

Legislative Analysis



TREASURY AUDITS: AUDIT STANDARDS AND DISCLOSURE OF WORK PAPERS

Mary Ann Cleary, Director
Phone: (517) 373-8080
<http://www.house.mi.gov/hfa>

House Bill 4291 as enacted
Public Act 35 of 2014
Sponsor: Rep. Jeff Farrington
House Committee: Tax Policy
Senate Committee: Finance

Second Analysis (7-23-14)

BRIEF SUMMARY: The bill requires the Department of Treasury to provide copies of the complete audit work papers to persons subject to audit by the department and to promulgate administrative rules specifying audit standards.

FISCAL IMPACT: House Bill 4291 would increase certain administrative costs within the Department of Treasury. The provision requiring the department to provide a complete copy of the audit work papers would increase costs to the department by an indeterminate amount. Additionally, the requirement that the department promulgate rules would increase administrative costs for the department. Any cost increases under the provision of the bill would be absorbed under current appropriation levels.

THE APPARENT PROBLEM:

There are two basic foundations to a state's tax climate: the type of taxes imposed and how those taxes are administered. Much of the discussion among the public and policy makers focuses on the features (base, rates, credits, exemptions, etc.) of various types of taxes imposed. Less discussed, but still vitally important, is how those taxes are administered. The administrative environment in which businesses and taxpayers operate directly relates to the ease of collection by the state and compliance among taxpayers.

As the Council on State Taxation (COST) notes, "our federal and state tax systems are premised, to a great degree, on voluntary compliance. It is a common truth that taxpayers will more fully and willingly comply with a tax system they perceive to be balanced, fair, and effective. Taxpayers operating in a system they perceive as oppressive, unfair, or otherwise biased are less likely to voluntarily comply. The clear message to state legislatures is that they must be sensitive to the compliance implications and competitiveness concerns created by poor tax administrative rules and ineffective tax appeal systems."¹ For many businesses, the cost of complying with the state's tax laws is not immaterial, and often requires a significant amount of time, money, and other resources that could arguably be spent on more productive uses directly related to the

¹ Douglas L. Lindholm and Frederick J. Nicely, "The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals and Procedural Requirements", Council on State Taxation, February 2010, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=75910>.

core functions of the business. Businesses realize these compliance costs through the hiring of additional staff or outside consultants (accountants and tax attorneys), litigation costs, and other related expenses.

There are many facets to a state's tax administration system, including the statute of limitations on refunds and assessments, the interest rates payable on overdue refunds or payments, the tax appeals process, transparency, and audit procedures. A number of bills have been introduced this session aimed at addressing concerns regarding the state's tax administration system.²

Among other tax administration issues, the Department of Treasury's audit procedures and methodologies are of concern to many in the business community. Currently, there is no clear statutory guidance on the audit standards and methodologies department auditors are to employ during the course of a tax audit. Several recent decisions of the Michigan Tax Tribunal (MTT) have invalidated assessments levied by the department against taxpayers because the MTT has taken issue with the department's audit methodologies, especially where disputes arise on whether taxpayers have maintained complete and accurate records.³ In *SMK, LLC v. Michigan Department of Treasury* (Docket No. 409504), the MTT held that the department's "calculations and methodologies result in imperfect estimates because they are based on a sample of purchase invoices for two months, extrapolated over an almost four-year period, using an estimated 'average' mark-up. [The department] does not consider inventory fluctuations, nor shrinkage inherent in a retail business..."⁴

Another area of concern regarding the department's audit procedures is the disclosure of the department's audit work papers to the taxpayer and their representatives. Reportedly, taxpayers and their representatives have had issues with obtaining the complete audit work papers, which are instructive in understanding how the department arrived at the tax assessment, with the department limiting disclosure due to concerns for taxpayer confidentiality.⁵

² See 2013 PA 133 (HB 4002), which imposes additional interest on the late payment of personal income tax refunds owed to taxpayers by the Department of Treasury; 2014 PAs 108 (HB 4288) and 109 (HB 4292), which limit the use of indirect audit procedures in sales/use tax audits; 2014 PA 277 (SB 327), concerning Department of Treasury administrative guidelines; 2013 PA 148 (HB 4289), establishing unclaimed property audit standards; HB 4290, which would require the Department of Treasury to make available various tax administration manuals to the public; and HB 4703, which would establish an appeals process for unclaimed property determinations.

