Sales and Use Tax Introduction

Carlos Hernandez
Ernst & Young LLP
Chicago, IL

Lauren Tallman
KPMG LLP
Seattle, WA
Presenters

Carlos Hernandez

- Ernst & Young LLP | Indirect Tax Services
- 115 N Wacker Drive | Chicago, Illinois 60606
  Tel: 312-879-4372
- E-mail: carlos.hernandez@ey.com
Presenters

Lauren Tallman

• KPMG LLP | International Indirect Taxes Group (SALT)
• 1918 8th Ave, Suite 2900 | Seattle, WA 98101
  Tel: 206-913-5149
• E-mail: lmcevoy@kpmg.com
Sales and Use Tax Introduction - Agenda

• Who imposes Sales and Use Taxes?
• Registrations
• 4 Major Types of Sales Taxes
• Tangible Personal Property vs. Services
• Interstate and Intrastate Commerce
• Use Tax Basics
Sales and Use Tax Introduction - Agenda

- Responsibility for Collecting and Remitting Taxes
- The concept of Nexus including SST
- Exclusions and Exemptions
- Statute of Limitations
- Voluntary Disclosure
- Amnesty Agreements
- Other Issues
Sales Tax Basics - Who Imposes Sales/Use Taxes?

- 45 states and the District of Columbia impose a sales tax
- Approximately 30 states allow localities to impose a sales tax in addition to the state tax
  - Approximately 8,000 Local Sales and Use Taxes in U.S.
- Only New Hampshire, Oregon, Montana, Alaska*, and Delaware (NOMAD) do not impose a state sales tax
  *Some Alaska municipalities impose a sales tax
Sales Tax Basics - Who Imposes Sales/Use Taxes?

• Most local taxes follow state law and are administered and collected by the state. The state later sends the localities its respective amount
• Some local taxes follow state law, but are administered and collected by the individual local jurisdiction (or appointed authority)
• Other local taxes do not follow state law and are administered and collected by the individual local jurisdiction (or appointed authority)
Sales Tax Basics - Who Imposes Sales/Use Taxes?

Local Taxes Include:

• County or Parish Taxes
• City Taxes
• Transit Authority Taxes
• Special District Taxes
• Other

• Arizona, Alabama, Colorado, and Louisiana - “Home Rule” Administration
Registration

Those entities that sell, lease or rent tangible personal property or provide enumerated taxable services are required to register if there is sufficient NEXUS established by the entity within the taxing jurisdiction.
Registration – Seller’s Permit

• A seller's permit is required for individuals, partnerships, corporations, or other organizations making retail sales, leases, or rentals of tangible personal property or taxable services
• Allows business with nexus to make sales in the state and collect and remit sales tax
• Is issued in the owner’s name, sometimes required for each business address
• Also known as “sales tax permit” or “sales tax license”
Registration – Resale Certificate

- Allows a business to make purchases without paying sales tax so long as the purchases will be used for resale or for use in the manufacture of products for resale (some states allow w/o registering if no nexus)
- Prevents the double collection of sales tax on products as tax is imposed on and collected from the final consumer
- Sellers may request to see the resale certificate before entering into business with customer
- Does not allow holder to purchase items for personal use without paying tax
- Also known as “resale permit” or “reseller permit”
4 Types of Sales Taxes

- Vendor or Seller Privilege Tax
- Vendee or Consumer Excise Tax
- Transaction Tax
- Gross Receipts Tax
Types of Sales Taxes - Vendor or Seller Privilege Tax

There shall be imposed, upon each person for the privilege of engaging in the business of selling tangible personal property and taxable services at retail, a tax measured by the gross proceeds (receipts) therefrom.

- Tax is generally imposed on seller for the privilege of doing business in state
- Seller must pay whether or not tax is collected from the buyer
- Collection of tax from buyer is based on contractual agreement
Types of Sales Taxes - Vendee or Consumer Excise Tax

Imposed on buyer
- Seller has the collection and remittance responsibility as an agent for the State
- Tax must be separately stated on the invoice
- Tax cannot be absorbed by the seller
- States such as: New York, Ohio, Pennsylvania
Types of Sales Taxes - Transaction Tax

A tax shall be imposed upon each transaction at retail at the rate of X% of the sales price that shall be collected by retailer from the purchaser.

