

Managing exempt sales during the rise of **ECONOMIC NEXUS**



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MANAGING EXEMPT SALES DURING THE RISE OF ECONOMIC NEXUS

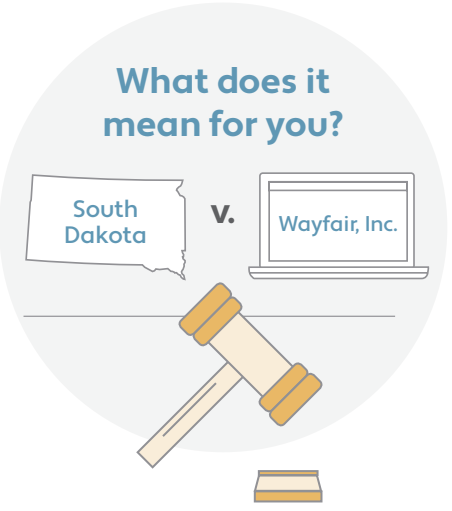
If you sell products or services that are exempt from sales tax, your compliance challenges and audit risk can be more complex and burdensome. In the event of a sales tax audit, you must prove that your exempt sales are backed by valid documentation. If not, you'll be assessed tax, audit fines, and penalties. Achieving complete sales tax compliance is only possible if you understand how to properly collect and maintain exemption certificates to support your company's sales process.

In 2018, the world of sales tax compliance was shaken by the new economic nexus standard after the Supreme Court of the United States ruled on South Dakota v. Wayfair, Inc. This ruling continues to have a dramatic impact as it expands nexus obligations for many remote sellers; more nexus obligations leads to more registrations, more sales tax collections and remittance, and more exemption certificate requirements. While economic nexus is a hot topic these days, it's important to remember that the physical presence standard for nexus still exists.

ECONOMIC NEXUS LAWS DEMAND BUSINESSES PAY CLOSE ATTENTION TO EXEMPTION CERTIFICATE MANAGEMENT

South Dakota v. Wayfair, Inc. redefines nexus standards

Since the Supreme Court decision in South Dakota v. Wayfair, Inc. many businesses have seen their sales tax registration and reporting obligations increase drastically. With the ruling, sellers with no physical presence in certain states are still on the hook for sales tax compliance if they reach a specified sales or transaction threshold. That means even if you don't have physical presence in a state and that state has an economic nexus law, you may still be required to collect and remit sales tax on behalf of the state. Many businesses spent 2019 scrambling to get licensed and registered in the new states where they now have nexus, but there are additional considerations to keep in mind.



Not only do you need to think about registering in new jurisdictions, but you should also consider how you manage exempt sales. Exemption certificates are an important part of sales and sellers use tax compliance and can be an area of liability during an audit. Missing, inaccurate, incomplete, or expired certificates can leave your business liable for sales tax not collected as well as additional audit fines and penalties. Exemption certificate management can be time-consuming and an onerous amount of work, and it's getting more complex and confounding with the rise of economic nexus laws. Expanding nexus obligations may mean a manual solution for securing and maintaining tax exemption documentation is no longer a practical option.

DID YOU KNOW?

The concept of economic nexus has been around for some time. In fact, some states already had a law in place, but before South Dakota v. Wayfair, Inc. they were unenforceable. After the ruling, it is now the new standard in the world of sales tax. For states with economic nexus laws, the most common threshold enforced by states is $100,000 in sales and/or 200 transactions.

Economic nexus thresholds are murky when it comes to exempt transactions

Product and service taxability is confusing because countless products and services are tax exempt in many states. As taxing jurisdictions continue to refine their rules about taxability, it's important to keep up. Sales can be exempt from sales tax for many reasons. How or where the goods are used by the buyer can create an exemption. One of the most common reasons for sales tax exemption is items intended for resale. Some states don't tax services and labor, and some do. Further, many states exempt nonprofits and government agencies from paying sales tax. As the number and types of products or services you sell grows, so does the likelihood of tax exempt sales and the complexity in maintaining compliance.

Add in economic thresholds and the confusion is compounded. States are defining their own rules for implementing economic nexus laws and while some include exempt sales in thresholds, some don't. In addition, some states take different approaches to sales and services that are exempt from sales tax.

Defining exempt sales can cause headaches for businesses in many ways. Individual state laws lack uniformity with rules, thresholds, and effective dates for economic nexus, thus compounding the complexity for businesses attempting to determine if they've established nexus based on economic activity. For example, exempt sales and services must be counted when determining if you've met the economic threshold in Mississippi, but if you're also doing business next door in Arkansas, exempt sales and exempt services aren't included. The good news is that as more states adopt economic nexus legislation, the laws are more deliberate when it comes to the definition and characterization of what types of sales are included in economic thresholds.

