When you have to be right

Tax & Accounting

Use Tax for Manufacturers and Distributors

Use tax considerations are relevant across four areas for manufacturers: machinery and equipment, R&D, inter-plant transfers and inventory withdrawals — with the last one pertaining to distributors as well.

Despite how complicated use tax is, it's important to both understand the regulations relevant to your manufacturing business and to ensure that your processes and software are accurate and efficient.

This white paper will examine these issues, specifically:

- **Possible consequences of poorly managed use tax, including overpayment of taxes, or audits and costly fees and penalties**
- **The four areas that trigger use tax**
- **How to protect your business from making use tax errors**

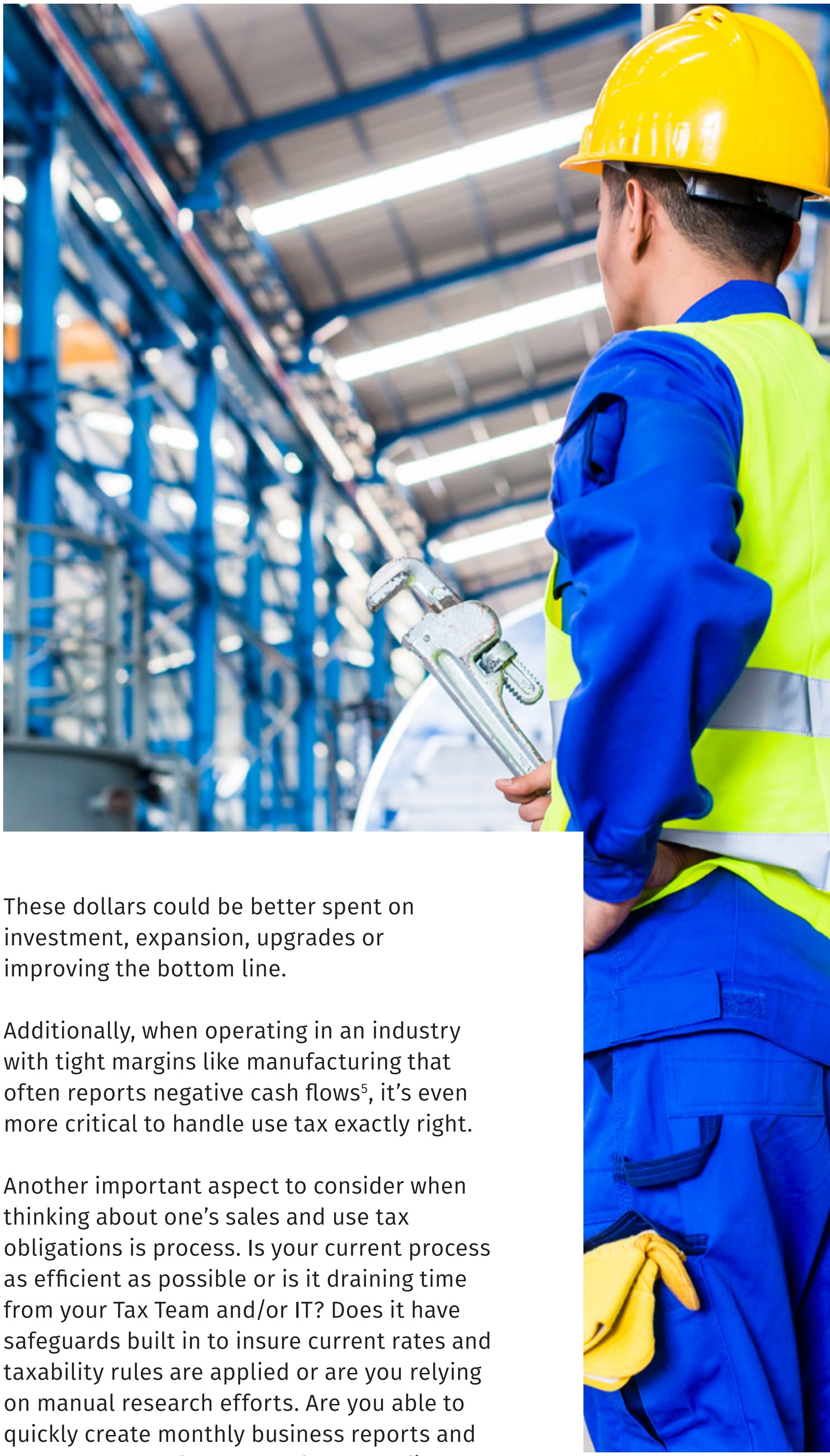
Let's start by defining "manufacturer" the way most tax jurisdictions do: "An operation of producing a new product, article or commodity that is different, and that has a distinctive name, character or use from raw material and that is intended to be sold either as a finished product or a component of a future finished product," explains Cory Barwick, Compliance Expert with Wolters Kluwer's Sales and Use Tax Group.

