

SALES AND USE TAX AUDIT MANUAL

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INTRODUCTION

A. AUDIT GUIDE

The primary objective of this manual is to provide instructions on the performance of a Pennsylvania sales, use and hotel occupancy tax compliance audit. In addition, minimum requirements for taxpayers with exposure to employer withholding tax, personal income tax, public transportation assistance fund taxes and fees and vehicle rental tax are outlined. Instructions are based on current state tax statutes, Department regulations, court cases, Departmental policies, previous audits, appeal decisions, and general accounting and auditing principles.

This manual is intended as guidance to the audit staff. Auditing methods and techniques suggested in the manual may not be necessary or applicable for every audit. This manual is not authoritative and may neither be cited to support an audit position nor relied on by the taxpayer.

This manual and its auditing procedures will be continuously evolving as it is impacted by changes in tax statutes, regulations, court cases and Departmental policies.

B. QUALITY CONTROL

This manual is designed for use by Bureau personnel in maintaining quality control. Audit reports must be in compliance with the requirements outlined herein as well as any additional regional instructions prior to final approval and the issuing of an assessment. This process will help ensure the audit reports prepared by the Bureau throughout the state are accurate, consistent, professional and sustainable through the appeal process.

Chapter 1 - TAX OVERVIEW

Entities that have nexus with Pennsylvania are required to charge, collect, report and remit various taxes on certain sales transactions. These taxes are referred to as business trust fund taxes and include the following:

- Sales and Use Tax (SUT)
- Hotel Occupancy Tax (HOT)
- Public Transportation Assistance Taxes and Fees (PTA)
- Vehicle Rental Tax (VRT)

In addition, Pennsylvania employers are responsible for the withholding of Pennsylvania personal income tax from employee wages subject to the tax. The personal income tax withheld is also considered a business trust fund tax.

A. NEXUS

An entity that establishes or maintains a market in Pennsylvania by having sufficient physical presence in this Commonwealth will be deemed to maintain a place of business and have nexus with Pennsylvania. One or more of the following activities conducted within the Commonwealth constitutes maintaining a place of business in Pennsylvania:

- An entity has at least one employee resident or an employee that is temporarily present in Pennsylvania engaging in any activity that allows the person to establish or maintain a market in Pennsylvania.
- An entity owns, rents, leases, maintains, or has the right to use tangible personal or real property that is permanently or temporarily physically located in the Commonwealth.
- An entity's employees own, rent, lease, use or maintain an office, distribution house, sales house warehouse, service enterprise or other place of business in Pennsylvania.
- An entity has goods delivered to Pennsylvania in vehicles the entity owns, rents, leases, uses or maintains or has goods delivered by a related party acting as a representative of the entity.

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- An entity's agents, representatives, independent contractors, brokers or others, acting on its behalf, own, rent lease, use or maintain an office, distribution house, sales house, warehouse, service enterprise or other place of business in Pennsylvania and this property is used in the representation of the entity in Pennsylvania.
- An entity's agents, representatives, independent contractors, brokers, or others acting on behalf of an entity, are regularly and systematically present in Pennsylvania conducting activities to establish or maintain the market for the entity whether or not these individuals or organizations reside in Pennsylvania.
- Activities that establish or maintain the market in the Commonwealth. These activities include: soliciting sales; servicing property sold or to be sold; collection on accounts related to the sale of tangible personal property or services; delivering property sold to customers; installation at or after shipment or delivery; conducting training for employees, agents, customers or potential customers; providing customer support; providing consultation services or soliciting, negotiating or entering into franchising, licensing or similar agreements.
- The establishment of nexus imposes on the entity the obligation to charge collect, report and remit the previously mentioned taxes.

B. TAX TYPES

The audit of sales, use and hotel occupancy tax records is the auditor's primary area of responsibility. However, the auditor is also responsible for auditing records that deal with related taxes. A brief description of each tax is given below.

1. Sales, Use, and Hotel Occupancy Tax

a. State Sales, Use, and Hotel Occupancy Tax

i. Imposition

Article II of the Tax Reform Code of 1971 (passed as Act 2 of March 4, 1971) selectively imposes a six percent sales tax on the sale at retail in Pennsylvania of tangible personal property and services (72 P.S. §7202(a)). This tax is normally charged, collected, reported and remitted by the vendor.

The code also selectively imposes a six percent use tax upon the use of tangible personal property and services within Pennsylvania (72 P.S. §7202(b)). Use tax is self assessed, reported and remitted to the Commonwealth by the purchaser when the vendor does not charge the purchaser sales tax.

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In addition, the code imposes a six percent hotel occupancy tax on the rental charge for each occupancy of a hotel room in Pennsylvania (72 P.S. §7210). Article II of the Tax Reform Code of 1971 is published at Title 72 of the Pennsylvania Statutes.

(1) Bracket Schedule

The 6% Pennsylvania state sales, use and hotel occupancy taxes are computed in accordance with the following bracket schedule (72 P.S. §7203):

Purchase Price	Tax
10 cents or less	0
11 cents but less than 18 cents	1 cent
18 cents but less than 35 cents	2 cents
35 cents but less than 51 cents	3 cents
51 cents but less than 68 cents	4 cents
68 cents but less than 85 cents	5 cents
85 cents but less than \$1.10	6 cents

The tax on purchases in excess of \$1 is 6% of each dollar plus the above bracket amounts on any fraction of a dollar.

Taxpayers report the charging and self-assessment of these taxes as well as their Pennsylvania sales activity on the PA – 3 PA Sales, Use and Hotel Occupancy Tax Return.

ii. Basic Rules

(1) Situs

The Commonwealth may tax only those transactions reflecting use within the boundaries of the Commonwealth, i.e., right to use, possession, ownership or custody.

(2) Purchase Price

For taxable transactions, tax is applicable upon the total purchase price. The purchase price is defined as the total value of anything paid or delivered, or promised to be paid or delivered, whether it be money or otherwise, in complete performance of a sale at retail, without any deductions on account of expenses incurred such as travel time or rentals of rooms, or equipment even when those items are separately itemized in billings to customers (see 72 P.S. §7201(g), 61 Pa. Code §32.1).

(3) Tangible Personal Property

The sale, use or service of cleaning, altering or repairing tangible personal property is subject to tax. Tax is applicable upon the total purchase price.

(4) Services

In addition to taxing a sale of tangible personal property, the law also taxes certain services. These include building maintenance or building cleaning services, lawn care services, disinfecting or pest control services, help supply services, employment agency services, lobbying services, credit reporting services, secretarial and editing services, premium cable services, adjustment and collection services, self-storage services and telecommunications services.

(5) Statutory Exclusions

Certain items are excluded from sales and use tax by law. These items include such things as unprepared food, clothing for everyday wear, water, coal, medicine, Pennsylvania state flags, and US flags.

(6) Exemptions

The law provides certain sales and use tax exemptions for purchases of goods and services that are normally subject to tax.

iii. Exemptions

Pennsylvania sales and use tax law exempts certain transactions based on the type of transaction or the nature of the entity involved with the transaction. A partial list of exempt entities is included in Appendix 4 – Codes and Information Lists “Sales Tax Exemptions Not Found in the Tax Reform Code”. These exemptions are listed below. It is important to note that the specific criteria used to determine the basis for an exemption may vary among the different taxes. Therefore, the law and appropriate regulations must be consulted to determine proper application.

(1) Business Exemptions

A limited exemption applies to purchases made by taxpayers for direct use in an exempt business activity. Examples include manufacturing, processing, mining, farming, dairying, public utilities etc (72 P.S. §7201(k)).

(2) Government Exemptions

Generally, there is an exemption on sales made to instrumentalities of federal and Pennsylvania state governments, municipal authorities, federal credit unions, and certain electric and agricultural cooperatives. It also extends to federal employees for Hotel Occupancy tax (72 P.S. §7204(12)).

(3) Resale Exemption

This exemption applies to property and/or services that will be resold or rented in the ordinary course of business by a vendor who is in the business of selling those same goods and services (72 P.S. §7201(k)). Note: Wholesalers are issued a number prefixed with a “95” to signify that they may purchase items for resale.

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(4) Special Exemptions

A limited exemption applies to institutions of purely public charity, school districts, individuals holding diplomatic ID and tourist promotion agencies. These exemptions are limited to purchases of tangible personal property or services for use (72 P.S. §7204(10)).

(5) Wrapping Supplies

Wrapping supplies and returnable containers for the ultimate consumer may be purchased exempt from tax by a seller/vendor when the supplies are used by the seller/vendor to wrap property sold to others (72 P.S. §7204(13)).

(6) Isolated Sale

This exemption applies to the sale of goods not normally sold in the ordinary course of business (72 P.S. §7204(1)).

(7) Out-of-state Sales

This exemption applies to the sales of goods or services that are delivered outside of Pennsylvania.

(8) Keystone Opportunity Zone (KOZ) and Keystone Opportunity Expansion Zone (KOEZ)

Keystone Opportunity Zones (KOZ) and Keystone Opportunity Expansion Zones (KOEZ) are geographic areas that are virtually free of state and local taxes. An exemption applies to the purchase of all tangible personal property and services used exclusively within these designated zones (73 P.S. §820.511) except building materials not qualifying as building machinery and equipment. It also applies to contractors making purchases of building machinery and equipment (BM&E) as part of a contract with an entity having a KOZ/KOEZ location.

(9) Direct Pay Permits

Direct pay permits allow qualified taxpayers to purchase all goods and services exempt from tax (72 P.S. §7237(d)) with the exception of those items listed in 61 Pa. Code §34.4. Companies holding direct pay permits are listed in the CCH at paragraph 61-250.

In order to qualify for a direct pay permit companies must:

- Have remitted at least \$10,000 in use tax to Pennsylvania during the prior year
- Must be in compliance with all Pennsylvania state tax requirements
- Must qualify for a business exemption
- Maintain auditable records.

iv. Pennsylvania Exemption Certificate (REV 1220)

A purchaser claiming an exemption on purchases of taxable goods and/or services is required to provide the vendor with a properly completed Pennsylvania Exemption Certificate (REV 1220) (72 P.S. §7237(c)). However, it is important to note that no exemption certificate is needed for items specifically exempt by statute, items shipped out-of-state by the vendor, or for the sale of taxable items where the sales invoice clearly shows the purchaser to be a federal or Pennsylvania state agency.

Taxpayers use this form to claim an exemption from state or local sales and use tax, hotel occupancy tax, PTA, and VRT taxes. Specific form requirements are provided in 61 Pa Code §32.2. The auditor is required to review the taxpayer's exemption certificates to determine if each form provides a valid basis for exemption. The form is valid only when properly completed. The auditor is encouraged to make copies of any exemption certificates disallowed in an audit and include them as exhibits in the audit report.

(1) Completion of Form

Proper completion of the form is discussed below.

Type of Tax – The appropriate box must be checked to clearly indicate the type of tax exemption for which the form is intended.

Unit or Blanket Exemption - The appropriate box must be checked indicating whether the certificate applies to one or several transactions.

Name of Seller or Lessor – The form must accurately provide the name and address of the seller or lessor.

Exemption Reason – The basis for exemption is indicated by marking the appropriate box. A partial list of exempt entities to which box #2 applies is found in Appendix 4 – Codes and Information Lists “Sales Tax Exemptions Not Found in the Tax Reform Code”. If box #7 – Other is marked there must be a written explanation provided in the appropriate space for the form to be valid.

Name, Address and Signature of Purchaser – This section of the form must correctly identify the purchaser claiming the exemption.

Date – The date of the purchaser’s signature is the date used to determine whether or not the exemption certificate was provided within 60 days of the related sale.

(2) Exempt Organization Declaration of Sales Tax Exemption Form (REV 1715)

This form is issued to vendors by exempt organizations in connection with the exemption certificate to claim an exemption on purchases of \$200 or more. The certificate and the form together create a presumption of good faith acceptance on the part of the vendor and relieve the vendor from collecting sales tax. This form is only used by exempt organizations that have a valid “75” number. The form may only be used for one invoice.

The use of the form is optional. Therefore, a vendor may elect to accept a properly completed exemption certificate from an exempt organization without this form. However, the vendor may later incur a tax liability if the department determines that the transaction was subject to tax.

Tax liabilities are enforced against the purchaser via the Bureau of Business Trust Fund Taxes in the following situations:

Sales of less than \$200 supported by a properly completed exemption certificate.

Sales of \$200 or more supported by properly completed and retained REV-1715 and exemption certificate.

The auditor is required to document these types of transactions on a separate set of worksheets. These worksheets are then sent under cover letter to the Sales and Use Tax Program Manager. Complete names and addresses of the exempt organization making the purchases are mandatory for documenting these transactions.

Completion of the form consists of both the vendor and the purchaser signing prewritten declarations verifying the nature of the transaction and acknowledging potential liability. The related invoice must be attached to the form.

vi. Uniform Sales & Use Tax Certificate – Multijurisdiction

The Multistate Tax Commission created this form. Purchasers may use the Uniform Sales & Use Tax Certificate – Multijurisdiction when claiming the resale exemption subject to the provisions of 61 Pa. Code §32.3.

The form contains an error pertaining to Pennsylvania. Instruction 27 indicates that the vendor must have a Pennsylvania sales and use tax number in order to use this form. However, a Pennsylvania sales and use tax number is NOT required to use this form.

b. Local Sales, Use and Hotel Occupancy Tax

Pennsylvania state law authorizes certain counties to impose a tax on each separate sale at retail of tangible personal property or service that originates within the county. The law also

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authorizes the counties to impose a tax on the use within those same counties as well as on the rental charge for a hotel room. This tax is commonly referred to as the “local” tax.

The rules for imposition, collection, reporting and remittance are generally the same as those for state sales tax under Article II of the Tax Reform Code of 1971. However, unlike state sales tax, local tax is a point of origin tax. The rate for local tax is one percent. Currently, Philadelphia and Allegheny counties are the only counties imposing the tax. Taxpayers report this tax under the local tax columns of the PA-3 Sales, Use and Hotel Occupancy Tax return.

The 1% local sales, use, and hotel occupancy taxes are computed in accordance with the following bracket schedule:

Purchase Price	Tax
50 cents or less	0
51 cents but less than \$1.51	1 cent
\$1.51 but less than \$2.51 cents	2 cents
\$2.51 but less than \$3.51 cents	3 cents
\$3.51 but less than \$4.51 cents	4 cents
\$4.51 but less than \$5.51 cents	5 cents
\$5.51 but less than \$6.51 cents	6 cents
\$6.51 but less than \$7.51	7 cents
\$7.51 but less than \$8.51	8 cents
\$8.51 but less than \$9.51	9 cents
\$9.51 but less than \$10.00	10 cents

The tax on purchases in excess of \$1 is 1% of each dollar plus the above bracket amounts on any fraction of a dollar.

c. Related Taxes

i. Public Transportation Assistance (PTA) Taxes/Fees

Article XXIII of the Tax Reform Code of 1971 imposes the following taxes and fees:

Retail Sale of New Tires for Highway Use	\$1.00 per new tire.
Motor Vehicle Lease	3% tax on the total lease price. This is in addition to sales tax.
Motor Vehicle Rental	\$2 fee for each day or part of a day for which the vehicle is rented. This is in addition to sales tax.

The provisions of Article II of the Tax Reform Code of 1971 apply to PTA taxes and fees (72 P.S. §9301). In other words, if the sale of a new tire for highway use, motor vehicle lease or

rental is subject to state sales tax, then the same item is subject to PTA tax. This tax is also referred to as the Mass Transit Tax.

The taxpayer reports the related taxes and fees charged via the PA-4 Public Transportation Assistance Taxes and Fees Return.

ii. Vehicle Rental Tax

Vehicle Rental Tax (VRT) is listed under Article XVI – A under the Tax Reform Code of 1971. Article II of the TRC and regulations promulgated there under apply to the VRT (72 P.S. §8601-A ff).

With respect to rental contracts involving motor vehicles designed to transport 15 or fewer passengers, a tax of 2% is imposed upon the rental payments. With respect to rental contracts involving trucks, trailers and semi-trailers used in the transportation of property other than commercial freight, entered into on or after July 1, 1997, a tax of 2% is imposed upon the rental payments made on or after July 1, 1997. If the vehicle rental company fails to collect the applicable tax, the purchaser shall pay the tax directly to the Department on a form prescribed by the Department. A vehicle rental company is defined as a business engaged in the business of renting passenger cars in this Commonwealth.

The taxpayer reports these taxes via the PA –5, Vehicle Rental Tax return.

d. Tax Collection

Collection proceeds from each of the taxes referenced above are considered trust fund money. Vendors are considered agents of the Commonwealth in the collection of these taxes. Consequently, vendors are required to charge, collect, report and timely remit this money to the Commonwealth (72 P.S §7237). Failure by the vendors to successfully fulfill their fiduciary responsibilities in relation to these taxes may result in the imposition of additional interest, penalties, fines and/or imprisonment.

e. Interest and Penalty

Rates and amounts applicable to unpaid sales & use, PTA and VRT taxes assessed via audit are given below.

i. Interest

The interest rate for any given year is established by the U.S. Treasury Secretary and is effective on January 1st of each year. The per diem rate is arrived at by dividing the announced interest rate by 365 (representing the number of days in a year) and the result becomes the per diem rate.

For taxes due after January 1, 1982, the rate of interest will vary from year to year. The date that the tax is first due and payable will determine the applicable rate of interest. The table below lists the rates.

Due Date	Annual %	Daily Rate
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01/01/88 THRU 12/31/91	11%	.000301
01/01/92 THRU 12/31/92	9%	.000247
01/01/93 THRU 12/31/94	7%	.000192
01/01/95 THRU 12/31/98	9%	.000247
01/01/99 THRU 12/31/99	7%	.000192
01/01/00 THRU 12/31/00	8%	.000219
01/01/01 THRU 12/31/01	9%	.000247
01/01/02 THRU 12/31/02	6%	.000164
01/01/03 THRU 12/31/03	5%	.000137
01/01/04 THRU 12/31/04	4%	.000110
01/01/05 THRU 12/31/05	5%	.000137
01/01/06 THRU 12/31/06	7%	.000192
01/01/07 THRU 12/31/07	8%	.000219
01/01/08 THRU 12/31/08	7%	.000192

ii. Penalties

(1) Understatement Penalty

A charge is made of 5% of the amount of the understatement.

(2) Failure to File/Major Understatement

For failure to file any return, there is a charge of 5% of the tax due for each month or fraction of a month that a proper return for the period remains unfiled, up to a maximum of 25 % of the amount of the tax due for the period. In no case shall such charge be less than \$2.

If the amount of the understatement is more than 50% of the true amount due, a charge of 5% of the amount of the understatement for each month or fraction of a month a proper return for the period remains unfiled, up to a maximum of 25% of the amount of the understatement. In no case shall such charge be less than \$2.

(3) Tax Evasion (Major Penalty)

For attempt to evade or defeat a tax, there is a penalty charge of one-half of the total amount of the tax evaded. These penalties are posted under “Major Penalty”.

iii. Multiple Additions/Penalties

A taxpayer who files a return, but understates the true amount due by more than 50%, is subject to both the flat 5% understatement penalty and the 5% per month (to a maximum of 25%) major understatement penalty for each month or fraction of a month that a proper return for the period remains unfiled.

A taxpayer who fails to file a return is subject to both the flat 5% understatement penalty and the 5% per month (to a maximum of 25%) failure to file penalty for each month or fraction of a month that a proper return for the period remains unfiled.

A taxpayer who attempted to evade or defeat the tax is subject to both the charge of one-half the total amount of the tax evaded, and either one of the above referenced additions in this sub section.

f. Administration and Enforcement of Tax Laws

The Pennsylvania Department of Revenue is charged by the State Legislature to administer and enforce the state sales and use tax laws. Accordingly, the Department has authority to issue regulations, general rulings and statements of policy (see 72 P.S. §6 & 61 Pa. Code §3). The Department may also issue confidential letter rulings to individual taxpayers that address specific questions. In addition, the Department provides general information in the form of instruction booklets, The Tax Updates, tax bulletins, etc.

If there appears to be a conflict between documents within the Revenue Information System, the order of precedence shall be as follows:

- (1) Statutes
- (2) Regulations
- (3) Statements of policy
- (4) Bulletins
- (5) Letter rulings
- (6) Revenue information

The PA Code also requires the Department of Revenue to publish a general listing of taxable and nontaxable goods and services every three years. This list is published as the “Retailers’ Information” Handbook (Rev –717) and is also posted in the Pennsylvania Bulletin.

g. Information Resources

Excerpts from the Tax Reform Code of 1971 and Title 61 of the Pennsylvania Code are issued to each auditor. The list published as the Retailers’ Information Handbook (Rev-1717) is available to view on the Department’s website.

2. Employer Withholding of Pennsylvania Personal Income Tax

The auditor is required to review a taxpayer’s compliance with Pennsylvania employer withholding at the same time the taxpayer is being audited for compliance with sales tax laws.

a. Pennsylvania Personal Income Tax

i. Individuals

Each individual with gross taxable earnings over \$33 of Pennsylvania source income or who incurred a loss from any transaction as a sole proprietor, partner in a partnership or

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Pennsylvania S corporation is required to pay personal income tax at the state's specified rate and to report their earnings to Pennsylvania (72 P.S. §7302). The individual's employer normally withholds tax due on wages received. The individual should receive a W – 2 Wage and Tax Statement from the employer at the beginning of the following year in which the wages were earned. Individuals are required to report their earnings via a PA-40 Pennsylvania Income Tax Return by April 15 of the following year. The individual must maintain the W-2 received from the individual's employer in the event the Department requests a copy of the W-2 to verify wages. The taxpayer is also responsible for paying any additional tax due at this time. If the taxpayer is self employed, schedules filed with the return must outline all income and expenses.

A sales and use tax audit of a sole proprietor, partnership or an "S" corporation also involves the examination of the owner's and partner's PA-40s.

ii. Partnerships

(1) PA-20S/PA-65 – Commonwealth of Pennsylvania Pa S Corporation/Partnership Information Return

Partnerships are required to file a PA-20S/PA-65 – Commonwealth of Pennsylvania PA S Corporation/Partnership Information Return if:

- during its taxable year, the partnership earned, received or acquired any gross taxable income allocable to Pennsylvania or,
- the partnership had at least one partner that was a Pennsylvania resident. The PA-20S/PA-65 details the partnership's net profit or loss allocable to Pennsylvania.

In addition, beginning in 2006, a Partner/Member/Shareholder Directory is required to be included. The form must be accompanied by Pennsylvania Schedules RK-1 Resident Partner's Share of Income, Loss and Credits or NRK-1 Nonresident Partner's Share of Income, Loss and Credits showing the apportionment of profits or losses allocable to Pennsylvania among each partner. The individual partner uses the appropriate schedule to help calculate their Pennsylvania personal income tax liability. The individual partner must file a PA-40 to report the allocation and appropriate personal income tax.

(2) PA-40NRC – Nonresident Consolidated Income Tax Return

A partnership may file a joint consolidated income tax return for all nonresident partners that have no other Pennsylvania source income. Unless rejected, the Department considers this return as a group of separate Pennsylvania income tax returns that meet the individual filing requirement of Pennsylvania law.

iii. Personal Income Tax Rates

Year	Rate	Comments
January 1982	.022	
January 1983	.0245	
January 1984	.0240	
January 1985	.0235	
January –August 1986	..022	
September –December 1986	.021	
January 1987 to December 1990	.021	
1991	.026	Effective Rate
January 1992	.0295	
January 1993 – December 31 2003	.028	
January 2004 - Present	.0307	

b. Employer Withholding Requirements

Pennsylvania law requires each Pennsylvania employer to withhold personal income tax from the taxable compensation of its employees. Employers are required to remit their withholding semi monthly or monthly and to report these withholdings quarterly via Pennsylvania form PA-W-3 - Employer Quarterly Reconciliation Return of Income Tax Withheld.

At the end of each year, the taxpayer is responsible for issuing a Wage and Tax Statement (W-2 forms) to their employees reporting annual wages and the related tax withholdings. Also, the employer must file with the Department of Revenue a W-2 Transmittal (Rev 1667) reconciling all individual withholdings to the taxpayer’s annual wage and withholding totals. Records for employer withholding of Pennsylvania personal income tax are generally audited in conjunction with sales and use tax records.

Chapter 2 - THE AUDIT FUNCTION

A. RECORD KEEPING REQUIREMENTS

The same law that imposes Pennsylvania sales, use and related taxes on certain transactions also requires vendors to maintain appropriate tax records. Specifically, a vendor is required to maintain records that support the information reported by the taxpayer on all tax returns. These records must distinguish between taxable and nontaxable transactions as well as document the proper charging, collection and remitting of tax money to the Department. The taxpayer is responsible for maintaining these records for three years from the end of the calendar year to which they pertain. This requirement is determined by the time limitation on assessment and collection imposed by 72 P.S. §7258.

B. EXAMINATION OF RECORDS

Title 72 P.S. §7272 states that the Department or any of its authorized agents is authorized to examine the books, papers and records of any taxpayer in order to verify the accuracy and completeness of any return made or, if no return was made, to ascertain and assess the tax imposed by Pennsylvania state law. This also includes the right to examine taxpayer records to verify compliance with laws pertaining to employer withholding of Pennsylvania personal income tax. Taxpayers are required to provide the Department with all necessary tax records upon request. In addition, taxpayers must provide the opportunity and physical facilities to enable the Department to examine the records. The Department may use “Order to Appear” letters and “Secretary’s Writs” to obtain the records necessary to conduct an audit in situations where the taxpayer fails to cooperate.

The Department is required to use audit procedures that are in conformity with state law, Department regulations and policies. These procedures involve examination of source documents, journals, ledgers, schedules, tax returns and other records used by the taxpayer to record sales and purchase transactions as well as the withholding of Pennsylvania personal income tax. The auditor may conduct a complete review or utilize test methods that allow for the examination of a representative portion of the taxpayer’s business activities. Audit findings must be documented in a report that includes a narrative, forms, worksheets, schedules and exhibits.

C. CONFIDENTIALITY

Taxpayer records viewed by an auditor as part of an audit are confidential (see 72 P.S. §7274). Therefore, specific discussion with those other than the taxpayer and

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appropriate Department personnel is forbidden. The auditor should establish that a taxpayer's representative is authorized before any information is disclosed.

In addition, auditors are responsible for maintaining strict security of written and computerized materials. Computer security systems and the Department's Central Records tracks each time a tax file is accessed. Computer security and the Inspector General periodically review these records.

The auditor must adhere to the restrictions listed below when handling private tax information.

- Confidential tax information may only be accessed and released for work related purposes in accordance with the Standards of Conduct, tax laws, and Department policy.
- Confidential tax information is not to be left unattended or available for access by non-Department employees.
- The auditor must exercise care in the logging of security identification number into the Department's computer system so that no one else can access confidential tax information under the auditor's identification number.
- If an auditor is uncertain whether accessing tax information or releasing it has been authorized, the auditor must ask their supervisor.
- All legal requests, subpoenas, and court orders for tax information should be promptly sent to the Chief Counsel's Office for disposition.

D. MEASURING COMPLIANCE

The measure of compliance with Pennsylvania's sales and use tax laws as reflected in the taxpayer's records is expressed in terms of a deficiency or credit. An audit that finds a taxpayer to be in complete compliance with Pennsylvania sales and use tax laws results in no deficiency (a "none" audit). In certain circumstances, the audit may result in a credit for the taxpayer. An audit that finds the taxpayer not to be in compliance with these laws results in a tax deficiency. The deficiency is expressed in monetary terms and results in the issuance of a tax assessment against the taxpayer. The assessment will also include interest and penalty. The taxpayer may appeal the assessment to the Department's Board of Appeals and then to the Board of Finance and Revenue. The appeal process may continue through the state courts.

E. TAXPAYER’S RIGHTS AND RESPONSIBILITIES

The Taxpayers’ Bill of Rights requires the Department to issue a disclosure statement to all taxpayers contacted by the Department for purposes of audit (72 P.S. §3310-202). The disclosure statement is to include:

- The rights of a taxpayer and the obligation of the Department during an audit.
- The procedures by which a taxpayer may appeal or seek review of any adverse decision by the Department, including administrative and judicial appeals.
- The procedure for filing and processing refund claims and taxpayer complaints.
- The procedures that the Department may use in enforcing taxes.

Consistent with this requirement, the Department has prepared REV-554 EO, “Commonwealth of Pennsylvania, Department of Revenue Disclosure Statement of the Department’s and Taxpayers’ Rights and Obligations” (commonly referred to as the Taxpayer’s Bill Of Rights).

Chapter 3 - PROCEDURES (Tax Type)

A. OVERVIEW

Audit procedures described in this manual are divided into two main sections:

- Type of Tax – Chapter 3
- Type of Examination – Chapter 4

This chapter of the manual specifically describes the general procedures to be followed by an auditor in the performance of a state and local sales, use and hotel occupancy tax audit.

The minimum examination and documentation requirements of a sales, use and hotel occupancy audit regarding the related taxes are explained in separate sections of this chapter.

B. PRE AUDIT PLANNING

Pre audit planning involves becoming familiar with all available information about a taxpayer prior to contacting the taxpayer. It also includes becoming familiar with laws and regulations pertaining to a taxpayer's business activity. Procedures for researching this information are described below.

1. Taxpayer Research

In researching information about a taxpayer, the auditor must specifically review the following items:

a. Audit Request

Every field audit requires an Audit Request form. The form is downloaded from the AASTART system. It represents the Bureau's official issuance of an audit assignment. The form is sequentially numbered (audit assignment number) for accountability and control. The auditor should extend every effort to conduct assignments in numerical sequence. However, field audit requests that indicate special instructions are to be given a priority status by the auditor. Normally, a priority audit is an audit that has been referred from other areas within the Department.

An audit must be completed within nine months of the assignment date unless an extension authorized by the regional manager has been granted or the assignment is a bankruptcy audit which must then be completed within thirty days of the bar date.

The audit request must be reviewed for accuracy. The taxpayer's name, address, account number, employer identification number and NAICS code as listed on the form must be compared to the Department's records as summarized on the Taxpayer Summary Information (TSI) accessed through the audit application. The TSI report extracts the taxpayer's current information from the Department's mainframe files. Any differences to actual information

must be addressed during the audit. Special instructions noted on the Audit Request form must also be addressed. Special instructions may include notifying headquarters regarding a taxpayer's direct payment permit, bankruptcy, an attachment or other documentation. In all cases, special instructions must be addressed during the audit and thoroughly explained in the audit narrative, Conflict of Interest Statement or on the Additional Headquarters Processing Request. In addition, notification of action required on information forwarded to headquarters must be indicated on the Additional Headquarters Processing Request.

b. Schedule 1 – Returns as Filed

The auditor must review the taxpayer's reported sales and use tax amounts for the audit period. The reported information is downloaded from information posted to the Department's KITS (Keystone Integrated Tax System) mainframe computer and must be included in the audit report as Schedule 1, Returns as Filed. The auditor will review this schedule for delinquent returns, incomplete returns, sales, sales tax reported, use tax reported, taxable to gross sales ratio and/or fluctuation of reported amounts.

Delinquent returns that fall outside the audit period must also be addressed and filed as part of the audit.

c. Taxpayer Summary Information (TSI)

Prior to contacting the taxpayer, the auditor must review all the relevant Department computer files for information about the taxpayer. The Taxpayer Summary Information report accessed through the audit application facilitates this review. This report provides current information available about the taxpayer from the Department's mainframe files including the KITS, AASTART, Corporate Tax, and the Board of Appeals RAPS system. Specifically, the auditor must review the following:

i. Section 1 – Registration Information

The taxpayer's name, address, and NAICS listed in this section should be compared to the information shown on the Audit Request form. The information on the summary report will normally be more current. Any differences should be addressed during the course of the audit prior to the submission of the audit report.

In addition, the auditor should also note the taxpayer's local tax registration, direct pay permit status, current list of locations, owners, and Keystone Opportunity Zone (KOZ) registration. Detailed information about the taxpayer's local tax and KOZ registration can be accessed via KITS R124 - Account Detail.

ii. Section 2 – Previous Audit Information

The auditor must review any prior audit listed in this section of the report. If the report indicates that any relief was granted on the previous audit, the auditor must review the appeal decision to determine the areas of relief. Hard copies of Board of Appeals decisions dated prior to January 2003 related to the previous audit should also be on file at the region. These decisions may also be reviewed on the Bureau's Sales Tax Division Intranet page under "Tax

Research”. Supervisors may request additional documents in the appeal file for appeals filed prior to January 2003 via email to Headquarters.

Appeal decisions dated after January 2003 may be reviewed via the RAPS (Revenue Appeals Processing System) database.

iii. Section 3 - Appeal/ Refund Petition

The auditor must review this section for refund petitions filed for any period included in the current audit period to ensure duplicate credit is not granted within the audit. Supervisors may obtain refund decisions and file documents through email requests to headquarters’ personnel. Board decisions after January 1, 2003 may be viewed together with supporting schedules via the RAPS system. The RAPS system may be accessed via the Bureau’s home page. The RAPS link is listed under the organizational view. After accessing the link and inputting the appropriate passwords, the auditor may select several search options from the RAPS “Main” page. If the docket number is known, the auditor may enter it into the docket number field or select the “Search” tab to query the system by taxpayer/practitioner name, account number, or employer identification number. The actual written decision will be listed under the “decision” link. Supporting documentation is listed under “Docs”.

iv. Section 4- Letter Rulings

This section should be reviewed for possible letter rulings that have been issued to the specific taxpayer under audit.

v. Section 5- Possible Affiliated Account Numbers

This section should be reviewed for potential audits on other accounts that may be related to the taxpayer. The account numbers listed in this section are limited to those taxes maintained in the KITS system.

vi. Section 6 – Tax Return Analysis

This section is meant to provide an overview of the taxpayer’s reported tax for the audit period. It is meant solely to provide background information to the auditor and does not replace the reporting history downloaded as part of the initial audit preparation that later becomes Schedule 1 in the report.

vii. Additional Detail Report

This is a supplemental report to the Taxpayer Summary Information. It displays KITS notes and detail on collection cases. This information may help the auditor develop alternate sources of contact for the taxpayer.

viii. Bankruptcy Info

This report provides bankruptcy information directly from the bankruptcy section of the Bureau of Compliance.

d. Department Mainframe Computer Files

Most of the information available on the Department's mainframe computer files is provided through the Taxpayer Summary Information report, the Audit Request and the Schedule 1 download. However, there are certain types of information that must be obtained directly through researching certain mainframe files. These files are described below. Instructions for searching these files along with all other mainframe files are provided in Appendix 3 – Computer Files.

i. Annual System

The Department uses the Annual System to maintain information on the filing of individual, partnership and S corp returns. When planning the audit for these types of entities, the auditor must access the Annual System to review the taxpayer's filing history as well as the detail for the individual returns. Nonfiled returns must be addressed as part of the audit report.

ii. KITS (Keystone Integrated Tax System)

KITS R208 – Period Summary List must be reviewed to determine any delinquent returns that fall outside the audit period. Delinquent returns that fall outside the audit period must be addressed and filed as part of the audit. Also, KITS maintains information on previous names, addresses and account numbers used by the taxpayer.

iii. PTA (Public Transportation Assistance) System

This is the only source of information on the taxpayer's registration and filing of PTA returns. This system must be researched when the taxpayer appears to have exposure to PTA taxes and fees.

e. Internet

The auditor should search the Internet for the taxpayer's home page or other links that may provide information on the taxpayer's location, business activities, products and annual reports. In addition, the auditor may also use the Internet to gather information about the taxpayer's industry. A list of useful Internet research sites is found in Appendix 4 – Codes and Information Lists.

f. Tax Returns

During preaudit planning or during the course of the audit, the auditor may determine that it is necessary to review the taxpayer's actual filed returns. The auditor may use these documents to determine a contact person for the taxpayer, affiliates, business activities, compare figures reported on the sales tax return etc.

Returns are available as indicated below:

- Sales Tax Returns: - Sales tax returns filed for 1998 forward have been "imaged" and are available for review through the Bureau's home page via the "View Imaged Returns" link located under "Organizational View". When accessing this file, the auditor is presented with several search parameters ranging from employer identification number (EIN) to

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account number to document locator number (DLN). After entering the search criteria, press the search key at the bottom of the menu. The results will then be provided in a list form. The auditor then selects the item for view and is presented with the imaged document.

While some returns prior to that time have also been imaged, most of the returns prior to 1998 must be obtained by supervisors through an email request to Headquarters. Information from archived returns is also available from headquarters in summary format.

- Employer Withholding of Pennsylvania Personal Income Tax – W-2 Transmittals from 1998 forward have been “imaged” and are available for review through the Bureau’s home page via the “View Imaged Returns” link following the same instructions given for sales tax returns. W-2’s may also be obtained via the “Microfilm Request” link found under “Audit Information on the Bureau’s web page.
- Personal Income Tax Returns – PA-40 Personal Income Tax Returns from 1998 forward have been imaged and may be viewed through the Bureau’s home page via the “View Imaged Returns” link following the same instructions given for sales tax returns. A list of codes pertaining to PIT DLN numbers is provided in Appendix 3. Information on returns prior to that date must be obtained by supervisors through an email to headquarters personnel.

The auditor should review the returns for all principals of sole proprietorships, partnerships, LLCs and S-corporations to insure that they filed a Pennsylvania personal income tax return and to verify that the business income claimed on the return is consistent with the financial records reviewed by the auditor in the course of conducting the sales and use tax audit.

- Partnership Returns – These returns are available from 1999 forward. Most of the 1999 returns must be requested by supervisors through an email request to headquarters personnel. However, a few of these returns together with all partnership returns from 2000 forward, may be reviewed via the “View Imaged Returns” link following the same instructions given for sales tax returns.
- PTA Returns – Copies of these returns may be obtained by supervisors through an email request to headquarters.
- Vehicle Rental Tax – Copies of these returns may be obtained by supervisors through an email request to headquarters.
- Corporate Tax - Copies of these returns may be obtained via the Bureau’s web page under the “Audit Information” link. The reports are requested via the Microfilm Request command. Corporate tax returns received after 01-08-02 may also be viewed under the “View Imaged Returns” link from the web page’s main menu.

g. Department of State (DOS)

Department of State information is useful when trying to determine if a merger has occurred. DOS information may be requested by a supervisor through email to headquarters.

h. Information Requests

The sales tax division's page contains information request links that allow field personnel to request certain types of documentation. From the sales tax division's main menu, go to the Information Request link. Click on this link to see the request options. These options include:

- Aircraft and Boat Registration
- Audit Research Questions and Account Referrals
- Bankruptcy
- Corporate Clearance
- Bulk Sale
- Department of State (copy of merger agreements) (refer to web page)
- PennDOT records (vehicle registration information)
- Labor & Industry (quarterly wage reports).

2. Tax Research

All preaudit planning must include a review by the auditor of sales and use tax laws, regulations and policies pertaining to the taxpayer's business activities. The taxpayer's business activities are normally determined by the listed NAICS code, previous audit information, attachments to the Audit Request, Department files, the Internet, invoices, advertising materials or other information.

In addition to determining the taxpayer's exposure to sales and use tax, the auditor must also determine the taxpayer's exposure to:

- Public Transportation Assistance Fund Taxes and Fees
- Vehicle Rental Tax
- Employer Withholding of Pennsylvania Personal Income Tax
- Pennsylvania Personal Income Tax

There are several sources of information the auditor is expected to use in determining the taxpayer's tax exposure. The sources are listed below.

a. CCH Pennsylvania Sales and Use Tax Reporter

Commerce Clearing House (CCH) publishes the tax reporter exclusively for the Department of Revenue. This is the auditor's main source of information on tax laws and regulations pertaining to Sales, Use, PTA and VRT taxes. CCH provides periodic updates for each reporter distributed to the Department.

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The CCH is located on the hard drive of the auditor’s laptop computer. The auditor is required to maintain the CCH by timely downloading all updates provided by Computerized Audit Support. Instructions for using the CCH are provided in the *How to Guide – a quick reference for CCH CD-ROM and Online for Windows*. This booklet is issued to each auditor.

i. Law

The law represents the actual statute written by the State legislature. The Law section of the reporter reproduces Articles II and XVIII of The Tax Reform Code of 1971, the Pennsylvania Intergovernmental Cooperation Authority Act for cities of the first class, the Public Transportation Assistance Act, and the Philadelphia Code - Sales and Use Tax. Some of the most common legal cites referenced as part of the audit function are available for review in Appendix 4 – Codes and Information Lists “Citations”.

References to the law in the audit report should be as specific as possible and cited using the following format:

72 P.S. §7201 (o) (4) (B) (ii)

ii. Regulations

The regulations represent the Department’s interpretation of the law as set forth in the Tax Reform Code of 1971. They are issued by the Department of Revenue and promulgated by the Independent Regulatory Review Commission to provide taxpayers with rules of general application so that taxpayers might clearly understand their rights and duties under the law.

References to regulations in the audit report should be as specific as possible and cited using the following format:

61 Pa. Code §32.21(a) (2) (ii) (B)

If the cite is used at the beginning of a sentence, the word “Title” must be inserted in front of the cite. For example:

Title 61 Pa. Code §32.21(a) (2) (ii) (B)

iii. Rulings

Rulings issued by the Department advise the public of the Department’s application of the tax laws to a general factual situation. A ruling is issued to ensure uniformity in the application of the law. References to rulings in the audit report should be as specific as possible and cited using the same format for regulations. For example:

61 Pa. Code §53.1(c) (2) (xiv)

If the cite is used at the beginning of a sentence, the word “Title” must be inserted in front of the cite. For example:

Title 61 Pa. Code §53.1(c) (2) (xiv)

iv. Revenue Pronouncements – Statements of Policy

The pronouncements are used by the Department to interpret law or policies that the Department expects to implement in a future regulation or to follow in a future adjudication, explain an administrative procedure within the discretion of the Department or implement an act of assembly if the Department finds it is unnecessary to use regulatory powers to perform its duties and responsibilities provided by law. The pronouncement is in effect once it is published in the Pennsylvania Bulletin. References to pronouncements in the audit report should be as specific as possible and cited using the following format.

61 Pa. Code §60.6(f) (2) (iii) (A)

If the cite is used at the beginning of a sentence, the word “Title” must be inserted in front of the cite. For example:

Title 61 Pa. Code §60.6(f) (2) (iii) (A)

v. Miscellaneous

Other types of information are also found in the CCH. These items are described below.

Compilation – The compilation presents the history and description of tax along with constitutional provisions. It cites sections of the law, regulations and rulings where additional information and examples are contained. However, much of the information in this section represents the interpretation of the CCH publisher. Consequently, while it may be useful as a guide it has no legal foundation. Material from this section is not cited in the audit report.

Listing of Taxable and Exempt Property – This listing is the same listing published by the Department to the public as the Retailer’s Handbook. Information from this listing may be cited in the audit narrative using the following format:

Title 61 Pa Code §§58.1 – 58.2 REV 717AS Retailer’s Information. The page number must also be included in the cite.

b. Department and Division Resources

i. Office of Chief Counsel Letter Rulings

Many letter rulings issued by the Office of Chief Counsel are available on the Department’s web page. These may be used by the auditor in researching tax issues.

ii. Sales Tax Division Letter Rulings Database

This topically organized database provides an index with a brief description of issues addressed via letter rulings that are on file at headquarters.

iii. Audit Application Resources

The audit application has a collection of lists showing taxable and exempt items for several industries. Most of these lists are based on Office of Chief Counsel letter rulings.

iv. Board of Appeals Decisions

RAPS may be searched by taxpayer or by topic to find decisions that may be helpful in researching a tax issue.

c. Internet

The auditor is permitted to use the Internet to search out information on taxpayers under audit. The research may include gathering product or industry information that may be useful in accurately determining the taxpayer's business activities and tax exposure. For instance, www.naics.org provides a search for financial documents on insurance companies.

d. Field Management Staff

The auditor must discuss questions regarding tax determinations with their supervisor. If the supervisor requires assistance in making a proper tax determination, the supervisor may contact sales and use tax audit program specialists at headquarters. This may be done via email or telephone. However, the use of email is preferred. Emails should include the name of the taxpayer and the assignment number in the subject line.

3. Audit Referrals

The auditor may discover, during preaudit planning and during the course of the audit, other entities that should be referred for audit. Procedures for identifying potential audits and making an audit referral are discussed below:

a. Collateral Audits of Affiliated Companies

The auditor must evaluate the necessity to conduct collateral audits of affiliated companies.

An affiliated interest exists when two corporations, associations, partnerships, proprietorships or other businesses, in which one corporation, association, partnership, proprietorship, individual or other business owns more than 50% of the stock or assets, including inventory, machinery and equipment of the remaining corporation, association, partnership, proprietorship or other business. Also, the common ownership of more than 50% of the stock or assets of each of two or more business entities results in an affiliated interest between the two commonly owned entities.

The auditor must:

- Determine if the affiliate(s) is registered for sales and use tax in PA and if so, review the reporting history for compliance. If the affiliate(s) has not been in compliance (i.e. delinquent returns), a collateral audit must be conducted.

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- When common management is responsible for the reporting of sales and use tax and areas of deficiency were found in the current audit, a collateral audit(s) should be performed on the affiliate(s).
- When common management (e.g. parent of sister corporation) is responsible for the reporting of sales and use tax for affiliated companies, the auditor should complete a Sales Tax Audit Potential Worksheet for the affiliated companies.

