SALT ADVOCATES

Vital Sales & Use Tax Issues in 2024

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OSCPA Oklahoma Society of CPAs

With You Today

SALTA, LLC
YOUR STATE AND LOCAL TAX ADVOCATES
Brent Watson, CPA

bwatson@saltapllc.com

Direct: 918.236.1286 – Cell: 918.284.8499

www.saltapllc.com

LIMITATION OF PURPOSE

This document supports SALTA's marketing of professional services and is not tax advice directed at the facts and circumstances of any person. If you are interested in topics covered in this presentation, we encourage you to contact us or another tax advisor to discuss your situation.

LEARNING OBJECTIVES

- Gain a basic understanding of vital issues in sales and use taxes so that you can recognize issues that can impact the business of your employer or businesses of your clients

- Engagement letters – Public accountants should consider specifically stating in their SOWs that they are not providing services for state and local taxes – unless they intend to do so.

STATE LAW

- Explanations of tax laws in this presentation pertain to Oklahoma unless noted. Sales tax laws vary between states and are frequently inconsistent.

AGENDA

1) 2024 Legislative Developments
2) Audit Trends
3) Manufacturing Issues
4) Multi-state Sellers
5) Multi-state Contractors
6) Sales of Business Assets
7) Contractors
8) Duties of Sellers

2024 Legislative Developments

- Exemption of Groceries – state portion – HB 1955
  - Effective August 29
  - Includes food and food ingredients, bottled water, candy, and soft drinks
    - "Food and food ingredients" are substances in a liquid, concentrated, solid, frozen, dried, or dehydrated form that are sold for ingestion or chewing by humans, consumed for their taste or nutritional value, and are not specifically excluded items.
    - Excludes: alcoholic beverages, dietary supplements, marijuana, usable marijuana, marijuana-infused products, over-the-counter medications with a drug facts or active ingredients label, prepared food, and tobacco products.

Food: Groceries v Prepared Food

- Prepared food is excluded from the exemption – described as: (See OTC Guide published June 2024)
  - Food that is sold in a heated state or that is heated by the seller; or
  - Food in which two or more ingredients are mixed or combined by the seller and sold as a single item; or
  - Food sold with eating utensils, plates, bowls, cups, glasses, napkins or straws provided by the seller.

Prepared Food Criteria

- Food that is sold in a heated state or that is heated by the seller

  Excludes selling of items to customers who can heat their own items in a microwave on premises

  Includes items that were heated but do not need to be hot when sold – such as baked goods – pies, cakes, etc.

- Food in which two or more ingredients are mixed or combined by the seller and sold as a single item

  Includes salads, ice cream, sandwiches

Prepared Food Criteria

- Food sold with eating utensils, plates, bowls, cups, glasses, napkins or straws provided by the seller.

  Food qualifies as prepared food if the food is sold with eating utensils provided by the seller, even if the seller did not heat the food or mix ingredients to create the food. This includes including placing utensils with food sold, giving or handing utensils to buyer, or making utensils available to buyer.

  Excludes manufactured items that include utensils

Prepared Food Criteria

- Food sold with eating utensils, plates, bowls, cups, glasses, napkins or straws provided by the seller.
  - If more than 75% of a seller's sales consist of prepared food, all of their sales are treated as sales of prepared food – with one exception:
    - Exception for Serving Size – Sales:
      - Not sales of prepared food
      - Items sold that consist of servings of 4 or more
      - Not heated or made by the seller
      - Eating utensils not handed to the buyer

Bitcoin Mining at Colocation Facility

- 68 OS 1359 – exemption statute is amended to add exemption of (Paragraph 17):

"…machinery and equipment, including but not limited to, servers and computers, racks, power distribution units, cabling, switchgear, transformers, substations, software, and network equipment, and electricity used for commercial mining of digital assets purposes in a colocation facility."

