Sales and Use Tax Updates and Concerns for CPA's

MERIT ADVISORS, L.P.

June 1st, 2016

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Sales and Use Tax – Intro

Types of Tax

- There are 2 main types of sales taxes in the United States. Other nations usually impose a VAT Tax.
- Sales tax was initiated by MS in 1932. Every state except a few have imposed it (AK, OR, MT, NH and DE).
- Transaction Tax
- Gross Receipts/Privilege Tax

Sales and Use Tax – Intro

Transaction Tax

- A transaction tax is the majority type currently.
- The tax is imposed on each taxable sale of TPP or taxable services (regardless of prior tax paid).
- The tax is ultimately the consumer’s tax.
- The seller operates in a trust capacity. This is shifted to the “final” retailer with exemption/resale certificates.

Sales and Use Tax – Intro

Gross Receipts/Privilege Tax

- A gross receipts/privilege tax is imposed in only a few states.
- The tax is based on economic activity by the seller (regardless of profit or prior tax paid).
- The tax is ultimately the seller's responsibility.
- The seller pays the tax for the right to conduct business.

Sales and Use Tax – Intro

Use Tax

- Use tax is imposed to "level the playing field" between in-state and out-of-state sellers.
- Use tax is imposed on the first taxable use of TPP brought into a jurisdiction.
- Use tax can also be imposed on taxable transactions where the seller fails to collect.
- Seller's can be required to collect use tax if they have nexus

Sales and Use Tax – Intro

Tax Imposition

- Sales tax is typically imposed on sales of tangible personal property, unless exempt.
- Many states also impose tax on certain enumerated services, unless exempt.
- A few (gross receipts) states impose tax on all activity unless exempt.

Sales and Use Tax – Intro

What about Oklahoma?

- Oklahoma does not tax as many services (telecommunications, amusements, transportation, etc. but not repair/maintenance or real property services)

- There is discussion at the State legislature about broadening the sales tax base to include services. Either matching New Mexico or Texas. These discussions have included everything from taxing horses to school lunches.

Sales and Use Tax – Intro

Tax Base

- Sales tax is imposed on a tax base or gross receipts of the transaction.

- Each state has their own definition of tax base.

- The tax base can include items on the invoice such as: installation, delivery, seller’s costs, and services necessary to complete the sale.

Sales and Use Tax – Intro

OK Sales Tax Specifics

- OK imposes a transaction type sales tax.
- Oklahoma has a 4.5% state rate with additional local taxes at the city and county level.
- Unlike nearby Texas, Oklahoma does not have a cap on how high local sales taxes can be.

Sales and Use Tax – Intro
Sourcing

- Oklahoma local taxes are based on the "streamlined sales tax initiative" hierarchy; essentially where the customer takes delivery (destination state).

- Under audit the state will commonly make an assumption on sourcing and delivery which favors the assessment of additional tax. The actual delivery and sourcing must be supported with documentation to prevail.

Sales and Use Tax – Intro

State Enforcement

- Oklahoma enforces sales and use tax compliance through approximately 30 auditors based primarily out of OKC and Tulsa.
- Oklahoma also uses the services of several contract audit firms. These firms work under the OTC and include RDS and Broussard Partners.

Exclusions from Tax

1. **Services** – Usually only those enumerated as taxable by statute.

2. **Intangible goods** – sales of gift cards, stocks (basis of corporate acquisitions not being taxable), postage, etc.

3. **Real Estate** – rental or purchase or real property

Exemptions from Tax

Exempt Users

1. Churches - Exempt in OK & TX, but OK requires church to obtain exemption letter to supply to vendors. Must be paid in church funds.

2. Governmental Agencies – The agency often must make the purchase and not a contractor for the agency.

Exemptions from Tax

Exempt Users, continued…

3) Federal Governmental – only exempt if purchased by the government. Generally, sales to contractors are taxable.

4) Indian Tribes – OK: must be used by Indian tribe on Indian property

Exemptions from Tax

Exempt Users, continued…

5. Miscellaneous Non-Profits – Scouts, Red Cross – *Not necessarily exempt from sales tax just because an entity is a non-profit for income taxes.*

6. Miscellaneous Individuals – 100% Disabled veterans in OK, etc.

Exemptions from Tax

Exempt Use

1. Resale - for sale – not consumed while providing service, etc.

2. Manufacturing – in OK, purchaser must obtain an MSEP from OTC; No special permit to apply for in TX.

3. Pollution control – in both OK & TX

Exemptions from Tax

Exempt Use, Continued…

4. Agricultural – OK purchaser must have a state-issued card. TX has a special exemption certificate.

5. Medical – OK: Prosthetic items sold under prescription to Medicare and Medicaid patients; TX: Non-profit hospitals, prescription medication, and prosthetics devices.