If an affiliated company meets the objective criteria stated above for audit selection, a collateral audit is required. An audit referral must be made to headquarters for the issuance of the appropriate assignment.

b. Other

Audit referrals may also be generated because of a change in ownership of the entity under audit. In these circumstances, audit referrals must be made in accordance with the instructions found under Chapter 6 – Audit Report.

Audit referrals may also be generated when the auditor discovers, during the course of an audit, purchase invoices showing taxable sales by vendors who are not charging sales tax. When conducting a sales examination of a vendor, referrals should be made when exemption certificates are construed as being accepted in good faith by the vendor under audit but independent research of the purchaser's activities are not consistent with the exemption claimed.

c. Sales Tax Audit Potential Worksheet

The Sales Tax Audit Potential Worksheet is the auditor's primary tool used to gather information about a taxpayer for an audit referral. The completed worksheet allows for a systematic review of the taxpayer's business activities as well as a determination of whether or not the entity listed on the worksheet meets the Bureau's audit criteria. The worksheet is prepared via the computerized worksheet application or manually as circumstances require. In most instances, the auditor will complete the worksheet via computer.

The auditor, supervisor and regional manager must sign the completed worksheet prior to submitting the worksheet to headquarters. Upon receipt, headquarters staff will review the information presented on the sheet. If it is determined that the entity will be audited, the information recorded on the worksheet is entered into the Bureau's Audit Assignment Tracking and Report System (AASART). The information gets posted as a potential audit assignment until it is converted into an Audit Request.

C. CONTACTING THE TAXPAYER

1. Audit Engagement Letter and Related Documents

An Audit Engagement letter is initially sent to the taxpayer from the regional office under the manager's signature. The letter serves as notice to the taxpayer of the Department's intent to audit. It also identifies the audit scope and records required for audit. The letter should be sent

to the taxpayer when the Audit Request is received in the regional office. The preparation and sending of the letter is normally a clerical function within each region.

In addition to the Audit Engagement Letter, the taxpayer must be sent a REV-554, Department of Revenue Disclosure Statement of the Department's and Taxpayer's Rights and Obligation.

2. Telephone Contact

The auditor assigned to conduct the audit should contact the taxpayer or a duly authorized representative by telephone within 60 days of the date on the engagement letter to make the preliminary arrangements for the preaudit conference.

When making the call the auditor should:

- Clearly state his/her name, agency and purpose of the call.
- Obtain the name (including verification of correct spelling), title, phone number, and fax number of the person responsible for handling the taxpayer's audits.
- Obtain the email address for the audit contact person.
- Verify with the contact person receipt of the engagement letter and the taxpayer's bill of rights.
- Verify entity name and location.
- Arrange place, date and time for the pre audit conference. The taxpayer should be advised at this time if additional audit staff will be attending the conference. The person contacted should be informed of the purpose of the conference and should be advised that the taxpayer's designated representatives must be present at the conference. Making arrangements for the conference also involves getting directions to the taxpayer's place of business.
- Discuss record requirements and ask for a brief description of the taxpayer's record keeping system.
- Discuss with the taxpayer the entity's business activities.
- Ask clarifying questions where appropriate.
- The auditor should keep a written record of each contact made with the taxpayer. This includes listing the name of each contact along with the date and time of the contact. The auditor must document in chronological order all attempts to contact the taxpayer and include the documentation as an exhibit in the audit report if necessary.

3. Confirmation Letter

The auditor is required to send a confirmation letter to the taxpayer for out-of-state and mandatory assignments. This letter should, at a minimum, verify the date, time and place of the

preaudit conference. The auditor may customize the confirmation letter as circumstances warrant.

It is recommended that the auditor send the taxpayer a confirmation letter for local assignments.

Confirmation letters should be included as an exhibit in the audit report and referenced in the audit narrative.

4. Taxpayer Delay

The taxpayer may find it necessary to delay the audit for various reasons. Where it is apparent that the reasons stated by the taxpayer are authentic and not intended to interfere with the orderly conduct of an audit, the auditor may arrange for a date sometime in the future for a preaudit conference. In the event of repeated postponements, or a postponement of over 60 days, the taxpayer must request a postponement in writing on company letterhead. The request must include the reason for the delay and the date when the preaudit conference can be held. The taxpayer should be asked to provide the letter within two weeks. The proprietor, a partner, or a corporate officer must sign the letter. This letter is to be included in the audit report.

5. Agreement to Extend Time Limit for Assessment/Determination of Tax and to Extend Period of Time for Record Retention (Waivers)

If the statute of limitations is about to expire on a portion of the audit period and the taxpayer requests a legitimate postponement, the auditor will request the taxpayer to execute an Agreement to Extend Time Limit For Assessment/Determination of Tax and to Extend Period of Time for Record Retention.

This form must be executed in accordance with the Bureau's waiver policy prior to granting any postponement. This also applies to situations where the taxpayer's request for a postponement involves a time period that will affect the statute of limitations for the current audit period.

If the taxpayer refuses to sign a waiver requested in conformance with the waiver policy, a jeopardy assessment will be issued on the year that will be lost due to statute.

D. PREAUDIT CONFERENCE

During the preaudit conference, the auditor should exercise every reasonable effort to secure the goodwill and cooperation of the taxpayer. Since the conference is only the preliminary or introductory phase of the audit, the discussion with the taxpayer of business activities, maintenance and retention of records and various methods of audit procedures should be general in nature.

The audit period is normally established during the preaudit conference. Inform the taxpayer that if circumstances prevent the audit field work from concluding within a reasonable time from the preaudit conference, the audit period will be extended. If delays prevent the field work from being completed within twelve months and the originally determined audit period end date does not bring the audit period through the end of the calendar year, the auditor is required, at a minimum, to extend the audit period to include the entire calendar year.

The Department is required, upon advance written request of the taxpayer, to make an audio recording of the preaudit conference at the taxpayer's own expense and with the Department's equipment. The taxpayer may also make an audio recording of the interview with the taxpayer's own equipment if, prior to commencement of the interview, the taxpayer notifies all parties present that the interview will be recorded. (72 P.S. §3310-203)

1. Preliminary Information

The auditor, after presenting his/her credentials to the taxpayer, secures and records the names, official titles, or in the case of outside representatives, the professional status and authorization of all persons attending the conference on behalf of the taxpayer. This information should be recorded for inclusion in the audit narrative.

The auditor should verify receipt by the taxpayer of the audit engagement letter and the taxpayer's bill of rights. If the taxpayer indicates that these items have not been received, the auditor must provide copies to the taxpayer.

2. Statement of Purpose and Request for Cooperation

The auditor should inform the taxpayer of the Bureau's intent to perform a routine sales and use tax audit. Also, assure the taxpayer that the orderly procedures of the business operations will not be disrupted or interfered with to an extent greater than is absolutely necessary to conduct the examination.

The auditor should state the audit period subject to audit. Normally an audit period consists of all reporting periods within the last three complete calendar years and the reporting periods required to have been reported in the current year.

The auditor should state that a limited examination of employer withholding will also be conducted. The auditor should state that if the taxpayer is found to have exposure to other taxes and fees administered by the Department, a limited examination will be conducted in these areas as well. If a deficiency results from the examination, a separate audit assignment will be issued on the specific tax.

3. Business Activities

Through discussion with the taxpayer, the auditor should determine the overall nature of the business activities, operations, nexus with Pennsylvania, number of business locations, type of entity, changes in entity, additions and deletions in divisions, affiliates and other related parties. The auditor must first determine the taxpayer's business entity, affiliates and business activities in Pennsylvania. The auditor must identify sales locations, including out-of-state locations making sales into Pennsylvania, as well as locations in counties that impose a local sales tax. The auditor must record information regarding the type of business activity and the taxable and nontaxable sales and purchases made by the taxpayer. Business activities between affiliates must also be recorded so that they may be later described in the audit report.

A list of business locations must be included in the audit report when the taxpayer has more than one Pennsylvania business location. This list must provide a brief description of each

location (e.g. manufacturing facility, admin office, etc.) and clearly indicate those locations in counties that impose a local sales tax. In addition, locations operating with a KOZ/KOEZ must be identified. The list must also include the beginning and ending dates of those locations that did not operate for the entire audit period. This list should be included as an exhibit in the audit report. A copy of the taxpayer's current annual report may provide most of this information. The auditor should request a tour of the taxpayer's business operations. These arrangements should be made definite as to time, place, and persons involved. Inform the taxpayer that it is a necessary prerequisite to the conduct of an audit to become thoroughly familiar with the nature of the taxpayer's business activities and operations prior to the design of any audit procedure. The auditor should document these items in the audit narrative.

4. Systems Survey

To ensure all tax monies due the Commonwealth are reported, the auditor must determine the flow of the transactions from the source documents through the taxpayer's accounting system to the tax return.

The auditor must obtain a description of the taxpayer's record keeping system throughout the audit period including:

- the fiscal or calendar year,
- changes in record keeping or accounting systems,
- accrual versus cash basis of accounting for sales tax returns, federal and state income tax returns, and
- whether the taxpayer used a computerized or manual accounting system.

The auditor should determine what changes, if any, the taxpayer has made to its accounting and reporting methods. A description of the changes and the reporting periods in which the changes took place must be explained in the audit narrative.

The description obtained from the taxpayer should be sufficient for the auditor to understand the audit trail for sales, use and hotel occupancy purposes, as well as employer withholding, PTA, and VRT taxes, when applicable.

The auditor must identify and discuss with the taxpayer delinquent returns, late filing, filing without remittance, and the taxpayer's reporting cycle.

A written description of the audit trail and items discussed with the taxpayer are required to be included in the audit report. All records referred to in the audit procedures section of the narrative must be explained as part of the audit trail in the narrative description of the systems survey.

5. Bureau of Audits - Registration Update

If the taxpayer under audit is registered with the Department, the auditor is required to present the taxpayer with a Bureau of Audit - Registration Update form. The taxpayer should be

informed that the completed form will be used to verify that all information on file with the Commonwealth for the subject taxes is current. Changes reported on this form will be updated on the Department's records. This form should be completed by the taxpayer at the pre audit conference or as soon after as possible and returned to the auditor.

The auditor is required to review the form to make sure it has been filled out completely and then compare the information on the form to the Taxpayer Summary Information report. In addition, the auditor should take special note of changes in ownership (entity changes), bulk sale or merger information indicated on the form. These actions may require the creation of additional audit assignments.

The form should then be noted in the upper right hand corner with any items that need updated and then scanned to P:\Temp\PA-100s & Registration Updates for processing by headquarters staff. This is normally done by scanning the document to either the auditor's or auditor supervisor's email if the copier/scanner is not programmed to scan the image directly to the LAN. From the email, the document is saved to the above referenced LAN address. The auditor should follow the procedures established by their individual regions. Once corrections or registrations are processed by Headquarters, they are removed from the file.

If the taxpayer refuses to complete the registration update form, the auditor is required to complete the form using information found in researching the taxpayer.

6. Requirements for the Audit Review of Third Party Credits

The auditor is required to present this form to the taxpayer at the preaudit conference. The auditor must include a date on the form by which the taxpayer must present documentation to support third party credits requested by the taxpayer for inclusion in the audit report. The auditor should review the contents of the Requirements for the Audit Review of Third Party Credits, answer taxpayer questions regarding the form, and obtain a signature of the taxpayer's representative acknowledging that they received a copy of the form.

7. PA-100 Pennsylvania Enterprise Registration

If the taxpayer is not registered for sales and use tax with the Department, the auditor is required to present the taxpayer with a PA-100, Pennsylvania Enterprise Registration Form and Instructions booklet. The taxpayer should be advised that the form will be used to obtain a license number for the purposes of processing the current audit, if necessary. The form should be completed by the taxpayer at the preaudit conference or as soon after as possible and returned to the auditor.

If the taxpayer refuses to complete the PA-100, the auditor is required to complete the form using the best available information. The form must be included in the audit report.

The following information must be placed on the upper left corner of the first page of the PA-100 containing the following information:

- Audit Period Local Tax, if applicable (Philadelphia or Allegheny)
- North American Industry Classification System (NAICS)
- Type of Application: SUT, PTA and/or EW

- Permanent or In/Out Number for assessment purposes

It is required that the form be scanned to P:\Temp\PA-100s & Registration Updates as soon as possible. This is normally done by scanning the document to either the auditor's or auditor supervisor's email when the copier/scanner is not programmed to scan directly to the LAN. From the email, the document is saved to the above referenced LAN address. The auditor should follow the procedures established in the individual region. Headquarters personnel review these documents everyday for corrections. Once corrections or registrations are processed, they are removed from the file.

The auditor must include the original PA-100 in the audit report.

A license number is not necessary to process a "none" audit of a taxpayer that was not previously registered.

8. Discussion and Preliminary Conclusions

Discuss with the taxpayer the techniques or procedures usually followed by the Bureau in conducting an audit based on the current available information. However, the taxpayer must be informed that the auditor may be compelled to change the discussed procedure once the records are examined.

9. Arrangements

The auditor should request that necessary records and adequate physical facilities be made available to conduct the audit. The auditor should also determine office hours and the taxpayer's contact person(s) that will be assisting in the conduct of the audit.

10. Direct Payment Permit Holders

The auditor is required to verify that all information on the most recent application for direct payment permit on file with the Bureau is complete and accurate. The auditor must obtain an updated Application for Direct Payment Permit when any of the following have occurred since the most recent application was filed:

- Name change
- Business locations added or discontinued
- Sales and use tax license number change
- Business activities change
- Business activities qualifying for the business exemption have been discontinued
- Another entity has merged into the company holding the DPP

At the conclusion of the audit, the auditor must make a recommendation regarding the taxpayer's continued use of the direct payment permit. A memo must be attached to the Additional Headquarters Processing Request advising headquarters of the auditor's recommendation.

The auditor's recommendations should be based on the following:

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- Has the taxpayer remitted at least \$10,000 in use tax to Pennsylvania during the prior year?
- Is the taxpayer in compliance with all Pennsylvania state tax requirements?
- Does the taxpayer qualify for a business exemption?
- Has the taxpayer maintained auditable records?

When the auditor recommends revocation of the taxpayer's direct payment permit, the memo must clearly state the reason for revocation (e.g. lack of records, no longer qualify for a business exemption).

A copy of the most recent application will be attached to the audit request when it is sent to the regional office by headquarters. If the application is not attached to the audit request when it is received in the regional office, the auditor should email a sales and use tax audit program specialist and request a copy of the application.

11. KOZ/KOEZ

The Department defers to the Department of Community and Economic Development (DCED) on the issue of qualification for benefits related to a Keystone Opportunity Zone/Keystone Opportunity Expansion Zone. If DCED determines that an entity is a "qualified business", DOR accepts the determination and grants benefits accordingly.

During an audit, the auditor is required to verify that the KOZ/KOEZ account number currently being utilized by the taxpayer is current and valid by reviewing R124 Account Summary Information in KITS. The detail page of this conversation will show a "hot key" (PF10-KOZH) if a KOZ number exists. Note: All KOZ/KOEZ exemption numbers will start with the prefix "72". There is also a KOZ indicator on the Taxpayer Summary Information report.

Not all KOZ numbers are properly posted to KITS. If a taxpayer claims to be a qualifying business for any tax year not appearing in KITS, contact headquarters for further research.

The auditor must further verify that all purchases of building machinery and equipment, services and tangible personal property for which the taxpayer is claiming the exemption are used or consumed exclusively within the KOZ/KOEZ (see 73 P.S. §820.511).

12. Plant Tour

When auditing a manufacturing entity, the auditor should make arrangements for a plant tour at this time. Failure of the taxpayer to comply with this request constitutes a scope limitation since the auditor cannot visually inspect how equipment is being used.

E. TYPE OF TAX – PROCEDURES

Taxes covered include:

- State and Local Sales Tax
- Use Tax
- Hotel Occupancy Tax
- Public Transportation Assistance Fund Taxes and Fees (PTA)
- Vehicle Rental Tax.

In addition, the minimum requirements to be conducted for Employer Withholding of Pennsylvania Personal Income Tax (EW) and for Pennsylvania Personal Income Tax are explained within.

1. Sales Tax

a. Gross Sales

The objective of the gross sales examination is to determine that all categories and sources of sales are properly included on the Sales and Use Tax Return and are made available to the auditor for examination. The examination of gross sales is conducted to:

- Become familiar with the business activities and locations (determine exposure to local sales tax)
- Substantiate that all areas of business activities are made available for audit
- Validate the basis for the examination of taxable sales, nontaxable sales, and sales tax
- Determine all sources of taxable sales or sales tax charged
- Establish the credibility of records
- Uncover affiliates and intercompany transfers
- Ensure accurate basis for the selection of test periods
- Determine the areas of potential use tax liability, such as contracts to real estate

The auditor will use the information gathered regarding the completeness, availability, and credibility of records during the examination of gross sales to determine the type of audit that will be performed on sales.

Prior to the examination of gross sales, the auditor should review the chart of accounts to become familiar with the sales accounts that would be expected to be included in the gross sales reported on the Sales and Use Tax Return.

i. Reported Gross Sales Per the Federal Return vs. Reported Gross Sales on SUT Return

Reported gross sales (Schedule 1, Returns as Filed) should be compared to the sales on the Federal Income Tax Return or other federal return (ex. 1120, 1120S, 1065, 1141, 990's etc.), Pa Corporation Tax Report (RCT-101); Federal Form 1040 Schedule C; or Partnership Return (PA-65) for a minimum of at least one year during the audit period. Differences must be reconciled. Categories of income not included in gross sales in the reported amounts should be examined to determine if they might contain taxable sales such as rent, other income, etc.

The auditor should determine the general ledger accounts to which the differences relate and determine if the sales should be included in the gross sales per book on the schedule, Comparison of Reported Sales to Book Sales. If the difference cannot be reconciled and the taxpayer cannot provide a satisfactory explanation of the difference, the auditor should compare the federal returns to the reported amounts for the remainder of the audit period. The taxpayer should be given a schedule documenting the differences and a Request for Financial Records, requesting that the taxpayer explain the source of the underreported sales. No adjustment should be made to gross sales when the difference is identified as an obviously nontaxable category of sales (such as real estate rents and royalties).

Book gross sales on the schedule, Comparison of Reported Sales to Book Sales, should be adjusted for any unsubstantiated differences and substantiated differences that contain sales with possible tax exposure. A Gross Sales Assessment should be made on the unsubstantiated difference in sales. Substantiated differences of gross sales that have possible sales tax exposure should be examined as part of the Taxed and Nontaxed Sales Examination.

Material, unexplained discrepancies in which the gross sales as reported on the SUT returns is greater than the gross sales reflected on the PA-20S/PA-65 or PA-40 Schedule C, should be referred to headquarters as a referral of a potential PIT audit.

ii. Trace and Compare the Reported Gross Sales to the Total of the General Ledger Sales

Reported gross sales should be traced to the general ledger accounts for the audit period. This comparison may be done on a reporting period or annual basis. The auditor should prepare a reconciliation schedule to verify that all locations and applicable general ledger accounts are included in the total book gross sales. Book gross sales should be adjusted on the schedule, Comparison of Reported Sales to Book Sales, to reflect differences found by the auditor.

iii. Local Sales or Use Tax Exposure

During the verification that sales from all locations are included in the gross sales amounts reported, the auditor must identify locations that are physically located in a county that imposes

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a local sales and use tax. The gross sales from these locations should be compared to the gross sales reported for each taxing jurisdiction. The results should be recorded on the schedule, Comparison of Reported Sales to Book Sales.

iv. Validation of Book Gross Sales and Completeness of Records Presented

The auditor should verify the completeness of the records made available for audit. The original books of entry (e.g. accounts receivable journal, cash receipts journal, sales journal) should be traced to the general ledger sales accounts to ensure that all sources of sales were properly recorded for one year within the audit period.

When discrepancies are found, the auditor should examine additional periods to determine if the unrecorded or erroneously recorded transactions were isolated or recurring. If the discrepancies are found to be recurring, the auditor should prepare a reconciliation schedule for the audit period. Book figures on the schedule, Comparison of Reported Sales to Book Sales, should be adjusted to reflect the unrecorded or erroneously recorded sales.

The auditor must approximate the number of sales transactions per month and identify how the approximation was determined. A sample of entries should be traced from the books of original entry to the source document to verify proper recording and existence of source documents. Source documents include items such as sales invoices, cash register tapes, hotel guest folios, and general journal posting vouchers. A sample of source documents should be traced to books of original entry to verify completeness of recorded sales. Exceptions should be noted in the audit report.

The auditor should vouch a sample of entries in the general ledger to the books of original entry to assure that all are made available for examination. Unusual entries or adjustments to the general ledger accounts should be investigated and clearly explained in the audit report when they affect the audit findings.

General journal entries posted to general ledger sales or income accounts should be investigated to determine if the entry represents sales from affiliated interests or intercompany transfers. These entries should be documented in the audit report when the sales from the intercompany transfers are determined to include taxable transactions. These transactions should be assessed as additional taxable sales if the taxpayer did not properly tax them. The information obtained regarding the availability, credibility, and completeness of the records presented during the gross sales verification should be used by the auditor to determine the type of audit that should be conducted on the taxed and nontaxed sales portion of the audit.

If the taxpayer has exposure to hotel occupancy tax, the auditor should identify the records necessary to separate regular sales from occupancy. The auditor should also determine exposure to public transportation assistance taxes and fees (PTA) and vehicle rental tax (VRT) and determine if a collateral audit should be requested. Minimum requirements regarding taxpayers with exposure to PTA or VRT are separately outlined in respective sections of this chapter.

b. Sales Tax Accrual

i. General

A complete reconciliation of accrued state and local sales tax per books to state and local sales tax reported is required for every reporting period in the audit period. The procedures in this

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section are required for both state and local sales tax. The auditor must be completely familiar with the taxpayer's procedures for the reporting of sales tax charged in order to ensure the proper reporting of all sales tax charged. For audit purposes, the accrued sales tax per books can be the general ledger sales tax account, a sales journal which includes a sales tax entry or any other type of sales listing which includes a sales tax entry listed from the source documents that can be totaled to arrive at the total sales tax charged. The auditor should verify that all sources of both state and local sales tax were included in the total sales tax accrual amounts reported. When the taxpayer has multiple locations and/or multiple sales journals, the auditor should verify that all sources of sales tax were posted to the sales tax accrual account for each reporting period. The auditor should verify that local sales tax from all locations identified to be located in counties which impose a local sales tax are included in the sales tax reported for each applicable jurisdiction.

The taxpayer is required to report the greater of the sales tax actually charged and accrued or sales tax as computed by the applicable sales tax rate multiplied by the taxable sales. In situations where actual taxable sales are identifiable, the auditor should verify that the larger of the two amounts were used for reporting purposes.

The auditor should verify the proper recording and posting of state and local sales tax by tracing sales tax listed on a sampling of source documents to the sales tax accrual account. The audit trail should be explained in the audit narrative.

The auditor is required to prepare a schedule, Reconciliation of Accrual Amounts (Book to Reported). This schedule should be included in every sales and use tax audit report and referenced in the audit narrative. All unreported trust funds must be recorded in the audit report on this schedule. This schedule triggers an automatic review to determine if a Responsible Party Assessment is warranted.

When trust fund deficiencies are recorded on this schedule, a list of responsible parties must be attached to the REV-1105, Additional Headquarters Processing Request Form, and forwarded to headquarters. The list should include the name, title, social security number, and home address of the owners, partners or corporate officers. The list of responsible parties may not be included in the audit report of the entity due to the nature of the confidential information.

If the auditor is unable to perform a reconciliation of accrual amounts, the "book" amounts for sales tax should be marked "not available" for each period where records were not provided.

If discrepancies are found, the auditor should prepare a schedule and include it in the audit report to document accrued amounts not included in the reported tax amounts. Book amounts per the schedule, Reconciliation of Accrual Amounts (Book to Reported), should be adjusted to reflect the auditor's findings.

ii. Converting Cash Basis to Accrual Basis

Sales tax may only be reported on an accrual basis. In a situation where the sales tax is being reported on other than an accrual basis (i.e. cash basis), the auditor is required to compare the taxpayer's sales tax account to an accrual basis and assess any additional tax due as a result of the findings.

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- First Time Audit

When the sales tax accrual account must be converted from cash to accrual, any deficiency will be assessed in the last period of the audit via the Reconciliation of Accrual Amounts (Book to Reported) schedule. The auditor must request, via the Additional Headquarters Processing Request form, a letter to be sent to the taxpayer from Headquarters. The letter will advise the taxpayer that sales tax must be reported on an accrual basis and that similar deficiencies in subsequent audits will be assessed on a period by period basis.

- Subsequent Audits

If the sales tax accrual account must be converted from cash to accrual in subsequent audits, any deficiency will be assessed on a period by period basis.

iii. Taxes Collected and Not Reported

In a situation where the taxpayer is found to have charged or collected sales tax and did not report such tax, the auditor is required to determine if major penalties are appropriate. For attempt to evade or defeat the tax, there is a penalty charge of one-half of the total amount of the tax evaded.

iv. Debits to the Accrual Account

The auditor should review the sales tax accrual account(s) and determine the source of all material debits that are not reductions due to the payment of sales tax on a corresponding return. The auditor should review the sales tax account(s) to verify that the taxpayer did not make unallowable deductions for bad debts. Material, invalid or unsubstantiated reductions to the sales tax accrual account should be listed. The listing along with a Request for Financial Records requesting that the taxpayer provide documentation supporting the reduction to the accrual account should be given to the taxpayer. If the taxpayer does not adequately explain or cannot substantiate the reduction, the auditor should include the amounts in the total book sales tax on the schedule, Reconciliation of Accrual Amounts (Book to Reported) and assess the difference.

When the taxpayer is found to have not reported all taxes accrued, the auditor must evaluate the necessity to refer the taxpayer to the Office of Criminal Tax Investigations.

v. Credits Taken on the Return

The sales and use tax return provides for a credit to be taken against the overall remittance on line 8 of the PA-3 Sales and Use Tax Return. Credits taken on the return will be included on the information downloaded from KITS and appear on Schedule 1, Returns as Filed, in the Credit column. The auditor should reference credits taken in the audit report and verify the source and validity of the credits. Credits for other than Department approved credit memos or verifiable Taxes Paid on Purchases Resold (TPPR) should be listed on a separate schedule. If the taxpayer erroneously took a credit on their return for taxes that they would otherwise have been entitled to take against their sales or use tax account (i.e. a credit for sales tax erroneously accrued and remitted in a previous reporting period), the taxpayer should be notified of the proper method for taking such a credit. The fact that the taxpayer was notified of the proper

method of taking the credit should be documented in the audit report. If the taxpayer took a credit on their return for items that they were not otherwise entitled to take (i.e. third party sales tax credit), then the disallowed items should be included on a separate worksheet or schedule and assessed as part of the audit findings.

vi. Taxes Paid on Purchases Resold

Credit for Taxes Paid on Purchases Resold (TPPR) may not be included in the audit findings as a projection. Credit for taxes paid on purchases resold may only be granted on a complete basis. This represents a sales tax finding and reduces the sales tax liability.

TPPR credits should be developed by the taxpayer and verified by the auditor. The taxpayer must provide the auditor an attestation on company letterhead. The taxpayer must state that they have verified that the credit was not previously received through a vendor credit memo, petition for refund, or any other means. The attestation must be signed by a corporate officer or a holder of power of attorney.

TPPR credits disallowed by the auditor must be documented on a supplemental schedule. Disallowance will increase the sales tax liability.

vii. One Percent Discount

The taxpayer may take a one percent discount on the tax return for sales tax timely reported and remitted. The one percent discount is not applicable to use tax reported. When a taxpayer has reported use tax as sales tax and has taken the one percent discount, the auditor must assess the taxpayer for the amount of the unallowable one percent discount taken.

c. Taxable and Nontaxable Sales

i. Sales Taxed By the Taxpayer

During the examination of sales, the auditor should multiply taxable sales amount by the proper tax rate on a sampling of sales invoices to verify that the proper tax rate was used. If exceptions are found, the auditor should compute the proper tax rate for each sales transaction in the sales population examined. The additional taxable amount resulting from sales being taxed at less than the proper rate should be recorded and included in the total deficient sales for the population examined (whether sales were examined on a complete or test audit basis).

The auditor should examine a sampling of sales transactions to verify that the taxpayer charged tax based on the incremental basis of tax for state and local sales tax pursuant to the bracket system outlined in 72 P.S. §7203 and 53 P.S. §12720.503. Exceptions should be scheduled and included in the audit findings as additional taxable sales. The auditor should increase the sample to determine if the noted exceptions were isolated or recurring. If the exceptions are found to be recurring, the auditor should consider determining the additional tax due by use of an effective rate examination.

During the examination of sales, it may come to the auditor's attention that the taxpayer was charging sales tax on nontaxable sales. When this occurs, the auditor should inform the

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taxpayer of the error. The auditor should document in the sales tax section of the audit narrative that the taxpayer was informed of the error and instructed on the proper tax disposition of the sales transactions involved.

If a use tax liability results from transactions on which sales tax was erroneously charged:

- **First Time Audit** – The error and the use tax exposure should be explained to the taxpayer. The taxpayer should be informed that use tax will be assessed in subsequent audits on similar transactions. The auditor should document in the audit narrative that the taxpayer was informed. The auditor should indicate on the Additional Headquarters Processing Request, that the taxpayer should be sent a “Contractor’s Letter.”
- **Subsequent Audit** – If the taxpayer is found to be charging sales tax on nontaxable items on which the taxpayer is required to pay use tax, the auditor should verify that the taxpayer was informed of the proper payment of tax in the previous audit. If the taxpayer was informed, the auditor should assess use tax on those items. No offsetting credit for sales tax collected will be allowed.

The taxpayer is not entitled to a credit or refund for the collection and payment of sales tax on a nontaxable sale. The purchaser must apply to the Board of Appeals to recover this type of credit. An auditor may not accept an Assignment of Rights from a purchaser.

ii. Nontaxed Sales

In examining nontaxable sales, there are four fundamental types of audit examinations that may be employed:

- Complete Audit
- Modified Complete
- Test Audit
- Combination Audit

In each of these types of audits, the auditor must determine the taxability of each sale in the population actually examined. Each transaction occurring within the population is examined to determine whether the proper amount of tax (tax incurred) has been charged and recorded on taxable transactions. The auditor should verify that the taxpayer properly charged, recorded and remitted local sales tax on taxable sales made from locations originating within counties that impose local sales tax. Exemption certificates that support claimed nontaxable transactions are examined for authenticity and validity.

iii. Transaction Analysis

Is transaction (sale or use) within Commonwealth?
If so...

Is the transaction tangible personal property, hotel occupancy or a taxable service subject to state and/or local sales tax?

If so...

Is there a purchase price (or implied purchase price)?

If so...

Is the purchase price taxed at the proper state/local sales tax rate?

If not...

Is there a valid exemption available to the purchaser with respect to the item of property or service that is subject of the transaction and is a valid exemption certificate accepted in good faith on file for the transaction when applicable?

If not...

The auditor should list all items not properly taxed on the sales tax worksheet, or some other schedule that includes the information included in the sales tax worksheet. The detail of the items listed should include: invoice/transaction date, invoice number, purchaser, item(s) purchased, invoice amount, taxable amount, tax due, tax paid, deficiency and clarifying remarks to help explain the basis for assessment.

iv. Acceptance in Good Faith

To be accepted in good faith an exemption certificate must:

- State the reason for the exemption and be consistent with the activity of the purchaser and the character of the property.
- Be signed by the purchaser/representative.
- Be dated on or before the 60th day after the transaction.

v. Invalid or Missing Exemption Certificates

A copy of the sales tax worksheet or schedule identifying all invalid or missing exemption certificates should be presented to the taxpayer along with a Request for Financial Records specifically requesting that the taxpayer solicit exemption statements from those customers whom the taxpayer believes to be exempt.

vi. Exemption Statements

Exemption statements must be on the customer's letterhead, reference the invoice in question by date and invoice number, state what was purchased, the reason it is exempt (how it is used) and include a signature, title and date. Exemption certificates cannot be considered as accepted in good faith in lieu of exemption statements unless the date of the certificate is within 60 days of the actual sale.

The taxpayer should be given 30 days to obtain statements.

vii. Missing Invoices or Source Documents

If the source document for the sale is not available for examination and an alternative means of determining if the item was subject to tax and/or tax was charged is not available, the auditor should list the transaction on the sales tax worksheet and indicate “invoice missing” in the Comments column. These items are presumed to be taxable until the taxpayer provides documentation to support that the item is not subject to tax or that the item was properly taxed at the time of the sale.

The taxpayer should be given a copy of the worksheet along with a Request for Financial Records, requesting that the taxpayer supply documentation supporting any items they believe should be removed from the worksheet prior to assessment. The form should reference the worksheet and include a date by which the documentation is needed (usually 30 days). The taxpayer should be asked to provide an explanation as to why the items are not available for examination. A copy of the schedule given to the taxpayer should be included in the audit report as an attachment to the Request for Financial Records or as a separate schedule that is referenced on the request for records.

viii. Tax Self-assessed by Customers

The Department’s position on removing items found to be deficient based on documentation furnished by the customer to the taxpayer regarding transactions identified as deficient in the current audit is as follows:

- When the customer responds on the exemption statements that use tax was paid (by the purchaser), the purchaser must furnish their applicable use tax accrual record (or excerpt) or use tax accrual worksheet and the period when it was reported in order to be acceptable. The auditor should corroborate the third party information submitted by verifying that the customer is registered and did remit use tax adequate to cover the nontaxed items. This policy will apply whether a complete or test audit is performed.
- When the customer responds on the exemption statement that they (the purchaser) were audited for a period that contains the transaction listed as deficient, it is necessary to confirm that an audit in fact was performed on the customer. The customer must supply their account number and the period for which they were audited. If the customer was audited for the period, the item shall not be assessed in the current audit and the item shall be deleted from the listing of deficient items. It is not necessary to verify that the specific item was assessed in the audit of the customer, only that the customer was audited for the period that contained the item listed. It is not required to confirm that the assessment against the purchaser has been paid. This policy will apply whether a complete or a test audit is performed on the seller.

Note: This differs from the policy regarding elimination of transactions when a use tax audit is performed.

ix. Incremental Sales Tax (Bracket System)

Sales tax charged is based on the state bracket system. The auditor must ensure compliance with 61 Pa. Code § 31.2.

Items found to be deficient should be listed on the Invoice Detail, Sales Tax Worksheets.

2. Hotel Occupancy Tax

Concepts applied in sales and use tax auditing generally apply to hotel occupancy tax audits. A thorough working knowledge of the hotel occupancy tax and the rules and regulations promulgated, coupled with a complete understanding of the sales tax audit principles and techniques will enable the auditor to effectively perform hotel occupancy tax audits. Any occupancy tax deficiency found must be separately identified in the audit report.

a. Types of Hotel Occupancy Tax Audits

i. General

The following types of audits, which are employed in sales tax auditing, are adaptable to and generally utilized in hotel occupancy tax auditing:

- Complete Audit
- Modified Complete
- Test Audit
- Combination Audit

The procedures, techniques and forms employed in sales tax audits are utilized for state and local hotel occupancy tax audits except that occupancies are examined instead of sales.

The individual occupancy listings, which serve as the basis for the audit findings, are recorded on worksheets designed by the auditor, showing for each:

- Inclusive dates of occupancy
- Invoice or bill number
- Name of the occupant
- Total rental value of the occupancy
- Taxable rental value of the occupancy
- Tax incurred on the taxable rental value
- Tax charged on the occupancy
- Reason the auditor considers rental value as taxable where taxpayer has considered such rental value as nontaxable

On audits conducted on hotels or motels, distinct audit findings related to occupancy must be explained and documented. The deficiency related to occupancy must be specifically identified in the audit report.

For the purposes of assessment, the deficiencies related to sales and occupancy must be combined and assessed as sales tax even though they are calculated separately within the audit report.

ii. Test Audits

When conducting a test audit on room revenues (occupancies), the population for choosing test periods for hotel occupancy will be different than the population used to determine the sales tax test period. This is necessary because sales tax and hotel occupancy tax operate under different exemption rules. Separate error rates should be calculated for each area of tax. Separate projections should be done for each area of tax. Two separate test forms are required. Sometimes taxpayers have monthly reports of tax exempt rooms or separate folders for banquet/catering charges.

Note – Direct payment permits may **not** be used for the purchase of hotel occupancy.

3. Use Tax

The auditor is to verify that the taxpayer self-assessed use tax on purchases of taxable tangible personal property and services that were not properly taxed by the vendor. In addition, the auditor must verify eligibility for the KOZ/KOEZ exemption where such exemption has been used to make nontaxed purchases.

The use tax examination involves three distinct parts: Use Tax Accrual Verification, Capital Purchases Examination, and Expense Purchases Examination. Each of these parts must be clearly explained and documented in the audit report. The auditor must approximate the number of expense transactions per month and identify how the approximation was determined.

a. Use Tax Accrual

i. General

The auditor must establish the audit trail as it pertains to the accrual of state and local use tax and document the trail in the audit narrative. The auditor must explain how the taxpayer identifies purchases not properly taxed by the vendor, how the tax is calculated, how the use tax is accrued, and how the taxpayer codes the invoice to show that use tax was accrued.

A complete reconciliation of the state and local use tax per books to use tax reported is required to be conducted for the audit period. The results of the reconciliation by jurisdiction must be included in the audit report on Reconciliation of Accrual Amounts (Book to Reported). When use tax is accrued from more than one source and errors are found in posting to the accrual account, a supplemental schedule detailing the amount from the various sources of use tax for each reporting period should be included in the audit report.

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The auditor should verify the proper recording of use tax by tracing use tax listed on a sampling of source documents to the use tax accrual account. Exceptions should be scheduled and included in the audit findings. If errors are found, the auditor should increase the sample to determine if the noted exceptions were isolated or recurring. If the exceptions are found to be recurring, the auditor should not rely on the use tax coding on the source documents and treat use tax reported as an offset to the overall liability established by the auditor in the capital and expense examination of the audit report.

The auditor should specifically determine the following and make note of any exceptions. Audit procedures should be adjusted appropriately to accommodate the findings:

- Material fluctuations in the amount of use tax reported throughout the audit period.
- Ability to trace coded purchases to the use tax accrual account.
- Ability to trace adjustments from the use tax accrual account to the supporting documentation.
- Ability to segregate use tax reported on capital purchases from use tax reported on general expenses.

If the taxpayer reports an arbitrary use tax amount or if the records necessary to verify that the use tax accrued agrees with the use tax reported are not made available, the use tax reported should be treated as an offset to the overall use tax liability established by the auditor in the examination of capital purchases and expenses. When documenting arbitrary amounts on the Reconciliation of Accrual Amounts (Book to Reported) schedule, the amount paid should be listed as the amount reported and the book amount will be listed as zero. The audit narrative must describe this as an offset.

The auditor must also verify supporting documentation transactions where the taxpayer added sales tax to a purchase invoice and remitted the tax to their vendor. Documentation for in-state vendors consists of proof of remittance. Out-of-state vendors must provide a written statement on their letterhead that gives their license number and states that they are registered to collect tax in Pennsylvania.

b. Capital Purchases

i. General

A complete examination of capital purchases is generally required.

A listing of capital purchases acquired during the audit period should be included in the audit report as an exhibit and referenced in the narrative (i.e. a current depreciation schedule). This listing must be verified by tracing entries from the general ledger to the federal tax return or other independent source. The auditor should trace all capital purchases from the capital purchase listing to the purchase invoices.

When necessary, the taxability of a capital item should be determined by a physical inspection of the item while in use as well as an examination of supporting documentation. Supporting documentation includes purchase orders and capital expense requisitions.

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Note: When auditing a manufacturing entity, visual inspection of equipment during the plant tour is an integral part of this phase of the audit. Failure by the taxpayer to provide a plant tour in this scenario represents a scope limitation because the auditor cannot visually inspect how a piece of equipment is actually used in the manufacturing process.

Items not properly taxed by the vendor should be traced to the use tax accrual account. Deficient items should be listed on the Invoice Detail, Use Tax, Capital worksheets. The taxpayer should be presented with the invoice detail and be given an opportunity to review the entries and provide supporting documentation and explanations for those items that the taxpayer believes are not taxable or on which tax was paid.

The auditor should examine purchase invoices and the local use tax accrual records to determine if local sales or use tax was paid on all taxable items shipped to a taxpayer's location within a county that imposes local sales and use tax. Exceptions should be assessed.

The auditor should examine purchase invoices to determine if local sales tax was charged on all taxable purchases from vendors located in counties that impose a local sales tax. The auditor should examine the taxpayer's local use tax accrual records to determine if local use tax was accrued and remitted on all purchases with use tax exposure when not properly taxed by the vendor. Exceptions should be assessed.

When the taxpayer uses an assessed item in both a taxable and nontaxable capacity, the auditor must determine predominance of use. The narrative should include an explanation of how predominance was determined. Supplemental documentation should be included in the audit report when available.

If the taxpayer claims that a listed item was assessed in an audit of the seller, it is the taxpayer's responsibility to obtain the sales tax license number, employer identification number and audit period from the seller. The auditor will then corroborate the information provided by examining internal records.

If the seller was audited, the item found to be deficient in the current audit would be deleted only if the identical item was assessed sales tax in the audit and the seller paid the tax.

If the seller was audited on a test basis for the population that contained the deficient item, the deficient item will be deleted from the current audit only if the particular item found to be deficient was assessed in the test period and the sales tax was paid by the seller.

Note: This differs from the sales tax audit policy.

Where the taxpayer added sales tax to a purchase invoice and tax was paid to the vendor, a statement must be obtained from the vendor on their letterhead indicating they are registered (giving account #) with the Department of Revenue and that they recorded and remitted to the Department all the sales tax added to the invoice amount by the customer. Out-of-state vendors must provide a written statement on their letterhead which gives their license number and states that they are registered to collect tax in Pennsylvania.

ii. Testing of Capital

When computerized records can be obtained for capital, a review should be made to determine if an efficient complete or modified complete examination of capital can be performed. A test of capital purchases may be made in very limited circumstances.

Criteria for performing a test of capitalized purchases:

- A verifiable computerized listing of capital purchases must be available for the entire audit period.
- A stratified random sample methodology must be used.
- 80% or more of the total dollars must be reviewed on a complete basis.
- The top dollar strata cutoff must be less than \$17,000.

If the above criteria result in a stratified random sample that requires more than 4,000 individual records to be examined, specific individual proposals will be reviewed on an individual basis by the program manager.

iii. Missing Invoices

The auditor should present the taxpayer with a list of all invoices that could not be located by the auditor indicating the word “missing.” A Request for Financial Records specifically requesting that the taxpayer provide the missing records should also be given to the taxpayer. The Request for Financial Records should specifically reference the list presented to the taxpayer. The list should be included in the audit report as an attachment to the request and as a separate schedule.

c. Expense Purchases

i. General

In examining expenses, there are four fundamental types of audit examinations that may be employed:

- Complete Audit
- Modified Complete
- Test Audit
- Combination Audit

In each of these types of audits, the auditor must determine the taxability of each expense purchase in the population examined. Each transaction occurring within the population is examined to determine whether the proper amount of tax (tax incurred) has been charged by and remitted to the vendor or that use tax was accrued and reported on taxable transactions. The auditor must approximate the number of expense transactions per month and identify how the approximation was determined.

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When a test audit is performed, the auditor should review the taxpayer's chart of accounts and general ledger to identify accounts that have a large dollar amount and include a small number of transactions. Accounts with large dollar amounts and a relatively small number of transactions should be removed from the test population prior to the selection of the test period(s) and examined on a complete basis. Examples of such accounts include utilities, lease payments, and telephone accounts.

The auditor should verify that all source documents were made available for examination by tracing a sampling of entries in the books of original entry (i.e. disbursements journal or accounts payable journal) to the source documents. The auditor should also trace a sample of source documents to the books of original entry to verify the items were properly recorded. This sample should be traced to the disbursements to verify that sales tax was paid to the vendor when charged. Exceptions should be addressed in the audit report and assessed when deficiencies are discovered.

If the taxpayer claims that a listed item was assessed in an audit of the seller, it is the taxpayer's responsibility to obtain the sales tax license number, EIN, audit period and copies of worksheets showing that the item was assessed during the audit of the seller. The auditor will then corroborate the information provided by examining internal records.

If the seller was audited on a complete basis for the population that contained the deficient item, the item will be deleted from the current audit deficiency only if the identical item was assessed in the audit and the seller paid the sales tax.

If the seller was audited on a test basis for the population that contained the deficient item, the deficient item will be deleted from the current audit only if the particular item found to be deficient was assessed in the test period of the seller and the seller paid the sales tax.

All transactions in the population chosen for examination should be examined to determine if the vendor charged sales tax on all taxable purchases. Items not properly taxed should be traced to the use tax accrual account to determine if the item was self-assessed by the taxpayer. Items found to be deficient should be listed on the Invoice Detail, Use Tax Expenses.

The auditor should examine purchase invoices and the local use tax accrual records to determine if local sales or use tax was paid on all taxable items shipped to a taxpayer's location within a county that imposes local sales and use tax. Exceptions should be assessed.

The auditor should examine purchase invoices to determine if local sales tax was charged on all taxable purchases from vendors located in counties that impose a local sales tax. The auditor should examine the taxpayer's local use tax accrual records to determine if local use tax was accrued and remitted on all purchases with use tax exposure when not properly taxed by the vendor. Exceptions should be assessed.

