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Sales and use tax 101 – A basic level overview for accountants

By Brent Watson, CPA

Twenty-eight years ago, my supervisor, the tax director at a Fortune 500 manufacturer, asked me what I knew about sales tax, and I replied, “It’s at the bottom of my Walmart receipts.” You may have the same reply if you were asked this question today. However, sales tax has a vital impact on many businesses: proper handling of it can produce significant savings, while improper handling has resulted in business failures.

While sales taxes can seem confusing to anyone whose job is not to specialize in them, it would be helpful for any CPA to obtain a basic level of understanding in order to be familiar with major issues affecting their clients and/or employers.

What’s the difference between sales and use taxes?

Sales taxes are imposed on intrastate sales, normally by vendors who charge tax on invoices. (However, whenever stock is removed from tax exempt inventory for sale, this is also subject to sales tax.) In contrast, use taxes are imposed on interstate sales. Two types of use taxes exist: (1) consumer use tax is imposed on a purchaser who makes purchases from a seller who does not collect sales taxes (usually an out-of-state unregistered seller), and (2) vendor use taxes – for sellers who sell from one state remotely into the purchaser’s state.

Most audit assessments consist of either (1) failure of a seller to properly collect and remit sales taxes or produce valid exemption certificates to verify non-taxed sales, or (2) failure of purchasers to properly accrue and remit use taxes on taxable purchases that were untaxed by the seller.

On which transactions are these taxes imposed?

Sales taxes are imposed on the sale of tangible personal property generally. Unless an exemption applies to either the seller or the buyer, or because

of the type of item sold, tax is due. However, by contrast, tax is not generally imposed on services or sales of real or intangible property. Tax has been imposed on a few services in Oklahoma (including admissions, dues or fees for the privilege of use of athletic, recreational, amusement or entertainment facilities, lodging, utilities, telecommunications, parking and storage).

Transfers between related legal entities are transactions that could be subject to sales taxes, while transfers between divisions within an entity are not.

Temporary storage in Oklahoma

Purchases made for usage in another state but temporarily stored in Oklahoma are subject to sales tax or consumer’s use tax, but the use tax is refundable when the goods are taken out of state. However, holders of direct payment permits are not required to accrue tax on goods temporarily stored in Oklahoma but used in other states. Most states allow a credit for tax previously paid to another state for items later brought into their state. However, states have denied credit for Oklahoma use tax paid on goods that were temporarily stored in Oklahoma then later shipped into their state, on the grounds that the Oklahoma tax is refundable—even if it was never refunded. Their rationale is that the tax was not “legally imposed” because it was refundable.

Defaults, exclusions and exemptions

By default, the sale of tangible personal property is taxable. It is only non-taxable if an exemption applies to the sale.

Some of the major exemptions that commonly apply to taxation of sales of tangible personal property include:

- Resale exemption — This exemption applies to goods that are resold, including packaging materials. In order to claim the resale

exemption, the buyer must have a sales tax account. Out-of-state purchasers may supply their home state's account number for drop shipments the seller makes for them.

- **Manufacturing exemption** — Oklahoma's exemption for manufacturers is one of the most generous in the nation. It covers machinery and repair parts, consumables (such as welding gas, machine lubricants, safety apparel for employees, boiler chemicals, cutting fluid, ammonia, hydraulic fluid, catalysts, etc.), and utilities used in manufacturing at the manufacturing facility. Manufacturers must obtain a manufacturer's sales tax exemption permit (MSEP) from the Oklahoma Tax Commission (OTC) to claim the exemption.
- **Pollution control exemption** — This applies to manufacturing facilities permitted pursuant to the Oklahoma Hazardous Waste Management Act or approved by the Department of Environmental Quality (DEQ) for cleanup of contamination.
- **Agricultural exemption** — A purchaser must obtain an Agricultural Exemption Card from the OTC.
- **Specific non-profit purchasers' exemptions** — This applies to U.S. governmental entities, Oklahoma cities and counties, churches, public and private schools and colleges and specifically designated nonprofits. Please note, to qualify for exemption, these purchases must be paid for with funds of the exempt organization, and the organizations must supply a copy of their letter or card from the OTC certifying their exempt status.

There are many other specific exemptions, and vendors should consult OTC Packet D for the complete list.

In contrast, the sale of services by default is excluded from taxation unless the legislature has imposed tax on the particular type of service rendered. Similarly, sales

of real or intangible property are excluded from taxation.

Basis of the tax

Basis, or the amount that is subject to sales tax, is the total cost of the item, including all costs that are bundled together and not separately stated, such as freight-in, installations, warranties, etc. Credit for trade-ins does not reduce the taxable basis. A seller's discounts reduce the taxable amount, while manufacturer's coupons and rebates do not reduce the taxable amount. In contrast, separately-stated costs for installation, freight and taxes (like franchise taxes on utility bills) imposed on the consumer are excluded from the basis.

