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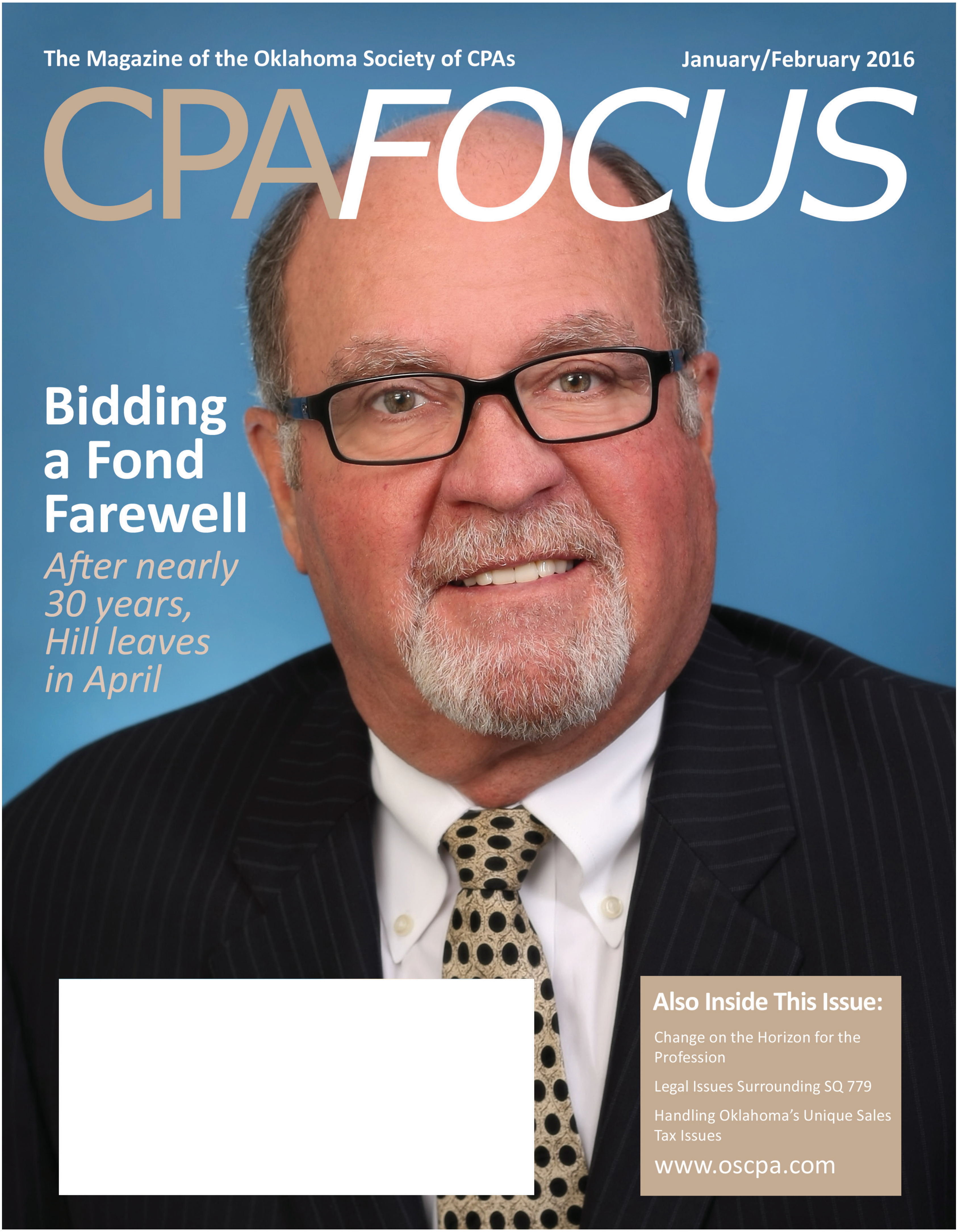
CPA FOCUS



Bidding a Fond Farewell

After nearly 30 years, Hill leaves in April

Also Inside This Issue:

Change on the Horizon for the Profession

Legal Issues Surrounding SQ 779

Handling Oklahoma's Unique Sales Tax Issues

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Brent Watson, CPA, is a state and local tax manager for Grant Thornton LLP in Tulsa, Okla. An OSCPA member for seven years, he has served on the OSCPA's Taxation and Continuing Professional Education Committees, and is now serving on the Oil & Gas Committee. His 25 years of practice in state and local taxes has included sales and use tax, property tax and state incentive programs. His expertise is concentrated in the manufacturing, oil and gas, multi-state contracting and retailing industries.

