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# JOURNAL

## OF EQUIPMENT LEASE FINANCING



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### ***Trends, Challenges, and Solutions for Tax Compliance in the Leasing Industry***

By Patricia L. Pelino and Wayne Robinson

In spite of their dedicated accounting efforts, many leasing companies fall short when it comes to tax compliance. The Sarbanes-Oxley Act and varying state tax systems complicate the task. One solution is process automation.

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### ***Lease Financing Transactions and In re Commercial Money Center Inc.***

By Benjamin R. Norris

Should the ability to prevent fraud in lease financing transactions be trumped by a perceived need to preserve flexibility in such transactions? This article discusses problems raised by a 2006 bankruptcy decision and suggests ways in which creditors may obtain some limited protection.

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### ***Learning From the Leaders: Why a Select Few Leasing Companies Consistently Outperform Their Peers***

By Scott A. Thacker

There are the Outperformers, and then there are the Others. In this summary of a research project commissioned by the Foundation, lessors will find the differentiators for financial performance and key business capabilities.

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### ***Preparing for a Correction***

Held in January, the 26th Industry Future Council identifies trends, issues, and potential economic indicators that will have consequences for equipment leasing companies. Here is the conclusion to that report.

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### ***Winner Announced for 2006 Article of the Year***

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# Trends, Challenges, and Solutions for Tax Compliance in the Leasing Industry

By Patricia L. Pelino and Wayne Robinson

The leasing industry has reached \$800 billion in size and continues to grow. But this industry boom has a dark side, as the sheer volume and nature of leasing agreements present significant tax challenges and increase the risk of audit assessments for lessors.

Businesses that operate across state lines and lease interstate equipment find myriad differences in federal, state, and local taxes. Most of these tax processes are complicated and confusing enough on their own, yet companies often augment the challenge by using a manual, detailed jurisdiction-by-jurisdiction analysis that attempts to reconcile the varying conditions while maintaining full compliance.

In 2005, Vertex conducted a survey of tax professionals and state audit officials, both to identify the most common contributors to sales and use tax assessments and to address ways that companies can manage their tax challenges more efficiently. Seldom, if ever, have state audit officials spoken so candidly about the audit process, and their responses confirmed the pain that most tax professionals have been reporting for the past few years.

When asked about the major reasons for audit assessments, the majority of state tax officials cited unreported tax on taxable purchases, due either to missing or invalid exemption certificates or to incorrectly applied tax rules and rates.

For these reasons as well as the challenge of identifying nexus and jurisdiction rules, many equipment leasing companies still fall short of meeting all the necessary requirements for compliance, despite such dedicated accounting efforts.

By understanding the influencing factors in the U.S. tax law environment, the causes behind each of these audit assessment contributors, and the possible solutions for resolving them, equip-

ment lessors can approach their tax compliance requirements with greater confidence and control.

## TAX LAW ENVIRONMENT

In recent years, two key factors have shifted the focus and methods for handling federal, state, and local tax regulations, and significantly impacted lease tax processes: the Sarbanes-Oxley Act and the Streamlined Sales Tax Project (SSTP).

### Sarbanes-Oxley Act

When the Sarbanes-Oxley Act passed in 2002, one of its major provisions included a requirement that public companies must be entirely transparent in their auditing practices. This means evaluating and disclosing the effectiveness of their internal controls as they relate to financial reporting. Additionally, independent auditors for companies must agree and adhere to this disclosure policy.

As a result, corporate tax procedures have dramatically changed over the past few years in order to comply with Sarbanes-Oxley. A separate survey conducted in 2005 by Vertex highlighted these shifts, showing that the majority of business taxpayers were either testing their internal controls or performing remediation efforts related to those controls.

### Streamlined Sales Tax Project

Introduced in 2000, the Streamlined Sales Tax Project is a state-government initiative whose mission is “to develop measures to design, test, and implement a sales and use tax system that radically simplifies sales and use tax.” As of 2006, 19 states have conformed their sales and use tax laws to the Streamlined Sales and Use Tax Agreement (SSUTA).

As such, SSTP is an evolving process. Even with “conformance of their laws,” many states

In spite of their dedicated accounting efforts, many leasing companies fall short when it comes to tax compliance. The Sarbanes-Oxley Act and varying state tax systems complicate the task. One solution is process automation.

