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The Complexities of Sales Tax

With special consideration for the leasing, technology, manufacturing, and construction industries.

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Summary

Sales tax compliance is complex, there's no doubting it. While many hoped that the Supreme Court decision in South Dakota v. Wayfair would make things more clear, it did quite the opposite. Not only do companies still have to consider their potential physical presence in states, they now also have to consider their economic presence.

As a result of the Wayfair decision over two years ago, sales tax obligations have impacted more and more businesses across all industries, many who previously had no sales tax obligation.

Introduction to Nexus

A business's sales and use tax obligation begins with where it has nexus. Nexus is a connection between a company or a person and a taxing authority or jurisdiction. Historically, sales tax nexus was defined as a substantial physical presence. Since the U.S. Supreme Court ruling in South Dakota v. Wayfair, sales tax nexus can also be defined as an economic presence, it was the largest change in sales tax in over 50 years. Economic nexus is determined on a state-by-state basis and is calculated by the number of transactions or sales made in a state or jurisdiction.

Today, a business needs to evaluate whether they have either a physical presence or an economic presence in each state. All states have adopted some form of economic nexus that requires an out-of-state business to collect and remit sales tax.

These obligations potentially affect many industries, and may mean that a company does not have any physical presence but if their sales revenue and/or number of sales transactions exceeds a certain threshold over a one year period of time, then the state will assert sales tax nexus and require the business to collect the applicable sales tax.

Sales tax nexus should also be considered at the legal entity level and will affect all sales channels. For example, you may have sales tax nexus and follow applicable sales tax rules for your core business, whose sales channel is traditional sales representatives. If you also have an ecommerce line of business within the same legal entity as your core business, then your online sales are subject to the same sales tax rules as your traditional sales.

(For additional perspective and discussion on physical and economic nexus, please refer to our guide here.)

In this eBook, we'll now look at some of the nuances and sales tax complexities in four industries: manufacturing, construction, leasing and technology.

Manufacturing

"Manufacturing" for sales tax purposes is often defined as a physical application of materials and labor to change the characteristics of tangible personal property. Makes sense, but does that mean your business is exempt? Not so fast. Every state has nuances on how sales tax applies to the manufacturing process and the various equipment and materials that are used and consumed. Many gray areas can create significant exposure, or savings, for your business.

Being strategic in how you purchase items and the way you design the manufacturing process can affect your sales tax expense (some tax exemptions are more clear than others). "Consumables," for example, are materials purchased and used ("consumed") during manufacturing but don't attach themselves directly to the tangible property that leaves your manufacturing facility. Examples might include gases or chemicals used to change the physical nature of tangible property during manufacturing. Depending on the state where you have your manufacturing facility, these products could be taxed differently.

Raw materials are different than consumables and can also be exempt – depending on their use and the state. Let's say you buy materials in bulk, exempt from sales tax, that have a predominant use in your manufacturing process. You place these materials in inventory but pull from that inventory to build items for use in the manufacturing facility or otherwise use the materials in a non-manufacturing capacity. At that point the inventory can be deemed mixed-use inventory and its sales tax exemption might be in question.

Raw materials can also come in the form of packaging and labelling. A lot of states either include these items in the definition of raw materials or have a specific exemption for packaging and similar products.

Machinery is an easier call – slightly. Generally, sales tax exemptions apply to the machinery and equipment that directly impact the manufacture of the tangible personal property. But again, there are variables. Depending on your type of manufacturing, equipment ancillary from the manufacturing process itself could qualify.

For example, if your raw materials must be kept at a certain temperature or agitated constantly, special equipment may be required. Some states expand their exemption to include this type of machinery. (Some states give complete exemption, some a discounted tax rate.)

Other examples of equipment with exemptions in many states:

- Equipment to move your product during the process (a forklift, for instance). Some states exclude such equipment from exemption if it moves raw materials from storage to the beginning of the process. If you split the use of such equipment between exempt and non-exempt activities, most states will say your predominant use of the equipment is the guiding rule.

- Controls, piping, conveyors and other devices allowing for the operation of your manufacturing process.

- Quality control, research-and-development equipment and, in some cases, computers and related equipment.

- Utilities such as water (when used as a coolant, for example) and chemicals added to the water to facilitate cooling. Some states allow percentage deductions for utilities, such as electricity directly involved in manufacturing.

- Other items possibly qualifying for exemption include hand tools, lubricants, and metered fuels.

Documenting exactly how and when you use purchased materials and equipment can go help minimize your tax exposure.

Sales tax is complex for all industries, but what seems simple for manufacturing, may be more complex than you realize. Be sure to understand the rules associated with the states in which you have nexus and monitor them regularly. If you need additional help, working with a sales tax expert can be extremely beneficial so you aren't left figuring out the complexities on your own.

(Check out our webinar on sales tax complexities in the manufacturing industry.)

Construction

Manufacturing isn't the only specialized industry with sales tax complexities. For instance, if you're a construction contractor (especially if you're engaged in contracts in different states) you have to evaluate your sales tax responsibilities in each state where you have customers.

