

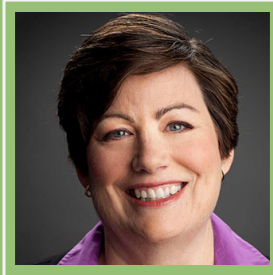
# The Great Exemption Adventure: Finding Them, Applying Them and Making Sure They Stick



On-Demand Webinar

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## ➤ Industry Exemptions

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### Manufacturing Exemption

- Many states offer an exemption for machinery and equipment used to manufacture items of tangible personal property for sale.
- “Manufacturing” definition varies by state
  - Statutes and regulations define the beginning and end point of the manufacturing process.
- Equipment definition can vary also

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## Manufacturing Exemption (cont.)

- Items often included in exemption
  - Machinery and equipment
  - Repair or replacement parts
  - Utilities used to power manufacturing equipment
  - Packaging supplies and equipment
  - Pollution control equipment

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## Manufacturing Exemption (cont.)

- Items often included in exemption (cont.)
  - R&D equipment
  - Computers used in manufacturing process
  - Leases of qualifying manufacturing equipment
  - Repair and services to qualifying manufacturing equipment
  - Other items necessary to manufacturing process

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## Manufacturing Exemption (cont.)

- Terms used in manufacturing exemptions
  - Equipment: The actual asset being used in production
  - Repair parts: Durable parts with a defined “useful life” to replace a part of the machinery or equipment.
  - Consumable supplies: Items that are dissipated or used up during the production process

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## Manufacturing Exemptions

- Some states grant their manufacturing exemption for predominate use equipment while others require exclusive use.
  - In making the determination for predominate use, the state determines whether 50% or more of the use of the machinery is in an exempt manner. If so, the entire item is exempt from tax. (e.g. Illinois)
  - In an exclusive use state, if any use of the equipment is in a taxable manner, the entire item is taxable. (e.g. Massachusetts)
  - Some states allow a partial exemption for the percentage of use in an exempt manner. (e.g. Indiana)

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## Manufacturing Exemptions (cont.)

- States also generally look to direct and indirect use of equipment to determine exemption.
- Most of the states that offer a manufacturing exemption require direct use for the exemption to apply. This generally requires that the machinery touches or has a direct impact on the item being produced for the exemption to apply.

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## Manufacturing Exemptions (cont.)

- A few states use an integrated plant theory
  - This concept doesn't require a direct test but rather whether the equipment is part of the integrated process necessary to complete manufacturing.
  - Machinery and equipment that are used in Kansas as an integral or essential part of an integrated production operation by a manufacturing or processing plant or facility where integrated production operations are conducted to manufacture or process tangible personal property to be ultimately sold at retail is exempt.

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## Sales for Resale

- All sales tax statutes contain a provision exempting purchases for resale
  - Hawaii does not allow a 100% exemption but rather a reduced rate
- Wholesale, Distributor, or Retailer purchases
  - The intermediary sales in the production process qualify for the resale exemption.

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## Sales for Resale (cont.)

- Items used in production of other goods
  - Raw materials and items that become a component part of the manufactured item for sale qualify for the resale exemption.
  - Packaging materials are included with the resale exemption
  - Items for the benefit of the seller (price tags) are usually excluded
- Service purchases
  - If property and services are incorporated in providing a taxable service, the property and services may qualify for the resale exemption.

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## Enterprise Zones

- Geographical areas set aside by states for special tax treatment
- Aimed at redeveloping languishing areas or drawing in new businesses
- Enterprise zone programs usually include income tax credits, property tax abatements, sales tax exemptions and payroll credits.
- Businesses need to meet certain criteria to qualify

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## Enterprise Zones

- New Jersey Enterprise Zone
  - Reduction of sales tax rate charged by certified sellers located in the zone to 3.3125%.
  - All sales have to be made from the seller's place of business in the enterprise zone.
    - Either the purchaser must accept delivery at the seller's place of business within an enterprise zone or the vendor must deliver the tangible personal property from its place of business within a zone, but delivery may be made to the purchaser outside of the zone.
  - The place of business may not be used primarily for the purpose of catalog or mail order sales.
  - Receipts from mail order, telephone, telex and similar transactions are subject to sales tax at the full rate when delivery is made to a location within the state
  - Reduced rate applies to purchases for businesses located within the zone

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## Enterprise Zones (cont.)