4. Items Subject to Other Taxes – Motor fuels, cement in TX, motor vehicles and aircraft (subject to special excise taxes), etc.

Exemptions from Tax

Exempt Use, Continued…

7. *Oklahoma does not provide a general exemption for mining or drilling equipment. In TX, some equipment qualifies as exempt on a manufacturing basis.*

Sales and Use Tax – Intro
“take-aways”

- Oklahoma and other states are similar in some respects but differ widely. Each state must be examined independently.
- It is important to know the distinctions and plan accordingly.
- Sourcing, taxability, tax base, tax rates, exemption/resale certificates, definitions, refund claims; these all vary greatly.
- Problems occur when assumptions are made.

Sales and Use Tax Nexus

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What is Nexus?

- Nexus is a term used to describe when a State has the Constitutional authority to impose a tax, or a tax collection responsibility on a person.

- Congress has the Constitutional authority to regulate nexus but largely hasn’t (this may change).

- Instead the concept has developed over the last 60 years through case law.

Federal Limitations on State Power

- Due Process Clause (14th Amendment)
  - Fundamental Fairness
  - Notice
  - Presumed where a vendor economically benefits from the sale of goods into a state.

- Commerce Clause
  - Congress has authority to regulate interstate commerce.
  - Where Congress hasn't acted the Supreme Court created a "Dormant" Commerce Clause which prevents a state from unduly burdening interstate commerce.

What is Due Process?

- Based on fundamental fairness in governmental activity.
- Proxy for notice, the business must have minimal contacts and some warning that tax may be due.
- “Scioto” = receiving payments alone is not a sufficient contact.

3 Cases: National Bella Hess, Complete Auto, & Quill

- National Bella Hess – (Mail order company) The Court said there must be some physical presence.

- Complete Auto – Established 4-part test:
  - Substantial Nexus
  - Tax is fairly apportioned
  - Tax doesn’t discriminate against interstate commerce
  - Tax is fairly related to the services provided to the taxpayer

- Quill – (another mail order company) Upheld National Bella Hess and Complete Auto and invited Congress to intervene.

More on the Dormant Commerce Clause

- National Bella Hess (1967)and Quill Corp (1992) established the criteria for states exercising collection authority.
  - Substantial Nexus = Physical Presence
  - Not transitory or fleeting presence
  - Not mere communication with people in a state

What is Physical Presence Anyway?!

- The Court didn't bother to define it explicitly leading to conflicting holdings and confusion.
- More than "slight" presence or mere communication.
- Can include: independent contractors, agents, real property, tangible personal property, inventory, performing services, company delivery, entering the state to purchase, procure or display advertising, etc.

What is NOT Physical Presence

- The following would not create sales and use tax nexus:
  - Shipping items into the state via common carrier,
  - hosting a website that residents can access,
  - internet and telephone solicitation,
  - accepting payments,
  - advertising through media,
  - common ownership/affiliation but without an agency relationship,
  - occasional in-state meetings with suppliers, and
  - visiting professionals or government officials.

Physical Presence “Grey” Areas

- The following vary between states: telecommuters, certain deliveries, and trade shows.
- There are special protections in some states for:
  - Printers,
  - Web-based ownership and use of in-state servers, and
  - Call centers, distribution centers, and fulfillment centers.

Nexus Recent Developments Background Info.

- The first modern sales tax started in 1932 in MS.
- Every state, except 5, have a type of sales and use tax (AK, NH, DE, MT and OR).
- Sales and use taxes provide “critical funding” for state and local governments.
- There is a significant compliance problem with use tax.

The Trend
Nexus Erosion

- In response to the use tax compliance problem, States have passed laws expanding sales and use tax nexus.
- *"Click through"* Nexus
- Attributional and Affiliate Nexus (Amazon Laws)
- Many states are now imposing "economic nexus" with hybrid tax types. These include WA, UT, SD to name a few. Oklahoma is also looking into this.

Factors “Pushing” the Trend

- The overall trend is to impose a tax collection responsibility on remote sellers.
- With the advent of e-commerce this is becoming more and more of an imperative for states.
- “Brick and Mortar” stores are also pushing this legislation.
- Prudence demands that taxpayers prepare themselves to address increasing nexus risks.