Not all manufacturers use raw materials in their processes, of course. Some, like automobile manufacturers, buy parts or components from suppliers and then manufacture/machine/fabricate those parts into a new, complete product. These companies still operate as "manufacturers" as defined by tax authorities.

Note: Certain industries that do manufacture goods, such as pharmaceuticals, tech and construction, often fall under tax law specific to their industries and will not be covered in depth in this white paper.

Distributors, for tax and legal purposes, are often defined as "any individual, partnership, corporation, association or other legal relationship that stands between the manufacturer and the retail seller in purchases, consignments or contracts for sale of consumer goods." [1]

[1] http://www.leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=CIV&division=3.&title=1.7.&part=4.&chapter=1.&article=2



Consequences of Poorly Managed Use Tax

One possible consequence of the failure to properly apply complicated use tax regulations is a negative audit penalty. Audits, especially on use tax, are becoming increasingly common. “For a long time, sales tax was the primary component of an audit, and it was the primary assessment vehicle,” Barwick explains.

“As sales tax software became more accessible and businesses were able to get sales tax more accurate as a result, use tax has become the primary assessed tax in an audit. In my experience, both with Wolters Kluwer and in tax consulting, over half of the audit penalties we were aware of were based purely on purchase activities [use tax], not anything to do with sales activities.”

These penalties, fees and interest charged on unremitted tax add up exponentially. Many states add on a 5–25 percent penalty for failure to file, 1–5 percent in interest per month, plus perhaps 3–25 percent for failure to pay — for total penalties of up to 55 percent.[2]

Worse, some states, such as New York[3] and Florida[4], can penalize up to 200 percent in cases of negligence, tax evasion or fraud — and even pursue criminal charges.

Given the complex nature of use tax, as well as the potentially high penalties, many companies have taken an approach to err on the side of caution. Meaning they would rather overpay than get caught in a negative audit situation.

Overpayment may feel like a type of insurance against such prohibitive penalties. Although this approach may have had some benefits in the past, it’s unwise in today’s market. Overpayment is not only money lost — with no return — it has opportunity costs.

These dollars could be better spent on investment, expansion, upgrades or improving the bottom line.

Additionally, when operating in an industry with tight margins like manufacturing that often reports negative cash flows[5], it’s even more critical to handle use tax exactly right.

Another important aspect to consider when thinking about one’s sales and use tax obligations is process. Is your current process as efficient as possible or is it draining time from your Tax Team and/or IT? Does it have safeguards built in to insure current rates and taxability rules are applied or are you relying on manual research efforts. Are you able to quickly create monthly business reports and are you prepared to respond to an audit?

[2] https://revenue-pa.custhelp.com/app/answers/detail/a_id/211/~/how-is-sales-tax-penalty%2Finterest-calculated%3F
[3] https://www.tax.ny.gov/pubs_and_bulls/tg_bulletins/st/sales_and_use_tax_penalties.htm
[4] http://floridarevenue.com/taxes/Documents/penalty.pdf
[5] http://csimarket.com/Industry/industry_growth_rates.php?cfw&ind=206
[6] http://www.cchgroup.com/roles/accounting-firms/tax/research/cch-intelliconnect

Machinery and Equipment

Most of the 45 U.S. states and District of Columbia that collect sales and use tax offer a use-based exemption to manufacturers on the purchase of machinery and equipment used directly in the manufacturing process. Based on research via CCH® IntelliConnect®,[6] 35 states offer a use-based exemption from tax, and three more offer a reduced rate.