DID YOU KNOW?

Exemption certificates expire! To maintain compliance, you need to know how long certificates will remain valid. In many states, certificates must be renewed every five years. In others, it's three years. And in some states, certificates never expire.

EXEMPTION CERTIFICATES AND THE IMPACT OF ECONOMIC NEXUS

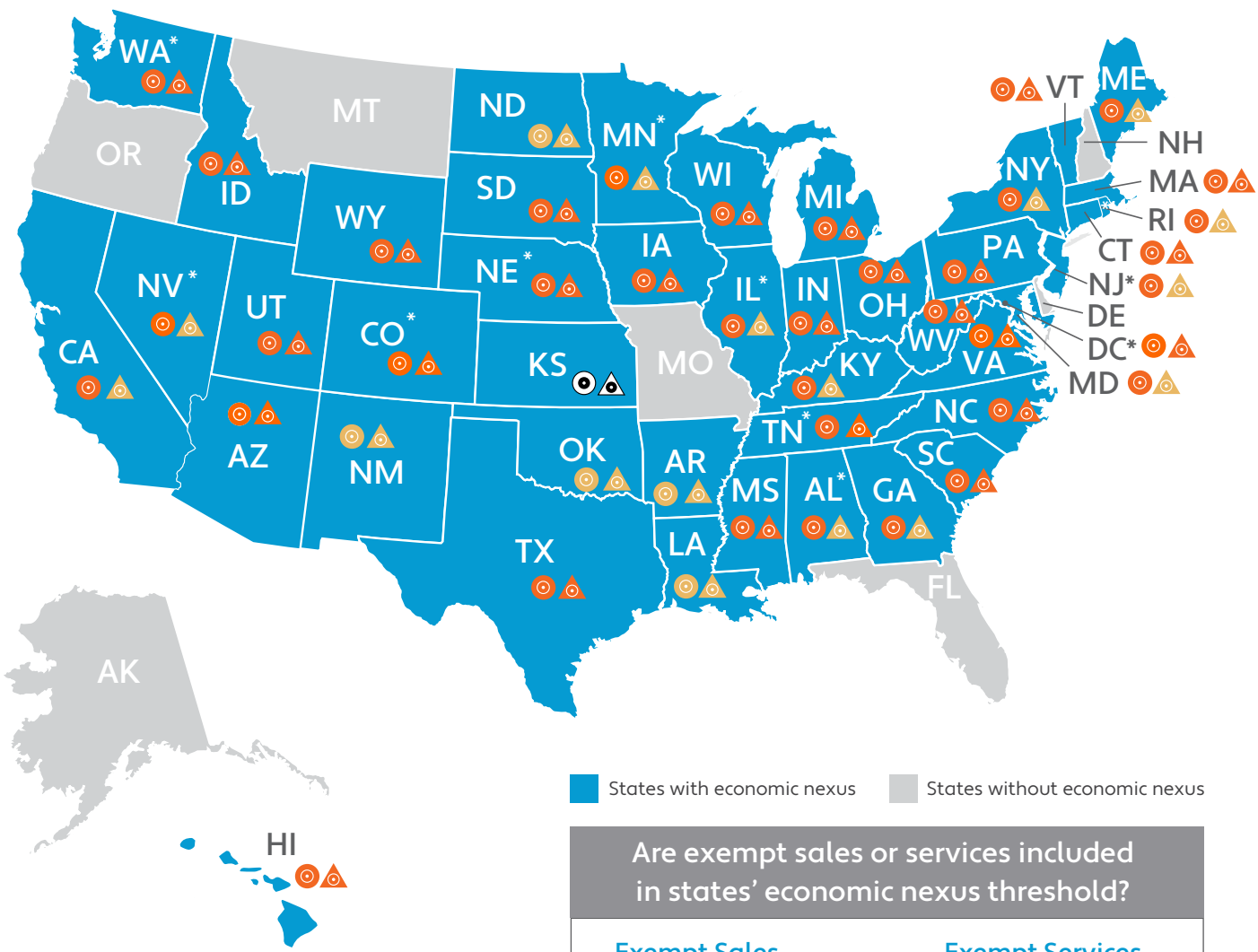
As new economic nexus laws expand sales tax collection, the requirements for collecting and properly documenting exempt sales are growing significantly. More than 40 states now have economic nexus laws, and many include exempt sales in the sales or transaction threshold. Previously, a company with only a handful of exempt sales in multiple states wasn't required to collect exemption certificates because it didn't have nexus in a certain state. However, as a result of the Wayfair decision, if these sales carry a high price tag, only a few sales could cause the company to surpass an economic threshold. Or if a business has a high number of transactions with a relatively low cost per invoice, the number of transactions may also surpass an economic threshold. With economic nexus, meeting a sales or revenue threshold and/or a transaction threshold establishes a sales tax obligation.