³ On this issue generally, see Eric S. Tresh and Madison J. Barnett, "State Audit Guessing Games: When Can States Issue Estimated Assessments?," *State Tax Notes*, March 5, 2012, <http://www.sutherland.com/files/upload/SALTArticle3.6.12.pdf>.

⁴ See *SMK, LLC v. Michigan Department of Treasury*, Michigan Tax Tribunal, Docket No. 409504, final opinion entered September 26, 2011, <http://www.dleg.state.mi.us/ham/tax/pdf/decisions/sales/409504.pdf>. See, also, *Fradco, Inc. v. Michigan Department of Treasury*, Michigan Tax Tribunal, Docket No. 409506, final opinion entered September 26, 2011, <http://www.dleg.state.mi.us/ham/tax/pdf/decisions/sales/409506.pdf>.

⁵ See, Chris Gautz, "Bills seek tighter tax audit rules for state," *Crain's Detroit Business* (online), April 23, 2013, <http://www.crainsdetroit.com/article/20130421/NEWS/304219972/bills-seek-tighter-tax-audit-rules-for-state#>.

THE CONTENT OF THE BILL:

House Bill 4291 amends the Revenue Act (1941 PA 122, MCL 205.21) to require the Department of Treasury to provide a copy of the complete audit work papers and the audit report of findings upon a request from the person subject to the audit by the department (or its agents), or from a person whose books, records, and papers have been examined by the department.⁶

The bill further provides that any audit performed by the department (or its agents) must be performed in accordance with auditing standards established through the promulgation of administrative rules within one year from the bill's effective date (March 20, 2014). The standards must include, but are not limited to, standards on confidentiality, technical training, independence, due professional care, planning, supervision, understanding of the audited entity (including internal control and assessment of risk), audit evidence and documentation, sampling and sampling projections, and elements of the audit report of findings.

ARGUMENTS:

For:

The bill is needed to ensure that the Department of Treasury's audits of taxpayers are conducted in a fair, open manner, by requiring the department to promulgate administrative rules setting forth its auditing standards. Several cases, highlighted by the Michigan Tax Tribunal's September 2011 *SMK* and *Fradco* decisions suggest that departmental auditing procedures and methodologies could be improved upon. Even where the MTT held that a taxpayer's records were not accurate and Treasury was permitted to base its determination on the best information available (including sampling projections), the MTT held "the Tribunal agrees with [the taxpayer] that certain of [the department's] calculations and methodologies likely result in imperfect estimates and not exact tax determinations."⁷ Moreover, a March 2013 report by the Office of the Auditor

⁶Audit "work papers," also referred to as "audit documentation" is defined in the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 3 as "the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the [audit] engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor."

See, http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_3.aspx. See, also, the audit documentation standards of the American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards (SAS) No. 103, <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00339.pdf>.

⁷ See *Plum Hollow Market, Inc. v. Department of Treasury*, Michigan Tax Tribunal, Docket No. 348020, final opinion entered May 16, 2011, <http://www.dleg.state.mi.us/ham/tax/pdf/decisions/sales/348020.pdf>. The Court of Appeals upheld the MTT's *Plum Hollow* decision, stating, "This Court has approved the use of supplier invoices as the basis for an assessment in situations where the taxpayers did not maintain proper records. Although that method has its limitations, this Court has held that the Legislature has granted [the department] wide discretion in the selection of auditing methods." (Internal citations and quotations omitted.) See *Plum Hollow Market, Inc. v. Department of Treasury*, Michigan Court of Appeals (unpublished), Docket No. 305505 (October 16, 2012). Regarding the Department of Treasury's ability to base assessments on available information, the Court of Appeals

General found that the department "did not review and document all audits in compliance with its audit guidelines" and "did not have assurance that audit results were accurate, supported by appropriate documentation, and consistent in the application of tax laws before the results were provided to the taxpayer."⁸

The promulgation of administrative rules could help with the administration of tax audits (and compliance with the tax laws) by requiring the department to publicly lay out its auditing standards, which can help with a more consistent audit methodology and application of audit procedures. The rule promulgation process aids the auditing process by allowing for public comment on proposed rules and some review of those rules by the Legislature.