Why are use-based tax exemptions provided to manufacturers and how do they work?

In order to entice businesses into the state to create jobs, states look for ways to tax manufacturers less than other states and localities do. One example is the use-based exemption.

The use-based exemption doesn't apply to the materials, supplies or parts used in the manufacturing process because manufacturers, are reselling these materials, and are able to purchase them exempt from sales tax using a "resale certificate."

If these special manufacturing exemptions did not exist, this machinery and equipment could be taxed under sales tax at the point of sale to the manufacturer.

In order to qualify for the use-based exemption, when buying this equipment and machinery, a manufacturer presents a use-based exemption certificate or has it on file with suppliers; otherwise, the seller of the machinery will usually be required to add sales tax to the transaction. In this scenario, where you present your use-based exemption certificate, the seller is left to assume that the exemption certificate applies to all items associated with the transaction and does not apply sales tax. Later, if you fail to pay use tax on items that do not qualify for this use-based exemption, you may be subject to audits and then penalties and interest, in addition to owing the tax obligation.

When a state exempts machinery/equipment, the state regulates what is exempt and for what uses specifically.

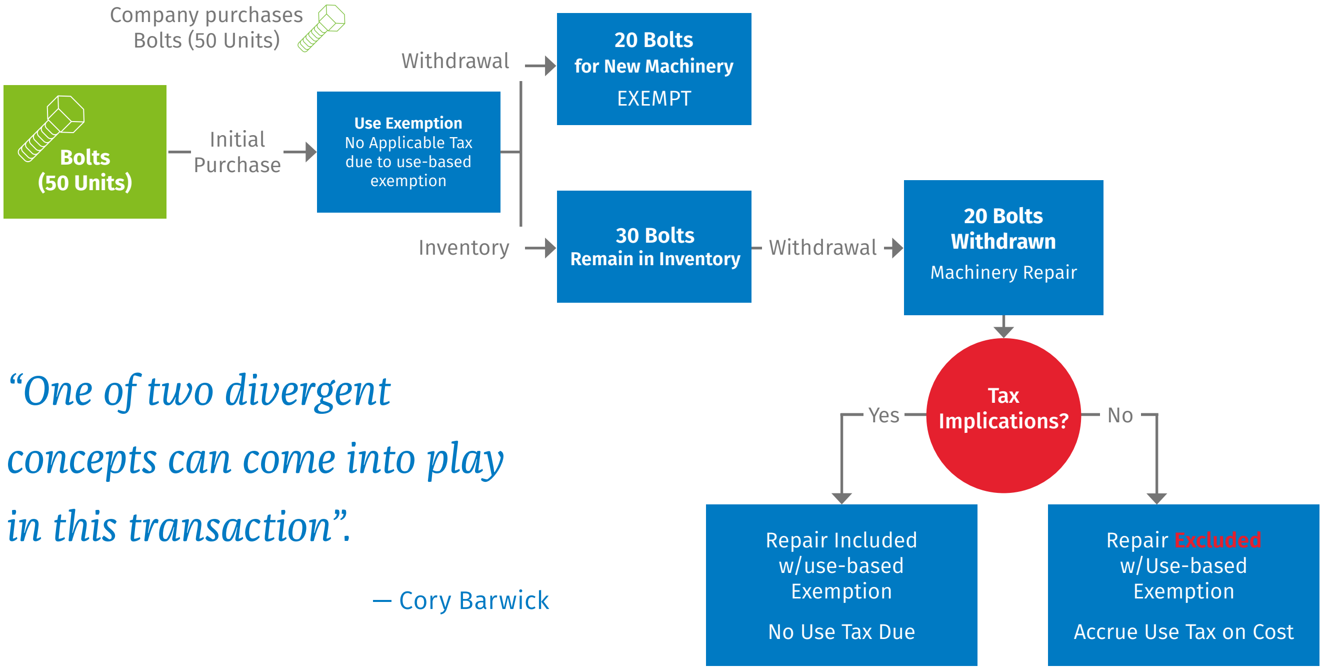
In addition to requiring that the equipment/machinery be used directly in the manufacturing process, other limitations usually associated with use-based exemptions include:

