



Minimizing Consumer Use Tax Liability Through Automation

A White Paper

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INTRODUCTION

It's no secret that state budgets are under enormous pressure these days. Both national and global events have tightened federal purse strings, resulting in less funding to states for critical public services including education, safety and public works. In the boom times of the late 1990's, these issues would have been fairly easy to resolve. Revenues from all tax sources were growing, investment returns on assets in pension plans and other vehicles were returning double digit growth and consequently the states' rainy day coffers were well funded. States were in a position to help themselves and ultimately their constituents in this heady environment.

A fast-forward to the 21st century portrays a completely different picture. The three-year recession has reduced state budget surpluses to deficits, threatening the delivery of these essential services to their constituents. A recent budget survey of approximately 30 states noted that revenue collections are below budget forecasts. Twenty-four states report that either the governor or a member of the legislature has offered tax increase proposals.¹

Personal and corporate income taxes as well as sales taxes are the most likely sources of these increases, simply because they represent the largest revenue sources for the states. The most popular increases under consideration are the "sin" taxes on both alcohol and cigarettes, with at least 14 states considering raising taxes on these items. Additionally, six state officers indicated that a general sales tax rate increase or base expansion is possible, while four said that increases in personal income tax are under consideration.

Reductions in services are certainly in the plans for all states as well. The governor of Arkansas has proposed a 5/8-cent sales tax increase, while the current New York budget proposal includes eliminating the sales tax exemption for clothing, resulting in an additional \$363 million in sales and use taxes. While the remedies to the problem may vary, the states' predicament is clear. Revenues must be raised from existing sources or essential services will be curtailed.

¹ Hubbard, Catherine. "States Face Growing Budget Gaps, Half Eyeing Tax Increases." *The SOHO Daily News on the Web*. 21 March 2003 <<http://www.toolkit.cch.com/columns/taxes/03-330statetax.asp>>



THE GROWING ROLE OF USE TAXES

Ever since the first sales tax was imposed in 1930, questions arose concerning the states' ability to tax interstate transactions. Use taxes mirroring the in-state sales tax were imposed to address the taxation of interstate sales made by out-of-state vendors. While the goal of this imposition was to increase a state's overall tax base, the business environment in those early days rendered the use tax as fairly insignificant compared to the sales tax.

The national and global reach that exists today in business was not prevalent even 20 or 30 years ago. Back then, companies typically purchased goods from sellers within their locality. Sales taxes (assessed on an intrastate transaction) were charged on taxable goods and services and remitted to the vendor who reported the liability and remitted the tax collected to the appropriate jurisdiction. As transportation networks improved and business logistics became a mainstream function of industry, the vendor pool became regional and ultimately national in scope. The era of next day and same day delivery had arrived. An increased number of vendor choices were available to businesses and consumers alike, pushing prices down to the ultimate benefit of all in the supply chain as evidenced by the post WWII economic boom.

As commerce moved across state lines, determining when a taxpayer was liable for the sales tax became cloudy and more difficult to regulate and enforce. Clearly, the ultimate consumer (either businesses or households) was responsible for paying a tax on their purchases; the obligation for assessing the tax, however, posed some problems.

The landmark Supreme Court *Quill* decision in 1992 attempted to provide some clarity on this issue. The concept of *nexus* or physical presence was reinforced to require those businesses that met the profile of an entity engaged in commerce (represented by a level of investment in physical or hard assets, a labor force employed or volume of commerce engaged) within a particular jurisdiction to assess and collect a seller's use tax. In the absence of qualifying for this physical presence test, the burden of assessment and remittance remained with the end-purchaser who would be required to assess and remit **Consumer Use Tax** to the state where the goods or services would ultimately be consumed.

Clearly, businesses that fell within the "gray" area of nexus determination preferred to take the low road regarding the responsibility for assessing this transactional tax, assuming that the end-customer would assess and remit according to their own legal obligation. Self-serving interpretations of the tax laws would ensue between the states and these "out-of-state" vendors, with the former making a case as to why



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physical presence was evident (requiring the vendor to assess and collect seller's use tax), and the latter asking why it wasn't (requiring the customer to assess and remit consumer use tax). Although difficult to measure at times, it is easy to see where the absence of clear authority to calculate and remit these tax liabilities provided a void that contained a large pool of uncalculated and non-remitted funds.

