



presents

Sales and Use Tax Audits: Effective Records Management Under Conflicting State Demands

Best Practices For Retaining, Administering and Producing Required Records

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Silvia Aguirre, President, **Tax Technology Services**, Raleigh, N.C.
Dan Davis, Partner, **Associated Sales Tax Consultants**, Sacramento, Calif.
Gus Rivera, U.S. Transaction Tax Manager, **Intel Corp.**, Santa Clara, Calif.
Dr. Will Yancey, **CPA**, Dallas

Thursday, October 15, 2009

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
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Sales And Use Tax Audits: Effective Records Management Under Conflicting State Demands Webinar

Oct. 15, 2009

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Today's Program

- Key Audit Issues, Improving Exemption Certificate Management, slides 3 through 11 (*Silvia Aguirre*)
- Intel Corp.'s Experience, Procedures, slides 12 through 18 (*Gus Rivera*)
- Use Tax Documentation, Staff Training, State Documentation Demands, slides 19 through 28 (*Dan Davis*)
- Responding To Complaints Of Inadequate Documentation; Legal Issues From Document Production, slides 29 through 36 (*Will Yancey*)

Key Audit Issues, Improving Exemption Certificate Management

Important Audit Topics In Records Management

Personnel

- More responsibilities, fewer personnel on both corporate and states' sides
- Cross-trained employees; sales tax must tie to income tax

Technology

- More detailed data is available and requested
- Must be able to filter to important data
- Must support doing more with fewer people

Important Audit Topics In Records Management (Cont.)

Rapidly changing legislation

- SST: Good faith standards, sourcing and membership changes

From the latest proposal at BAC meeting 9/29/09:

Good Faith – Exemption certificate - Subsection D of Sec. 317–
9/29/2009

“The burden of proof shall be on the state to ascertain the seller has knowledge, or has reason to know, the information was materially false when the purchaser provided it.”

Important Audit Topics In Records Management (Cont.)

Rapidly changing legislation (Cont.)

- WA – Joins SST, then adjusts exemption certificate rules

<http://dor.wa.gov/Content/FindTaxesAndRates/RetailSalesTax/ResellerPermit/default.aspx>

Recent e-mail correspondence with WA:

From: DOR Reseller

Sent: Monday, Sept. 28, 2009 3:48 PM

Subject: RE: SST form

Thank you for your follow-up e-mail.

No. Businesses located in Washington State making purchases for delivery in Washington State must provide a Washington State Reseller Permit to make wholesale purchases. Without a valid Reseller Permit, sellers must collect WA retail sales tax, unless the purchase is exempt by statute.

Thanks again.

Sent: Monday, Sept. 28, 2009 12:44 PM

To: DOR Reseller

Subject: RE: SST form

To further clarify my question:

Can we still accept the Streamlined sales tax exemption certificate form for **Washington (In-State)** resellers after January 1?

Important Audit Topics In Records Management (Cont.)

Rapidly changing legislation (Cont.)

- TX – You must provide all data within 30 days, or else
- CA – Similar to TX and “expectation” of two-year audit completion period

http://www.boe.ca.gov/meetings/pdf/1698_5_sdp.pdf

- LA – Three different sales tax certificates within one year

Prior to 1/1/09, the infamous “W” requirement

Effective 1/1/09 and to expire 10/31/09 – Form 1042

<http://revenue.louisiana.gov/sections/faq/default.aspx?type=GEN&cat=REPSLS>

Effective now – Form R-1064 and R-1055 (pre-printed forms)

<http://revenue.louisiana.gov/forms/lawspolicies/RIB09015.pdf>

- NY – Modifying the nexus rulings

Improving Exemption Certificate Records Management

Goals of better records management

- Close the audit as quickly as possible
- Reduce tax liabilities

Focus on the important areas first

- Use tax or sales tax?
- Stay focused during the audit on getting to those areas as soon as possible

If your business has more potential sales tax liability than use tax, the recordkeeping process needs to be perfected and in place throughout the company before the audit happens

Improving Exemption Certificate Records Management (Cont.)

Evaluate your current sales tax practices

- Who is receiving the exemption certificates? Are they trained?
- How are you keeping up to date on regulation changes?
- Are documents organized in a method easily adapted to audits?
- Are expirations being tracked? What happens to replaced certificates?

Use tax certificates

- Document as much as you can for your purchasing team to follow
- Explain the basics – no exemption in California

Improving Exemption Certificate Records Management (Cont.)

Manage certificates for different exempt purchases

- TX – Direct pay permit; why does it need to be in a certificate now?

You can search our records to find out if an entity currently holds an active direct payment permit for paying Texas sales and use taxes. While this site can help verify an entity's permit status, it neither eliminates the requirement that sellers must accept a properly completed direct payment exemption certificate (see [Rule 3.288](#)) nor requires sellers to confirm an entity's direct payment permit status in order to accept a direct payment exemption certificate.

- How critical is the seller's name or buyers name in a certificate? More important than you think. Unfortunately, the economic situation has forced businesses to restructure or go out of business
- An incomplete certificate is the number one reason for invalidating a certificate

Seasoned tax professionals are stunned more often now than before
because the rules have changed (and not in business' favor)

Improving Exemption Certificate Records Management (Cont.)

Retrieving certificates during an audit

- Documents should be centrally stored or maintained electronically
- Organization by state, then company name, can reduce search times
- Tie the certificate valid period to the invoiced dates

Intel Corp.'s Experience, Procedures

Intel's Record Retention Policy

- The Tax Department sets the record retention policy globally for the following records:
 - Accounting
 - Accounts payable: Invoices, ledgers, cash/check donations, credit card, expense reports
 - Accounts receivable: Invoices, ledgers, collection records
 - Capital property: Fixed asset records, transfers, depreciation schedules, acquisitions
 - General accounting: Account ledgers, accounting procedures, balance sheets, general ledgers, journal entries, trial balances
 - Bank
 - Statements, deposits, reconciliations, check registers
 - Financial
 - Reports, budgets, plans, forecasts
 - Purchasing
 - Purchase orders, agreements, contracts
 - Manufacturing
 - Product inventory reports, production costs, production yield reports

Intel's Record Retention Policy (Cont.)

- Payroll
 - Checks, registers, W-2s, W-4s, time cards
- Sales and marketing
 - Price lists, returns, customer lists, billings reports
- Shipping and receiving
 - Outbound and inbound shipping docs
- Treasury
 - Bank information such as agreements, account analyses, correspondence, lines of credit
 - Board resolutions
 - Hedging reconciliations
 - Intercompany loan agreements
 - Treasury accounting documentation

Intel's Record Retention Policy (Cont.)

- Intel's "golden rule" is 15-year global retention period for hard-copy and electronic records
 - Created using the 80% rule and living with some risk
 - Exceptions can be made with the Tax Department only if the business unit conducts a country-by-country analysis signed off by each tax representative from the respective country. Recently refreshed the Logistics Group's country matrix

Tax Department's Role

- Intel's Tax Department takes an active role by establishing the record retention policy and posting it on the Legal Department's internal website
- Educating our business partners on the policy
- Refreshing the policy periodically to ensure that all documents have been captured and country matrices have been updated

Categories Of Documents In An Audit

- Ledgers for the sales tax payable and use tax payable accounts
- Tax returns and back-up (sales tax and income tax)
- State fixed asset ledger (acquired, retired and transfers)
- Accounts payable invoices
- Purchase orders
- Sales invoices
- Exemption certificates
- Journal vouchers (inventory withdrawal)
- Corporate purchasing card reports and back-up

Supplier Methods For Billing Intel

- There are seven separate ways for a supplier to bill Intel:
 - Paper
 - Web invoice
 - XML
 - Non-PO ship
 - Non-PO TIDE
 - Consignment
 - ERS
- Tax Department was **engaged early** on as a stakeholder in and approver of for each method. Formatting and archiving requirements were also given

Use Tax Documentation, Staff Training, State Documentation Demands

Special Challenges Of Use Tax Documentation

A. Fixed assets: Documents supporting fixed-asset acquisitions may include capital asset requisitions or authorizations for expenditures; purchase contracts; purchase orders; purchase invoices; check vouchers; shipping documents; correspondence

1. If the vendor didn't charge tax, who owes it?
2. Usually audited in detail or through a stratified sample.
3. May qualify for a manufacturing exemption in some states

Special Challenges Of Use Tax Documentation (Cont.)