Oklahoma's Unique Sales Tax Issues & How to Handle Them

By Brent Watson, CPA

States' rights are a major foundation upon which our nation was founded. The Tenth Amendment to the U.S. Constitution states that, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."

Because the Constitution does not give the federal government jurisdiction over sales and use taxes, each state determines the laws for that state. The evolution is a patchwork of laws that are inconsistent, confusing and a costly burden for multi-state businesses. This article explores some of Oklahoma's unique sales tax issues and how to handle them.

I. Qualifying for and Using the Manufacturing Exemption

a. Qualifying for the Manufacturing Exemption: Oklahoma is one of the few states that require taxpayers to obtain special certification to make exempt purchases for usage in manufacturing operations. Oklahoma's exemption certification is referred to as a manufacturer's sales tax exemption permit (MSEP). Taxpayers must apply through the Oklahoma Tax Commission ("OTC") by completing Packet M.

Manufacturing is defined in Oklahoma Statute 68 §1352.14: "Manufacturing" means and includes 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. In the past, the OTC has denied MSEP permits to many manufacturers who produced customized products. MSEPs must be renewed every three years. Consequently, vendors who accept MSEP exemption certificates from customers should be aware that these exemption certificates expire at the date shown on the MSEP for each manufacturer.

b. Using the Manufacturing Exemption: Oklahoma provides one of the broadest sales tax exemptions in the nation for manufacturers. 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-OAC-710:65-13-150.1 and Okla. Stat. 68 §1359[1]). The exemption applies to materials used beginning with the place materials enter a manufacturing site and ends with the place materials leave the manufacturing site. It applies to items that are taxable in most other states, including warehouse racks, yard tractors, prototypes, inventory tracking materials and machinery, energy used in the manufacturing process, maintenance tools, employees' safety apparel and materials that are consumed during production (such as welding gases, lubricants, catalysts, reagents, patterns, boiler chemicals, etc.). In contrast, all of Oklahoma's neighboring states apply tax to many of these types of purchases, either at a full tax rate or based on reduced rates or partial exemptions. Oklahoma's manufacturing exemption does not extend to oil and gas production, though it does apply to certain types of gas plants, and some mining operations (Okla. Stat. 68 §1359[13]).

II. Audits, Penalties and Interest, and Voluntary Disclosures

a. Audits: Audits in Oklahoma have been especially challenging because the Tax Commission's audit section has historically been understaffed and has suffered from turnover. Consequently, it is common to have changes in auditors assigned to the audit before it is completed and less experienced auditors may not understand the industry they are auditing.

Additionally, the OTC has not used statistical sampling for audits but typically relies on block sampling (selecting sample months from an audit period to extrapolate to the entire audit period). Block sampling often produces skewed results because of changes in business practice, seasonality or just outlier types of abnormal transactions that may occur. Therefore, taxpayers should carefully consider before signing sampling agreements, as there is no requirement to do so. Before signing an agreement, orally agree in principal with an auditor to try block sampling while reserving the opportunity to challenge results. If a sampling agreement is signed before this point, the ability to challenge the audit projection may be lost.

b. Penalties and Interest: While all states impose interest on tax deficiencies, Oklahoma imposes a punitive interest rate of 15 percent, the second highest in the nation. Interest is seldom waived except when a voluntary disclosure agreement is in place. Oklahoma penalties are similar to most states and are often waived when requested if reasonable basis for a waiver is provided.

c. Voluntary Disclosure Agreements (VDA): A VDA can be effective for taxpayers who owe taxes that need to be reported for prior periods, such as when a taxpayer determines he or she had nexus and should register for and begin to collect sales taxes as well as remit taxes that should have been collected for prior periods. A third party should apply on a no-name basis on behalf of the taxpayer to protect the applicant's identity. Penalties, as well as half of the interest, are waived, curbing the Statute of Limitations to the regular three-year period. Unfortunately, unlike most states, Oklahoma does not allow permit holders who discover underpaid taxes to pay them under a VDA. If sales or other trust types of tax were collected but not remitted, a VDA can be utilized, but no reduction of interest is allowed.