Until recently, you may not have been required to collect exemption certificates, but you may now need to collect, manage, and keep your documentation up to date for all sales in states where economic nexus is established, as well as, in any state where physical presence nexus was established prior to the Wayfair ruling.

To minimize your risk of non-compliance with economic nexus and exempt sales, it's crucial to continuously re-evaluate your business activities for economic thresholds. As previously mentioned, some states include exempt sales or services, while others don't. And there are even some states, like Illinois and Nevada, that include exempt sales but exclude sales that are for resale. As of December 2019, more than half of states include exempt sales in their economic nexus thresholds. The map below illustrates whether individual states include exempt sales and/or services in their economic nexus thresholds, and should help you determine where you may need to dig deeper when it comes to exempt sales. For the most current information on specific thresholds, visit our website for a state-by-state guide to economic nexus laws.

Exempt sales in states with economic nexus laws

(As of December 15, 2019)



States with economic nexus

States without economic nexus

Are exempt sales or services included in states' economic nexus threshold?

Exempt Sales	Exempt Services
Included	Included
Not Included	Not Included
Unclear	Unclear

*States that include exempt sales in the threshold count but exclude sales for resale or wholesale

Economic nexus and supply chain

The number one reason for a sales tax exemption is when the sale is for resale – such as part of a supply chain. The key to understanding this complexity is to know that there are multiple dealings involved and each transaction needs to be evaluated on its own. To maintain your compliance and minimize risk with supply chain sales, it's critical to learn where your sales land throughout the supply chain. With more states passing economic nexus laws, your obligation to track and manage exempt sales is likely impacted in some way.

To re-evaluate your nexus obligation based on the recent economic nexus laws, it's important to first identify where the nexus obligation may fall and who is responsible for the resale or exemption certificate – the seller or supplier. This determination is a big part of maintaining compliance and involves accountability for both parties, one for collecting current and accurate exemption certificates and the other for supplying the necessary exemption certificate documentation.

The scenario below helps to define the included parties and how each transaction within the supply chain carries its own level of responsibility.

How your role in the supply chain can establish nexus and trigger exemption certificate requirements

NOTE: The definitions in the example below pertain to this example only. Other supply chain relationships may change the definitions and relationships among the businesses involved.



CUSTOMER
The individual/business placing the order from a purchaser or retailer.



SELLER
The company or retailer placing the order from the supplier and selling to the customer.



SUPPLIER
The company that fulfills the order to the customer.

SALES TRANSACTION A: A customer buys a dishwasher from a seller (retailer).	SALES TRANSACTION B: Seller (retailer) buys the dishwasher from the supplier.	FULFILLMENT TRANSACTION C: Supplier delivers the dishwasher to the customer
An individual customer buys a dishwasher online from a seller (retailer). The seller doesn't have a physical location in the state where the customer lives; however, the state has an economic nexus law that includes exempt sales. This sale makes the retailer cross an economic threshold for remote sellers in this state. As a result, the seller must now register, collect, and remit sales tax in the state where the customer is located.	To fulfill the customer order from Transaction A, the seller buys a dishwasher directly from a supplier (manufacturer) located in another state. The supplier sells many items to the seller and reaches the transaction limit for economic nexus in the state. This specific sale is for resale, so the supplier isn't required to collect sales tax. But, due to the transaction threshold being met, the supplier is now required to register and collect a valid resale certificate from the seller.	For delivery of the sale in Transaction A, the seller (retailer) has the supplier deliver the dishwasher directly to the end customer, this is sometimes referred to as drop shipping. The seller established nexus in Transaction A and already collected sales tax. As explained in Transaction B, the seller must issue a valid resale certificate to the supplier for the state where the customer is located.

Drop shipping adds complexity

As you can see in the previous example, drop shipping relationships between businesses can cause additional confusion. Many states don't consider the transaction between a seller and supplier taxable, as long as the supplier is provided with a valid resale exemption certificate. The resale exemption certificate indicates that the items delivered by the supplier are for resale, so an out-of-state resale certificate or multijurisdictional form may be an acceptable form of documentation, or in most cases you must obtain a valid resale certificate in that state. In some circumstances, the supplier must collect a resale certificate from the seller, but in others, the seller is responsible for collecting and managing certificates from the end customer. If your business is involved in either using drop shipping or providing drop shipping services, the chart below should help you determine your responsibility for exemption certificates.