Generally, a business that considers themselves in the construction industry is performing a service and most services are excluded from sales and use tax. So you might think you have nothing to worry about from a sales and use tax perspective. That might be true in some states, but different states have different rules when it comes to construction services. Here are some of the complications you could face.

1. Real Property Improvement vs. the Sale and Installation of Tangible Personal Property

Most states have general guidelines regarding sales tax requirements for contractors, and they hinge on the definitions of real property improvement (RPI) versus the sale and installation of tangible personal property (TPP). The definition is important as each type of transaction will potentially have different sales and use tax obligations.

2. Understanding Tax Obligations: Matter of State, Job, and Client

Most states think of the contractor as the end user of the property (i.e., supplies and materials) bought to perform services. In those states, those services are not subject to sales tax, but the supplies and materials used in performance of the service are.

There are exceptions, though. The state of Washington considers a general contractor essentially a retailer. So instead of paying tax on materials at purchase, contractors buy the materials exempt from sales tax and then charge tax on their gross receipts from contracting.

One possible problem: if you buy a project's materials in one state and pay the appropriate sales tax, but then utilize these materials in a different state. Even though you have paid sales tax on the materials at the time of purchase, there may be additional use tax due depending on the state in which you utilized the materials. There is reciprocity amongst many of the states, but that is typically only at the state level and not so much at the local level.

3. Working with Tax-Exempt Entities

Contracts with tax-exempt entities, such as government entities or nonprofits, can be challenging. Most states allow you to purchase materials for those contracts exempt from tax (aka, a "pass-through exemption") by using a special form from the state. Other states have no pass-through exemption but treat the contactor as making direct, tax-exempt purchases on behalf of the entity.

And a few states, such as South Dakota, mandate that the contractor must accrue and remit use tax on the fair market value or purchase price of the materials, which are deemed "property" of the entity itself.

(See our webinar on sales tax complexities for the construction industry.)

Leasing

Some sales tax concepts for the leasing industry are quite simple while others are more complicated. A lessor, by definition, owns property and leases the use of said property to a lessee. This property that is owned by the lessor creates sales tax nexus wherever the equipment resides – a generally straightforward concept.

The taxability of the lease itself and certain related services is much more complex.

'Rental' versus 'lease'. Most tax laws describe a "rental" agreement as a commitment of 30 days or less. A "lease" is generally longer, typically 12 months or more in most states. (Short-term or rental agreements, in some jurisdictions, carry a higher tax rate.) Other important definitions are "real property" and TPP. In most states, the lease of real property long-term is generally not a taxable event. TPP is generally taxable whether through sales, lease or rental.

'Operating' versus 'finance'. Operating and finance (capital) leases also have different tax treatment by tax authorities.

For sales and use tax purposes, an operating lease is for temporary use of an item with no intention to transfer ownership of that property at the end of the term of the lease. In most states, sales tax is imposed on the stream of payments for an operating lease, and sales tax is imposed on the upfront purchase price for a capital lease. On an operating lease, responsible parties can charge sales tax up front if the tax initially charged is the same as what would be due over the course of the arrangement.

A finance lease is considered a sale with tax imposed on that sale, though payment of the sales tax can be somewhat built into the lease terms. Note that finance charges in a finance lease are generally not subject to sales tax.

The structure of the contract for the finance lease needs to include that the intent of ownership will remain with the lessee. This means either that the terms of lease are such that the full value of the item is paid for during the course of the lease arrangement or, if it has a residual value at the end of the lease, there's a nominal purchase price.

Ancillary, or vertical, services in leasing can include such services as support, maintenance and delivery – and they can all come with their own sales and use tax wrinkles. Delivery can be taxable or exempt depending on the state and type of product delivered. And with operating leases, many items become part of the gross receipts and are taxable.

Among other arrangements to consider in terms of sales tax:

Set up and dismantling. This comes up often when leasing such items as stages, lights, sound systems and other equipment that require technical set-up and delivery. This is generally going to be taxable – but if a company sold a stage, in some states the sale would be taxable but the installation service, if separately stated, would not be.

Rental/lease with operator. Let's say a company is providing the above lighting equipment for a concert but the equipment is so sophisticated that the leasing company must also provide an operator. In most states, that rental or lease with an operator is not subject to sales tax but instead is essentially considered a professional service.

Maintenance. Leased, sophisticated equipment must frequently be maintained in a certain way. Often too, the lessor wants to be involved in that maintenance and requires that the lessee contract for ongoing maintenance. In an operating lease, this again is considered part of the gross receipts and will likely be taxable.

Tax Situs. Tax situs is defined as the location in which a taxing event occurs. In situations where property is in a fixed location, the tax situs is quite simple. In some situations, the property may not be in a fixed location. Multi-state usage happens with contractors using large, industrial equipment leased long-term. These contractors may move the equipment state to state depending on the project. (Note: equipment that can be driven without a trailer on the open road usually means a transition from a sales tax event to one of a motor vehicle tax.)