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have carved out those items that are not included in the conformance. Most notable are motor vehicles (rented or leased) and other transportation equipment.

Furthermore, confusion arises among both the states that do follow SSTP rules and criteria and those states that are not yet participating members. Companies that deal with both camps heighten their chances of confusing the definition sets and thereby increase their audit risk.

For example, states that approved participation in the Streamlined Sales Tax Project have adopted SSTP amendments, one of which defines a lease. In order for a transaction to be considered a lease, the purchase option offered at the end of the lease has to be greater than \$100, or 1% percent of the total payments. If it is less, the transaction is considered a sale, and the tax is due up front on the contract price.

In other instances, some companies have applied these definitions to equipment that may become technologically obsolete within a few years, only to realize they would stay more com-

petitive if they entered the agreement as a lease rather than a sale.

By structuring a deal as a lease, the companies avoid taking ownership of the property and do not have to enter it as an asset. That way, instead of fully replacing the equipment when it becomes obsolete, they can tell the leasing company they want to replace it, which shifts the cost of disposing it to the lessor.

In states that have not adopted SSTP amendments, auditors default to a literal interpretation of the lease contract and the accounting entry. Depending on the auditors' interpretation, the tax results could differ from the current customer invoice treatment, rendering an assessment to the lessor. This generally happens when the transaction was booked as a lease with tax collected on the monthly payment rather than being booked as a sale with tax collected in full at the time the sale is completed.

The audit assessment could accelerate the balance of the tax due in addition to penalties and interest being applied. This could create a billing

### Methodology

Though they represent multiple industries and interests, tax professionals have little trouble agreeing that compliance and audit concerns associated with missing or invalid exemption certificates are significantly challenging—too costly, too fraught with errors, and too often leading to assessments that drain revenues and resources. With that in mind, Vertex Inc. surveyed tax professionals and state audit officials to identify ways to streamline exemption certificate management, reduce sales and use tax assessments, and help companies deal with related tax issues more efficiently.

**State audit officials.** From April to June 2005, ShearSpire Inc. conducted 23 in-depth, conversational interviews on behalf of Vertex with Department of Revenue sales and use tax audit officials from 23 sales tax-collecting states. This represents 51% of states collecting sales and use taxes.

**Tax professionals.** In June 2005, Vertex invited 3,053 tax professionals to participate in an “audit pain” web survey. This survey assessed the status of tax department automation in exemption and resale certificate management and its impact on the audit processes. The response rate was 9%, recording responses from 261 tax professionals in the manufacturing, distribution-wholesale, and retail industries.

The surveys, conducted separately, revealed that although tax professionals and state audit officials see the challenges from different vantage points, there are many shared concerns. There are also important areas of agreement on how to solve some of the most vexing certificate and tax issues, particularly regarding ways to reduce assessments.

and customer service issue for that particular customer because the payment would change, but the customer most likely would be billed for the balance of the lump sum tax payment due on a single invoice.

However, there clearly is risk in this approach, particularly if the original contract shows that the agreement was a conditional sale, rather than a lease. In such cases, the companies' tax treatment and accounting must be defensible under audit. It is important for both the lessor and the lessee to review each contract to ensure that the terms are what they expected to see and that the tax treatment is in compliance with state and local tax laws.

**Audit Assessment Contributors**

Leasing companies face many of the same risks that firms in any other industry face when it comes to audit assessments, such as exemption certificate management and rate application. That said, there are specific nuances related to these audit contributors that the leasing industry must take steps to address. Otherwise, the industry will face increased risk of audit assessments.

**UNREPORTED TAX ON TAXABLE PURCHASES**

The Vertex study of tax professionals and audit officials concluded that most audit assessments stem from unreported tax on taxable purchases, more commonly known as consumer use tax, and from missing or invalid exemption certificates (see Chart 1).

Certain situations create accrual issues—a common problem with use tax in any industry. For leasing, this could stem from having mixed-use items on lease by the same company. Depending on the use of the item, there could be use tax obligations if the item is used in a taxable manner after being purchased without tax being charged at the time of purchase.