- Illinois Enterprise Zone Program
  - Businesses may be eligible for:
    - Exemption on retailers' occupation/use tax paid on building materials incorporated into real property in the zone and no qualification; does require an Enterprise Zone Building Materials Certificate issued by DOR
    - Expanded state sales tax exemptions on purchases of personal property used or consumed in the manufacturing process or in the operation of a pollution control facility
      - The exemptions include repair and replacement parts for equipment and machinery, fuels, material, and supplies for the maintenance, repair, or operation of the machinery and equipment.
    - Exemption on the state utility tax for electricity and natural gas
    - Exemption on the Illinois Commerce Commission's administrative charge and telecommunication excise tax

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## Enterprise Zone (cont.)

- Illinois Enterprise Zone Program
  - In order to qualify for the exemptions, a high impact business must
    - Make investments that create at least 200 full time Illinois jobs or retain at least 2,000 full time Illinois jobs; or
    - Make investments of at least \$40 million and retain at least 90% of jobs in place on date exemption granted
    - Be located in an enterprise zone and be certified by Dept of Commerce and Economic Opportunity
  - For a listing of the enterprise zones and additional info, visit <https://www2.illinois.gov/dceo/ExpandRelocate/Incentives/taxassistance/pages/enterprisezone.aspx>

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## High-Tech (Data Center) Exemption

- Found in states that are interested in attracting more “clean” industry and higher priced jobs.
- Typically applies to equipment (and often building materials) used to establish high tech service centers such as server farms or high-tech developers.
- Businesses typically need to meet certain criteria to qualify.

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## Enterprise Zone and High-Tech Exemptions

- These exemptions frequently contain minimum employment requirements for businesses to qualify.
- Minimum investment requirements are also frequently included.
- A specified dollar amount of purchases may be required in order for the exemption to apply.
- These exemptions may require certification or for the business to fall under certain North American Industry Classification System (NAICS) codes.

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## Enterprise Zone and High-Tech Exemptions (cont.)

- Georgia High Technology Company Exemption
  - The exemption applies to qualified purchases or leases of computer equipment for operational use in Georgia, if the amount being purchased or the fair market value of the computer equipment being leased **exceeds \$15 million in a calendar year.**
  - A High Technology Company **must be classified under certain relevant North American Industry Classification System (NAICS) codes.**

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## High-Tech (Data Center) Exemption (cont.)

- Texas High Tech Exemption
  - Texas has enacted a temporary sales and use tax exemption for certain tangible personal property used in data centers that meet certain capital investment and new employment requirements.
  - A data center may be certified if, on or after September 1, 2013, the qualifying owner, qualifying operator, or qualifying occupant, jointly or independently:
    - Creates at least 20 qualifying jobs in the county in which the data center is located, not including jobs moved from one county in this state to another county in this state; and
    - Makes or agrees to make a capital investment of at least \$200 million in that particular data center over a five-year period beginning on the date the data center is certified by the comptroller as a qualifying data center.

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## High-Tech (Data Center) Exemption (cont.)

- Texas High Tech Exemption (cont.)
  - The exemption covers tangible personal property that is necessary and essential to the operation of a qualified data center, which includes:
    - electricity;
    - an electrical system;
    - a cooling system;
    - an emergency generator;
    - hardware or a distributed mainframe computer or server;
    - a data storage device; network connectivity equipment;
    - a rack, cabinet, and raised floor system;
    - a peripheral component or system;
    - software;
    - a mechanical, electrical, or plumbing system that is necessary to operate any of the above TPP;
    - any other item of equipment or system necessary to operate any of the above TPP, including a fixture; and
    - a component part of any of the above TPP

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## Temporary Storage Exemptions

- Some states exclude, from their definition of use, property which is stored in the jurisdiction temporarily before shipment outside the jurisdiction.
- The temporary storage exemption applies to use tax, not sales tax. It applies for purchases made from out-of-state vendors.
- This exclusion is usually embedded in the state's definition and is not listed separately as an exemption. Therefore, you must look closely for this exclusion.

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## Temporary Storage Exemptions (cont.)

- In order for the temporary storage exemption to apply, usually there can be no use of the property prior to its shipment outside the state.
  - Some states allow repackaging, testing or other incidental use.
  - Other states will view these actions as use and subject the property to tax.
- States may attach other conditions to their temporary storage exemption
  - The state may specify a maximum amount of time the property can be stored in-state.
  - The purchaser may need to have intent to subsequently use the property outside the state
- If the temporary storage exemption is utilized, remember to self-assess the use tax on the value of the property in the ultimate use state.

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## Temporary Storage Exemptions (cont.)

- Missouri Temporary Storage Exemption
  - In general, the temporary storage of property in Missouri with the **intent to subsequently use the property outside the state** is not subject to use tax.
  - To be "for subsequent use outside the state" the purchaser must intend at the time the property is delivered to a Missouri location to subsequently use the property outside the state.
  - Generally, property kept or retained for **less than a year** may be considered temporary.
  - **Any use of the property**...other than temporarily keeping or retaining the property in this state for subsequent use outside the state, **constitutes a taxable use**.
  - The exclusion will not apply if **any further processing, fabrication or other modifications are performed on or to the property while in this state**.

