



Sales Tax and The Credit Department

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

EXECUTIVE SUMMARY

While some Credit Departments carry a primary responsibility for managing Sales and Use Tax, others deal with it only when it becomes a collection or deduction issue. Either way, it is important to fully understand the impact that problems with an audit can have on a company and its customers. The latter often have less of an understanding of Sales and Use Tax, and what their responsibilities may be, particularly with exemption certificates. Consequently, the Credit Professional will have to not only resolve/ collect any unpaid amounts, but they will have to explain the circumstances to that customer and also the Sales or Operations personnel involved. Not doing so will increase the probability that an unhappy customer will look elsewhere and, therefore, adding the loss of business to the costs associated with an unsatisfactory state tax audit. In turn, there is damage to the Sales/ Operations/ Credit relationship.

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The first thing to understand is that laws and regulations concerning Sales and Use Tax vary between states and even between local jurisdictions within a given state. Sometimes, depending upon circumstances and proximity to an international border, another country's laws may further confuse a cross-border customer. While it is impossible to cover all of the nuances in this document, several real-life situations should serve to add perspective.

Sales Tax vs. Use Tax

Each jurisdiction may use slightly different wording, but, basically, "Sales Tax" is a tax imposed on the purchase of goods or services within a given state, while "Use Tax" is imposed for goods and services purchased outside of that state, brought into it and consumed or otherwise used there.

Each state will provide a definition, as shown here for Maryland:

The sale of tangible personal property is generally taxable except as otherwise provided by law; the sale of a service is generally not taxable except for certain taxable services provided by law. For example, food sold in grocery stores and prescription medicines are generally not taxable. Furthermore, there are no additional sales taxes imposed locally in Maryland.

As for “Use Tax”:

Every time you purchase taxable tangible goods or alcoholic beverages, whether in person, over the phone, or on the Internet, the purchase is subject to Maryland’s 6 percent sales and use tax on goods and 9 percent alcoholic beverages tax on alcohol if you use the merchandise in Maryland.

When you purchase goods from businesses located outside of Maryland, they are not required to collect Maryland’s sales tax unless they have a physical location, or deliver services, in Maryland. Also, you are not required to pay the sales tax in the state where the business is located. However, you **are** required to pay the 6 percent use tax or the 9 percent alcoholic beverage tax directly to the Comptroller of Maryland by **filing the consumer use tax return**.

Generally speaking, most consumers, who physically purchase something in another state, will pay that state’s tax. However, suppose that other state is contiguous to the consumer’s state, as in Delaware and Maryland sharing a border? Delaware does not have a Sales Tax, while Maryland does have a Use Tax. It is not unheard of for Maryland residents to travel across the state line to shop, and then return home, to use whatever they bought. While the Maryland tax authorities may ignore that circumstance for clothing and similar goods, it is not the same for expensive items that may require delivery. Therefore, it is also not unheard of for Maryland to assign people to sit at the state line on major thoroughfares, to look for delivery trucks from major retailers. They will check the manifest for names and addresses, to send a “Use Tax” invoice to the lucky party.

Of course, as a Business Credit Professional, you will be more concerned with purchases made by other businesses, rather than consumers.

Determining When and How Much to Charge for Sales and Use Tax

There is a lot of confusion concerning this subject. The “when” is relatively simple, in that sales tax is to be charged based on when and where physical possession changes from the seller to the buyer. That could be within the same jurisdiction, even the same building, as in a customer in a wholesaler’s branch making an over-the-counter purchase. It could also be within the same jurisdiction, involving a delivery to the customer’s location or to a job site. It may also involve a “service”, rather than the sale of material. Suppose the seller and buyer are in different jurisdictions, and the tax rates differ? What happens if the buyer resells that material to someone else? For that matter, what if your customer’s customer is “Tax Exempt”? What does the term “Resale” really mean? From personal experience, many contractors in the Construction Industry believe that they “re-sell” material, when they install it! Let’s start with that problem:

Resale: Generally speaking, when tangible material is purchased for resale, in its original and unaltered form, one can claim an exemption using what is referred to as a Resale Certificate. The seller must apply for this with, and be approved by, the relevant jurisdiction. If installing it in a building alters the material, it is usually not considered to be a “resale” transaction, so Sales Tax is due at the time of purchase. Sometimes, this is made very clear, as in Connecticut, in an 85-page publication titled, *Building Contractor’s Guide to Sales and Use Taxes*, from which this is taken:

INTRODUCTION

Sales tax is imposed on certain contractor services performed in Connecticut. Generally, services to existing commercial, industrial, and income-producing property are taxable. Some services to residential property are also taxable. This guide presents information on the sale and purchase of services and materials for contractors.