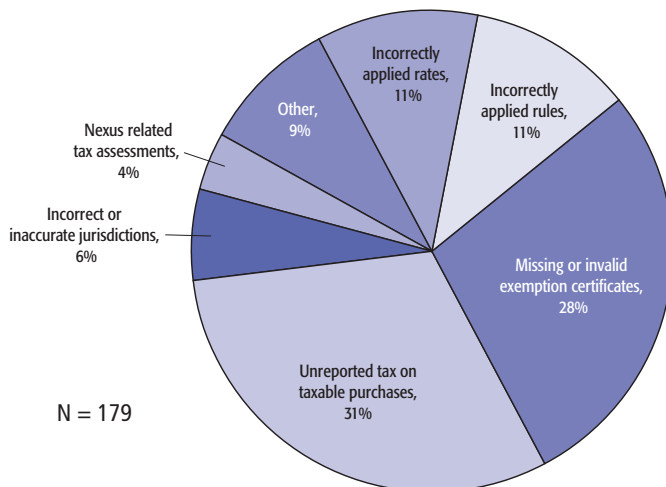
For example, a manufacturing company leases forklifts and is not charged tax at the time the transaction is completed. Some of these forklifts are used as part of the manufacturing process and could be exempt, whereas others are used outside of the process and would be subject to tax. Or, consider computer equipment that is used in the manufacturing process versus

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**Chart 1**

**Causes of Audit Assessment**

**Question: In a typical sales and use tax audit please estimate what percentage of your audit assessments are as a result of the following:**



**Findings:**

Unreported tax on taxable purchases and missing or invalid exemption certificates are the largest contributors. This finding was corroborated by the responses given to this question in a separate study (reported in full elsewhere) with Department of Revenue audit officials.

Incorrectly applied rules and rates appear to be relatively moderate contributors to an audit assessment for Vertex customers.

% = percent of audit assessment (\$) that is due to the named reason in a typical sales and use tax audit. Relative distribution drawn from open-ended comments. Data assumes that there are no other reasons for audit assessment

Audit officials who participated in the survey believe that manufacturing exemptions and issues in controlling exemption certificates will face the greatest scrutiny in the near future.

computer equipment used in the office. This is another example of the same type of equipment being used in the manufacturing process and also outside that process.

The key is to know how an item is being used and what the tax exemption covers. If the use doesn't meet the exemption, and the item was withdrawn from inventory or purchased or leased with no tax paid at the time of purchase, then consumer use tax is due.

#### EXEMPTION CERTIFICATE MANAGEMENT

In Vertex's study, tax professionals repeatedly cited exemption certificates—searching for them, verifying them, and trying to produce them—as a challenge and a resource drain.

One tax professional noted: "Being able to always locate the exemption certificates we need at audit time would significantly reduce audit assessments." Audit official respondents said that the predominant reason that exemption certificates are disallowed in audits is that their forms are incomplete or invalid.

One solution is to centralize the certificates, rather than keep them in the customer lease file. Moreover, centralizing certificate management in the tax department will be more effective than having it in the customer support area. If customer support needs the certificates, a photocopy can be made available. Alternatively, the certificates can be scanned and made available electronically to other areas that need access to them.

Lessors should review certificates as they are received for complete and accurate information. They should also review files periodically to ensure valid certificates are on file, and review records to ensure that certificates are in house when tax wasn't charged.

Up-to-date certificates reduce the potential for audit assessments due to incomplete or outdated certificates. Lower audit assessments can mean a lower tax reserve account. Centralized processing ensures more control over exemption certificates related to accessibility, completeness, accuracy, and validity.

Like companies in other industries, customers of leasing companies (the lessee) must meet the criteria for the exemption. The way equipment or vehicles are used must be in concert with the exemption criteria for a state.

For example, agricultural use is valid only for the raising of food substances (that is, animals for food or grain for food). Agricultural use would not include raising grain to feed the animals being raised for food. On the equipment level, if a forklift is used in the manufacturing process, a manufacturing exemption could apply. However, another forklift used by the same company for purposes outside of the state-defined manufacturing process could be subject to tax.

Vehicle leasing companies face similar use issues, such as when vehicles leased by hospitals and nursing facilities for the transport of patients are considered exempt, whereas vehicles leased for use by the directors of those facilities are subject to tax.

In addition, leasing companies must ensure that they not only have the certificate but also that it is signed, dated, and in the proper format. In fact, audit officials who participated in the survey believe that manufacturing exemptions and issues in controlling exemption certificates will face the greatest scrutiny in the near future.