• Tax is imposed on the sale or purchase transaction itself
• Buyer and seller are equally liable for payment of tax (audit implications)
• Tax must be separately stated on the invoice
• States such as: Florida, Indiana, Texas
Types of Sales Taxes - Gross Receipts Tax

Imposed on seller

- Similar to Seller Privilege Tax (imposed on seller, not buyer) but fewer exemptions or exclusions
- Virtually all services are taxable
- The vendor can absorb the tax and no requirement to separately state the tax
- Often even sales to Federal Government are taxable (e.g., NM - 50% taxable)
- States such as: New Mexico, Hawaii
Sales Tax Basics - Tangible Personal Property (TPP)

• Tangible personal property (TPP) – Property which is perceivable to the human senses (i.e., can be seen, touched, felt), but is not real property
• Tax generally imposed upon sale, lease and rental of TPP
• Sale of TPP generally presumed to be taxable unless specifically exempt
• Generally does not apply to real property or intangible property
• Not always a bright line between services and TPP
Sales Tax Basics - Services

• Services are generally not taxable unless specifically enumerated in statute
• Generally the person performing the taxable service is treated as the consumer of machinery, equipment, and supplies used in performing the service, i.e., such items are not purchased for resale as part of performing the service
Sales Tax Basics - Services

- Many states include certain services in the tax base/sales price
  - Sales price of the service typically includes labor charges, materials, overhead, and travel costs
- Services commonly taxed:
  - Installation of TPP
  - Repair and maintenance of TPP
  - Public utilities and telecommunications
  - Transient lodging
  - Data processing and other information services
**Sales Tax Basics - TPP or Services?**

- Distinction between TPP and service is not always clear, for example
  - Engineering services vs blueprints
  - Training services vs training manuals
- Some states apply a “true object” test
  - Was the intent of the purchaser to acquire tangible personal property or was the TPP incidental to the rendering of a service?
  - "the true object test is based on whether the buyer's purpose is to obtain services or tangible personal property" (SBE v. Advanced Schools, Inc.)
Interstate & Intrastate Commerce

- Interstate Commerce – Sales in which product crosses from originating state into another state’s boundaries
- Intrastate Commerce – Sales which originate and end within the borders of one state
Use Tax Basics - Why Have a Use Tax?

- Essentially provides states the ability to tax interstate sales
- Protects in-state businesses from a competitive disadvantage with out-of-state businesses
Use Tax Basics - When is Use Tax Due?

• When item or service is purchased from a vendor that does not charge tax (generally an out-of-state vendor)
• When item is transferred internally from one state to another
• When item originally purchased for exempt use is used in a non-exempt manner (Example - Withdrawal of items from inventory originally purchased exempt for resale for own use)
Responsibility for Collecting and Remitting Tax

• A retailer is required to collect tax on taxable sales in his home state
• A retailer is also required to collect sales or use tax on sales made into other states if the retailer has nexus in those states – or has voluntarily registered under SSTA or other type of agreement
• Nexus – the minimal degree of business activity required before a jurisdiction can require a seller to collect its sales or use tax
• Nexus can be created by a physical presence such as property, employees, agents, affiliates or deliveries into a state with own vehicles
Nexus - Why is Physical Presence Required?

- Due process clause of the U.S. Constitution
- Commerce Clause of the U.S. Constitution
- *Quill Corporation v. North Dakota*
Nexus - Why is Physical Presence Required?

• Due process clause of the U.S. Constitution
• Commerce Clause of the U.S. Constitution
• Quill Corporation v. North Dakota
• The 14th Amendment was added to the U.S. Constitution in 1868. The first sales tax took effect in the 1930s. It was not written to specifically address tax issues – but provided for a broad definition of national citizenship.

• The Due Process Clause of the 14th Amendment states in part:

• "...nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny any person within its jurisdiction the equal protection of its laws"
Nexus - Due Process

• A state or local tax is considered a deprivation of property from the taxpayer
• With regards to tax issues, this clause serves to prevent a state from depriving any person of property without due process of law – is there enough “activity” in the state for the state to exercise power over the individual or company?
Nexus - Commerce Clause

• The Commerce Clause restricts the state’s ability to tax out-of-state businesses (interstate commerce)
• The Commerce Clause states in part, “Congress shall have the power to regulate commerce with foreign nations, and among the several States..."
• Congress has the exclusive right to regulate interstate and foreign commerce
• States are prevented from discriminating against interstate commerce in favor of intrastate commerce (negative or dormant commerce clause)
Nexus

• The Due Process Clause has been interpreted as prohibiting a state’s imposition of tax where a business does not have a “minimal connection” with the state, such as soliciting sales through mail-order catalogs

• The Commerce Clause has been interpreted as prohibiting a state from requiring a business to collect sales/use tax unless the retailer has “substantial nexus,” or physical presence, with that state
Nexus

• Thus, a state can more easily assert a tax collection responsibility under the Due Process Clause (minimal connection) than under the Commerce Clause (substantial nexus)
• States avoid making decisions on constitutional grounds
Nexus - Streamlined Sales Tax Agreement

• First SST Agreement effective 10/1/2005. The current Agreement is dated May 4, 2016
• Per the SST Governing Board: The purpose of the Agreement is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance
• www.streamlinedsalestax.org
Nexus - *Streamlined Sales Tax Agreement (SST)*