- B. Supplies, minor assets and other expenditures for internal use:
Supporting documents examined may include purchase orders;
purchase invoices; shipping documents; correspondence
1. Supplies used in manufacturing may be exempt
 2. Great weight may be given to accounting classifications
 3. Generally audited using statistical sampling, but block sampling is still employed by some states

Special Challenges Of Use Tax Documentation (Cont.)

- C. Software: Supporting documents may include authorizations for expenditures; licensing agreements, purchase contracts; purchase orders; purchase invoices; check vouchers; shipping documents; correspondence
1. Method of transmission may confer exemption
 2. Custom software is exempt in most (but not all) states
 3. In some states, software used to operate manufacturing equipment may be exempt

Special Challenges Of Use Tax Documentation (Cont.)

- D. Internal withdrawals and use of resale inventory: Required documentation may include internal requisitions and work orders; materials transfer sheets; internal journal entries; costing documents; and purchase invoices
1. Nature of use determines whether tax applies
 2. Different activities are taxable in different states, e.g., research and development and quality control
 3. Documentation should show quantity withdrawn, nature of use and post-use disposition

Staff Training For Use Tax Accrual And Documentation

A. Purchasing department and order administration staff:

1. Generally responsible for issuing purchase orders and related documents instructing vendors whether to charge sales tax
2. Documents should indicate tax status and reason for exemption (for resale, etc.), if applicable
3. Must know how tax should apply

Staff Training For Use Tax Accrual And Documentation (Cont.)

B. Accruing use tax on untaxed purchases:

1. Decision to accrue may be made by the accounts payable department, fixed asset acquisition personnel, general ledger accounting department, or some combination thereof. Each department must be trained to the extent of its responsibility
2. Use tax accrual documents may vary in format but should show measure of tax and tax accrued, and should be clearly traceable to the accrual account and sales/use tax return worksheets

Staff Training For Use Tax Accrual And Documentation (Cont.)

C. Sales and use tax manager as coordinator:

1. Generally responsible for coordinating training pertaining to applicable sales/use tax issues
2. Periodically should review overall use tax compilation process and quality of documentation
3. Recognize, report upon and initiate implementation of needed improvements

State Documentation Requirements

A. Electronic records:

1. Generally must provide the same information as paper equivalents
2. Must provide an audit trail
3. Microfilm or microfiche usually acceptable, but not everywhere
4. Consider requesting written opinions from applicable states
5. May need to supplement recordkeeping

State Documentation Requirements (Cont.)

B. Retrieving records in required state formats:

1. Set up retrievable records according to information requirements of the more demanding states; generally will satisfy the remainder of states
2. Still may need supplemental records for a couple of states
3. For some specialized functions, there may be no specific state requirements. Format then must be based on general state information requirements (and common sense)

Responding To Complaints Of Inadequate Documentation; Legal Issues From Document Production

Unavailable For Audit

- Taxpayer's inability to retrieve all documentation requested by auditor is common in sales and use tax audits
- Two major categories of unavailability:
 - Specific segment
 - Supporting documents for a few random sample items

Segment Unavailable

- Define segment unavailable (time period, business unit, specific vendors, document types, etc.)
- Explain to auditor why it is unavailable
- Develop method of projecting *from available* records segment *onto unavailable* records segment

Unavailable Items

Alternative procedures when the auditor's preferred documentation (invoice, receiving report, proof of use, etc.) is unavailable

- Request another copy from vendor
- Other invoices from the same vendor
- Affidavit from business operations staff

Negative Items

- Negative items are reversals in records (such as reclassifications, error correction, price adjustments, returns, etc.)
- It is difficult to document negative items
 - Not retain documents to show transactions that net to zero
 - Unable to locate the positive amount that offsets the negative amount

Best Available Evidence

- State statutes and judicial precedent give tax auditors authority to use “best available evidence” when taxpayer has unavailable records
- This is NOT an unlimited authority to use any evidence at auditor’s convenience
- Taxpayers should challenge auditors to use the BEST available evidence.

Responding To Auditor Requests

- Taxpayers should involve attorneys if there are questions on auditor's authority
- Contract auditors might not have the same authority as government agency counsel
- Some taxpayers want subpoenas as protection against disputes by third parties (such as customers, employees, vendors)

Confidentiality

- Confidentiality is important with patient health information, competitive pricing, etc.
- Some auditors are sloppy with information security and ignore agency rules
- Most agencies have inter-agency information-sharing agreements
- Can auditor access be limited to on-site?

Model Recordkeeping and Retention Regulation

***A Report of the Steering Committee
Task Force on EDI Audit and Legal Issues
for Tax Administration***

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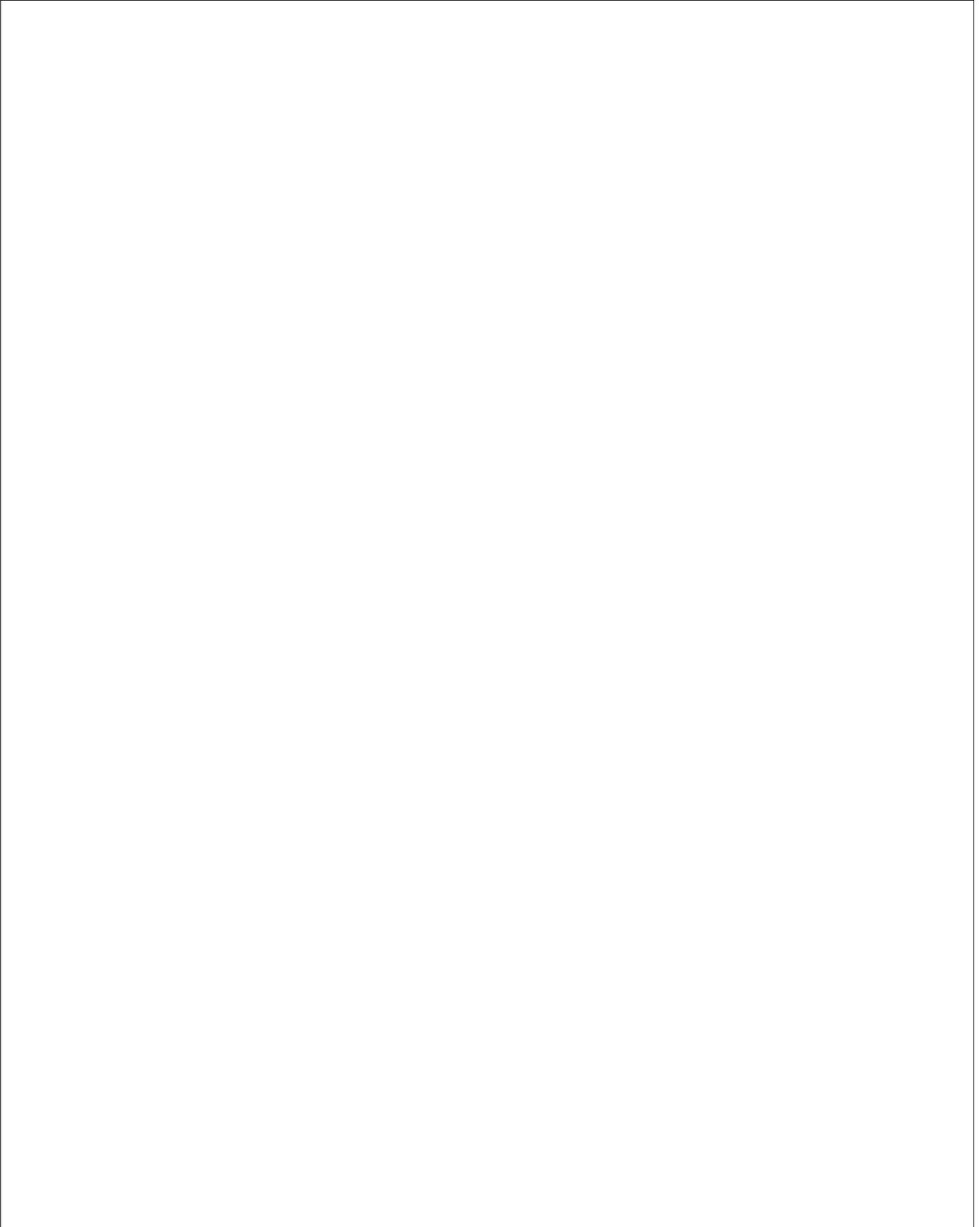
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FOREWORD

Over the past 18 months, the Task Force on EDI Audit and Legal Issues for Tax Administration, consisting of representatives from the Committee On State Taxation, Federation of Tax Administrators, Institute of Property Taxation, Multistate Tax Commission, and Tax Executives Institute, has been examining the impact of various electronic commerce technologies on the tax administration process. This report presents the first work product of the Task Force, a model state administrative regulation to govern taxpayer retention of books and records, particularly electronically generated and retained books and records, for tax administration purposes.

