Healthcare tax checkups

Podcast transcripts

Episode 8: Reverse sales and use audits

Announcer

Hello, and welcome to Healthcare Tax Checkups, a KPMG podcast series, featuring KPMG tax leaders on emerging and perennial tax issues impacting the healthcare industry.

Announcer

Today's episode explores how reverse sales and use audits can benefit healthcare organizations.

Lori Robbins

Hello everyone, and thank you for tuning into this podcast episode. I'm [Lori Robbins 00:00:05], deputy tax industry leader of KPMG's healthcare tax practice, with me as Patrick Lee.

Lori Robbins

Patrick is a Managing Director in KPMG's state and local tax practice in Seattle. In his 17 years of service at KPMG, he has provided a broad range of state and local direct tax services to clients in many industries. Prior to joining KPMG, he filled various management positions in the healthcare industry with health plans in California and Washington. With that experience, Patrick focuses his time and talents on serving many clients in the healthcare and nonprofit sector.

Lori Robbins

Patrick is a leader of KPMG's national state and local healthcare team and a member of KPMG's indirect tax leadership. Patrick, thank you for joining us. We hear a lot about IRS audits and audits conducted by state auditors with respect to state and local income and sales taxes. But today we're going to be talking about reverse sales and use tax audits. What are these audits generally? Because admittedly, I think until I joined KPMG, I'm not sure I'd ever heard of them.

Patrick Lee

Well, that's a great question, Lori. And first of all, I think it's important to say that most companies don't like to hear the word audit at all, particularly if an auditor is coming from the outside, like from the IRS or from a state taxing authority. So it's good to sort of dispel the myth up front here. The word audit in this context has a much more benign meaning and it's more akin to an internal review where a company wants to be sure that its processes and decision making and outcomes are what they should be before any outside agency comes to examine them. So companies often ask our advice regarding the appropriate amount of sales tax, if they should be paying now and going forward. But in a reverse audit, a company looks back retrospectively to see what tax was paid and whether it was paid correctly.

Patrick Lee

If a company has overpaid, particularly with sales tax, they may use the findings of a reverse audit to get refunds. And if they've underpaid, they may use those findings to come into compliance with the states tax laws. So either way, a company may discover that they have processes or tools that may need addressing or updating. Depending on a state statute of limitations, if a company has overpaid tax, they may be able to go back and get refunds. Like I said, up to five years, looking back. A company usually goes into reverse audit with the idea that refunds will be found, in fact, I've been asked where the term reverse audit comes from, and I like the thing it has to do with the fact that with the reverse audit, the focus is on looking for opportunities to recover tax or to recover overpaid tax, whereas in a typical audit that's conducted by a state tax authority, the focus is almost always on looking for where a company's been deficient with the tax payments.

Lori Robbins

Right, yeah you're probably right that maybe the term reverse audit has a more negative connotation than what we generally think of with respect to audits. And maybe we need to find a new name for it, but for the time being we'll stick with reverse audit. And we don't usually think of healthcare organizations as big [inaudible 00:03:39] of sales and use taxes. What types of transactions are we talking about that can lead to sales and use tax refunds in connection with these reverse audits that you just explained to us, for healthcare organizations in particular?

Patrick Lee

Well, Lori, for all the great work that they do, you would think that healthcare organizations would get a break across the board in terms of having to pay sales tax. But it just isn't true. Many states do offer some sort of, I would call it an entity level exemption from sales tax. For example, most states do offer nonprofit healthcare companies or nonprofits in general, a break or even a 100% exemption from sales tax. But several states, including states out here in the West California and Washington, those states don't let nonprofits escape the sales tax at all.

Patrick Lee

Beyond the exemption for profits that many states offer, we then generally have to look at the types of items or services that are involved in a transaction. And depending upon the state, there typically are exemptions from sales tax for particular items or services that are used in the provision of medical services to patients, such as prescription drugs, over the counter drugs, laboratory reagents, prosthetics, durable medical equipment, disposable supplies, and equipment like tubings and needles and syringes, et cetera, for companies that do research in the healthcare area, often equipment parts and supplies and things like that are used in R&D, may have exemptions from sales tax that... The healthcare industry, both providers and payers are also huge consumers of electronic services and software.