- **Percentage of Actual Usage —** Tax jurisdictions that offer use-based exemptions stipulate the usage requirements of the applicable qualifying item, which usually includes terms such as primary, majority, predominately, exclusively, and even "a preponderance of the time." The requirement, regardless of the term, will usually range from 51 percent to 100 percent usage. The usage percentage is very important to ascertain because some states will allow a qualifying item to be used both in a taxable use as well as an exempt use, but some states will require a qualifying item to be used exclusively in the exempt activity.

- **New and Expanding Operations —** Some tax authorities limit use-based exemptions to items that are part of a "new manufacturing operation" or that "expand the existing manufacturing process," meaning that machinery and or equipment acquired to replace or repair a worn out piece of machinery, or one that has become obsolete, would not qualify under some states' exemption provisions. Conversely, many states, such as California[7], Iowa[8] and New York[9] do not impose the "new and expanding" qualification, and some states, like Arkansas, provide partial exemptions on certain qualifying repair uses.[10]

- **Minimum Dollar Amount or Minimum Useful Life —** Another limitation associated with use-based exemptions is the establishment of minimum dollar amount and/or useful economic life. A typical minimum dollar requirement might be $100–$500.

[7] https://www.boe.ca.gov/sutax/manufacturing_exemptions.htm#Qualifications
[8] https://tax.iowa.gov/iowa-sales-and-use-tax-manufacturing-and-processing
[9] http://www.tax.ny.gov/pdf/publications/sales/pub852.pdf
[10] http://www.arkleg.state.ar.us/assembly/2017/2017R/Acts/Act465.pdf



"One of two divergent concepts can come into play in this transaction".

— Cory Barwick

A typical range of a minimum economic life might be from one to three years. For example, the state of Utah requires "an economic life of at least three years." [11] These limitations complicate the determination as to what qualifies.

For instance, here's an example applying the New and Expanding Operations limitation above. Under some states' use-based exemptions, a bolt is exempt only in certain situations. For instance, if a company takes bolts (the "equipment") and uses them to build a new manufacturing operation (the "limitation"), many states will say that's tax exempt. But if the same company uses bolts to replace some of the original bolts in the machinery, those fall under "repair of machinery and equipment." In some states, the bolts used in the repairs would not qualify for the use-based exemption, and the manufacturer, which bought the bolts with its use-based certification, would need to remit use tax.

It is critical that a manufacturer understand:

