



## Texas Franchise Tax Audit Process

Now that the Comptroller's revised rule for cost of goods sold is in place and effective, the Comptroller has begun moving forward with franchise tax audits that had previously been placed on administrative hold and assigning new franchise tax audits to auditors.

The following information from Karey Barton provides an outline of what your company should expect at the beginning, during and after the audit process. For companies that had their audits put on hold several of the steps in the audit process may have already occurred.

If you have questions regarding this information, your audit or issues raised during your audit, please feel free to reach out to our consultant, Karey W. Barton at 512-497-2880 or Karey@BSTA.biz.

After your company has been selected for audit, the Comptroller assigns the audit to an auditor. The Comptroller's Office mails an Audit Questionnaire and a Notice of Routine Audit Letter to your company when an audit is generated or assigned in the local audit office. The Audit Questionnaire will request information on your company's authorized representatives, business activity, and computer system. This information includes:

- the names and titles of the individuals to contact to schedule an entrance conference;
- the name and title of the individual(s) authorized to enter into written agreements;
- the location of your company's records; and
- a general description of your company's business activities.

### **Entrance Conference**

After receipt of the audit questionnaire, the auditor should contact the person designated on the Audit Questionnaire to:

- discuss the tax (sales tax, franchise tax, etc.) to be audited;
- discuss the business description, activities and organization's structure;
- establish an appointment for the entrance conference;
- establish a starting date for the audit;

- tell you what records may be required and that additional records may be necessary as the audit proceeds;
- determine the location of your records. If the records are outside of the audit office assignment area, the audit may be transferred to another audit office; and
- obtain any other information that may be needed before the entrance conference takes place.

The entrance conference is generally the first face-to-face meeting between the auditor and your company's designated representative, prior to beginning the examination of your company's books and records.

During the entrance conference the auditor should make you aware of the purpose of the audit and what is expected of you, as well as what you may expect of the auditor. For example, the auditor should discuss:

- the purpose of the audit (i.e., to insure compliance with the state tax laws and reporting procedures);
- the time periods being audited;
- the your company's accounting system;
- the personnel who prepare the returns and whether they have changed during the audit period; and
- your company's tax return work papers and records used to prepare the returns.

**HELPFUL TIPS:** It is important for you to discuss these issues and to have a clear understanding of what to expect from the audit. It benefits both your company and the auditor to have the audit conducted in the most efficient and professional manner possible. Although it is not necessary to establish a close personal relationship with the auditor, you should be cordial and professional in dealing with the auditor.

You should provide the auditor a reasonable working area that is separate from company personnel. One company contact person should handle communications with the auditor. Having the auditor deals with more than one company representative may lead to miscommunication and incorrect information being relayed. You should get the auditor's requests for production of books, records, and other documentation in writing. And you should make copies of all documents given to the auditor and keep them in an audit file. You should request periodic status reports from the auditor about how the audit is going and when it will be completed.

You should be cooperative with the auditor, but should not hesitate to ask the auditor for additional information. For example, the Comptroller has broad but not unlimited authority to examine books and records. If the auditor asks for information that is not related to the examination, consider whether it is appropriate to provide it. If you doubt the propriety of a request, consider consulting with a tax advisor. If you do not understand the basis for the auditor's

treatment of revenue or expenses, you should ask the auditor for specific authority supporting the auditor's position.

### **Examination of Your Company's Records**

Expect that the auditor will request the following information for the relevant time periods under audit:

- organizational charts and/or list of legal entities, including ownership percentages;
- consolidated federal income tax returns with work papers;
- proforma federal income returns and supporting documents
- franchise tax returns, work papers and underlying data;
- Chart of Accounts;
- general ledgers and trial balances;
- job cost/expense files; and
- apportionment and allocation work papers

### **Statute of Limitations**

Although there are exceptions (e.g., in the case of fraud), the general statute of limitations for franchise taxes is four years from the date that the tax becomes due and payable (May 15<sup>th</sup> if no extension is requested, November 15<sup>th</sup> if proper extensions are filed).

**HELPFUL HINT:** In most instances, the Texas franchise returns that will be subject to audit will be for 2009 and subsequent report years. Report Year 2008 will be out of statute unless statute of limitations extension waivers have been signed by your company.