III. Sales of Business Assets; Lack of Isolated Sales Exemption

Unlike most states, Oklahoma does not provide an exemption for isolated or occasional sales, such as the sale of non-inventory business assets like equipment or furniture and fixtures. A purchaser can provide an exemption certificate if he or she holds the appropriate type of sales tax registration or an exemption letter. For example, a taxpayer who is purchasing a set of manufacturing assets should apply for an MSEP before making the purchase. Failure to apply for the MSEP beforehand has resulted in loss of the ability to claim the exemption in the past, and this can be a costly mistake for the buyer. Similarly, inventory purchasers from an existing business can make the purchase on an exempt resale basis, but they should obtain a sales tax permit before the transaction so a valid exemption permit can be issued.

A limited exemption exists (Okla. Stat. 68 §1360) for formation of a new corporation or partnership, upon the liquidation of a corporation and certain other business reorganizations. These exemptions are not clearly written and application of them to specific transactions must be done carefully. When related entities have intercompany transfers of assets (for example oil and gas operators transferring pipe between entities), tax is due upon that non-common ownership interest in the related entities. For example, if Seller Company has partners 1, 2, 3 and 4, all having 25 percent ownership, transfers pipe to Buyer Company, which has partners 1,2,3 and 5, all having 25 percent ownership, tax is due on the 25 percent ownership represented by the new, non-common partner.

When oil and gas operators sell interest in oil and gas wells, they are required to file a Change in Operator document (Form OCC 320) with the Oklahoma Corporation Commission (OCC). The OCC will later share this information with the OTC, putting the OTC on notice that a sales type transaction has occurred, and thus the need to report and pay tax may have occurred. These transactions are generally reported by filing a Casual Sales Tax return (STS 20015). If a seller fails to file the STS 20015, the OTC will eventually contact the seller and/or buyer looking for the tax on the tangible personal property transferred.

Also, retailers (including restaurateurs) who purchase substantially all of the assets from a previous owner may be forced to pay outstanding sales tax liability from the prior owner of the assets before being issued a sales tax permit. Buyers need to make sure the former owner has paid all taxes and should request a tax clearance letter. They should also include protection clauses in the purchase agreement to cover such tax liabilities.

IV. Contractors – Pass-Through Exemptions

Contractors face special problems because of the nature of their business. Because contractors transform personal property into real property, they are normally seen as the consumer of the incorporated personal property, and by default, owe sales taxes on their purchases of materials. However, Oklahoma law includes many special provisions for some types of exempt customers (including manufacturers, some state and local governmental agencies and churches) that allow the customer's exempt status to pass through (subrogate) to the contractor for the exempt purchase of materials. Additionally, for a few specific types of exempt taxpayers (including agricultural permit holders, colleges and rural electrics among others), the contractor can even purchase consumable materials used in the project on an exempt basis.

Generally, OAC 710:65-7-13(c) requires the vendor to obtain documentation from the contractor, including a copy of the exemption letter or card issued to the exempt entity, which the contractor has contracted, and documentation indicating the contractual relationship between the contractor and the entity. Contractors should be aware that specific exemptions apply to specific types of exempt customers. Sales to contractors who are working for the federal government are not generally exempt, unless the government is the purchaser of the supplies, possibly by appointing the contractor as its purchasing agent.

Contractors also face the challenge of inconsistent treatment of materials purchased when the materials are received in one state and used in another where they may have been exempt. For example, if materials are purchased in Oklahoma from an Oklahoma vendor, that vendor will be required to collect sales tax from the contractor regardless of situations where the materials would have been non-taxable if purchased in the state in which the materials are installed. Below are some possible solutions to this problem.