In making the determination of the taxability of the items examined, the auditor may, in addition to examining the purchase invoices, examine other supporting evidence such as purchase orders, account coding, contracts, and physical inspection of the items in use. When the auditor relies on supporting documentation to determine the taxability of an item, the documentation should be referenced in the audit narrative and on the use tax worksheet. A copy of the chart of accounts, purchase orders, contracts or other supporting documentation

should be included in the audit as exhibits when they are necessary to support the taxability of items found to be deficient.

ii. Construction Contracts

In cases where a taxpayer is engaged in the performance of a construction contract, the auditor is to conduct a complete examination of all job related costs. Job related costs must be discussed separately from other expenses in the audit narrative.

When computerized records can be obtained for materials used in construction contracts, a review should be made to determine if an efficient complete or modified complete examination of capital can be performed. A test of construction material purchases may be made in very limited circumstances.

Criteria for performing a test of materials used in construction contracts:

- A verifiable computerized listing of all construction material purchases must be available for the entire audit period.
- A stratified random sample methodology must be used.
- 80% or more of the total dollars must be reviewed on a complete basis.
- The top dollar strata cut off must be less than \$17,000.

If the above criteria results in a stratified random sample that requires more than 4,000 individual records to be examined, specific proposals should be presented to the program manager for review.

iii. Missing Invoices

Missing invoices should be listed and the list should be presented to the taxpayer along with a Request for Financial Records, specifically requesting the missing invoices, and any necessary supporting documentation. Missing invoices should be listed on the “Invoice Detail, Use Tax Worksheets” as deficient.

iv. Procurement Cards / Purchase Cards / P-Cards

Procurement cards allow authorized employees to purchase goods and services using a company credit card without using the traditional purchasing process. Usually there is a limit on the maximum single purchase, the accounts or cost centers for which it may be used, or the types of items that may be purchased using the card.

Audit issues regarding the use of p-cards include:

- A purchase order is not used.
- The monthly lump sum payment made to the credit card company is for multiple purchases to multiple vendors and does not include transactional level detail necessary for audit purposes.
- Vendor source documents identifying an item description, purchase price and sales tax charged are often not maintained or readily accessible.

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- A single payment may be assigned to several accounts and cost centers.
- Organizations are replacing checks with purchasing cards and automating the payment to the supplier complicating proof of payment related to the individual purchases.

The auditor should review the taxpayer's purchasing methods and determine if separate audit procedures are necessary to properly and adequately determine sales and use tax compliance prior to selecting the general expense population to be tested.

The audit narrative must specifically address:

- The taxpayer's use of procurement cards.
- The audit procedures used in the examination of procurement cards.

d. Third Party Credits Granted in the Audit

Credit for taxes paid erroneously to vendors must be granted in the sales and use tax audit if it can be established through clear and convincing documentary evidence that the taxpayer has paid the tax in error and the taxpayer has not received credit for the overpayments through any other means.

Whenever third party credit is given for sales tax paid erroneously on a construction contract, the auditor should refer the schedule of related credits to headquarters with examples of transactions in question. Headquarters will review the vendors for possible audit or ask Office of Chief Counsel to write the contractor advising them to stop collecting sales tax and pay use tax on materials consumed in performing the construction contract.

4. Public Transportation Assistance Taxes and Fees (PTA)

The auditor must be familiar with 61 Pa. Code §47.19, Public Transportation Assistance Taxes and Fees. The auditor should be familiar with the exemptions and exclusions available for PTA taxes and fees and how they differ from the exemptions and exclusions available for sales and use tax.

a. Minimum requirements

The following must be conducted with all sales and use tax audits:

- PTA Book vs. Reported – The auditor must determine if the taxpayer is registered for PTA tax. If the taxpayer was registered for PTA during any period within the sales and use tax audit period, the auditor must obtain reported PTA figures for all quarters within the statute of limitations. The auditor must verify that all accrued PTA taxes and fees (tire fee, rental fee and lease taxes) are included in the quarterly reported amounts. This verification should include accruals due to sales to customers and accruals due to taxes and fees not paid to the vendors. The sales and use tax audit report must include a schedule to document that these procedures were performed. If a deficiency results from this verification, a separate PTA audit must be conducted. If an overpayment is discovered, the taxpayer should be advised of the overpayment.

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- When a taxpayer's business activities include selling tires, leasing vehicles, or renting vehicles, the population examined for sales tax purposes should also be examined to determine if applicable PTA taxes and fees are being properly charged to customers consistent with 61 Pa. Code §47.19. In addition, any sales transactions involving the sale of new vehicles should be examined to determine the tire fee for each new tire was properly charged and accrued. If the taxpayer is found to not be charging taxes or fees when applicable, a separate PTA audit must be conducted.
- During the use tax portion of the audit, the population examined for expenses should also be examined to determine if the proper taxes and fees were charged by the vendor on the purchase of tires, leases of vehicles and rental of vehicles consistent with 61 Pa. Code §47.19. If the taxpayer is registered for PTA, a sample of items not properly charged tax or a fee by the vendor should be traced to the PTA accrual account to determine if PTA tax was properly self-assessed. If deficiencies are found, a PTA audit is required.
- If deficiencies are found and the taxpayer is not registered for PTA, the auditor is required to obtain a license from headquarters. PTA license numbers are obtained by submitting a completed PA-100 to headquarters. The auditor should indicate whether the license should be assigned as an in/out license number or a permanent license number.

b. Obtaining Reported PTA Information

PTA taxes and fees are reported on a quarterly basis. Reported amounts for each complete quarter within the statute of limitations should be obtained and compared to the taxpayer's recorded amounts.

Reported PTA information is obtained through the mainframe PTA system.

c. PTA Audit Assignments

The overall audit procedures and documentation requirements regarding the conduct of a PTA audit are the same as those required for a sales and use tax audit assignment. Exceptions and procedures specific to PTA audit assignments are explained below.

PTA audits will be designated an assignment number beginning with a MT (Mass Transit) prefix. PTA audit assignments should be conducted concurrently with the sales and use tax audit assignment. The information necessary for an assessment of PTA taxes and fees should be captured using the sales and use tax audit application.

The sales and use tax audit diskette should then be copied at the conclusion of the sales and use tax audit. The information on the Audit Report and Basis of Assessment should be changed to reflect the MT assignment number and PTA account number. This disk should then be used to generate the PTA audit report.

The same populations examined for sales and expenses in the sales and use tax audit should generally be used for the examination of PTA taxes and fees.

PTA audits are manually assessed in headquarters.

i. Book vs. Reported Amounts

The audit trail for taxes and fees should be documented in the audit report. The auditor should verify that all PTA taxes and fees accrued were properly reported on the PTA returns for each reporting period in the audit period. The auditor should prepare MT Audit Schedule 1 – Returns as Filed. This schedule shall segregate the book and reported amounts by lease tax, rental fee, or tire fee. When there is more than one source for a particular tax or fee (lease, rental, or tire fee), the auditor should prepare a schedule listing the individual sources to verify that all sources were included in the amounts reported.

The reporting period for PTA taxes is always quarterly.

When errors are found, the auditor should prepare a Schedule of Accrual Differences. This schedule is found on the Audit Application program. This schedule will state the book to reported differences by reporting period for the audit period.

A sample of PTA taxes and fees that were charged on sales invoices should be traced to the books of original entry to verify that taxes and fees were properly recorded in the PTA accrual accounts. The sample should also be examined to verify that tire fees, rental fees and vehicle lease taxes were charged at the appropriate rate.

ii. Sales Subject to Taxes and Fees

Each transaction examined during the sales tax phase of the collateral sales tax audit should be examined to verify that the proper taxes and fees were charged. When the proper tax or fee was not charged to the customer, exemption certificates should be examined to determine if a proper exemption certificate is on file. Deficient transactions should be listed in the audit application indicating the type of taxes and fees applicable.

iii. Lease Tax

Lease tax examinations are generally conducted on a complete or modified complete basis. Test audit procedures may be used when the auditor can document that conducting a complete audit is unduly burdensome due to the number of transactions and that conducting a modified complete audit is impractical due to the substantial changes in the leasing customers over the audit period.

iv. Rental Fee

Rental Fee examinations should generally be conducted on a complete or modified complete basis.

Test audit procedures may be used in limited circumstances. Because the rental fee is based on daily rentals, to properly conduct a test audit procedure, the auditor must know the total number of rental days.

The rental days on which the rental fee was not charged should be divided by total rental days. The factor should then be multiplied by the total rental days in each reporting period to determine the projected deficient rental days in each reporting period. The results should be multiplied by \$2 to compute the rental fee deficiency by reporting period.

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If the taxpayer does not make the records available to perform a complete, modified complete, or test audit procedure as explained above, the auditor should document that the necessary records were not made available by specifically requesting the necessary records on a Request for Financial Records. The auditor may then use available records to compute a ratio of rental tax to sales (or deficient rental days to sales) and apply the ratio to sales in the remainder of the audit period to compute the projected deficient rental fee for each reporting period in the audit period.

v. Tire Fee

Tire fee examinations should generally be conducted on a complete or modified complete basis.

Test audit procedures may be used in limited circumstances. The tire fee is based on the number of new tires sold for over the road use. To properly conduct a test audit procedure, the auditor must know the total number of tires sold in each reporting period.

The total number of tires found to be deficient in the test period should be divided by the total number of new tires sold during the test period. The total number of new tires sold in each of the nontested reporting periods should then be multiplied by this ratio. The results should be multiplied by \$1 to compute the tire fee deficiency by reporting period.

Another reasonable projectable basis may be used for the computation of the tire fee (such as the number of new cars sold multiplied by 5) when the exact number of tires sold cannot be determined. Sales dollars should not be used to project the tire fee unless the number of tires sold cannot be determined.

If the taxpayer does not make the records available to perform a complete, modified complete, or test audit procedure as explained above, the auditor should document that the necessary records were not made available by specifically requesting the necessary records on a Request for Financial Records. The auditor may then use available records (usually the same period as the sales tax test examination) to compute a ratio of deficient tire tax to sales (or deficient number of tires to sales). The computed ratio is then applied to sales for the remainder of the audit period to compute the projected deficient tire fee for each reporting period in the audit period.

For the convenience of the taxpayer, this procedure may be used when the taxpayer provides a signed, written request.

vi. Taxes and Fees Not Properly Charged By the Vendor

The expense population examined during the sales and use tax audit should also be examined to verify that the vendor properly charged all applicable PTA taxes and fees. Exceptions should be traced to the taxpayer's PTA accrual account to determine if tax or fees were self-assessed. Items found to be deficient should be listed on the audit application indicating the proper taxes and fees applicable.

vii. Type of Examination

Examination of purchases for the proper payment of applicable taxes and fees should be conducted on a complete or a modified complete basis.

When a complete examination was made of expenses during the concurrent sales and use tax audit, a complete audit should be conducted on the same population for PTA taxes and fees.

When a test audit is performed on expenses during the concurrent sales and use tax audit, a modified complete audit should be conducted on PTA taxes and fees. Generally, very few vendors will be found to be not properly charging PTA taxes and fees when applicable. The taxpayer should be given a Request for Financial Records specifically requesting a vendor history and purchase invoices for those vendors found to be deficient during the test period.

5. Vehicle Rental Tax (VRT)

The auditor should be familiar with 61 Pa. Code §47.20, Vehicle Rental Tax. The auditor should be familiar with the exemptions and exclusions available for VRT and how they differ from the exemptions and exclusions available for sales and use tax.

a. Minimum requirements

When the taxpayer's business activities include the rental of vehicles in the Commonwealth, the following minimum requirements must be completed and documented in the sales and use tax audit report:

- The auditor should determine if the taxpayer is registered for VRT. VRT registration is verified by contacting Headquarters personnel. If the taxpayer is registered, the reported amounts should be compared to the book amounts for all periods within the statute of limitations.
- A VRT reported versus accrual schedule must be included in the audit report.
- If the taxpayer is not registered, the auditor should verify that the taxpayer did not charge VRT on source documents while examining those documents during the sales tax phase of the audit.
- If the auditor determines that the vehicle rental tax has not been reported or was underreported, a VRT audit should be requested and conducted.
- When the taxpayer is found to be renting five (5) or more vehicles, the auditor should verify that vehicle rental tax has been properly charged at a rate of 2% on all rental contacts of 29 days or less. The verification that the rental tax was properly charged should be conducted on source documents concurrently with the sales tax examination. When the taxpayer has been found not to be properly charging VRT on vehicle rentals, a VRT audit should be requested and conducted.

Note: Direct Pay Permit holders may not use the permit to claim exemption from vehicle rental tax based on 61 Pa. Code §47.20(b) (5).

The population examined for expenses should also be examined to determine if the vehicle rental tax was properly charged on the rental of vehicles consistent with 61 Pa. Code §47.20. When the taxpayer is registered for VRT, a sample of vehicle rentals not properly taxed by the vendor should be traced to the VRT accrual account to determine if VRT tax was properly self-assessed. If deficiencies are found, a VRT audit is required.

b. Obtaining Reported VRT Amounts

The Bureau of Audits does not have direct access to reported VRT amounts. These figures must be obtained from the Bureau of Trust Fund Taxes. The audit supervisor should send an email request for reported VRT amounts from headquarters through the Sales and Use Tax Division web page. They may be specifically made through the Information Request links for Audit Research Questions and Account Referral. The email request should include: taxpayer name, employer identification number, sales and use tax account number, and the period for which the records are required.

The VRT license number is identical to the sales and use tax license number. However, the VRT information is maintained separately from the sales and use tax information. VRT returns are filed on a quarterly basis.

c. VRT Audit Assignments

The overall audit procedures and documentation requirements regarding the conduct of a VRT audit are the same as those required for a sales and use tax audit assignment. Exceptions and procedures specific to VRT audit assignments are explained below.

VRT audits will be designated an assignment number beginning with a VT (Vehicle Tax) prefix. VRT audit assignments should be conducted concurrently with the sales and use tax audit assignment. The auditor may use a disc formatted for sales and use tax for the purposes of compiling the VRT audit report. However, the auditor must customize schedules and worksheets to capture the various items assessed. Currently, there are no predefined forms, schedules or worksheets on the Audit Application for Vehicle Rental tax.

i. Book vs. Reported Amounts

The audit trail for vehicle rental tax must be explained in the audit report.

The auditor must verify that all VRT accrued was properly reported on the VRT returns for each reporting period in the audit period. The auditor must prepare a schedule by reporting period that includes tax per books, tax reported and the difference. When there is more than one source for vehicle rental tax, the auditor should prepare a schedule that lists the amounts accrued from each source by reporting period for the audit period to verify that all sources were included in the amounts reported.

A sample of VRT taxes that were charged on source documents should be traced to the books of original entry to verify that taxes and fees were properly recorded in the VRT accrual accounts. A schedule should be prepared to document posting errors.

When errors are found, the auditor should increase the sample to determine if the posting errors were isolated or recurring. If the errors are found to be recurring, the auditor must examine all source documents that include vehicle rental tax and prepare a schedule listing all tax charged and not properly recorded.

A sample of VRT invoices should be examined to verify that tax was charged at the appropriate rate.

ii. Vehicle Rental Tax – Sales Transactions

The examination of the proper charging of VRT on sales transactions may be conducted on a complete, modified complete, or a test basis. Test audit procedures may be used on the sales transactions when the auditor can document that conducting a complete audit is unduly burdensome or the records necessary to conduct a complete or modified audit were not made available. The test period(s) examined should be selected based on average total vehicle rental sales. The auditor should specifically document that total vehicle rental sales for each reporting period in the audit period were requested by presenting the taxpayer with a Request for Financial Records. Vehicle rental sales should be used to compute the projectable average ratio and the projection of the deficient sales in the nontested reporting periods.

Other sales populations that include total vehicle rental sales may be used for the selection of the test period (and projection of test period findings to the remainder of the audit period) when the taxpayer does not make the total vehicle rental sales available.

Upon a signed written request from the taxpayer, the test period(s) chosen for VRT may be consistent with the test periods for sales tax.

iii. Sales Subject to Taxes VRT

The proper population to examine when verifying that vehicle rental tax was properly charged is total vehicle rental sales. The auditor should attempt to obtain the total vehicle rental sales by reporting period for the audit period.

A sample of VRT source documents should be examined to verify that tax was charged at the appropriate rate.

The source documents should be examined to determine that VRT was charged when applicable. Exemption certificates should be examined to determine if the taxpayer has proper support for all nontaxed sales in Pennsylvania.

NOTE: Direct Payment Permits are not a valid exemption for Vehicle Rental Tax.

Deficient transactions should be listed on a VRT worksheet prepared by the auditor. The worksheet should generally include:

- Inclusive dates of rental
- Invoice date
- Invoice or bill number
- Name of the customer/renter
- Description of the vehicle rented
- Total rental amount
- Total taxable rental amount
- Tax incurred on the taxable rental
- Tax charged on the invoice or bill
- Deficiency

- Reason auditor disallowed the exemption certificate, if applicable.

Not every field listed above will be required in every VRT audit. The worksheet may be modified for the circumstances of the audit and may contain additional descriptive fields as necessary to fully document the rentals found to be deficient.

The auditor should give the taxpayer an opportunity to obtain an exemption statement or other documentation to support the exemption or proper payment of tax on any item listed on the worksheet.

iv. Expenses Subject to Vehicle Rental Tax

The examination of the proper charging of VRT on expense transactions may be conducted on a complete or modified complete basis. Generally, a modified complete examination should be conducted. Vendors identified not to be properly charging vehicle rental tax during the examination of expenses in the use tax phase of the concurrent sales and use tax audit should be listed. The list, along with a Request for Financial Records requesting a vendor history and the expense invoices for those vendors for the audit period, should be presented to the taxpayer.

A test audit should not be conducted when examining expense transactions for proper VRT unless the information regarding vendors found to be deficient during a sample period is not made available for the remainder of the audit period.

The invoices should be examined and those found to be deficient should be listed on a “VRT Expense” audit worksheet.

The auditor should prepare a worksheet listing vehicle rentals not properly taxed by the vendor. The worksheet may include:

- Inclusive dates of rental
- Invoice date
- Invoice or bill number
- Name of the vendor
- Description of the vehicle rented and how it was used
- Total rental amount
- Taxable rental amount
- Tax incurred on the taxable rental
- Tax charged on the invoice or bill
- Deficiency

Not every field listed above will be required in every VRT audit. The VRT expense audit worksheet may be modified for the circumstances of the audit and may contain additional descriptive fields as necessary to fully document the rentals found to be deficient.

6. Employer Withholding Of Pennsylvania Personal Income Tax

This section includes only minimum Employer Withholding requirements to be conducted in all audits.

The statute of limitations for employer withholding of PA personal income tax (EW) is three years from the date the return is filed. Therefore, the EW examination should be conducted as soon as practical during the sales and use tax audit since EW has a rolling statute. In situations where the auditor anticipates that the sales and use tax audit will take several months to complete, the auditor should attempt to complete the EW portion of the audit within 60 days of the preaudit conference to avoid losing periods due to the statute of limitations.

a. Minimum Requirements

There are three minimum employer withholding requirements that must be conducted and documented in every sales and use tax audit report. In addition, when audits are performed on partnerships or S corporations, the auditor is required to verify that tax was paid by or on behalf of nonresident principals. Tax issues relating to resident principals may be addressed through the issuance of a PT audit. Names and social security numbers of principals must not be disclosed in a sales and use tax audit.

Reference to these requirements should be included in the General Discussion section of the audit narrative.

i. W-2 to W-3 Reported Amounts

Verify that the sum of the W-3 tax reported each year agrees with the W-2 amount reported for each year of the audit period.

The auditor is required to prepare a schedule that compares the total yearly tax reported on the quarterly W-3's to the amount of tax reported on the W-2 transmittal for the corresponding year. This schedule is required to be included in the sales and use tax audit and must be referenced in the audit narrative.

If exceptions are found, the taxpayer should be given a Request for Financial Records and a copy of the schedule. The taxpayer should be asked to submit documentation and explain the exceptions noted on the schedule.

After the auditor reviews the documentation submitted by the taxpayer, the following actions should occur:

- If the exception was the result of the over reporting of tax withheld as reported on a W-3(s) and the auditor verified this by examination of the actual amount of tax withheld, an amended W-3R should be included with the audit report when it is sent to headquarters. The original W-3-R should be attached to the Additional Headquarters Processing Request, along with instructions to process the form. The narrative should state that these forms were sent to headquarters for processing.
- If the exception results from incorrect information submitted on the W-2 transmittal and the auditor verified this by recomputation of the total PA tax included on the W-2s, an amended W-2 transmittal along with a copy of the W-2's should be included with the audit report when the audit is sent to headquarters. The original should be attached to the

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Additional Headquarters Processing Request along with instructions to process the form and attachments. The narrative should state the W-2 and Transmittal were sent to headquarters for processing.

- If the exceptions result from underreported tax withheld on the W-3's, a deficiency has been identified. A separate employer withholding audit assignment is required.

Note: Taxes withheld are trust fund monies. The statute of limitations does not apply to trust fund monies withheld and not reported.

ii. Verify Withheld vs. Reported Amounts

Verify that the tax withheld per the taxpayer's records agrees with the tax reported for each reporting period of the audit period.

The auditor is required to prepare a schedule which compares the total yearly tax reported on the quarterly W-3's to the amount of tax withheld per the taxpayer's records. This schedule is required to be included in the sales and use tax audit and must be referenced in the audit narrative.

If the taxpayer has over reported tax, the auditor should request that the taxpayer provide amended W-3's signed by the taxpayer. If the taxpayer will not provide signed amended W-3's, the taxpayer should be informed of the overpayment of tax and instructed to apply for a refund or credit.

If the taxpayer has under reported tax, a deficiency has been identified. A separate employer withholding audit assignment is required.

iii. Verify Proper Computation of Tax Withheld

Verify that all taxable payroll was included in the computation of tax withheld and that tax was withheld at the proper rate for a minimum of one reporting period.

The W-3 – Employer Quarterly Reconciliation Return of Income Tax Withheld is considered the return for reporting purposes of withholding of PA personal income tax. Therefore, a reporting period will be one quarter. The auditor may examine one quarter or any period of time greater than one quarter to fulfill this requirement.

The auditor is required to verify that all taxable compensation was included in the computation of the tax withheld. If additional taxable wages were not included on the individual W-2's submitted to the employees, a separate employer withholding audit must be conducted.

If the wages used to compute taxes withheld were incorrect, but the proper Pennsylvania wages were included in Block 16 (beginning 2001) or Block 17 (prior to 2001) of the W-2's submitted to employees:

- First Time Audit – The taxpayer should be informed of the error and the requirement to withhold tax at the statutory rate. The taxpayer should be informed that upon subsequent

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audit, the taxpayer will be held liable for additional tax not properly withheld on Pennsylvania wages. The audit report should document the error and the fact that the taxpayer was informed of the error in the auditor report. A request for a Director's Letter should be indicated on the

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Additional Headquarters Processing Request, along with an explanation for the request.

- Subsequent Audit – The auditor should verify that the taxpayer was previously informed of the statutory requirement to withhold tax at the proper rate. The auditor should request a separate employer withholding audit to assess the additional tax due.

The auditor is required to verify that the proper tax rate was used to compute tax withheld. The verified Pennsylvania taxable wages should be multiplied by the proper rate and the result should be compared to the tax withheld.

If the tax rate was found to be in error, but the proper Pennsylvania taxable wages were included on the employee's individual W-2 for the year:

- First Time Audit – The taxpayer should be informed of the error and the requirement to withhold tax at the statutory rate. The taxpayer should be informed that upon subsequent audit, the taxpayer will be held liable for additional tax not properly withheld on Pennsylvania wages. The audit report should document the error and the fact that the taxpayer was informed of the error in the auditor's report. A request for a Director's Letter should be indicated on the Additional Headquarters Processing Request, along with an explanation for the request.
- Subsequent Audit – The auditor should verify that the taxpayer was previously informed of the statutory requirement to withhold tax at the proper rate. The auditor should request a separate employer withholding audit to assess the additional tax due.

The period(s) examined and the procedures employed to verify the proper wages and tax rate must be referenced in the audit narrative.

7. Pennsylvania Personal Income Tax

a. General

NOTE: In no case should personal income tax returns be requested from, or the fact that an individual failed to file be disclosed to, the business entity unless the individual the auditor is working with is the sole proprietor or 100% shareholder of a PA S corporation.

A limited examination of Pennsylvania personal income tax is required when conducting a sales, use and hotel occupancy audit of a sole proprietorship, partnership, S corporation or Limited Liability Company electing pass thru status.

i. Statute of Limitations

The statute of limitations for Pennsylvania Personal Income Tax (PT) is three years from the date the return is filed or the return due date, whichever is later.

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If total gross income is underreported by twenty five percent or more, the statute of limitations is six years from the date the return is filed. If a return has not been filed, there is no limitation imposed by statute.

The PT examination should be conducted as soon as practical during the sales and use tax audit due to the fact that PT has a rolling statute. In situations where the auditor anticipates that the sales and use tax audit will take several months to complete, the auditor should attempt to complete the PT portion of the audit within 60 days of the preaudit conference to avoid losing a year due to the statute of limitations.

ii. Assessment

When a personal income tax audit is conducted, the assessment will be against the owner, partner or shareholder (to include nonresident sole proprietors) that failed to file or underreported income tax on their individual return. When a nonresident officer or partner failed to file, the entity will be audited and assessed.

The audit of the entity must not disclose the fact that a PT audit is being conducted on the partners, members or shareholders as this represents a breach of confidentiality. Also, the personal liabilities of a principal or the fact that a principal failed to file should not be discussed in the sales and use tax audit or fuels tax audit report.

iii. Accessing Personal Income Tax Returns

Personal income tax returns (including partnership returns) filed with the Department can be accessed through the “View Imaged Returns” link on the Bureau’s web page under “Organizational View”. When accessing the scanned image, the auditor is presented with several search parameters ranging from social security number to document locator number (DLN) to tax year. After entering the search criteria, press the search key at the bottom of the menu. The results will then be provided in a list form. The auditor then selects the item for view and is presented with the imaged document.

Information submitted electronically will appear on the Annual System under the Department’s mainframe computer files.

b. Minimum Requirements

When an audit is conducted on a sole proprietor, partnership, LLC electing pass through status or an S corporation, the following must be conducted with all sales and use tax and fuel tax audits:

- A general review of the business income as reflected on the Schedule C or PA-20S/PA-65 should be made to determine that the business income reported is consistent with the books and records reviewed during the course of the sales and use tax audit of the entity. If the

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pass through income of the owner or principals is understated on a PA-40 as a result of an understatement of income on the entity return as determined by the verification of gross sales and review of expenses, the auditor should request a personal income tax audit on the owner or principals to adjust their reported income.

- The auditor must verify that each individual owner, partner, member or shareholder of the entity under audit filed Pennsylvania personal income tax returns for each year of the audit period. Do not verify limited partners.
- When dealing with pass through entities, the auditor must review all filed PA-20S/PA-65's. The auditor must also verify that the entity has prepared an RK-1 for each principal. The total of the pass through income by category as shown on the RK-1s should equal the total income by category on the entity returns in each year of the audit period.

For pass through income, include the following language in the audit narrative to convey that the PIT procedures have been conducted:

The entity's state return (PA-20S) as filed has been reviewed. The entity has prepared RK-1s for each principal. The total of the pass through income by category as shown on the RK-1s equals the total income by category on the entity returns in each year of the audit period.

- When the taxpayer has filed a PA-40, the auditor must verify that the income from business operations on the entity return for the entity under audit (or proportional share if a partnership, LLC or S Corporation) is properly included in the income reported on the PA-40.
- The auditor should briefly review the personal income tax returns of the individual principals to insure that income was properly included in the correct classification and that no unallowable offsets or omissions were made, such as loss carry forwards.

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- If K1s from non PA S-Corporations are included with the individuals return, verify that the income was included as dividend income and not included in the income from business activities. When a material loss from a non PA S-Corporation is included in PA income from business activities, a personal income tax audit should be conducted to adjust total taxable income.

NOTE: Beginning January 1, 2006, all federal S-Corporations are considered to be PA S-Corporations other than those who opted out under form REV-976, Election Not to be Taxed as a Pennsylvania “S” Corporation.

- While conducting the expense portion of the audit, the auditor should determine if any expenses were direct payments for the personal expenses of the owner (partners). Material personal expenses such as mortgage payments, property tax payments for addresses other than the business addresses, car payments other than vehicles used in the business and tuition payments should be recorded. The auditor should also verify that no payments were made to an owner or partner that were expensed to an account other than an equity withdrawal. If payment of the above referenced personal expenses results in a material adjustment of tax due over the three year audit period, or the auditor discovers payments made to owners expensed outside of an equity withdrawal, the auditor should adjust net income and request a personal income tax audit.
- The auditor should review unreimbursed employee expenses and request an explanation for material amounts that are not clearly related to the wages received by the individual claiming the expenses.
- When the taxpayer failed to file a PA-40, the auditor must determine if the taxpayer had income from business operations in the year not filed. If the taxpayer had income, the auditor should request a personal income tax audit (if determined to be material).

c. Required Audit Documentation

- The documentation of the procedures performed regarding the limited examination of PIT returns should be limited to the statement in the General Discussion section of the audit narrative at the entity level that the sales and expenses presented for review were compared to the sales and expenses reflected on the entity income tax return. This section of the narrative must also state that total business income was properly reported and distributed. No mention should be made regarding the PA-40 comparison to the business records.
- The narrative of the entity may disclose whether the entity made the proper estimated withholding payments for nonresidents and/or a PA-40NRC was filed on behalf of nonresident principals.
- PA-40's, schedules and attachments should NOT be included in the sales and use tax or fuels audit of a pass through entity; such an inclusion is a breach of confidentiality.
- When a PA-40 has not been filed by an individual owner, partner, member, or shareholder and a potential liability results, a Personal Income Tax Audit should be conducted.

- If a PA-40 has not been filed and the net adjustments result in an additional, relatively immaterial liability, forward the information documenting the amount and sources of income to Headquarters on an Additional Headquarters Processing Request form. This information will be combined with other known sources of income and forwarded to the Bureau of Individual Taxes for assessment.

d. Limited Liability Company (LLC) – Filing Guidelines

- An LLC that elects to file as a corporation with the Internal Revenue Service files as a regular corporation for PA. The LLC files for PA on a RCT-101 Corporate Tax Report.
- An LLC that elects to file as an S corporation with the Internal Revenue Service for Federal purposes may elect PA Subchapter S status for PA, and file using the PA-20S/PA-65.
- An LLC that elects to file as a partnership with the Internal Revenue Service files as a partnership for PA using the PA-20S/PA-65.
- An LLC that elects to file as a disregarded entity with the Internal Revenue Service files as a sole proprietor for PA on a PA-40, PA Personal Income Tax Return, if the single member is an individual as defined by PA PIT law.

F. CONCLUSION OF THE FIELD WORK AND SUMMARY OF AUDIT FINDINGS

At the conclusion of the audit fieldwork, the auditor must prepare schedules that summarize the audit findings. These schedules must be sufficient to enable tracing of individual items found to be deficient to the final schedule of deficiency by reporting period used for assessment purposes. These schedules must be included in the audit report.

The auditor should give the taxpayer copies of all pertinent schedules and worksheets necessary to understand the audit findings by reporting period prior to the post audit conference.

1. Summarize Audit Findings

The auditor must discuss all areas of significance in the audit narrative. Items discussed in the narrative should keep with facts and not express an opinion. Items of significance include:

- Special audit instructions on the Audit Request.
- Major areas of taxpayer disagreement.
- Employer withholding tax examination procedure and results. Include EW account number, period(s) examined and amounts.
- Advise the taxpayer of prospective audit application.
- Board decisions, settlements, legal opinions that are in conflict with current policy.

- Erroneously charged sales tax on the sale of nontaxable items.
- Exemption certificates which were allowed in the current audit but will be disallowed in the next audit.
- Public Transportation Assistance Tax examination procedures and results.
- Civil penalties statement (criminal referral audits).
- Vehicle Rental Tax examination.

2. Credits Granted In Audit Findings

a. Credit Schedule Requirements

A Credit Recap Schedule must be included in the audit report that specifically identifies the total credit represented in the audit findings. If credits were included in a projection, a computation of the projected credit included in the audit findings must be included on this schedule. The schedule must be referenced in the audit narrative and included in the audit report. The schedule is generated through the audit application.

A separate “Third Party Credit Detail” worksheet must be included in the audit report in situations where third party credits other than TPRR credits are given. Credit from this worksheet will roll up by reporting period and be included in the use tax worksheet total on the audit Recap Schedule.

Schedules listing requests for third party credits that were prepared by the taxpayer and verified by the auditor must be included in the audit report and clearly identify those items for which credit was granted by the auditor and those items for which the auditor denied the requested credit.

Third party credits granted in the audit findings must be by the date paid as identified by the date of the payment check or date of the voucher traceable to a corresponding disbursements entry. If proof of payment cannot be clearly established, credit should not be granted.

b. Supervisory Review

When the auditor is granting credits to the taxpayer of \$5,000 or more the supervisor must provide a written statement on the “Rev 119 –Conflict of Interest Statement and Auditor’s Comments Form,” indicating that the supervisor has reviewed and concurs with all credits granted in the audit report. The supervisor must sign the statement.

c. Verifying Prior Credits

Prior to granting credits in any audit, regardless of whether it results in a net credit, the RAPS system (for filings after January 2003) must be checked to determine if the taxpayer applied for a refund for any period covered by the current audit. File documents should be reviewed to ensure that the taxpayer is not being granted duplicate credits.

If the taxpayer did apply for a refund for any period covered by the current audit, review RAPS, and obtain the detailed schedules needed to determine the specific credit granted.

If the file documents are not available through RAPS, contact headquarters to obtain the file.

G. POST AUDIT CONFERENCE

A post audit conference must be conducted for every audit. Prior to the post audit conference, the auditor must provide the taxpayer with all worksheets and schedules necessary to understand the basis of the audit findings. The auditor should allow the taxpayer an opportunity to review the worksheets and schedules prior to the post audit conference. The auditor should be prepared to provide a detailed explanation of the basis for the audit findings. This includes providing the taxpayer with specific references to the law and regulations pertaining to the deficiency.

A post audit conference should be held in person. In circumstances where a face to face conference cannot be held, the auditor must document his/her attempt to set up an in person conference.

The taxpayer may tape record the post audit conference. At the taxpayer's request, the Department will provide a recorder and a tape.

1. Post Audit Conference Requirements

At each post audit conference, the auditor must:

- Record the date, the names of those participating in the conference, the location of the conference, and the length of the conference. This information must be included in the audit narrative.
- Review the audit findings with the taxpayer and answer any questions that might arise at this time. The auditor should explain how the various worksheets and schedules previously given to the taxpayer tie into each other from the original entry through the summary of deficiency.
- Inform the taxpayer that the audit findings are subject to review and possible correction by the Bureau.
- Determine areas of disagreement and reasons for such disagreement. The auditor should explain in the audit narrative the taxpayer's reasons for disagreement as they relate to the various audit findings. Corrective recommendations are to be given and noted on the post audit conference form.
- Present the taxpayer with a Taxpayer's Acknowledgement of Post Audit Conference form. This form will identify the audit period, areas of deficiency, and recommendations for correcting the areas of deficiency.

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- Advise the taxpayer that they will receive a Notice of Assessment including the amount of deficiency, interest, penalties, credits, and any payment (made before the assessment is issued) via U.S. mail. The taxpayer should be informed that interest and penalties are always billed and explained on the assessment notice.
- Inform the taxpayer of their appellate rights. As part of this, the auditor must specifically explain to the taxpayer that the statute of limitations for any transaction occurring within the audit period is six months from the date on the Notice of Audit Assessment. Inform the taxpayer that any credits that they seek for any transaction occurring during the audit period, that were not granted in the audit, must be included in a refund petition to the Board of Appeals within six months from the notice date (except for bad debts for which a petition for refund must be filed within three years of the payment of the tax written off). The Board of Appeals must receive a Petition within ninety (90) days (beginning 1/1/08) from the mailing date on the assessment notice. The auditor may also give the taxpayer a copy of Rev 23- Board of Appeals, Practices and Procedures of the Board, Department of Revenue. In addition, the auditor may advise the taxpayer that they can file their Petition through the Board's website at www.boardofappeals.state.pa.us.
- Advise the taxpayer that the appeal rights are explained on the Notice of Audit Assessment. The taxpayer's appeal rights extend to the Board of Finance and Revenue and Commonwealth Court.
- Request the taxpayer to complete the Post Audit Conference form and signify agreement, disagreement in part, or disagreement entirely with the audit findings. The taxpayer may elect to leave the form blank and merely sign. If the taxpayer declines to sign the form, the auditor is to note on the form and in the narrative the date, time and the fact that the taxpayer refused to sign the form. The auditor must inform the taxpayer that completion of the post audit conference form does not waive any rights to appeal.
- Inform the taxpayer that a complete Basis of Assessment will be sent with the Notice of Assessment (beginning January 1, 2008).

A copy of the Taxpayer's Acknowledgement of Post Audit Conference form should be given to the taxpayer. If a copier is not available, the auditor is to inform the taxpayer that a copy will be sent to them prior to the audit being submitted for processing.

2. Taxpayer Payments Received by the Auditor

Payments received by the auditor anytime during the audit (including the post audit conference) must be accepted and processed only as a convenience to the taxpayer. The auditor is not to solicit payment for tax liabilities during the conduct of an audit.

If time is not available to post the payment before processing the assessment, inform headquarters of the date the payment was received so that proper credit is applied after the assessment is issued.

When a taxpayer makes a payment, complete a Checks Received in the Field Memo. This memo and the check must be forwarded immediately by the auditor to the district Collections

and Taxpayer Services (CATS) Office. A copy of the check and the memo should be included in the audit report as an exhibit. The check and memo should be referenced in the audit narrative and the appropriate information should be recorded on the Audit Report and Basis of Assessment.

The payment received is to be applied to the one day period to be assessed (the last day of the audit period).

3. Adjustments to the Audit Findings

If corrections are made to the audit findings after the post audit conference, the taxpayer must be informed of the correction.

a. Reduction in the Audit Deficiency

If the correction results in a reduction in the audit deficiency, the taxpayer must be contacted by telephone and informed of the correction. If the correction was the result of specific items being deleted from the audit worksheets, the taxpayer should be sent a copy of the revised worksheets. The original Taxpayer's Acknowledgement of Post Audit Conference form will be corrected in ink and initialed by the individual making the correction. All other documents in the audit report must be adjusted as necessary to reflect the correction(s).

b. Increase in the Audit Deficiency

If the correction results in an increase in the audit deficiency (or reduction of allowable credit), the auditor must prepare a new Taxpayer's Acknowledgement of Post Audit Conference form. Both the original and the revised form must be included in the audit report and referenced in the narrative. The revised form, along with all worksheets and schedules, should be sent to the taxpayer. The auditor will conduct a second post audit conference (either in person or by telephone). All other audit report documents must be revised as necessary to reflect the corrections.

4. Post Audit Conference by Phone

A post audit conference by phone is allowable when conducting a post audit conference in person is not practical due to proximity or necessity. In addition to the preceding requirements for a post audit conference held in person, the following requirements must also be performed:

- Prior to a post audit conference by telephone, a copy of the Taxpayer's Acknowledgement of Post Audit Conference, along with all schedules and worksheets necessary to explain the audit findings, should be sent to the taxpayer.
- The date, time, and names of those participating should be recorded by the auditor and referenced in the audit narrative. The taxpayer should be asked if they received and reviewed the form, worksheets, and schedules. The taxpayer's response should be referenced in the audit narrative.
- After the post audit conference, the taxpayer must be sent a Post Audit Conference by Telephone Letter signed by the regional manager. This letter will state the names of those

who participated in the post audit conference by phone, the date of the conference, and the deficiency. Also, this letter must be included in the audit report as an exhibit.

- The original Taxpayer's Acknowledgement of Post Audit Conference form should be sent to the taxpayer along with a self-addressed stamped envelope. The taxpayer should be instructed to sign and return the form to the regional office.

5. Inability to Schedule a Post Audit Conference

A post audit conference by certified mail may only be conducted after a reasonable effort to conduct the conference in person or by telephone has been made. The auditor must document all efforts to contact the taxpayer (including phone calls, faxes, in person visits, emails, and mailed correspondence) to conduct the conference in person or by telephone and must include the documentation in the audit report. Such documentation will include a chronological listing of attempts made by the auditor, supervisor or regional manager to contact the taxpayer to set up the post audit conference.

Information provided to the taxpayer through voice mail does not constitute a post audit conference under any circumstances.

a. Inability to Schedule Post Audit Conference Letter

An "Inability to Schedule Post Audit Conference Letter," signed by the regional manager must be sent via certified mail to the taxpayer along with all pertinent worksheets and schedules necessary to explain the audit findings. A "Taxpayer's Acknowledgment of Post Audit Conference," should be completed and included with the letter. The auditor should retain a copy of this form and the letter and exhibit them in the audit report. The letter must:

- Explain that the subject audit has been completed.
- Formally notify the taxpayer of the time and date that the post audit conference will be conducted in the Revenue regional office.
- Inform the taxpayer that the deficiency, interest, penalties, and the taxpayer's right to appeal will be included on the assessment.
- Specifically identify the enclosed worksheets and schedules included with the letter.
- Reference the post audit conference form.
- Indicate that the letter will be considered the close of the audit in the event the taxpayer fails to attend the scheduled post audit conference.

The Taxpayer's Acknowledgement of Post Audit Conference form should be sent to the taxpayer. The date of the form should be the date of the scheduled conference. Schedules and work papers pertinent to support the deficiency shown on the post audit conference form must also be sent to the taxpayer.

H. Completion and Submission of the Audit Report

Upon completion of the post audit conference, the auditor should gather together all audit documents, including the completed audit narrative, and verify that all required worksheets, forms, and exhibits have been properly prepared for submission. This includes proof reading, checking citations, checking header information, required signatures and cross footing audit totals. The completed audit report should be in complete compliance with the requirements outlined in Chapter 6 – Audit Report.

The assessment must be made within 30 calendar days of the post audit conference. The assessment date is five days after the date of upload.

The audit report must be received in Headquarters on or before the date of the assessment upload by the region.

Chapter 4 – PROCEDURES (Examination Type)

Audit procedures described in this manual are divided into two main sections:

- Type of Tax – Chapter 3
- Type of Examination – Chapter 4

This chapter of the manual specifically describes the general procedures to be followed by an auditor in determining the type of audit method and related procedures in the conduct of the audit.

A. DETERMINATION OF THE AUDIT METHOD

OVERVIEW

Prior to determining the audit method to be employed, the taxpayer should be presented with a Computer Audit Feasibility Questionnaire to determine whether the taxpayer can make computerized records available for audit. Computer assisted audits can be conducted using any audit method.

When the taxpayer does not have complete records or when the review of each transaction would be unduly burdensome for the Department to conduct a complete audit in a timely and efficient manner, the Department will determine whether to examine all of the records of the taxpayer for the entire audit period, employ a test audit method, or utilize a combination of audit methods.

There are four basic audit methods available:

Complete Audit

All records in the audit period are examined.

Modified Complete

All records for portions of the audit period are examined. Items found to be in error (by customer/vendor or account) are examined for the remainder of the audit period. No projection is made.

Test Audit

A representative sample(s) from the audit period is examined and the results are used to project the deficiency (or credit) for the remainder of the audit period. The primary test audit procedures include Stratified Random Statistical Sampling and Block Sample – Projectable Average.

In addition, alternative testing procedures may be used to estimate tax liability when the taxpayer fails to maintain adequate records to properly conduct a previously listed audit method. These alternative testing procedures include: Gross Sales Assessment, Development of Taxable Sales/Purchases – Elimination of Obviously Nontaxable Items, Current Sales Sample Audit – Projectable Average (Tally), Estimate Taxable Sales using Purchase Records, and Effective Rate/Taxable to Gross Auditing Technique.

Combination Audit Prior to selecting the test period(s), the total population is separated into two or more distinct populations. Each distinct population is examined independently. A test is performed on one (or more) distinct population and a complete or modified complete examination is performed on the nontested population(s).

1. Factors in Determining the Audit Method

In making the determination of the methods to be used, the Department will consider the following factors:

- The type of tax under audit.
- The nature of the business activities.
- The number of transactions in the population – state in the narrative the approximate number of transactions and where this information was found. Also, include how the invoices are filed (voucher batch, customer folder, vendor folder, electronic image, microfilm, and microfiche). Do not merely state that there was a large number of invoices. The transactions should be defined in the audit report (such as sales invoice, expense invoice, expense charge).
- The adequacy and availability of the taxpayer's records – obtain acknowledgement from the taxpayer by way of a Request for Financial Records when any needed records are not made available.
- Whether the business is cyclical or seasonal.
- Whether significant changes occurred in the taxpayer's business activities during the audit period – such as discontinuing a line of business.
- Other relevant factors – a change in accounting systems, a division going from an individual accounting system to a company wide centralized accounting system, and major changes in the personnel responsible for making the determination of the taxability of items.

These items must be considered and fully addressed whenever a test audit procedure is used. These items must be addressed in the narrative and explanatory documentation should be used when pertinent.

B. COMPLETE AUDIT

A complete audit is an examination of all transactions made during a specific audit period. This is the most sound audit method. Time, personnel, and resource limitations on the part of the taxpayer and/or the Bureau may make it impractical or unduly burdensome to conduct complete audits.