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## ➤ Entity Exemptions

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### Exempt Organizations

- States are free to choose whether to tax non-profit organizations and charitable organizations.
- Many states tie exempt status to Section 501 of the Internal Revenue Code. Other states tie exempt status to the purpose of the organization.
- In some states, exemption at federal level means automatic exemption at state level
- Most states require an application by the organization to receive exempt status

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## Exempt Organizations

- Most states' non-profit exemptions only apply to purchases related to non-profit activity.
- The state may require the organization to have an exemption identification number in order to take advantage of the exemption.
- The state may require the organization to initially pay tax on its purchases then apply for a refund of tax paid.
  - Example: North Carolina

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## Exempt Organizations (cont.)

- Examples of potentially exempt organizations include schools, churches, non-profit hospitals, charitable organizations and PTAs
- Donations to charitable organizations are normally taxable under use tax to the donor
- Exempt entities operating in multiple states
  - May require separate registration
  - Exemption may not apply due to different laws

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## Exempt Organizations (cont.)

- Massachusetts
  - “The tangible personal property or services...is used in the conduct of such religious charitable, educational or scientific enterprise”
  - “Such corporation, foundation, organization or institution shall have first obtained a certification from the commissioner stating that it is entitled to such exemption”
- Illinois
  - To qualify for exemption, the charitable, religious, or educational organization **must have an active exemption identification number (E-number)** issued by the Department of Revenue.

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## Exempt Organizations (cont.)

- Some states don't have an exemption or are very limited
  - California does not provide a general exemption for sales or purchases of nonprofit organizations. However, there are certain exemptions and exclusions that may apply.
  - In Hawaii, sales to nonprofit organizations are generally subject to tax

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## Exempt Organizations (cont.)

- The following states do not generally exempt sales to nonprofit organizations:
  - Alabama
  - Arizona
  - Arkansas
  - California
  - Georgia (some entities qualify)
  - Hawaii
  - Idaho (some entities qualify)
  - Iowa (some entities qualify)
  - Louisiana (some entities qualify)
  - Maine (some entities qualify)
  - Mississippi (some entities qualify)
  - North Carolina (refund)
  - North Dakota (some entities qualify)
  - South Carolina
  - South Dakota
  - Washington
  - West Virginia (some entities qualify)

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## ➤ Sales to Government Agencies

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## Federal Government

- States are prohibited from taxing direct sales to the Federal Government under the principal of federal sovereignty and the supremacy clause of the U.S. Constitution.
- Some states specifically include an exemption for sales to the Federal Government. Others simply exempt sales that they are prohibited from taxing under the U.S. Constitution.

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## Federal Government (cont.)

- For all sales to the Federal Government, evidence of the sale must be retained in order to claim the exemption.
- To qualify for the exemption the sale must be made directly to the federal government and paid for by federal funds.
  - If there is a purchase order, it has to be for the government agency.
  - Selling to an individual who gets reimbursed won't qualify for the exemption
- Proof of the exemption is usually via purchase and payment documents rather than a traditional exemption certificate

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## Federal Government (cont.)

- Washington Rules
  - Purchases by federal gov't employees are only exempt if they are paid for by the federal government.
  - Federal gov't employees with an Individually Billed Account (IBA) must pay sales tax on purchases, even if they are reimbursed by the federal gov't.
  - In order to document exempt transactions with federal employees, vendors must keep the following information in addition to a receipt:
    - Federal employee's name
    - Federal government agency's name
    - Type of agency card (e.g., purchase card, fleet card, travel card, integrated card)
    - Expiration date of credit card
    - Name of credit card company
    - The sixth digit of the card (for Travel or Tax Advantage Travel cards)
  - (*Special Notice*, Washington Department of Revenue, 10/25/18)

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## State and Local Government

- The exemption for state and local governments is purely a product of the legislative process and of legislative grace. States are free to provide exemptions without question of discrimination against other non-governmental agencies.
- Some states provide exemptions to state governments of other states only if the other state provides a similar exemption.
- Not all states provide an exemption for sales to themselves.

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## State and Local Government (cont.)

- Illinois special rule
  - Only sales of tangible personal property invoiced directly to and paid by governmental bodies that possess active E-numbers are exempt. If an individual government employee provides a credit card to the retailer containing the name of the employee along with the name of the governmental body, tax will be due even if the employee provides an active E-number.

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## State and Local Government (cont.)