### **Exit Conference**

At the end of the audit the auditor will meet with your company's designated representative for the exit conference. This meeting is used to:

- inform you of the audit results and ensure that you understand the audit results;
- explain the taxpayer's rights and available administrative remedies;
- collect the deficiency, if possible and applicable, and inform you of penalty, interest, and billing processes.

What you should expect from the auditor, discussion of:

- any adjustments noted and the applicable law or rulings involved. If not already done, the auditor may should provide copies of Comptroller rules and decisions that support the audit adjustments;
- any discrepancies that the auditor noted but did not schedule;
- the records used or examined; and
- the mechanics of the audit, including any calculations or projections as well as the information available to the taxpayer on the auditor's detailed schedules. If he has not already done so, the auditor will give the taxpayer copies of all final audit schedules.

If the audit resulted in a liability, the auditor should explain that the taxpayer will receive a

billing of taxes, penalty, and interest calculated through the date of the billing. The billing will go out approximately one month after the audit is submitted to review. The auditor should also explain how the penalty and interest on the liability are calculated and discuss the penalty waiver criteria and whether the taxpayer's penalty will be waived.

### **Penalties and interest on audit assessments**

If you did not remit the tax on or before the date it was originally due and payable and the tax is later assessed in an audit, your company incurs a mandatory 5 percent penalty. After the first 30 days delinquency, an additional mandatory penalty of 5 percent is assessed and an additional 10 percent is imposed if the audit assessment is not paid on or before the date indicated on the "Texas Notification of Audit Results."

After the first 60 days of delinquency, interest begins to accrue at a variable rate that is the prime rate plus one percent as published in the *Wall Street Journal* on the first business day of each calendar year.

Under the Comptroller's guidelines penalty or interest on an audit liability may be waived if the taxpayer exercised reasonable diligence to comply with the Texas tax laws. The Comptroller has delegated to the audit manager the initial authority to waive penalty and interest in appropriate cases. At the exit conference, you will be told whether any penalty or interest will be waived. At this conference you may request the audit manager to reconsider the decision on penalty or interest waiver.

The taxpayer will be advised of the audit manager's acceptance or rejection of the request for waiver of penalty or interest in the audit cover letter sent with the copy of the audit schedules. If a taxpayer's request for waiver is denied at the audit level, the taxpayer may raise the issue as a contested case matter during either a refund or redetermination hearing.

When reviewing a penalty waiver request in an audit or in a contested case, the Comptroller considers the following factors regarding a taxpayer's account:

- the taxpayer's audit history;
- the tax issues involved;
- a change in Comptroller policy during the audit period;
- the size and sophistication of the taxpayer;
- whether tax was collected but not remitted;
- whether returns were timely filed;
- the completeness of the taxpayer's records;
- any delinquencies in other taxes; and
- the taxpayer's reliance on advice provided by the Comptroller's office that caused the imposition of penalty and interest.

Although it is not uncommon for penalty to be waived in an audit, especially in the taxpayer's first audit, interest is only waived if much more narrow criteria are met.

When reviewing an interest waiver request, the Comptroller considers the following factors

regarding a taxpayer's account:

- undue delay caused by Comptroller personnel;
- reliance on advice provided by the Comptroller's office that caused the imposition of penalty and interest; and
- natural disasters.

### **Contesting an Audit Assessment**

If you disagree with the audit results, and are unable to resolve the issues during the audit or at a reconciliation conference with the auditor's supervisor or audit manager or an Independent Audit Review conference, your company may request a redetermination or refund hearing. If you are not satisfied with the outcome of the hearings, you may contest the audit in court.

**Helpful Tip:** The following Comptroller publications provide more detailed information on audit procedures and contesting audit results:

- 96-146 Notice of Routine Audit  
[http://www.window.state.tx.us/taxinfo/taxpubs/tx96\\_146.pdf](http://www.window.state.tx.us/taxinfo/taxpubs/tx96_146.pdf)
- 96-1253 Contesting Disagreed Audits  
[http://www.window.state.tx.us/taxinfo/taxpubs/tx96\\_1253.pdf](http://www.window.state.tx.us/taxinfo/taxpubs/tx96_1253.pdf)

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