Recent Developments Oklahoma Nexus Actions

- Oklahoma has been at the **forefront** of the movement to expand nexus.
- Streamlined Sales Tax Initiative
- Affiliate Nexus and Required Notification Laws
- Limitations on the application of the “Quill” physical presence test.
- Economic nexus is being considered.

Streamlined Sales Tax Initiative

- The state's response to National Bella Hess *(which stated that part of the problem was conflicting and complex laws between states).*

- Oklahoma signed SSUTA in 2000.

- Provides for uniform terminology, single administration, and uniform sourcing.

- Many large states (like TX because of sourcing) wouldn't sign hampering the effectiveness of SSUTA.

OK Affiliate Nexus

- Modeled after a Colorado statute. Okla. Stat. tit. 68, Sec. 1401(9) attempts to establish nexus through affiliated companies.
- The statute may not pass Constitutional muster Members of a controlled group are "presumed" to have nexus.
- Some of the factors:
  - Substantial ownership interest (or owned), substantially similar products, sold under a substantially similar name, and cross promotion.

Amazon Laws

- 2 basic approaches:

- Impose nexus by “click through” via a paid affiliate’s website.

- Impose a reporting requirement on “use” tax customers or to inform them of their liability.

OK Notification Requirements

- Modeled after a Colorado statute. Okla. Stat. tit. 68, Sec. 1406.1 (effective 10-1-10) requires use tax liability notification.
- The statute requires retailers that do not collect to notify customers they owe use tax.
- A similar Colorado statute was held **unconstitutional** in Federal district court.

Nexus Implications & Tips

- Case law allowing nexus for a minimal physical presence is restricted to “sales tax” so many states are looking at creating new tax types. Gross receipts, occupational taxes and similar new taxes.

- Oklahoma looks at whether a company is affiliated with a related entity to see if nexus exists. Similar names and branding are factors which might create a presumption of nexus.

- The state is cash strapped and having budget issues due to low energy prices. Creative legislative solutions could take many forms.

Sales and Use Tax Compliance

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Note: The contents of this presentation are abbreviated in nature and are not intended to be relied upon as legal advice. Adequate research in regard to any particular fact pattern should be done before making business decisions.

Effective and Efficient Compliance

Why is this Important?

1. Sellers who fail to collect tax or gather exemption documents assume significant risk.

2. To avoid risk - seller’s tend to over-collect tax.

3. Sellers sometimes incorrectly apply taxes.

4. Effective compliance can identify and mitigate these issues before they become material.

Goals of Effective Compliance

- Minimize audit liability.
- Minimize likelihood of audit.
- Gain or preserve statute-of-limitations protection.
- Secure refunds of overpaid taxes.

Example - Texas Compliance

- Texas
  - *Who must file:* Persons responsible for collection or payment of sales tax must file reports with respect to sales tax.
  - Form 01-114 & 01-117 (Short) Sales and Use Tax Return.

Filing Electronically - Texas

- Tax filers who paid $50,000 or more during the previous year are required to file their return data electronically.
  - ***WebFile***
    - The payment transactions before 6:00 pm on the bank business day before the due date.
    - Remit on TEXNET.
  - ***Electronic Data Interchange (EDI)***
    - EDI is designed for taxpayers with a large number of outlets or filing multiple returns.
    - Transactions with payments must be completed by 2:30 pm on the bank business day before the due date.

Paying Electronically - Texas

- Taxpayers who paid $10,000 or more in tax during the previous year must pay by Electronic Funds Transfer (EFT).
  - ***TEXNET***
    - a payment-only option
    - The payment transactions before 6:00 pm on the bank business day before the due date.
  - ***Electronic Data Interchange (EDI)***
    - EDI is designed for taxpayers with a large number of outlets or filing multiple returns.
    - Transactions with payments must be completed by 2:30 pm on the bank business day before the due date.

Texas - Use Tax Compliance

- Texas
  - *Who must file:* Every person storing, using, or otherwise consuming in the state taxable items. Taxpayer's liability is not extinguished until the tax has been paid to the state.
  - Form 01-156 Texas Use Tax Return.

Oklahoma - Use Tax Compliance

- Oklahoma consumers and businesses are both responsible to remit use tax.
- Businesses can obtain a separate use tax permit. Retailers can report use tax on divergent inventory on line 2.
- Businesses without a separate use tax permit can find the OTC trying to impose a 5 year review period in audit.