When computerized records are available, Computerized Audit Support may be utilized to perform various sorts, summaries, or merging of taxpayer information to aid the auditor in conducting a complete audit to reduce time and resources on the part of both the taxpayer and the Bureau.

Complete audits of a taxpayer's records are only performed where adequate records are available and where such audits are practical. Complete audits are employed when the volume of merchandise sold is small and the unit price of each sale is large (such as mobile homes, boats, airplanes, fine jewelry sales and construction equipment).

In those cases where a taxpayer is engaged in the performance of a construction contract, the auditor is to conduct a complete examination of all job related costs. Any exception to performing a complete audit on job costs must be approved by headquarters. Job related costs must be discussed separately from other expenses in the audit narrative. When computerized records can be obtained for materials used in construction contracts, a review should be made to determine if an efficient complete or modified complete examination of capital can be performed. A test of construction material purchases may be made in very limited circumstances.

In the conduct of a complete audit, each transaction occurring during the audit period is examined to determine whether the proper amount of tax has been charged, collected, accrued and remitted on applicable taxable transactions.

All items found to be deficient are individually listed on the audit worksheets and/or schedules and summarized by reporting period for assessment.

Third party credits may only be included in the audit findings on a complete basis based on the date the tax was paid to the vendor.

C. MODIFIED COMPLETE AUDIT

This method of auditing may be used when the taxpayer's record keeping systems, accounting structure, sales customers/expense vendors are generally consistent throughout the audit period. This method is generally not used when the taxpayer has had a large change in the type of products sold (or purchased), the customers (or vendors) change frequently from year to year, and the taxpayer's records are capable of being audited on a complete basis with minimal additional field time.

A complete audit is conducted on a portion of the audit period (such as one year or a reporting period in each year). Like items, customers, vendors or accounts found to be in error are examined on a complete basis for the remainder of the audit period.

When computerized records are available, Computerized Audit Support should be used to sort data to identify transactions pertinent to the various accounts, customers, cost centers or other criteria that is used by the auditor to identify transactions to be examined when employing a modified complete examination.

Note: The original periods, time frames or areas reviewed to determine the scope of the modified complete examination of the remainder of the audit period must be specifically identified in the audit narrative.

D. TEST AUDIT

The Department is authorized by statute to use test procedures in an audit (72 P.S. §10003.21). Test audit procedures are used when complete records are not available or when it would be impractical to make an examination of the taxpayer's records on a complete basis.

Only a portion of the transactions of an entire audit period is examined in detail for the purpose of verifying the taxpayer's compliance.

Because the audit findings are supported only by a portion of the total transactions made during the audit period, the audit narrative and supporting documentation should make it very clear that:

- Reviewing each transaction would be unduly burdensome and
- To review each transaction could not be accomplished in a timely and efficient manner.

Each individual item found to be deficient during a test audit has a greater impact on the audit results due to the projection of the test period(s) results to the remainder of the audit period. Therefore, the auditor should make an effort to clearly explain the

taxability of those items listed as deficient during the test period. This should be accomplished through pertinent citations, supporting documentation (such as copies of invoices or purchase orders), clear descriptions in the audit narrative and on the audit worksheets, and the inclusion of account and/or cost center to which the item was posted. When account coding or cost centers are included on the audit worksheets or in the audit narrative, a chart of accounts and/or a listing of cost centers should be included as an exhibit in the audit report.

Prior to performing a test audit procedure, the auditor will determine through review of the taxpayer's general ledger accounts, review of past audits, and discussion with the taxpayer, what areas or accounts (if any) will be eliminated from the population to be tested and audited on a complete or modified complete basis. This must be done prior to the selection of the test period(s).

1. Test Audit Plan

Prior to performing a test audit procedure, the auditor is required to provide the taxpayer with a Taxpayer's Concurrence with Test Audit Plan. This plan must be in writing and must state:

- The time period subject to audit. The audit period will be extended under limited circumstances.
- The records subject to review. Indicate the transaction to be examined (i.e. invoice amount or expense charge). Specifically indicate which accounts are included in the test population; this must be clearly stated on the form or on another document that is specifically referenced on the form.
- The methods for selecting the records to be examined (Stratified Random Sample or block sample). The basis for selecting the test period(s) must be clearly explained on a Schedule or a Request for Financial Records must be included in the audit report to substantiate that the auditor made a reasonable attempt to obtain the records necessary to properly select the test period(s). The schedule or request must be referenced on the test audit plan and referenced in the narrative.
- When statistical estimation is used, the form must include a statement that the taxpayer has the right to request an increase in the sample size. This is necessary only when a Stratified Random Sample test audit procedure is conducted. When a Stratified Random Sample is used, the Computerized Audit Support division will complete the Taxpayer's Concurrence with Test Audit Plan.

a. Test Audit Plan Requirements

The Taxpayer's Concurrence with Test Audit Plan must state:

- The manner in which any tax liability will be calculated based on the records reviewed.
- The deficient transactions will be divided by the total of the transactions in the tested period. That the error rate will be applied to transactions from the same population for the remainder of the audit period to determine the total deficient projected transactions.
- The total projected deficient transactions will be multiplied by the applicable tax rate to compute the total projected deficiency for the population tested for the audit period.

The plan must be presented to the taxpayer. The taxpayer should be asked to sign, date, and include their title on the form. The taxpayer should also be asked to indicate on the form if the business activities were cyclical or seasonal, or if there were significant changes in the taxpayer's business activities during the audit period significant enough to affect the selection of test periods and application of test audit procedures.

The taxpayer should be asked to indicate on the form any reason they may have for disagreeing with the selection of the test sample and/or test audit procedures to be employed.

The auditor must evaluate the taxpayer's concerns and address them in the audit narrative. If the taxpayer's concerns are reasonable and can be substantiated, the auditor may make adjustments to address the taxpayer's concerns. If the adjustment results in any deviation from the originally selected test period, a letter requesting the change, which states the reason for the request must be obtained from the taxpayer and included in the audit report. At this point, a second Taxpayer's Concurrence with Test Audit Plan should be completed and presented to the taxpayer.

If the taxpayer refuses to sign the Taxpayer's Concurrence with Test Audit Plan, the auditor should indicate on the form: to whom the form was presented, the date the form was presented and the fact that the taxpayer refused to sign the form.

Note: When the auditor expects to conduct a test audit on occupancies and sales as part of a hotel audit the population for choosing test periods for hotel occupancy will be different than the population used to determine the sales tax test period. This is necessary because sales tax and hotel occupancy tax operate under different exemption rules. Separate error rates should be calculated for each area of tax.

Separate projections should be done for each area of tax. Separate test forms are required for each area of tax, e.g. sales tax and hotel occupancy.

2. Inclusion of Credits in the Test Period Audit Findings

When a test period for expenses is selected on a representative basis using key characteristics, credits for use tax paid directly to the Commonwealth will be included in the numerator of the error rate. As outlined in 61 Pa. Code §8a, “Enforcement,” if the results of a representative sample (block sample or Stratified Random Sample) yield a net credit, a credit will be projected for the reporting periods represented by that test sample.

For example, if one reporting period was chosen from each of three years in the audit period (2006, 2007 and 2008), and the 2006 and 2007 test periods resulted in a net deficiency and the 2008 test period results in a net credit, a credit would be projected for all reporting periods in 2008. A deficiency would be projected for the reporting periods in 2006 and 2007.

Credits will be projected when:

- The test periods are chosen on a representative basis (i.e., average expenses), as outlined in 61 Pa. Code §8a, and use tax was reported on a consistent basis throughout the audit period.
- A Stratified Random Sample is selected and the number of observations results in a level of precision that is mutually agreed upon by the Department and the taxpayer.
- The test periods are selected using one reporting period per year or one complete year within the audit period and use tax was reported consistently throughout the audit period.

When the test period(s) chosen is less than one reporting period per year, the approval of the Regional Manager in writing is required before a credit projection can be made.

Only credits for taxes paid directly to the Commonwealth are used to determine the credit. Third party credits may not be granted on a test basis. In no case should third party credits (taxes paid to vendors) be included in the results of any expense test audit (or complete).

Credits should not be projected when the test periods were selected based on a scope limitation such as the availability of records or use tax reported on expenses was not consistent. This requirement may be waived if the records for a substantial portion of the audit period are available and the sample(s) selected are chosen as representative from those periods that are available.

a. Credit Schedule Requirements

A schedule must be included in the audit report that specifically identifies the total credit represented in the audit findings. If credits were included in the projection, a computation of the projected credit included in the audit findings must be included on this schedule. The schedule must be referenced in the audit narrative.

b. Supervisory Review

When the auditor is granting credits to the taxpayer of \$5,000 or more, the supervisor must provide a written statement on the “Rev 119 –Conflict of Interest Statement and Auditor’s Comments Form,” indicating that the supervisor has reviewed and concurs with all credits granted in the audit report. The supervisor must sign the statement.

c. Verifying Prior Credits

Prior to granting credits in any audit, the Revenue Appeals Processing System (RAPS) must be checked to determine if the taxpayer applied for a refund for any period covered by the current audit.

If the taxpayer did apply for a refund for any period covered by the current audit, the auditor should review the refund information on RAPS to ensure duplicate credit is not granted. The auditor should also validate refund requests prior to the audit period to make sure credits do not duplicate refunds.

Copies of the Board schedules should be included in the audit report when necessary to substantiate returns already granted.

If the file documents are not available for review on RAPS, contact headquarters personnel to obtain the hard copy of the Board file.

d. Documentation of Credits Granted in the Audit

The auditor should explain in the narrative if the purchases were identified by posting date, by purchase invoice date, by merchandise receipt date, by check date, or some other factor. Also, if only certain invoices were included in the test period due to account classification or other accounting factors, this must be clearly stated.

e. Taxes Paid on Purchases Resold

Credit for Taxes Paid on Purchases Resold (TPPR) may not be included in the audit findings as a projection. Credit for taxes paid on purchases resold may only be granted on a complete basis.

3. Type of Test

Types of test audits are listed below.

- Stratified Random Sample – Projectable Average
- Block Sample – Projectable Average

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- Gross Sales Assessment Audit
- Development of Taxable Sales/Purchases – Elimination of Obviously Nontaxable Items
- Current Development of Taxable Sales Audit – Projection of Purchases
- Sales Sample Audit – Projectable Average (Tally)
- Effective Rate/Taxable to Gross Auditing Technique

a. Stratified Random Sample

Stratified Random Sample test procedures will only be conducted in conjunction with Computerized Audit Support and will utilize computerized records.

Ideally, Stratified Random Sample tests utilize transactions from the entire audit period. However, Stratified Random Sample testing may be performed in conjunction with a projectable average computation when the transactions selected for examination are selected for examination from less than the entire audit period. A true Stratified Random Sample may be performed, or a Stratified Random Sample test may be performed in conjunction with a projectable average computation when the items selected for examination are selected from less than 100% of the audit period.

i. Record Requirements

Computerized records and related source documents should be requested for the entire audit period on a Request for Financial Records. In addition, the auditor should have the taxpayer acknowledge that the source documents are available for the entire audit period. If the taxpayer cannot or will not make the records available for the audit period, the auditor should have the taxpayer indicate this fact on the Request for

Financial Records or on some other acknowledgement signed by the taxpayer. In no case should less than one complete accounting cycle (usually one year) be used to select the Stratified Random Sample without approval from the Audit Program Manager.

ii. Selection of Stratified Random Sample Size

When utilizing a Stratified Random Sample method, the original sample size will be determined based on the stratified data received by the computerized audit support division. The sample size may be increased until mutual agreement is reached between the Department and the taxpayer or until the desired precision is obtained.

iii. Stratified Random Sample Procedures

- Computerized transactions are obtained from the taxpayer and presented to Computerized Audit Support (CAS).

CAS will sort and subtotal the records at the auditor's direction and present the auditor with the results. The auditor is requested to verify the taxpayer's computer data prior to CAS pulling a sample. Acceptable methods of verification include:

If the data was obtained from the accounts payable system and both debit and credit records were provided, use the change in the balance of the accounts payable liability account for the same period of time. If the data was obtained from the accounts payable system and only debit records were provided, compare the value of the credit records in the accounts payable account for the same period.

If general ledger detail was obtained for audit purposes, compare several of the most material expense account totals to income statements or trial balance sheets for the same period.

Compare several expense account totals to general ledger balances for the same period. If accounts payable data was obtained for audit purposes, reconciliation will need to be performed in order to identify differences due to entries from other journals (Payroll, General Journal, Accounts Receivable, etc.).

Methods of verification may vary depending on the taxpayer's accounting system:

- The auditor will identify for CAS the accounts or other areas of the total population that are not to be included in the population to be tested. Only those accounts with potential tax liability should be included in the population to be tested.

- CAS will eliminate the areas of the population identified by the auditor, perform the stratification, and identify the items or transactions to be included in the test sample. CAS will complete the Taxpayer's Concurrence with Test Audit Plan. CAS will present and explain this form to the taxpayer.
- The auditor will present the test sample to the taxpayer along with a Request for Financial Records requesting that the taxpayer pull the records for examination. After review of the records, the auditor will notify CAS of the results. The auditor may not replace transactions from the sample even if the records are missing.
- CAS will compute the error rate, perform the projection, and calculate the precision. An error rate computation and projection schedule along with a precision calculation schedule will be sent to the auditor. It is the auditor's responsibility to review all transactions selected in a Stratified Random Sample including those with use tax occurrence.
- The auditor will notify the taxpayer of the results of the projection and discuss the precision of the projected deficiency. If there is agreement with the computed precision, no further testing is performed. At the taxpayer's request, the sample size will be increased.

iv. Application of Credits

Credits will be included in the numerator of the Stratified Random Sample for use tax paid by the taxpayer directly to the Commonwealth. This credit will only be included in the Stratified Random Sample calculation when the auditor can verify that the use tax coded to each of the transactions was posted to the use tax accrual account and that all use tax accrued was remitted. When less than the entire audit period was used to select the sample, the auditor must verify that use tax was reported consistently throughout the audit period prior to projecting credits. In no case will third party credits (sales tax erroneously paid to a vendor) be included in the Stratified Random Sample computation.

v. Less Than 100% of the Audit Period Used to Select Sample

If the Stratified Random Sample was selected from less than the entire audit period, it is necessary to compute a projectable average to be applied to the periods not included in the sample selection. A projectable average should be computed as the deficient sales (or expenses), divided by the total sales (or expenses) in the population from which the Stratified Random Sample was selected. The projectable average should be multiplied by the additions to the same accounts in all reporting periods not included in the selection of the sample to arrive at the taxable sales (expense) for those reporting periods.

vi. Direct Payment Permit Holders – Formulary Method of Reporting Use Tax

During the preaudit conference of direct payment permit holders, the taxpayer shall be informed that a formulary method of reporting use tax on expenses is available and that the procedures for computing a use tax factor for expense transactions can be performed during the current audit.

Statistical sampling procedures must be used to develop the factor for formulary reporting of use tax on expenses.

The numerator of the formulary factor will include:

- All expense transactions with a net change (additional taxable purchases or purchases on which use tax was remitted in error).
- All expense transactions in the test sample on which the taxpayer properly remitted use tax.
- All expense transactions in the test sample which the taxpayer properly paid sales tax to the vendor except those for which it was mutually agreed to exclude, for example, occupancy.
- The denominator for the formulary factor will be the dollar value of all transactions in the test sample.

vii. Formulary Use Tax Reporting Applications

Applications for formulary reporting of use tax are available through headquarters.

Audit periods for Direct Payment Permit holders should end on a calendar year, December 31.

b. Block Sample - Projectable Average Procedures

When a block sample method is chosen, the Department will select blocks in which the average is approximately equal to the computed average of key characteristics for the type of transaction and the time period to which they apply.

i. Selection of the Population to Be Tested

Prior to selecting test periods, the population to be tested must be defined. The taxpayer's general ledger accounts shall be examined to determine what accounts (if any) should be eliminated from the population being tested and audited independently of the test procedure. Accounts with large dollar amounts and relatively few transactions should be excluded from the tested population prior to the selection of the period(s) to be tested and audited independently.

The error rate computed for a test period shall be applied only to those periods and population from which the test period was selected with two exceptions:

- When the taxpayer does not make records available for the entire audit period.
- The taxpayer provides express written consent to applying test period results to periods not included in the selection of the test period. (For example, bring an audit current if audit was put on hold for several months before the beginning of the fieldwork.)

ii. Local Tax Consideration

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When it has been determined that the taxpayer had sales locations during the audit period in a jurisdiction(s) that imposes a local sales tax, separate error rates must be computed for each jurisdiction.

The auditor should request that the taxpayer provide detailed sales information by location for each reporting period in the audit period on a Request for Financial Records. It is the taxpayer's responsibility to provide the sales breakdown by location. The auditor should verify the accuracy of the information provided to the taxpayer's books, but should not spend time extracting the information.

If the taxpayer can provide a breakdown of sales by location, separate test periods should be selected for each local tax jurisdiction. The numerator of the error rate will be the total deficient sales (by jurisdiction); the denominator will be the total sales for the specific jurisdiction for the period tested.

When the taxpayer cannot provide a detailed breakdown of sales by location for each year in the reporting period, the test period(s) selected for state sales tax will be used to test the local sales. The numerator will be the local sales (by jurisdiction) found to be deficient. The denominator will be the total sales in the test population.

When the taxpayer cannot provide detailed sales locations by jurisdiction, the auditor should verify that the locations in operation during the test period(s) were in operation for the periods on which the error rate will be projected. If it can be determined that the taxpayer did not have sales from a local jurisdiction that imposes a sales tax during a portion of the audit period, the error rate will be applied to only those reporting periods during which sales were made from a taxable jurisdiction.

iii. Selection of Block Sample Size

When utilizing a block sample method, the sample size required is as follows:

- One reporting period in each year of the audit period. Partial years may be combined with complete years (up to an aggregate of 18 consecutive months) for the purposes of choosing a single test period. The error rate established for each test period shall be applied to only those periods from which the test period was selected (or)
- One complete year (calendar or fiscal) within the audit period.

The taxpayer should be presented with a Request for Financial Records that specifically requests the detail needed to properly select the test periods. All block sample audits should be approached using these criteria.

iv. Deviations from the Test Period Requirements

(1) Deviation at Taxpayer's Request

If the taxpayer requests that fewer test periods be examined, the auditor must obtain a written acknowledgement from the taxpayer attesting to their request. The acknowledgement must be:

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- Written by the taxpayer on the taxpayer's letterhead.
- State specifically the number of reporting periods requested to be examined.
- State the specific reason for the request of deviation.
- Include the date of the request.
- Include a statement that the individual signing the request is a duly authorized representative.
- Include a signature of the authorized representative.

The auditor may also accept this information in an email from the taxpayer or on a Taxpayer's Concurrence with Test Audit Plan signed by the taxpayer.

This acknowledgment should be included in the audit report as an exhibit and referenced in the audit narrative and on the Taxpayer's Concurrence with Test Audit Plan. The auditor must document that the taxpayer's business activities were relatively consistent throughout the periods for which the test period(s) apply and that there is no reason to believe the test period(s) chosen are not representative of the entire period to which the results will be applied.

Acknowledgement of Bureau management is required on a Conflict of Interest form indicating that the supervisor agrees with the deviation in the test period selected.

In all cases where the taxpayer requests that less than the required number of periods be examined, the auditor shall make a documented effort to obtain computerized records and pursue a statistical or other form of computerized audit procedure.

(2) Deviations at the Bureau's Request

The Bureau may not unilaterally deviate from the required number of test periods without written approval from the Director of the Bureau of Audits. This decision will be based on the total number of transactions per reporting period, the availability of records, and the results of the findings of prior audits of the taxpayer. It is the auditor's responsibility to indicate it would be unduly burdensome to examine additional records.

When less than the required number of test periods are selected and computer records are not available, the test period (s) will be selected from the periods for which the error rate will be applied. For example, if the taxpayer presents a written request that one reporting period be selected to represent the entire audit period, the period selected will be the reporting period closest to the average key characteristics computed for the entire audit period. The supervisor must comment on the Conflict of Interest form that they reviewed and agreed with the size of the sample and method used to conduct the test selection.

v. Documentation of the Test Periods

The taxpayer should be presented with a Request for Financial Records that specifically requests the detail for the test period(s) selected, as well as a Taxpayer's Concurrence with Test Audit Plan. All block sample audits should be approached using these criteria.

The selection of a block sample test audit period(s) must be supported by a schedule. A schedule must be included in the audit report that shows the calculation of the selection of the test periods. The schedule must clearly indicate the test period(s) chosen, include a footnote referencing the accounts or other items eliminated from the population prior to selecting the test periods, and contain a footnote referencing partial or combination years used to select a test period. The schedule must be included in the audit report. The schedule must be referenced in the narrative and on the Taxpayer's Concurrence with Test Audit Plan. The only exception to this should be when records are not adequate to determine test periods based on average characteristics.

vi. Records Not Available to Properly Select Test Periods

In every instance where adequate records are not available to select test periods based on average sales, expenses or some other key characteristic, a Request for Financial Records must be included in the audit report to support that the necessary records were requested and the taxpayer was given a reasonable amount of time to produce the records. The Request for Financial Records should be referenced on the Taxpayer's Concurrence with Test Audit Plan under the "Basis for Selecting Test Period", included in the audit report, and referenced in the audit narrative. When records are not available for the entire audit period, the test periods will be selected based on the characteristics of the periods for which records are available.

vii. Factors That Must Be Considered When Determining Test Periods

The following factors must be considered when determining test periods:

- Average Gross Sales or Average expenses (use actual if reported amounts are incorrect).
- Ratio of taxable to gross sales (when applicable).
- Whether the taxpayer's business is cyclical or seasonal.
- Significant changes in the business activities during the audit period.
- Adequacy and availability of taxpayer's records.
- Other relevant factors that could affect the representation of the selected test periods.

These factors must be addressed in the narrative.

Schedules must be included in the audit report to support the selection of the test periods (or test sample).

viii. Computation of the Projectable Average

One error rate will be computed for each population tested and be applied only to that population from which the tested transactions were selected.

Error rates will be computed to six decimal places and rounded to five decimal places.

(1) Numerator

All transactions found to be deficient will be recorded and included in the numerator of the error rate calculation. Credit for use tax paid directly to the Commonwealth will be included in the numerator when the auditor can verify that use tax coded to the invoice was properly recorded in the use tax accrual account and the use tax accrued was remitted. The auditor should also verify that credit had not previously been granted through a refund petition.

Credits will not be included in the projectable average computation if the test period was selected based on a lack of records.

(2) Denominator

The denominator will be the net dollar value of all transactions in the test sample. When it appears that the characteristics of the business for particular periods have changed and conditions are not constant or comparable, or where changes in the law substantially affected the taxability of merchandise or services sold by the vendor throughout the audit period, a separate projectable average should be computed for periods before and after material changes.

The dollar amount of the denominator should be the same as the dollar amount listed for the same period(s) on the schedule used to select the test periods. One error rate will be computed for each population tested and be applied only to that population from which the tested transactions were selected.

ix. Isolating Transactions in the Test Sample

When conducting a statistical or block sample, every transaction determined to be an outlier will be removed from the numerator prior to the computation of the error rate and treated as an isolated transaction. The outlier will be identified in the audit narrative and listed on a separate audit worksheet. The outlier will remain in the denominator of the projectable average calculation. The remainder of the audit period will not be examined to determine if like transactions occurred in other reporting periods.

(1) Outliers

Title 61 Pa. Code §8a, “Enforcement,” gives guidance in determining (quantifiably) which items found to be deficient in the test period should be isolated from the test period’s results prior to computing the error rate.

If an item is greater than 2% of the total tested population, that transaction is a “suspected” outlier.

When entering the denominator for the test period during step two of the projection procedure in the audit application, the auditor will get a message that indicates a transaction is a suspected outlier if an item is greater than 2% of the population being tested. In order to determine if the transaction is a confirmed outlier the following computation should be performed:

IF: Suspected outlier - mean $>$ or $=$ 4
div. by $\frac{1}{4}(\text{range})$

THEN: The item is a confirmed outlier.

The mean is the total of the transactional differences (less the outlier) divided by the total number of transactions examined (less the outlier).

The range is the difference between the largest and smallest transactional difference (not including the outlier).

Both deficiency and credit items may be outliers.

Stratified Random Sample – The use of stratification on computer assisted audits can reduce the possibility of encountering outliers. When a Stratified Random Sample is conducted, computerized audit support will do the computations to confirm an outlier.

Block Sample – When conducting a block sample, any transaction that is determined to be a suspected outlier will be considered a confirmed outlier. Therefore, any transaction found to be deficient (or a credit for taxes paid directly to the Commonwealth) that is greater than 2% of the test population will be excluded from the numerator of the error rate and treated as an isolated transaction. The transactions determined to be outliers will remain in the denominator of the error rate computation.

x. Test Periods Not Selected Using an Average

When test periods are not selected based on average key characteristics due to the unavailability of records, the requirement to isolate transactions greater than 2% does not apply. The reason being that the scope limitation imposed did not allow for an adequate review of large items so that they could be audited on a complete basis. In this circumstance, the auditor may:

- Leave the transaction in the numerator. This may be done when the selected test period is not considered to be a representative period because it was chosen based on lack of records. Or
- Isolate the transaction and treat it as an outlier. This may be done when the selected period is considered to be a representative period. Or
- Examine like transactions on a complete basis and project on the remaining deficient items.

Under the third bullet, the denominator will be reduced by the total of the isolated transaction. This is allowable because changing the denominator will not affect the selection of the test period since the selection was not based on an average.

xi. Discontinuing the Test Audit Procedure

When conducting a block sample test on one reporting period in each year of the audit period and no exceptions were found in the first test period examined, the auditor may abandon the examination of the remainder of the test periods if: 1) the business activities were consistent in each year of the audit period and 2) the taxpayer's reporting history was relatively constant.

When performing a block sample test on one reporting period in each year of the audit period and very few transactions are found to be deficient during the first period examined, the auditor may perform a limited examination on the remaining test periods. Like items, as those found to be deficient, should be examined on a modified complete basis for the remainder of the audit period and no projection shall be made for assessment purposes. This may only be done when very few customers (vendors) are found to be deficient, the items sold (purchased) during the audit period remained constant, the taxpayer's reporting history is relatively constant, and the majority of the sales are to repeat customers (or purchases are continuously made from the same vendors).

xii. Examples of Test Period Selection

(1) Sample All Sales

BLOCK SAMPLE OF SALES WHEN ALL SALES ARE INCLUDED IN THE POPULATION TO BE TESTED

When performing a block sample test of sales:

- Identify the three periods in each year (or partial/combination year) that are closest to the average sales for the year.
- Of the three periods coming closest to the average in each year, choose the period that comes closest to the average taxable sales to gross sales ratio for the year.

(2) Sample Sales **Combination Audit**

BLOCK SAMPLE OF SALES WHEN ALL SALES ARE NOT INCLUDED IN THE POPULATION TO BE TESTED

When a block sample test will be performed on only a portion of the total sales population, the block sample will be chosen as the period that comes closest to the average sales from the population being tested. The sales used to compute the average shall include only those sales being tested.

Separate block sample tests may be performed on various populations. When this is done, a separate test period must be chosen in each year for each population tested.

When segregating sales into separate test populations, the supporting schedule must clearly define the populations tested.

c. Gross Sales Assessment

Note: This audit method may be adapted for use with expenses, capital purchases, PTA and VRT.

Prior to utilizing this audit method, the auditor must present the taxpayer with a Request for Financial Records, requesting the records necessary to conduct the audit utilizing a complete

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audit method, a modified complete audit method, or a test audit method using representative test period(s).

When it is impossible or impractical to effectively employ another type of audit method because of a taxpayer's failure to maintain or provide auditable records, the Department may assess the taxpayer on the gross amount of sales. The results of the gross sales assessment computation should be presented to the taxpayer. The taxpayer should be given a Request for Financial Records, requesting that the taxpayer provide sufficient competent evidence that would support the computation of the tax actually due.

The Revenue Regional Manager must approve this procedure before it is used to establish an audit assessment. This memo must be attached to the Additional Headquarters Processing Request.

In the conduct of an audit resulting in a gross sales assessment, every reasonable attempt must be made to eliminate obvious nontaxable transactions from gross sales. If any of the taxpayer's records permit the development of a sample technique that will reliably measure the extent of nontaxable transactions, such a technique should be implemented.

After compiling gross sales figures (by audit period) presumed to be taxable, the effective rate of tax is applied and the deficiencies by period are determined as illustrated below.

i. Sample of Gross Sales Assessment

APPLICATION OF IMPOSED RATE
Verified Gross Sales
(Or Amount Sufficiently Inclusive) –

	Individual Periods	Imposed Tax Rate	Tax Liability Individual Periods
Period A	\$ 87,500.00	6%	\$5,250.00
Period B	120,000.00	6%	7,200.00
Period C	112,000.00	6%	<u>6,720.00</u>
			<u>\$19,170.00</u>

	Tax Liability Individual Periods	Tax Reported	Deficiency Individual Periods
Period A	\$5,250.00	\$ 1,000.00	\$ 4,250.00
Period B	7,200.00	2,000.00	5,200.00
Period C	<u>6,720.00</u>	<u>2,600.00</u>	<u>4,120.00</u>
	<u>\$19,170.00</u>	<u>\$13,570.00</u>	

d. Development of Taxable Sales (Purchases) By Eliminating Obvious Nontaxable Items

Prior to utilizing this audit method, the auditor must present the taxpayer with a Request for Financial Records, requesting the records necessary to conduct the audit utilizing a complete audit method, a modified complete audit method or a test audit method using representative test period(s).

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This audit method is generally used on sales when the taxpayer has not kept adequate auditable source documents but has kept gross sales records evidencing that a portion of sales were obviously nontaxable. This audit method may be adapted for use on capital purchases or expenses if the taxpayer has not kept sufficient source documentation but does maintain capital purchases or expense totals and does maintain some documentation indicating the purchase(s) were put to a nontaxable use (such as obvious use in public utility, manufacturing or mining direct use). There must be convincing evidence that the specific sale or purchase is not taxable prior to eliminating the item from the gross amount assessed.

Before using this test procedure, the supervisor must be consulted. The technique employed is designed to eliminate those clearly nontaxable transactions from a representative test period, thereby creating a presumption that the remaining items within the test period are taxable. The test findings are then projected to the entire audit period. The results of the Development of Taxable Sales (Purchases) assessment computation should be presented to the taxpayer. The taxpayer should be given a Request for Financial Records requesting sufficient competent evidence that would support the computation of the tax actually due.

In the conduct of this type of audit, each transaction occurring within the test period is examined for the purpose of classifying it as obviously nontaxable (e.g., clothing, prescription drugs etc.) or taxable. The total nontaxable transactions for the test period are divided by the total of gross transactions for the sample period. The result, representing the ratio of nontaxable to total transactions, is projected to determine the total deficiency in the following manner:

- The ratio of nontaxable to total gross transactions derived from the sample is applied to the verified total gross sales (total expenses) for each reporting period in the audit period to determine the total nontaxable transactions (sales, capital, expenses) for each reporting period in the audit period.
- The total nontaxable transactions for each reporting period are subtracted from the total gross sales (capital purchases or expenses) for each period to arrive at total taxable transactions for each reporting period.

Either:

- the rate of tax (or taxpayer's reported effective rate, if greater) is applied to the total taxable amount computed for sales (purchases) for each reporting period to arrive at the total tax liability for the audit period *or*
- the tax rate for the applicable jurisdiction will be applied to the computed taxable capital or expense purchases to arrive at the total use tax liability for each audit period.

The total tax reported for each reporting period is then subtracted from the total tax liability computed for each reporting period to compute the tax deficiency.

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When reporting period totals are not available for each year of the audit period, yearly totals may be used. The yearly computed deficiency should be divided by the number of reporting periods. The assessment should be applied equally over the reporting periods.

i. Sample – Obviously Nontaxable

The following is an illustration of this procedure:

SAMPLE FINDINGS	
a. Gross sales – sample period (1/1/X1 to 1/31/X1)	\$100,000.00
b. Nontaxable sales – sample period	20,000.00
c. Taxable sales – sample period	<u>\$ 80,000.00</u>

Ratio of nontaxable sales to gross sales expressed as a percentage.

$b / a = 20\%$

Step (1)

a. Gross sales – nonsampled period (2/1/x1 – 2/28/x1)	\$150,000.00
b. Percentage of nontaxable to gross sales – sample	20%
c. Nontaxable sales (nontested period)	<u>\$ 30,000.00</u>

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Step (2)

a. Gross sales (2/1/X1 – 2/28/X1)	\$150,000.00
b. Less nontaxable sales (2/1/X1 – 2/28/X1)	\$30,000.00
c. Taxable sales	<u>\$120,000.00</u>

Step (3)

a. Taxable sales (2/1/X1 – 2/28/X1)	\$120,000.00
b. Imposed rate of tax (or the reported effective rate, if greater than the flat, imposed rate)	6%
Tax liability (entire audit period)	<u>\$ 7,200.00</u>

Step (4)

a. Tax liability (2/1/X1 – 2/28/X1)	\$ 7,200.00
b. Total tax reported (2/1/X1 – 2/28/X1)	5,700.00
c. Total deficiency	<u>\$ 1,500.00</u>

These computations should be conducted for each reporting period.

e. Current Sales Sample Audit – Projectable Average

Prior to utilizing this audit method, the auditor must present the taxpayer with a Request for Financial Records requesting the records necessary to conduct the audit utilizing a complete audit method, a modified complete audit method, or a test audit method using representative test period(s).

A Current Sales Sample Audit – Projectable Average is used when the taxpayer has failed to maintain auditable sales tax records. In this audit method, the auditor will perform a test audit of current sales in progress (REV-153, Tally Sheet) and use the results as a basis for projecting the taxpayer's liability over the entire audit period. The basis is accomplished by listing a sufficient number of sales transactions in progress to establish an average percentage of taxable sales to gross sales and an average effective rate of tax incurred.

Because a current period is used as the test period due to lack of records, the test period will be a period after the preaudit conference. The auditor may extend the audit period to include the test period.

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Sales for a current test period are recorded. The recorded information is used to compute a taxable to gross ratio. The taxable sales to gross sales ratio should be applied to total sales for the audit period to determine total taxable sales.

The recorded information should also be used to compute the correctness of the effective rate based on the incremental sales tax liability using the bracket system. The computed taxable sales should be multiplied by the effective rate to compute the projected sales tax liability.

Reported sales tax should then be subtracted from the computed sales tax liability to determine the sales tax deficiency.

i. Tally Sheet

The Tally Sheet (Form REV-153) may be used when the auditor records the sample transactions and is designed to provide a record of opening and closing cash register readings for each day, the selling price and description of each sale, tax charged and tax incurred. The auditor may use custom computerized schedules that capture essentially the same information.

The application and summarization of the tally sheet findings are essentially similar to the projection technique utilized in connection with the Records of Past Sales Sample Audit – Projectable Average.

f. Estimating Taxable Sales Using Purchase Records

Before using this test procedure, the supervisor must be consulted. Where a taxpayer has failed to maintain adequate sales tax records but has kept adequate purchase and gross sales records, a sales tax liability may be established from a sampling of purchase records.

Prior to utilizing this audit method, the auditor must present the taxpayer with a Request for Financial Records requesting the records necessary to conduct the audit utilizing a complete audit method, a modified complete audit method, or a test audit method using representative test period(s).

When this method is used, each purchase for resale occurring in the sample period is examined and classified as either a taxable type purchase (i.e., a purchase which upon resale ordinarily would be taxable) or a nontaxable type purchase (i.e., a purchase which upon resale is not taxable). When summarizing the sample findings, the total

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of the taxable type purchases for the sample period is divided by the total sample period purchases. The ratio derived may then be applied to gross sales for the entire audit period if there is not a substantial difference in the average markup on taxable and nontaxable merchandise.

If substantial differences can be established by product or product type, the auditor may use a combined markup or individually apply the markup by product.

i. Average Industry Markup

Average industry markup of cost of goods sold to sales may be used when other adequate documentation is not available. Headquarters has access to various reference materials regarding industry average markup of cost of goods sold. These industry averages may be used to determine the reasonableness of the taxable purchases to gross purchases ratio claimed by the taxpayer when adequate documentation is not maintained to verify the taxability of actual sales transactions on an individual basis. Typical use of these averages would include examinations of smaller retail establishments such as restaurants.

a. Sample

The following illustrates this procedure:

SAMPLE FINDINGS

a. Gross purchases – sample	\$100,000.00
b. Taxable purchases – sample	20,000.00

Step (1)

Sample findings stated as a percentage ratio of taxable purchases to gross purchases:

$$b / a = 20\%$$

Step (2)

a. Gross sales (total all periods)	\$480,000.00
Percentage of taxable to gross purchases, which is presumed to be an average percentage of taxable to gross sales.	20%
c. Taxable sales (total all periods)	\$ 96,000.00

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Step (3)

a. Taxable Sales (total all periods)	\$96,000.00
b. Imposed rate of tax (or taxpayer's reported rate, if such rate is greater than the flat rate of tax imposed)	6%
c. Tax liability (entire audit period)	\$ 5,760.00

Step (4)

a. Tax liability (entire audit period)	\$ 5,760.00
b. Total tax reported (total all periods)	4,960.00
c. Total deficiency (total all periods)	<u>\$ 800.00</u>

The total deficiency should be prorated among the individual reporting periods by applying the ratio between the total deficiency and the audit period gross sales to the gross sales of each reporting period.

g. Effective Rate/Taxable Sales to Gross Sales Auditing Technique

This testing method is used when the auditor has uncovered possible noncompliance with the sales tax bracket system and incorrect taxable to gross ratio.

An effective rate/taxable sales to gross sales auditing method is generally employed when auditing business establishments that have many small transactions (i.e. restaurants, bars, variety stores and mini markets).

This method may be employed using a Current Tally Projectable Average when there is a lack of records maintained by the taxpayer under audit. This method may also be employed using a Record of Past Sales- Projectable Average.

i. Procedures

- A period is selected (or a current tally is maintained) for a minimum of one full week.
- Source documents (i.e. guest checks, receipts, or register tapes) are examined.

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- The auditor must then list the gross sales, taxable sales, sales tax incurred, and sales tax charged from all of the source documents by individual customer sale for each day. The auditor should sum these transactions and verify completeness by comparing the result to the taxpayer's sales journal. If the taxpayer has failed to maintain a sales journal, the auditor may use alternative records such as bank deposits.
- The auditor should also list additional transactions listed in the sales journal not previously recorded due to missing source documents.
- The auditor must compute the taxable sales to gross sales ratio for the period examined.
- The auditor must then compute the effective tax rate for the test period by dividing the tax liability into the taxable sales for the test period (as computed by the auditor).
- Compute the rate to six decimal places and round to five.

If the auditor was able to verify that reported taxable sales were accurate, the auditor will apply the computed effective rate to taxable sales in each reporting period to determine the computed sales tax liability. The sales tax reported will be subtracted from the computed liability. The difference will be additional sales tax liability due to failure to charge sales tax using the bracket system.

If the auditor was unable to verify reported taxable sales either due to the taxpayer's method of record keeping or due to a lack of records, the auditor will multiply the gross sales by the computed taxable to gross ratio for each reporting period. If the taxpayer did not maintain records necessary to determine and/or verify gross sales, the auditor may use gross sales from other sources (such as bank deposits or income tax returns).

The computed taxable sales must be multiplied by the computed effective rate to compute the tax liability using the effective rate. The reported sales tax is then subtracted from the computed sales tax. The difference is the additional sales tax liability for failure to charge tax using the bracket system.

Chapter 5 – AUDIT POLICY

This section of the manual describes the policies to be used by auditors in addressing certain audit issues.

A. AUDIT ENGAGEMENT LETTERS

The following audit engagement letters are to be forwarded for each audit assigned. The letter is to advise each taxpayer of the impending audit and the records that will be required to complete the audit.

Within 60 days of the issuance of the audit engagement letter, an auditor is to contact the taxpayer to schedule a time and date to begin the audit.

Following this section are samples of both in-state and out-of-state audit engagement letters and confirmation letters.

1. In-state Sample Letter

DATE

@1

@2

@3

Dear Taxpayer:

Re: Pennsylvania Sales/Use Tax
Local Sales/Use Tax
Public Transportation Assistance Taxes and Fees
Vehicle Rental Tax

The Bureau of Audits will be conducting routine field audits of your records for the purpose of determining compliance with the subject taxes, as well as a limited examination of Employer Withholding of Pennsylvania Personal Income Tax.

In the near future, you will be contacted by the auditor assigned to conduct the audit. Detailed records such as invoices, register tapes, summary records including journals and ledgers, and exemption certificates will be examined.

A valid Exemption Certificate must be on file to support all Pennsylvania sales of tangible personal property for which you did not collect and report sales tax. The certificate must disclose a valid basis of exemption and be completed in its entirety before the 60th day following the date of sale or lease to which the certificate relates. If an exemption certificate is not obtained within the 60 day time period, the auditor may request that you secure a statement from the purchaser explaining the exempt use of the property.

An exemption certificate is not needed for sales of tangible property that are of a type never subject to tax, sale or lease of property in interstate commerce, and sales to the U.S. Government or Pennsylvania and its political subdivisions.

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Your cooperation is greatly appreciated.

Enclosed is a REV-554, Department of Revenue Disclosure Statement of the Department's and Taxpayer's Rights and Obligations, and a Computerized Audit Feasibility Questionnaire.

Very truly yours,

Revenue Regional Manager
Telephone Number

2. Out-of-state Sample Letter

DATE

@1

@2

@3

Dear Taxpayer:

Re: Pennsylvania Sales/Use Tax
Local Sales/Use Tax
Public Transportation Assistance Taxes and Fees
Vehicle Rental Tax

The Bureau of Audits will be conducting routine field audits of your records for the purpose of determining compliance with the subject taxes, as well as a limited examination of Employer Withholding of Pennsylvania Personal Income Tax.

In the near future, you will be contacted by the auditor assigned to conduct the audit. Detailed records such as invoices, register tapes, summary records including journals and ledgers, and exemption certificates will be examined.

A valid exemption certificate must be on file to support all Pennsylvania sales of tangible personal property for which you did not collect and report sales tax. The certificate must disclose a valid basis of exemption and be completed in its entirety before the 60th day following the date of sale or lease to which the certificate relates.

If an exemption certificate is not obtained within the 60 day time period, the auditor may request that you secure a statement from the purchaser explaining the exempt use of the property.

An exemption certificate is not needed for sales of tangible property that are of a type never subject to tax, sale or lease of property in interstate commerce, and sales to the U.S. Government or Pennsylvania and its political subdivisions.

Past history has proven that most taxpayers have cooperated and provided the books and records requested by the auditor to confirm compliance with the provisions of the Sales Tax Act. Accordingly, the auditor will travel to your place of business to perform the audit at the

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Department's expense. The Department of Revenue does, however, have the authority to require a taxpayer maintaining records outside of the Commonwealth to assume reasonable audit expenses (72 P.S. §7271 I). We will only invoke this authority if you do not make your books and records readily available to our auditor resulting in excessive time and possible return trips to complete the audit.

Your cooperation is greatly appreciated.

Enclosed is a REV-554, Department of Revenue Disclosure Statement of the Department's and Taxpayer's Rights and Obligations, and a Computerized Audit Feasibility Questionnaire.

3. Sample Confirmation Letter

@1
@2
@3

Dear (TAXPAYER):

Re: Pennsylvania Sales/Use Tax Audit

License:

Assignment:

This letter is to confirm the telephone conversation of _____ (DATE) _____ between you and (AUDITOR) _____ of this office during which the audit was schedule to begin on (DATE).

Should you have any questions concerning this matter, please contact this office at _____ TELEPHONE NUMBER _____.

Very truly yours,

Revenue Regional Manager
_____ Regional Office

B. AUDIT PERIOD – STATUTE OF LIMITATIONS

The statute of limitations discussed below applies to:

- State and Local Sales, Use and Hotel Occupancy Tax
- Public Transportation Assistance Fund Taxes and Fees
- Vehicle Rental Tax

1. General

The audit period is normally established during the preaudit conference. The standard audit period for a taxpayer is the previous three calendar years and all of the current year's returns due as of the preaudit conference date (see 72 P.S. §7258).

2. Exceptions

The only exceptions will be those audits involving: 1) fraud, 2) tax evasion, or 3) a properly executed waiver. The auditor is to include all tax collected and not reported for the six preceding years. For taxes collected and not reported during the prior six years, the auditor is to notify the supervisor of the number of periods and the amount of trust fund money involved. The supervisor will request via email the approval of the regional manager and Director to include those years in the audit period.

3. Delinquencies beyond the Statutory Audit Period

When an audit is assigned, the auditor is to determine if the taxpayer is delinquent beyond the statute. If a taxpayer is found to be delinquent, the auditor is to determine and document sales tax collected and not reported.

In such situations, the following assessment policy is to be applied to registered and nonregistered taxpayers:

- Audit assessments for delinquent periods beyond the statute are to be prepared only when sales tax is collected and not reported.
- Sales tax collected and not reported can only be assessed if the auditor, after examination of the books and records, can prove and document the fact that the taxpayer has collected tax during periods beyond the statute. Any exceptions to this require the program manager's approval.