In addition, the bill provides greater clarity that the complete audit work papers and the audit report of findings are to be provided to taxpayers upon request, and not shielded from even the entities that are the subject to the audit.

Against:

The requirement that the Department of Treasury must promulgate administrative rules on its audit standards is seriously problematic in that while there are a number of audit standards, their application to tax audits (where the purpose is to determine a tax liability) may be inconsistent with the other auditing purposes for which those standards were originally written, such as ensuring compliance with federal grant programs or ensuring that the entity's accounting records are accurate and its financial controls are proper.

Whereas the financial auditor can issue an adverse opinion in cases where an entity's records are inaccurate and incomplete, the tax auditor must still complete the audit of a firm with inaccurate and incomplete records and make a determination on the entity's tax liability based on information that is available. Recent findings from the Office of the Auditor General's spoke more to the quality assurance and review process (which the department has recently reviewed and revised), rather than the quality of the audit determinations themselves. Overall, the report spoke well of the department's tax compliance efforts and noted that the department was "effective in selecting and conducting audits to address the risk of taxpayer noncompliance" and "effective in detecting and pursuing potential individual and business taxes owed to the State of Michigan."⁹

held in *Vomvolakis v. Department of Treasury*, 145 Mich App 238 (1985) that under the several tax statutes the department, "is to make assessments only when it has reason to believe that a return does not supply sufficient or accurate information or when proper records are not maintained by a taxpayer. The state's power to tax would be greatly eroded if the [department] could not make assessments on available information in situations where taxpayers do not maintain proper records." Among other things, the disputes in *SMK* and *Fradco* concerned whether the taxpayer failed to keep accurate and complete records. (Determining the adequacy of taxpayer records, observers have noted, "is a facts and circumstances analysis with few objective criteria to evaluate the results. See, "State Audit Guessing Games: When Can States Issue Estimated Assessments?"). In *SMK* and *Fradco*, the MTT held that the taxpayers' records were accurate and complete, and invalidated the department's assessments.

⁸ Michigan Office of the Auditor General, *Performance Audit of the Tax Compliance Bureau, Department of Treasury*, March 2013, http://audgen.michigan.gov/~audgenmi/finalpdfs/12_13/r271014012.pdf.

⁹ Ibid.

One area of concern is the scope of any proposed standards on sampling, and how specific those standards would have to be, and when sampling could be employed. The department has developed an audit sampling manual that discusses the procedures to be used for sampling the taxpayer's records to conduct sales and use tax audits, including statistical sampling (random sampling and probability) and non-statistical sampling (samples selected through the auditor's professional judgment). The department also uses the American Institute of Certified Public Accountants' (AICPAs) *Statement on Auditing Standards No. 39, Audit Sampling*¹⁰ and the Multistate Tax Commission's *Sampling Policy & Guidance Manual*¹¹ to inform its auditors on proper auditing sampling techniques. Sampling is used as an internal control test to determine the accuracy of an entity's records.

There is a concern that requiring these standards to be placed in administrative rules would infringe on the department's ability to effectively and efficiently conduct audits. If the rules required a specific confidence interval in its statistical sampling, it could significantly increase the department's workload while only marginally improving the confidence in the results of the audit and further disrupting the operations of the business subject to the audit, as the time it takes to conduct and complete an audit lengthens.

Legislative Analyst: Mark Wolf
Fiscal Analyst: Ben Gielczyk

■ 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.

¹⁰ <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00350.pdf>

¹¹ http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Audit_Program/Resource/MTC%20Sampling%20Manual%20-%20%20July%202008.pdf