayers subject to an audit at the hands of a

***order to reap the most financial gain for both the self-interested auditor and the state.***

cost-recovery based auditor risk the auditor sharing the taxpayer's information with other states. This risk increases exponentially when there is a large tax bill as a result of the audit. Sharing information with other states raises a whole host of issues surrounding the constitutionality of disclosing taxpayer confidential information and taxpayer due process rights.

Before allowing a cost-recovery auditor to start an audit, the company should insist on reviewing the auditor's authorization/appointment by a specific state. The taxpayer should review the legal basis for that appointment and challenge it as appropriate. Taxpayers should also insist on a written confidentiality agreement from the contingent fee or cost-recovery auditor that he or she will not share information, results, or taxpayer identification with any jurisdiction other than the one for which he or she is auditing.

### A Place for Contingent Fee Representation

Recent challenges to Circular 230 are instructive and possibly provide guidance for what to watch out for in terms of future legislation limiting attorneys' fees in the state arena. In 2007, the Internal Revenue Service revised Circular 230, which generally spells out requirements for practitioners and regulates the conduct of anyone providing tax advice or preparing tax returns for compensation, including attorneys, certified public accountants, and enrolled agents.

The 2007 regulations permit a practitioner to charge a contingent fee for services rendered in connection with the IRS examination of, or challenge to:

- an original tax return; or
- an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination, or a written challenge to the original tax return.

The 2007 regulations also permit the use of contingent fees for services rendered in connection with a claim for credit or refund filed in connection with the determination of statutory interest or penalties assessed by the Service. However, the 2007 revisions generally prohibit contingent fee arrangements where a claim for refund or return is filed before IRS has initiated an audit of the return.

Many tax and accounting shops formerly conducted federal (as well as state) representation on a contingent fee basis. According to Ryan LLC, the revisions to Circular 230 dramatically affected business. Ryan LLC filed suit April 12 in the U.S. District Court for the District of Columbia challenging the provisions of Circular 230.

Ryan seeks declaratory judgment that the Circular 230 provisions prohibiting the use of contingent fee arrangements are unconstitutional. The first count claims unconstitutionality under the Petitioner Clause of the First Amendment. The second count claims unconstitutionality under the Due Process Clause of the First Amendment. And the third and final claim alleges the provisions of Circular 230 are reflective of IRS overreach in regulating the practice of certified public accountants.

California and other states are looking to prevent contingent fee-based representation. Proposed legislation, California's S.B. 342, would prohibit the use of contingency fee agreements between tax advisers and taxpayers for any matters involving tax imposed under the Revenue and Taxation Code. The bill also would prohibit attorneys' fees from being awarded pursuant to any other statutory provision or common law doctrine regarding the award of attorneys' fees.

The bill would define reasonable fees in relation to Revenue and Taxation Code Section 19717, which provides that fees shall not be in excess of $125 per hour unless the court determines that a special factor, such as limited availability of qualified attorneys for the proceeding, difficulty of the issues presented in the case, or the local availability of tax expertise justifies a higher rate.

This is an area of change that is likely to experience a variety of developments in the coming years. Therefore, companies are well-advised to monitor the field for how it might affect business.

### Concluding Remarks

When it comes to state tax audits, taxpayers today face more challenges than ever before, due in large part to the economic shortfalls government face. It may seem like your auditor is single-handedly balancing the state deficit through your company's tax bill. Most auditors try to do a good job; however, every once in a while you will encounter a difficult auditor.

The guidelines in this article can be applied to all audits and should help you run your audit more smoothly. Whether faced with a conscientious auditor or a rogue auditor, there are ways to minimize exposure.

When faced with a runaway auditor, or a shotgun methodology, the taxpayer, with the proper preparation, can circle its wagons and defend against the attack. Applying the strategies discussed above will help the taxpayer corral the runaway auditor.

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