The lessor might not know where the equipment is being used for a given time and so may not be able to apply the appropriate sales tax at any given time. The tax responsibility can shift in some such cases to the lessee.

(Check out our webinar on sales tax complexities within the leasing industry.)

Technology

Technology is a large piece of many industries, including the three previously discussed. When it comes to sales tax, tech companies, particularly Software-as-a-Service (SaaS), have always had challenges. But with the proliferation of SaaS as a delivery mechanism and the introduction of economic nexus, the sales tax landscape has become exponentially more complex.

Tech companies – especially those dealing in downloads of software and SaaS delivery – can protect themselves if they understand key terms and processes. SaaS is currently the predominant delivery method for tech/software companies (especially newer companies), followed by electronically downloaded software. Very few companies continue to deliver software via a tangible CD. Each delivery method can have a different sales tax treatment in each of the states. As software companies continue to change their delivery mechanism, the states must adapt their statutes. Software delivered via CD will have the most states that tax it, while electronically downloaded software will have fewer states, and SaaS will have the least number of states that tax it. (Although SaaS is currently taxable for sales tax purposes in roughly half the states.)

A few examples:

- Connecticut taxes SaaS as does Texas. However, Connecticut applies a reduced 1% tax rate on SaaS provided it is sold to a business; otherwise the standard sales tax rate applies. Texas exempts 20% of the charge for SaaS.
- New Jersey doesn't tax SaaS but does tax sales of downloaded software unless the software is for business use.
- South Carolina exempts sales of downloaded software but taxes SaaS.
- Illinois doesn't tax SaaS but does tax sales of downloaded software. Separately, the city of Chicago taxes SaaS.

Often when software is sold, regardless of the delivery mechanism, ancillary products and services are sold with it: hardware, customization, implementation, maintenance contracts and so on. As in leasing, ancillary products and services have their own unique tax treatment. Hardware, for example, falls into the category tangible personal property, and all states with a sales tax treat the sale of hardware as a taxable event.

Among others:

Customization and implementation. Generally, services such as customization and implementation when separately stated on an invoice will be exempt from sales tax.

Software maintenance. Historically, hardware or downloaded software can come with a maintenance agreement. This agreement could be mandatory or optional – and there are differences on how the two might be treated for sales and use tax purposes. Generally, the mandatory support and maintenance will follow the tax treatment of the original software while optional support and maintenance can have a different tax treatment.

Tax situs can affect both nexus determination and the taxability determination for SaaS businesses. For example, a company may have a customer based in New York (which taxes SaaS), but the customer accesses the software from all over the country – not all of the users are located in New York. The proper way to look at this from a sales tax perspective is to consider where the benefit of use is received. In this example, the benefit of use is received where the users are located.

This does, however, create several questions:

1. Do we really know from where all a customer's users are accessing the software?

2. Do we have nexus in all the states from where a customer's users are accessing the software?

3. What is the tax treatment in each of the states from where a customer's users are accessing the software?

This creates a complex taxing situation – as well as a complex and unclear invoice to the customer. "Why are you charging me tax for this user but not this user?"

As a result of this level of complexity, many businesses choose to apply tax based on the business bill to address. Some states like Washington, which taxes SaaS, have a multiple points of use exemption. In this situation, the customer may present to you an exemption certificate whereby they are attesting to certain users being outside the state of Washington and therefore relieving you of the obligation to charge sales tax on the entire invoice.

(To learn more, check our webinar on sales tax complexities in the technology industry.)

How to Manage the Complexities

Understanding you have nexus is only part of the battle. You must also understand the unique taxing rules from state to state. Managing sales tax compliance is an on-going process. For most businesses there are three options in managing compliance going forward:

- Attempt to manage everything in-house
- Outsource sales tax compliance
- Do nothing and roll the dice

There are pros and cons to each of these options and not a decision businesses take lightly. From over-burdening staff, to receiving an audit notice and being caught with years of un-collected sales tax, it's an important decision.

With even more changes coming in 2021 (and beyond) from many of the 10,000+ taxing jurisdictions, sales tax compliance is clearly a specialty and not getting any easier. If you're looking to reduce costs, increase efficiencies and minimize the substantial risk of noncompliance, reach out to a sales tax expert.

TaxConnex has assisted companies in many industries to alleviate the burden of sales tax. We are experts when it comes to navigating tax regulations and managing your filings. Contact us to learn more about how TaxConnex can take sales tax off your plate entirely.

About TaxConnex™

TaxConnex ™ is how businesses finally get sales tax off their plate – no matter how many states they're in or how often regulations change. Sales tax is more complicated than ever, especially in a post-Wayfair world. Yet the providers who claim to simplify sales tax often still leave the hardest parts – and the liability – up to you. When you work with TaxConnex, it's all on us. This means you get all the know-how, all the backup, and none of the risk. It's only possible because of our proprietary platform and network of sales tax experts. That's why large to mid-sized corporations, including accounting firms, turn to TaxConnex.

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