



## Customer Exemption Management

Successful customer exemption management is critical to a business that has exempt customers (or customers that can be treated as exempt under certain situations). Understanding the relevant requirements will help you minimize tax exposure and future audit assessments.

## Introduction

One of the most important but often challenging tasks for many companies doing business in taxable states is managing their customer exemptions. From an audit exposure and potential future audit assessment standpoint, there should be extra sensitivity shown and additional effort allocated towards this ongoing task. Proper management of this function has various facets that need to be considered such as:

1. Exemption certificate requirements (e.g. if required by law, acceptable form or format — multistate, state specific based on exemption classification, separate local, etc.)
2. Expiration periods
3. Scope and application limitations
4. Good faith requirements
5. Home-state certificate provisions relating to drop-shipment transactions
6. Single-use administration
7. Product/service exclusion and administration
8. Customer relations

At the end of the day, successful customer exemption management is critical to a business that has exempt customers (or customers that can be treated as exempt under certain situations), in order to minimize tax exposure and future audit assessments. Since sales tax is generally a pass-through tax and in most cases the seller is required to support any exemptions claimed relative to their exempt sales transactions, it is advantageous to understand the relevant requirements and then implement the needed systems, policies and procedures that will ensure compliance with state and local laws.

## General Requirements

Under the general theory of sales and use tax, the sale or use of tangible personal property is presumed to be taxable unless otherwise made exempt by statute or if a valid exemption certificate is obtained from the customer in lieu of collecting the tax to support a claimed exemption. Consequently, differentiating between exemptions that require exemption documentation and those that don't is important both from an administrative and a systemic standpoint.

Product-based exemptions (e.g. food, clothing, medical, newspaper) are supported by statute and do not require exemption certificates to support the exemption, whereas "entity-based" and "use-based" exemptions usually require some sort of exemption documentation to support the allowable exemption and to release the seller from the obligation of collecting tax on a taxable transaction.

## Entity-based and Use-based Customer Exemptions

For purposes of supporting either an entity-based (e.g. government, charitable organization) or use-based (e.g. manufacturing, agricultural, resale) exemption, most taxing authorities require "proof" that the customer is exempt, and in most cases, this proof comes in the form of a valid exemption certificate. Relative to entity-based and use-based exemptions, if the customer doesn't provide hard copy exemption documentation, or in some states, the required data elements to support the exemption in electronic form, the customer is not considered exempt nor is the licensed seller released from the liability of collecting the tax that is due. There are a few exceptions to the general rule such as:

1. A sale to the federal government, which usually only involves demonstrating the identity of the government agency via an invoice, purchase order or contract.
2. A seller's permit number that will suffice for purposes of supporting the exemption.
3. An import letter demonstrating that the goods are intended to be shipped outside the United States.

Whatever exemption documentation requirements exist to support an exemption, a seller needs to understand that in most cases the burden of obtaining the required exemption documentation and proving to a taxing authority that a customer is exempt from tax is their responsibility. The seller will be held accountable for non-compliance in an audit situation.

## Exemption Certificate Types and Sources

There are several customer exemptions (or exemptions that are available to customers based on an exempt use) that taxing authorities accept, including but not limited to:

1. Resale
2. Government
3. Exempt Organization (e.g. religious, educational, and charitable)
4. Manufacturing/Industrial
5. Agricultural
6. Direct Pay Permit
7. Capital Improvement
8. Aircraft Maintenance
9. Data Processing
10. Enterprise Zone

All taxing jurisdictions have some combination of these exemptions and have their own exemption certificate requirements and limitations associated with them.

In performing customer exemption management there are various sources of exemption certificate documentation that can be obtained and used to support a customer exemption, which include the following:

- Exemption and resale certificates published by the state or locality.
- Uniformed Multi-jurisdictional Exemption Certificate produced by the Multistate Tax Commission (MTC) — limited to 38 states and primarily limited as a resale certificate.
- Streamlined Sales Tax Exemption Certificate specifically designed for the twenty-three Streamlined Sales Tax states.
- Home-grown exemption certificates may also be acceptable providing they meet the exemption certificate requirements as outlined in individual state statutes.

## Exemption Certificate Receipt Requirements and Useful Life

Each taxing authority has its own specific requirements relating to when exemption certificates or other acceptable documents are required, as well as any associated expiration period or useful life of the exemption documentation.