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Audit Sources

- 4797 Audits
  - No general occasional sale exemption
  - Not all sales are taxable
  - Horror story – small family-owned manufacturer
- One-month exemption certificate "easter egg" discovery audits
- Resulting from audits of others or past audits with deficiencies

Audit Procedural Problems

- Sampling
  - Block samples can be useful but can produce skewed results
  - Best practice: Do not sign block sampling agreements before results indicate a fair outcome. Agree with auditor to try this method, but ask for agreement to eliminated outlier transactions; If results show a normal result, then sign the agreement

Audit Procedural Problems

- Statute of limitations waiver
  - Auditors sometimes ask for a signed SOL waiver immediately, as if they could complete the audit the next day (I don't think that this is fair – they should give a reasonable cushion)
  - Often the SOL waiver asks for a full year. We advise against signing prolonged extensions; Instead, offer to sign a shorter period
  - SOL waivers are sometimes beneficial for all parties

Audit Procedural Problems

- Usage of bank deposits as measure of taxable sales
  - When an obvious accounting of sales is lacking this can be a way to estimate sales (as in fraud), but it is fraught with error, often overstates sales, and usually better measures of sales exist.
- Frustration
  - Relying on bank deposits when alternate evidence exists

Audit Procedural Problems

- Refusal to offset credits for overpayments against debits for underpayments
  - This one gets my goat!
- Collection notices from >20-year-old assessments
- Exemption Certificate Gotcha
  - Retailers and wholesalers should perform a self-audit of check exemption certificates after audit notification

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Manufacturing Exemption

- Manufacturers are entitled to a generous exemption of inputs into the manufacturing process, including utilities, consumables used in manufacturing, and machinery and equipment.
- Manufacturers must obtain a Manufacturer's Sales Tax Exemption Permit ("MSEP") from the OTC to claim the exemption.

Scope of exemption

- The exemption applies to "goods, wares, merchandise, tangible personal property, machinery and equipment sold to a manufacturer for use in a manufacturing operation" (Oklahoma Administrative Code 710:65-13-150.1 and Okla. Stat. 68 §1359[1])

Scope of Exemption

- Begins where materials enter manufacturing site, and continues through the point where the items leave the site (68 O.S. Sec. 1352(15))
- VERY broad – covers the integrated manufacturing process - including items like storage racks or tanks for raw materials and finished goods.
- Extends to machinery, utilities and chemicals consumed for pollution control, and consumables

MSEP

- Manufacturer's sales tax exemption permit
- Must be obtained from OTC to validly claim exemptions on purchases
- PROBLEM: OTC frequently denies issuance of MSEP if any mention of customization is made in applications

The Law

OS 68 Sec. 1352:

"Manufacturing" means …the activity of converting or conditioning tangible personal property by changing the form, composition, or quality of character of some existing material or materials, including natural resources, by procedures commonly regarded by the average person as manufacturing, compounding, processing or assembling, into a material or materials with a different form or use. "Manufacturing" does not include extractive industrial activities …"

OK Supreme Court Case: McDonalds Corp. v. OTC - 1977

Average Person Test

- The term ‘Manufacturing' shall mean those establishments primarily engaged in manufacturing or processing operations
- And appellant restaurants were said to not be manufacturers because: “…It is doubtful that the *average man* would think of the drink dispensing machine operation or Appellant's fast food operation in general as ‘manufacturing'

OTC Administrative overreach – A regulation lacking statutory basis

- Denial of "custom manufacturing"
- Examples: heat exchangers, aircraft parts, metal fittings, RVs, store fixtures
- OAC 710:65-19-60. *Made-to-order and custom sales* - Where persons contract to manufacture, compound, process or fabricate their materials into articles of tangible personal property according to the special order of their customers, the total receipts from the sales of such articles are subject to tax. … Articles commonly made to order are curtains, draperies, tents, awnings, clothing, and slipcovers. … The equipment, tools and supplies directly used or consumed in the production of such articles and not becoming a part thereof are subject to tax.

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Doing Business in Other States

- "Nexus" (connection) is what determines if taxpayers must comply with tax laws in a particular taxing jurisdiction
- The USSC's 2018 Wayfair v. South Dakota decision expanded the basis of nexus to include economic factors.