#### INCORRECTLY APPLIED RATES AND RULES

The differences in definitions of leases and conditional sales add another layer of compliance complexity to already complex laws governing the leasing industry. Many leasing companies are still dealing with contract differentiation between leases and conditional sales. Each option warrants a different tax treatment and book entry and calls for the application of a specific tax rate or rule. Failure to apply rates and rules correctly could significantly increase audit assessments.

Lessors must also consider that the rate may be the same for both types of contracts, but the method of collection (monthly on the payment versus in full at the time of purchase) could contribute to audit assessments. This is a prime example of incorrectly applying a tax rule.

As commonly defined within the equipment leasing industry, in a true lease, the party using the equipment does not actually take ownership of it at the end of the contract. On the other hand, conditional sales refer to a stipulated buy-out (usually a financing agreement).

Confusion often arises from differing leasing industry terminology in various states. Although some states use the terms “rental” and “lease” interchangeably, others follow specific definitions. The lessor should be familiar with the state classifications to best distinguish the terms.

The original lease contract should also make clear which option the agreement follows. This determines the appropriate tax treatments, which vary from state to state depending on the structure of the contract. For example, in Pennsylvania, a vehicle lease is subject to 9% tax on the monthly payment, whereas a conditional sale is subject to 6% tax at the time the vehicle is purchased. No tax is charged on the monthly payment.

### Rental Agreements

Rental versus lease agreements can also present different rates, as do short-term leases or rentals versus conditional sales. Under accounting principles a rental is usually for a term of one year or less. For tax purposes, a rental is defined by state statute, with some specifying 28, 30, 90, or 180 days. Contracts classified as rentals are generally subject to additional fees and surcharges. These additional fees and surcharges are also generally required to be reported on separate tax returns—thereby increasing the taxpayers’ overall cost of compliance.

In addition, rental agreements may be subject to additional fees and surcharges that a lease would not. This is more common on the vehicle side of the industry, where daily rentals (think Hertz or Avis) could apply several additional fees or surcharges in addition to the sales tax.

It is important for the employees in a company’s finance, accounting, and sales departments to be aware of distinct state criteria for contracts as well. On the sales side, representatives should

know how taxes would be applied for each type of contract in question and be able to explain that to the potential lessee prior to closing the sale. The tax department must then ensure that tax is collected in the correct way and at the correct rate based on the contract type, in order to ultimately meet the definitions set by the state.

To complicate issues, the state may employ a tax collection acceleration method that requires the tax due to be collected up front, rather than over the given contract time frame. For example, instead of collecting tax over the rental stream, the state will require its remittance to be based either on the cost of the asset or on total lease payments. To further complicate the matter, a local jurisdiction could impose tax at a different rate and have different remittance requirements. For example, in Illinois, the state sales tax is due up front. However, the city of Chicago has a lease tax that is required to be collected on the monthly payment.

Lessors also must keep in mind that tax is paid up front for a sale (although some states require upfront payment for a lease too), whereas for a lease the tax is usually extended over the given number of payments. When this principle is applied to equipment that has been transferred out of state, or between taxing jurisdictions, there could be an issue under audit for reciprocity.

### Reciprocity

Reciprocity works as follows: Some states allow a taxpayer to take credit for a taxes paid to another state. However, where a lease contract is concerned, if a company is to receive credit for tax it paid in another state, that tax has to be paid in the same manner that the new state is requiring it to be collected. So if a company is charged tax on the payments in one state, but then transfers the leased equipment to another state where the tax is due in full, no tax credit is available.

Additionally, the tax type generally must be the same. A sales or use tax paid in a jurisdiction may not be allowed for an excise tax due in the new jurisdiction.

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Some companies don't realize that those kinds of conditions are part of the state tax code. The result: Customers obtain credits that they are not entitled to.

### NEXUS AND JURISDICTION IDENTIFICATION

Three key factors play into nexus and jurisdiction identification: asset-specific taxes, mobile property, and reciprocal credits.

#### Asset-Specific Taxes

Asset-specific taxes—or miscellaneous fees imposed on leased equipment—pose an ongoing challenge to tax departments due to their frequent revisions and additions. SSTP rules dictate that a state cannot impose multiple rates. For example, farm machinery cannot incur a different rate from construction equipment.