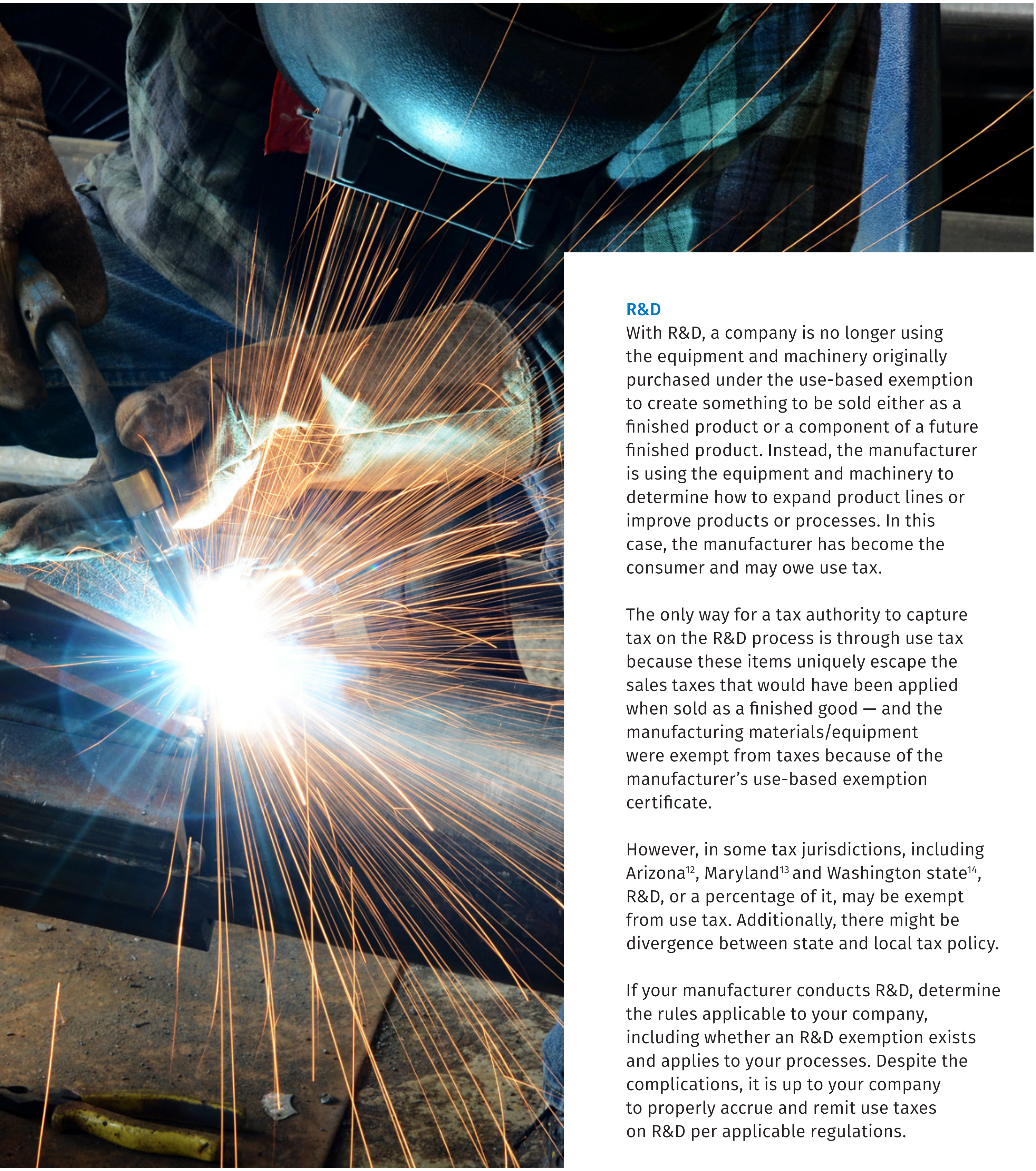
- What is tax exempt in all relevant taxing jurisdictions.
- How the equipment/machinery must be used to make it tax exempt.

Another possible compication could be that some taxing authorities, of which there are more than 25,000, are autonomous from the states, and the use-based exemption policies and tax rates may be different from the relevant state's. For instance, some local jurisdictions will offer partial, instead of full, use-based exemptions.

Special Consideration

Although fairly uncommon, some tax jurisdictions offer partial exemptions or partial use-based exemptions as opposed to a full exemption on items usually prohibited from use-based tax, such as the materials, tools, energy or fuel used or consumed in the manufacturing process. This is yet another reason that a manufacturer needs to know and understand all sales and use tax laws applicable to the company.

[11] http://www.tax.utah.gov/forms/pubs/pub-25.pdf



R&D

With R&D, a company is no longer using the equipment and machinery originally purchased under the use-based exemption to create something to be sold either as a finished product or a component of a future finished product. Instead, the manufacturer is using the equipment and machinery to determine how to expand product lines or improve products or processes. In this case, the manufacturer has become the consumer and may owe use tax.

The only way for a tax authority to capture tax on the R&D process is through use tax because these items uniquely escape the sales taxes that would have been applied when sold as a finished good — and the manufacturing materials/equipment were exempt from taxes because of the manufacturer's use-based exemption certificate.

However, in some tax jurisdictions, including Arizona[12], Maryland[13] and Washington state[14], R&D, or a percentage of it, may be exempt from use tax. Additionally, there might be divergence between state and local tax policy.