Contractors are unique in that they are both the consumer of materials and retailers of their services. Therefore, building contractors must:

1. Pay sales and use tax on materials, supplies, and equipment used in their construction contracts; **and**
2. Charge and remit sales tax on their services when appropriate.

You must register with the Department of Revenue Services (DRS) if you are conducting business in Connecticut. Taxes for which you may be liable include sales and use taxes, withholding tax, corporation business tax, and business entity tax. See **Informational Publication 2006(11)**, *Getting Started in Business*, for more information.

Connecticut's definition of a contractor is virtually the same everywhere, in that contractors are almost always taxable.

Registration: The last paragraph above points to a universal issue. In order to legally collect Sales and Use Tax, a company must register in every state in which it conducts business. Obviously, this definitely includes what is often referred to as "brick and mortar", namely a physical building. However, there is another principle at work, which is:

Nexus: The word is Latin for "connection", meaning something other than a physical building, such as:

- Payroll, as in having company personnel living in that jurisdiction
- Soliciting sales, even when done by a related company
- Attending trade shows, which is the same as above
- Performing services in the state, such as delivering material in a company vehicle

If any of these circumstances exist, a company must register to collect and pay Sales and Use Tax. This applies to both the Vendor, meaning your company, as well as your Customer. While it is simple to believe that your customer's registration and obedience to the law is his/ her problem, you, too, can be affected, as you will see in this example:

- You have a branch in Erie, PA and a customer in nearby Lawrence Park
- Your customer's job is in South Ripley, NY, involving a GC working with a tax-exempt entity
- You deliver material to your customer, both in PA and, via a direct factory shipment, to the NY site.
- Sales tax is billed, according to the applicable rates in both states
- Your customer defaults. You have a Joint Check Agreement in place, so you make a demand on the GC. That company refuses to honor it, until you credit the all sales tax.



- You cannot do so, because your customer has not submitted the proper NY exemption certificate. Why? He is not registered in NY, so he cannot claim an exemption, even though the end-user is a school.
- You cannot credit the sales tax, even though you may get paid if you do. The GC refuses to simply deduct the tax, which you can then absorb as a loss, since you have already compensated the State of New York.
- You cannot credit the PA tax, because that material was transferred in PA, not NY.
- It will be an interesting court case.

Exemption Certificates: Once again, every state has different rules, when it comes to who can claim an exemption from Sales and Use Tax. As mentioned, many contractors, large and small, believe that they can use a Resale Certificate. Since these forms are often available online, it is up to the vendor to accept or decline it. Some vendors believe that they can accept these in “good faith”. If you happen to be in Mississippi, that is true.

However, other states are not so forgiving. Some states have very elaborate mechanisms for handling what are referred to job exemptions. Still other states allow an exemption for certain materials only, so split invoices are in order.

- The above case in NY would require that the contractor register there, even though he is in PA, because of the *Nexus* scenario of doing the job in NY. He could then obtain a Form ST-119.1 from the GC/ end user, which would then allow him to provide you with a form ST-120.1 for that specific job only. You do not bill the Sales Tax, and the GC loses his argument to refuse to honor the JCA. Once registered, the exemption forms are available online.
- Connecticut is one of the most demanding states, with very complex rules, thus the 85-page guide mentioned above.

Repair or Maintenance

A contractor repairing or maintaining HVAC units is rendering taxable maintenance and repair services to tangible personal property. Sales of items of tangible personal property to contractors rendering the service are taxable unless the items are integral parts. For the definition of integral part, see *Repair or Maintenance of Tangible Personal Property (Units)* on Page 19.

A contractor that both installs and repairs or maintains HVAC systems used in clean rooms may purchase items of **inventory** that can be used in both installation and repair, such as wiring or piping, on a resale basis. If the item is used for installation, the contractor must self assess use tax on the purchase price of the item. If the item is used for repair purposes, the contractor must collect tax from its customer. The contractor cannot use a resale certificate to purchase items that can only be used in an installation, such as ventilation units, etc.

Repair or Replacement (of an existing paved driveway, parking lot, or walkway)

Materials: The paving contractor pays tax on all materials purchased to repair or replace an existing paved driveway, parking lot, walkway, basketball court, or tennis court.