Texas - Direct Pay Tax Compliance

- Texas
  - *Who must file:* The holder of a direct pay permit issued by the Comptroller may give a blanket exemption certificate to its sellers. The blanket exemption certificate covers all future sales of taxable items to the permit holder and relieves the seller of the obligation to collect taxes. The direct pay permit holder agrees to accrue and pay the Texas Tax.

  - Form 01-119 Texas Direct Payment Return.

Oklahoma - Direct Pay Tax Compliance

- Oklahoma does not have a separate direct pay reporting form.

- This can cause some issues on whether tax is classified under sales or use tax designation which can affect the applicable rate.

Sales & Use Tax Refunds

- Refunds can be requested from vendors
  - Vendors sometimes resist because of the effort required on their part to amend returns.
  - Obtaining refunds (in the form of cash refund or credit memos) from vendors can be much faster that waiting for a refund from the State.

Sales & Use Tax Refunds

- Refunds can be requested from the State
  - Can result in audit.
  - For TX: Assignment of Rights forms (if unregistered); for OK – no such requirement for taxpayer, but auditor will contact vendors.
  - The waiting time for a refund to be processed can be a couple years but often takes less time. Having a perfected claim can help expedite.

Registrations

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Registration Basics - Example

- Oklahoma
  - Nexus Requirement
    - Oklahoma participates in the Multistate Tax Commission's National Nexus Program.
    - Oklahoma is a full member of the Streamlined Sales and Use Tax Agreement.
  - Oklahoma Taxpayer Access Point (OkTAP)
  - Oklahoma Packet A
- Texas
  - Nexus Requirement
    - Texas participates in the Multistate Tax Commission's National Nexus Program.
  - Texas Online Tax Registration.
  - Texas Application for Sales & Use Tax Permit Form AP-201.

Sale of Business Assets

What is an Occasional Sale?

Oklahoma has no exemption.

Occasional Sales can be exempt in TX only if conditions are met.

State specific issue.

Texas Specifics

Sale of Business Assets

1. Occasional Sales
   - Seller must be unregistered
   - Only applies to first two sales per 1 year period
   - Does not relieve registered purchaser of use tax liability

2. Sale of a Complete Division
   - Must be sale of entire set of operating assets of a division, branch or identifiable segment
   - Must be consummated in single transaction

Exemption Certificates

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Certificate Management Concepts

1. For every sale into a state where the seller has nexus, either tax or a valid certificate should be collected.

2. Customer exemptions should be requested at inception and periodically updated.

3. The personnel managing certificates must be conversant on the potential issues requiring remediation.

Certificate Management Concepts

- A file should be maintained regularly which records the certificates received and their details.

- Some certificates expire but most do not. This is state-specific. Customers and their exemptions often change and must be updated periodically.

- Not every state allows you to gather missing certificates!

- Some states allow a permit copy but most do not. Expired permit copies are not adequate and they must be updated.

Voluntary Disclosure Agreements

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Voluntary Disclosure Agreement

A voluntary disclosure allows a taxpayer to come forward and avoid some or all penalties and interest.

It also may limit the “look back period” for the liability at issue.

This is state-specific and may have certain conditions to qualify.

Often disclosure anonymously through a 3rd party is required.

Audit Defense

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Audits Should be Carefully Reviewed Because:

- Audits should be carefully reviewed because:
  - Sales tax laws are complex and difficult to apply.
  - Auditors make human mistakes and have bias.
  - Auditors usually do not try to find overpaid taxes.
  - Sampling can result in skewed assessments.

What Causes Audits?

- Audits are often generated for vendors during an audit of customers.
- Audits are often generated for customers during an audit of vendors that reveals questionable exemption certificates that were provided.
- Direct Pay holders are usually regularly audited as are companies with a large percentage of non-taxed sales.

What else can cause an audit?

- Snitching – by former employees or competitors.
- Triggered by refund claim.
- Industry targeting by state.
- Random selected.

Pre-Audit Review

Review Exemption Certificates

- Sellers should begin a self-audit immediately upon notice of an audit; and missing certificates should be sought.
- Sales are presumed taxable unless documentation shows otherwise.
- A vendor is absolved if documentation is timely received in good faith.

Statute of Limitations

- Statute of limitations is normally 3 years in OK and 4 years in TX, but there is no limitation if:
  - Taxpayer is not registered.
  - Taxpayer filed returns that are fraudulent.
  - Oklahoma may pursue 5 years if there is no use tax permit.
  - Texas can go back 7 years for gross under-reporting.