Also, during audits where the taxpayer does not maintain records beyond the statute and there is a strong presumption, based on fact, that the taxpayer has collected sales tax and not reported, the audit findings will be referred to the Office of Chief Counsel to determine if such an assessment has legal merit. Documentation supporting this position should be forwarded to the program manager.

Use tax is never to be assessed beyond the statute without a waiver.

4. Extension of the Audit Period for Assignments

a. Extensions at the Taxpayer's Request

Requests by the taxpayer to bring the audit period current should be honored if the following criteria are met:

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- The taxpayer provides a written request on their letterhead for the audit period to be extended and that they agree to allow the auditor to project test results from previously selected test periods against the extended periods.
- Business activities in the extended period are consistent with business activities included in the original audit period. For example, if average expenses were used to choose a test period for expenses, expenses incurred during the extended period must be reasonably consistent with that average.
- Prior to making a projection onto the interim periods, the auditor should verify that the charging of sales tax was consistent and the remittance of use tax was consistent with the original audit period.
- The taxpayer makes the necessary sales and expense information available to properly extend a projectable average based on either test periods in the original audit period, or a projectable average based on the original audit period when a complete examination was conducted.
- The taxpayer makes the necessary capital purchase documentation available for the extended period.

b. Extensions due to the Length of Time Necessary to Complete the Fieldwork.

If the fieldwork takes longer than 12 months to complete, the audit period should be extended through the end of the last year of the original audit period. For example, at the pre-audit conference, the original audit period is determined to be 1/1/2005 - 6/30/2008. The audit should be brought through 12/31/08 if the fieldwork takes more than twelve months to complete.

The auditor must verify the following prior to extending the audit period:

- Business activities for the extended periods are consistent with the original audit period.
- Reporting of sales and use tax for the extended periods are consistent with the original reporting period.
- A reasonable projectable average can be determined for both sales and expenses.

The taxpayer should be presented with a “Request for Financial Records” form which specifically requests information for capital purchases and the sales and expense totals necessary to apply the projectable averages from the original audit period over the extended period.

The taxpayer should also be presented with a Taxpayer’s Concurrence with Test Audit Plan containing an explanation of the procedures to be used to determine the liability or credit for the extended period. The taxpayer must be given an opportunity to state, in writing, reasons for objections to the extension of the audit period. The auditor must address any taxpayer

objections and their relevance to the reasonableness of the procedures used to determine the liability or credit for the extended period.

If the necessary sales or expense totals are not provided for which to apply the projectable averages from the original reporting period, assessment for the extended audit periods should be based on an average net liability (or credit) found during the original audit period.

If the necessary capital information is not made available, the average liability/credit per reporting period for the original reporting period should be applied to each reporting period in the extended period (subject to materiality).

C. BANKRUPTCY AUDITS

1. Procedures

When an auditor receives a field audit request on a bankrupt taxpayer, it must be given priority status.

- The auditor is to contact the bankruptcy court and obtain the bar date. The bar date is the last date to file a claim. The audit must be submitted at least thirty days prior to the first bar date. The auditor should note that this is different than the normal nine month period given to other priority audits.
- The auditor should also check for a 2nd bar date referred to as the administrative bar date for any post bankruptcy audits. This is done by checking KITS R101. This conversation will show a bankruptcy date in the appropriate field if a bankruptcy case is still open. When the case is closed, the date is removed from this field. When conducting post bankruptcy audits, if this date field is still active, contact headquarters to verify if an administrative bar date exists. Failure by the Department to file a claim by the administrative bar date may prevent the Department from collecting on post bankruptcy tax assessments.
- The tax liabilities established must be separated into pre and post bankruptcy periods. Therefore, the auditor must separate the findings in accordance with the date the taxpayer is declared to be in a bankruptcy status. If a liability is to be assessed, the auditor must also file two separate audit reports. Each report will be issued under its own assignment number. Two separate assessments will be issued. Bankruptcy information should not be included on the Audit Report and Basis of Assessment form (REV-149) of the post bankruptcy assignment. Instead, the Additional Headquarters Processing Request form (1105) should indicate that it is a post bankruptcy assignment and provide the bar date.
- Should an auditor discover that the taxpayer on any assignment currently in inventory has declared bankruptcy, advise headquarters of the bankruptcy status so that the Bureau of Compliance and Office of Attorney General may be informed.

Bankruptcy information is to be reflected in the appropriate section of the Audit Report and Basis of Assessment (REV-149) as well as the preaudit section of the narrative.

2. U.S. Bankruptcy Courts in Pennsylvania (United States Third Circuit)

	Local Number	Toll Free Number	
Pennsylvania-Eastern	(215) 597-2244	(888) 584-5853	
Pennsylvania-Middle		(877) 440-2699 8) 531-9485	(8
Pennsylvania-Western	(412) 355-3210	(800) 795-2829	

Out-of-state courts are listed in Appendix 4 – Codes and Information Lists (Bankruptcy Courts). Additional information about the courts (addresses and phone numbers) may also be found at the web site ‘Public Access to Court Electronic Records’ at <http://pacer.psc.uscourts.gov/pubaccess.html>.

It should also be noted that some bankruptcy courts have a web page that will provide you with information about bankruptcy filings in their state. For example, the Delaware Bankruptcy court has a link called “Claims Information” that will provide you with the necessary information you need for any Delaware bankruptcy filing.

D. BILLING FOR OUT-OF-STATE AUDIT EXPENSES

When audit time is wasted and return trips had to be made on out-of-state sales and use tax audit assignments because the taxpayer did not have the records available for audit or when unreasonable delays were encountered waiting for records to complete the audit, the Department may bill the taxpayer for the cost of the return trips. This is addressed in the out-of-state engagement letter.

An out-of-state audit engagement form letter is initially sent to announce the audit and to advise all out-of-state taxpayers that if return trips are required because of unreasonable delays in providing records, the statutory provision for billing out-of-state audit expenses may be invoked.

Accordingly, each region is to take the following steps to recover audit expenses for costly delays in providing records:

- After the out-of-state audit engagement letter is sent and the taxpayer has been contacted to arrange an audit start date, a letter is to be sent to the taxpayer confirming the audit start date. This confirmation letter may later support or document the need to bill the out-of-state taxpayer for the normal expense to conduct the audit.
- Should the auditor experience delays in obtaining records while conducting the audit, the auditor should advise the taxpayer of the provisions noted in the letter.
- The auditor should log the date and number of hours the auditor had to wait for records when unreasonable delays were encountered at the out-of-state audit site.
- When the auditor returns to the regional office, the record of delays and possible return trip to complete the audit is to be brought to the regional manager’s attention by the auditor and supervisor.

- If it is determined that the auditor spent an unreasonable amount of time on the out-of-state audit assignment or if a return trip was required because of delays, the hours lost waiting for records and travel expenses incurred by the auditor are to be reported to the Director of the Bureau of Audits.
- The Director will review each case and will forward all cases in which costly delays were encountered to the Comptroller's Office. Each taxpayer responsible for the loss of audit time and travel expenses incurred by the Department will be billed reasonable out-of-state audit expenses by the comptroller for failing to cooperate with the auditor and provide them with needed records.

E. BULK SALE ASSESSMENTS

When an audit assessment is being issued against a taxpayer who has transferred 51 % or more of a class of Pennsylvania assets (bulk sale), a bulk sale assessment shall be issued as an operation of law against the purchaser (72 P.S. Section 1403). An asset is defined as any stock of goods, wares, or merchandise of any kind, fixtures, machinery, equipment, buildings or real estate, located in Pennsylvania. The bulk sale assessment is issued against the purchaser to protect the Commonwealth's interest in any Pennsylvania taxes due related to the assets sold.

The PA Department of Revenue must be notified 10 days prior to the sale or transfer in bulk of 51% or more of any stock of goods, wares, or merchandise of any kind, fixtures, machinery, equipment, buildings or real estate, located in Pennsylvania. The transfer of assets does not have to be 51% or more of total assets located in Pennsylvania but 51% or more of a class of assets located in Pennsylvania. Failure of the seller to obtain a Bulk Sale Clearance from the Department makes the purchasers or assignees, as well as the seller/assignor, jointly liable for all taxes incurred up to, and including, the date of the sale or transfer.

If a Bulk Sale Clearance has been issued, the taxpayer should provide the clearance certificate to the auditor. If it is questionable whether a bulk sales clearance has been issued, headquarters personnel, when contacted, will determine if the Bureau of Compliance has issued a Bulk Sale Clearance. Where the seller has failed to obtain a Bulk Sale Clearance, the company under audit will be assessed taxes and the auditor will recommend a bulk sale assessment, via the Headquarters Additional Processing Request, against the purchaser or assignees. If available, please attach a copy of the sales agreement. In order to issue the assessment, the purchaser must be licensed with the Department. If the purchaser is not licensed, an "in/out" number must be obtained via a PA-100 completed by the auditor.

The auditor should review question 13 of the Bureau of Audits – Registration Update form or section 10 on page 6 of the PA-100 to see if the taxpayer indicates a bulk sale transaction occurred.

Note: The bulk sale clearance file may be viewed via the View Imaged Return option on the Bureau's web page under the Corp Tax tab using the appropriate account number. However, the file does not contain an image of the certificate.

F. BUSINESS ACTIVITIES QUESTIONNAIRE

The Business Activities Questionnaire is used by the Bureau of Business Trust Fund Taxes to determine if out-of-state vendors selling property within the Commonwealth have nexus.

The Bureau of Audits may use the form in those instances where a corporation under audit has unregistered affiliated corporations making sales in Pennsylvania with a potential sales or corporation tax liability. The auditor should ask the affiliate to fill out the questionnaire to determine if the affiliate has nexus in Pennsylvania. If nexus is found and the auditor is unsure that the affiliate met its tax responsibility, the auditor should require the affiliate to become registered and perform an audit for tax compliance.

The completed Business Activities Questionnaire should be attached to the Department's Additional Headquarters Processing Request form as part of the completed audit report.

G. CONSOLIDATION OF ENTITIES FOR SALES AND USE TAX AUDITS

If an entity under audit requests, in writing, that the parent and any subsidiaries be assessed under one sales and use tax license number, the Bureau can accept the letter and assess two different entities with separate Employer Identification Numbers (EIN) under the one sales and use tax license number. The letter is to be included as an exhibit in the audit package and fully explained in the audit narrative.

The PA-100 or Registration Update form must include all locations for all the entities reporting under the single sales and use tax license. Headquarters should be contacted when this situation exists due to special processing requirements. KITS files must be updated to make sure that all locations for all entities are added and must include notes for the entities involved and describe the circumstances.

H. COUPON SALES

The taxable base of the transaction is the amount the retailer records on the cash register.

For example, a customer has a coupon worth \$1 that he transfers to a retailer for a packet of cigarettes. The retailer records on the cash register the amount of \$1 and accepts the coupon. Since the retailer considers the coupon as "value," the customer is required to pay 6% sales tax on the purchase. If the retailer exchanges a packet of cigarettes for the coupon and does not record the sale, no tax is due. If the retailer records \$1 on the cash register, accepts the coupon and enters it as a "discount" on the cash register in the amount of \$1, the customer would pay no sales tax since the adjusted purchase price would be zero.

I. CREDIT MEMOS

In situations involving a net refund to the taxpayer, the taxpayer's departmental records will be reviewed for any outstanding balances owed on other tax systems prior to issuance of a credit memo. Once a taxpayer receives a credit memo, it can either be applied as a payment on a routine return/assessment or it may be forwarded to the Bureau of Trust Fund Taxes, Credit Section for a refund.

The procedure of applying previously approved tax credits in one general fund tax prior to the computation of penalty and interest is authorized under Section 1108(b) of the Fiscal Code (see 72 P.S. §1108(b)). This section also authorizes the application of assigned credits from one taxpayer to the taxpayer that is assessed.

Auditors may not allow as an offset against audit discovered deficiencies, any credit amounts that originate from an official Notice of Credit issued by the Bureau of Business Trust Fund Taxes.

Normally, a Notice of Credit will be issued as a result of a refund order issued by the Board of Appeals or Board of Finance and Revenue. Such credit notices can be used by the taxpayer in lieu of a cash or check payment and can be applied to any subsequent sales and use tax return filed with the Department.

It is important that all audit discovered deficiencies are officially assessed. Subsequently, the liability may be satisfied by a taxpayer presenting a Notice of Credit in payment of part of that deficiency, in lieu of tendering a check or cash.

The Notice of Credit must be physically surrendered to the Department so that the taxpayer does not erroneously receive duplicate credit.

J. CREDITS RECOGNIZED BY AUDITORS

1. General

The auditor may grant credits in an audit for

- Sales tax accrual overpayments
- Third party credits (including TPPR – Taxes Paid Purchases Resold)
- Use tax overpayments

These credits may be granted for all periods covered in an audit.

2. Verifying Prior Credits

Prior to granting credit within any audit, the auditor must review RAPS to determine if the taxpayer received a refund during any portion of the audit period. Note that section 3 of the Taxpayer Summary Information report contains a summary of refund and appeal filings to help facilitate this review.

If file documents are not available on RAPS, then headquarters personnel should be contacted to obtain the file.

3. Third Party Credits

If a taxpayer discovers that during the audit period under examination, the taxpayer overpaid tax to a vendor and the taxpayer provides sufficient evidence to the auditor that the tax is not rightfully due the Commonwealth, the auditor will be permitted to grant a credit for the sales tax overpaid on that transaction. This is called a “third party credit”.

In order for the auditor to make a determination that the taxpayer overpaid tax to a vendor, the taxpayer must provide the following: (i) a copy of the source document for the transaction, (ii) proof of tax payment, (iii) a valid reason for exemption with adequate documentation if the exemption reason requires additional documentation, e.g. predominate use or direct use in manufacturing, and (iv) taxpayer's attestation that no credit memo, tax refund, or any similar reimbursement for tax overpayment was provided to taxpayer. If insufficient evidence is submitted to the auditor, the auditor must deny the credit.

The tax payment made to a vendor for a transaction, which is determined by the auditor to be nontaxable, will be either subtracted from the final deficiency or added to any net overpayment determined for taxpayer's returns, to determine the accuracy of taxpayer's returns. Third party credits will not enter into the calculations used in the test audit procedure, which is employed to verify the accuracy and completeness of taxpayer's returns.

If, for any reason, the auditor does not grant credit for a sales or use tax overpayment made by the taxpayer for tax not rightfully due the Commonwealth for any time period covered by the audit, the taxpayer must file a petition for refund within six months of the mailing date of the Notice of Assessment for the audit period or the taxpayer forfeits the right to claim a refund or credit for any overpayment made during the audit period (see 72 P.S. §10003.1(b)). The Notice of Assessment will notify the taxpayer of the Department's finding of overpayment, underpayment, or no discrepancy for taxes due in the audit period.

Q: If the auditor denies the taxpayer's requested credit, is the taxpayer's recourse to file a petition for refund or can the taxpayer contest the denial when it challenges the assessment?

A: If the auditor denies a credit, the taxpayer's only recourse is to file a petition for refund. Section 3003.1(b) specifically states that if a credit is not granted in the audit report, the taxpayer must file a petition for refund.

Q: Does it make a difference if the credit arose during the test period?

A: No.

4. Sales Tax Accrual Errors

Overpayments of sales tax resulting from verifiable sales tax accrual errors that have been included in the sales tax return filed by the taxpayer shall be recognized within an audit.

5. Auditor's Responsibility for Developing Use Tax Credits

The auditor will make a reasonable effort to develop use tax overpayments rightfully due the taxpayer. However, the auditor will not expend excessive time in verifying or developing overpayments. In situations where an excessive amount of time is involved in such work, the auditor will request the taxpayer to develop the necessary documentation supporting the overpayments and the auditor can include this offset in his report after verifying its accuracy and completeness. If the taxpayer is unable to provide this information by the conclusion of the audit, the auditor should inform the taxpayer that the statute of limitations for any transaction within the audit period is six months from the date of the Notice of Assessment and that it is

necessary to file a petition for any credits not granted in the audit. These petitions must be supported by sufficient documentation that proves the overpayment of tax.

6. Inclusion of Credits in the Expense Test Period Audit Findings

When a test period for expenses is selected on a representative basis using key characteristics, credits for use tax paid directly to the Commonwealth will be included in the numerator of the error rate. As outlined in 61 Pa. Code §8a, “Enforcement”, if the results of a representative sample (block sample or Stratified Random Sample) yield a net credit, a credit will be projected for the reporting periods represented by that test sample.

Credits will be projected when:

- The test periods are chosen on a representative basis (i.e., average expenses) as outlined in §8a.
- A Stratified Random Sample is selected and the number of observations results in a precision mutually agreed upon by the Department and the taxpayer.
- The test periods are selected using one reporting period per year or one complete year within the audit period.

Only credits for taxes paid directly to the Commonwealth are used to determine the net credit. In no case should third party credits (taxes paid to vendors) be included in the results of an expense test audit.

Credits should not be projected when the test periods were selected based on the unavailability of records. This requirement may be waived if the records for a substantial portion of the audit period are available and the sample(s) selected is chosen as representative from those periods that are available. When records are not available for the entire audit period, regional manager approval is required prior to projecting the results of a net credit test period.

7. Supervisory Review

When the auditor is granting credits to the taxpayer of \$5,000 or more, the supervisor must provide a written statement on the “Rev 119 –Conflict of Interest Statement and Auditor’s Comments Form,” indicating that the supervisor has reviewed and concurs with all credits granted in the audit report. The supervisor must sign the statement.

8. Credit Schedule

A schedule is required to be included in the audit report to support the total value of the credit included in the audit findings. This schedule must include credits granted for sales tax accrual, third party credits, overpayment of use tax on capital purchases, and overpayment of use tax on expense purchases. When an expense test is performed, the total use tax credit represented in the projection must be computed and included on the schedule. All credits used as an offset in an audit report must be completely supported by adequate documentation including, but not limited to, a listing of specific items and reasons for exemptions from tax. All facts and discussions with the taxpayer concerning credits should be fully documented in the narrative.

K. DETERMINATION OF FAIR RENTAL AMOUNTS BETWEEN AFFILIATED INTERESTS

It is necessary to have uniform application in establishing a constructive fair rental charge between affiliated interests consistent with 61 Pa. Code § 47.16, Rental of Equipment Between Affiliated Interests.

An affiliated interest exists when two corporations, associations, partnerships, proprietorships or other businesses, in which one corporation, association, partnership, proprietorship, individual or other business owns more than 50% of the stock or assets, including inventory, machinery and equipment of the remaining corporation, association, partnership, proprietorship or other business. Also, the common ownership of more than 50% of the stock or assets of each of two or more business entities results in an affiliated interest between the two commonly owned entities.

After determining an affiliated interest exists, the following procedures are to be used. In instances where property is owned by one entity and is being used by an affiliated entity, the auditor must determine:

- If there is consideration between the two parties
- Whether the consideration is at arm's length.

If the auditor questions the amount of consideration between the two parties as being a fair rental charge, an explanation must be provided in the audit report. The consideration transferred must be documented to support a "sale at retail."

To be considered an arm's length transaction, fair market value will be considered to be the prevailing market rate (by hour, day, or month).

The auditor should document the determination of the fair market value established by use of supporting documentation such as rate schedules or price lists.

In situations where a fair rental amount is not at arm's length and the prevailing market price cannot be determined, the auditor should apply a "percentage of costs" (4% of the purchase price per month on most items, 3% on cars, and 2% on airplanes). One method to determine if the rental charge is reasonable is to examine the net profit (loss) of the lessor. If a reasonable profit has been made, it is assumed to be a fair value charged.

If there was no consideration involved in the transaction, the affiliate originally acquiring the property would be liable for tax on the purchase price. The resale exemption does not apply since the affiliate acquiring the property did not buy it for resale but put it to a taxable use by giving it to the other affiliate.

L. DROP SHIPMENTS

Drop shipment is a term adopted for a situation in which one taxpayer purchases tangible personal property and directs a second taxpayer (the vendor) to deliver the tangible personal property into Pennsylvania to a third party.

Example:

- A Pennsylvania customer orders taxable property from a nonregistered out-of-state retailer who has no nexus in Pennsylvania.
- The retailer orders the property from an in-state or out-of-state manufacturer/wholesaler purchasing the items exempt from sales tax by claiming the resale exemption.
- The manufacturer/wholesaler ships the property to the retail customer in Pennsylvania.
- The retailer bills the Pennsylvania based customer for the taxable property.

The Bureau will accept a resale exemption certificate without a sales tax license number from an out-of-state retailer that does not have nexus in Pennsylvania.

Likewise, the Bureau will now also permit an out-of-state vendor to tender a Pennsylvania Exemption Certificate claiming resale even when not licensed to collect sales tax, provided the certificate includes a statement indicating the taxpayer does not have nexus or that no taxable sales are made in Pennsylvania.

M. ERRONEOUSLY CHARGED SALES TAX ON THE SALE/INSTALLATION OF REAL PROPERTY

The offsetting of erroneously charged sales tax against the sale/installation of real property (incurred use tax) in conjunction with a first time audit is an administrative policy.

Sales taxes which have been erroneously collected and remitted to the Department will offset any use tax liability found to be due and owing by the contractor in a first time audit. This is to be applied on an individual transaction or contract basis. That is, sales tax erroneously collected on one contract can only offset the use tax due from that specific contract.

No credit or refund will be granted to the contractor for erroneously collected sales tax after applying such collections against use tax due upon purchases used in the performance of realty construction activities.

The contractor is to be notified in writing at the conclusion of the audit that where a customer later makes application and receives a refund of erroneously paid tax, the contractor will be assessed for the amount of tax refunded on the basis that the property was used in the performance of realty construction activity.

The policy will be extended on the condition that the contractor agrees to correctly apply the provisions of the sales tax law with respect to future transactions. The contractor shall at this time also be advised in writing that the Department will follow up to ensure compliance with the law.

The contractor's written notice will state that the Department will not extend the policy subsequent to the date of formal advisement that his procedures were in error. In subsequent audits, use tax will be assessed on all purchases not properly taxed by the vendor. No off set for sales tax collected will be granted.

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The auditor must notify the audit supervisor of the erroneous sales tax collected and remitted. The audit supervisor must then record this situation on the Additional Headquarters Processing Request form. It shall be the responsibility of Audit headquarters to prepare a letter formally notifying contractors of the conditions outlined above. A copy of this letter will be kept in the audit file and in Headquarters' files.

The taxpayer should be apprised of these conditions and they should be addressed in the audit narrative.

Note: With program manager approval, this policy may be applied to other circumstances where the sales tax was erroneously charged and a use tax liability results from the same transaction.

N. INTERIM STORAGE

Interim storage is broadly defined as temporarily having possession of tangible personal property in a state for any purpose including exercising any right or power over such property. Pennsylvania imposes use tax on such storage of tangible personal property within its boundaries.

When an item (purchase) is initially delivered to another state but subsequently brought into Pennsylvania, the Bureau of Audits will recognize tax credit for sales/use tax paid to another state if that state taxes interim storage and has reciprocity with Pennsylvania. However, credit should not be allowed for tax paid, if that state does not tax interim storage.

The following states tax temporary or interim storage and such tax paid should be recognized where appropriate:

Arizona	Massachusetts*	Rhode Island
Arkansas	Michigan	Tennessee***
California	Mississippi	Texas
Colorado	New Jersey	Utah
Georgia	New York**	Vermont
Indiana	North Dakota	Virginia
Kentucky	Ohio	Washington
Maryland	Oklahoma	Wisconsin

* Massachusetts taxes interim storage on property purchased from a MA registered vendor

** See Chapter 5. V. RECIPROCITY.

*** Charges tax on interim storage of materials not held for resale.

When a purchase is delivered to a state other than those listed and tax was paid to that state, Pennsylvania tax prevails, since the taxpayer paid tax to another jurisdiction when he was not legally required to do so.

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Example 1:

Company X has stored computers in Rhode Island (a state that taxes interim storage) and paid Rhode Island use tax prior to shipping the computers to Pennsylvania.
Reciprocity for Rhode Island tax should be recognized.

Example 2:

Company Y has stored office furniture in Minnesota (a state that does not tax interim storage) and paid Minnesota use tax there prior to delivering furniture to Pennsylvania.

Minnesota tax payments are not recognized since it was not legally due and therefore, Pennsylvania use tax can be assessed.

O. INSTITUTIONS OF PURELY PUBLIC CHARITY (IPPCs)

1. IPPC Audits

When auditing Institutions of Purely Public Charity (IPPC) please note the following:

- For an entity granted exempt status after November 26, 1997, the Department's refund period for tax paid begins with the date of its application to the Department for exempt status. Consequently, entities qualifying as IPPC's after November 26, 1997, will be audited as exempt entities only for the portion of the audit period beginning with the application date.
- In situations where there has been a break in the taxpayer's IPPC certification during the audit period and the auditor can verify that there has been no substantial change in the taxpayer's activities during the break, the taxpayer will be treated as an exempt entity for the entire period.
- If a taxpayer files a Petition for Refund claiming it is an exempt entity but has not filed an application with the Department, the Board of Appeals will deny the request for refund and forward to the petitioner a Sales Tax Exemption Application.
- Supervisors must contact Bureau headquarters personnel to request expedited processing of pending Sales Tax Exemption Applications in instances where the outcome of an audit depends on the determination of the taxpayer's IPPC status.

2. Contracts with Exempt Entities

- Direct Purchase Order. The exempt entity must issue its purchase order directly to the vendor supplying the materials the contractor will use and provide the vendor with a copy of the Exemption Certificate.
- Direct Invoice. The vendor's invoice must be issued to the exempt entity rather than to the contractor.

- Direct Payment. The exempt entity must make payment directly to the vendor from its own funds.
- Passage of Title. The exempt entity must take title to the tangible personal property from the vendor at the time of purchase or delivery by the vendor.

Another potential area for consideration by the auditor is the assumption of the risk of loss. An exempt entity will be deemed to have assumed the risk of loss if the exempt entity bears the economic burden of obtaining insurance covering damage or loss or directly enjoys the economic benefit of the proceeds of such insurance.

3. Agency Agreements with Exempt Entities

All of the criteria below must be satisfied in order for an agency relationship to exist.

- Written agreement. The agency agreement must be in writing at the time of the transaction.
- Disclosure. The agency or relationship must be disclosed on the invoice to the customer.
- The agency agreement states that the principal will be bound by the action of the agent.
- The agency itself must have a valid business purpose.

P. LOCATING TAXPAYERS

There will be occasions when regional audit office employees have difficulty locating a taxpayer who has been assigned for audit. In such situations, it is important to minimize the amount of unproductive audit hours expended by an auditor in attempting to locate the taxpayer. Regional managers are encouraged to use their supervisors to perform the necessary tasks required to locate the taxpayer. As a matter of policy, auditors will not be permitted to expend more than 7 ½ working hours attempting to locate a taxpayer.

When an audit assignment is received, the “Audit Engagement Letter” is to be forwarded to the taxpayer using the address provided with the audit assignment. If this letter is returned by the postal service as undeliverable or the auditor is unable to make telephone contact with the taxpayer, the audit assignment should be returned to the appropriate supervisor who will attempt to locate the taxpayer by using the following techniques:

- Using KITS, determine if there is an alternative mailing address available. KITS may also be used to review taxpayer contact established through the Department’s collection efforts. Taxpayer contact information may be reviewed under the “Additional Detail” component of the Taxpayer Summary Information template accessed via the audit application or by going directly to KITS conversation R653 – Contact Inquiry.
- Call the telephone company’s information section for a possible telephone listing. Note: If there is an unlisted number, it should indicate they are in the area.

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- Check the address of the business and the owner in the local city directory, if possible. (Several Bureau of Collections and Taxpayer Services' District Offices have subscribed to cross reference directories known as Polk directories, Cole directories, or the City Publishing Company directory. Consider contacting your local district office of Collections and Taxpayer Services to determine if they can locate a valid mailing address from such a directory).
- Contact the local office of the Bureau of Collections and Taxpayer Services and inquire if they have had any investigations or recent contacts with the taxpayer.
- Search the internet for other possible locations.
- Contact the local post office and request the current address or forwarding address for the taxpayer. If the local post office will provide this information in person only, make this visit while in the general area in route to or from another audit assignment, or request assistance from another auditor/supervisor who frequently travels or lives within that area. Also, if feasible, visit the business location address for any information on the building and make inquiries of adjoining property owners if possible.
- Contact headquarters to request the latest address listed with Pennsylvania Department of Transportation.
- Contact headquarters to determine if the most recent imaged return contained a current phone number.

Q. MERGERS

1. Assessments

When a corporation is merged into another, the surviving corporation is always responsible for all liabilities, including future tax liabilities, resulting from audits regardless of what statements to the contrary are in the plan or articles of merger. Therefore, where a corporation under audit has gone out of existence (O/E) or is pending out of existence (POE) as a result of a merger, the audit assignment on the nonsurviving corporation must be cancelled and an assignment created for the surviving corporation.

The format for assessing audits where mergers have occurred is as follows: Where ABC, Inc., the company under audit, has merged into XYZ Corporation and XYZ is the surviving corporation, the legal name should read XYZ Corporation. At this point, the audit may also have to be expanded to include a review of XYZ Corp. prior to the date of the merger.

An assessment involving trust fund taxes (collected or withheld and not reported) for the period prior to the merger but discovered after the merger will be assessed against the survivor of the merger in accordance with 15 Pa. C.S. Section 1929 I. Also, a recommendation for a corporate officer assessment against the officers of the merged (O/E) corporation should be made via the Additional Headquarters Processing Request.

Whether a corporation has merged with another may be verified by using the Corporation Tax System on the Department's Information Management System (IMS). The command CTBNG + Box Number <enter> will provide the surviving box number under STATUS CHANGE and TO BOX sections when the merged corporation is Out of Existence (O/E). If a final corporate tax return has not been filed with the Department, the status of the corporation on the system will be POE (Pending Out Of Existence) and merger information will not be listed. In order to verify a merger, the auditor should request the Articles of Merger and the Docketing Statement that are required to be filed with the Department of State. If the auditor is unable to get a copy of the Articles of Merger from the taxpayer, a copy may be requested from the Department of State by contacting headquarters personnel. A Docketing Statement that shows the merged corporation and surviving corporation is available via the MIMENU system under CT and the Box Number. The Docketing Statement may also be requested from headquarters personnel. Merger information may be also be obtained through the PA Department of State.

2. Waivers

When a merger occurs and the surviving company executes a waiver, the waiver will apply only to the business activities of the surviving company prior to the merger unless the waiver specifically identifies the company that was merged out of existence. If the company that was merged out of existence was not specifically identified on the waiver, the out of existence company's business activities should be audited only for the statutorily available period as of the time the audit is conducted (three years plus the current year).

For example – An audit is issued on XYZ Corp. for the audit period of 2005, 2006, and 2007. On June 30, 2008, XYZ Corp. signs a waiver for the year 2005 with the record retention date being December 31, 2009. The waiver identifies only the business activities of XYZ Corp. ABC Corp. merges with XYZ Corp. on July 1, 2006, with XYZ Corp. being the survivor entity. The waiver signed by XYZ Corp. in 2008 will cover the activities of XYZ Corp. (and what had been ABC Corp. subsequent to the merger). The business activities of ABC Corp. prior to the merger will be audited only for the statutory allowable period as if they were still a separate legal entity. In this case, assuming the fieldwork is conducted in 2009, the business activities of ABC should be audited beginning 2006 unless the waiver signed by XYZ specifically included the business activities of ABC.

- If XYZ Corp. had signed the waiver prior to ABC Corp. merging into XYZ Corp., the waiver **would not** cover ABC Corp. activities in 2005.
- For example, an audit is issued on ABC Corp. for an audit period of 2005, 2006, and 2007. ABC Corp. signed a waiver for 2005 on June 30, 2008, holding open 2005 until December 31, 2009. On July 1, 2007, ABC Corp. merges with XYZ Corp. with XYZ Corp. as the survivor. The original waiver signed by ABC Corp. remains legally enforceable. The surviving XYZ Corp. can extend any waivers signed by ABC Corp. for the year 2005. The audit initially issued on ABC Corp. should be cancelled and a new audit requested on the survivor.

When an entity has merged out of existence and a waiver of the survivor is intended to hold open the business activities of the out of existence company for a period prior to the merger, in addition to the regular information required for the surviving entity, the waiver should also identify: the out of existence entity name, SUT account number, EIN, and the period applicable

to the out of existence entity which is to be held open by the waiver (if it is different from the surviving company).

Currently, the waiver generated by the audit application pulls in the taxpayer information from the REV-149. Therefore, it will be necessary to enter the additional information pertaining to the out-of-existence company on the face of all three copies of the waiver. This can be done in the open space of “Part I: Taxpayer Identification.” Enter as “XYZ Corp, as successor to ABC Corp, (EIN), (SUT account number)”.

If the information will not fit on the face of the waiver due to more than one merged company, reference an attachment on the face of the waiver and include the information in an attachment.

If business activities will be held open for both the entity that was merged out of existence and the surviving entity, two separate waivers are necessary. An attachment can be used if multiple companies merged into the survivor.

R. MOTOR VEHICLES

1. Demonstrator Vehicles

a. Recordkeeping

The maintenance of records regarding the usage of demonstrator vehicles is required as the primary method of demonstrating to the Department the taxable and nontaxable use of vehicles. Examples of records essential to the audit process include paperwork listing:

- a vehicle’s date of acquisition and date of sale
- odometer readings at the time of acquisition and date of sale
- logs reflecting the taxable or nontaxable mileage accrued by individual vehicles.

b. Incomplete Records

In audits where adequate documentation is unavailable, the auditor will equate the vehicle’s mileage (from date of acquisition) to months of taxable usage. For the purpose of this proposal, each 750 miles (or fraction thereof) of unrecorded mileage will be assessed one month of tax on the fair rental value. As an example, if a vehicle subjected to audit has accrued 1200 miles since its acquisition and no records have been kept to differentiate which of those miles were for nontaxable purposes, two months of use tax would be assessed on the vehicle. In no case will the total number of months assessed exceed the number of months the vehicle was in inventory.

c. Documentation of Actual Number of Months of Service

Should the dealer be able to document the actual number of months a vehicle is in service, the use tax assessment should not exceed the amount imposed for that number of months. For example, if the dealer can demonstrate with records that a demonstrator vehicle was only in the dealer’s possession for three months, no more than three months of use tax could be imposed, regardless of the number of miles accrued.

2. Early Termination of Leases

Outlined below is the Department’s position regarding the early termination of motor vehicle leases by a Lessee, a motor vehicle dealer, or upon receipt of an insurance company’s payment. This reflects a change in policy as a result of recent Board decisions. If you have any questions, contact the SUT division.

a. General Factual Scenarios

The Lessor’s business. The Lessor is in the vehicle lease finance business. As part of that business, the Lessor purchases vehicle lease contracts (and the related vehicles) from motor vehicle dealers (“Dealers”) that entered into those leases with retail vehicle customers (“Lessees”). Those contracts provide the Lessees with possession of the vehicles in exchange for monthly lease payments.

Scenario 1: Lessee purchase transactions. The first type of transaction is a “Lessee purchase transaction.” In a Lessee purchase transaction, before the scheduled end of the lease term, a Lessee contacts the Lessor because the Lessee wants to purchase the vehicle from the Lessor instead of continuing to lease the vehicle.

If the Lessee and Lessor agree to a purchase price, the Lessee and Lessor terminate the lease contract, the Lessee pays the Lessor the agreed to purchase price and ownership of the vehicle is transferred by the Lessor to the Lessee. The purchaser (former Lessee) purchasing the vehicle should pay sales tax at the time of registration on that entire purchase price because paying that sales tax is required for a certificate of title to be issued to the purchaser. See 72 P.S. §7238.

Scenario 2: Dealer purchase transactions. The second type of transaction is a “Dealer purchase transaction.” A Dealer purchase transaction is similar to a Lessee purchase transaction, but in a Dealer purchase transaction, the Lessee who desires to end the lease and purchase the leased vehicle or another vehicle brings the leased vehicle to the Dealer and the Dealer, not the Lessee, offers to purchase the vehicle from the Lessor.

Similar to the Lessee purchase transaction, if the Lessor and Dealer agree to a purchase price, the Lessor and Lessee terminate the lease contract, the Dealer pays the Lessor the purchase price and ownership of the vehicle is transferred by the Lessor to the Dealer for resale to the Dealer’s customer (either the former Lessee or another customer). Neither the Dealer nor the Lessor are obligated to purchase or sell the vehicle to accommodate the Lessee. When the Dealer resells the vehicle to the former Lessee or another customer, sales tax is paid on the entire sale price of the vehicle because paying that sales tax is required for a certificate of title to be issued to the subsequent purchaser. See 72 P.S. §7238.

Scenario 3: Insurance proceeds. The third type of transaction is the “receipt of insurance proceeds.” A Lessee purchases insurance from an insurer (“Insurer”) to cover damage to the vehicle or to cover theft of the vehicle. The Lessor is named as the loss payee in that insurance agreement. In the event that the vehicle is destroyed beyond repair or stolen, the Lessor receives insurance proceeds from the Insurer. The payment made by the Insurer is based solely on the fair market value of the vehicle, not lease payments outstanding at the time the vehicle

was destroyed or stolen. The Lessee has no continuing obligations under the lease if the vehicle is damaged beyond repair or stolen.

When the Lessor receives the proceeds from the Insurer, the Lessor transfers ownership of the vehicle to the Insurer. If the vehicle is damaged beyond repair, the Insurer sells what remains of the vehicle to a salvage yard, and if a stolen vehicle is recovered, the Insurer sells the vehicle at auction.

b. Department's Positions

Scenario 1. It is the Department's position that in scenario #1, the former Lessee would be responsible for the sales tax when the motor vehicle is registered in Pennsylvania. No Public Transportation tax (PTA) would be due because the lease has been cancelled.

Scenario 2. It is the Departments position that in scenario #2, no sales tax or PTA tax is due on the sale from the Lessor to the Dealer because the lease contract is cancelled and the sale of the motor vehicle to the Dealer would constitute a sale for resale. The Dealer's subsequent sale of the vehicle would be subject to sales tax.

Scenario 3. It is the Department's position that in scenario #3, no sales tax or PTA tax is due from the receipt of insurance proceeds because transfer of insurance proceeds by the insurance company is not in exchange for the tangible personal property, but to indemnify the Lessor for its property loss. In addition, provided the lease is then cancelled between the Lessor and Lessee, and the Lessee is not obligated to pay any part of the remaining lease payment, then no sales tax or PTA tax is due from Lessee to Lessor.

S. NONRESIDENT – NONREGISTERED TAXPAYERS

Listed below are the various situations involving businesses conducting transactions within the Commonwealth. Some of these businesses may be audited on a retroactive basis, whereas others will be requested to register for prospective compliance. There are also certain situations that will have to be decided on an individual basis depending on the extent of nexus with Pennsylvania.

The various categories and type of action to be taken are indicated below:

METHOD CONDUCTING BUSINESS	COURSE OF ACTION
Contractors who perform work within the state	Retroactive Audit
People who collect Pennsylvania sales tax and are not registered (and have no nexus)	Retroactive Audit (Accrual Account Only)
People who have a business location in Pennsylvania and do not charge sales tax	Retroactive Audit
Businesses that perform services in connection with sales	Retroactive Audit
Mail order or internet sales only	Retroactive Audit
Businesses who solicit through salesmen	Retroactive Audit
Businesses who advertise and deliver	Retroactive Audit

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Prior to completing audits on out-of-state vendors, all assignments involving either a prospective or retroactive application decision are to be referred to the Bureau Director. A memorandum is to be forwarded to the director's office explaining type of sales, nexus in Pennsylvania, volume of sales, potential tax due, etc. The Bureau will either proceed with the audit assignment on a retroactive basis or the taxpayer will be contacted and informed to register on a prospective basis.

An entity that is registered in Pennsylvania for sales tax but does not have nexus with Pennsylvania will only be audited for the proper reporting of sales tax charged. Such taxpayers will not be audited for additional taxable sales.

Deficiency resulting from an audit of a nonregistered taxpayer must be assessed on a monthly basis. This allows the Bureau to remain consistent with the Registration Division's policy of registering new taxpayers automatically as monthly filers.

T. ORDER TO APPEAR

An "Order to Appear" letter is issued when the taxpayer refuses to grant an auditor access to records that may be necessary to perform an audit. The letter constitutes a legal order to the taxpayer to appear at a specified location for the purpose of producing the required documents and is issued when all other reasonable efforts to obtain the taxpayer's cooperation have been exhausted. The auditor must document these efforts. An "Order to Appear" formally documents that the taxpayer was formally ordered to appear and present necessary records. The document is initiated by the supervisor and issued by the regional manager and should be sent directly to the taxpayer via certified return receipt mail. The order should also be sent to the designated representative. The order must be sent at least 21 days prior to the appearance date set forth in the letter. A copy of the order must be included in the audit report as an exhibit.

(See an example of an Order to Appear Letter on next page)

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1. Sample

Sample Letter – Order To Appear

DATE

ORDER TO APPEAR

Mr. John Doe
T/A Doe's Enterprises
Donegal, PA 15628

Re: License No.: _____
Audit No.: _____

Dear Sir:

You refused to cooperate with our representative of the Bureau of Audits when he attempted to make an appointment to audit your records.

YOU ARE HEREBY ORDERED AND DIRECTED TO APPEAR, pursuant to Section 268(b) and 272 of the Tax Reform Code of 1971, as amended, _____
Date, Time and Office _____

_____ to testify concerning certain matters relative to the enforcement of administration of the Sales and Use Tax Laws of this Commonwealth. You will report to _____, Audit Supervisor. The office telephone number is _____.

You will then and there produce your collection and payment records, copies of tax returns and proof of payments as well as the prescribed figures necessary to complete your returns for the period _____, including sales invoices, purchase invoices, sales journals, purchase and/or disbursement journals, general journal, general ledger, Personal Income Tax information and any other records pertinent to a sales and use tax and personal income tax audit.

NOW TAKE NOTICE, that failure to comply with this order is a criminal offense against the Commonwealth which is punishable by a Fine of One Thousand (\$1,000.00) Dollars and/or One Year Imprisonment, or Both.

Very truly yours,
Revenue Regional Manager

2. Content

The letter should be addressed to each owner, partner, officer, or other responsible individual. The information to be included in the order consists of the individuals name, title, and address; the specific records requested; and the exact time, date and location where such records are to be presented.

U. PAYMENTS RECEIVED FROM TAXPAYERS/CHECKS RECEIVED IN THE FIELD

All payments received by the auditor are to be processed immediately according to the following procedures. Payments from taxpayers are only to be collected as a courtesy service for them as noted on the post audit conference form.

When a payment is received in the field, a memo must be prepared which includes the following information. This information is crucial to assure the payment will be properly applied to the correct assessment. This information must be presented to the Collection and Taxpayer Services (CATS) office in the form of a memo.

- Taxpayer Name
- Employer Identification Number
- Assignment Number
- Type of Tax
- Account Number
- Date of Check
- Effective Date (date received or post marked, see below)
- Check Number
- Amount of Check
- Last Day of Audit Period

The auditor must mark on the face of the check, “Received by the Bureau of Audits,” and the date that the check was physically received.

If the taxpayer mails the payment to the regional office, the envelope used to mail the payment must be included with the payment when it is presented at the CATS office.

When payments are mailed to the Regional Office, the effective date will be the date of the United States Postal Service (USPS) postmark. If the envelope is not post marked by the USPS, the effective date will be the date the payment was received in the regional office. Do not use the date from a private postage meter date, such as Pitney-Bowes, as a received date.

When the check is to be applied to more than one reporting period and/or more than one tax type, the taxpayer should provide written instruction as to how the payment should be applied (i.e. type of tax, period, and account number). The auditor should prepare a schedule that clearly indicates how the payment should be applied. The taxpayer’s instructions and the schedule should be included in the information presented to CATS.

1. Application of Payment by Tax Type and Period

All payments received in full or partial satisfaction of a taxpayer's liabilities will be applied in the following sequence unless the taxpayer specifically directs otherwise:

1) Tax Liability, 2) Interest, 3) Penalty, and 4) Legal Cost

Copies of all documentation presented to CATS must be included in the audit report as an exhibit and referenced in the audit narrative.

2. Indication of Check Received on Additional Headquarters Processing Request (1105)

The Additional Headquarters Processing Request form (1105) transmitted with the audit must indicate an 'Audit to Follow Check' was applied to the assessment period to alert Headquarters to verify the proper application of the money to the one day period before the assessment is sent.

V. RECIPROCITY

Pennsylvania will grant credit for state sales and use taxes legally paid to another state, provided the state grants similar tax credit for taxes paid to Pennsylvania. Pennsylvania will also grant credit for local sales and use taxes, provided such taxes are: (1) collected by the state and (2) paid pursuant to the provisions of the state law which has been adopted by the local government. Maximum credit granted includes state and local sales and use tax, when indicated. Evidence showing tax has been paid must substantiate claims for tax credit.

Reciprocal credit is only to be recognized when possession of tangible personal property is taken in a reciprocal state and subsequently brought into the Commonwealth. For example, if a Pennsylvania based company purchases \$1,000.00 worth of office supplies in Maryland, takes possession of the goods in Maryland, and pays the Maryland 5% sales tax (\$50.00), the transaction would be subject to an additional Pennsylvania tax of \$10.00 (6% of \$1,000 = \$60.00 less \$50.00 reciprocity credit) when the goods are brought into Pennsylvania.