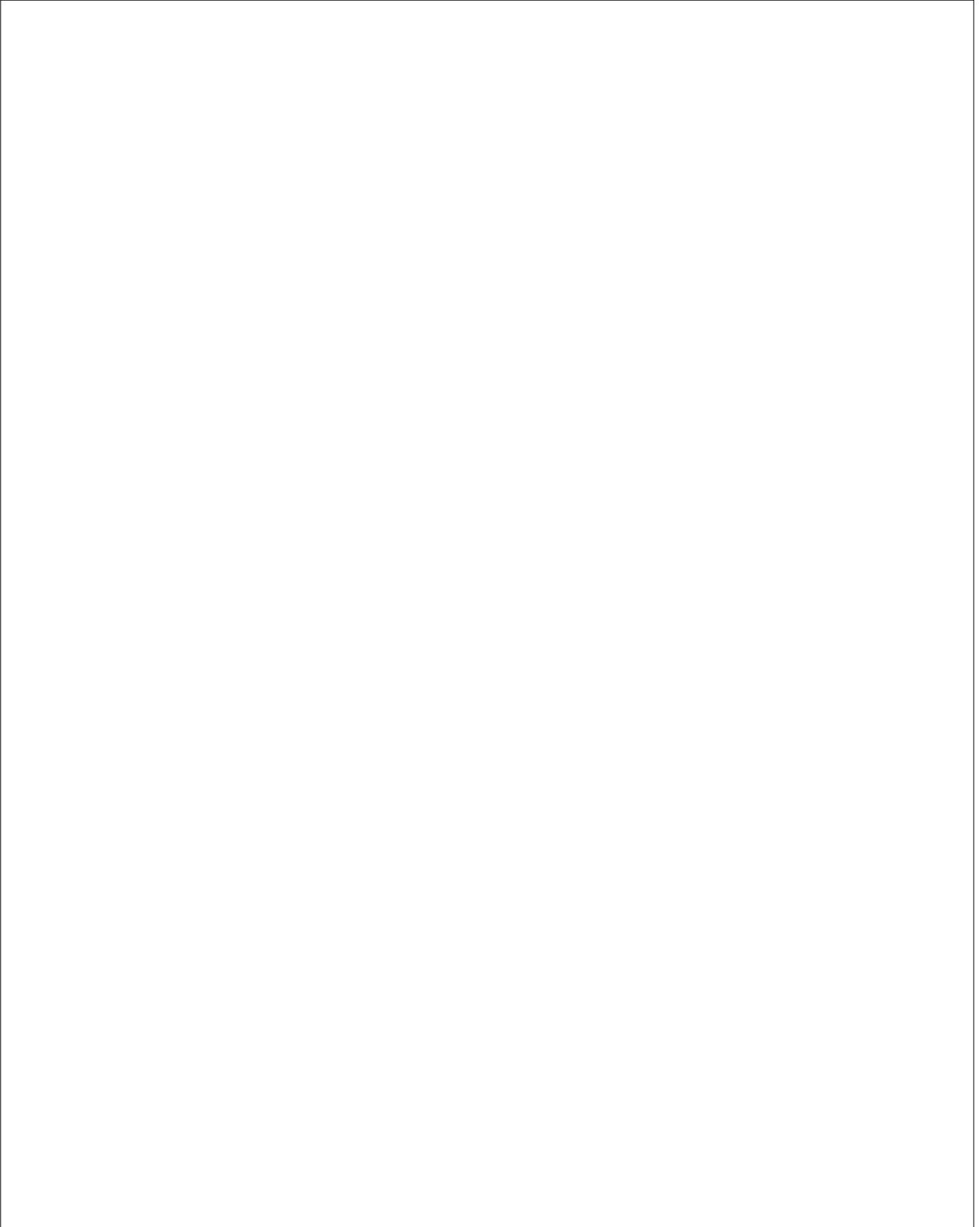
The regulation, and the Task Force process as a whole, reflects a considerable amount of work by a large number of taxpayers and state administrators. It also reflects a substantial effort by parties on 'both sides of the table' to understand the needs of their counterparts and to work together to fashion solutions that are satisfactory and acceptable to all. As such, the process has been a healthy one which will pay rewards in many other areas.

The Steering Committee is optimistic that states will understand the importance of facilitating an efficient and effective tax administration process and will use the model regulation as a starting point when defining the record retention and maintenance requirements imposed under state tax statutes. However, the model regulation, as presented in this report, is not binding on any one state or taxpayer organization.

The Steering Committee wishes to acknowledge the contributions of all individuals who devoted their time and effort in developing and refining the *Model Recordkeeping and Retention Regulation* and related materials.

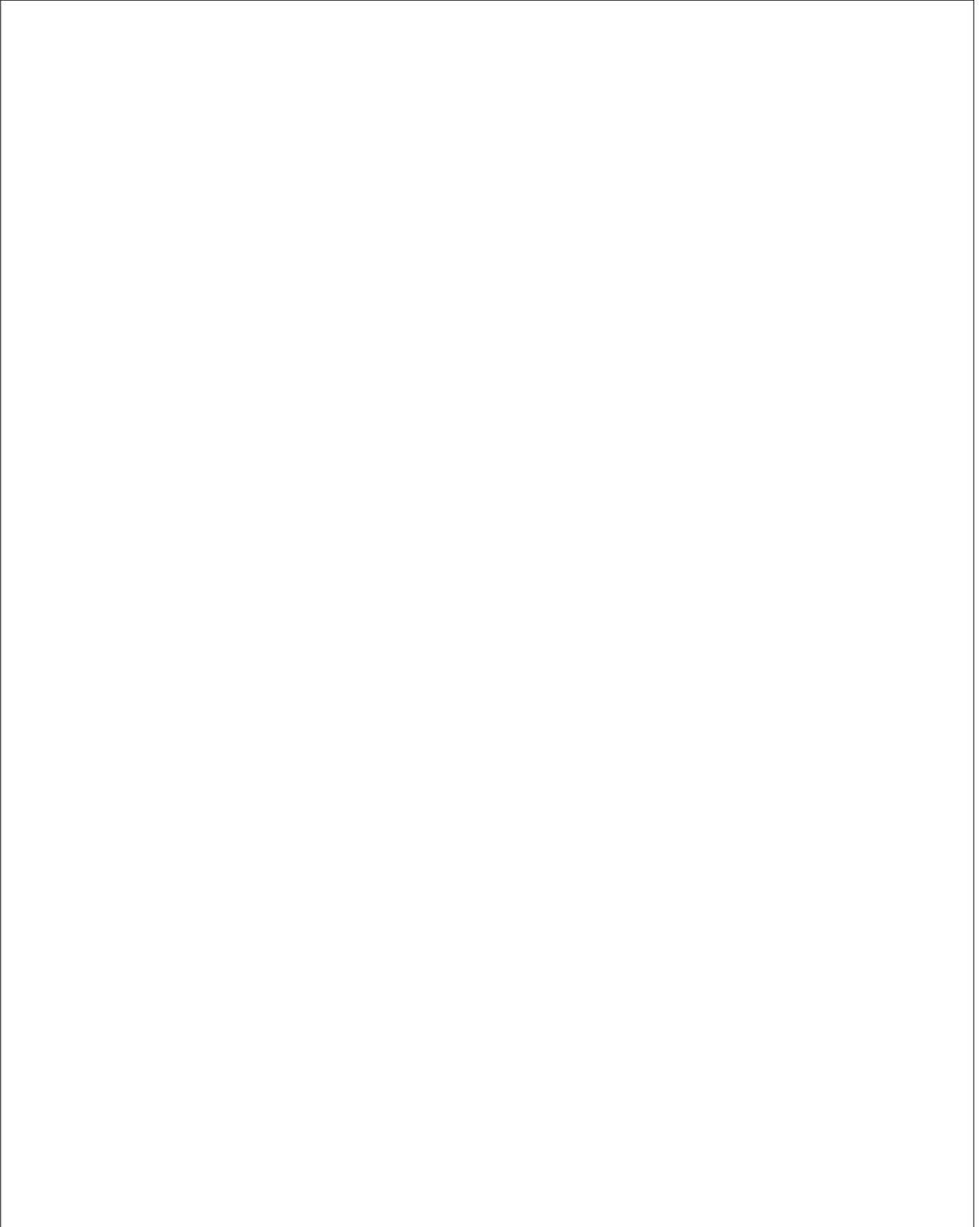
Stanley R. Arnold, Steering Committee Chair
Commissioner
New Hampshire Department of Revenue Administration