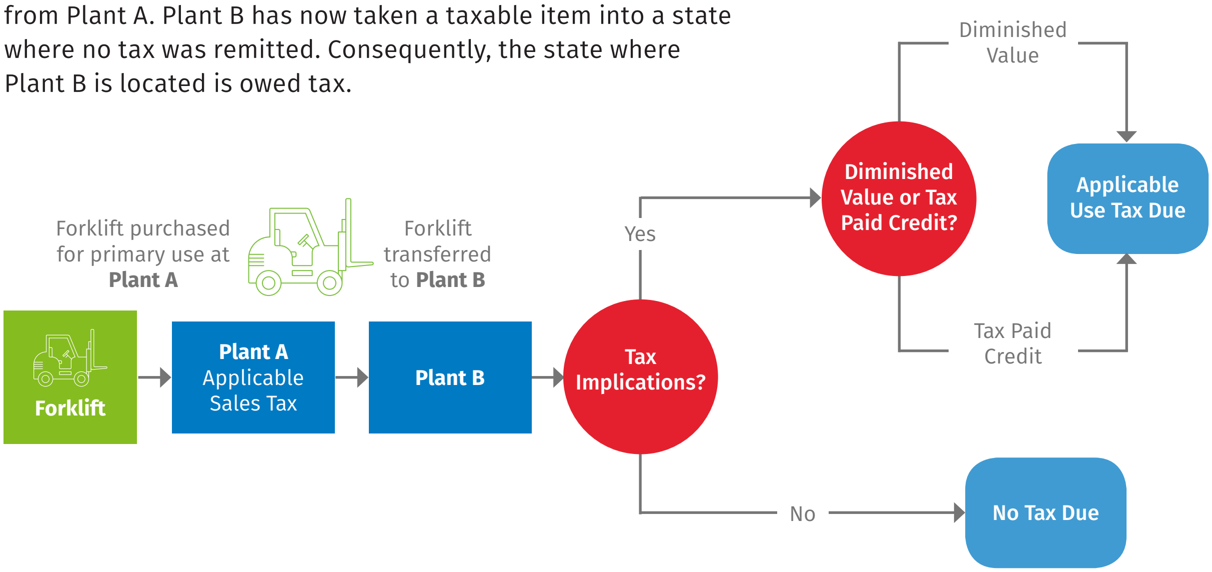
If your manufacturer conducts R&D, determine the rules applicable to your company, including whether an R&D exemption exists and applies to your processes. Despite the complications, it is up to your company to properly accrue and remit use taxes on R&D per applicable regulations.

12 http://www.fso.arizona.edu/tax-services/az-sales-use/faq#4
13 http://taxes.marylandtaxes.com/Business_Taxes/Business_Tax_Types/Sales_and_Use_Tax/Sales_Records/exempt_materials_used_in_production_activities.shtml
14 http://dor.wa.gov/Docs/Forms/ExcsTx/ExmptFrm/ManufacturesSlsUseTxExmptCert_E.pdf

Inter-plant Transfers

Inter-plant transfers occur when machinery, equipment or parts are transferred from one plant/factory to another. This should be an area of concern for manufacturers because these usually trigger "taxable events." The Tax Department needs to be made aware whenever such a transfer takes place in order to assess the tax implications.

Consider this scenario: A taxable forklift is transferred from Plant A to Plant B. Plant B is in a different taxing jurisdiction from Plant A. Plant B has now taken a taxable item into a state where no tax was remitted. Consequently, the state where Plant B is located is owed tax.



1. What is the item's current value and does Plant B get to use the diminished value as the base on which to pay taxes? Some states will say, "yes," that the diminished value is the fair value of the equipment. The states that say, "no," and there are a handful of them, lead to the second concept.

2. Does the company get a credit for sales tax already paid to the state in which Plant A resides? Typically when the state charges taxes based on the original purchase price, they allow the tax credit of what was already paid.

Another example is a piece of equipment or machinery that qualifies for a use-based exemption. Will the transfer of this item from one plant to another plant across state lines trigger tax in the second state?

The Tax Department needs to determine if the item still meets the use-base exemption in the receiving state and what the tax implications are.