The maintenance or repair service provider may purchase integral parts using a resale certificate. The term *integral part* means a part, such as a circuit board, heating element, control panel, or gear that retains its separate identity even after being incorporated into repaired equipment. The term integral part does not include materials such as lubricants, coolant, stain, paint, varnish, glue, solder and wire that do not retain their separate identity after being used to repair tangible personal property, but are consumed by the contractor.

“Good Faith” can be very expensive in many states, since state auditors tend to be rather demanding.

Sales and Use Tax Audit: The number of these increased considerably after the September 11, 2001 terrorist attacks. Why? States increased security measures, particularly at airports and train stations, which cost a lot of money. Rather than raise taxes of all kinds, they looked to other sources of income, including the fines and penalties associated with non-payment of Sales and Use Tax. How do they choose the subject of an audit? Several ways, to include:

- Frequent late or lack of payments and/ or filing of returns
- Nexus with no registration
- Resale certificates with no sales tax registration (Your customer is also subject to an audit, with fines/ penalties, some of which can be criminal in nature)
- Trickle down from audits of vendors or upward from customer audits
- Internal whistle-blowers
- Lack of Use Tax reporting
- High sales volume, which translates to high tax revenue, and frequent failure to properly police exemptions
- Large dollar or transaction volume of “exempt” sales

The allure of the fines and penalties due from violations of the laws and regulations is what drives the audit. The actual tax is secondary, since that would have been routinely collected, if the audited party had properly understood and enforced the law in the first place. THAT is why any responsible Credit Professional should be well aware of these laws and regulations. (It is highly recommended that you also educate others in your organization.) Once an auditor finds a range of violations, your company will be repeatedly targeted. Neighboring states sometimes share the names as well.

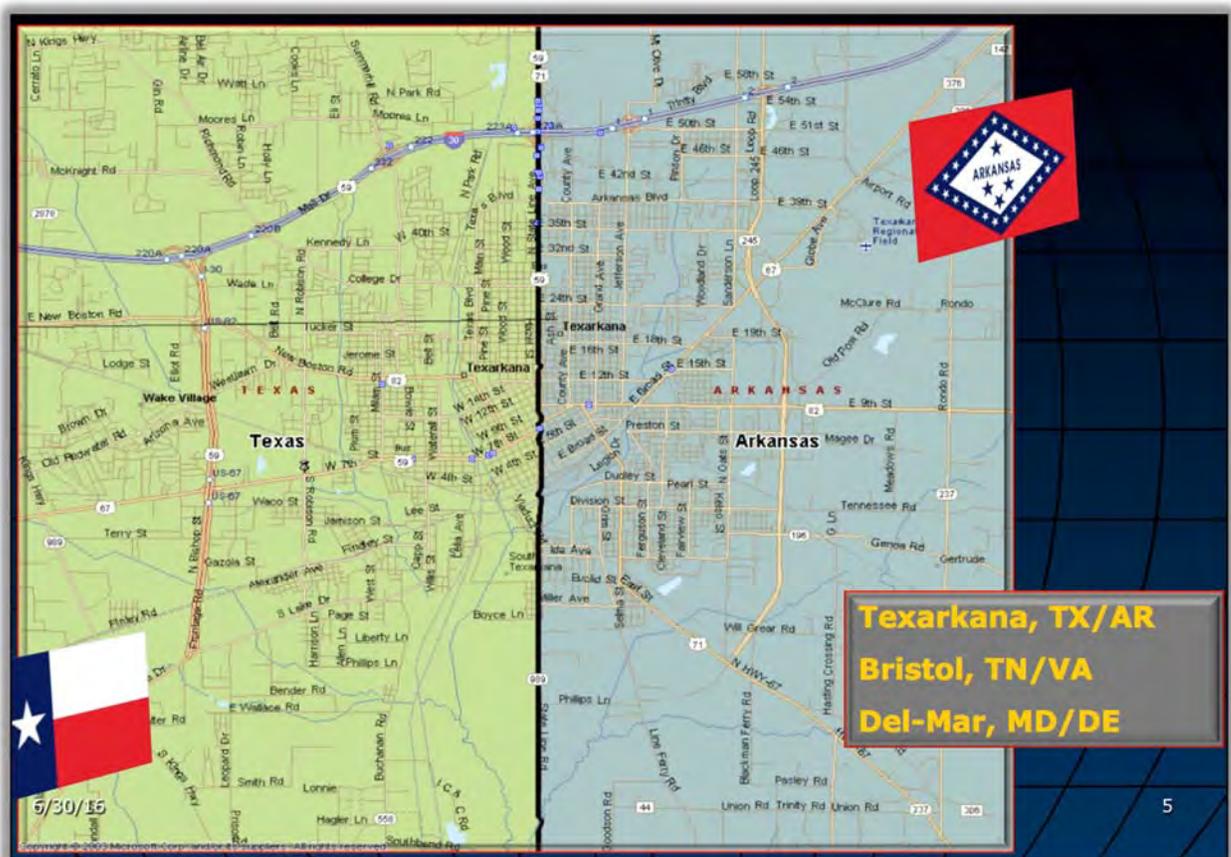
How does the process work? It may vary by state, but typically:

- The state will choose an audit period, in months or years.

- You will be required to provide sales and tax payment data for that time period.
- You will be given a sampling of exempt sales during the audit period, for which you will have to provide the proper justification for not paying the potential tax.
- Some auditors will dig deeper into your AR, to include write-offs and other adjustments.
- An error rate will be calculated, based on the sampling, and then extrapolated to the entire audit period. That rate includes both the number and dollar volume, so an error on a larger invoice will be more influential than one on a smaller ticket.
- Besides the actual unpaid tax, your company will be assessed fines and other penalties, which could include, in extreme cases of fraud and depending upon the state, criminal charges.

Therefore, it is imperative that adequate records be maintained, including a documented procedure for personnel involved in the process. As mentioned, each state is different, so these procedures must be flexible and exact, by jurisdiction. This is especially true when business can cross state lines.

Speaking of crossing state lines, there are some odd situations where cities or towns are bisected by a state line:



The black line down the center of this map of Texarkana is a street called State Line Avenue. It is also the state border. Suppose your company is located in the city on the

Texas side, and your customer is on the Arkansas side. He is exempt in the state of Arkansas, which is valid for that entire state. If he visits your location and makes a purchase, taking delivery there, in Texas, you are able to accept that exemption.

Other states make it even more complicated for you, as a vendor, when trying to determine whether to charge Sales Tax or accept an exemption certificate.

For instance, if your company is located in Tennessee, that state allows for businesses in surrounding states to carry their exemptions across the border, IF they carry the purchased material back to their home state to use it.

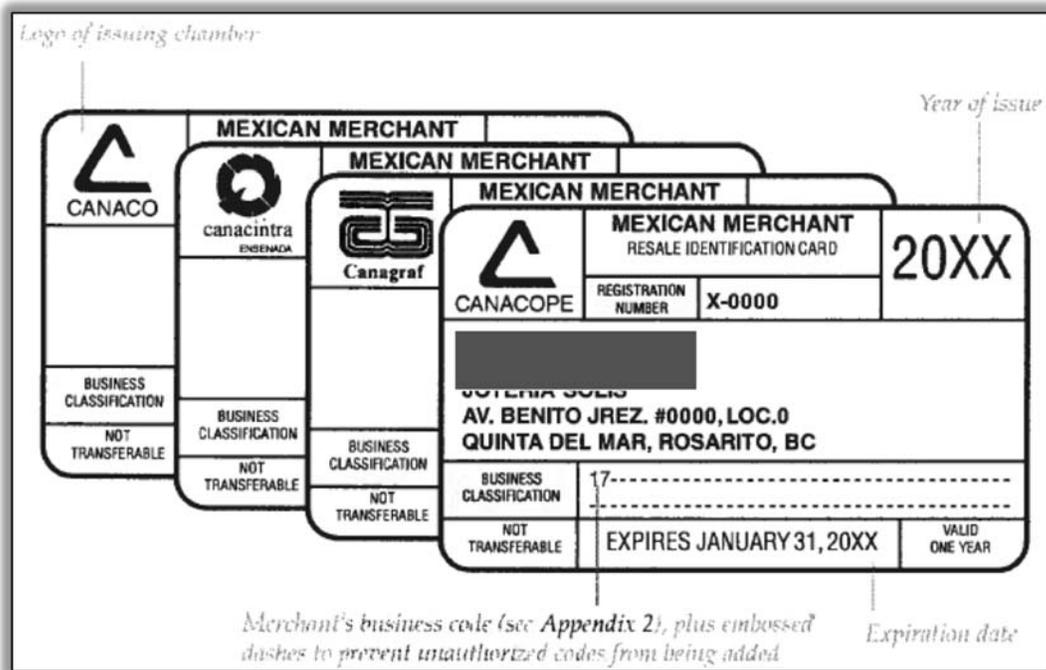


The Commonwealth of Virginia is similar, yet even a little more extreme. There is a downloadable form that allows a customer from any state, literally, who brings their home state exemption certificate to make a purchase, and then certify that he/ she is taking it back to that state to use it. Clearly, that process was intended for people in close, but not necessarily contiguous, states. For instance, it is not a terribly long drive from Delaware, Pennsylvania, even Ohio, to pick up a hard-to-get product for a tax-exempt job in one of those states. Then again, the burden of proof appears to be the customer's, not the