March 1996



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MODEL RECORDKEEPING AND RETENTION REGULATION

A Report of the Steering Committee Task Force on EDI Audit and Legal Issues for Tax Administration

Introduction

U.S. businesses are increasingly employing electronic data interchange (EDI)¹ technology in the conduct of commerce. The EDI Group, Ltd. estimates that in 1995, nearly 100,000 U.S. businesses utilized EDI technology. Growth in the EDI market is expected to average in excess of 15 percent per year to the year 2000.²

At its simplest level, EDI involves the exchange of information and documents necessary to a transaction between trading partners via computerized or electronic means rather than the exchange of paper documents. For example, an EDI transaction might involve ordering products through the electronic transmission of a purchase order to a supplier, providing an electronic invoice to the purchaser and paying the invoice through electronic funds transfer once receipt of the product is acknowledged. In this manner, the entire transaction can take place without creation of a paper document detailing the commodity purchased, the price of the commodity, identification of the seller and purchaser, location of delivery and whether or not tax was paid on the transaction.³

Companies (and governments)⁴ employ EDI technology for a number of reasons. It can reduce costs of operations and allow more rapid and accurate transmission and capture

of important commercial information. One effect of EDI, however, is to eliminate the paper records and detail source documents traditionally used in the tax administration process. The increased use of EDI in the conduct of normal business accordingly raises a number of issues and concerns for state tax administrators and taxpayers alike.

From a taxpayer perspective, the absence of traditional paper records raises issues such as policies regarding the retention and availability of EDI transactions and records for administration purposes, the retention and availability of other electronically generated records, the availability of electronic records for audit purposes, and the educational needs of auditors and taxpayers.

State tax agencies are likewise concerned with the impact of EDI on tax administration. A recent survey of revenue agencies indicated that they were generally concerned about developing approaches to the audit of EDI-based companies and securing the appropriate training and education for their auditors. Specific concerns of the states include (1) potential alteration of electronic records; (2) state access to electronic records; (3) the ability to audit the taxpayer's system and access the system documentation; and (4) training of state auditors.⁵

Task Force on EDI Audit and Legal Issues for Tax Administration

Taxpayers and tax administrators alike agree that the nature of the issues involved makes it desirable that taxpayers and tax administrators work cooperatively to identify and examine the impact of EDI on tax administration and audit.

In November 1994, the Federation of Tax Administrators (FTA), after discussions with various taxpayer groups, facilitated the formation of a task force of state tax administrators and taxpayer representatives to address the issues posed by the use of EDI technology and other similar business processes. Formally titled the Task Force on EDI Audit and Legal Issues for Tax Administration, it consists of representatives of the Committee On State Taxation (COST), Institute of Property Taxation (IPT), Tax Executives Institute (TEI), Multistate Tax Commission (MTC), FTA and Commissioners from several state tax administration agencies.

Mission and Objectives. The general mission of the Task Force is to coordinate efforts between the business community and tax administrators in analyzing and addressing the issues posed for tax administration by electronic data interchange and related business processes. The Task Force is responsible for making recommendations to the governing bodies of the participating organizations on the actions states and taxpayers should take in addressing those issues.

Organization. The work of the Task Force has been accomplished by a Steering Committee and two Work Groups focusing on specific areas and issues.

The *Steering Committee* is chaired by Stanley R. Arnold, Commissioner, New Hampshire Department of Revenue Admin-

istration, and consists of twenty-two persons, including tax administrators and business representatives from each of the participating organizations. The Steering Committee is responsible for establishing the scope of work of the Task Force, providing an initial identification of the issues to be addressed by the Work Groups, and providing overall direction and assistance to the effort. It serves as the final reviewing entity for recommendations developed by the Work Groups. The Steering Committee membership is listed in Appendix C.

Two Work Groups have been formed. The Work Groups are comprised of tax agency employees and taxpayer representatives with expertise in required areas, e.g., auditors, lawyers, tax managers, systems/technology people, etc. Each Work Group has co-leaders — one tax administrator and one taxpayer representative.

- *The Legal Requirements and Recordkeeping Work Group* has generally focused on the legal issues involved in the taxpayer movement to EDI, with a particular focus on recordkeeping and retention issues. It is co-chaired by Lloyd Callaway, Coca-Cola Co., Atlanta, Georgia, and Marjorie Welch, Assistant General Counsel, Oklahoma Tax Commission.
- *The EDI Audit Approaches Work Group* has focused on identifying the issues involved when auditing electronic records and assessing alternative approaches to the audit of such records. The Group has been chaired by Stan Borawski, Michigan Bureau of Revenue, and B.J. Denton, Koch Industries, Wichita, Kansas.

The Federation of Tax Administrators has provided general staff support to the Steering Committee and Work Groups.

Current Status. To this point, work of the Task Force has focused on two issues deemed by the Steering Committee to be of most immediate interest: (1) *records retention requirements*, including general legal requirements surrounding electronic records and the nature and availability of records necessary for tax audit purposes; and (2) the approaches available to states in *auditing a taxpayer using EDI technology* and other electronic recordkeeping and accounting systems. Within the latter area, there are a number of issues including the nature of the records required, use of computer auditing techniques, access to the taxpayer's system and source documentation, confidentiality requirements and the like.⁶

Model Recordkeeping and Retention Regulation

The remainder of this report presents the initial work product of the Legal and Recordkeeping Work Group, namely a model state administrative regulation to govern taxpayer retention books and records, particularly electronically generated and retained records, for tax administration purposes. The text of the model regulation is presented in Appendix A, and a detailed explanation and commentary is presented in Appendix B.

The model regulation draws on a variety of sources, including existing state regulations, IRS Revenue Procedure 91-59 governing automated recordkeeping and accounting systems, suggested revisions to Rev. Proc. 91-59 which had been developed by the Tax Executive Institute, and a draft regulation by the California Board of Equalization. It was originally drafted by the Legal and Recordkeeping Work Group and substantially revised during several meetings of tax administrators and business representatives from both the Work Group and the Steering Committee. A draft was also circulated among all state tax agen-

cies. The final version was adopted by the Steering Committee at a meeting on November 15, 1995, in Salt Lake City, Utah.

Basic Framework. In reviewing the regulation, the reader should keep in mind several general principles regarding what the regulation is intended to be and what it is not intended to be. More specifically:

- The regulation has been developed as a "model" regulation to allow it to be modified to meet certain particular requirements of various state laws such as retention periods and penalties for noncompliance. The regulation also allows states to identify specific records or documents they require to be retained in addition to the general requirements specified in the regulation. No attempt was made to address the nuances of each individual state statute regarding each type of tax. The general requirements of the regulation should, however, apply across all types of taxes, and specific details can be addressed by states individually.
- The regulation is designed to cover not only the retention of records created using EDI technology, but also the retention and access to records generated through other electronic means and maintained by taxpayers in various computerized accounting systems. This approach was chosen for two reasons. The retention of EDI records is so intertwined with other electronic systems for maintaining accounting records that it cannot be realistically divorced from the subject of computerized accounting systems. In addition, state recordkeeping regulations did not appear generally to have been updated so as to capture the widespread use of such accounting systems by all types of taxpay-

ers. In addition to the actual retention of records, the regulation addresses such topics as access to the records during a tax audit, maintenance of the records over time, and conversion of hard-copy records to other storage media.