Generally speaking, if a seller doesn't impose tax on a taxable transaction, then an exemption certificate must be obtained in lieu of collecting the tax on or before the date of sale. There are of course some exceptions to this general rule that allow grace periods for obtaining the needed exemption documentation, which may extend as much as 90 days. It is noteworthy to mention that it is not unusual for taxing authorities to allow taxpayers additional time after missing exemption certificates are identified during a sales tax audit. The additional time may be as much as 120 days, or perhaps even longer if the seller signs a statute of limitation waiver. But as a matter of practice, this additional time should be viewed as an "audit mercy" on behalf of the auditor rather than an excuse not to have to obtain the needed certificate at the time of sale.

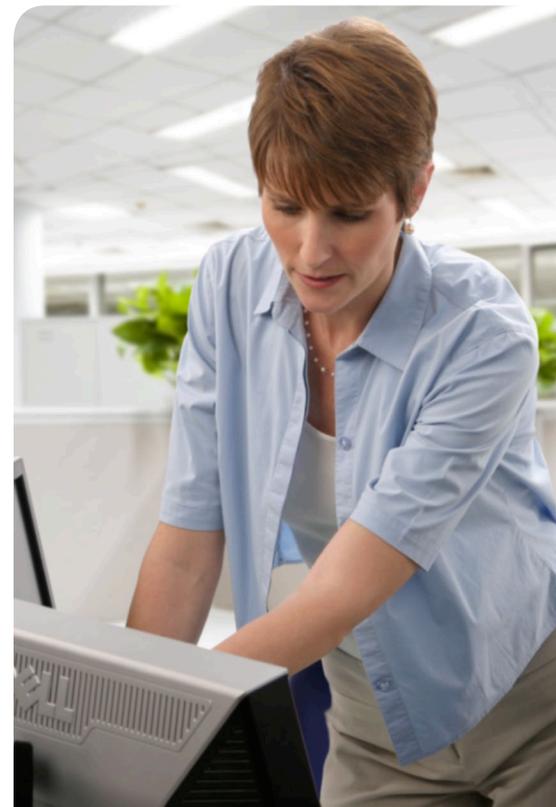
It is also noteworthy to mention that under the exemption provision of the Streamlined Sales and Use Tax Agreement (SSUTA) that governs the twenty-three Streamlined Sales Tax states, sellers have 90 days to obtain the needed exemption certificate or the applicable exemption certificate data elements that are required. After the 90 day period, the seller may have up to 120 days upon request from the member state to either prove that the transaction was exempt by other means or obtain an exemption certificate from the purchaser in accordance with the member state's "good-faith" provision.

Relative to the expiration period or useful life of an exemption certificate, each state and applicable locality have their own requirements and policies. The useful life can be as short as a single transaction or can be as long as indefinitely, unless voluntarily revoked by the customer. Also, under the provision of the SSUTA, Streamlined Sales Tax exemption certificates (whether in hard copy or electronic form) can be valid indefinitely as well, providing there is at least one customer exempt transaction executed against the certificate per year.

## Other Important Twists and Turns to Consider

- **Hawaii Resale Certificate** — With the exception of use tax related to imports for sale or purchase for wholesale, Hawaii does not completely exempt sales for resale. Sales to a licensed retail, jobber or other licensed seller for resale purposes are sales at wholesale for general excise tax purposes and are taxable at a reduced rate of 0.5%.
- **Washington's New Resale Exemption Policy** — Effective January 1, 2010, the state of Washington stopped accepting traditional self-issued resale certificates to support a wholesale sale to resellers. In the place of the traditional resale certificates, a seller must obtain a copy of a new state-issued "Reseller Permit" from its resale customers. These new state-issued "Reseller Permits" are available for retailers, wholesalers and manufacturers and have a useful life of either two or four years. Businesses engaged in construction activities can also obtain a new Reseller Permit, but the useful life is limited to a period of one year. Businesses that make resale sales that don't qualify for a Reseller Permit will need to pay the tax associated with their purchases and afterwards claim deductions on their sales tax returns or request refunds directly from the Department of Revenue. In lieu of the new Reseller Permit, a Streamlined Sales Tax Exemption Certificate can still be accepted.
- **Single Use vs. Blanket Exemptions** — As a practical matter, most customers that provide their vendors exemption certificates do so under a blanket approach and then self-assess use tax on any items that don't apply; however, there are occasions in which there is a need to be able to manage a single-use exemption certificate. In this particular scenario, the customer wants to be treated as exempt only in relation to a single transaction. A single-use is usually applicable to a "use-based" exemption such as manufacturing or perhaps some other one-time special project that is being performed that qualifies under a use-based exemption provision. For administration purposes, a single-use exemption is usually referenced to purchase order or invoice number, or applicable contract.