Benefits per SST

- State level administration of sales and use tax collections
- Uniformity in the state and local tax bases
- Uniformity of major tax base definitions - states can still choose what is taxable and what is exempt
- Central, electronic registration system for all member states
- Simplification of state and local tax rates
Exclusions and Exemptions
Exclusions

• Do Not Meet Definition of Items Subject to Tax
• No Supporting Documentation Required
• Examples
  o Bonds, Fees, Goodwill, Professional Services, Intangibles
Exemptions

• Tax is Normally Imposed but Specifically Noted as Not Subject to Tax in Statute, Regulation, Etc.
• Requires Supporting Documentation
• Examples
  Sales to Government, Occasional Sales, Sale for Resale, Prescription Drugs, Agricultural, Manufacturing
Exemptions

• Item Sold or Service Provided
  o Prescription Drugs Purchaser’s Status
  o Sale to Federal Government
• Nature of Transaction
  o Sale for Resale
  o Occasional Sale
• Needs and Clout of Business Community
  o Manufacturing
  o Agricultural
Common Exemptions

• Sale for Resale
• Occasional Sale
• Sale for Export
• Manufacturing Exemptions
• Agricultural Exemptions
• Grocery and Medical Exemptions
• Sales to Exempt Entities
• Interstate Commerce Exemptions
Other Exemptions

- Temporary Storage Exemption
- Substantial Use Exemption
- Research & Development
- Natural Disasters
- Enterprise Zones
Exemptions - Documentation

Resale Certificate
• Issued by Registered Purchaser
• Purchase is for Resale

Exemption Certificate
• Item or Service is Exempt
• Entity is Exempt
• Nature of Transaction Creates Exemption

Direct Payment Permit
• Issued by Permit Holder
• Tax Paid Directly by Permit Holder to Taxing Authority When Item is Used
Exemptions-Certificates

Certificate Management
• Timely Issued
• Complete Information
• Proper Form
• Expiration
• Good Faith Acceptance by Seller
Statute of Limitations

• Period of time a taxpayer remains legally liable for a state tax obligation
• Also limits the period of time in which a taxpayer can file a refund claim
• Generally is 3 to 4 years from the date the tax is due and payable
• If no return is filed and the taxpayer had nexus, no limitation of time under the statute of limitations for underpayment assessments, generally statute barred for refunds
Voluntary Disclosure

• Allows a taxpayer with any tax obligation to come forward to the tax jurisdiction and “come clean”
• Often involves a third party providing a no-name fact letter to the tax jurisdiction and negotiating an agreement on behalf of the taxpayer
• May be an option, even if you are already registered and have filed returns for the periods in question
Voluntary Disclosure - Specifics

- Often limits the “look-back” period
- Penalty abatement is common
- Note that all taxes collected but not remitted must be disclosed and paid to the tax jurisdiction. Look back would not be limited in these cases
- “Notice” from the state often eliminates voluntary disclosure as an option
Amnesty Agreements

- State-specific legislation
- Penalties are waived
- Interest may be reduced
- Applications must be filed within a specified timeframe and approved by the tax jurisdiction
- Punitive provisions for non-participation
Other Issues

- Contractors
- Taxability – TPP and Services
- Multiple Points of Use – MPUs
- Consumer’s Use Tax
- Property Classification
- Drop Shipments
Other Issues - Contractors

• One who enters into a contract with end users to perform real property construction contracts
• Generally, states have special provisions that apply to contractors
• Contractors are generally treated as the consumers of the materials they buy
• Exemptions for purchases and sales by contractors vary from state to state
• New construction vs. real property repairs/improvements
• Flow-through exemptions are very limited
Other Issues - TPP and Services

Taxability

• Tangible Personal Property
  o Perceptible to the Senses
• Taxable Services (*Enumerated*)
  o Specifically Named within Statute as Taxable
• Assumption For Compliance Purposes
  o Taxable purchase unless the applicable exemption can be found in a statute, hearing, or court decision
Other Issues - Multiple Points of Use (MPU)

• What is the Taxing State?
• Is the MPU Software Taxable?
• Benefits to the Taxpayer?
Other Issues - Property Classification

• Critical in Determining Appropriate Tax Applications
• TPP Classified as Real Property
  o Permanently Attached to Land
  o Intended to Remain there Permanently; and
  o Property Cannot be Removed Without Causing Damage
  o Important to Plants and Construction Activities
Other Issues - Drop Shipments

• The tax treatment and certificate management and acceptance varies among the tax jurisdictions.
• Toughest state – California
Relevant Cases