- The regulation attempts to balance the interests of taxpayers and tax administration authorities and to create an environment which will make the tax administration process efficient for all parties. As a general approach, the regulation is focused on clearly identifying the responsibilities and obligations imposed on taxpayers to provide the books and records necessary to verify that the correct tax liability has been reported and paid. Beyond this, the regulation tends to provide a taxpayer with considerable flexibility in the manner in which it wishes to meet the obligations.
- The regulation does not address the issue of tax authority access to the taxpayer's EDI processing, accounting or other systems for purposes of verifying or evaluating the integrity and reliability of those systems to provide accurate and complete records. While most observers consider that such evaluations are important to the tax administration process, it was considered beyond the scope of this effort to specify any regulations governing those evaluations. The Audit Work Group is developing suggested approaches to conducting such evaluations, however. Moreover, it was agreed by members of the Steering Committee that state ability to conduct such evaluations was within the general authority of the states under their authority to examine the books and records of the taxpayer to determine tax compliance.

Specific Elements. Following is a summary of the most significant particular aspects of the regulation:

- The general requirement imposed on taxpayers is to retain those records necessary to verify that the correct tax liability has been reported and paid by the taxpayer.
- If a taxpayer maintains records in both hard copy and machine-sensible (i.e., electronic) forms, the taxpayer must provide the state taxing authority with access to the records in machine-sensible form at the time of an audit if so requested by the taxing authority.
- Taxpayers may in all instances demonstrate tax compliance through traditional paper records, but this does not eliminate the requirement to provide access to machine-sensible records if requested.
- Access to machine-sensible records may be accomplished in a variety of ways, but taxpayers must have the capacity to extract required records and convert them to a standard record format at the request of the taxing authority.
- Individual EDI transactions need not be retained in their original format if the data elements required to be retained under the regulation are captured from the EDI transaction and maintained in the taxpayer's accounting and recordkeeping systems in accordance with the regulation.
- Original hard-copy records may be converted to alternative storage media such as microfilm, microfiche or various "storage-only imaging systems," provided that certain standards regarding access, readability, and integrity are met.

Once converted, the original hard-copy documents need no longer be retained for tax administration purposes.

Conclusion

The model recordkeeping regulation represents the considerable work product of a large number of tax administrators and taxpayer representatives. It attempts to achieve a realistic balance between the needs of tax administrators and the needs of taxpayers. Above all, it is aimed at facilitating an efficient and effective tax administration process.

Notes

¹ For purposes of this document, the term EDI means the computer-to-computer exchange of business documents in a structured format.

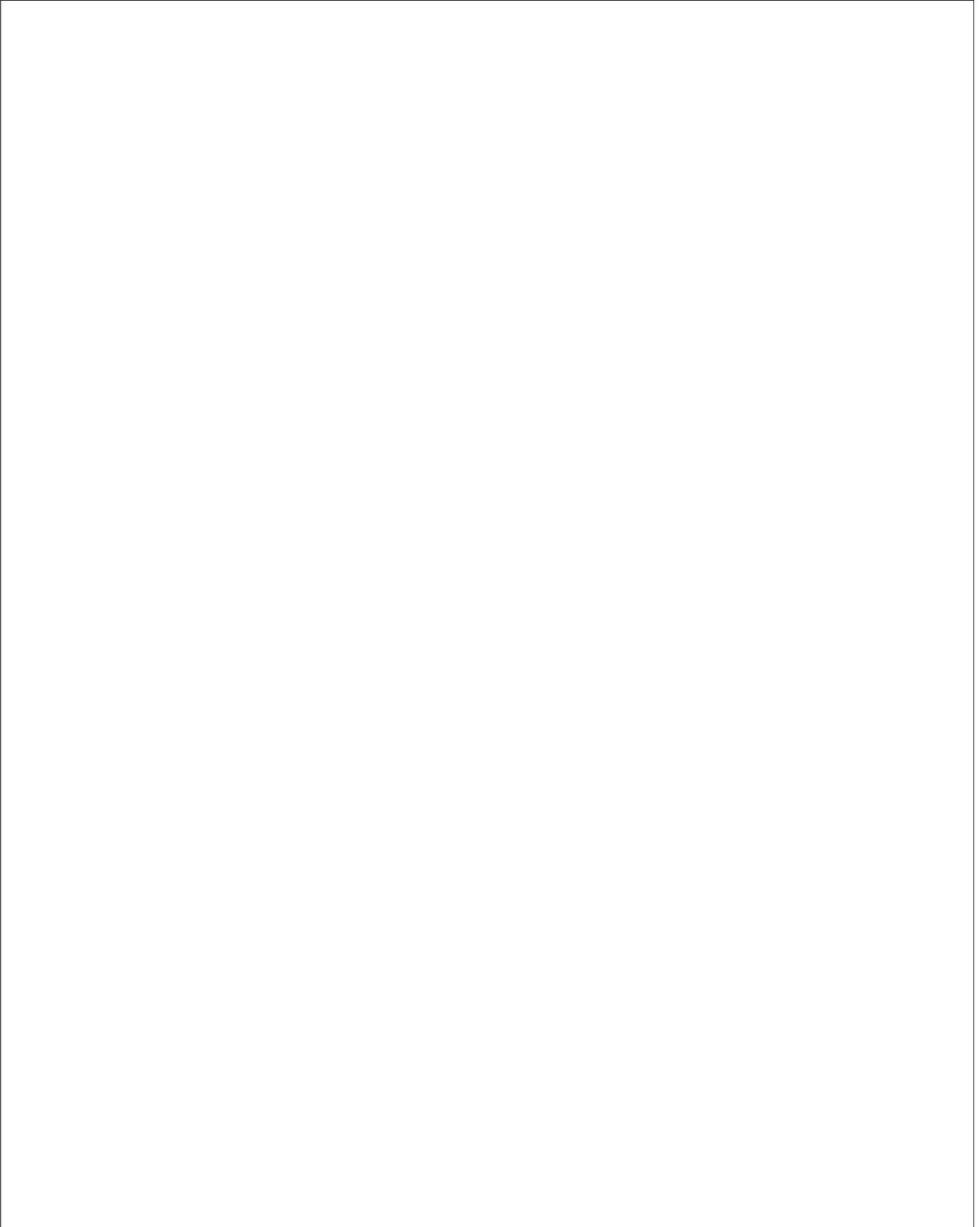
² The EDI Group, Ltd., "1995 U.S. EDI Market Forecast Summary," November 1995.

³ For an excellent description of EDI technology and its use in various business processes, see Richard Bort and Gerald Beilfeldt, *Handbook of EDI*, New York: Warren, Gorham and Lamont, 1994. The discussion here and throughout the report is primarily oriented toward transactional taxes such as sales and use taxes; it is equally relevant to operational (e.g., income taxes) where transactional detail is examined to determine the accuracy of reported income details.

⁴ Government use of EDI is not the subject of this report. For a discussion of this topic, however, see Jonathan Lyon, "Cooperation a Key to Successful EDI Implementation," *Tax Administrators News*, September 1995, p. 86.

⁵ "State Audit Concerns on Business Use of EDI Paperless Processes," FTA Bulletin B-436, February 4, 1994. Available from Federation of Tax Administrators.

⁶ The EDI Audit Approaches Work Group has completed a draft of recommendations for states and taxpayers on a series of issues it identified regarding the audit of taxpayers in an electronic environment. Those draft recommendations and related discussions are currently (March 1996) circulating among Work Group members for review and comment. It is expected to be presented to the Steering Committee for review, revision and ultimate approval in a May 1996 time frame.



APPENDIX A

MODEL RECORDKEEPING AND RETENTION REGULATION

1. PURPOSE

1.1 The purpose of this regulation is to define the requirements imposed on taxpayers for the maintenance and retention of books, records, and other sources of information under *[insert appropriate citations to state tax statutes]*. It is also the purpose of the regulation to address these requirements where all or a part of the taxpayer's records are received, created, maintained or generated through various computer, electronic and imaging processes and systems.

2. DEFINITIONS

2.1 For purposes of this regulation, these terms shall be defined as follows:

2.1.1 "Database Management System" means a software system that controls, relates, retrieves, and provides accessibility to data stored in a database.