This decision has resulted in a "Sales Tax Tsunami"

- Allowed states to impose sales tax laws on vendors who have no physical presence in the state
- Wayfair's impact extends far beyond large e-commerce sellers:
  - Traditional brick-and-mortar sellers like distributors or manufacturers
  - Myriads of smaller e-commerce sellers

Economic Nexus: Current Status

- All 46 states that impose sales taxes plus DC impose economic nexus compliance
- Most states have an annual sales threshold of $100,000 (5 states are higher: AL & MS - $250K, CA, NY, and TX $500K)
- The measurement of "sales" varies by state:
  - Some exclude all services or non-taxable services
  - Some exclude resales only
  - Some exclude all exempt sales
  - The majority include all sales

Economic Nexus: Current Status

- Most states have centralized administration of local taxes, in those states, taxpayers that have nexus in the state must collect all local taxes that are imposed
- For states with locally administered jurisdictions (AL, CO, and LA), nexus applies on a separate basis for each jurisdiction. This may change when the locals become centrally administered – as in AK.

Costly Consequences

- Inconsistent laws create major costs and concerns
  - Thresholds vary in amount, but also in what is included in the amounts to be considered (gross sales, retail sales, taxable sales, exclusion of sales through marketplace sellers, services, etc.)
  - Once nexus is tripped, some states require sellers to begin collecting tax on the very next sale!
  - Multiplies issues with collection of exemption certificates

"Cleanup on Aisle 3"

Whoops, we goofed what next?

- Remediation – VDAs, registration w/ back reporting
- Gathering of exemption certificates – "XYZ" letters
- Implementation of sales tax software and sales tax compliance
- Implementation of sales tax exemption software
- The costs of non-compliance can be brutal!

Physical Nexus

- Sellers should be aware of business changes that could create nexus (even if performed by contract worker or workers temporarily in a state) in additional states:
  - Sales activities
  - Deliveries in company vehicles
  - Repairs or installations
  - Employees
  - Inventory or facilities

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Sales of Business Assets

OCCASIONAL/ISOLATED/CASUAL SALES

- OK is one of four states that does not provide an exemption for occasional sales (sales of TPP - non-trade assets) except for some limited exceptions:
    - formation of a new corporation or partnership
    - certain business reorganizations
    - liquidation of a corporation or partnership
    - transfers between wholly owned subsidiaries
- In OK, sales of non-inventory business assets are NOT generally exempt.

Sales of Business Assets

TRANSFERS BETWEEN PARENT COMPANIES AND WHOLLY OWNED SUBSIDIARIES

- Exemption was added in 2021
- The exemption applies generally to transfers between parent companies and wholly owned subsidiaries or between wholly owned subsidiaries and is not limited to transfer of trade assets
- This could impact taxability or sales between related entities, although that was probably not the intent of the legislation.

Sales of Business Assets

- Many businesses who buy or sell business assets are surprised by this pitfall
- Sellers are primarily responsible for filing a sales tax return to report the sales of business assets
- Identifying the value for which TPP is transferred is a challenge. PLANNING TIP - PSAs should identify values of TPP
- The OTC checks for sales tax reporting of assets shown to be sold – IRS Form 4797

Sales of Business Assets

- The OTC can pursue either the buyer or the seller for taxes due on sales of TPP – including occasional sales
- Normally, the PSA for a sale of business assets indicates that the purchasers must reimburse the seller for sales tax on sales of business assets
- Purchasers need to obtain a sales tax permit, manufacturer's sales tax exemption permit, or any other exempt designation BEFORE the purchase in order to issue an exemption permit that is effective as of the date of the transaction.

Sales of Business Assets

- Examples of Tax Liability for Occasional Sales

  Example 1: Sale of Restaurant

  $200,000 of the sales price is attributable to equipment, furniture and fixtures and $10,000 is attributable to inventory.

  Tax is due on the $200,000 if the buyer provides a re-sale exemption certificate for the inventory. Otherwise, tax is due on $210,000.

  - Buyer should apply for sales tax permit BEFORE closing to issue the resale exemption certificate

Sales of Business Assets

Example 2: Sale of Factory – Based on a recent situation!

- The sale of a factory is made with the following breakout: $200,000 furniture and fixtures, $800,000 for inventory, and $5M for mfg. equipment.
  - Tax is due on the $200,000.
  - If the buyer is registered for a MSEP, an exemption certificate can be issued for the inventory and mfg. equipment. If the buyer holds a sales tax permit, the inventory only could be bought tax free for resale. Otherwise, tax will be due on the entire $6M.