So what has changed in the last 10 years to bring this issue to a focus? Though the transformation from a local economy to a broader based one has had implications on who is responsible for assessing and remitting sales taxes to the respective states, the transformation has been somewhat orderly. Additionally, physical presence criteria and measurement have survived fairly intact over time. If the physical presence test was met by the seller, then bill, collect and remit the tax, if not, don't.

Now that the new economy, and more specifically the Internet, has emerged for both consumers and businesses as an acceptable vehicle to transact business, the traditional nexus measurements have become irrelevant. Does a sole bank of computer servers, by itself, hosting an e-commerce web site located in a remote state qualify as establishing "physical presence?" Probably not, based on these limited facts. This issue has become core to the arguments made by the states that are losing tax revenues to this interpretation as well as traditional brick and mortar businesses that claim that these e-tailers possess a competitive pricing advantage equivalent to the sales tax obligation that they have been relieved. While statistics vary, Forrester Research estimates that uncollected sales tax from e-commerce and remote sales amounted to \$13 billion in 2001, and will rise to about \$55 billion by 2011.²

[1] Current initiatives like the Streamlined Sales Tax Project, as well as recent litigation brought forth by many states challenging the status of out-of-state vendors may ultimately address sales tax collection obligations of remote sellers. Additionally congressional pressure to overturn Quill may gain momentum as today's budget and tax collection issues facing the states will require them to explore avenues that will generate additional sales tax revenues – such as the audit.

Consumer use taxes would be one of the most likely taxes for the states to focus their attention. Accordingly, businesses should be prepared to prioritize the calculation of this self-assessed tax, and to the greatest degree possible, take advantage of the emerging automation tools that are becoming available to render these calculations as a routine and complimentary function of their core business processes.

² Anonymous. "New Study Shows Sales Tax Revenue Losses From E-Commerce...", et al." *Institute For State Studies*. 30 March 2003. <<http://www.statestudies.org/news1.html>>



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This paper addresses the common areas of consumer use tax compliance, the underlying difficulties of compliance, and the potential to automate routine aspects of the consumer use tax self-assessment and remittance functions through a company's Enterprise Resource Planning System (ERP) or their financial applications.

TRADITIONAL DIFFICULTIES OF CONSUMER USE TAX COMPLIANCE

A new compliance study issued by the Washington State Department of Revenue recently asserts that Washington businesses failed to pay 27.9 percent of use taxes due on out-of state purchases, costing state and local governments more than \$100 million a year (*Vancouver Business Journal*, Vancouver, WA February 14, 2003). Accounting errors were the most common reason for noncompliance, occurring 56.9 percent of the time. Ignorance of statute accounted for 21.6 percent of noncompliance, difference of opinion for 15.7 percent, and negligence/fraud for 5.7 percent. These statistics support the common perceptions that the difficulties compiling the underlying data, as well as an unclear understanding of the applicable taxability of these transactions are the most common sources of noncompliance.

The compliance difficulties encountered are most commonly associated with routine accounts payable items, expenses that comprise the majority of the purchases that support the day-to-day operations of business. However, other areas of consumer use tax liability also pose the same accounting difficulties noted for the expense items, notably recognizing tax liabilities for inventory removal as well as asset movement transactions.

CONSUMER USE TAX CATEGORIES

There are three primary sources of consumer use tax liability that a typical business will encounter. These specific areas are:

- General purchases through the accounts payable process
- Fixed asset interstate (and inter-company) transfers
- Inventory removal transactions – goods converted from exempt to taxable use

GENERAL PURCHASES

Every business establishes relationships with vendors to supply the critical goods and services that they will require to produce goods or services to sell to their customers at a profit. These



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purchases can take many forms including raw materials that will be converted to finished goods, routine office supplies to provide to office workers, as well as services for office cleaning and professional fees. When a purchase qualifies for an exemption or non-taxable status, typically the buyer will provide an exemption certificate to the seller instructing them not to charge tax.

In most states, items that are purchased for eventual resale (notably, inventory) are usually exempt from taxation. However, there are many other purchases that fall into jurisdiction-specific categories that may qualify for an exemption from sales tax. It is incumbent on the buyer to know which purchases are exempt in what jurisdictions and inform the vendor accordingly (through issuance of an exemption certificate or some other acceptable method). In these situations, the buyer must have access to (or be in a position to pay for) the requisite tax research in order to make an informed taxability decision. This research access, often summarized in complex tax matrices, must be continuously maintained given the constantly changing tax laws.