*Varies by state. Consult your tax professional.

DID YOU KNOW?

A recent report by Wakefield Research found that more than 50 percent of survey respondents had missing or inaccurate documents – including exemption certificates – and couldn't produce the correct documentation when requested by an auditor.

CALCULATING THE RISK OF NON-COMPLIANCE

For finance professionals like you, it can be challenging to get management to understand that tax liability is a potential risk because they've never been audited. But the risk is real and the consequences can be costly to your business. Let's quantify how sales tax compliance risk has the potential to translate into real financial impact.

Ask yourself these three questions about doing business in a single state:

1. What are your average total annual sales in a state?
2. What percentage of the total sales is exempt?
3. What percentage or dollar amount of your exempt sales isn't covered by a valid certificate?

Take that amount and multiply it by the average sales tax rate, interest, and penalty rate and that's your total sales tax liability. An audit typically covers a four-year period that projects errors to claimed exempt sales causing potential revenue loss to your company if you were to get audited by a single state.

Let's run through an example

Company ABC generates $20M in revenue a year from one single state. Out of that, 50 percent of the sales is tax exempt. That's $10M in exempt sales and the company is only confident that 50 percent of those exempt sales have a valid exemption certificate. In this example, the total tax liability would be $533,750 from that state.

Estimated exempt sales not covered by a valid certificate		$5,000,000
Average sales tax rate (8.54%) of $5,000,000		$427,000
Estimated interest rate (typically 15%)	=	$64,050
Estimated penalty rate (typically 10%)	=	$42,700
Total: $427,000 + $64,050 + $42,700	=	**$533,750**



What's the chance of an audit and is it worth the risk? It's probable that businesses will receive more notices and inquiries from states now that economic nexus laws are being widely adopted. Supply chain sales are easily traceable relationships. If your supplier is audited and you're a seller, your risk of audit increases. The reverse is true as well. In addition, many businesses have accrual accounts or tax liability balances on their financial statements for potential future audit risk. This liability is something auditors look at as an indicator of potential non-compliance. It's critical to get a handle on your economic nexus footprint and related exemption certificates. If you wait, it only gets more complicated and the risk increases.

What to do next?

If you're a company with exempt sales, including sales for resale or are part of a supply chain, there are a few steps we recommend. It's critical that you fully understand if your nexus footprint has grown due to new economic nexus laws and then evaluate your supplier relationships to see where you may be required to collect exemption certificates.

1. Assess your business relationships: Do you have sales for resale? Where are you using a supplier for drop shipping or providing drop shipping services?
2. Determine if your business meets the physical presence criteria or economic thresholds are being met: Visit our sales tax laws by state guide for detailed state-specific information.
3. Evaluate which party is responsible for collecting certificates or sales tax.
4. Register your business: Once you establish nexus, you're required to register to collect and remit sales tax in the state.
5. Learn the ins and outs of exemption certificates and sales tax compliance: Understand how to correctly fill out resale certificates, including the required information, exact details, expiration dates, and signatures.
6. Collect exemption certificates: Begin the process of obtaining exemption certificates for resale transactions based on your role in the sale. This is determined by state-specific thresholds and whether you're a seller or supplier.

Avalara CertCapture

Avalara CertCapture can help you collect, store, manage, and renew exemption certificates safely in the cloud. With CertCapture, ease the burden of managing exemption certificates and benefit from an automated solution that improves process and delivers a better customer experience.

Be audit ready and minimize risk: Lessen compliance risk by being prepared for some of the most common mistakes found by auditors. Missing and/or expired certificates will be a thing of the past when you ensure all your exemption certificates are easily searchable and accessible.

Optimize resources: Automatically request and obtain certificates through a secure online portal. Track and send renewal reminders for expired certificates seamlessly. With our mobile app, convert paper documents to digital formats at the time of transaction.

Scale for growth: Easily add new forms or documents to deploy new client instances easily. CertCapture integrates with hundreds of customer management systems and tax calculation engines to scale as your business grows.

If you're just starting to digitize and automate with a certificate management solution, our Avalara Managed Services group helps save you time and resources. While you focus on your core business, our Managed Services team is ready to handle compliance documentation setup and operations to streamline and simplify your exemption certificate management process. While we hope you find this information valuable, this is not a substitute for tax advice from a certified tax professional. If you're unsure of your tax liabilities, please contact a tax expert.

To learn more, call us at 844-722-5748 or contact your Avalara Account Manager.

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