However, states are now removing certain equipment from the sales tax imposition, and instead creating an excise tax imposition for it. In this way, they can tax the item uniquely and at a different rate, or provide different exemptions based on terms and how the equipment is used or who is using it, thereby preserving reduced rates and exemptions allowed for specific industries.

The creation of asset-specific taxes has occurred most frequently in states adapting to SSTP and seeking full membership, and their arbitrary excise tax additions make it significantly more confusing for leasing companies' tax departments.

Previously, the sales tax code delivered all the information a company needed, but now the excise taxes may not be found in the same section of tax code as the sales tax information. Tax professionals now have to look at multiple sources of tax code to ensure that they have captured all of the appropriate taxes, surcharges, and fees that might apply to that particular lease transaction.

Not only does this become an important compliance issue for the leasing company side, but it is also more expensive, because excise taxes are often higher than the sales tax. The excise taxes also require a separate tax return filing, which

means more work, more cross-referencing, and more room for error.

To compound the complexity, asset-specific taxes might encompass other line items that leasing companies will ultimately need to account for as part of standard business costs. In other words, they might not be able to pass the cost to the lessee, and thus recoup the fees or surcharges.

Examples of excise taxes include the Texas road diesel fee, California tire fee, North Carolina document tax, and Florida documentary stamp tax. Another frequently cited excise tax is the California e-waste tax. Enacted to help pay for the recycling of displays, the e-waste tax is based on the size of the display. (For example, a PC with a 15-inch monitor is taxed at \$6; a 17-inch monitor, \$8; a 20-inch monitor, \$10; and so forth.)

Leasing companies also run into problems when dealing with heavy equipment, construction equipment, and farm machinery equipment. Exemptions certainly vary from state to state—but also within the state itself. So while one piece of equipment may be exempted on the state level, it may be taxed on the local level.

However, instead of customers bearing the burden with increased product cost, leasing companies ended up with the tab. This meant that for all applicable equipment (such as computers) leased out, leasing companies had to increase their acquisition costs—a less-than-desired outcome.

Because the asset-specific tax is relatively new and tends to occur in conjunction with SSTP adoption, it is difficult for the leasing industry to forecast how long and how often these additions will continue. It is also uncertain if and how the taxes will affect states that are already full SSTP members.

In the meantime, one way leasing companies can mitigate the confusion is to educate their tax and finance staff about all changes, set or pending. This way, the appropriate departments can prepare for the extra maintenance involved as well as reevaluate the company's internal tax

software and determine whether it can handle multiple tax types. Overall, these steps will aid compliance efforts, ensuring that the appropriate taxes are being charged and remitted on lease transactions.

### Mobile Property

Mobile property, which includes mobile homes and equipment, carries special sales tax considerations, too. One of the biggest challenges that a leasing company faces in this particular area is keeping abreast of changes to the location of the property.

Often the lessee will move the asset to another location without advising the lessor of the change in tax jurisdiction. The move could be across county lines or across the country, but the impact is the same—incorrect rates and tax rules are being applied because the lessor is calculating tax at an incorrect location. This inaccuracy could add to an audit assessment if the auditor obtains information that the asset is no longer located at the original location and is not being taxed in the new location.

This situation not only affects sales tax compliance but could also affect personal property tax declarations and tax payments. One possible solution is to improve internal controls and the notification process. This solution would enable the tax department to track fees when equipment moves and ensure that the appropriate taxes are being remitted to the correct states.

### Reciprocal Credits

A leasing company's size and scope—be it regional or national—is another factor that compounds the amount of tax compliance issues regarding asset movement. The most prevalent issue in asset movement is reciprocity of tax credits, which often requires navigating varying state laws and potential conflicts.

The key to reciprocity and reciprocal credits lies in the collection requirement. Say a company is required to pay asset tax in full up front in one state, only to move those assets into a state where it is required to pay a monthly tax payment. Whether the leasing company can take a tax credit in the state it moved the asset from could

ultimately be affected. Alternately, depending on the state law, a lessor is able to claim the reciprocal credit if it moves assets between states with the same collection requirement.

Another common issue in reciprocity—again, ultimately determined by individual state statutes—occurs with levels of tax. If the first state imposes state, county, and city taxes, while the second state only imposes a state tax, the lessor may claim credit only for the state tax—but not any local level tax paid.