Patrick Lee

And these are often very expensive transactions. When you buy an ERP system or you buy a medical record system and these transactions have lots of gray area, and then when it comes to what's taxable and what's not. So again, things like electronic medical records or electronic research libraries, software that's used to power equipment, software as a service that may manifest itself as an interactive site for buying health insurance, software that may be purchased in one state but accessed by users in many states, all of these purchases of electronic products and services present potentially large refund opportunities that may not be readily apparent to a buyer. And sometimes it requires significant digging to actually understand what the product attributes are and what the product functions are, because those things may drive whether or not a state's sales tax applies or not. [crosstalk 00:06:48].

Lori Robbins

Your software point is well taken Patrick, because thinking about it, there's so many software changes that healthcare organizations have undergone lately. So many ERP implementations that healthcare organizations are either pursuing or have pursued recently and I did not realize that apparently all of that comes into play when it comes to a reverse audit.

Patrick Lee

Absolutely. Yeah. It's a huge area of opportunity for many companies.

Lori Robbins

So Patrick, for those in healthcare organizations that are listening to this, what are some of the factors to consider in deciding whether to undergo such a reverse sales and use tax audit? And what are some of the benefits that you've seen to healthcare organizations or whom you helped undergo such audits?

Patrick Lee

Sure. Another good question, Lori. I think these factors that you're suggesting are applicable not only to companies in the healthcare industry, but probably to any industry. The first question I would ask myself is if I'm a company thinking about this is, when was the last time I audited by the state and what was the outcome of that audit? So sometimes the outcome of a state audit can indicate whether or not there might be opportunity for a company with a reverse audit.

If a state audit ended in the no change, they call it, meaning there was no assessment, there was no refund, or if it ended in an assessment, it may be an opportunity for a company to go back into the audit period and look for things that the auditor may have missed on in terms of taps over payments.

Patrick Lee

So that's the first thing I might ask myself, the second thing is, is my company currently under audit? If a company is currently under audit by estate tax authority, that's a great time to start a reverse audit. Because as I may have mentioned earlier, state taxing authorities, when they come audit you, they're not generally looking to give you money back. They're looking for deficiencies and areas where they can assess you additional tax. So if you're under audit, expecting that sort of outcome to be assessed, which is typical, it's a great time to start looking internally at refund opportunities that might offset that potential assessment. I would also look at how sophisticated a company's tax determination processes and in the healthcare industry, these big healthcare organizations are buying tens of thousands or maybe hundreds of thousands of different products.

Patrick Lee

And it's very hard to keep straight, what is taxable and what is not. And how sophisticated is a company's in the tax determination process? Do they have a pretty good system for figuring out what's taxable and what's not? And do they keep that system updated on a regular basis as states tax laws change? Particularly if you're operating in a multi-state atmosphere, you've got to keep track of what's going on in several states. And then, I would think also looking at a company's resources for managing indirect tax, many companies, and particularly in my experience with nonprofit companies, if there are tax resources available, those are generally spent on protecting a company's nonprofit status from a federal perspective. And there may not be tremendous resources to put on overseeing a sales tax function.

Patrick Lee

So sometimes if the company doesn't have the resources to do that kind of thing, there hasn't been great oversight on sales tax and so that's another opportunity to do a reverse audit. A company with a high volume of transactions, again, typical in the healthcare industry particularly for providers. I guess another factor might be, if a company's undergone a merger or an acquisition, which is going on to a great extent in healthcare these days and then I would look at, have there been any conspicuously, large transactions? Again, like these large ERP system implementations. Again, those large transactions can sometimes create opportunities. And lastly, just from a general perspective, in 2018, the US Supreme court made a decision in the Wayfair case. So it's four years ago, it's not new, and most people know about it, but in Wayfair, the court decided that a remote seller does not necessarily have to have a physical presence in a state in order to be on the hook for collecting and remitting sales tax.

Patrick Lee

So what we've seen over the last four years is remote sellers who may not have a physical presence in a state have upped their sales tax collection activity. And they may be collecting and remitting on items that are actually exempt from tax. I think just Wayfair in general has caused us to think reverse audits are a good idea in many respects. So those are some of the factors I would think about. In terms of benefits, I think, the number one benefit to a reverse audit is recovery of cash. And it's cash right to the bottom line. And as I mentioned, the other benefit might be offsetting a state audit assessment to reduce what you might have to pay, or actually converting an assessment into a refund. That's happened many times.

Patrick Lee

The other couple benefits would be to, in a reverse audit, as I mentioned before, you might uncover processes or systematic issues that are causing errors to be created, whether they be overpayments or underpayments and those problems can be fixed. And then one last thing I can think of, which is often very beneficial to companies, there are a lot of gray area issues in tax law and companies wonder whether or not they're paying sales tax correctly.