However, if a taxpayer purchases tangible personal property from an out-of-state vendor who collected that state's tax and the taxpayer takes possession of the goods within the Commonwealth, the transaction is not subject to the reciprocal credit. The transaction would be fully subject to Pennsylvania tax and an erroneous overpayment of tax to the other state would exist. For example, if a Pennsylvania based company purchases \$1,000.00 worth of office supplies from a Maryland vendor, takes possession of the goods in Pennsylvania, and pays the Maryland 5% sales tax (\$50.00), the transaction would be subject to Pennsylvania tax of \$60.00 (\$1,000 x 6%). The Maryland tax (\$50.00) erroneously paid to Maryland cannot be offset as a reciprocal credit against the Pennsylvania tax (\$60.00) and the taxpayer would be entitled to a \$50.00 refund from Maryland.

There are two provisions in the New York state sales tax law that could possibly affect the incidence of tax for Pennsylvania:

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The first exemption available to New York taxpayers involves the receiving of property in bulk. If the property is later distributed to various states, then the original acquisition of the property is exempt from tax. Therefore, if the records indicate that New York tax was paid on such acquisitions, it may be possible that the tax was not legally due to New York and the auditors should not apply any reciprocal credit. Instead, the full amount of the Pennsylvania sales tax is due on the property used within the Commonwealth and should be assessed.

The second instance, which also involves the New York state sales tax statutes, regards New York contractors who acquire property within the state of New York and install such property outside their state. In such instances, the contractor is required to pay the tax at the time of purchase and apply for a refund from the New York State Tax Commission upon the installation of the property into real estate outside of New York.

The Department of Revenue does not allow credit for New York sales taxes paid when the New York state contractor acquires property within the state of New York, pays New York sales tax, transports the property to Pennsylvania, and upon installation in Pennsylvania, the property becomes real property.

The reason for disallowing this credit is the fact that the New York contractor has the legal right to obtain a refund or credit of the New York state sales tax originally paid on the property since that property is properly subject to tax in Pennsylvania.

(See New York law at CONSOLIDATED LAWS, CHAPTER 60 TAX LAW, Article 28 Sales and Compensating Use Taxes, Part III Exemptions. Sec.1119. Refunds or credits based on proof of certain uses--)

W. REMOVING RECORDS FROM AUDIT SITE

All sales and use tax audits are to be performed at the taxpayer's place of business unless the taxpayer specifically requests that the auditor examine the records at the regional office or if there are other unusual circumstances in which it would not be prudent for the auditor to perform the audit at the taxpayer's business location.

Prior to removing records, the auditor is to acquire the regional manager's approval through the audit supervisor. Also, the auditor is to give the taxpayer a detailed receipt of all records removed, signed by both the auditor and the taxpayer. When records are returned, the auditor is to acquire a receipt signed by both the auditor and

the taxpayer recording the fact that the taxpayer received all records originally removed. These receipts are to be included as an exhibit to the audit report and reference must be made in the narrative report explaining the reason for the removal of records.

An example of such a receipt for record removal is as follows:

On ___(Date) , I _____(Taxpayer) authorize

_____(Auditor)_____ to remove records for the purpose of performing the audit in the regional office.

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The records removed are as follows:

1. _____
2. _____
3. _____

Auditor Signature and Date

Taxpayer Signature and Date

All referenced records were returned to me _____(Taxpayer) by _ Auditor)_____ on

(Date)

Taxpayer Signature and Date

Auditor Signature and Date

X. REQUESTING RECORDS

The following covers two main categories of record requests as well as information about requesting records from third parties:

- Procedures for obtaining records necessary to identify detailed transactions.
- Procedures for obtaining specific source documents.

1. Obtaining Records for Detailed Transactions

This procedure should be used when records necessary to identify the detailed transactions are needed. Failure to provide the requested information would lead to a severe scope limitation resulting in an assessment that is not based on specific transactions.

All requests for records allowing 30 days or more must be on a Request for Financial Records.

If the taxpayer wishes a period longer than 30 days to obtain the requested records, the request must be in writing on the taxpayer's letterhead. The request must specifically indicate the date on which the records will be made available for examination.

The auditor should make arrangements to return on or shortly after the date identified on the form or the taxpayer's selected date.

The auditor will follow up the request for financial records with a letter to the taxpayer. The letter should reference the requests and the date on which the auditor will return to review the requested records. If applicable, the letter should reference the taxpayer's written request acknowledging the date the taxpayer agreed to make the records available.

The letter will be copied to (at a minimum) the department head. A department head is generally the individual responsible for the taxation function of the company and usually reports to a corporate officer.

Upon the return of the auditor on the agreed upon date, the auditor will review the records made available.

Records not made available will be requested on a second Request for Financial Records. The taxpayer will be given an additional 30 days to produce the records.

A copy of the 2nd request should be mailed to the taxpayer, the department head, and a corporate officer along with a cover letter indicating that this is a second request and that the records requested were not made available on the originally agreed to date. The date of the auditor's return should be indicated in the letter. The original request and second request should be included as attachments to the letter.

At the end of thirty days, the auditor will examine the records made available. The auditor will compute the total liability (credit) based on the information presented. Missing documentation will result in the items being coded as deficient.

After appropriate adjustments are made, all worksheets and schedules should be presented to the taxpayer. If a jeopardy assessment will result from the failure to provide requested documents, provide the taxpayer with a schedule(s) documenting the amount of the anticipated assessment. Also, provide a letter indicating the date of the post audit conference. Identify the last date any additional documentation will be accepted for review. This letter should be sent to the taxpayer's representative, the department head, and a corporate officer. Thirty days should be granted from the date of the letter to the date any additional documentation must be presented.

Upon the auditor's return to conduct the post audit conference, appropriate adjustments will be made to the audit findings and the audit will be closed.

2. Obtaining Specific Source Documents

This procedure should be used when information has been made available to identify specific transactions, but the source documents necessary to properly determine the proper application of tax to the transactions have not been provided. This situation would apply to the request for source documents such as exemption certificates, purchase orders, specific sales invoices, and specific purchase invoices.

All requests for specific source documents or supporting documentation that allow 30 days or more must be on a Request for Financial Records.

The request will list the specific documents requested or reference an attachment that lists the specific documents requested.

If the taxpayer wishes a period longer than 30 days to obtain the requested records, the request must be in writing. The request must specifically indicate the date on which the records will be made available for examination.

The auditor should make arrangements to return on or shortly after thirty days or the taxpayer selected date.

Upon the return of the auditor on the agreed upon date, the auditor will review the records made available and will make the appropriate adjustments to the audit findings.

The auditor will compute the total liability or credit based on the information presented. Missing documentation will result in the items being coded as deficient.

All worksheets and schedules should be presented to the taxpayer for review. A date for a post audit conference should be established. The taxpayer should be informed that any additional information presented to the auditor by a specified date prior to the post audit conference will be reviewed, the worksheets and schedules will be adjusted, and the post audit conference will commence immediately following the adjustment of the schedules.

If the taxpayer does not require time to review the adjusted worksheets and schedules and the taxpayer agrees to the assessment of the missing items or indicates that they will not be able to locate the records, the post audit conference may be held without granting additional time.

3. Requesting Records from a Third Party

The confidentiality provisions of the Sales and Use Tax Act require approval in those instances where an auditor contacts the supplier or customer of a taxpayer under audit for information.

The auditor should request that the taxpayer secure all necessary documentation to conduct the audit. A Request for Financial Records should be presented to the taxpayer for all necessary records not made available.

When the taxpayer does not have records in their possession, they may obtain documentation from third parties.

The auditor may not contact a third party for documentation unless express written consent has been obtained from the taxpayer.

The only exception to the requirement to obtain written permission from the taxpayer is when third party contact is necessary in establishing fraud. Should the reason for contacting a supplier be to establish fraud, you are to request the approval of the Director of the Bureau of Audits. All facts surrounding the audit must be explained in the request. Approval will then be sought from the Office of Chief Counsel in order to protect the auditor from the charge of violating confidentiality.

a. Sample Letter

ABC Company
1001 Market Street

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Harrisburg, PA 17043

Jones Motor Company
1300 Second Street
Harrisburg, PA 17042

Dear Mr. Jones:

This is to authorize Department of Revenue Field Auditor _____
(Auditor Name)

access to records and/or transactions regarding our business activities for the period
_____ to _____.

(Begin Audit Period) (End Audit Period)

Should you have any questions regarding the auditor's request for records, please call

_____ at _____.
(Name of Contact Person) (Telephone Number)

(Corporate Office, Partner, or Owner's Signature)

(Date)

Y. RESEARCH AND DEVELOPMENT – TESTING LABORATORIES

The auditor must use the following methods to determine whether a testing laboratory qualifies for the manufacturing/research exemption:

Determine areas that are not directly used in manufacturing – managerial activities, sales activities, or other non operational activities of a research establishment or project, motor vehicles, & etc.

The test laboratory may concede certain labs/division as not qualifying for an exemption under the Lancaster Labs court decision. Labs that only test water samples or do nutritional label testing may be excluded.

The taxpayer under audit must survey customers to determine whether the testing being done for clients qualifies for the manufacturing/research exemption.

Sample Questions:

- Describe your company's general business operations and the specific business activities that were relevant to your transactions with (taxpayer's name).
- For the listed invoices, please describe the services that were provided by (taxpayer's name) and the specific segment(s) of your business to which the services relate. If samples were submitted for analysis, please describe the nature of the submitted samples and from where in your business process the samples were generated.
- Describe the primary objectives of the services that were provided by (taxpayer's name).

The taxpayer must be able to provide total revenue per customer and based on determination for each customer, calculate revenue generated from activities that meet the threshold of manufacturing in Lancaster Laboratories and or qualify as contract research. “Exempt Customer Revenue” / Total Revenue = %. If the percentage is more than 50%, the lab equipment and supplies qualify for the manufacturing exemption.

If the taxpayer refuses to do the survey, this will be documented in the audit narrative and should be formally documented by a “Request for Financial Records” or other evidence that the request was made and the taxpayer refused. All assets and expenses will be assessed. This procedure has been sustained through BOA and BF&R.

Z. SECRETARY’S WRIT

A Secretary’s Writ may be used when the Department determines that it is necessary to issue a formal demand for access to the financial records or for information pertaining to the tax matters of a particular individual or business. The writ is prepared in headquarters for the signature of the Secretary of Revenue or their representative. The Department seal is affixed to all writs. Legal citations pertaining to the writ are on the back page.

1. Requesting A Secretary’s Writ

The auditor and supervisor must submit the following documentation to the sales and use tax program manager:

- Name, address, assignment number, audit period, EIN, and tax account number.
- A report outlining the facts in the case, i.e., attempts to contact the taxpayer and the taxpayer’s failure to provide requested information.
- Copies of correspondence, log of phone calls, visits, Order to Appear, and certified mail receipt or statement from the auditor attesting to receipt of the Order to Appear letter by the taxpayer.
- Name and address (residence and/or office) of person or institution to be served with the writ. Examples: owner, officer, partner, bank, or financial institution.
- Information required to complete the audit assignment should be as detailed as possible, yet tailored to the type of information the subject of the writ can supply.
- If multiple writs are needed for the same audit, the requests may be combined, provided the required information for each subject is provided. This usually only occurs when writs are requested for owners, officers, or partners as well as financial institutions.

2. Serving A Secretary's Writ

Headquarters' personnel will prepare the writ to be signed by the Secretary's designee. The signed Writ will be forwarded to the audit supervisor. The supervisor is responsible for the following:

- Contacting the local sheriff's office to determine the local procedures prior to requesting a writ from headquarters.
- If the sheriff's office requires payment in advance, the name of the person to be served along with the sheriff's office name, EIN, address, and payment amount are to be provided with the request for a Secretary's Writ in order to have the check prepared. When the check is written, it will be forwarded to the regional office to be delivered to the sheriff's office along with the Writ.
- If the sheriff's office does not require payment in advance, the name of person that was served, the sheriff's office name, EIN, address, and the payment amount are to be emailed to the headquarters' administrative section to have a check prepared.
- Filling in the date to appear on the Writ; generally, the date entered should be postdated at least four (4) weeks from the date the Writ is expected to be served.
- If the writ is a formality requested by a taxpayer or financial institution, it may be served by an auditor, supervisor, or by mail and arrangements for receipt of the information coordinated with the subject of the writ.
- If the taxpayer fails to respond to the Writ, a written report must be filed with the Director's office. This report must include the case history, copy of the Order to Appear letter, acknowledgement of receipt, and a copy of the Writ. This report is forwarded to the Office of Chief Counsel for the appropriate court action. The taxpayer who fails to comply with the Writ may be held in contempt of court.

AA. SERVICES – EMPLOYEE COSTS

The Bureau will allow the purchaser to obtain amended invoices or statements from the vendors establishing the amount of employee costs when such costs were not listed on the original invoice. This policy will apply to only the purchaser of Help Supply, Employment and/or Interior Office Cleaning services.

The statements from the vendors must be on the vendor letterhead and signed by the vendor or authorized representative and include the period of time of the transactions and the percentage of employee costs on each individual invoice or the aggregate percentage of employee costs.

BB. TAXABLE USE OF EQUIPMENT PURCHASED EXEMPT FOR RESALE, RENTAL OR CHARTER

When a taxpayer purchases equipment or other items exempt from tax by claiming resale, rental or charter, the taxpayer is responsible for self-assessing use tax on the fair rental value of the item put to taxable use. Fair rental value will be considered to be the prevailing market rate (by hour, day or month). If the rental usually includes an operator, the cost of the operator may be subtracted from the prevailing market rate to arrive at the fair rental value. Operators supplied by anyone other than the owner of the equipment should be treated as help supply.

The auditor should document the determination of the fair rental amount established by use of supporting documentation such as rate schedules or price lists.

Note: The tax applicable to the fair rental value of items purchased for resale, rental, or charter should not be confused with items that are determined to be exempt from tax due to predominance of use.

CC. TAXES PAID, PURCHASES RESOLD

Taxes Paid, Purchases Resold (TPPR) credit will be recognized and is explained in 61 Pa. Code §58.11, Taxes Paid; Purchases Resold. The TPPR credit is to be allowed for the entire audit period. This situation arises when the taxpayer pays tax on tangible personal property that the taxpayer later resells. The taxpayer claims this credit on line 8 of the Sales and Use Tax Return. Credit within an audit for TPPR credits may only be granted on a complete basis. An attestation letter must be obtained prior to granting TPPR credits.

DD. TEMPORARY SALES TAX LICENSES

Temporary licenses are no longer being issued. This information is supplied in case the auditor encounters Exemption Certificates that contain temporary sales tax license numbers.

Temporary sales tax licenses are called vendor sales tax licenses and contain 7 digits. The first 2 digits represent the district office from which the number was issued; the next 5 digits represent the item number. If the vendor is a transient vendor, the number will also contain a T at the end.

EE. WAIVERS

This form is used to extend the time limit for record retention and assessment of the specific tax under audit. When collateral audits are performed on different types of taxes, a separate waiver is needed for each type of tax.

When properly completed, the waiver becomes a binding legal document. The revenue regional manager is ultimately responsible for obtaining the waiver and the timely completion of the assignment.

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Prior to September of each year, the audit supervisor must review each auditor's assignment inventory. The assignments by date of assignment and potential for material adjustments to reported figures must be prioritized.

In those instances where the taxpayer has not responded to the auditor's reasonable attempts of contact, the auditor should discuss alternative methods of audit with the supervisor.

However, in those cases where a taxpayer requests a delay and it is doubtful that the auditor can complete the audit by statutory deadlines, the agreement to delay the beginning of the audit must include the taxpayer's agreement to waive the period subject to the statute of limitations. The auditor must timely submit the completed waiver to their supervisor for review.

In those cases where the taxpayer refuses to allow the auditor access to the records, the auditor must follow the Bureau's policy for requesting records.

The taxpayer must not be asked to sign a waiver nor should the auditor examine the period about to be lost due to the statute of limitations or record retention requirements on any audit assignment dated or started within two months of the expiration of statute. Generally, this means November 1. The only exception is when the audit is coded as priority or mandatory and contains instructions regarding the period to be audited.

The audit supervisors are to monitor each audit in progress on which a waiver has been obtained to make sure that the auditor begins and completes the audit timely and allows sufficient time for the audit assessment to be mailed before the period expires. As part of this monitoring process, the audit period beginning and ending dates should be entered into AASTART as soon as possible.

The above waiver policy does not pertain to trust fund money taxes collected and not reported. Taxes collected and not reported may be assessed for any period beyond the statute.

Chapter 6 – AUDIT REPORT

Purpose

The purpose of the audit report is to document audit findings and to provide a clear basis of assessment to all parties that may be involved in a potential appeal. These parties include the taxpayer, practitioners, administrative boards, and state courts. Interested parties also include auditors and management staff who may be called to testify in hearings or who are involved in a follow up audit. An audit report is, therefore, intended to be a self-sustaining record. The audit report must independently account for all events that impact audit findings.

Content

The audit report is made up of a narrative and supporting documentation. The narrative provides a written explanation of audit procedures, audit findings, and the legal basis for any assessment. Supporting documentation includes schedules, worksheets, exhibits, and forms. This documentation is intended to summarize, itemize, and illustrate audit findings.

Each piece of documentation within the report, including the narrative, is considered evidence. The evidence presented in the audit report supports the Department's issuance of a tax assessment. Therefore, audit documentation must be prepared in such a way that it can rebut challenges made during an appeal by accurately depicting the facts on which the assessment is based. The Bureau has implemented certain requirements that must be followed in the preparation of each part of the report with this objective in mind. These requirements are listed below.

A. NARRATIVE

The audit narrative is the auditor's written explanation of audit procedures and the legal basis for assessment. The narrative should be written as the audit progresses. For instance, the pre audit section of the narrative should be prepared as soon as the conference is completed so that pertinent details about the discussion are not forgotten. This will allow the auditor to record events timely and accurately. It will also contribute to efficient conduct of the audit.

The narrative cites the provisions of the law and Department regulations that pertain to the audit findings. It also serves as the document that ties the entire audit report together by referencing all other supporting documentation. This is the mortar that cements the various supporting data into a meaningful whole.

General Rules

There are general rules of “do’s and don’ts” that apply to the body of the narrative.

Do....

- Do cite laws and regulations where appropriate. This includes narrative discussions of areas contested by the taxpayer, areas of large deficiency, and an area of potential appeal as well as cites that apply directly to the taxpayer’s line of business. Cites should be as specific as possible and must be written in the proper format.

Cites to the law:

72 P.S. § 7201(o) (4) (B) (ii)

Cites to regulations, rulings and pronouncements:

61 Pa. Code §32.21(a) (2) (ii) (B)

If the cite to a regulation, ruling or pronouncement is used at the beginning of a sentence, the word “Title” must be inserted in front of the cite. For example:

Title 61 Pa. Code §32.21(a) (2) (ii) (B)

Additional citation formats are listed in Appendix 4 – Codes and Information Lists “Citation Formats”.

- Do reference and explain all schedules and worksheets. The name of the document as listed on the Index should be the name by which the document is referenced in the narrative. Reference all forms presented to the taxpayer for signature.
- Do use correct spelling, grammar and punctuation.
- Do write the narrative in third person (the auditor, the taxpayer, etc.).
- Do consult this manual in the preparation of the narrative.

Don’t...

- Don’t reference supervisors, management staff, or headquarters personnel in the narrative. However, supervisor or manager attendance at a pre or post audit conference must be referenced.
- Don’t reference internal memos, documents or email. These items are confidential. Internal documents may be referenced on the Conflict of Interest Statement and Auditor’s Comments.
- Don’t reference letter rulings in the narrative unless the Office of Chief Counsel has directly addressed the ruling to the taxpayer under audit.

- Don't use "canned" narratives. "Canned" narratives are prewritten narratives that often contain data from a different audit report.
- Don't wait until the conclusion of the audit to begin writing the audit narrative.

1. Pre Audit Conference

The purpose of this section of the narrative is to document initial contact with the taxpayer and the information discussed with the taxpayer prior to the beginning of the audit. Therefore, this part of the narrative must specifically address the following areas:

a. Name

The taxpayer's legal and trade names must be identified.

b. Engagement Letter & Related Items

This section of the narrative must give the date that the Audit Engagement Letter, copy of the REV-554 Disclosure Statement of the Department's and Taxpayers' Rights and Obligations, and Computer Audit Feasibility Questionnaire were sent to the taxpayer. Each of these items must be specifically addressed. The engagement letter must be specifically referenced in the narrative by exhibit. This section of the narrative must also disclose the taxpayer's acknowledged receipt of these items. If the taxpayer claims that these items were not received, then this section of the narrative must also state that they were given to the taxpayer, with appropriate explanation, at the pre audit conference.

c. Follow up Contact

The date and place of follow up contact to set an appointment for the conference must be described. If numerous attempts were necessary to establish contact, then this section of the narrative should reference an exhibit that documents each attempt. The narrative must reference any additional correspondence with the taxpayer with appropriate references to exhibits (i.e. confirmation letter).

d. Conference Information

The date, place, and length of the pre audit conference must be specifically stated.

e. Attendees

The names and titles of attendees must be included in the narrative. This section must also indicate if any of the taxpayer's representatives are operating under "Power of Attorney" authorization. A copy of the appropriate verification must be included in the audit report as an exhibit and referenced in the narrative.

f. Registration Update/PA-100

The completion by the taxpayer of either the Bureau of Audits – Registration Update form or the PA-100- Pennsylvania Enterprise Registration form must be noted in this section of the narrative.

g. Requirements for the Audit Review of Third Party Credits Form

The narrative must specifically state that the auditor reviewed the form with the taxpayer, informed the taxpayer the date by which supporting documentation must be presented, and that the taxpayer was presented with a copy of the form.

h. Audit Period

The audit period must be specifically identified in this section of the narrative. If the defined period is not in conformity with the standard audit period (three years plus the current), then this section of the narrative must provide an appropriate explanation. Waivers signed by the taxpayer that extend the audit period must be referenced in this section with a description of the facts surrounding the need for the form.

i. Audit Scope

This generally involves a statement describing the taxes being examined as part of the audit.

j. Taxpayer Records

This generally consists of a statement discussing record requirements and availability.

k. Areas of Discussion

Information regarding entity changes, affiliates, collateral audits, and bankruptcy must be included in this section of the narrative. Information on bankruptcy must include the bankruptcy date, cause number, bankruptcy type, and bar date. In addition, issues regarding nexus or information given by the taxpayer via a Business Activities Questionnaire must be addressed.

l. Location of Audit

This section of the narrative must specifically list the address of the location where the audit was conducted.

m. Plant Tour

This section of the narrative must indicate what arrangements, if any, were made for a plant tour.

2. Business Activities

This section of the narrative is intended to provide a clear description of the taxpayer's nexus with Pennsylvania, entity type, line of business, and tax exposure. Specifically, this section of the narrative must indicate the laws and regulations that apply to the taxpayer under audit. This section of the narrative must address the following items:

a. Entity Type

The type of entity must be specifically stated. The most common types of entities are: sole proprietorships, partnerships, corporations, subchapter "S" corporations, joint ventures, associations, limited liability partnerships, and limited liability corporations. If the entity is a corporation, the date and state of incorporation identified on the registration update form or the PA-100 must also be stated.

b. Business Locations

This section of the narrative must specifically list and describe the taxpayer's Pennsylvania business location(s). The description should include the start date and end date for the facility if the location did not operate during the entire audit period, location, local tax jurisdiction, and activities (e.g. warehouse, office, etc.) When the taxpayer under audit has more than one location, an exhibit giving a list and description of all Pennsylvania locations must be included in the audit report and referenced in the narrative.

c. Business Operations

The start date (see PA-100 section 1, block 2 or KITS R118) and the end date of the taxpayer's operations in Pennsylvania must be stated. A description of the taxpayer's business operations must also be provided. Examples of business operations include: retailer, construction contractor, manufacturer, etc. If the taxpayer is a manufacturer or processor, then this section of the narrative must provide a general description of where the exemption begins (first step in manufacturing) and where it ends (last step in manufacturing). Sales and use tax regulations pertaining to the taxpayer's business operations must be referenced as part of this description.

d. Sales

This section of the narrative must specifically identify the taxpayer's taxable and nontaxable sales. If the taxpayer's sales activities include the charging of local, PTA, or VRT taxes, this must also be included as part of the description.

e. Purchases

This section of the narrative must specifically identify the taxpayer's taxable and nontaxable purchases. If the taxpayer's purchases are subject to local, PTA, or VRT taxes, this must also be included as part of the description.

3. System Survey

The purpose of this section of the narrative is to provide a description of the taxpayer's financial records used to document the flow of sales and purchase transactions from the source documents through the taxpayer's accounting system to the sales and use tax return. It is also to provide an overview of all available records and the taxpayer's reporting history. All records referred to in the narrative must be addressed as part of the system survey. The following items must be addressed in this section of the narrative:

a. Audit Trail

This description must include a step-by-step explanation that traces the information reported on the sales and use tax return from the source document through the accounting system to the return. In instances where the taxpayer has not filed a return or accrued tax, a description of the taxpayer's existing record keeping system for sales and purchases must still be provided.

b. Reporting History

A description of the taxpayer's reporting history that indicates filing frequency, periods filed late, nonfiled periods, and periods filed without remittance. This description must include a reference to the Returns As Filed schedule.

c. Accounting System

The narrative must provide information on the taxpayer's fiscal year, accounting basis (accrual vs. cash), and type of system (manual vs. computerized). This section of the narrative must also describe how the taxpayer calculates tax. Any changes in the accounting system must also be addressed.

d. Records

A list of available records used by the auditor must be provided in this section of the narrative. This list should include those records that may not be a direct part of the sales and use tax audit trail but are still relevant to the audit of the tax return (e.g. Chart of Accounts).

4. Audit Procedures

This section of the narrative must explain records and procedures used to determine the taxpayer's compliance with tax laws and regulations.

a. Gross Sales

The narrative must describe the results of verifying gross sales as reported on the tax returns to the appropriate federal or state income tax returns and the general ledger for the audit period.

There must be a clear explanation of the records used to verify gross sales as well as an explanation of any variances. Significant variances should be supported by a schedule. The Comparison of Reported Sales to Book Sales schedule must be specifically referenced.

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If federal or state returns are not available for the verification of gross sales, the narrative must disclose that a Request for Financial Records was given to the taxpayer and explain the reasons the records were not provided.

Other sources used to verify gross sales in the absence of federal or state returns must be specifically identified.

The audit report must provide an approximation of the number of sales transactions per month and identify how the approximation was determined.

b. Sales Tax Accrual Account

The narrative must clearly state the findings of comparing the taxpayer's reported sales tax to amounts recorded in the taxpayer's sales tax accrual records and general ledger accounts. The narrative must also describe the records and procedures used to verify remittance by the taxpayer to the Department of all sales tax collected.

The narrative must reference the Reconciliation of Accrual Amounts (Book to Reported) schedule.

Variations must be explained and documented.

c. Credits Taken

Credits taken on the sales and use tax return must be discussed in this section of the narrative. The discussion should include whether or not the credits were legitimate and the basis for any disallowance by the auditor.

d. Nontaxed Sales

The narrative must specifically state the type of audit conducted (i.e. complete, modified complete, test). The narrative must discuss the tracing of a sample of invoices to the books of original entry to the return to verify the proper recording of all invoices. Also, explain the tracing of entries from the books to the invoice to verify all invoices were made available for examination. In addition, the narrative must address the completeness of the taxpayer's computer records. The method used to verify the status of the computer records must be disclosed.

If a test audit was conducted, the narrative must provide the details of the test plan. This includes the disclosure of the reason for testing, the test type, the test period selection criteria, the test periods, and the actual procedures. The test plan disclosed in the narrative must be consistent with the test information provided on the Taxpayer's Concurrence with Test Audit Plan form. The information presented in the narrative and on the form must disclose the Department's full compliance with 61 Pa Code § 8(a). This information must be recorded in the narrative for each separate test.

If a modified complete audit was conducted, the narrative must specifically describe the original periods, time frame, or area reviewed that was used to determine the modified examination of the remainder of the audit period.

The narrative must describe the records examined during the audit.

The narrative must specifically state the amount of time given for the taxpayer to obtain exemption certificates or statements.

A general description of the items assessed and the basis of assessment must be given.

The narrative must provide appropriate detail for major areas of assessment and areas contested by the taxpayer. This includes referencing the laws and regulations that support the assessment.

Reference must be made to the related invoice detail worksheets as well as pertinent schedules and exhibits.

e. Use Tax Accrual Account

This section of the narrative must clearly state the findings of comparing the taxpayer's reported use tax to use tax accrued in the taxpayer's books. The narrative must describe the records and procedures used to verify remittance by the taxpayer to the Department of all use tax accrued. The narrative must reference the Reconciliation of Accrual Amounts (Book to Reported) schedule and discuss the tracing of a sample of invoices to the return to verify the proper recording of all invoices. Variances must be explained and documented. If reported amounts cannot be traced to a use tax accrual account and an itemized listing of the specific purchases, specifically state that fact in the narrative.

f. Use Tax – Capital Purchases

The narrative must describe the methods and records used to conduct an audit on capital purchases made by the taxpayer during the audit period. This includes referencing the taxpayer's fixed asset/depreciation schedule exhibited as part of the audit report. The taxpayer's capital asset listing must be verified by tracing entries from the general ledger to the federal tax return or other independent source. The auditor must also examine fixed asset accounts in the general ledger for current year items not yet included on the depreciation schedule. If asset purchases were found to be deficient, a general description of the item(s) and basis of assessment must be given.

The narrative must state the approximate number of capital purchases made during the audit period and indicate the source.

The narrative must provide appropriate detail for major areas of assessment or taxpayer contested areas. This includes referencing appropriate laws and regulations.

The capital worksheets, together with related schedules and worksheets, must be referenced.

g. Use Tax – Expenses

The narrative must explain how sample entries were traced from the books of original entry to the expense purchase invoices to make sure all invoices were available for review when records are presented. The narrative must address the completeness of the taxpayer's records. The method used to verify the status of the records must be disclosed.

The narrative must state the approximate number of expense transactions per month or year and identify how the approximation was determined.

There must be a description of the type of audit performed (i.e. test, modified complete, complete).

If test procedures were used, then this section of the narrative must include a statement that gives the reason for conducting a test (i.e. volume of records, record availability, etc.). The criteria for selecting test periods must also be given. The selected test periods and test method must be described. Reference must be made to the Taxpayer's Concurrence with Test Audit Plan form as well as a test period selection schedule, error rate calculation schedule, and a projection schedule. The information given in the narrative must be consistent with information given on the form and must reflect compliance with 61 Pa. Code § 8(a).

If a modified complete audit was conducted, the narrative must specifically describe the original periods, time frame, or area reviewed that was used to determine the modified examination of the remainder of the audit period.

There must be a general description of nontaxed purchases assessed by the auditor and the basis for assessment.

An audit of a construction contractor must also separately address job costs from actual company expenses. Job costs are not traditional expenses and contractor audits require separate purchase examinations from actual company expenses.

The narrative must provide appropriate detail for major areas of assessment or taxpayer contested areas. This includes appropriate cites to laws and regulations.

Reference must be made to the appropriate invoice detail worksheets as well as summary schedules and any related exhibits that support narrative statements.

h. Third Party Credit

The narrative must specifically explain third party credits granted in the audit and reference the related worksheet. The third party credit worksheet is required to be included in the audit report and referenced in the narrative. The narrative should also explain why credits requested by the taxpayer were denied. All corresponding schedules, worksheets, and exhibits supporting the granting or denial of the credits must be referenced.

5. General Discussion

This section of the narrative deals with other areas pertinent to the audit. These areas include:

a. Unusual Areas or Findings

If the deficiency in the current audit is significantly different than previous audits, an explanation must be provided.

b. Employer Withholding of Pennsylvania Personal Income Tax

This section of the narrative must describe the results of comparing taxable wages and personal income tax withheld as reported to the Department via W-2 transmittal and W-3 returns to the taxpayer's records. The narrative statement must be supported by a referenced schedule. Records and periods examined must be specifically identified.

When the taxpayer has remitted all taxes due but has nonfiled returns, the narrative must indicate that the taxpayer was instructed to file the missing returns. The missing returns presented to the auditor should be filed with the completed audit report via the Additional Headquarters Processing Request.

If the initial exam of these records results in a collateral audit, then the resulting audit assignment must be referenced.

c. Other Taxes

The narrative must provide a general statement that describes the exposure and compliance with PTA and VRT taxes. Records and periods examined must also be identified. Collateral audits must be identified via the audit assignment number.

For sole proprietors, partnerships, and subchapter "S" corporations, the narrative must describe the taxpayer's compliance with Pennsylvania Personal Income Tax requirements. The narrative must state that the business income was reviewed and that the entity properly reported the income to the principles on a RK-1 or NRK-1 form. If an entity's income tax return was not filed with the Department, state the year or years not filed.

d. Civil Penalties

This section of the narrative must address recommendations for major penalties based on the taxpayer's failure to remit taxes collected. The following language should be used in the narrative when it is being recommended that major penalties be assessed:

"The major penalty was imposed in accordance with 72 P.S. §7267(b) for the failure to report sales and use taxes of _____ for the period beginning _____ and ending _____ as recorded on Schedule _____."

6. Post Audit Conference

The purpose of this section of the narrative is to document the information presented to the taxpayer by the auditor at the conclusion of the audit. This section of the narrative must specifically address the following areas:

a. Conference Information

The date, place, and length of the post audit conference. If the conference is conducted by telephone, the time of day must also be specifically indicated in the narrative. The follow up Post Audit Conference Letter must also be referenced in this section.

b. Attendees

The names and titles of attendees must be listed in this section of the narrative.

c. Audit Findings

The total deficiency must be stated in this section of the narrative with reference made to the audit summary schedule. The audit period and deficient tax must be specifically identified. A description of documentation provided to the taxpayer must be stated. Recommendations made to the taxpayer for correction must also be stated.

d. Interest and Penalty

The narrative must disclose that the Department's policy on interest and penalty as it relates to the deficiency was explained to the taxpayer.

e. Payment

There must be a description of payments received by the auditor during the conference. This description must include the liability for which it is intended, check date, check number, and amount of payment. The description must reference an exhibit of the collection envelope and check.

f. Appeal Rights

This section of the narrative must disclose that appeal rights, as well as appeal procedures, were explained to the taxpayer. The narrative must specifically state that the taxpayer was informed that the statute of limitations for all credits related to the audit period is six months from the date on the notice of assessment.

g. Taxpayer's Acknowledgement of Post Audit Conference Form

The narrative must disclose that the taxpayer was presented with the Post Audit Conference form for signature. The taxpayer's concurrence or intent to appeal must be stated.

h. Areas of Disagreement

Areas of disagreement must be addressed in this section of the narrative. Taxpayer arguments against the audit findings should be discussed. In addition, the basis for assessment on any disputed items should be restated.

B. SCHEDULES

Audit schedules are generally intended to summarize audit findings and itemize certain transactions not included on the worksheets. Schedules must be prepared in accordance with the Bureau's standard format described below:

- Each page of each schedule must be properly headed. Headings must include the assignment number, taxpayer's name, sales tax account number, employer identification number, audit period, schedule name, and schedule number.
- Schedules must be paginated using the Page X of Y format (e.g. Page 1 of 2).
- Schedules must reference any supporting worksheets or other documentation.
- Footnotes should be included to provide necessary explanations.
- Schedules must be footed and cross-footed to prove mathematical accuracy.
- Schedules must be neat and legible.

There are several schedules that must be submitted with each audit report. These schedules are standardized and are created through the Bureau's computerized Audit Application program. Schedules that must be submitted with each audit report include:

- Returns as Filed
- Comparison of Reported Sales to Book Sales
- Reconciliation of Accrual Accounts (Book to Reported)
- Final Summary of Deficiency

Audit reports that include a deficiency must also include:

- Recap Schedule

Audit reports that assess a local tax deficiency must also include a schedule showing:

- Summary of Tax and Major Penalty Due By Jurisdiction

Audit reports that include test procedures must also include the following schedules:

- Test Period Selection or a Request for Financial Records
- Error Rate Calculations
- Projection Details

If the test involves credits, the audit report must include:

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- Credit Error Rate Calculation Schedule
- Credit Projection Detail Schedule

If the test involves local and state tax, separate test schedules must be prepared for each jurisdiction.

Audit reports that involve statistical sampling must include the following schedules:

- Error Rate Computation
- Error Rate Projection
- Precision Calculation

Audit reports that include credits recognized as part of the audit must include:

- Credit Recap Schedule

Audit reports that include a deficiency based on federal or state income tax returns must include a schedule that illustrates these differences. This is not a standardized form. The auditor customizes this schedule for each report.

Explanations for most of the schedules are explained below. Additional explanations for test schedules are explained in Chapter 4 Procedures – Examination Type and Chapter 10 – Computer Assisted Auditing

1. Returns As Filed

This schedule is required in every audit report. It is referred to as Schedule 1 and is the only pre numbered schedule in the audit report. It gives the information reported by the taxpayer through the PA – 3 Sales and Use Tax Return during the audit period. It also provides Department calculations based on the reported figures. The data on the schedule is based on information downloaded from the Department’s KITS system. However, this information may also be manually entered through the audit application system. The schedule includes:

- **Period** = Beginning and ending dates for monthly, quarterly or semiannual filing period.
- **Locality** = This field designates the jurisdiction to which the tax return pertains. “0” = State, “2” = Allegheny County (local tax), “51” = Philadelphia County (local tax). Please note that this schedule provides the filing history for each jurisdiction.
- **Gross Sales** = Gross sales reported by the taxpayer for the reporting period.
- **Taxable Sales** = Taxable sales reported by the taxpayer for the reporting period.
- **Sales Tax** = Sales tax liability reported by the taxpayer for the reporting period.
- **Use Tax** = Use tax liability reported by the taxpayer for the reporting period.
- **Credit** = Credits claimed by the taxpayer during the reporting period.

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- **Taxable to Gross** = This ratio is calculated by the Department and expresses taxable sales as a percentage of gross sales for the reporting period.
- **Sales Tax to Taxable** = This ratio is calculated by the Department and expresses total sales tax due as a percentage of taxable sales based on the information reported by the taxpayer. It is also referred to as the effective rate of tax.
- **Total for Year: (year)** = These are annual figures calculated by the Department that are based on all filed returns for the specified year.
- **Averages for Year** = These averages are calculated by taking the annual figures for each field and dividing the number by the total number of periods filed.
- **Total for State** (or Allegheny or Philadelphia) = These amounts represent the totals for all periods listed on the schedule by type of tax (State, Allegheny, Philadelphia).

2. Comparison of Reported Sales to Book Sales

This schedule is required to be included in every audit report. The auditor prepares this schedule through the audit application program. The purpose of the schedule is to document the comparison of sales information recorded in the taxpayer's books to the information reported to the Department by the taxpayer on the Sales and Use Tax Return. The auditor manually enters the numbers from the taxpayer's books when the numbers are different from those reported on the tax return. Differences are calculated by the application.

- **Period** = Beginning and ending dates for monthly, quarterly or semiannual filing period.
- **Locality** = This field designates the jurisdiction to which the tax return pertains. "0" = State, "2" = Allegheny County (local tax), "51" = Philadelphia County (local tax). Please note that this schedule provides the filing history for each jurisdiction.
- **Gross Sales – Book** = Gross sales recorded in the taxpayer's records for the filing period.
- **Gross Sales – Reported** = Gross sales reported by the taxpayer on the sales and use tax return for the filing period. This figure should match the gross sales figure for the same period on the Returns as Filed Schedule.
- **Difference** = This represents the difference between gross sales in the taxpayer's records and the gross sales reported on the sales and use tax return for the same reporting period.
- **Taxable Sales – Book** = Taxable sales recorded in the taxpayer's records for the reporting period.
- **Taxable Sales – Reported** = Taxable sales reported by the taxpayer on the Sales and Use Tax Return for the same reporting period. This figure should match the taxable sales figure for the same period on the Returns as Filed Schedule.

- **Difference** = This represents the difference between taxable sales in the taxpayer's records and taxable sales reported on the Sales and Use Tax Return for the same reporting period.
- **Book Taxable to Gross** = This field expresses the amount of taxable sales recorded in the taxpayer's books as a percentage of the gross sales recorded in the taxpayer's books. The audit application program automatically calculates this figure.
- **Total for: (year)** = This field gives yearly totals for each column of reported and book amounts.
- **Total for (State, Philadelphia or Allegheny)** = This field provides the total for all periods listed on the schedule based on tax type.

3. Reconciliation of Accrual Amounts (Book to Reported)

This schedule documents the tax liability reported by the taxpayer to the Department and the tax liability recorded on the taxpayer's books. This schedule must be included with every audit report.

- **Period** = Beginning and end dates for monthly, quarterly or semiannual reporting period.
- **Locality** = This field designates the jurisdiction to which the tax return pertains. "0" = State, "2" = Allegheny County (local tax), "51" = Philadelphia County (local tax). Please note that this schedule will always provide the filing history for each jurisdiction.
- **Sales Tax – Book** = Sales tax accrued as recorded in the taxpayer's records for the reporting period.
- **Sales Tax – Reported** = Sales tax due as reported by the taxpayer on the Sales and Use Tax Return for the filing period. This figure should match the sales tax figure for the same period on the Returns as Filed schedule.
- **Difference** = This represents the difference between sales tax accrued in the taxpayer's records and sales tax due reported on the sales and use tax return for the same reporting period. This difference becomes a tax deficiency or a credit.
- **Use Tax – Book** = Use tax accrued and recorded in the taxpayer's records for the reporting period.
- **Use Tax – Reported** = Use tax due reported by the taxpayer on the Sales and Use Tax Return for the reporting period. This figure should match the use tax figure for the same period on the Returns as Filed schedule.
- **Difference** = This represents the difference between use tax accrued in the taxpayer's records and use tax due reported on the Sales and Use Tax Return for the same reporting period. This difference becomes a tax deficiency or credit.

- **Total for Year:** (year) = This field gives yearly totals for each column of reported and book amounts.
- **Averages for Year** = These averages are calculated by taking the annual figures for each field and dividing the number by the total number of periods filed.
- **Total for (State, Philadelphia or Allegheny)** = This field provides the total for all periods listed on the schedule based on tax type.

4. Recap Schedule

This schedule is required to be in every audit report that includes a tax deficiency. This schedule breaks out the total tax deficiency by type (sales or use), by jurisdiction (state or local), and by individual reporting period. The figures are compiled through the worksheet and supplemental schedule totals prepared by the auditor through the Audit Application. Generally, the schedule begins with sales tax and is compiled automatically in the Audit Application using figures from the schedules and worksheets designated by the auditor.

- **Location** = Area of jurisdiction (i.e. State, Allegheny, and Philadelphia).
- **Period End** = The last date of the reporting period to which the deficiency pertains.
- **Sales Tax Recap Entries** = This field identifies the totals immediately following as sales tax deficiency totals.
- **Use Tax Recap Entries** = This field identifies the totals immediately following as use tax deficiency totals.
- **Accrual Dfcy** = The amounts in this field cross reference to the amounts in the “difference” field from the “Reconciliation of Accrual Amounts (Book to Reported)” for sales and use tax.
- **Sched (#)** = This field identifies the individual schedules from which totals are pulled by the audit application. The number of schedule headings depends on the number of schedules created as part of the audit report.
- **Worksheets** = This field shows the totals by period of tax deficiency listed on other worksheets.
- **Totals** = This field shows the total amount of deficiency per period, per tax type, by jurisdiction.
- **Total (Period Ending)** = This field totals the tax deficiency by document. The period total for each document should match the total “totals” due for the period.
- **Total Sales Tax** = This field gives the total sales tax due by document and for all the periods listed on the schedule.

- **Total Use Tax** = This field gives the total use tax due by document and for all the periods listed on the schedule.

5. Final Summary of Deficiency

This schedule is required in all audit reports. This report is prepared through the audit application. The purpose of the schedule is to summarize total sales and use tax deficiency by period. It includes the totals for state and local tax deficiency.

- **Period** = Beginning and ending dates for monthly, quarterly or semiannual filing period.
- **Sales Tax Deficiency** = This field gives the total amount of sales tax deficiency for each period listed.
- **Use Tax Deficiency** = This field gives the total amount of use tax deficiency for each period listed.
- **Total Deficiency** = This field gives the total sales and use tax deficiency for each period.
- **Totals for (year)** = This field gives yearly totals for each column.
- **Totals** = This gives the grand totals for each column.

6. Summary of Tax and Major Penalties Due by Jurisdiction

This schedule is required when an audit deficiency includes local tax. Its purpose is to provide separately stated totals for state and local tax. A sample page of a schedule and related heading definitions are provided below.

- **Period** = Beginning and ending dates for monthly, quarterly or semiannual filing period.
- **Deficiency for STATE** = The entries following this caption relate to state tax only.
- **Deficiency for ALLEGHENY** = The entries following this caption relate to Allegheny local tax only.
- **Deficiency for PHILADELPHIA** = The entries following this caption relate to Philadelphia local tax only.
- **Sales Tax Deficiency** = This field gives the total amount of state or local sales tax deficiency for each period listed.
- **Use Tax Deficiency** = This field gives the total amount of state or local use tax deficiency for each period listed.