From a consumer use tax perspective, the ultimate use of the goods or services typically dictate the taxability of the purchase. For example, items are almost always exempt from tax when purchased directly for re-manufacture with the ultimate purpose of being sold in the normal course of business. The actual physical make-up of these goods has no bearing on their taxability. In other cases goods or services are exempt by statute because of their unique characteristics. A good example is legal services that are typically exempt from taxation versus the trend to tax IT consulting services. The taxpayer must be able to view taxability from both perspectives, the ‘How’ and the ‘What’ in order to properly reflect the correct tax on their purchases.

OTHER CONSIDERATIONS

Quill directly addressed the tax collection and remittance obligations of out-of-state vendors that passed the physical presence or nexus tests. Although these concepts appear quite simple, compliance on both ends of the transaction can prove rather difficult. Many vendors only have the ability to treat a customer’s purchases as exempt or taxable in totality. Those customers buying a variety of merchandise that fell under both taxable and non-taxable scenarios were forced to unwind the improperly determined amounts through both the debit and credit sides of their tax accrual general ledger accounts, or by filing tax refund requests directly to the jurisdictions, such as:



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Direct Pay Permits, now granted by 36 states, place the calculation and remittance burden directly on the buyer of goods and services who will buy “tax free” from all vendors selling to them in a particular state. The buyer, better prepared to make the tax determination, must now be prepared to do so in all cases.

Managed Compliance Agreements, granted in conjunction with a Direct Pay Permit, allow taxpayers to apply a blended tax rate on all agreed-upon purchase classes by calculating and remitting the tax directly. For example, a taxpayer in the manufacturing industry who purchases a variety of clearly non-taxable items (raw materials), taxable items (office supplies), and those that are somewhere in between (indirect factory overhead type expenses) may negotiate a single blended rate on all non-inventory purchases that will be lower than the standard tax rate, but applied to all non-inventory type purchases. This self-assessed and remitted tax relieves the taxpayer of its obligation to review all of its purchases in order to determine when to accrue a tax (or perhaps identify an overpayment).

Evaluated Receipts Settlement, better known as “ERS” transactions, have become a popular formalized agreement between buyer and seller that places the calculation burden for not only tax, but the purchase itself, directly on the buyer. No invoice is issued by the seller, rather the buyer will rely on pre-established terms (represented in a purchase order or other agreement) to calculate their obligations and remit payment directly to the seller. An up-to-date knowledge of the seller’s tax status (where they have nexus) must be maintained in order to assess tax at the proper rate (sales, sellers use or possibly consumer use tax rates).

FIXED ASSET MOVEMENTS

Movement or transfer of fixed assets, including machinery and office equipment, either across county and state boundaries or between legal entities (regardless of a change in venue) can have sales tax consequences, even if sales tax was paid on the original purchase of the assets. Differences in applicable sales tax rates, in situations where the jurisdiction to which the assets moved are greater than the rate in the jurisdiction where the tax was originally assessed and paid, can also create tax obligations. Other complicating factors include calculating the taxable basis of the depreciated asset that has been moved, determining whether the transaction was actually a sale or temporary transfer, or whether the purpose or use of the transferred asset has



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changed. These are just some of the many questions that must be addressed in order to evaluate the proper tax treatment of transferred assets.

INVENTORY REMOVAL TRANSACTIONS

The direct costs (and some indirect costs) incurred to produce goods for sale are typically exempt from sales tax across all jurisdictions. Occasionally firms will have the need to remove goods from inventory and use them for their own internal purposes or the inventory may be redirected for another purpose such as a donation to a charitable cause. In either case the tax implications must be examined according to jurisdictional law. A furniture manufacturer may prefer to furnish an executive's office with goods held for resale. Removing these items, assembled with components parts initially purchased "tax free," from their finished goods stock will usually trigger a taxable event. Other not-so-clear examples of inventory conversion that should be examined for possible tax consequences include product samples that will be distributed to customers at tradeshows or through direct mail promotions.

Additionally, some states recognize a different tax treatment (than the standard taxability) when the item or group of items is defined as an occasional sale. As is the case with asset transfers, defining the taxable basis can vary from state to state, including fully loaded costs, retail selling price, net realizable value or other method.

ERP SYSTEMS

Managing a successful business requires the ability to make timely decisions based on accurate information. This obvious statement would apply to all businesses with an emphasis on the concept of time. Today's market leaders no longer have the luxury of time to correct their mistakes. Guessing incorrectly on the proper inventory levels, overcharging customers, or shipping a day late can ruin a company's reputation that may have been earned over many decades.