V. Temporary Storage for Usage in Other States – Possible Multiple Taxation

Similar to the dilemma facing multi-state contractors, retailers and other companies that

(CPE cont. 12)

(CPE from 11)

purchase materials from Oklahoma vendors that are then temporarily stored pending usage in other states are likely to encounter problems. An example would be a retailer who receives fixtures or equipment at an Oklahoma warehouse, who then later ships the items to stores outside of Oklahoma. Oklahoma vendors are required to collect sales tax because no exemption from sales tax exists based on the purchaser's usage in another state. According to Okla. Stat. 68 §1402, unless the taxpayer holds a direct payment permit, the purchaser will also be required to accrue use tax. Once the goods are removed for usage in another state, a credit can be taken against use tax liabilities.

The states to which these goods are later shipped for usage will impose tax on materials used in the business. Normally, a second state will allow a credit for sales or use tax that was previously paid because it was legally imposed in another state. Because the use tax due on temporarily stored goods is refundable by Oklahoma, destination states have asserted that the tax credit would not apply because it was not legally imposed. This can result in doubled taxation.

One possible solution to this dilemma is for a contractor or multi-state retailer to utilize a purchase company to make purchases for usage out of state on a tax free resale basis. The procurement company would then invoice the sales tax to the operating company when the goods are withdrawn from storage and shipped to the destination state.

Another solution is to utilize a direct payment permit.

VI. Understand Advantages and Disadvantages of Direct Payment Permits

- **Advantages of Direct Payment Permits:**
  A direct payment permit is a special type of sales tax permit that allows the purchaser to make tax-free purchases in exchange for accruing tax on taxable sales and remitting it directly to the state. Direct Payment Permits offer many advantages to holders, including:

  o Allows the purchaser, such as a manufacturer, to be in full control of accrual of the tax based on usage of the goods;

  o Allows a purchaser who purchases goods destined for usage in other states to avoid the requirement to accrue use tax on purchases, and to apply for a refund when shipped to other states. This is based on a 2012 law change to 68 O.S. Sec. 1364.1. The statute now states no sales or use tax is due from a direct pay permit holder with respect to tangible personal property intended exclusively for use in states other than Oklahoma, but is stored in Oklahoma pending shipment to other states or is temporarily retained in Oklahoma for purposes of fabrication, repair, testing, alteration, maintenance or other service; and

  o Direct payment permits may also be helpful in accruing the correct and sometimes lower local taxes where items are used.

- **Disadvantages of Direct Payment Permits:**
  A direct payment permit does come with disadvantages:

  o They are subjected to regular sales tax audits, and

  o A reliable system must be in place to determine which purchases are taxable, and to accrue and pay the taxes due. Failure to correctly accrue and pay tax could result in significant liabilities. Like all states, Oklahoma has unique sales tax laws that can greatly impact businesses. By recognizing these critical issues at a high level, you can help your business or your clients' businesses maximize savings and avoid expensive exposure issues. Clients often believe their accountants are advising them on all tax-related matters, whether or not such services are contemplated in engagement letters. Therefore, CPAs can provide a very valuable benefit to their clients by advising them of these issues.

CPE Self-Study Section: Earn CPE credit for reading article on pages 10-12.

Earn one hour of CPE credit by reading the preceding CPE article and completing the provided self-study exam. Mail in the completed exam by **March 1, 2016**, to the OSCPA CPE Department for grading. If you receive a score of 70% or higher, you will be issued a certificate for one hour of CPE credit, dated as of when the test arrives in the OSCPA office. If you score below a 70%, you will be notified of your score and may be allowed to retake the exam. The answers for this exam will be printed in the next issue of the CPA*FOCUS*.

Self-Study CPE Details

Interest Area: Taxation

Designed for: CPAs in public accounting and industry tax departments

Objective: To provide an overview of Oklahoma's distinctive sales tax laws

Level: Intermediate

Prerequisite: None

Advanced Preparation: None

Recommended CPE Credit: 1 hour

Note: CPE credit is available to OSCPA members only.