Patrick Lee

And they consider going to the tax authority with a ruling request to say, "Hey, what should I be doing here?" There's a separate fee, usually have to pay to go do those ruling requests. In a reverse audit a lot of gray area issues are just automatically answered, because you have to go through and figure out and develop a refund request that you send to a state and then they make a decision and give you answers. And so it's kind of a way to get answers from the state without approaching them specifically and calling attention to a particular issue. So there's some benefits.

Lori Robbins

Okay. That makes a lot of sense and obviously cash is key in terms of the benefits that is significant benefit for healthcare organizations that have [inaudible 00:14:16] themselves in the last few years, cash strapped, especially by the pandemic. But let's say a healthcare organization is looking at some of the factors that you just discussed and says, "well, maybe it does make sense to undergo one of these reverse sales and use audit." Can you give them a little preview of what to expect, maybe explain a little bit about how in your team conducts these audits and what the process is really like for them.

Patrick Lee

Absolutely. So if the company is interested in a reverse audit, I think the first thing we'd like to do is just double check that it really is a good idea. If we are hired to do this, we know that in certain industries, particularly in healthcare, there almost always is an opportunity for refund. We do this a lot for healthcare companies and we almost always find significant refund opportunities. So just the industry itself lends itself to having a successful, reverse audit. But the first thing we would do is some testing, maybe just some short tests, we call them. Sampling a few invoices or two transactions just to see what's going on historically with a company's sales tax payments. And just from those short tests, we can often reinforce our idea of whether or not there's an opportunity.

Patrick Lee

So that's kind of a feasibility phase. If we go through that successfully, then we move on to actually doing the reverse audit. And I would say that the level of difficulty of doing a reverse audit is sort of dependent upon how well a company's files are organized and the sophistication of their system. Do they have a really good electronic system? Or they've captured transaction data well and tax information like, do we know what product they sold? Is it well described in the transaction system? Do we know what the price was for the particular item? Was tax captured in the electronic system? If those things are there, then we have a great tool that we created at KPMG called the Indirect Tax Analytics Platform or ITAP. ITAP is a... We like to think of it as a great solution for doing reverse audits.

Patrick Lee

And it has greater capacity than this. We'll talk about ITAP in the context of a reverse audit. So ITAP is able to take data from a client's system or a company system, ERP system and regardless of the format, format doesn't matter, it can take almost all types of formats. We draw the information, the purchase information into ITAP where it's organized and prepared for a, what I would call a, line by line analysis. So we might get millions of records into ITAP, but because of the way it's organized and prepared, it becomes doable for us to go through essentially on a line by line basis to look at each transaction and whether or not tax was appropriately charged and paid according to a state's tax law.

Patrick Lee

Once we do that, and we analyze what the tax opportunity might be by line item, then we prepare a claim for refund and we make sure the client is on board with this and understands our positions and what we think is refundable. And with their approval, we prepare a claim for refund or claims for refund because many states require a purchaser to go to its vendors first to ask for a refund of tax that they believe they've overpaid. Some states allow a buyer or purchaser to go directly to the state tax authority. So we're either going to file a claim with a state tax authority, or we're going to file several claims with a company's vendors to ask for a refund of the tax. Once those claims are filed, then there's typically lots of follow up associated in the wake of filing those claims, questions to answer, additional documentation to provide, et cetera.

Patrick Lee

And we pursue that until we either have a refund from the vendor, or we have a refund from a state tax authority. Sometimes state tax authorities won't agree with our positions, but we may be right and so we make a decision with the company, with the client, whether or not we're going to contest a state's denial of a refund claim. And we may go on to appellate levels within the administrative appeal organization of a state tax authority until we actually have the money in hand for the client. So that's the process and it takes, generally, I would say several months from start to finish, to go through a reverse audit and actually have money in hand for the client.

Lori Robbins

Okay, great. That's helpful. And thank you Patrick, for explaining the whole reverse sales and use audit process and benefits to us. As someone who doesn't do much of this, this has been really informative and hopefully our listeners found it to be such as well. To our podcast listeners, thank you for tuning into this episode. For more information about reverse sales and use tax audits, please check out the slip sheet and deck on the indirect tax analytics platform. Links to which can be found on this podcast episodes web page. If you have any questions about the topics we discuss today, please reach out to Patrick, me or your local KPMG representative.

Announcer

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