vendor's. (Yours truly has not had the pleasure of experiencing otherwise in a Commonwealth of Virginia audit.)

It would take a very large volume to cover every state and local jurisdiction with rules concerning who may or may not claim an exemption. For instances, New Jersey has what it calls Urban Enterprise Zones, with very specific rules concerning what purchases qualify for a reduced rate and also who can claim an exemption within that zone, of which there are 32. The Commonwealth of Pennsylvania requires that all exemption certificates be verified with the tax authorities, to confirm that the registration is still valid. There is; however, one more complex subject, with meaning for companies with locations or *Nexus* in states bordering Mexico.

There is an entity known as the Border States Caucus, which includes Mexico, the states that share a border with that country and, for some unknown reason, the non-contiguous State of Utah. Essentially, the agreement is that a Mexican entity will register with one of several Mexican Chambers of Commerce, which will provide them with an ID card. They can bring that card into the US member states, complete an exemption form, which is available in either English or Spanish, and then make purchases, to be taken back to Mexico for use. The cards look like this:



The interesting thing about the example provided on the first card is that the street in Baja, California is relatively short:



The advantage of today's mapping programs, satellite imagery and views of streets, virtually worldwide, is that one can verify that, for instance in this case, there are no visible businesses. Of course, that does not preclude someone operating from home, but it is a nice tool, nonetheless. It can even be used to help your customer:

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**Av Benito Juarez
Rosalito, Baja California**

Resale or not???

- Doesn't look like retail
- CT: Must pay tax on equip & consumables, like solder & wire
- Can claim resale on "integral parts" that retain identity inside equipment
- Dual-purpose parts (?)
- Possibly re-sells oil? Tanker out of sight to the left, but not relevant to an equipment supplier.
- If false, civil penalty for you, but possible civil & criminal for customer

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City State Zip

and is registered with the above listed states and cities within which your firm would deliver purchases to us and that any such purchases are for wholesale, resale, ingredients or components of new product to be resold, leased, or rented in the normal course of our business. We are in the business of wholesaling, retailing, manufacturing, leasing (renting) the following:

HVAC repairs + installs

Wholesaler
 Retailer
 Manufacturer
 Lessor
 Other (specify)

"Today's Oil Price \$3.61"

Basics of Credit Management

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Back to complicated Connecticut, this customer believes himself to be exempt, because he is a Retailer, as checked on the State provided form. However, his description of his activities, plus the fact that his building does not readily appear to be a retail establishment, begs for a more detailed discussion, with both the customer and your Sales Associate, since he allegedly visited this location.

Direct Pay Permits: Some companies will make a case with a given state that they will pay Sales Tax directly to that state, without going through their vendor. Again, the requirements will vary by state law. This Maryland permit is an example. Once you have this, you do not have to charge this customer Sales and Use Tax, and the burden of complying with the law rests with the customer. Lastly, most states will have the means for you to confirm the validity of any exemption certificate, so it is recommended that you do so.

Sales and Use Tax Direct Payment Permit

This permit issued pursuant to the provisions of Section 11-407 of the Tax-General Article of the Annotated Code of Maryland is subject to the limitations, terms and conditions set forth therein; and authorizes the permittee named below to make direct payment of sales and use tax to the Comptroller of Maryland, Revenue Administration Division, in lieu of payment to the vendor or lessor for purchase or lease of tangible personal property or services for use or consumption by the permittee.

Name of Permittee



Mailing Address

Frederick, MD 21702-1201

This permit is issued upon the further condition that the assigned holder shall fully comply with the requirements under Regulation .31 under COMAR 03.06.01, so that the State of Maryland shall not suffer loss of revenue by reason of the issuance of this permit. The permit may be revoked by the Comptroller for cause at any time. The permit cannot be assigned or transferred and is valid only for the permittee named above.

Comptroller of Maryland
Compliance Division

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