MUST BE COMPLETED AND SUBMITTED BY MARCH 1, 2016, TO QUALIFY.

Answers for CPE Self-Study from the November-December 2015 issue: 1-D, 2-A, 3-A, 4-D, 5-A

Oklahoma's Unique Sales Tax Issues and How to Handle Them – CPE Exam *(For OSCPA members ONLY; please circle your answers.)*

1. Oklahoma's sales tax manufacturing exemption allows manufacturers to make tax-free purchases of which of the following?

a. Manufacturing machinery and repair parts.
b. Utilities consumed in manufacturing.
c. Consumables, utilities and manufacturing machinery and repair parts used in manufacturing.
d. Safety apparel provided to employees for usage in the manufacturing process.
e. All of the above.

2. Which of the statements is true regarding sampling methodology for sales and use tax audits?

a. The OTC regularly uses random statistical sampling to conduct audits.
b. Taxpayers are required by law to sign sampling agreements.
c. Block sampling involves selecting transactions from certain agreed upon periods to be treated as representative for an entire audit period.
d. Block sampling rarely produces non-representative results and is commonly accepted as a scientifically acceptable method.
e. Once a taxpayer signs a sampling agreement, they may elect to change the number of months included in the sample or elect to have a 100 percent audit.

3. Which of the following is not true regarding voluntary disclosure agreements (VDAs)?

a. It is advisable to use a third-party to file for a VDA on behalf of the taxpayer.
b. Collected but unremitted sales tax can be included in a VDA as long as the collector was not previously registered for sales tax.
c. VDAs result in full waiver of interest and penalties, and application of a three year look-back period.
d. A taxpayer who is registered for consumer's use tax discovers they have underpaid $10,000,000 in tax may not participate in a VDA to report and pay the liability

The information below pertains to question #4.

Business A sells manufacturing machinery as well as office furniture and fixtures to Business B. Business A is owned by Partner 1 (10 percent), Partner 2 (60 percent) and Partner 3 (30 percent). Partners 1 and 3 have the same ownership in Business B, but Partner 4 owns the remainder of that business. Business B is clearly a manufacturer, but has not yet obtained an MSEP.

4. Which of the following are true:

a. The entire transaction is taxable if Business B does not obtain an MSEP.
b. If Business B obtains an MSEP, and issues a copy of it to Business A, no tax will be due on the manufacturing equipment because of the manufacturing exemption.
c. Tax will be due on 60 percent of the value of the furniture and fixtures.
d. Both b and c are true.

5. Which is the least true regarding goods that an Oklahoma based company purchases for usage in another state?

a. Other states will allow a credit for Oklahoma use tax accrued for items that were temporarily stored in Oklahoma.
b. If the Oklahoma-based company has a direct payment permit, they are not required to accrue use tax when the goods are purchased.
c. Oklahoma sales tax must be paid to vendors even if the purchased goods are intended for usage out of state and would be exempt in the destination state.
d. Accrued Oklahoma use tax is refundable when the goods are actually transferred for usage in another state.

Participant Evaluation

Please use the following scale to complete the below evaluation: 5=strongly agree; 4=agree; 3=neutral; 2=disagree; 1=strongly disagree

1) The stated learning objectives were adequately met.	❍ 5	❍ 4	❍ 3	❍ 2	❍ 1
2) The authors conveyed a strong knowledge of the subject matter.	❍ 5	❍ 4	❍ 3	❍ 2	❍ 1
3) The article was timely and relevant.	❍ 5	❍ 4	❍ 3	❍ 2	❍ 1
4) The article and exam were well-suited to my background, education and experience.	❍ 5	❍ 4	❍ 3	❍ 2	❍ 1

My overall rating for the self-study program is: ❍ Excellent ❍ Very Good ❍ Average ❍ Fair ❍ Poor

It took me ____ hours and ____ minutes to read the article and complete the exam.

Name: ____________________ OSCPA Member No.: ____________ Firm/Company: ____________________

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Payment Information (choose one):

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After completing the exam above, please mail this page (photocopies accepted) along with your payment information to:

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