Sales of Business Assets

- Example 3: Sale of Oil and Gas Properties
- A group of leases on oil and gas properties is made. Allocation of the sale price is included in the PSA, listing the value of each well, but no other detail is provided
  - Tax is due on the TPP – the value of which is an issue
  - The OTC' may base taxable amount on sales price or remaining undepreciated basis
  - OTC may refer to buyer's income tax return for basis

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Contractors

- Contractors are deemed to be consumers of materials purchased to either incorporate into real property or consume during construction.
  - Contractors must pay tax on the materials they use. Their billings are not taxable.
  - Normally, the exempt status of customers is irrelevant to taxability of contractors' purchases.
  - Some exempt entities have an exemption that passes through to contractors, allowing contractors to purchase materials incorporated into the project free of sales tax.

Pass-through exemptions

- Pass-through exemptions are of special importance to contractors in OK – sales tax law provides pass-through status to a long list of taxpayers: including refineries, most state and local governmental agencies and churches
- Only specified classes of exempt entities enjoy a pass-through exempt status
- Additionally, for some types of exempt taxpayers (including agricultural permit holders, colleges, schools, churches, rural electrics, and some state and local government agencies), the contractor can also purchase consumable materials used in the project on an exempt basis.

Entities with Pass-through Exemption Status (OAC 710:65-7-13(b))

- **710:65-7-13(b)(1):**
- Oklahoma municipalities and counties
- Public school districts
- Institutions of the Oklahoma System of Higher Education
- Rural water districts

Entities with Pass-through Exemption Status

- **710:65-7-13(b)(1):**
- Specific state agencies and quasi-governmental agencies including: the Grand River Dam Authority, the Northeast Oklahoma Public Facilities Authority, the Oklahoma Municipal Power Authority, the City of Tulsa-Rogers County Port Authority, the Broken Bow Economic Development Authority, the Muskogee City-County Port Authority, the Oklahoma Ordnance Works Authority, the Durant Industrial Authority, the Ardmore Development Authority, the Oklahoma Department of Veterans Affairs, the Central Oklahoma Master Conservancy District, or Department of Central Services only when carrying out a public construction contract on behalf of the Oklahoma Department of Veterans Affairs

Entities with Pass-through Exemption Status

- **710:65-7-13(b)(2)** Private schools - However, the institution must be registered or accredited with the Oklahoma State Regents for Higher Education, the State Board of Education, or the State Department of Education.
- **710:65-7-13(b)(3)** Agricultural permit holder to construct a facility which will be used directly in the production of any livestock, including facilities used in the production and storage of feed for livestock
- **710:65-7-13(b)(4)** Colleges – IF: they are exempt from taxation pursuant to Section 501(c)(3) of the Internal Revenue Code and they have exemption status from the Tax Commission
- **710:65-7-13(b)(5)** Pollution Control Agencies – must have a letter certifying the exemption status from the Tax Commission

Entities with Pass-through Exemption Status

- **710:65-7-13(b)(6)** A contractor, or a subcontractor to such contractor, with whom a church has duly entered into a construction contract may make purchases of tangible personal property or services exempt from sales tax which are necessary for carrying out such construction contract.
- **710:65-7-13(b)(7)** Rural electric cooperatives
- **710:65-7-13(b)(8)** Child care centers operated for educational purposes, qualified for exemption pursuant 68 O.S. §1356(69)
- **710:65-7-13(b)(9)** Manufacturing operation classified under NAICS No. 324110 (Petroleum Refineries)

Entities with Pass-through Exemption Status – DO NOT INCLUDE:

- Manufacturers – except refineries.

- Federal government (68 O.S. Sec 1356(1) and Rule 710:65-13-131). While a party acting as a purchasing agent can make purchases exempt on behalf of the government as long as the government receives the property immediately, a contractor is excluded from exemption because they receive the property before installing it.

Pass-through Exemption Documentation

- In order to document purchases made by contractor claiming exempt basis based on a pass-through exemption, vendors should require (see OAC 710:65-7-13(c)) that contractors provide the following documentation:
  - A copy of the exemption letter or card issued to one of the entities described in (b) of this Section;
  - Documentation indicating the contractual relationship between the contractor and the entity; and,
  - Certification by the purchaser, on the face of each invoice or sales receipt, setting out the name of the exempt entity and the contract for which the items are purchased

Contractors v Fabricators v Retailers

- Contractors sometimes "wear multiple hats" – functioning both as a contractor, and also as retailer, fabricator or service provider.

