Missing Exemption Certificates Can Cost You a Bundle on Audit

-by Ned Lenhart, President, Interstate Tax Strategies, P.C.

Get the paperwork right!! That's the mantra I chant when dealing with clients who have a large percentage of their sales classified as "sales for resale". This primarily relates to wholesalers and distributors who sell property to other companies who, in turn, sell the property to the final customer. There is no question that all of the sales prior to the final sale are tax exempt as "sales for resale". But can you prove it under audit? Unfortunately, for many companies the answer to this question is NO!!

So what's the big deal about having exemption certificates to support the nontaxable sales you make? In virtually every state, the sale of property is deemed to be taxable unless the seller has a properly executed exemption certificate from the purchaser specifying the reason why tax should not be charged. The failure to have these documents will make these sales taxable. On audit, the states are aggressively looking for companies who don't have the proper exemption certificates and they are not afraid to levy tax on the sales made without documentation.

Most states provide sellers a reasonable period of time to obtain missing certificates. However, if your customer is out-of-business or is no longer a customer then your chances of getting a valid certificate may quickly approach 0%. Missing certificates means your company pays the sales tax on the transaction. Don't forget the interest and penalty also.

The other problem with exemption certificates is making sure you have the right one. Some states like California and Florida, will only accept certificates from their state. If you make a sale to a "sale for resale" to a California customer and they give you a Georgia resale certificate, the state will not honor that on audit. Other states are more generous and will allow you to accept certificates from almost any other state to support "sales for resale" that occur in their state. For example, if you make a "sale for resale" in Georgia, Georgia will allow a resale certificate from any other state to support that transaction.

If you make 3rd party drop shipments then the rules become even more confusing and can lead to some very difficult discussions with customers. In these situations, your company is shipping property to the location of your customer's customer. You may be in Florida, your customer is in Iowa, and they have asked you to ship goods directly to California. Your need to collect exemption certificates will depend on whether your company has nexus in California, whether your customer has nexus in California, and whether the sale is otherwise taxable in California. This can be very challenging for companies do deal with and can lead to some rather expensive audit findings if these transactions are detected.

Your need to collect exemption certificates is also driven by whether your company has nexus in other states. We discussed nexus in a previous article. If your company has nexus in a state, then you must collect exemption certificates for non-taxable sales you make in that state.

With many companies going out of business and with the states desperate for additional cash, the need to carefully review your company's exemption certificate policies and procedures is very important. 10 years ago, it was not that critical to have exemption certificates. Today it's a different story. States are looking for money in about any way they can get it and assessing sales tax on missing exemption certificates is about as easy as it gets.

A note about the author: Prior to starting Interstate Tax Strategies, P.C., Ned Lenhart served as Director of Multistate Tax Services for Deloitte's Atlanta office. He served as Director of the Missouri Department of Revenue's Compliance Division and led civil and criminal tax enforcement efforts; and served as Deputy Director of the Missouri Division of Taxation. He is a licensed CPA in multiple states and an active member in AICPA and GSCPA.

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