- **Limited Use Exemptions** — For purposes of limiting tax exposure, customers sometimes provide exemption certificates to their suppliers with specific instructions not to exempt certain items associated with the transaction because they don't qualify as exempt, either because they don't meet the requirements of a use-based exemption or because certain items or a certain number of items will not be resold. This approach can become problematic for sellers to administer but it is something that they may have to deal with from time-to-time to better meet their customers' demands.
- **Home-state Exemption Certificates Associated with Drop-Shipment Transactions** — For the majority of states, drop-shipment transactions are viewed as resale transactions, and a high percentage of those states allow the acceptance of a seller's "home-state" resale certificates in lieu of one from the ship-to state.
- **Home-rule Localities Acceptance of State Exemption Certificates** — The general presumption that exists with most sellers is that "home-rule" localities accept a state exemption certificate to support the local exemption as well; however, this is not true in all cases. It's important to know which ones do accept a state certificate and which ones require their own.



## Best Practice Guidelines to Consider

1. As a general rule when configuring a customer exemption record in your ERP system or Tax Calculation Engine Customer Exemption Management module for purposes of invoking a systemic exemption, it should be done after receiving the required exemption certificate documentation.

Even though some states have grace periods to obtain the required exemption certificates, and auditors don't often enforce the state's statutory requirements, it is a good practice to be able to support the applicable customer exemption at the time of sale rather than trying to go back and track down the required exemption certificate after the fact. If following this practice results in excessive amounts of crediting of sales invoices after the original invoice has been generated, it may be necessary to modify sale or order entry procedures to ensure that the required exemption certificate documentation is obtained on or before the date of sale.

2. Many states and localities have expiration periods associated with their exemption certificates (e.g. 1 year, 3 years), and so it will be important to know what the expiration periods are for each taxing jurisdiction and assign the appropriate expiration date in your ERP system or Tax Calculation Engine Customer Exemption Management module. The expiration period is not usually printed on the certificate, so it may be necessary to perform the needed research to ascertain the expiration period.

3. When requesting updated certificates from customers, it is a good practice to start the process 60 to 90 days in advance of the expiration period to allow for adequate lead time to obtain the needed exemption certificate documentation.

4. The states and localities that don't have expiration periods associated with exemption certificates usually recommend that a seller update its customer exemption certificates every 3 to 5 years.

5. Occasionally, customers believe that providing a seller a copy of their registration or permit number in lieu of providing a valid exemption certificate is sufficient to support the exemption; however, most states and localities require specific data elements in order to support an exemption, including a signature and effective date. If this situation arises, you can contact the applicable taxing authority for direction.

6. Before deleting an exemption record in your ERP system or Tax Calculation Engine Customer Exemption Management module, be sure that the customer exemption record is no longer needed or applicable.

7. When a customer revokes an exemption certificate, it is important to eliminate the exemption in your ERP or Tax Calculation Engine Customer Exemption Management module as soon as possible to avoid exempting an otherwise taxable transaction.

8. Be sure when dealing with "home-rule" localities that you obtain a separate local exemption certificate, if required, and then create a separate local exemption in your ERP system or Tax Calculation Engine Customer Exemption Management module. Some locals may accept the state exemption certificate documentation, but some will not. If unsure of a locality's acceptance policy, contact the applicable local jurisdiction for specific guidance.

9. If a customer provides an exemption certificate but specifies — either on the face of the exemption certificate or purchase order or via a contract — that the certificate excludes certain products and services, the instructions from the customer should be followed and tax should be imposed if subject to tax.

## CCH's Approach to Customer Exemption Management

CorpSystem® Sales Tax Office v3.0 has a Customer Exemption Management module built into the tax calculation application and is a fully functional and integral part of the workflow and tax decision making process. This module allows a taxpayer to either manage the customer exemption certificate information directly within Sales Tax Office or in conjunction with the ERP system or a third-party Exemption Certificate Management System.

Within the Customer Exemption Management module itself, a user can configure item exceptions, track expiration periods, assign acceptable state and locality relationships, differentiate between "active" and "inactive" customer exemptions, and configure special allowance for customers to continue processing exemptions beyond the expiration date when the certificate is in route.

### About the Author

Phil Schlesinger has been in the sales and use tax field for 22 years and has extensive knowledge and experience in compliance, audit (internal and external), tax research, and automation, both in a corporate environment and in a consulting role. While in consulting, he prepared taxability matrixes for dozens of companies representing numerous types of industries such as software, manufacturing, services, food, medical, advertising and construction. Over his career, Phil has also been heavily involved in the design, testing and/or operation of several sales and use tax software tax calculation engines and tax return processing systems including CCH, Vertex, Taxware and AvaTax.

For more information about Sales Tax Office and its Customer Exemption Management functionality, you can contact a sales rep at **866-513-2677**, or go online at **SalesTax.com**



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