Tax education applies here as well, as it will enable the tax department to apply the applicable tax credit rules when property is moved from one jurisdiction to another. However, depending on its size, the company may need more resources to keep abreast of ever-changing tax rules in this area. A more manual compliance process does not allow a company to be proactive in tax planning around leasing activity, such as dealing with exemption certificates or finalizing leasing contracts. In addition, the more manual interaction involved in these processes, the higher the percentage of costly errors.

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### A COMPREHENSIVE SOFTWARE SOLUTION

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One solution that addresses many of the challenges outlined throughout this article is automated tax software specific to leasing tax processes. The right automation software for leasing compliance can significantly reduce the time-consuming and complex tasks associated with corporate multistate tax collection in several ways.

First, the software coordinates application of jurisdiction-specific tax rules with supporting jurisdiction-specific rules, then, based on the transaction-specific jurisdiction information supplied by the taxpayer, applies them during the invoice process. This eliminates the burden of determining taxability on a per-transaction basis. Tax professionals can also enter exemption certificates and direct-pay permit information associated with their customers, which will also be recognized at the invoice, and make it easily accessible during audits.

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Indeed, while software solutions are a large and critical component of solving the tax lease riddle, a significant human element remains integral to the process.

The more flexible the software is, the more options it gives a tax department by way of full reliance on any system-supplied taxability rules, full customization based on a business's particular practice, or a combination of both approaches.

Second, multiple dimension taxability allows for additional parameters that can be associated with a lease tax. These drivers, which are defined according to specific business rules, support the requirement of lessors of vehicles and manufacturing or agricultural equipment to base the taxability of property on many factors other than tax jurisdiction or the customer's tax status.

Finally, automated tax software takes multiple impositions into account. This functionality automatically calculates and returns the contract's sales tax, surcharges, and fees, and it removes the need for manually prepared invoices that incorporate the same information.

## CONCLUSION

With the majority of the tax decision-making programmed into the software, an automated tax compliance system reduces the manual effort involved in maintaining and updating rental and leasing rules for any given state or local jurisdiction. True process automation also reduces costs stemming from the management of tax calculations for leases and rentals.

The leasing company has to make sure that its legal documents meet proper definitions of a rental or a lease document. Thus, those responsible for the tax compliance function should have a good working knowledge of the business. They should also know the customer and product exceptions inherent in that business, given that those exceptions might require minimal manual intervention to maintain the information.

There are many options for customized training on tax products as well as consulting services that can provide guidance on how to improve and better manage homegrown solutions that companies can use to improve their overall compliance efforts. Companies struggling with the issues presented in this article should investigate

the options based on their specific business needs.

Leasing companies should identify their staff's current level of knowledge, the size of company and related compliance problems, and their specific goals. Based on the information gathered, the company can then select the best consultant or training program to fit its needs. In turn, these consultants will handle staff education, provide custom product taxability matrices and other tax compliance tools and reports, and demonstrate how to apply that information to the business's daily operation.

Ultimately, automation can deliver long-term cost savings by significantly reducing audit exposure. Furthermore, as leasing companies get their tax planning tools in place, they are better able to address acquisitions up front, rather than on the back end. This proactive stance can transform the tax department from a cost center to a profit center, and achieve more strategic business objectives.

Tax technology certainly helps leasing companies facilitate process management, streamline tax compliance processes, and discover opportunities for tax savings related to leasing and financing transactions. However, it is still critical for leasing professionals to understand the specific challenges present in their industry and how those challenges contribute to audit assessments.

Leasing companies should also evaluate the use of documentation and other forms of knowledge transfer as part of a larger knowledge management system that supports corporate strategy. More importantly, they must then impart this knowledge to the entire organization, so that any employee in any department—and any lessee under contract—sees the relationship between tax compliance and business performance.

Indeed, while software solutions are a large and critical component of solving the tax lease riddle, a significant human element remains integral to the process. The company's people are still the ones addressing unique situations and making the decisions.

A leasing company's ultimate goal should be in-depth, open communication with knowledge-sharing—supported by a flexible, dynamic software solution. A truly effective communication process will make a leasing company's tax processes all the more fluid, and render its tax department capable of handling any transaction, asset movement, or audit in real time.



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