Are You Over-Paying (or Under-Paying) Consumer Use Tax?

Automation and Improved Control Can Save Your Company Millions

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It's no secret that taxing jurisdictions across the country are suffering from the economic downturn, and are anxious to close the tax gap. Before asking their constituents for a tax increase, they're deploying sophisticated auditing techniques like statistical sampling to uncover incorrect calculation of consumer use tax.[1] This is especially true when the taxpayer has such a volume of records that it's impractical for an auditor to examine every record.[2] In this environment, it may be a good time to review the processes your company currently has in place to manage consumer use tax. First, a primer.

Consumer Use Tax: What Is It?

Every state that imposes a sales tax has a mirror image tax called a use tax. The tax can take two forms: a seller's use tax or a consumer use tax. The seller's use tax is imposed upon an inter-state transaction and is collected from the buyer by the seller. The requirement for a seller to collect use tax depends upon whether or not the seller has nexus in the buyer's state. (Nexus is the minimum necessary connection between a business and a jurisdiction in order to trigger the requirement to register and collect tax.) If the seller does not have nexus in the buyer's state, the state then requires that the buyer self-assess the use tax, and remit payment to the state. This is known as consumer use tax. Most states have a consumer use tax at the local level as well as the state level, which adds to the complexity of maintaining compliance.

Use Tax is Often a Second Priority

While most companies have been diligent about calculating, collecting, and remitting sales tax, a systematic approach to dealing with consumer use tax is not as widespread. Most businesses maintain in-house tax expertise or use consulting services to determine the taxability of what they *sell*. Determining the taxability of what they *purchase* is typically left to the purchasing or accounting department. This loss of control for the tax department can result in underpayment or overpayment, costing a company millions.

There are a number of contributing factors that can make this approach costly:

1) the volume of invoices processed in a typical accounts payable environment,

2) the limited amount of information available on the invoice,

3) the lack of tax knowledge on the part of procurement and accounts payable personnel

Determining Taxability

When determining consumer use taxability, there's a myriad of considerations, including:

- What was purchased?
- Is the product subject to an exemption or exception?
- If the product is shipped to a temporary location, will it be forwarded to another location? Does the state where the item is originally received have a 'Held in Temporary Storage' exemption?
- Is the product tax exempt based on its use?
- How are freight charges taxed by the state with jurisdiction over the transaction tax?
- What happens if there are both taxable and exempt charges on the same invoice?

In addition, there are specific asset and inventory events that should trigger a closer look at consumer use tax liability, including:

- Asset Movement: If your company re-locates an asset from its initial location, its tax status must be re-evaluated to determine whether additional taxes are due or any tax credits are available. Many states will give the taxpayer a credit for taxes paid to the jurisdiction where the asset was first located.

[1] California State Board of Equalization, "Audit Manual", Chapter 13, Statistical Sampling, 1301.05, 2000.
[2] Florida Department of Revenue, "Tax Information Publication", No. 07ADM-02-Practice and Procedure—Audits by Tax Type—Statistical Sampling of Fixed Assets, 205-067, June 29, 2007.

- Inventory Removal: In most states, inventory purchases are tax exempt under the theory that the items will either be sold to a final consumer or incorporated into the final product that will be sold at retail. As a buyer, you would present an exemption certificate to the supplier to reflect the tax exempt status of the purchase. But if you remove items from inventory for another purpose – a computer to be used in one of your company's departments or samples to give to customers, for example – you need to re-examine the taxability under the laws of the jurisdiction where you have nexus.

Other Considerations

To further complicate the process, here are two additional scenarios that can affect taxability determination. Both require that a company use an automated system for consumer use tax. But without careful management, both scenarios can result in over-payment or under-payment.

- Direct Pay Permits: Most states allow taxpayers to pay the sales and use tax on their purchases directly to the tax jurisdictions instead of their suppliers. Direct pay permits are often used in the manufacturing sector where it is difficult for the purchasing department to ascertain the tax status of items at the time of acquisition. Many states require the taxpayer to substantiate the adequacy of its record-keeping system. A reliable automated solution which enables the capture and reporting of accurate tax data should help.

- Evaluated Receipts Settlement (ERS): Under the ERS option, no invoice is issued by the supplier and no payment is made by the buyer at the time of purchase. Instead, a purchase order is transmitted to the supplier who ships the goods with a packing slip. When the receiving department enters the packing slip information into the purchasing system, the buyer must wire the total amount due to the supplier, including sales and use tax within a pre-determined number of days.

Automation is the Solution

Without a thorough understanding of all the intricacies of consumer use tax, your company could be over-paying, or under-paying. Given the complexities of the tax laws and the multitude of items most companies purchase and use in different ways, the only feasible way to handle the requirements of consumer use tax is through automation. There are software applications available that provide tax rule support in conjunction with data element mapping and configuration capabilities. By utilizing general ledger account numbers, project numbers, vendor codes or usage codes, these applications can make the proper use tax determinations.

When the time for an audit does come, the fact that your business has a system in place for consumer use tax will go a long way toward convincing the authorities that your company doesn't have *systemic* use tax problems. This will make audits go quicker and help prevent examinations from spiraling out of control. This, in turn, will reduce the administrative overhead associated with the use tax audit and minimize penalties and interest for incorrectly reporting use tax. The bottom line? Automating consumer use tax can dramatically affect your bottom line.

About the Author

John Minassian is a financial executive with over thirty years of experience in operational, accounting, finance and tax matters. He currently leads the tax research function for Vertex Inc.

Mr. Minassian's work experience includes positions with E. I. DuPont de Nemours, ICI Americas, and AMP, Inc. (now Tyco Electronics). More recently he was the Director of International Tax Audits at The Franklin Mint. He was also the Tax Director for Bentley Systems where he was responsible for all tax planning, compliance and audit defense.

About Vertex

Founded in 1978, Vertex Inc. is the leading provider of corporate tax software and services to automate, integrate, streamline or outsource tax processes for companies of all sizes, from small to medium-sized businesses to global multinationals. Vertex provides solutions for all tax types with industry-specific solutions for retail, communications, hospitality and leasing industries.

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