Specifically, when the Tax Department examines the situation, the following criteria should be evaluated:

- Is this transaction a taxable event?
- What's my tax base, current value or original purchase price?
- What's my tax rate?
- Do I get a refund from the original state?
- What do I owe the second state?

What sometimes happens is that when Tax Departments are made aware of these transfers, the manufacturer often accrues and remits too much use tax in order to avoid penalties because they aren't sure what the rules are and are motivated to ensure that the company avoids fees and penalties. This "insurance" approach has an immediate impact on cash reserves, as well as opportunity costs. Another contributing factor is that many businesses rely on basic, native-tax functionality within their ERP. Native sales and use tax capabilities within ERPs often lack the tools and content needed to meet the sophisticated and nuanced sales and use tax needs of most businesses.

Knowing and understanding the rules, having processes in place to identify inter-plant transfers and using sophisticated software and processes to correctly calculate tax is vital in order to accrue and remit the appropriate amount without either overpaying or underpaying. After all, you want precision across your manufacturing process. Why settle for anything less when calculating appropriate taxes?

Tradeshows/Inventory Withdrawal

Tradeshows and other situations that result in inventory withdrawal is where distributors, in particular, need to take note because inventory withdrawals should be taxed and often are not. This may expose a manufacturer/distributor to use tax violations.

Consider this scenario: A distributor buys inventory from a manufacturer. The distributor, provides the manufacturer a "resale certificate" that states that the distributor, will resell the item and is, therefore, not liable for sales tax. A sales rep at the distributor requests 50 widgets from inventory for a tradeshow or to send to potential customers to keep as samples. The "withdrawal" is the event, and that creates a tax situation: The distributor, has now become the end consumer of those widgets, as they will not be taxed in a sale. Therefore, the resale exemption from sales tax no longer applies to those units. Consequently, the distributor, must accrue and remit use tax on those units.

While state use tax auditors look for these events, sometimes the Tax Department at the manufacturer/distributor is not aware when one of these taxable events has taken place. This could be due to lack of experience or more likely because the Tax team wasn't made aware of the withdrawal, or even more likely because of a communications problem. For instance, when the Tax Departments monitor the inventory stream via ERP reports, for these reports to be useful and accurate, inventory personnel must have coded withdrawals accurately. If not, the Tax Department cannot properly calculate use tax.

Another complication: Some states require use tax on these "free" items when distributed to someone within their state boundaries, no matter where these units were withdrawn from. If the company already paid use tax on these inventory withdrawals in the home state, it brings up additional considerations, such as does the company get credit for the tax already paid in the home state.

It most cases, it will not be worth a state auditor's time to pursue a company for unpaid use tax on a small number of annual inventory withdrawals. However, if the items withdrawn are steel rods valued at $10K each, then use tax on a small number of units may be worth pursuing because the tax obligation becomes high value.

Whether a state will pursue a manufacturer and or distributor, is a function of either or both of the following:

1. Sale value
2. Number of distributors/units

Because an inaccurate process may result in unpaid taxes and associated fees and penalties that add up across a number of years, it's important that manufacturers and distributors understand whether or not the business is properly calculating tax on inventory withdrawals. Also, be sure to look at your business to see if this could be an issue in the future.

"In our experience, many companies pay audit penalties not because they feel they were in the wrong but because they do not have the resources and time to prepare proper and thorough audit defense."

— Cory Barwick

How to Protect Your Business

Poorly managing use tax may have serious consequences, including audits with costly penalties, fees and interest. Because of these possible consequences, the increased enforcement of use tax by state auditors and the increasingly complicated and overlapping tax regulations, many savvy manufacturers and distributors are conducting deep assessments of their sales and use tax processes. These are used to determine if the company is able to calculate tax both accurately and efficiently.

When carrying out these assessments, many manufacturers are finding that there is much room for improvement. These savvy companies are seeing the need to invest in automated sales and use tax software in order to protect the business from paying penalties/fees or overpaying taxes, so the business can:

- Operate more profitably
- Position itself competitively now and into the future
- Meet its business objectives

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