- **Total Deficiency** = This field gives the total sales and use tax deficiency by period for the specified tax.
- **Major Penalties** = This field gives the amount of major penalty applied to each period.
- **Totals for (year)** = This field gives the total annual amount for each column.
- **Totals for STATE, ALLEGHENY or PHILADELPHIA** = This field gives the total amount due for each tax jurisdiction.
- **Overall Totals** = This field gives the grand totals for each column. This amount includes all jurisdictions.

7. Other Schedules

Auditors are permitted, and in some cases required, to create custom schedules, in addition to the mandatory standardized schedules, according to the needs of the audit report. These customized schedules may compile tax deficiency amounts or provide supplemental information that may clarify other schedules. Schedules giving tax deficiency totals must be imported into the audit report through the audit application.

C. WORKSHEETS

1. General

Worksheets are designed to itemize individual transactions found to be deficient. The audit application has standardized invoice detail worksheets which the auditor is required to use to document deficient sales, expense purchases, and capital purchases. Separate worksheets are required to be generated for state tax and local tax. The audit application allows these worksheets to sort the items in various ways. The title of each worksheet indicates the type of tax (state or local) and the type of sort used to present the information. Generally, the worksheets included in the audit report are sorted by period. Customized worksheets must be headed in accordance with the Bureau's standardized format (i.e. audit application).

2. Local Tax

Audit reports that include a local tax deficiency on sales or purchases must include separate worksheets for local tax and state tax.

3. Test Audits

Audit reports that include test projections must include the following worksheets for state and/or local tax when the worksheets are used to itemize deficient transactions:

For sales:

- Sales Tax Invoices Sorted by Projection

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- Sales Tax Invoices not used in any projection (if applicable)

For expenses:

- Expense Invoices Sorted by Projection
- Expense Invoices not used in any projection (if applicable)

These worksheets are generated by selecting the corresponding title from the SUT Audit App. Preview Rpt Menu using either the State or Local Invoice menu in the audit application.

These worksheets are used because the standard worksheets that sort by period do not clearly separate tested invoice amounts from the nontested invoice amounts.

4. Credits

Credits granted to a taxpayer as part of an audit must be supported by the Invoice Detail, All Credit Invoices, Sorted by Period worksheet that details the credits given by period.

A separate worksheet must be included in the audit report that contains the total third party credit granted in the audit report. If the credits developed are listed on a supplemental schedule prepared by the auditor or provided by the taxpayer, the period totals must be entered into the credit worksheet. Both the credit worksheet and schedule must be made part of the audit report.

Credit granted is based on the date the tax was paid to the vendor NOT the invoice date of the source document.

The worksheet (or the supplemental schedules supporting the worksheet entries) must provide sufficient information to support the granting of credit.

D. EXHIBITS

Generally, exhibits are documents supplied by the taxpayer and are included in the audit report to reinforce the audit findings. Exhibits may also consist of written correspondence between the Department and the taxpayer. All exhibits must be referenced in the narrative. There must be continuity among the exhibits. Each page of each exhibit must be properly headed using the following information:

- Audit Assignment Number
- Taxpayer Name
- Exhibit Letter
- Exhibit Name
- Sales Tax Account Number
- Employer Identification Number (EIN)
- Audit Period
- Page number

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Certain exhibits are required to be included in every audit report. These include:

- A copy of the Audit Engagement letter

- Copies of written correspondence with the taxpayer such as, cover letters for waivers, confirmation letters, and post audit conference letters, etc.
- A copy of the taxpayer's fixed asset/depreciation schedule

In addition to these standard exhibits –

- A listing of locations must be included in the audit report when the taxpayer has more than one location.

- A copy of an "Order to Appear" letter must also be included in the report when used during the course of an audit.

Other suggested exhibits include:

- Chart of Accounts
- Brochures provided by the taxpayer
- Photographs
- Copies of leases
- Copies of PUC rights
- Federal Tax Return
- Merger Agreements
- Partnership Agreements
- Organizational Charts
- Name Change Documentation
- Taxpayer's Records
- Sale Agreements
- Disallowed Exemption Certificates

The use of exhibits is encouraged so the auditor may provide a well documented, comprehensive, and thorough report.

E. FORMS

The conduct of a sales, use, and hotel occupancy tax compliance audit involves several types of forms. These include forms that are specifically designed for use in conducting an audit as well as forms used by the taxpayer that must be examined as part of an audit. The auditor must be familiar with each of these forms.

1. Audit Report and Basis of Assessment (Cover Sheet)

This form is the cover sheet for every audit report. It provides summary information on the report.

a. Completion of Form – Page 1

- The form is completed using the audit application. The information input onto this form must tie into AASTART, PA-100 or Registration Update, Taxpayer Summary Information report, KITS, and summary schedules within the report.

- When an 1105 is included with an audit report, the REV-149 must be marked.

The 1105 indicator is marked by selecting “yes” in the “Add'l Processing Form” box on the second page of the add/edit form of the REV-149.

When the box is marked yes, “1105” will appear on the printed REV-149 directly under the “Audit Report and Basis of Assessment.”

Marking the “Add'l Process Form” box is independent from the completion of the 1105 form.

The reason for the 1105 indicator on the Audit Report and Basis of Assessment is to insure that all 1105s are properly recognized and routed in the event there is a failure of the automated email notification.

- **Legal Name** = This is the taxpayer’s legal name and is the same as the legal name listed under section 1 of the Taxpayer Summary Information report, PA-100 section 2 line 4 and/or Bureau of Audits – Registration Update line 1. It should also match the Business Name 1 field listed on AASTART.
- **Trading/As Name (T/A Name)** = This is the taxpayer’s trade name and is the same as the trade name listed under section 1 of the Taxpayer Summary Information report, PA-100 section 2 line 6 or line 3 of the Bureau of Audits – Registration Update, and AASTART – Business Name 2. The legal name and trade name may be the same.
- **Business Address** = This is generally considered to be the taxpayer’s “headquarters” address. It is the same address listed as the physical street address under section 1 of the Taxpayer Summary Information report, PA-100 section 2 line 8 or line 5 of the Bureau of Audits – Registration Update. There is no corresponding field for this address on AASTART.

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- **Assessment Mailing Address** = This is the address to where the assessment is mailed. It is generally the same as the mailing address listed under the Taxpayer Summary Information report – section 1. It is also generally the same mailing address as either the address listed under PA-100 section 2 line 9 or line 6 of the Bureau of Audits – Registration Update form. NOTE: When a taxpayer requests the assessment be sent to an address that is different than the taxpayer’s business or mailing address (e.g. accountant’s address), an email should be sent to the Sales Tax Division at email address ‘RV, Audits Sales Tax Division’ at the time the assessment is uploaded. The email should indicate if the original assessment or a copy be sent to the designated address.
- **Principals (Owners/Officers)** = The individuals listed in this section are the same as the individuals listed on line 15 on the Bureau of Audits – Registration Update form or PA-100 sections 6 and 6a. The individuals should also be the same as those listed as the owners under section 1 of the Taxpayer Summary Information report or KITS System R119 – Notes. If the business is a sole proprietor, then the name of the owner in this section will also correspond to AASTART – Business Name 1.
- **Standard Industrial Classification (SIC/NAICS)** = This is a numeric code identifying the taxpayer’s line of business. It must be consistent with information presented on PA-100 Section 7 or line 8 of the Bureau of Audits – Registration Update form. It should also be the same as the SIC/NAICS code listed under section 1 of the Taxpayer Summary Information report.
- **Address Where Records Located** = This is the location where the taxpayer keeps its records. It is the same address listed on the PA-100 section 2 line 10. However, there is no corresponding line item on the Bureau of Audits – Registration Update form. It may also be the same as the audit address information listed on AASTART.
- **Taxpayer’s Representative Assisting in the Audit** = This individual is normally referenced in the narrative as the taxpayer’s representative attending the audit conferences and providing records during the course of the audit. This person is also normally listed as the contact person under AASTART.
- **Organization Type** = This field indicates whether the taxpayer is a corporation, partnership, sole proprietor, etc. If the taxpayer is a corporation, then the date and state of incorporation must also be listed. This information must be consistent with line 7 of the Bureau of Audits – Registration Update form or PA-100 Section 5.
- **Date Business Started in PA** = This date must be consistent with PA-100 section 2 line 2 and KITS R118 – Business Details Inquiry. There is no corresponding line item on the Registration Update form.
- **Date Business Terminated** = If the Department’s records did not reflect the termination date prior to the start of the audit, the auditor must obtain a completed REV 1706 to close out the taxpayer’s sales and use tax account.
- **Number of Pennsylvania Locations** = If this field indicates more than one location, the audit report must include an exhibit listing all locations.

- **Bankruptcy Information** = The bar date must be the first bar date listed in the taxpayer's bankruptcy filing. An estimated assessment must be filed by the bankruptcy unit or the actual assessment must be mailed prior to the Proof of Claim (Bar) Date. All other bankruptcy information in this section is part of the specific identification of the bankruptcy claim filed in court.
- **Waiver Information** = The beginning, ending, and expiration dates listed in this section must be the same as the dates listed in Part III & IV of the waiver. Waiver From, Waiver To, Waiver Exp fields on page 2 of AASTART must match the same dates listed on this form.
- **Audit Assessment Findings** = This section must identify the summary schedules for each type of tax (sales or use) assessed. Normally, this will be the Recap Schedule. The Total Tax Amount to Be Assessed must equal the total amount listed on the Final Summary of Deficiency schedule included with the audit report.

b. Completion of Form – Page 2

NOTE: This page is actually labeled as “Internal Audit Report and Basis of Assessment” on the Department's Audit Index.

- **Assessment Amount** = This is the same as the TOTAL TAX AMOUNT TO BE ASSESSED in the previous section. The Non Assessed Amount field is used to document the amount of delinquent tax remitted by the taxpayer on or after the date of the audit engagement letter.
- **Regional Assessment Data** = The Audit From and Audit To Dates as well as the Pre and Post audit dates in this section of the form must match the information provided in the rest of the audit report and posted to AASTART.
- **Regional Office Reviewers Dates** = This section of the form must list the names of managerial staff who approved the report and the date of the approval. Each individual listed should initial the form.
- **Regional Office Processing Dates** = This reflects the processing dates involved with issuing the assessment and sending the final report to headquarters. **Headquarters must receive the completed report within thirty days of the post audit date listed under the Regional Assessment Data section.**
- **Headquarters Processors Date** = Not used by field personnel.

2. Audit Index

Each audit report must contain an index. The index provides a list of all forms, worksheets, exhibits, and schedules included in the audit report. Each document listed on the Index must be in the report. Each form, worksheet, schedule, and exhibit must be included on the index.

The first section of the index lists audit forms. The second section of the index lists schedules. The next section lists worksheets. The last section lists exhibits.

3. Audit Request

This form must be included in each audit report. It represents the issuance of a formal audit assignment and summarizes the audit assignment information for the auditor. The taxpayer's information on this form must be compared to information listed on the KITS system prior to the audit. Any differences must be resolved as part of the audit.

4. Conflict of Interest Statement and Auditor's Comments

This form is confidential and is intended for Department use only. It is to be included in the Department's copy of every audit report and must be signed in ink by the auditor. It is not to be included in the taxpayer's copy of the audit report.

The auditor may use this form to disclose information relating to the audit that is not disclosed elsewhere in the audit report. This information may include auditor observations that provide additional insight into the audit findings. The auditor may also reference on this form Board of Appeal decisions, letter rulings, Department policy, etc., that support the audit findings. This form may also be used to explain large differences between current and prior audit findings.

This form must also be used by supervisors to document that credits granted by the auditor have been reviewed and approved by the supervisor. Test period exceptions must also be acknowledged by the supervisor on this form.

5. Taxpayer's Acknowledgement of Post Audit Conference

This form is required to be in every audit report. It is used to secure the taxpayer's written acknowledgement that the audit findings were discussed with the taxpayer at the conclusion of the audit and prior to the issuance of any assessment. It acknowledges that the auditor explained the procedures for assessment, additions of interest and penalty, and appeal procedures. This form is also used to record the auditor's corrective recommendations. This form is used for every type of post audit conference including face-to-face meetings and conferences conducted by phone. This form should also be sent to the taxpayer when a post audit conference is not held due to a lack of cooperation from the taxpayer (post by mail). The details on the form are input by the auditor using the audit application. The form is then presented to the taxpayer for signature.

a. Completion of the Form

Completion of the form is discussed below.

- **Audit Period** – This period must be the same as the period referenced throughout the audit report.
- **Audit Deficiency** – This is the total tax deficiency established by audit. It does not include penalty and interest that will be posted as part of the official assessment. It must equal the

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total amount listed on the Final Summary of Deficiency schedule as well as the amount quoted in the post audit conference section of the narrative.

- **Name of Auditor** – The name of the auditor conducting the conference must be listed in this block.
- **Areas of Deficiency** – This section of the form must break out the amount due by area and reference the supporting schedule or worksheet.
- **Recommendations To Taxpayer For Correcting Areas Of Deficiency** – This section of the form must always be completed. It must provide recommendations to the taxpayer for eliminating the deficiencies identified in the audit.
- **Name and Signature of Taxpayer or Authorized Representative** – The taxpayer or the taxpayer’s representative must be asked to sign the form. The term “taxpayer’s representative” includes employees of the taxpayer who represented the taxpayer during the audit. As part of providing the signature, the taxpayer may also indicate agreement or disagreement with the findings. The taxpayer may also provide additional comments. If the taxpayer refuses to sign the form, the auditor must note the time, date, reasons, and the person involved.

b. Letter – Inability to Schedule Post Audit Conference

The auditor uses the sample letter below in circumstances where the auditor has been unable to schedule a post audit conference. This letter must be sent via certified mail.

DATE

Mrs. Jane Q. Public
R. D. #1
23 Somewhere Road
Anywhere, PA 12345

Re: (SALES AND USE, EMPLOYER WITHHOLDING, COUNTY, MASS TRANSIT,
VEHICLE RENTAL)

Dear (TAXPAYER REPRESENTATIVE):

Please be advised that the subject audit(s) on (TAXPAYER) have been completed by Revenue Auditor _____.

This is to formally notify you that on (DATE) at (TIME), (AUDITOR) will be at the _____ Revenue Regional Office, (ADDRESS), to conduct a post audit conference.

If the post audit conference scheduled on the above noted date is not held, the audit will be forwarded for assessment without a formal post audit conference

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The tax deficiency, interest, penalty, and your right to appeal the audit findings will be set forth on the assessment notice.

Enclosed are (ANY RECORDS, WORKSHEETS, SCHEDULES, FORMS, ETC.)

Very truly yours,

(REVENUE REGIONAL MANAGER)
(REGIONAL OFFICE)

Enclosure
Certified Mail
Return Receipt Requested

c. Letter – Telephone Post Audit Conference

Telephone post audit conferences must be followed with a letter setting forth the details provided to the taxpayer during the conference. A sample letter is shown below.

DATE

Company
P. O. Box
Kansas City, MO 64141-6099

Re: (Sales and Use, Employer Withholding, County, Mass Transit Tax,
Vehicle Rental)
Assignment
License No.

Attention:

Dear Mr. _____:

This letter is to confirm the telephone conference held between Revenue Auditor _____ of this office and yourself on _____.
You were advised that the subject audit(s) have been completed and a tax deficiency of \$ _____ has been established. This deficiency is comprised of \$ _____, _____ tax and \$ _____, _____ tax.

A Taxpayer's Acknowledgement of Post Audit Conference is enclosed herein. This form outlines the audit deficiency and provides general information relevant to the execution of the form and the assessment of the deficiency. Please sign and return the form promptly in the stamped, self-addressed return envelope. Please retain a copy of the form for your records.

In the near future, you will receive a Notice(s) of Audit Assessment that will outline, by reporting period, deficiency, penalties, and interest. A copy of the complete audit report will accompany the Notice of Assessment. You have ninety (90) days from the mailing date on the Notice of Assessment to file a petition to appeal. Instructions for the filing of an appeal are included on the rear of the Notice of Assessment.

Should you have any questions regarding the information discussed herein, you can reach Auditor _____ or me at _____.

Very truly yours,

REVENUE REGIONAL MANAGER

REGIONAL OFFICE

6. Request for Financial Records

This form must be used and included in the audit report for every instance when the records requested are not furnished. This document provides a record of the auditor's specific request for, and the taxpayer's written explanation for failure to provide, records needed to conduct the audit. Proper use of this form will help eliminate any misunderstanding concerning record requests. It also provides documentation supporting the use of alternative audit techniques. More than one form may be required during the course of an audit.

This form is used for the purpose of documenting the specific records requested. Attachments or schedules referenced on this form must be included in the audit report as attachments to the records request. Items attached to the form should be an exact copy of the schedule or attachment referenced.

This form is also used to document that a reasonable amount of time was afforded to the taxpayer to provide the requested records prior to making an assessment on transactions due to missing or inadequate records. The auditor must include a date on the Request for Financial Records by which the records must be presented by the taxpayer.

This form must be typed or completed in ink.

7. Taxpayer's Concurrence with Test Audit Plan

This form is required to be included in every report where test procedures were used to develop a tax deficiency. It is designed to secure written acknowledgement that the auditor discussed the activities of the business with the taxpayer in order to arrive at a representative period(s) for testing. The taxpayer also acknowledges that the procedures to be used in performing the test audit(s) and the projection of any deficiency resulting from the test period(s) was thoroughly explained. Finally, the taxpayer has the option to comment on the selection of the test period and results of the test projection and state any reasons for nonconcurrence.

The information on this form must accurately describe the testing process and must be consistent with information presented in the narrative. It must also accurately reflect the explanation given by the auditor to the taxpayer. This form must be presented to the taxpayer for acknowledgement and signature prior to performing the test examination.

a. Completion of the Form

Completion of the form is done through the audit application. A separate form is required for each test.

The name of the auditor who discussed the testing process with the taxpayer must be listed under the CONCURRENCE section of the form.

- **Audit Period** = The audit period must be accurately stated.

- **Type of Test** = This field must indicate which type of test will be used. Types of test normally utilized by the Bureau include block sample projectable average and statistical sampling.
- **Test Objective** = The test objective must indicate that the taxpayer's records are being audited to determine the taxpayer's compliance with the tax laws to which the test relates.
- **Population to Be Tested** = This is the population from which the test period is selected. Examples of possible test populations include gross sales and general expenses. The population to be tested must be specifically defined. For instance, if a test is limited to a specific group of accounts, these accounts must be identified on the form or through an attachment to the form.
- **Test Periods** = Each test period must be specifically identified. This section of the form must also indicate what time frames the specific test periods represent.
- **Basis for Selecting Test Period(s)** = This part of the form must indicate what criteria was used to select the test periods. Examples of testing criteria include average gross sales, average taxable to gross sales ratio, average expenses, etc. All schedules referencing the population tested must be referenced on this form. In addition, this part of the form must reference related Requests for Financial Records when the selection of the test periods is based on the lack of available records.
- **Test Procedure** = This portion of the form must identify the transactions to be examined for the test periods, calculation of the error rate, and test projection methods. This section of the form must also indicate that deficient sales or expenses identified and projected as a result of the test shall be multiplied by the applicable tax rate to calculate the tax deficiency.
- **Taxpayer Comments** = This field is to be completed by the taxpayer. In this area of the form, the taxpayer may state areas of concern regarding the procedures to be employed or the representation of the populations selected to be tested.

The taxpayer and the auditor who explained the procedures to the taxpayer must sign this form. If the taxpayer refuses to sign the form, the auditor must note on the form whom the form was presented to, the date, time, and the fact that they refused to sign the form. The form must be included with the audit report. This information along with any other pertinent facts must also be noted in the narrative.

8. Agreement to Extend Time Limit for Assessment/Determination of Tax and To Extend Period of Time for Record Retention (Waiver)

a. Issuance of Waivers

This form is used to extend the time limit for record retention and assessment of tax. It becomes a binding legal document when properly completed. When collateral audits are performed on different types of taxes, a separate waiver is needed for each type of tax.

The Revenue Regional Manager is ultimately responsible for obtaining the waiver and ensuring that periods are not lost due to the expiration of the statute.

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Prior to September of each year, the audit supervisor must review each auditor's assignment inventory. The larger assignments and other assignments that have historically resulted in material liability must be prioritized.

In those cases where the taxpayer refuses to allow the auditor access to the records, the auditor must follow the Bureau's policy for requesting records.

The taxpayer must not be asked to sign a waiver nor should the auditor examine the period about to be lost due to the statute of limitations or record retention requirements on any audit assignment dated or started within two months of the expiration of statute. Generally, this means November 1. The only exception is when the audit is coded as priority or mandatory (reason code 66) and contains instructions regarding the period to be audited.

The audit supervisors are to monitor each audit in progress on which a waiver has been obtained to make sure that the auditor begins and completes the audit timely and allows sufficient time for the audit assessment to be mailed before the period expires. As part of this monitoring process, the audit period beginning and ending dates should be entered into AASTART as soon as possible.

The above waiver policy does not pertain to trust fund money taxes collected and not reported. Taxes collected and not reported may be assessed for any period beyond the statute.

b. Completion of Form

Part I: Taxpayer Identification. This section of the form must list the taxpayer's correct legal name and mailing address.

Part II: Tax and Tax Account Number This part of the form must indicate the tax and related account number to which the waiver applies. A single waiver may be used for more than one type of tax as long as all periods listed on the waiver can be legally extended for each type of tax. Each type of tax and account number must be noted on the form.

Part III: This part of the form must indicate the entire period being extended. For instance, if the period to be extended is 2008, then the beginning date must be listed as 1-1-2008 and the end date should be listed as 12-31-2008. If the extended period includes more than one year, the entire extended period must be reflected in the beginning and ending dates. For instance, if a waiver has already been executed for 2007 and an additional waiver is needed for 2008, the beginning dates on the new form should be 1-1-2007 and the ending date should be 12-31-2008. When a prior agreement has been executed, the additional Agreement must be executed on or before the date set forth at PART IV of the prior agreement. When more than one waiver covers the same period of time, all such forms should be retained by the regional manager.

Part IV: This part of the form represents the date by which an assessment for the waived periods must be issued. The postmark date on the assessment must be on or before this date. An assessment postmarked after this date loses assessed taxes for the waived period.

Part V: Agreement – This date is the same date that the taxpayer signs the form. This part must be completed in order for the form to be valid. If the taxpayer returns the form without completing this block, then the Regional Manager may insert the date of the taxpayer’s signature as listed on the taxpayer’s signature line.

For The Taxpayer – The taxpayer must sign the form. If the taxpayer is a corporation, the duly authorized officer must sign the form. An attorney or an agent acting under “power of attorney” authorization may also sign the form. However, a copy of the REV 677 documenting this authorization must be attached to this form. The taxpayer must sign this form prior to the expiration of the statute. For instance, if the period intended to be covered by the waiver is 2006, the taxpayer must sign this form by December 31, 2009. In Part V, the agreement date is the date on which the taxpayer signs the form.

For The Department Of Revenue-This form can only be executed by the regional manager. The regional manager signs the form after obtaining the signature of the taxpayer’s representative.

9. Rev 677 – Power of Attorney and Declaration of Representative

This form is used to document power of attorney authority vested by the taxpayer in another party or a declared representative of the taxpayer. This form may be included in the audit report when it is presented to the auditor by a representative possessing a power of attorney. However, this form must be included in the audit report when the taxpayer’s representative is signing documents that bind the taxpayer to certain actions or agreements. Also, this form must accompany the waiver when a representative holding a power of attorney or another declared representative of the taxpayer signs the waiver.

a. Completion of Form

Part I deals specifically with issuing Power of Attorney authorization. The taxpayer's legal name, entity identification number, and correct mailing address must be provided. The correct name, address, and phone number of the individual(s) designated as the taxpayer's attorney-in-fact must also be listed.

The authority is limited to representation for the TYPE OF TAX listed on the form. The representative is also limited to signing only those Department forms indicated under the "STATE TAX FORM NUMBER" block. Auditors should instruct the taxpayer to indicate "ALL" in this block so that the representative can sign all audit forms as needed. YEARS OR PERIODS indicated on the form must at least cover the time period during which the actual audit occurs. The taxpayer's initials or signature for different statements on the form indicate additional restrictions on the exercise of the authority.

The form specifically requires that if the named representative is not a certified public accountant or an attorney, the taxpayer's signature must be witnessed. Either obtaining the signatures of two witnesses or the proper authentication of the signature by a notary public satisfies this requirement.

Part II of the form represents the Declaration of the Representative. The representative must indicate the number listed in this part of the form that best describes the representative's capacity. The JURISDICTION must be listed as Pennsylvania. The representative's SIGNATURE and DATE are both required.

10. Bureau of Audits – Registration Update

Every audit report must contain either a Bureau of Audits – Registration Update form or a completed PA-100 – Pennsylvania Enterprise Registration Form. The Registration Update form is designed to be a condensed version of the PA-100 and used to update the accounts of registered taxpayers. The Registration Update form is not to be used when a non-registered taxpayer is applying for a new sales or use tax license or PTA account number. The PA-100 must still be completed for new tax registrations.

a. Instructions

The Registration Update form should be presented to the taxpayer during the preaudit conference for completion. When the form is completed and returned to the auditor, it should be reviewed for new information or corrections. The auditor is required to review the form to make sure it has been filled out correctly and then compares the information on the form to the Taxpayer Summary Information report. In addition, the auditor should take special note of changes in ownership (entity changes), bulk sale, or merger information if indicated on the form. These actions may require the creation of additional audit assignments.

The form should then be noted in the upper right hand corner with any items that need updated and then scanned to P:\Temp\PA-100s & Reg Updates for processing by headquarters. This is normally done by scanning the document to either the auditor's or auditor supervisor's email if the copier/scanner is not programmed to scan the image directly to the LAN. From the email, the document is saved to the above referenced LAN address. The auditor should follow the

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procedures established by their individual regions. Once headquarters processes corrections or registrations, they are removed from the file.

A copy of the form must be included in the audit report.

If the taxpayer refuses to complete the registration update form, the auditor is required to complete the form using all available information.

At the conclusion of the audit, the information on the form should be compared to the Taxpayer Summary Information to make sure that the information is the same. If differences still exist, they must be corrected prior to submitting the report for assessment. Special attention should be made to the following items as they have a direct impact on the Department's ability to collect the liability. These items include:

Box 1 – Enterprise Legal Name This is the name under which assessments are issued. The legal name listed in this box must be compared to the legal name listed under section 1 of the Taxpayer Summary Information report. For a sole proprietor, the legal name is the same as the owner's name. For a partnership, the legal name is the name listed in the partnership agreement. In the absence of a written agreement, the legal name is the trade name. For a corporation, the legal name is the name listed in the Articles of Incorporation, State Charter, or other governing document.

Box 2 – EIN If a taxpayer has an EIN, this is the entity identification number under which assessments are issued. EIN information can be compared to the EIN listed under section 1 of the Taxpayer Summary Information report.

Box 6 – Enterprise Mailing Address The assessment is mailed to this address. This address should be the same as the mailing address listed for the taxpayer under section 1 of the Taxpayer Summary Information report.

Box 7- Form and Type of Organization While this piece of information is not recorded on the assessment, the auditor must ensure that the Department's records reflect the correct entity type. It is part of identifying the correct entity.

The taxpayer may indicate in this section that the enterprise is a Limited Liability Company (LLC). An LLC is an entity formed under state law by filing articles of organization as an LLC. An LLC can be taxed for federal purposes as a partnership or an S-corporation. An LLC with a single owner can be an association taxable as a corporation or as a separate disregarded entity from its owner (corporation) and treated as a division of the corporation.

For purposes of Pennsylvania sales and use tax, an LLC in all instances will be considered a legal entity and will require a sales and use tax license.

In a sales and use tax audit of an LLC, the auditor will discover that an LLC has an election of how to file its federal income tax returns. An LLC can file F/F 1120 as a corporation, F/F 1120-S as a subchapter S-corporation, or a F/F 1065 as a partnership. The auditor should not be confused by the method that the LLC elects to file its federal tax returns. For Pennsylvania purposes, the LLC is classified as neither a corporation nor a partnership but rather is a specific type of entity termed "Limited Liability Company". During the course of an audit, the auditor may use the LLC filed federal income

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tax return (1120, 1120S or 1065) to verify gross sales, assets acquired (depreciation schedules), or taxable expense purchases.

Item 13 – Bulk Sale or Merger. If the taxpayer indicates that it made a bulk sale, the auditor must document the transfer of assets in the audit report and the supervisor must advise headquarters personnel through the Additional Headquarters Processing Request form to request that a bulk sale assessment be issued against the purchaser of the assets indicating, purchasing entity’s name, EIN, account number, and the date of the bulk sale. The assessment will consist of liabilities incurred by the seller on or before the date of transfer.

If the auditor is auditing a corporation that merged into another non-registered corporation designated as the survivor (see the “To Box” field in the corporate tax ledger (CTBNG)), then a new account number must be issued to the surviving corporation. A new audit assignment must be issued on the surviving entity and the old audit assignment must be cancelled. Any assessment will be issued in the name of the surviving corporation.

If the auditor is auditing a corporation that is the survivor of a merger and the corporation is registered with no changes in EIN, then no additional action is required.

Box 15 – Owners, Partners, Shareholders, Officers, Responsible Party Information

Except for sole proprietors, ownership information is not reflected on the assessment. However, this information must be correct on KITS and on the PA-100 so that the Department can enforce the assessment against the responsible parties. Partners in a partnership are jointly and separately liable for the assessment. Also, assessments can be issued against the listed corporate officers if the corporation fails to pay the assessment. In addition, the social security number listed for a sole proprietor serves as the entity identification number under which the assessment is issued in the absence of an EIN.

NOTE: If the information indicates that the taxpayer must register for sales and use, PTA, or VRT tax, the auditor must provide the taxpayer with a PA-100 for completion.

Box 16A – All Pennsylvania business locations must be listed. A list of Pennsylvania locations must be attached to the Registration Update if space on the form will not accommodate listing all locations. When corrections and/or additions to the taxpayer’s record on KITS are necessary, the attachment should be scanned and forwarded to headquarters with the Registration Update.

b. Entity Changes

If the registration update form discloses an EIN change or an ownership change occurring

as a result of a ...	then...
sole proprietorship to another sole proprietorship regardless if husband and wife	the successor sole proprietor is considered a new entity. The new entity must obtain a new account number via a complete PA-100. A new/collateral audit assignment must be issued for the new entity.
sole proprietorship to a	the corporation is considered a new

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corporation	entity. The new entity must obtain a new account number via a completed PA-100. A new/collateral audit assignment must be issued for the corporation.
sole proprietorship to a partnership (Whether or not the sole proprietor is one of the partners)	the partnership is considered a new entity. The new entity must obtain a new account number via a completed PA-100. A new/collateral audit assignment must be issued for the partnership.
partnership to a sole proprietorship regardless if a partner still exists	the sole proprietor is considered a new entity. The new entity must obtain a new account number via a completed PA-100. A new/collateral audit assignment must be issued for the sole proprietor.
partnership to add or subtract a partner and receives a new EIN	the partnership is considered a new entity since it received a new employer identification number. The new entity must obtain a new account number via a completed PA-100. A new/collateral audit assignment must be issued for the partnership.
partnership to a corporation	the new corporation is considered a new entity. The new entity must obtain a new account number via a completed PA-100. A new/collateral audit assignment must be issued for the new corporation.
corporation to a corporation	the new corporation is considered a new entity. The new entity must obtain a new account number via a completed PA-100. A new audit assignment must be issued for the new corporation.
corporation to a limited liability company (through merger or stock sale)	a new audit assignment number is necessary for the new LLC unless the LLC has retained the same EIN as the corporation. The name and entity type fields in KITS must be updated on the system accordingly.
corporation to a sole proprietorship	the sole proprietorship is considered a new entity. The new entity must

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	obtain a new account number via a completed PA-100. A new audit assignment must be issued for the sole proprietorship.
corporation to a partnership	the partnership is considered a new entity. The new entity must obtain a new account number via a completed PA-100. A new audit assignment must be issued for the partnership

A name change, change in corporate stockholders and/or officers, or changes in the number of partners with no changes in EIN requires no additional actions other than processing the appropriate updates.

11. PA-100 – Pennsylvania Enterprise Registration Form

The PA-100 is specifically used to establish new accounts. When an auditor determines that a taxpayer must register for sales and use, PTA, VRT tax, or the withholding of Pennsylvania personal income tax from employees, the auditor must obtain from the taxpayer a completed paper copy PA-100 – Pennsylvania Enterprise Registration form bearing the taxpayer’s signature. The taxpayer is not to use the online registration to obtain a sales and use tax number for purposes of audit.

If the taxpayer is not registered for sales and use tax with the Department, the auditor is required to present the taxpayer with a PA-100, Pennsylvania Enterprise Registration Form and Instructions booklet. The taxpayer should be advised that the form will be used to obtain a license number for the purposes of processing the current audit, if necessary. The form should be completed by the taxpayer at the pre-audit conference or as soon after as possible and returned to the auditor.

A label must be placed on the upper left corner of the first page of the PA-100 containing the following information:

- Audit Period, Local Tax, if applicable (Philadelphia or Allegheny)
- North American Industry Classification System (NAICS)
- Type of Application: SUT, PTA, VRT, and/or EW
- Permanent or In/Out Number for assessment purposes

It is required that the form be scanned to P:\Temp\P 100s & Reg Updates as soon as possible. This is normally done by scanning the document to either the auditor’s or auditor supervisor’s email when the copier/scanner is not programmed to scan directly to the LAN. From the email, the document is saved to the above referenced LAN address. The auditor should follow the procedures established in the individual region. Headquarters personnel review these documents everyday for corrections. Once corrections or registrations are processed, they are removed from the file.

A license number is not necessary to process a “none” audit of a taxpayer that was not previously registered.

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It is important to note that when the taxpayer is issued a sales tax license number or a use tax number, the taxpayer will originally be set up as a monthly filer.

If the taxpayer fails to provide the auditor with a completed PA-100, the auditor must fill out a PA-100 form based on available information. The auditor must indicate on the form that the auditor completed the form.

A copy of the completed PA-100 must be included in the audit report.

NOTE: Assessments for none audits are processed and issued by the Bureau of Audits. When a “none” audit is submitted from the region, an automatic email is generated to notify SUT staff to issue a zero assessment. These assessments are not issued through BTFT so no sales tax number is necessary.

If an audit of a previously non-registered taxpayer results in a credit audit (for instance, no audit deficiency was found but the taxpayer is entitled to third party credits), an in/out number will be necessary because the credit assessment is generated through BTFT.

a. Instructions

When a new license number is needed for a non-registered taxpayer, box 1 in section 1 must be checked indicating the PA-100 is being submitted for a new registration. The auditor must note on the front page of the form whether the application is for a permanent or temporary (in/out) number. The auditor must also indicate if the number is for sales and use, use, PTA, VRT, or Employer Withholding account number.

The information presented on the PA-100 must be compared to the appropriate KITS screens prior to the issuing of an assessment to make sure all the information has been correctly input for the new account. Special attention should be made to the following items as they have a direct impact on the Department’s ability to collect the liability. These items include:

Section 2 Box 4 – Legal Name This is the name under which assessments are issued. The legal name listed in this box must be compared to the legal name listed in KITS – R116 as shown under section one of the Taxpayer Summary Information report. For a sole proprietor, the legal name is the same as the owner’s name. For a partnership, the legal name is the name listed in the partnership agreement. In the absence of a written agreement, the legal name is the trade name. For a corporation, the legal name is the name listed in the Articles of Incorporation, State Charter, or other governing document.

Section 2 Box 5 – Federal Employer Identification Number (FEIN/EIN). If a taxpayer has an EIN, this is the entity identification number under which assessments are issued. EIN information can be compared to the EIN listed in the Taxpayer Summary Information report.

Section 2 Box 9 – Enterprise Mailing Address The assessment is mailed to this address. This address should be the same as the mailing address listed for the taxpayer under KITS – R121 as shown under section one of the Taxpayer Summary Information report.

Section 5 – Form of Organization While this piece of information is not recorded on the assessment, the auditor must ensure that the Department’s records reflect the correct entity type. It is part of identifying and assessing the correct entity. This information should be consistent with the information provided under KITS – R118 as shown in section one of the Taxpayer Summary Information report.

This section of the PA-100 provides a block for Limited Liability Companies (LLC). An LLC is an entity formed under state law by filing articles of organization as an LLC. An LLC can be taxed for federal purposes as a partnership or S corporation. An LLC with a single owner can be an association taxable as a corporation or as an entity separate from its owner (corporation) and treated as a division of the corporation.

For purposes of Pennsylvania sales and use tax, an LLC in all instances will be considered as a legal entity and will require a sales and use tax license.

An LLC may elect to file federally as a corporation, S-corporation, or a partnership. An LLC can file federal form 1120 as a corporation, federal form 1120S as an S corporation, or a federal form 1065 as a partnership. For Pennsylvania purposes, the LLC is classified as neither a corporation nor a partnership but rather is a specific type of entity termed “Limited Liability Company”. During the course of an audit, the auditor may use the LLC filed federal income tax return (1120, 1120S or 1065) to verify gross sales, assets acquired (depreciation schedules), or taxable expense purchases.

Section 6 and Section 6A– Owners, Partners, Shareholders, Officers, Responsible Party Information Except for sole proprietors, ownership information is not reflected on the assessment. However, this information must be correct on KITS – R122 and on the PA-100 so that the Department can enforce the assessment against the responsible parties. Partners in a partnership are jointly and separately liable for the assessment. Also, assessments can be issued against the listed corporate officers if the corporation fails to pay the assessment. In addition, the social security number listed for a sole proprietor serves as the entity identification number under which the assessment is issued in the absence of an EIN.

If the taxpayer indicates in section 10 of the PA-100 that it made a bulk sale, the auditor must document the transfer of assets in the audit report and the supervisor must advise headquarters personnel through the Additional Headquarters Processing Request form to request that a bulk sale assessment be issued against the purchaser of the assets indicating, purchasing entity’s name, EIN, account number, and the date of the bulk sale. The assessment will consist of liabilities incurred by the seller on or before the date of transfer.

If the auditor is auditing a corporation that merged into another non-registered corporation designated as the survivor (see the “To Box” field in the corporate tax ledger (CTBNG)), then a new account number must be issued to the surviving corporation. A new audit assignment must be issued on the surviving entity and the old audit assignment must be cancelled. Any assessment will be issued in the name of the surviving corporation.

12. Requirements for the Audit Review of Third Party Credits

This form outlines the Department’s position regarding the documentation required to substantiate the granting of third party credits in the audit findings.

The auditor must identify a date by which documentation supporting the taxpayer's request for third party credit must be submitted to the auditor for credit to be considered in the audit findings.

This form must be presented to the taxpayer during the preaudit conference. The auditor must explain the information contained on the form and answer the taxpayer's question related to the form.

The auditor should secure a signature from the taxpayer's representative.

The form is required documentation in the audit report.

13. REV 153 – Tally Sheet

This form is designed to accurately record taxable and nontaxable sales in progress during a sample audit period for the purpose of establishing the percentage of taxable to gross sales ratio and the effective rate of tax.

a. Completion of Form

If the auditor conducts the tally, taxable sales are fully described. If the taxpayer conducts the tally, nontaxable sales are fully described.

This form may be customized to meet the needs of the audit. However, the form must document opening and closing register readings to ensure all sales are accounted for and included in the test.

14. Additional Headquarters Processing Request (REV 1105)

This form is used to notify headquarters of processing requests and the results of special instructions. In addition to the items specifically listed on the form, these instructions may include processing tax returns, account cancellation requests, forwarding documents to appropriate personnel such as a Business Activities Questionnaire, memos for credits granted etc.

When an 1105 is included with an audit report, the REV-149 must be marked.

The 1105 indicator is marked by selecting "yes" in the "Add'l Processing Form" box on the second page of the add/edit form of the REV149.

When the box is marked yes, "1105" will appear on the printed REV-149 directly under the "Audit Report and Basis of Assessment."

Marking the "Add'l Process Form" box is independent from the completion of the 1105 form.

The reason for the 1105 indicator on the Audit Report and Basis of Assessment is to insure that all 1105s are properly recognized and routed in the event there is a failure of the automated email notification.

The 1105 should indicate if a check was received by the auditor to be applied to the assessment.

a. Completion of Form

This form is completed and signed by the supervisor. Supporting documentation needed to take the actions indicated on the form must be attached to the form.

The auditor must notify the supervisor of any additional processing requirements.

15. REV 1706 – License Cancellation Form

The taxpayer completes this form to cancel accounts. The form is found on the Department's website. If during the course of an audit, the auditor determines that a specific entity or account no longer exists, the auditor should have the taxpayer complete this form. If possible, the auditor should personally assist the taxpayer in completing this form. If necessary, the auditor may complete the form and forward the form to headquarters via the Additional Headquarters Processing Request for processing. Instructions for completion are provided below.

a. Completion of Form

The auditor must be certain of the following:

- License number is correctly recorded.
- Owner(s) name and trade name(s) is included.
- Correct date and reason the business was discontinued is given.

If there is a change in entity, the cancellation must be prepared for the entity that has discontinued business and a sales and use tax application to obtain a new license number prepared for the new entity. This procedure must take place pursuant to the conduct of the audit and processed prior to the completion of the audit.

If necessary, the auditor may complete and sign the form directly so that the appropriate accounts can be canceled.

This form must be typed or completed in ink – pencil is not permitted.

16. Notice of Assessment

This is the audit assessment notice sent to the taxpayer. The information is based on the audit information uploaded by the region into the Department's computer files. The name, address, entity ID, and account ID are all based on updated information provided by the taxpayer as part of the audit. The audit period end date is the last day of the audit period to which the assessment pertains. The information in these fields should match the information provided on the PA-100 or the Registration Update form. These fields must be correct. The notice number is computer generated and represents the assessment number.

a. Explanation

- **Total Tax Established by Audit** – This is the total amount of tax due for the period including reported and nonreported amounts.
- **Total Tax as Reported** – This is the total amount of tax reported by the taxpayer to the Department for the audit period.
- **Total Tax Amount Due (CREDIT)** – This is the total tax deficiency (credit). It represents the difference between Total Tax Established by Audit and Total Tax as Reported.
- **Penalty and Interest** – The penalty and interest amounts are explained on the back of the assessment form under “Additions and Penalties”.
- **Amount Remitted** – This is the amount of payment applied to the assessment.
- **Total Amount Due Per Audit** – This is the outstanding amount due on the assessment.
- The **Audit Period Detail** page gives a breakdown of the tax liability by individual reporting period.

b. Issuance

The assessment notice must be mailed to the taxpayer’s mailing address listed on the PA-100, section 2, line 9. If the taxpayer requests the assessment be sent to another location, the taxpayer must submit the request in writing on company letterhead. The auditor must forward this letter to headquarters attached to the Additional Headquarters Processing Request form with a note to send of a copy of the assessment to the address listed in the letter.

17. Secretary’s Writ

A Secretary’s Writ may be used when the Department determines that it is necessary to issue a formal demand for access to the financial records or for information pertaining to the tax matters of a particular individual or business. Refer to the previous discussion of this form in Chapter 5—Audit Policy.

F. AASTART

The Audit Assignment Tracking and Report (AASTART) system keeps track of potential audit assignments, converted (assigned) audits, and completed audits. Prior to submitting the audit report for assessment, the auditor and auditor supervisor must make sure that AASTART is updated to reflect the information recorded on the Audit Report and Basis of Assessment as well as the Taxpayer Summary Information report. This includes audit period, pre and post audit conference dates, waiver dates etc. The information must also be consistent with the information listed on the Bureau of Audits – Registration Update or the PA-100.

G. MULTI REGIONAL AUDIT ASSIGNMENTS

When more than one region is conducting an audit on the same assignment number, the lead auditor is responsible for coordinating the presentation of the final audit report. This must be thought about before the audit is started so that all the work done by a secondary region can be merged into one audit package and uploaded to the local area network (LAN) without difficulties.

Some of the areas that need to be thought about are the allocation of schedule numbers and headings as well as worksheet numbers and exhibit letters so that each portion of the audit has unique identifiers to be referenced in the audit. Also, audit narratives need to be organized so that the regional narratives can be merged into each other so that minimal rewriting or editing needs to be done by the lead auditor.

There should only be one index, one Additional Headquarters Processing Request, one set of coversheets (Audit Report and Basis of Assessment).

Requests for Records could be identified by date of request for reference purposes.

H. SUBMISSION AND DISTRIBUTION OF REPORT

The assessment must be uploaded within 30 calendar days of the post audit conference. The assessment date is five days after the date of upload.

The audit report must be received in Headquarters the same day as the assessment upload.

Currently, a department copy and taxpayer copy of each audit report is available on the Department's local area network (LAN). The original department copy is maintained in each regional office, the taxpayer copy is available on the Department's LAN. Original documents that are scanned to the audit report must be maintained in the Regional office.

1. Department's Copy

The original audit report is considered the Department's copy. Upon the manager's final approval of the audit package, the appropriate regional office personnel scan a copy onto the LAN. The original documents must be maintained in the regional office until the taxpayer's appeals are exhausted.

2. Taxpayer's Copy

This is the copy the taxpayer is sent with the Notice of Assessment beginning January 1, 2008.

Any requests from the taxpayer for a copy of the audit should be directed to headquarters. Headquarters will then send the taxpayer's copy (if the taxpayer has not appealed) directly to the taxpayer, the taxpayer's lawyer, or to an outside representative upon written request from the taxpayer.