2.1.2 "Electronic data interchange" or "EDI technology" means the computer-to-computer exchange of business transactions in a standardized structured electronic format.

2.1.3 "Hard copy" means any documents, records, reports or other data printed on paper.

2.1.4 "Machine-sensible record" means a collection of related information in an electronic format. Machine-sensible records do not include hard-copy records that are created or recorded on paper or stored in or by an imaging system such as microfilm, microfiche, or storage-only imaging systems.

2.1.5 "Storage-only imaging system" means a system of computer hardware and software that provides for the storage, retention and retrieval of documents originally created on paper. It does not include any system, or part of a system, that manipulates or processes any information or data contained on the document in any manner other than to reproduce the document in hard copy or as an optical image.

2.1.6 "Taxpayer" as used in this regulation means *[insert state's applicable definition of taxpayer and other*

persons required to maintain records necessary to determination of tax liability].

3. RECORDKEEPING REQUIREMENTS-GENERAL

3.1 A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under *[insert appropriate citations to state tax statutes]*. All required records must be made available on request by the *[state taxing authority]* or its authorized representatives as provided for in *[insert appropriate citations to state tax statutes]*. Such records shall include, but not be necessarily limited to:

[Insert elements of state law which require certain records to be retained (e.g., books of account, invoices, sales receipts), or specific tax elements or transactions (e.g., credits, exemptions etc.) for which particular records may be required.]

3.2 If a taxpayer retains records required to be retained under this regulation in both machine-sensible and hard-copy formats, the taxpayer shall make the records available to the *[state taxing authority]* in machine-sensible format upon request of the *[state taxing authority]*.

3.3 Nothing in this regulation shall be construed to prohibit a taxpayer from demonstrating tax compliance with traditional hard-copy documents or reproductions thereof, in whole or in part, whether or not such taxpayer also has retained or has the capability to retain records on electronic or other storage media in accordance with this regulation. However, this subsection shall not

relieve the taxpayer of the obligation to comply with subsection 3.2 of this regulation.

4. RECORDKEEPING REQUIREMENTS-MACHINE-SENSIBLE RECORDS

4.1 General Requirements

4.1.1 Machine-sensible records used to establish tax compliance shall contain sufficient transaction-level detail information so that the details underlying the machine-sensible records can be identified and made available to the *[state taxing authority]* upon request. A taxpayer has discretion to discard duplicated records and redundant information provided its responsibilities under this regulation are met.

4.1.2 At the time of an examination, the retained records must be capable of being retrieved and converted to a standard record format.

4.1.3 Taxpayers are not required to construct machine-sensible records other than those created in the ordinary course of business. A taxpayer who does not create the electronic equivalent of a traditional paper document in the ordinary course of business is not required to construct such a record for tax purposes.

4.2 Electronic Data Interchange Requirements

4.2.1 Where a taxpayer uses electronic data interchange processes and

technology, the level of record detail, in combination with other records related to the transactions, must be equivalent to that contained in an acceptable paper record. For example, the retained records should contain such information as vendor name, invoice date, product description, quantity purchased, price, amount of tax, indication of tax status, shipping detail, etc. Codes may be used to identify some or all of the data elements, provided that the taxpayer provides a method which allows the *[state taxing authority]* to interpret the coded information.

- 4.2.2 The taxpayer may capture the information necessary to satisfy section 4.2.1 at any level within the accounting system and need not retain the original EDI transaction records provided the audit trail, authenticity, and integrity of the retained records can be established. For example, a taxpayer using electronic data interchange technology receives electronic invoices from its suppliers. The taxpayer decides to retain the invoice data from completed and verified EDI transactions in its accounts payable system rather than to retain the EDI transactions themselves. Since neither the EDI transaction nor the accounts payable system captures information from the invoice pertaining to product description and vendor name (i.e., they contain only codes for that information), the taxpayer also retains

other records, such as its vendor master file and product code description lists and makes them available to the *[state taxing authority]*. In this example, the taxpayer need not retain its EDI transaction for tax purposes.

4.3 Electronic Data Processing Systems Requirements

- 4.3.1 The requirements for an electronic data processing accounting system should be similar to that of a manual accounting system, in that an adequately designed accounting system should incorporate methods and records that will satisfy the requirements of this regulation.

4.4 Business Process Information

- 4.4.1 Upon the request of the *[state taxing authority]*, the taxpayer shall provide a description of the business process that created the retained records. Such description shall include the relationship between the records and the tax documents prepared by the taxpayer and the measures employed to ensure the integrity of the records.

- 4.4.2 The taxpayer shall be capable of demonstrating

- (a) the functions being performed as they relate to the flow of data through the system;
- (b) the internal controls used to ensure accurate and reliable processing; and

- (c) the internal controls used to prevent unauthorized addition, alteration, or deletion of retained records.

4.4.3 The following specific documentation is required for machine-sensible records retained pursuant to this regulation:

- (a) record formats or layouts;
- (b) field definitions (including the meaning of all codes used to represent information);
- (c) file descriptions (e.g., data set name); and
- (d) detailed charts of accounts and account descriptions.

5. RECORDS MAINTENANCE REQUIREMENTS

- 5.1 The [state taxing authority] recommends but does not require that taxpayers refer to the National Archives and Record Administration's (NARA) standards for guidance on the maintenance and storage of electronic records, such as the labeling of records, the location and security of the storage environment, the creation of back-up copies, and the use of periodic testing to confirm the continued integrity of the records. [The NARA standards may be found at 36 Code of Federal Regulations, Part 1234, July 1, 1995, edition.]
- 5.2 The taxpayer's computer hardware or software shall accommodate the extrac-

tion and conversion of retained machine-sensible records.

6. ACCESS TO MACHINE-SENSIBLE RECORDS

- 6.1 The manner in which the [state taxing authority] is provided access to machine-sensible records as required in subsection 3.2 of this regulation may be satisfied through a variety of means that shall take into account a taxpayer's facts and circumstances through consultation with the taxpayer.
- 6.2 Such access will be provided in one or more of the following manners:
 - 6.2.1 The taxpayer may arrange to provide the [state taxing authority] with the hardware, software and personnel resources to access the machine-sensible records.
 - 6.2.2 The taxpayer may arrange for a third party to provide the hardware, software and personnel resources necessary to access the machine-sensible records.
 - 6.2.3 The taxpayer may convert the machine-sensible records to a standard record format specified by the [state taxing authority], including copies of files, on a magnetic medium that is agreed to by the [state taxing authority].
 - 6.2.4 The taxpayer and the [state taxing authority] may agree on other means of providing access to the machine-sensible records.

7. TAXPAYER RESPONSIBILITY AND DISCRETIONARY AUTHORITY

- 7.1 In conjunction with meeting the requirements of section 4, a taxpayer may create files solely for the use of the *[state taxing authority]*. For example, if a data base management system is used, it is consistent with this regulation for the taxpayer to create and retain a file that contains the transaction-level detail from the data base management system and that meets the requirements of section 4. The taxpayer should document the process that created the separate file to show the relationship between that file and the original records.
- 7.2 A taxpayer may contract with a third party to provide custodial or management services of the records. Such a contract shall not relieve the taxpayer of its responsibilities under this regulation.

8. ALTERNATIVE STORAGE MEDIA

- 8.1 For purposes of storage and retention, taxpayers may convert hard-copy documents received or produced in the normal course of business and required to be retained under this regulation to microfilm, microfiche or other storage-only imaging systems and may discard the original hard-copy documents, provided the conditions of this section are met. Documents which may be stored on these media include, but are not limited to general books of account, journals, voucher registers, general and subsidiary ledgers, and supporting records of details, such as sales invoices, purchase invoices, exemption certificates, and credit memoranda.

- 8.2 Microfilm, microfiche and other storage-only imaging systems shall meet the following requirements:

- 8.2.1 Documentation establishing the procedures for converting the hard-copy documents to microfilm, microfiche or other storage-only imaging system must be maintained and made available on request. Such documentation shall, at a minimum, contain a sufficient description to allow an original document to be followed through the conversion system as well as internal procedures established for inspection and quality assurance.
- 8.2.2 Procedures must be established for the effective identification, processing, storage, and preservation of the stored documents and for making them available for the period they are required to be retained under section 10.
- 8.2.3 Upon request by the *[state taxing authority]*, a taxpayer must provide facilities and equipment for reading, locating, and reproducing any documents maintained on microfilm, microfiche or other storage-only imaging system.
- 8.2.4 When displayed on such equipment or reproduced on paper, the documents must exhibit a high degree of legibility and readability. For this purpose, legibility is defined as the quality of a letter or numeral that enables the observer to identify it positively and quickly to the exclusion of all

other letters or numerals. Readability is defined as the quality of a group of letters or numerals being recognizable as words or complete numbers.