Complexity defines the many interrelationships that an entity has with itself. All functional areas of a business must be in synch in order to ultimately earn a customer's loyalty. These complexities could be minimized if each functional area including production, finance, sales and marketing, could share common sets of data, configurable at the user's request, that impact each user's workload. A single sales order impacts all areas of a business including production, billing, purchasing and accounts payable, sales commissions and payroll, income tax calculations, human resource staffing levels, marketing



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program evaluations, financial forecasts and budgeting, cash management and a host of other business “touch points.”

Traditionally, all areas worked independently with their own data sources. If anything went wrong in the process, it was often difficult to track down the original source of the error. Would an enterprise want to empower those responsible for decisions with the data needed to make these decisions? While the answer appears obvious, the evolution of the *relational database* is a fairly recent event. This shared connection to common sets of data defines the concept of relational databases, which was first developed by IBM in the 1970's. Seizing on the power of this tool, many of today's successful software vendors (as well as many who are no longer in business) developed complex applications (ERP solutions) that spanned an entity's many functional areas. These proprietary systems attempted to tightly integrate the needs of all users of data including not only company personnel, but vendors, customers and other third parties as well.

Events that traditionally took place in a specific area of a company no longer needed to remain in a silo. Sales order entry activities now directly impact the ordering patterns of the purchasing department who will have to account for supplier lead times in order to ensure that the proper inventory levels are maintained for production. In turn, production data will flow back to purchasing, finance, payroll and other departments in order for those areas to properly plan and perform their core responsibilities. Where does this leave the tax function?

TECHNOLOGY AND CONSUMER USE TAX

Data availability is the common thread of an ERP solution. Access to critical data (the data required to respond to the events that are most closely associated to the revenue cycle of a business) has received, and always will receive, the highest priority levels within an organization. The sales tax calculation can be viewed as a critical component of the revenue cycle since the tax will ultimately appear on a customer's invoice. If tax is not properly determined, the customer could hold payment or request a sales credit. Accordingly, order entry, credit and billing systems have been implemented to properly reflect an accurate sales tax calculation.

The consumer use tax calculation should also take advantage of the automation tools available in order to minimize tax liability and overall audit exposure, and ultimately improving the company's bottom line. While sales tax is a true pass through to an organization (whatever is collected is passed on directly to



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the taxing jurisdiction) true expense management can be realized from effective consumer use tax calculation and compliance.

For any tax department that has suffered through the pain of a sales tax audit and an assessment from unreported consumer use tax liabilities, this is not a new topic. Why haven't automation tools been developed to handle this common and routine tax function? There are many reasons depending on the organization itself and the industry niche in which it operates. Manufacturers by their very nature are subject to almost all areas of the sales and use tax code that narrowly define taxable and non-taxable events and circumstances. Multiply these individual state tax codes by 46 (the number of states imposing a sales and use tax), and the result is a maze of tax regulations and interpretations that either the tax or finance department is left to navigate in order to understand the implications and their relevance to any one of the activities noted above that can potentially give rise to a consumer use tax liability.

Applying the taxability rules to the literally thousands of purchasing decisions a business undertakes is not a simple task. Centralized purchasing functions that adhere to policies requiring the advance preparation of purchase orders that reflect the assumed taxability of the purchase is a step in the right direction, but it still leaves much of the burden on individuals that may not prioritize or understand the tax function. Exemption certificates may have been issued to vendors at some point in time, but do the same buying conditions still apply that are relevant to the taxability of a transaction today?

In decentralized purchasing environments, tax determination is typically a secondary responsibility of the buyer who is primarily concerned with ensuring an orderly flow of goods and services to keep his or her area, and in some cases, the entire business running smoothly. Many organizations rely on the accounting department to review processed accounts payable transactions in order to determine the proper tax treatment of a particular invoice. Wading through stacks of invoices at month end is a common task for accounting clerks who attempt to decipher specific line items on an invoice and make a tax determination based on limited understanding of the nature of the purchase. These after the fact processes are time consuming and prone to errors. When tax liabilities arise from fixed asset movement or inventory conversion transactions, they often go unreported by an entity and are only uncovered during an audit, accompanied by both penalty and interest assessments.