  Examples:

  - Fencing contractors who also sell fencing materials over the counter
  - HVAC contractors who fabricate ductwork and sell it to other contractors or the public out of a metal shop.

Multi-State Contractors - Billings

- Many states are like OK – contractor is consumer, not tax to be billed – Examples: MO, AR (with exceptions), LA
- Other states are nearly the opposite: Contractors remit tax on face value of contract – example MS, SD, NM, some northeastern states (unless the project is a "Capital Project)
- Another group of states vary in treatment of the project based on the type of contract. Examples
  - Texas – residential v. commercial; Commercial: lump sum new, separated new, or remodeling
  - Kansas – new versus remodeling
  - Indiana – separated versus lump-sum

Multi-State Contractors - Purchases

- Treatment of purchases is directly related to how billings are treated
- Issue: interstate movement of materials and equipment
- Can result in duplicative taxation: Materials purchased in one state, but used elsewhere are generally taxed in the state in which they are originally purchased, regardless of whether they would have been exempt if purchased in the state where they are used. Examples: CO – home rule cities (contractor pays tax on materials to city); MS and other states where contractor must collect tax but purchases in the state are not taxed.
- Solution: Direct Payment Permit – or direct shipments if feasible

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Service Providers are Consumers; Pay Tax on Materials

- Generally, sellers of services are not required to collect tax on billings but are liable for tax on purchases.
- In 2020 litigation was settled concerning whether certain service providers can itemize materials and collect tax on them as a retailer would. This had to do with services where materials that are sold are embedded into the earth (such as fracking proppants and drilling mud). Answer: The seller COULD itemize charges for goods transferred to the customer.

Sellers Must Be Equipped to Handle Compliance Duties

Sellers must be able to calculate and accumulate taxes to be paid and to track exemption certificates

- Many accounting software packages (even QuickBooks) have functionality to collect and track sales taxes but often depend on manual input and maintenance of rates.

- For sellers dealing with multiple states and a variety of local sales taxes, it is often advisable to purchase a sales tax software tool, such as AvaTax or Vertex.

Sellers Must Collect and Manage Exemption Certificates

- Exemption certificate management programs are sometimes needed and can be a tremendous tool to minimize future audit exposure
  - Must collect either tax or exemption certificates in states where nexus exists
  - Should only grant exemption to purchases for exempt entities if the purchases are made using funds of the exempt entity (credit card or check)

Sellers Must Monitor Their Nexus Footprint

If selling into other states, need to be aware of changes in business that could create nexus – sales activities, employees working remotely, deliveries in company vehicles, repair or installations, etc.

Sellers should know the taxability of the goods & services that they are selling

- While sellers do not need to function as "auditors" it is helpful if they understand the basic sales tax laws that apply to the products and services that they are selling. This would include sale of TPP, services, intangibles, sales to and by contractors, and a general knowledge of exemptions that purchasers (manufacturers, etc.) might be entitled to.
- Sellers should also be knowledgeable of taxability of ancillary charges that are added to invoices for items sold.

Sellers Who Manufacture

- Manufacturers must collect tax, or exemption certificates in lieu of tax, like other retailers.

- A special exemption applies to sales by an OK manufacturer to an out-of-state purchaser for immediate transportation and usage OOS (Rule 710:65-13-152.1). The seller must obtain an exemption certificate stating that the buyers will be immediately removing the goods for OOS usage.

Sellers are Fiduciaries

Sellers must understand their roles as fiduciaries

- A fiduciary acts as an agent in a trust capacity – in the case of sales tax collections or taxes withheld from employees, they act as an agent for the governmental agency that imposes the specific tax
- Failure by "responsible parties" to remit taxes collected from others is considered to be "conversion" or theft, and can result in personal liability
- "Responsible parties" are generally those who are in a position to choose who to pay and who not to pay

QUESTIONS

Thanks for your attendance today.

You are welcome to call anytime we can be of help!

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Your State and Local Tax Advocates

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