Doing business in other states

Operating a multi-state business is challenging, especially for sellers making sales remotely into other states. The concept of nexus (think connection) is what determines whether or not sellers must collect tax in a particular taxing jurisdiction. Traditionally, for a jurisdiction to consider nexus exists for a taxpayer to be subject to their tax law, it has been required that the taxpayer have at least more than a minimal amount of physical presence in a state. Nexus can be created by having payroll or property located in a state. Additionally, temporary presence for installations, repairs or even regular sales calls to create a market in a state constitutes nexus. This is true even if the person performing the service is a contract worker acting as an agent of the seller. Presently the concept of nexus requiring physical presence in a state is under full-scale attack by multiple states that have passed laws asserting nexus based solely on the number or value of sales into a state annually.

Sellers who discover they have nexus in additional states will need to register for a sales tax account in the affected state(s) and begin to collect and remit the taxes due in those states. However, this can be costly and complicated because of liability for prior periods brought into focus during the registration process. Most registration forms

ask when the first taxable sale into the state occurred or will occur, creating a "gotcha" situation for those who realize they should have been collecting and remitting tax for a while. Many states allow a voluntary disclosure agreement arrangement for taxpayers to disclose errors while receiving some relief in the provision of a limited look back period, waiver of penalty and, in some states, waiver of interest.

Sale of business assets

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. Purchasers who qualify for an exemption can supply exemption certificates showing they hold the appropriate type of sales tax registration or exemption letter. For example, a taxpayer who is purchasing manufacturing equipment should apply for an MSEP before making the purchase. Failure to apply for the MSEP beforehand has resulted in denial of the exemption by the OTC in the past, a costly result 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 resale exemption certificate can be issued. The tax is reported manually on a regular sales tax return, Form STS 20002, with a conspicuous writing of "ISOLATED SALE" written on the top of the form. However, oil and gas operators selling interest in oil and gas wells file Form STS 20015 instead. Recently, the OTC launched a major initiative to discover sales of business assets by looking for Form 4797 in corporate tax returns.

When oil and gas operators sell interest in oil and gas wells, they are required to file a change in operator document (Form OCC 1073) 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. The OTC will then inquire of the operator

(SALES cont. 29)

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about the reporting of sales tax.

Contractors

Contractors are deemed to be consumers of the personal property incorporated into the realty on which they work, and therefore owe sales taxes on their purchases of materials. However, Oklahoma law includes many special provisions for specific types of exempt customers (including some nonprofits, some state agencies, local governmental units, churches, agricultural permit holders, colleges and rural electricians among others) that allow the customer's exempt status to pass through (subrogate) to the contractor for the purchase of materials.

Generally, OAC 710:65-7-13(c) requires the vendor selling materials to a contractor claiming exempt status to obtain documentation including a copy of the exemption letter or card issued to the exempt entity which has engaged

the contractor, as well as documentation indicating the contractual relationship between the contractor and the entity. Sales to contractors who are working for the federal government are not generally exempt, unless the government is the purchaser of the supplies.

Contractors working in other states, especially Texas, New Mexico and Kansas, should be aware that sales tax laws affecting contractors in those states are fundamentally different than Oklahoma's sales tax law.

Duties of sellers

Sellers (except for a few non-profit organizations that are not required to collect sales taxes) must either collect sales tax or collect valid exemption certificates. The first objective for most auditors is to check exemption certificates—and if any are missing or invalid, audit liabilities can mount quickly. The saying that “an

ounce of prevention is worth a pound of cure” applies to exemption certificate management, too.

Sellers must have a basic familiarity with sales tax rules or they may fail to collect tax on certain charges on invoices, collect the wrong local taxes or they may accept invalid exemption certificates. Sellers who sell into many states or local jurisdictions may be advised to implement sales tax software for applying tax to invoices and reporting the tax.

Sales tax affects nearly all businesses in a significant way, making it important for accounting personnel to have at least a basic level of familiarity with these taxes. Understanding the concepts in this article should equip accountants to recognize major aspects of sales tax affecting businesses. 🏹

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Meet the OSCPA Staff:

Ashley Trattner, Communications Coordinator

Homegrown in OKC, Ashley loves to spend her time volunteering and giving back to her community. The University of Central Oklahoma graduate and Alpha Delta Pi Sorority alumna volunteers with the Ronald McDonald House Charities of Oklahoma City, the Girl Scouts of Western Oklahoma, PRSA-OKC, Ad2OKC and the Alpha Delta Pi Alumnae Association. “I also love spending time with my friends and spoiling my niece and nephews,” she added.



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