Individuals requesting copies of an audit report must be referred to headquarters. The request must be submitted in writing on the taxpayer's letterhead and must be signed by the business owner or corporate officer. The audit contact person listed on AASTART may also sign the request if

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necessary. Upon formal written request approved by the sales and use tax program manager, the taxpayer will be given the taxpayer copy of the audit.

3. Forms Distribution Chart

The content for each copy of the report is different. The table below indicates the content of the Department, taxpayer and regional copies.

Type or Number	Title	Dept	Taxpayer
	Field Audit Report and Basis of Assessment	X	X
	Index – Department Copy	X	
	Index – Taxpayer Copy		X
	Audit Request	X	
	Narrative Report Of Audit Findings	X	X
	Conflict Of Interest Statement & Auditor's Comments	X	
	Requirements for the Audit Review of Third Party Credits	X	X
	Taxpayer's Acknowledgement Of Post Audit Conference	X	X
	Request For Financial Records	X	X
	Taxpayer's Concurrence With Test Audit Plan	X	X
	Schedules & Worksheets	X	X
	Exhibits	X	
	Secretary's Writ	X	Delivered
	Bureau of Audits Registration Update Form	X	Taxpayer Prepared
PA-100	Pa Enterprise Registration Form	X	Taxpayer Prepared
REV-1706	Cancellation Of Sales Tax License	X	Taxpayer Prepared
REV-1220	Sales And Use Tax Exemption Certificate	X	Taxpayer Prepared
REV-1715	Exempt Organization Declaration Of Sales Tax Exemption	X	Taxpayer Prepared
REV-203	Business Activity Questionnaire	X	X
REV-1105	Additional Headquarters Processing Request	X	

I. CORRECTIONS TO THE FINDINGS

When errors are found in the audit findings during Regional review, prior to the assessment being uploaded, the auditor must do the following:

- Correct the worksheets in the audit application.
- If changes are made to supplemental schedules, then the excel spreadsheet must be updated and the supplemental input form must also be updated. The supplemental schedule should have the same title as the excel spreadsheet.
- The Recap schedule must be recompiled.
- The Final Summary of Deficiency schedule must also be recompiled.

All of these steps are required in order to correct the assessment amount.

Chapter 7 – APPEAL PROCESS

Taxpayers may appeal all audit assessments. Instructions for filing an appeal are provided on the back of the assessment notice. Appeals must be filed within designated time frames.

A. BOARD OF APPEALS

All appeals of audit assessments are initially filed with the Department of Revenue's Board of Appeals.

In order to file an appeal, the taxpayer must submit a Petition for Reassessment to the board postmarked within ninety days of the assessment notice date. A petition may be filed by mail or electronically through the Board's web page at <https://www.boardofappeals.state.pa.us>. The taxpayer may use form REV-65 Petition Form and REV-39 Sales and Use Tax Appeal Schedule. These forms may also be filed online. The petition must state the basis of appeal, be accompanied by an affidavit, and be signed by the petitioner.

The Board will review submitted evidence and conduct hearings as necessary to decide the merits of the taxpayer's case. After considering all evidence, the board will then issue a written decision to the taxpayer.

Board findings issued to specific taxpayers must be adhered to in follow up audits unless it is evident that the facts presented to the Board of Appeals differ from the facts in the current audit.

If the taxpayer disagrees with the findings of the board, the taxpayer may appeal the case to the Board of Finance and Revenue.

B. BOARD OF FINANCE AND REVENUE

The Board of Finance and Revenue (BFR) is the next level of appeal for taxpayers after the Board of Appeals. The 6-member intra-agency board consists of designees from the State Treasurer, Auditor General, Secretary of Revenue, Attorney General, General Counsel, and Secretary of the Commonwealth. The State Treasurer's designee is the chairperson.

Upon receiving the written decision from the Board of Appeals, the taxpayer has 60 days to file an appeal with BFR. BFR will review submitted evidence and conduct hearings as necessary to decide the merits of the taxpayer's case. After considering all evidence, the Board then votes on the merits of the case. The board will then issue a written decision to the taxpayer.

BFR's decision on a specific case for a specific taxpayer must be adhered to in any follow up audit unless the facts upon which BFR made their decision differ from the facts in the current audit. Copies of BFR decisions may be requested through headquarters. Beginning with 2000, BFR decisions on audit appeals may also be requested via MIMENU. BFR files relating to refund or appeal requests initially filed with BOA after January 2003 may be viewed on the RAPS system.

If the taxpayer disagrees with BFR's decision, the taxpayer may appeal to the Commonwealth Court of Pennsylvania.

C. COMMONWEALTH COURT OF PENNSYLVANIA

The Commonwealth Court has appellate jurisdiction over appeals on decisions made by state administrative boards like the Board of Finance and Revenue. A hearing before this court represents actual litigation where the Office of Attorney General represents the Department. The taxpayer has 30 days from the postmark date of the BFR decision to file an appeal at this level. The court will render a written decision describing the issues and the legal basis for its decision. The taxpayer may elect to pursue the matter to the Pennsylvania Supreme Court and beyond if Commonwealth Court finds in favor of the Commonwealth.

In many cases, the Department and the taxpayer will settle out of court. These settlements are nonbinding on future audits and only pertain to the specific case at hand.

D. REVENUE APPEALS PROCESSING SYSTEM (RAPS)

RAPS is the Department's appeals processing system that contains all data related to appeals (including refund requests). For petitions filed after December 9, 2002, RAPS provides images of petition documents, correspondence, and evidence submitted to support the appeal and the final decisions and orders issued at each appellate level.

RAPS may be accessed via the Bureau's home page. The RAPS link is listed under the organizational view. After accessing the link, and inputting the appropriate passwords, the auditor may select several search options from the RAPS main page. If the docket number for the refund or appeal case is known, the auditor may enter it into the docket number field or select the "Search" tab to query the system by taxpayer/practitioner name, account number, or employer identification number. The actual written decision as well as supporting documentation will be listed under the "Docs" link.

Chapter 8 – DELINQUENT TAXPAYER (DT) ASSIGNMENTS

A. OVERVIEW

Delinquent taxpayer assignments (also referred to as desk audits), are conducted on taxpayers that have failed to file Sales and Use Tax Returns, Employer Withholding Of Pennsylvania Personal Income Tax Returns, and/or Personal Income Tax Returns.

The goal of this program is to have the taxpayer file their returns so that follow-up enforcement action may be initiated.

The auditor does not challenge information received by the taxpayer. Therefore, these assignments are not considered field audits.

Upon receiving the audit assignment, the auditor assigned to conduct the audit must review departmental records to identify all delinquent SUT, EW, and PIT returns.

B. CONTACTING THE TAXPAYER

The taxpayer must be sent a letter signed by the regional manager and a copy of the Taxpayer's Bill of Rights. The letter must:

- Identify the date, time, and place the taxpayer is required to appear.
- Identify the delinquent returns.
- Request books and records necessary to determine the liability for the delinquent returns.
- Request federal income tax returns for the years which included deficient returns.
- Request alternative documentation necessary to determine any tax liabilities if formal accounting books and records are not maintained.
- Request that the taxpayer contacts the regional office if the returns listed as delinquent were recently filed.
- State that failure to appear at the appointed time may result in an estimated assessment based on departmental records, unless alternative arrangements have been made with the regional office prior to the date of the original appointment.

C. EXAMINATION PROCEDURES

Based on the initial feedback that is received from the taxpayer, a number of different scenarios may occur after the initial letter is sent for “DT” assignments. The guidelines for completing a delinquent taxpayer (DT) assignment are listed below:

If the taxpayer contacts the auditor and notifies him that the returns have been filed, the auditor should verify this by reviewing KITS or the Annual system in the case of personal income tax. When verified, the auditor may write up the report to that effect. It will not be necessary to have the taxpayer report with his records to verify their accuracy.

If the taxpayer reports to the office with returns and with his records, the records are to be reviewed to verify the amounts reported. The procedures used to verify the amounts reported should be documented on the auditor’s report. The report, along with the returns, must be forwarded to headquarters for processing.

If the taxpayer reports to the office with his returns but with no records, the auditor should accept the returns and forward the returns to headquarters with their report. Again, once the returns are received and processed with the report, no further action is necessary. If the auditor suspects underreporting of tax on the returns or if there are material fluctuations, a full sales and use tax audit should be requested.

If the taxpayer reports to the office with no returns but with his records, the auditor should review the records to establish the correct amounts to be reported. Returns should then be prepared and signed by the taxpayer and forwarded to headquarters along with the auditor’s report.

If the taxpayer fails to show, the auditor is to prepare an estimated assessment for all delinquent periods. The estimate should be based on returns that were previously filed by the taxpayer or other documents that support the estimated amounts on the returns filed with the assessment. Estimates should be based on previous reporting history. An arbitrary percentage should not be used to estimate tax liability.

If all efforts are exhausted trying to secure previous reported amounts to make an estimate, please consult headquarters personnel for further instruction. If no returns are on the system, an archive report should be obtained. If no returns have been filed, the taxpayer’s federal tax returns should be requested through headquarters. If available, the estimate can be based on this information. The schedule documenting the estimated liability by period should then be forwarded along with the auditor’s report to headquarters.

If an estimated sales and use tax deficiency is developed, a completed PA-3R Sales and Use Tax Return, should accompany the report for each delinquent period. If an estimated personal income tax deficiency is developed, a completed PA-40, PA Individual Income Tax Return, should accompany the report for each delinquent period. If an estimated employer withholding deficiency is developed, a PA-W-3R should accompany the report.

If the taxpayer appears for the engagement, they should fill out any delinquent returns and sign them. For all estimated returns, the word “ESTIMATE” should appear on the return in red ink. Blank PA-40’s, PA-3R’s, and PA-W-3R’s are available via the commodities list. In all cases,

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original returns must be filled out completely, including the date completed. The original returns must be attached to the report along with a copy of the returns. Original forms are required because copied forms will not image properly.

In all cases where the taxpayer does attend the scheduled appointment, a registration update form should be obtained.

Also, if a referral from Collections and Taxpayer Services meets the criteria for a sales and use tax audit, it will be issued as a sales and use tax audit. The sales and use tax audit will be done on a priority basis and the special instructions will note that it is being conducted under the delinquent tax program.

D. DT ASSIGNMENT REPORT

When conducting DT assignments, the following are required with the assignment report:

Report of Delinquent Returns – One attached for each tax (Sales & Use Tax, Personal Income Tax, Employer Withholding) for which estimated reports/actual reports have been determined.

Index – Only one Index is needed. A taxpayer's copy is not necessary.

Narrative – A short description in the following main areas:

Taxpayer contact (preaudit conference), Engagement Letter, a description of the intent of the examination.

General description of business activities. Determinations made by the auditor about the taxpayer's business must be addressed.

- A system survey description of available records must be provided if the taxpayer has appeared.
- For each tax, a description as to how the reported figures have been determined or how projections and/or estimates were developed. Periods missing from the Department's records will be treated as nonfiled periods.

General comments covering information pertinent to the audit not covered elsewhere in the audit report must also be addressed.

The details of the Exit Conference, if one was held, or the auditor's actions to advise the taxpayer of the results of the examination. The details should disclose that the taxpayer was informed of his appeal rights. Appeal rights apply to estimated deficiencies. In addition, recommendations made by the auditor to the taxpayer should also be disclosed.

Conflict of Interest and Auditor's Comments form should be included.

A registration update form, when completed by the taxpayer, must also be included.

Exhibits should include

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- Engagement Letter, any other pertinent documentation.
- A copy should be made and included in the report package of the PA-100, PA-3R, PA-40, PA-W-3R accompanying the report.

The auditor should also comply with the following:

- When estimating employer withholdings or personal income tax, be sure the proper tax rate is used for the year being estimated.
- One last check should be made of the Department’s computer system before the completed report is transmitted to make sure the taxpayer did not send in the returns on their own for the estimated periods.
- Before submitting the completed report, make sure all delinquencies for each tax type have been covered in the report.
- If delinquent Personal Income Tax is to be estimated (no prior reporting history), be sure to request IRS returns before making the estimate.
- The total amount of all deficiencies found for all tax types should be in the nonassessment amount in AASTART. If the taxpayer files returns with the auditor, production credit may be taken as a nonassessed amount on AASTART.
- The DT audit application in the sales and use tax audit application should be used to write up the DT report.

Chapter 9 – CRIMINAL TAX PROGRAM

This chapter is to be used as a reference of procedures available for handling possible criminal situations.

Not all tax crimes involve fraud; fraud is a crime of “commission”. The taxpayer must actually do something to hide the true tax liability. Another crime of commission is theft. If trust fund money is collected and spent by a taxpayer to keep the taxpayer’s business operating, the taxpayer is committing theft by failure to make required disposition of funds.

Tax laws also contain crimes of “omission”. In these situations, a taxpayer commits a crime by doing nothing, such as not filing a return or not paying tax that is due. Omission crimes are not discussed in this manual since the method of detection is self-evident. They do, however, constitute basis for criminal tax referral.

A. WHAT IS FRAUD?

Fraud is generally defined as deception, misrepresentation of material facts, or silence when good faith requires expression. It can be defined more simply as deception with the object of gaining by another's loss.

Tax fraud usually involves false documents, returns and/or statements and includes attempted evasion, conspiracy to defraud, aiding and abetting, or counseling of fraud with the intention of stealing trust fund monies which have been collected.

There are three elements that are common to all tax fraud cases.

They are:

- An understatement of tax liability or a failure to file.
- Willful intent to evade taxes.
- Course of action demonstrating the taxpayer's intent.

The mere existence of an understatement of tax liability is not indicative of a willful intent to evade taxes. Willful intent is usually shown by a pattern of understatements, deceit, concealment, misleading acts, misrepresentation, and other acts evident of willfulness. Acts either in the past or present that are representative of the taxpayer's state of mind when the possible fraud(s) occurred are the key to determining the willfulness of the taxpayer. Since the burden of proof in any fraud case rests on the Commonwealth, the Department must fully document each of these acts in order to establish any alleged fraud.

B. GUIDELINES FOR DETERMINING TAX EVASION AUDITS

The Department has the responsibility of factually proving a willful attempt to evade the tax. In civil fraud cases, willfulness may be shown by a preponderance of the evidence, whereas criminal cases must be proven beyond a reasonable doubt.

Some examples of common scenarios involving tax evasion during an audit are:

- Failure to report tax collected as shown on invoices.
- Reporting less tax than shown on the accrual account.
- Misappropriation of tax monies.
- Paying employees in cash (no withholding – PIT).
- Failure to deposit all sales tax and employer withholding receipts.
- Submitting a false document or affidavit.
- Failing to keep proper books and records.
- No records, poorly kept records, two sets of records, attempts to falsify records, or altering records.
- Destroying books and records without a plausible explanation or refusal to make certain records available.
- Knowingly making false, misleading, and inconsistent statements.
- Willful failure or refusal to collect tax.
- Bribery with money or other items or services of value.

Since it is necessary to determine whether the taxpayer's actions are willful, it is important to show a consistent pattern of tax evasion. The mere failure to report tax collected on sales of an

infrequent nature does not necessarily constitute tax evasion. When auditors have identified discrepancies, auditors must ask the taxpayer such questions as to how, why, when, where, and who in order to decide whether the audit should be discussed with the appropriate supervisor concerning fraud.

1. Possible Indications of Fraud

Possible indications of fraud include:

- The willful failure to consistently collect tax on taxable transactions.
- Consistently collecting tax and not remitting a part or all of the tax collected.
- Deliberately altering books and records to misrepresent tax liability.
- The consistent understatement of figures on tax returns.
- Destroying or refusing to turn over records when the Department has reasons to believe a tax liability can be established.
- Willful failure to maintain records.
- Failure to file returns.
- Aiding and abetting a taxpayer to defraud the Commonwealth of tax revenues.

2. Criminal Referral Criteria

All audit assignments involving the same taxpayer, including collateral assignments, must be simultaneously referred for criminal investigation to the Office of Criminal Tax Investigation (OCTI) even if only one of those audit assignments meets the criminal referral criteria. A taxpayer must be referred for criminal tax investigation if the total trust fund monies, in any combination of taxes, is greater than the materiality limit for such referral.

Additional referral guidelines include:

- Where feasible, document and schedule all available invoices that represent taxes collected and not reported. This will support and strengthen the criminal referral.
- Trust fund deficiencies established via projections should be referred regardless of the method used to establish the liability.
- Out-of-state audits will be referred.
- If a payment is made prior to assessing the tax deficiency, the regional manager is to contact the Office of Criminal Tax, Operations Manager, for a referral decision.

If the dollar criterion identified above is not met and any of the following events occur, the audit assignment should still be referred for evaluation. A memorandum must be attached to the Additional Headquarters Processing Request form stating the reason for the referral.

- Failure to carry out reasonable tax collecting, accruing, reporting, and/or paying responsibilities. For example, an initial audit discloses that the taxpayer was not collecting sales tax in one or more situations; the taxpayer was fully apprised of tax collecting

responsibilities; and upon reaudit, it was discovered that the taxpayer continues to make such sales and not collect the tax due.

- Failure to keep proper books and records; poorly kept records; two sets of records; attempts to falsify or alter records; refusal to make records available; destroying books and records.
- Flagrant and blatant noncompliance even if the dollar criterion as noted above is not met.

There is no flexibility as to whether an audit assignment should not be referred to the CTI Division. If any one of the above criteria is met, all audit assignments involving the taxpayer in question must be referred to the Criminal Tax Investigation Division.

Note: Do not refer assignments where the deficiency is generated solely from use tax (or untaxed sales).

3. Guide Lines for Imposition of Major Penalties

a. Major Penalties Imposed

Major penalties will be imposed on amounts of tax collected and not reported of greater than \$10,000.

Exceptions: Major penalties should be imposed on tax collected under \$10,000 when:

- The amount under \$10,000 is greater than 25% of all sales taxes reported for the audit period.
- The tax under \$10,000 is from delinquent period(s). (Example 1)
- There is a consistent pattern of underreporting. (Example 2)

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ASSIGNMENT : STSTD0000000
 NAME : PENALTIES INC.
 ACCOUNT : 80000010
 EIN : 12345678
 AUDIT PERIOD : 01/01/98-12/31/99

EXAMPLE 1
 Schedule 2
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Reconciliation of Accrual Amounts (Book to Reported)

Period	Locality	Sales Tax			Use Tax		
		Book	Reported	Difference	Book	Reported	Difference
1/1/1998 1/31/1998	0	6,118.07	6,118.07	0.00	0.00	0.00	0.00
2/1/1998 2/28/1998	0	7,228.39	7,228.39	0.00	0.00	0.00	0.00
3/1/1998 3/31/1998	0	7,968.12	7,968.12	0.00	0.00	0.00	0.00
4/1/1998 4/30/1998	0	6,831.79	6,831.79	0.00	0.00	0.00	0.00
5/1/1998 5/31/1998	0	7,092.15	7,092.15	0.00	0.00	0.00	0.00
6/1/1998 6/30/1998	0	7,369.54	7,369.54	0.00	0.00	0.00	0.00
7/1/1998 7/31/1998	0	6,406.47	6,406.47	0.00	0.00	0.00	0.00
8/1/1998 8/31/1998	0	7,530.90	7,530.90	0.00	0.00	0.00	0.00
9/1/1998 9/30/1998	0	7,841.63	7,841.63	0.00	0.00	0.00	0.00
10/1/1998 10/31/1998	0	6,365.85	6,365.85	0.00	0.00	0.00	0.00
11/1/1998 11/30/1998	0	6,530.90	6,530.90	0.00	0.00	0.00	0.00
12/1/1998 12/31/1998	0	7,222.41	7,222.41	0.00	0.00	0.00	0.00
Total for Year: 1998		84,506.22	84,506.22	0.00	0.00	0.00	0.00
1/1/1999 1/31/1999	0	6,438.54	6,438.54	0.00	0.00	0.00	0.00
2/1/1999 2/28/1999	0	9,985.22	0.00	9,985.22	0.00	0.00	0.00
Delinquent							
3/1/1999 3/31/1999	0	6,430.69	6,430.69	0.00	0.00	0.00	0.00
4/1/1999 4/30/1999	0	6,588.20	6,588.20	0.00	0.00	0.00	0.00
5/1/1999 5/31/1999	0	7,561.60	7,561.60	0.00	0.00	0.00	0.00
6/1/1999 6/30/1999	0	7,944.26	7,944.26	0.00	0.00	0.00	0.00
7/1/1999 7/31/1999	0	6,940.09	6,940.09	0.00	0.00	0.00	0.00
8/1/1999 8/31/1999	0	6,437.39	6,437.39	0.00	0.00	0.00	0.00
9/1/1999 9/30/1999	0	7,736.27	7,736.27	0.00	0.00	0.00	0.00
10/1/1999 10/31/1999	0	6,311.78	6,311.78	0.00	0.00	0.00	0.00
11/1/1999 11/30/1999	0	7,213.07	7,213.07	0.00	0.00	0.00	0.00
12/1/1999 12/31/1999	0	6,255.36	6,255.36	0.00	0.00	0.00	0.00
Total for Year: 1999		85,842.47	75,857.25	9985.22	0.00	0.00	0.00

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EXAMPLE 2
 Schedule 2

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Reconciliation of Accrual Amounts (Book to Reported)

Period	Locality	Sales Tax			Use Tax		
		Book	Reported	Difference	Book	Reported	Difference
1/1/1998 1/31/1998	0	1,070.64	993.46	77.18	0.00	0.00	0.00
2/1/1998 2/28/1998	0	1,380.68	1,265.86	114.82	0.00	0.00	0.00
3/1/1998 3/31/1998	0	1,387.14	1,277.14	110.00	0.00	0.00	0.00
4/1/1998 4/30/1998	0	1,242.12	1,133.23	108.89	0.00	0.00	0.00
5/1/1998 5/31/1998	0	1,426.14	1,332.56	93.58	0.00	0.00	0.00
6/1/1998 6/30/1998	0	1,484.44	1,395.38	89.06	0.00	0.00	0.00
7/1/1998 7/31/1998	0	1,255.51	1,142.57	112.94	0.00	0.00	0.00
8/1/1998 8/31/1998	0	1,321.00	1,231.00	90.00	0.00	0.00	0.00
9/1/1998 9/30/1998	0	1,140.52	1,038.98	101.54	0.00	0.00	0.00
10/1/1998 10/31/1998	0	1,381.29	1,299.72	81.57	0.00	0.00	0.00
11/1/1998 11/30/1998	0	1,428.89	1,303.65	125.24	0.00	0.00	0.00
12/1/1998 12/31/1998	0	1,009.95	909.96	99.99	0.00	0.00	0.00
Total for Year: 1998		15,528.32	14,323.51	1,204.81	0.00	0.00	0.00
1/1/1999 1/31/1999	0	1,316.70	1,205.48	111.22	0.00	0.00	0.00
2/1/1999 2/28/1999	0	1,230.21	1,142.16	88.05	0.00	0.00	0.00
3/1/1999 3/31/1999	0	1,441.25	1,362.68	78.57	0.00	0.00	0.00
4/1/1999 4/30/1999	0	1,357.89	1,253.87	104.02	0.00	0.00	0.00
5/1/1999 5/31/1999	0	1,279.85	1,162.63	117.22	0.00	0.00	0.00
6/1/1999 6/30/1999	0	1,463.12	1,354.66	108.46	0.00	0.00	0.00
7/1/1999 7/31/1999	0	1,430.95	1,320.92	110.03	0.00	0.00	0.00
8/1/1999 8/31/1999	0	1,129.77	1,019.33	110.44	0.00	0.00	0.00
9/1/1999 9/30/1999	0	1,350.31	1,276.74	73.57	0.00	0.00	0.00
10/1/1999 10/31/1999	0	1,451.11	1,368.68	82.43	0.00	0.00	0.00
11/1/1999 11/30/1999	0	1,387.33	1,287.35	99.98	0.00	0.00	0.00
12/1/1999 12/31/1999	0	1,209.72	1,086.94	122.78	0.00	0.00	0.00
Total for Year: 1999		16,048.21	14,841.44	1,206.77	0.00	0.00	0.00

When the decision has been made by the manager and supervisor to impose the major penalty, the basis for the imposition of the major penalty is to be explained in the general comments section of the audit narrative using the following format:

“The major penalty was imposed in accordance with 72 P.S. 7267(b) for the failure to report sales and use taxes of _____ for the period beginning _____ and ending _____ as recorded on Schedule _____”.

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b. Major Penalties not Imposed

Major penalties should not be imposed where

- The tax is consistently over and under reported netting to zero tax due. (Example 3)
- The tax underreported is more than \$10,000 but reflects a small part of total tax reported for the audit period and resulted from an inadvertent error in reporting. (This situation requires an audit judgment at the Regional Manager level. This situation doesn't occur often. (Example 4)

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EXAMPLE 3
 Schedule 2
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Reconciliation of Accrual Amounts (Book to Reported)

Period	Locality	Sales Tax			Use Tax		
		Book	Reported	Difference	Book	Reported	Difference
1/1/1998 1/31/1998	0	5,724.72	5,642.72	82.00	0.00	0.00	0.00
2/1/1998 2/28/1998	0	6,489.20	6,584.00	-94.80	0.00	0.00	0.00
3/1/1998 3/31/1998	0	6,116.40	5,995.12	121.28	0.00	0.00	0.00
4/1/1998 4/30/1998	0	6,514.26	6,514.26	0.00	0.00	0.00	0.00
5/1/1998 5/31/1998	0	7,026.67	7,026.67	0.00	0.00	0.00	0.00
6/1/1998 6/30/1998	0	6,680.78	6,803.08	-122.30	0.00	0.00	0.00
7/1/1998 7/31/1998	0	7,180.33	7,180.33	0.00	0.00	0.00	0.00
8/1/1998 8/31/1998	0	8,095.78	8,095.78	0.00	0.00	0.00	0.00
9/1/1998 9/30/1998	0	8,191.97	8,191.97	0.00	0.00	0.00	0.00
10/1/1998 10/31/1998	0	6,871.35	6,871.35	0.00	0.00	0.00	0.00
11/1/1998 11/30/1998	0	6,796.55	6,810.37	-13.82	0.00	0.00	0.00
	0	7,066.38	7,038.74	27.64	0.00	0.00	0.00
Total for Year: 1998		82,754.39	82,754.39	0.00	0.00	0.00	0.00
1/1/1999 1/31/1999	0	7,332.26	7,219.32	112.94	0.00	0.00	0.00
2/1/1999 2/28/1999	0	7,004.74	7,120.86	-116.12	0.00	0.00	0.00
3/1/1999 3/31/1999	0	6,852.84	6,852.84	0.00	0.00	0.00	0.00
4/1/1999 4/30/1999	0	7,615.89	7,615.89	0.00	0.00	0.00	0.00
5/1/1999 5/31/1999	0	7,819.00	6,708.19	1110.81	0.00	0.00	0.00
6/1/1999 6/30/1999	0	7,378.63	6,367.81	1010.82	0.00	0.00	0.00
7/1/1999 7/31/1999	0	7,218.85	6,308.02	910.83	0.00	0.00	0.00
8/1/1999 8/31/1999	0	7,192.76	10,222.04	-3029.28	0.00	0.00	0.00
9/1/1999 9/30/1999	0	6,816.12	6,816.12	0.00	0.00	0.00	0.00
10/1/1999 10/31/1999	0	6,345.41	6,345.41	0.00	0.00	0.00	0.00
11/1/1999 11/30/1999	0	6,948.33	6,948.33	0.00	0.00	0.00	0.00
12/1/1999 12/31/1999	0	7,094.83	7,094.83	0.00	0.00	0.00	0.00
Total for Year: 1999		85,619.66	85,619.66	0.00	0.00	0.00	0.00

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EXAMPLE 4
 Schedule 2
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Reconciliation of Accrual Amounts (Book to Reported)

Period	Locality	Sales Tax			Use Tax		
		Book	Reported	Difference	Book	Reported	Difference
1/1/1998 1/31/1998	0	83,109.52	83,109.52	0.00	0.00	0.00	0.00
2/1/1998 2/28/1998	0	86,402.28	86,402.28	0.00	0.00	0.00	0.00
3/1/1998 3/31/1998	0	86,837.65	86,837.65	0.00	0.00	0.00	0.00
4/1/1998 4/30/1998	0	91,534.81	91,534.81	0.00	0.00	0.00	0.00
5/1/1998 5/31/1998	0	93,170.72	93,170.72	0.00	0.00	0.00	0.00
6/1/1998 6/30/1998	0	92,528.57	92,528.57	0.00	0.00	0.00	0.00
7/1/1998 7/31/1998	0	88,395.52	77,564.56	10,830.96	0.00	0.00	0.00
8/1/1998 8/31/1998	0	87,190.75	87,190.75	0.00	0.00	0.00	0.00
9/1/1998 9/30/1998	0	86,113.12	86,113.12	0.00	0.00	0.00	0.00
10/1/1998 10/31/1998	0	78,213.67	78,213.67	0.00	0.00	0.00	0.00
11/1/1998 11/30/1998	0	75,329.51	75,329.51	0.00	0.00	0.00	0.00
12/1/1998 12/31/1998	0	85,113.54	85,113.54	0.00	0.00	0.00	0.00
Total for Year: 1998		1,033,939.66	1,023,108.70	10,830.96	0.00	0.00	0.00
1/1/1999 1/31/1999	0	83,366.80	83,366.80	0.00	0.00	0.00	0.00
2/1/1999 2/28/1999	0	74,847.78	74,847.78	0.00	0.00	0.00	0.00
3/1/1999 3/31/1999	0	73,934.39	73,934.39	0.00	0.00	0.00	0.00
4/1/1999 4/30/1999	0	71,531.69	71,531.69	0.00	0.00	0.00	0.00
5/1/1999 5/31/1999	0	75,308.24	75,308.24	0.00	0.00	0.00	0.00
6/1/1999 6/30/1999	0	74,693.88	74,693.88	0.00	0.00	0.00	0.00
7/1/1999 7/31/1999	0	81,990.51	81,990.51	0.00	0.00	0.00	0.00
8/1/1999 8/31/1999	0	76,324.35	76,324.35	0.00	0.00	0.00	0.00
9/1/1999 9/30/1999	0	78,888.58	78,888.58	0.00	0.00	0.00	0.00
10/1/1999 10/31/1999	0	73,566.00	73,566.00	0.00	0.00	0.00	0.00
11/1/1999 11/30/1999	0	84,640.39	84,640.39	0.00	0.00	0.00	0.00
12/1/1999 12/31/1999	0	70,754.00	70,754.00	0.00	0.00	0.00	0.00
Total for Year: 1999		919,846.61	919,846.61	0.00	0.00	0.00	0.00

Any exceptions to this policy must receive the Bureau Director’s approval.

4. Post Audit Conference on Criminal Referrals

A post audit conference will be held with a Bureau representative at the taxpayer’s place of business to explain the civil audit findings, make recommendations to correct areas of noncompliance, and provide the supporting schedules.

Audits referred on out-of-state entities can have a post audit conference via telephone and mail the Taxpayer’s Acknowledgement of Post Audit Conference and letter (see sample) of explanation, along with supporting schedules.

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Criminal referral and major penalties should not be discussed at the post audit conference. The decision to make the criminal tax referral and impose major penalties will be made upon regional review, after the conclusion of the audit.

If, during the course of the audit or at the post audit conference, the taxpayer questions the possibility of a criminal referral, a statement may be made citing the audit could be referred pending further review.

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Sample Post Audit Conference by Mail Letter

X
X
X

Attention: X

RE: Sales and Use, Philadelphia County, Employer Withholding Tax Audit
Assignment: No.
License No.

Dear X:

You are advised that subject audit(s) have been completed and a tax deficiency of _____ has been established. This deficiency is comprised of \$ _____ tax and \$ _____ Tax.

Taxpayer's Acknowledgment of Post-Audit Conference (form REV-59) is also enclosed herein. This form(s) outlines the audit deficiency and provides general information relevant to the execution of the form and the assessment of the deficiency. This form should be executed by a corporate officer and returned promptly in the stamped, self-addressed return envelope. Please retain a copy of the form for your records.

In the near future, you will receive a Notice(s) of Audit Assessment, which will outline, by report period, the civil assessment, including any additions of penalties and interest. A copy of the complete audit report(s) may be obtained upon request or appeal of the audit assessment(s). You have ninety (90) days from the mailing date on the Notice of Assessment to file an appeal. Instructions for the filing of an appeal are included on the rear of the Notice of Assessment.

Should you have any questions regarding the information discussed herein, you can reach me at (717)-000-0000.

Very truly yours,

Revenue Regional Manager
Regional Office

Enclosure

Chapter 10 – COMPUTER-ASSISTED AUDITING

A. INTRODUCTION / OVERVIEW

The Department's Computerized Audit Support (CAS) Division has been assisting auditors in the analysis of computerized accounting data during the conduct of sales and use tax audits since 1995. CAS has been able to read, sort, summarize, merge, and link many different types of data files provided by taxpayers. As a result, more complete and accurate audits can be performed while data entry of invoice information is reduced. Auditors have been helped in accomplishing complete examination of sales, capital, and expense transactions as well as the conduct of block sample testing and Stratified Random Sample testing. The Computer Assisted Auditing Brochure and Informational Handout further describe the benefits of computer assisted auditing to both the auditor and the taxpayer.

This chapter is divided into six main sections that will cover the following:

- A. Introduction and Overview
- B. Informing the Taxpayer
- C. Determining Taxpayer Eligibility
- D. Pre Audit Planning
- E. Verification of Data
- F. Forms and Schedules

B. INFORMING THE TAXPAYER

In addition to the Audit Engagement Letter, the taxpayer must be sent a REV-554, Department of Revenue Disclosure Statement of the Department's and the Taxpayer's Rights and Obligations. In some cases and at the regional manager's discretion, a Computer Assisted Auditing Brochure will be sent in conjunction with the Audit Engagement Letter.

C. DETERMINING TAXPAYER ELIGIBILITY

The taxpayer may or may not be a good candidate for computer assist. Some indicators, which may suggest a good candidate, include the following:

- Taxpayer possesses a large volume of records.
- Taxpayer operates in multiple locations.
- Taxpayer maintains invoices that are difficult to retrieve.
- Taxpayer utilizes Electronic Data Interchange (EDI) where transactions only exist in electronic or computerized form.
- Taxpayer who maintains direct pay permit, and/or
- Taxpayer maintaining or applying for an approved use tax formula.

D. PREAUDIT PLANNING

When the auditor has determined that a taxpayer is a good candidate for utilizing computer assisted auditing, CAS may be contacted. CAS will then contact the taxpayer's

information technology (IT) personnel to coordinate the transfer of the computerized accounting data. CAS will send the taxpayer an Informational Handout, which describes the desired data fields and file types, as well as the various methods of transferring the computerized accounting data to the Department. For very large and/or complex audit engagements, CAS may recommend that a conference be scheduled involving the auditor, a member of CAS, a member of the taxpayer's tax Department, and a member of the taxpayer's IT department. The auditor and CAS will jointly coordinate this meeting.

E. VERIFICATION OF DATA

The auditor is required to verify the completeness of the computer data provided by the taxpayer. CAS will provide summary reports (e.g. totals by account and period) that are to be compared to the taxpayer's accounting records.

F. FORMS AND SCHEDULES

This section discusses the forms and schedules currently used by CAS:

- Computer Assisted Auditing Brochure
- Informational Handout
- Sample – Taxpayer's Concurrence With Test Audit Plan (Stratified Random Sample – Projectable Average)
- Sample – Calculation of Deficiency
- Sample – Error and Precision Calculation

1. Computer Assisted Auditing Brochure

This brochure is sent to certain taxpayers in conjunction with the Audit Engagement Letter. The regional manager will determine which taxpayers receive this brochure.

2. Informational Handout

After the auditor contacts CAS, CAS will send this handout to the taxpayer, which describes the desired data fields and file types as well as the various methods of transferring the computerized accounting data to the Department.

3. Taxpayer's Concurrence with Test Audit Plan (Stratified Random Sample – Projectable Average)

After the population of computerized transactions has been obtained and determined in the conduct of a Stratified Random Sample – projectable average test procedure, CAS will compile the computerized accounting data and prepare the necessary audit forms for the auditor. Specifically, CAS will stratify the population transactions, randomly select the sample transactions, and prepare this form, "Taxpayer's Concurrence With Test Audit Plan." The auditor should present this form to the taxpayer. Both the auditor and the taxpayer should sign this form that will be included in the audit package.

4. Schedules

a. Calculation of Deficiency (Stratified Random Sample – Projectable Average)

The auditor prepares this schedule for inclusion within the audit package. This sample schedule shows the computation of the additional taxable amount for each stratum.

b. Error and Precision Calculation (Stratified Random Sample – Projectable Average)

The auditor prepares this schedule, which identifies the accuracy of the testing procedure, for inclusion within the audit package. The statistical measure that is used is the precision percentage calculated at a 90% confidence interval. This calculation identifies the range, with 90% certainty, that a complete audit of the tested population would have resulted in.

APPENDICES

Several appendices have been included to supplement the instructions given in the manual. The purpose is to provide the auditor with clear examples of forms, resources and reports that are part of an audit. These appendices include tax returns, computer files, audit documents and codes tables.

Appendix 1 – Tax Returns

This appendix is intended to supplement the information provided in the sales and use tax audit manual by displaying tax returns related to the audit function. The returns are listed below and are intended for informational purposes only:

Number	Title
Form 1040 – Schedule C	Profit or Loss from Business
Form 1065	U.S. Return of Partnership Income
Form 1120	U.S. Corporation Income Tax Return
Form 1120-S	U.S. Income Tax Return for an S Corporation
Form 941	Employer’s Quarterly Federal Return
Form 990	Return of Organization Exempt from Income Tax
Form 990T	Exempt Organization Business Income Tax Return
Form W-2	Wage and Tax Statement
PA-1	Use Tax Return
PA – 3 (filed via E-TIDES/Telefile)	Pennsylvania Sales, Use and Hotel Occupancy Return
PA – 4R	Public Transportation Assistance Fund Taxes and Fees Return
PA – 40	Pennsylvania Income Tax Return
PA – 5R	Vehicle Rental Tax Return
Pa 40 NRH	Schedule NRH Compensation Apportionment
Pa Schedule NRK-1	Non-Pa Resident’s Schedule of Pa S Shareholder/Partner Pass Through Income, Loss, and Credits
Pa Schedule RK-1	Resident Schedule of PA S Shareholder/Partner Pass Through Income, Loss and Credit
Pa-20S/Pa-65	Pennsylvania Corporate/Partnership Information Return
PA-40 – NRC	Pennsylvania Nonresident Consolidated Income Tax Return
PA-65 Corp	Partnership Directory
PAW-3 (filed via E-TIDES/Telefile)	Employee Quarterly Reconciliation Return of Income Withheld
Rev 1667 (filed via E-TIDES/Telefile)	W-2 Reconciliation Transmittal
Rev 976	Election Not to be Taxed as a Pennsylvania S Corporation

Appendix 2 – Audit Documents

Following is a collection of sample documents used, examined or issued to a taxpayer during the course of an audit. This appendix also includes documents relating to the appeal process. These documents have been included in the manual for information purposes only.

Form		Audit Index – Department Copy
Form		Audit Request
Form		Auditor’s Opinion and Conflict of Interest Statement
Form		Report of Delinquent Returns
Form		Request for Cancellation/Transfer of Audit Assignment/Potential
Form		Request for Financial Records
Form		Requirements for the Audit Review of Third Party Credits
Form		Uniform Sales and Use Tax Certificate – Multijurisdictional
Form	REV-1220	Pennsylvania Exemption Certificate
Form	REV-1715	Exempt Organization Declaration of Sales Tax Exemption
Form	(Manual)	Sales and Use Tax Audit Potential Worksheet
Form	1105	Additional Headquarters Processing Request
Form	2848	Power of Attorney and Declaration of Representative
Form	REV-677	Power of Attorney and Declaration of Representative
Form	PA-100	Pennsylvania Enterprise Registration Form and Instructions
Form		Bureau of Audits Registration Update
Form	REV-149	Audit Report and Basis of Assessment
Form	REV-153	Tally Sheet
Form	REV-1706	Business/Account Cancellation Form
Form	REV-1717	Taxpayer’s Concurrence With Test Audit Plan
Form	REV-1717	Taxpayer’s Concurrence With Test Audit Plan (Stratified Random Sample – Attachments I, II, III)
Form	REV-203	Business Activities Questionnaire
Form	REV-227	Sales and Use Tax Credit Chart
Form	REV-140	Waiver
Form	REV-39	Sales and Use Tax Appeal Schedule
Form	REV-554	Commonwealth of Pennsylvania Department of Revenue Statement of the Department’s and Taxpayers’ Rights and Obligations
Form	REV-59	Acknowledgement of Post Audit Conference form
Form	REV-640	Bulk Sale Clearance Certificate
Form	REV00K15	Notice of Audit Assessment
Form	REV-65	Petition Form
Letter		Audit Engagement Letter
Letter		Customized Confirmation Letter – Out-of-state
Letter		Writ of the Secretary of Revenue (front and back)
Letter		Request for Financial Records 1
Letter		Request for Financial Records 2
Letter		Request for Financial Records 3
Letter	BOA	BOA Sample Utility Survey and Explanation

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Publication		CAS DIV Information Handout
Publication		Computer Assisted Auditing brochure
Publication	REV-1799 BA	Time Limitations on the Filing of Petitions (prior to 01/01/08)
Publication	REV-1799A BA	Time Limitations on the Filing of Petitions (as of 01/01/08)
Publication	REV-20AS	Employer Withholding for Pennsylvania Taxable Compensation Guide – Directions for Completing Federal W-2 Block 16
Publication	REV-23BA	Practices and Procedures of the Board
Publication	REV-415	Employer Withholding Information Guide
Publication	REV-717	Retailers Information Booklet
Schedule	Schedule 1	Returns as Filed
Schedule		Reconciliation of Accrual Amounts Book to Reported
Schedule		Comparison of Reported Sales to Book Sales
Schedule		Selection of State Sales Tax Test Periods
Schedule		Error Rate Calculations
Schedule		Projection Details
Schedule		Credit Error Rate Calculations
Schedule		Credit Projection Detail
Schedule		Recap Schedule
Schedule		Final Summary of Deficiency
Schedule		Summary of Tax and Major Penalty Due by Jurisdiction
Schedule		Employer Withholding Reconciliation
Schedule		Stratified Random Sample – Error and Precision for Sample and Complete Stratum
Schedule		Stratified Random Sample – Calculation of Deficiency
Worksheet		Invoice Detail, State Sales Tax, Sorted by Period
Worksheet		Invoice Detail, Local Sales Tax, Sorted by Period
Worksheet		Invoice Detail, State Sales Tax not used in any projection
Worksheet		Invoice Detail, State Capital Use Tax, Sorted by Period
Worksheet		Invoice Detail, Local Capital Use Tax, Sorted by Period
Worksheet		Invoice Detail, State Expense Use Tax, Sorted by Period
Worksheet		Invoice Detail, Local Expense Use Tax, Sorted by Period
Worksheet		Third Party Credit Detail, All Expense, Sorted by Period
Worksheet		Invoice Detail, Mass Transit Tax, Sorted by Period

Appendix 3– Computer Files

AASTART
AASTART Reports – Audit Potential Worksheet
Annual System – General
Annual System – PA-40
Annual System – PA-40NRC
Annual System – PA65
Corporate Tax System – General
Corporate Tax System – CTSTART

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Corporate Tax System – CTSTART DLN Inquiry
Department of State
Keystone Integrated Tax (KITS) System – General
KITS – Downloading Schedule 1
KITS – R101 Taxpayer Inquiry
KITS – R116 Name Inquiry
KITS – R118 Business Details Inquiry
KITS – R119 Notes Inquiry
KITS – R121 Address Inquiry
KITS – R122 Relationship Inquiry
KITS – R124 Account Inquiry
KITS – R142 Employee Inquiry
KITS – R208 Financial Inquiry
KITS – R214 Summary Balance Inquiry
KITS – R630 Case Inquiry
KITS – R653 Contact Inquiry
MIMENU
MULTSESS
PTA MTTXR
PTA System
Taxpayer Summary Information (TSI)

Appendix 4 – Codes & Information Lists

Codes	Audit Cancellation Codes
Codes	Audit Reason Codes
Codes	Audit Source Codes
Codes	Annual System – Document Locator Number (DLN) Codes
Codes	Corp Tax System – Report Codes
Codes	Corp Tax System – Tax Type Codes
Codes	Corp Tax System – Transaction Codes
Codes	County Codes
Codes	DIF Scores
Codes	KITS Quick Reference Chart
Codes	PIT Quick Reference
Codes	RAPS – Tax Type Codes
Codes	Zip Codes – Allegheny County
Codes	Zip Codes – Philadelphia County
Info List	Bankruptcy Courts
Info List	Citation Formats
Info List	Citations
Info List	Direct Pay Permit Holders
Info List	Employer Withholding Audit Checklist (Sample)
Info List	Internet Sites
Info List	GSA Smartpay Card
Info List	Medical and Dental T/E List
Info List	Sales Tax Exemptions Not Found in the Tax Reform Code
Info List	Sales Tax Audit Review Checklist (Sample)
Info List	Tax Bulletins

Appendix 5 – SIC/NAICS Codes

These codes are used to identify industry type. The former Standard Industrial Code (SIC) was replaced by the North American Industry Classification System (NAICS). The actual table is taken from the federal Census Bureau’s web page.

End of Manual