8.2.5 All data stored on microfilm, microfiche or other storage-only imaging systems must be maintained and arranged in a manner that permits the location of any particular record.

8.2.6 There is no substantial evidence that the microfilm, microfiche or other storage-only imaging system lacks authenticity or integrity.

9. EFFECT ON HARD-COPY RECORDKEEPING REQUIREMENTS

9.1 Except as otherwise provided in this section, the provisions of this regulation do not relieve taxpayers of the responsibility to retain hard-copy records that are created or received in the ordinary course of business as required by existing law and regulations. Hard-copy records may be retained on a recordkeeping medium as provided in section 8 of this regulation.

9.2 If hard-copy records are not produced or received in the ordinary course of

transacting business (e.g., when the taxpayer uses electronic data interchange technology), such hard-copy records need not be created.

9.3 Hard-copy records generated at the time of a transaction using a credit or debit card must be retained unless all the details necessary to determine correct tax liability relating to the transaction are subsequently received and retained by the taxpayer in accordance with this regulation. Such details include those listed in subsection 4.2.1.

9.4 Computer printouts that are created for validation, control, or other temporary purposes need not be retained.

9.5 Nothing in this section shall prevent the [state taxing authority] from requesting hard-copy printouts in lieu of retained machine-sensible records at the time of examination.

10. RECORDS RETENTION - TIME PERIOD

10.1 All records required to be retained under this regulation shall be preserved pursuant to [insert adopting state's applicable statutory citation] unless the [state taxing authority] has provided in writing that the records are no longer required.

APPENDIX B

MODEL RECORDKEEPING AND RETENTION REGULATION

Explanation and Commentary

Section 1. Purpose

The purpose is stated as defining the record retention and maintenance requirements imposed under state tax statutes and further to address those requirements as they apply to records created, maintained or received through various computer, electronic and imaging processes and systems.

Section 2. Definitions

The following terms are defined: data base management system, electronic data interchange, hard-copy record, machine-sensible record, storage-only imaging systems, and taxpayer.

Section 3. Recordkeeping Requirements - General

This section establishes the general recordkeeping requirements imposed on all taxpayers without regard to whether they use paper, computer or electronic processes, systems or technology. The obligation is stated as a requirement to maintain those records necessary to determine the correct tax liability of the taxpayer.

Subsection 3.1 contains the basic requirement to retain all records necessary to the correct determination of tax liability and to make such records available to the state taxing authority. It also allows each state to list specific types of records (e.g., books of account,

invoices, sales receipts) or specific tax elements or transactions (e.g., credits, exemptions etc.) for which particular records may be required. Differing specific requirements can be provided for different types of taxes, e.g., motor fuel, sales tax, etc.

Subsection 3.2 provides that where a taxpayer maintains records in both machine-sensible (i.e., electronic) and hard-copy form as part of the normal business process, such taxpayer shall provide the records to the state taxing authority in machine-sensible form upon request. The subsection is intended to insure that the state taxing authority has access to appropriate machine-sensible records for examination purposes should it so desire. State taxing authorities may also request that the appropriate records be provided for examination purposes in hard-copy form. See also subsection 9.5.

Subsection 3.3 further provides that the regulation does not preclude the taxpayer from demonstrating tax compliance with traditional hard-copy documents even if the taxpayer has maintained machine-sensible records. The subsection does not relieve the taxpayer of the obligation to provide machine-sensible records if required under subsection 3.2. It is intended instead to allow a taxpayer to demonstrate tax compliance with information in hard-copy records if such

are needed to supplement or clarify information in the machine-sensible records or if it is otherwise determined that use of hard-copy records is the best means of determining the correct tax liability.

Section 4. Recordkeeping Requirements - Machine-Sensible Records

This section defines the requirements imposed on taxpayers when relevant records are generated or maintained through electronic means. It contains several subsections:

Subsection 4.1 outlines the general requirements related to the retention of machine-sensible records. *Subsection 4.1.1* requires that machine-sensible records must contain sufficient transaction-level information to allow the records relating to an individual transaction to be identified and made available to the state taxing authority on request. It is understood that for certain taxpayers with large volumes of sales transactions, source detail on individual *sales transactions* may not be available for prior years. Summary reports containing transaction-level detail and documentation on the preparation of the reports from individual transactions should, however, be available under the regulation. Moreover, taxpayers indicate that on a prospective basis, testing of the system and examination of source detail for a finite period could be done.¹ It is expected that individual transaction-level detail *on purchase transactions* will be available for examination for use tax purposes.

The subsection also authorizes the taxpayer, in his/her discretion, to discard duplicated or redundant records and information. For example, departmental records stored in departmental data files that are duplicated in a central system could be discarded provided that all required information in the depart-

mental records (including the department identification) is contained in the central system and the requirements of the regulation are met. Similarly, daily or weekly data files could be discarded provided that appropriate monthly, quarterly or annual data files with the ability to access appropriate transaction-level records are available.

Subsection 4.1.2 further provides that machine-sensible records must be capable of being retrieved from the computer system and converted to a standard record format that will facilitate use of the records during an examination. This requirement is intended to facilitate the use of computer-assisted audit techniques in examining large volumes of transactions. It is expected that the determination of the precise format of the data and the nature of the access to the electronic records will be determined in conjunction with the taxpayer. [See related items in Section 6.]

Subsection 4.1.3 provides that taxpayers will not be required to create the electronic equivalent of a traditional paper document unless that type of electronic record is created in the normal course of business. For example, taxpayers receiving invoices using electronic data interchange may not create or retain an electronic invoice file. Instead, they may take the data elements, required to be retained pursuant to Section 3.1, from the EDI record and transfer it directly to the accounts payable and other systems without retention of individual invoice data. Under the regulation, the taxpayer could not be required to produce an electronic invoice provided that transaction-level details on the purchase were available. They must, however, be able to provide complete information to determine that the correct tax liability for the transaction was paid.

Subsection 4.2 outlines the requirements for records received through electronic data interchange. *Subsection 4.2.1* provides that for taxpayers using EDI, the level of detail retained from an EDI transaction, in combination with other records related to the transaction, must be equivalent to that required in paper records. For example, the data elements retained would include information on the vendor, commodity purchased, tax paid, etc. Codes may be used to identify some or all of the data elements in the EDI transaction provided the state taxing authority is provided access to any code lists or other information necessary to interpret the transaction. It also provides that if the requirements of the regulation are met, the taxpayer need not retain the original EDI transaction data.

Subsection 4.2.2 provides that the information necessary to satisfy subsection 4.2.1 can be captured at any point in the accounting system, [e.g., invoice-related information can be captured in the accounts payable and other systems, rather than being retained separately] provided that the taxpayer can demonstrate the audit trail, authenticity and integrity of the processes through which the EDI transaction is parceled to the various other systems and that the required data is retained. If the taxpayer is capable of meeting these conditions, the original EDI transaction file need not be retained for examination by the taxing authority.

Subsection 4.3 establishes that electronic data processing accounting systems employed by taxpayers should incorporate methods and records that will satisfy the requirements of the regulation.

Subsection 4.4 provides that the taxpayer, at the request of the state taxing authority, is

required to provide a description or documentation of the various business processes involved with the creation, retention and maintenance of the records being examined and the internal controls associated with those systems. *Subsection 4.4.1* provides that the documentation is to include a description of the relationship between the records substantiating tax liability and the tax returns filed by the taxpayer as well as the measures used to ensure the integrity of the records. *Subsection 4.4.2* establishes that the taxpayer must be capable of demonstrating the functions and processes being performed and the flow of data through the various systems as well as the internal controls used to assure reliable and authentic records and to prevent unauthorized alteration of the records. *Subsection 4.4.3* establishes specific documentation requirements for retained machine-sensible records, including record formats, field definitions, code definitions and charts of accounts and associated descriptions.