Statute Waivers

<u>Waiver of Statute of Limitations:</u>

- Auditors often request a waiver to extend the statute of limitations. Often, these should be signed, but the length of time should be evaluated.
- In Oklahoma this can help with offsetting refund claims.
- Can be abused by auditors but can also help the taxpayer.

How to Treat Auditors?

- Be courteous and respectful. Auditors talk to each other, and they remember treatment for future audits.
- Try to establish trust and rapport but also remember that they are partisan.
- Provide information requested as long as it is reasonable. No business records are confidential as far as the states are concerned, but some are irrelevant and some requests are for non-existent records.

Auditors: What NOT to do.

- Allow unlimited access to information or employees. (They may ask leading questions of unprepared employees, or misunderstand records).

- Sign sample agreements or lengthy statute of limitations waivers without due diligence.

Sampling Methods

- Sampling can greatly reduce the amount of time required to conduct an audit. It can skew results if performed badly.
- Some states can force the use of statistical sampling for an audit provided that it meets certain standards (TX). In other states the taxpayer must agree (OK).
- Sample methods should be appropriate for the taxpayer's business and available records.
- The structure of a sampling arrangement should be carefully considered.

Sampling Methods, Continued…

- ✓ Assets often should be reviewed in detail.
- ✓ Outliners and unusual items should be treated distinctly.
- ✓ Make sure strata are not overly broad, and that the sample has been evaluated to show an acceptable variance between the population and sample amount per transaction.
- ✓ The selection of accounts to include in the population is an important consideration.

Sampling Methods, Continued...

- Time Period or Block Sampling
  - This sample method can be sound but it should factor in several considerations:
    - Outliners.
    - Cyclical business activity.
    - Sample size.
    - Variance between sample and population amounts per item.

Sampling Methods, Continued...

– Time Period Sample Epic Fail

- Example of Skewed Results:

  – For a manufacturing facility:

  – 42 month period using most recent 12 months – when in reality the activity in the final 12 month period had increased to a level that was nearly 150%

  – Likely result: a 50% over-assessment

Sampling Methods, Continued...

– Texas has a sampling manual which auditors must follow. It provides for a variety of sample methods. Once pulled it is rare that a sample will be recompleted. Review before you agree. (They can force the sample on you but often will seek consent).

– Oklahoma has no sampling manual and often performs a poor time period sample. It is not mathematically evaluated and can result in skewed results. The sample method must be agreed too by the taxpayer therefore conduct due diligence before you agree.

Informal Appeals

- Usually, this is where matters are settled. Often a dispute will not require a hearing.
- Keep in mind that sometimes auditors will misapply the law, misunderstand facts, and make poor assumptions. There is a time to fight.
- Try to deal with documentation issues in the audit if possible. On legal questions adjudication may be unavoidable.
- In Texas an Independent Review by another auditor can be requested at the exit conference. In OK often a meeting with the audit supervisor and manager can be helpful.

Administrative Appeals

- A written protest must be filed with the OTC within 60 days of the date of the proposed assessment. An additional administrative extension on this deadline can be requested in writing.

- A redetermination request can be filed in Texas once the Notice of Tax Due is received. It must include a statement of grounds.

Administrative Appeals, Continued…

An OK protest should contain these elements:

- Amount and type of tax assessed.
- The error committed by the Tax Commission.
- The legal authority to support the taxpayer’s position(s).
- A statement of the relief requested by the taxpayer and a verification that these statements are true.

Who is MERIT Advisors?

- MERIT is a full-service provider of:
  - Appraisal and property tax solutions for Oil & Gas Companies, Construction, Manufacturers and Service Firms, Business Personal Property, and Commercial Property
  - Sales Tax Consulting Services – audit defense, refunds, advice, software implementation, nexus determination and subsequent exposure minimization and remediation.
  - Business Incentive Programs – tax exemptions, credits and rebates, local infrastructure assistance, etc.

- Merit has about 50 employees – Most managers and directors have over 20 years experience. They are a leading provider of property tax services to the oil and gas industry, and has extensive experience with sales and use taxes.

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Rick is an MBA, and a member of the Institute for Professionals in Taxation and the OSCPA.

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Mike is a member of the Institute for Professionals in Taxation.

THANKS

- Please call if you have questions or would like to discuss an issue further.

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