TECHNOLOGY'S ROLE

Can today's technologies improve the ability to recognize consumer use tax liabilities (and tax overpayments)? The answer is a resounding "Yes"! As today's ERP systems permit data to be



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warehoused and accessed by many different users for many different purposes, this same data can be accessed to standardize the routine calculation and verification of tax on transactions giving rise to consumer use tax. Most of today's sales tax software vendors are able to calculate an accurate sales tax when goods are sold to a customer. Tax logic can be configured to recognize customer provided product exemptions (specific part numbers or SKU's supported by a valid exemption certificate) in specific jurisdictions. Similarly, the data warehouse makes it possible to provide all of the data elements necessary to make a consumer use calculation on purchase transactions just as simple as a sales transaction. Purchase transaction details passed from an ERP or homegrown financial application to third-party tax calculation software can include enough identifying data elements to make rational and routine tax determinations.

These data elements can include a number of different identifiers including general ledger account numbers, project numbers, vendor IDs or internal usage codes. The third-party tax software applications can be configured to return a desired tax result when elements of any of these pieces of data are introduced to a tax calculation engine. Jurisdiction identifiers (ZIP Codes, GeoCodes or similar) can be matched with the specific transaction to return the desired calculation that can either be accrued or reconciled to a tax amount billed by a vendor.

Similarly, events occurring outside the traditional financial applications (like inventory or fixed asset movements) now carry their own unique identifiers within the ERP that no longer have to remain behind the four walls of these applications. Inventories can be relieved from a company's books and records in a number of different ways. In a typical sales transaction a reduction in perpetual inventory records is triggered by a billing transaction (an invoice) to a customer. Both sales, including any sales tax receivables, and cost of sales are recognized when this event occurs. However when inventories were relieved to provide samples for trade shows, the historical financial treatment would be to recognize shrinkage from inventory whenever the periodic physical inventories occurred. Current ERP disciplines require that consumption records be created by those responsible to properly report on these non-routine consumptions.

Better record keeping provides better data to manage a business and these improved tools make the recognition of consumer use tax possible. When the consumptions are recognized, they can be routed to the tax calculation software in the same manner as the normal accounts payable transaction that will then be evaluated based on the pre-assigned parameters established by the taxpayer. Since these transactions by their nature are not routine, and can possibly be



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misinterpreted to result in a large tax liability, they can alternatively be routed to the tax area for evaluation **before** a tax is calculated and accrued.

CONCLUSION

The error prone and time consuming manual processes that have defined the consumer use tax activities of an organization can now be replaced by the automation tools that are present in most current financial applications that integrate with state-of-the-art third-party sales and use tax software. Those third-party packages that provide tax research support along with the data element mapping and configuration abilities previously mentioned, offer powerful tools that aid an organization's tax department.

Providing a systematic approach will improve morale and performance of over-burdened accounting and tax professionals who can now focus on more fulfilling and value-added activities. In addition, a systematic and automated approach to consumer use tax will provide a taxability blueprint that a state or local jurisdiction auditor can use to evaluate the overall accuracy of the methodology behind the system before the detailed audit fieldwork starts, hopefully reducing the scope of the audit itself. The tax department will have the tools to make the proper taxability decisions before the transactions are actually processed, with the desired outcome of paying the proper amount of tax without associated audit assessments.

ERP vendors have recognized that the proprietary systems that used to characterize installations in the 1990's have given way to open architecture and design. The costs to implement these complicated systems will be reduced through new technologies including JAVA and XML, allowing disparate financial systems to communicate across hardware and software/OS platforms. Similarly, integrating to third-party add-on software packages, including sales and use tax, will be simplified through the use of these available technologies. The successful businesses must be able to evaluate the long and short-term capabilities of these software vendors, based not only on their vision, but their track record of performance, support and reliability.



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About Vertex Inc.

Vertex Inc. is the leading provider of tax technology solutions, serving more than 10,000 customers worldwide. Vertex solutions automate processes and enhance decision information across every major line of business tax including income, sales, consumer use, value added, communications, payroll, and property. To serve its customers, Vertex works in partnership with leading software and service providers, including SAP, Oracle, Microsoft, J.D. Edwards, IBM and PeopleSoft. Founded in 1978, Vertex is headquartered in Berwyn, PA and has offices in Atlanta, Chicago, Dallas, Sarasota and Washington, DC.

To learn more about Vertex's solutions, call a Vertex representative at 800-355-3500 or visit us at **vertexinc.com**.