Section 5. Machine-Sensible Records Maintenance Requirements

This section provides general guidance on the maintenance of the electronic records which are required to be kept or retained. *Subsection 5.1* recommends that taxpayers refer to standards of the National Archives and Records Administration for guidance on the subject. *Subsection 5.2* further provides that the taxpayer's computer hardware and software shall accommodate the extraction and conversion of retained records. The intent of subsection 5.2 is to establish that even as a taxpayer's computer hardware and software change over time, the taxpayer has an obligation to be able to access retained machine-sensible records and provide them to the state taxing authority in a standard record format at the time of an examination.

Section 6. Access to Machine-Sensible Records

Subsection 6.1 provides that the manner in which a state taxing authority is to be provided access to machine-sensible records as required in subsection 3.2 is to be developed in consultation with the taxpayer and reflect the facts and circumstances of each taxpayer. *Subsection 6.2* outlines a variety of alternatives for providing such access including through use of the taxpayer's computer facilities and personnel, use of a third-party, conversion to a format and medium agreed to by the state taxing authority for processing either on-site or off-site with computer resources of the state taxing authority, or such other means as may be determined by the state and the taxpayer. The premise underlying this section is that decisions regarding access to electronic records should be capable of being mutually reached between the state and the taxpayer. These decisions should reflect the needs and preferences of both parties and facilitate the efficient conduct of an examination. In cases where there is an irreconcilable dispute between the taxpayer and the state taxing authority as to the manner in which access is to be provided, state law will control the outcome.

Section 7. Taxpayer Responsibility and Discretionary Authority

Subsection 7.1 provides that in meeting its obligations under the regulation, a taxpayer may create special files for use by the tax authority. This procedure would be used, for example, if a taxpayer chose to create an extract of the transaction-level details in its records for the state taxing authority to use in a computer-assisted audit, instead of allowing the taxing authority to access the records directly. In such a case, the taxing authority would specify the records and data elements it wished to have extracted. *Subsection 7.2*

provides that a taxpayer may use a third party to provide record management services. In such cases, a taxpayer retains the obligation to meet the requirements of the regulation.

Section 8. Alternative Storage Medium

Subsection 8.1 provides generally that as an alternative to the retention of paper documents and records, taxpayers may convert such records to microfilm, microfiche and other alternative "storage-only imaging systems." By definition (Section 2), a storage-only imaging system is one that is not designed to and does not include the ability to manipulate or process information in the imaged record other than to print a hard copy of such record. If the requirements of section 8 are met, the taxpayer is not required to retain hard-copy documents converted to alternative storage media for tax purposes.

Subsection 8.2 outlines the specific requirements that such records storage and conversion systems must meet. They include the availability of documentation of the system (§8.2.1), procedures for identifying, processing and storing the imaged documents (§8.2.2), access to facilities for reading, locating and reproducing the stored documents (§8.2.3), standards for readability and legibility of the stored records (§8.2.4), an ability to trace individual documents and records (§8.2.5), and ability to assure the integrity of the records (§8.2.6).

Section 9. Effect on Hard-copy Recordkeeping Requirements

This section generally outlines that unless otherwise provided, the regulation does not relieve the taxpayer of retaining hard-copy records received or produced in the normal course of business. *Subsection 9.1* provides that the hard-copy records and documents that have been converted to an alternative

storage medium in accord with Section 8 need no longer be retained for tax purposes. *Subsection 9.2* provides that if hard-copy records are not created or produced in the normal course of business, such hard-copy records need not be created. *Subsection 9.3* provides that hard-copy records generated at the time a transaction is entered into using debit cards or credit cards (i.e., sales receipts) must be retained unless all the details necessary to determine correct tax liability regarding the transaction are later received and retained by the taxpayer. The information required would include the vendor, item purchased, tax paid, shipping details, etc. It should not be assumed by taxpayers that the periodic billing statements associated with a credit or debit card will normally provide the required information. *Subsection 9.4* establishes that

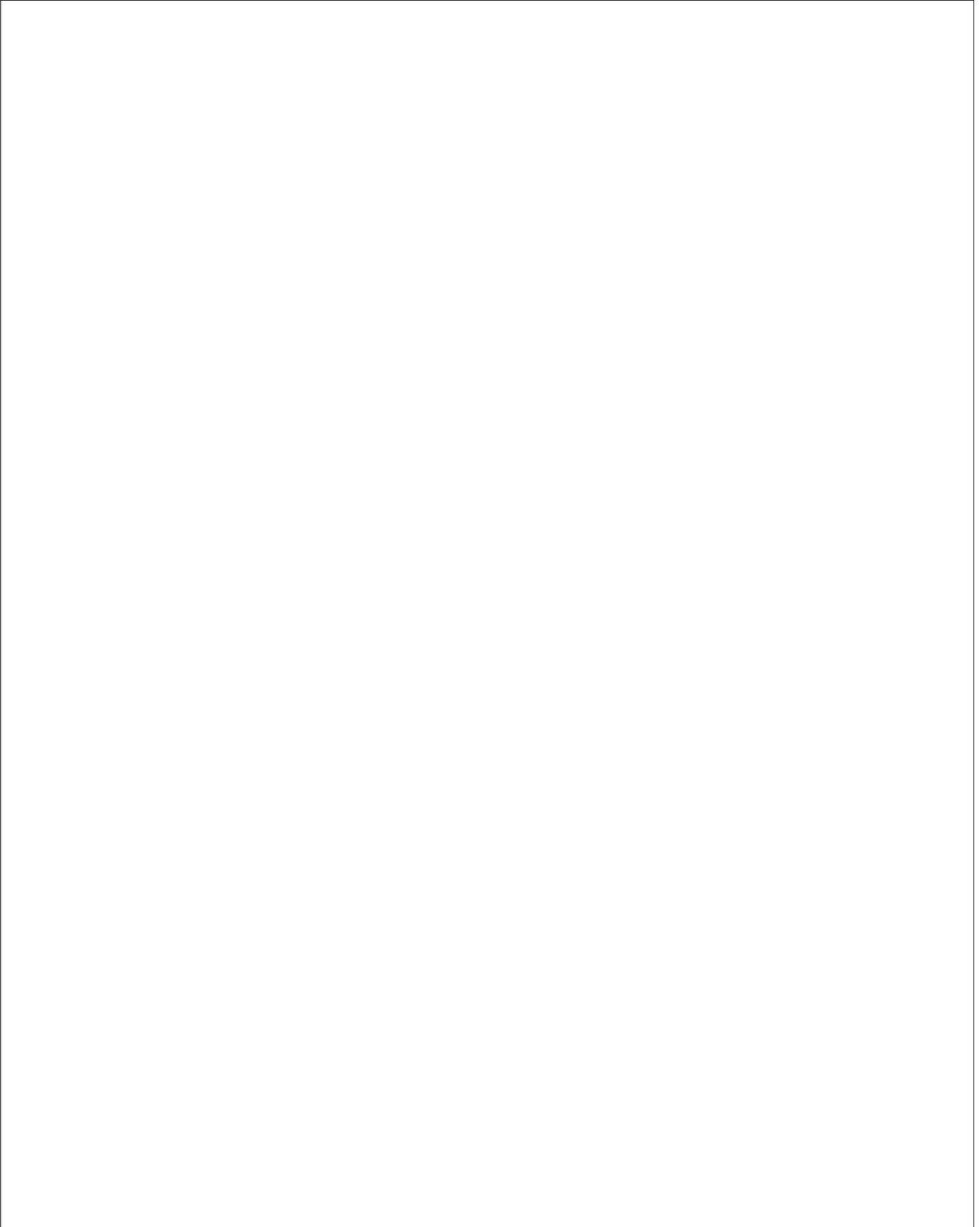
computer printouts produced for control or validation purposes need not be retained. *Subsection 9.5* allows the state tax authority to require production of hard-copy records in lieu of machine-sensible records during an examination.

Section 10. Record Retention Periods

This section provides that required records shall be retained for the period required under state law unless the state taxing authority provides in writing that they are no longer necessary.

Note

¹ Some states have expressed a preference for addressing this situation through a records retention limitation agreement with taxpayers.



APPENDIX C

STEERING COMMITTEE

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