• *National Bellas Hess v. Department of Revenue* (386 U.S. 753, 87 S.Ct. 1389 (1967))
• *Complete Auto Transit v. Brady* (97 S. Ct. 1076 (1977))
• *National Geographic v. Cal. Equalization Bd.* (430 U.S. 551 (1977))
• *Quill Corp. v. North Dakota* (504 U.S. 298 (1992))
National Bellas Hess v. Department of Revenue
(386 U.S. 753, 87 S.Ct. 1389 (1967))

• National Bellas Hess had its principal place of business in Missouri. It mailed catalogues to its Illinois customers and shipped merchandise to its Illinois customers via mail or common carrier from its Missouri plant.
• The Commerce Clause of the US Constitution (Section 8) restricts the state’s ability to tax out-of-state corporations (interstate commerce)
• The Commerce Clause states, Congress shall have the power:
  ▪ To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.
• Congress has the exclusive right to regulate interstate and foreign commerce
• States are prevented from discriminating against interstate commerce in favor of intrastate commerce (negative or dormant commerce clause)
• The Commerce Clause has been interpreted as prohibiting a state from requiring a business to collect sales/use tax unless the retailer has “substantial nexus,” or physical presence, with that state
• The Supreme Court decided that the State of Illinois could not impose a duty on the seller to collect use tax since the only connection in the State with its customers was via common carrier and US mail.
**Complete Auto Transit v. Brady (97 S. Ct. 1076 (1977))**

- Complete Auto Transit shipped General Motors automobiles by rail to a location in Mississippi. Then it loaded the automobiles on its trucks and delivered them to Mississippi dealers. The Mississippi Tax Commission levied a 5% privilege tax on the gross income derived in the State.
- Complete Auto argued that the tax violated the Commerce clause, as the shipment that occurred within the State of Mississippi was part of an interstate operation. However, the Supreme Court ruled that the tax was constitutional based on the “four prong test”. The tax is constitutional provided:
  1. It is applied to an activity that has substantial nexus with the taxing state (shipping the vehicles from rail location to MS dealers).
  2. It is fairly apportioned.
  3. It does not discriminate against interstate commerce.
  4. It is fairly related to services provided by the State (i.e. the company benefits from police protection and other public services within the State).

- National Geographic maintained two California offices to solicit advertising for the Society’s magazine.
- Its mail order operation was conducted from the District of Columbia and included the sale of maps, atlases, globes, and books directly to California customers.
- The two operations were a part of the same legal entity.
- National Geographic argued that the use tax was not due under the Commerce Clause.
- The Supreme Court decided that the company had sufficient nexus in the State due to the in state offices and therefore was required to collect use tax from California customers.

- Illinois passed its Telecommunications Excise Tax Act (Tax Act), which, inter alia, imposed a 5% tax on the gross charges of interstate telecommunications originated or terminated in the State and charged to an Illinois service address, regardless of where a particular call is billed or paid; and provided a credit to any taxpayer upon proof that another State has taxed the same call.
- The Supreme Court decided that the tax was constitutional because it satisfied all four prongs identified in the Complete Auto case.
Quill Corp. v. North Dakota (504 U.S. 298 (1992))

- Quill was a mail order distributor of office supplies with offices and warehouses in Illinois, California and Georgia.
- Quill sent catalogues to its North Dakota customers and also provided floppy disks with ordering software for use by its customers.
- The State argued that the presence of the floppy disks created nexus under the Due Process Clause of the Constitution.
- The Due Process Clause is the 14th Amendment to the US Constitution and was added in 1868. It states in part:
  
  "...nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny any person within its jurisdiction the equal protection of its laws"

- North Dakota argued that Quill had established a presence under the Due Process Clause.
- The Supreme Court opined that the four prongs of Complete Auto still applied and that Quill did not have the “substantial nexus” required under the Commerce Clause.
- The Supreme Court decided for Quill.

• D.H. Holmes operated department stores in the State of Louisiana and contracted with out of state companies to distribute catalogues to its Louisiana customers.
• The Louisiana Department of Revenue assessed use tax on the cost of the catalogs as the definition of use in the State includes “Distribution”. D. H. Holmes refused to pay the tax and argued that imposition of the use tax violated the Commerce Clause.
• The US Supreme Court decided in favor of the State of Louisiana.

- Jefferson Lines was a bus operator that sold tickets in Oklahoma for bus travel within the State and for travel from Oklahoma to other States.
- It collected tax on tickets for intrastate travel, but not for tickets sold for interstate travel.
- The Oklahoma Tax Commission assessed tax on the interstate tickets after Jefferson Lines filed for Bankruptcy.
- The Bankruptcy Court argued that the tax violated the Commerce Clause and imposed an undue burden on interstate commerce.
- The Supreme Court opined that the tax was constitutional as it was based on a discrete event (the sale of the ticket in the state of Oklahoma).