- North Carolina Special Rule
  - State or local governmental units are initially subject to tax on their purchases, but are entitled to apply for a refund.
  - To request a refund, a qualifying agency must file Form E-585 and include any documentation required by the Secretary of Revenue. A refund claim is due to be filed on an annual basis within six months after the end of the agency's fiscal year, and refunds applied for more than three years after the due date are barred.

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## Government Contractors

- Government contractors operate in a variety of roles which can impact the tax implications
- Tangible property contracts involve a contractor procuring or manufacturing tangible goods either for sale to or on behalf of an agency.
- Service contracts involve a contractor performing service typically on behalf of an agency which can involve the purchase of consumable supplies
- Real property contracts involve the development and construction of facilities that are the property of the agency.

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## Government Contractors (cont.)

- The tax treatment of purchases by government contractors remains a troublesome issue in many states.
- Since sales to the Federal government are constitutionally prohibited from taxation, many government contractors believe their purchases for Federal contracts should be exempt.
- Clearly, items that are incorporated into the TPP sold to the Federal government or any other entity would be exempt under the resale exemption. Disputes arise with government contractors' consumable purchases and contracts involving improvements to real property.

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## Government Contractors (cont.)

- Several states including California and Texas have court decisions ruling on the taxability of government contractors' purchases.
- The key concept in the various cases is whether title passes to the Federal government and/or the items are resold to the Federal government.

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## Government Contractors (cont.)

- California
  - The basis for exempting sales tax paid on indirect, consumable material and supplies consumed in the performance of contracts for the U.S. government stands on specific title vesting requirements of each contract and whether or not the U.S. government considers the costs allowable under the terms of the contract.
  - In *Aerospace Corporation v. State Board of Equalization*, 218 Cal. App. 3d 1300 (1990), the Court of Appeals held that title provisions contained in underlying cost reimbursement and fixed price contracts with the U.S. government resulted in a sale for resale of indirect (overhead) materials prior to use by the contractor.

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## Government Contractors (cont.)

- Texas
  - In *Texas Court of Appeals, Third District, Strayhorn v. Ratheon E-Systems, Inc.*, (2003), the Court of Appeals determined indirect (overhead) costs charged to federal government contracts were not taxable as they are sales for resale. The Comptroller felt the sale for resale exemption passed “control and use” rather than title but the court pointed out that a sale includes a transfer of title and/or possession.

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## ➤ Exemption Documentation

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## Exemption Documentation

- Understanding the rules in each jurisdiction is important
  - Each state may have specific guidelines for the type of certificate it will allow. Not all will accept the generic or multi state forms for non profit/government exemptions
  - 38 states accept the Uniform Multijurisdiction Exemption Certificate.
    - <http://www.mtc.gov/Resources/Uniform-Sales-Use-Tax-Exemption-Certificate>
    - Some have their own stipulations along with the uniform certificate.
  - The Streamlined Sales Tax (SST) Exemption Certificate is valid in member states
    - <https://www.streamlinedsalestax.org/Shared-Pages/exemptions>

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## Exemption Documentation (cont.)

- The types and number of exemption certificates that a state provides can vary widely.
  - Texas has one generic exemption certificate (Form 01-339) that can be used to claim most exemptions in the state.
  - New York has many different exemption certificates, such as:
    - ST-120 Resale Certificate
    - ST-120.1 Contractor Exempt Purchase Certificate
    - ST-121 Exempt Use Certificate
    - ST-121.2 Exempt Certificate for Purchases of Promotional Materials
    - And more

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## Exemption Documentation (cont.)

- Documentation
  - Applicable Jurisdiction
  - Blanket vs. Single
  - Purchase Order Certificate
  - Good Faith
  - Paper vs. Imaged
  - Electronic Certificate
  - Registration/Exemption Number
  - Renewal Period/Expiration Date

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## Exemption Documentation (cont.)

- It is the seller's duty to maintain current records of exemption certificates
  - Exemption certificate must be held until a new one is issued
  - Expired or updated certificates should be maintained until the period is closed for audit
- In Seller Privilege States (e.g. California, Arizona), the seller is primarily liable for the tax. If the purchaser didn't issue a certificate and the supplier didn't charge tax and it's an in-state supplier, the purchaser doesn't owe use tax.

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## Exemption Certificate - What's Required?

- Name & address of seller
- Name & address of purchaser
- Registration/Exemption number of purchaser
- Description of property purchased
- Reason for exemption
- Indemnification statement
- Date & signature of purchaser

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## Exemption Certificate Renewal Periods

- Renewal periods for exemption certificates vary by state and type of exemption
  - Some states' exemption certificates do not expire.
  - Other states' certificates expire within a set period of time, frequently 3-5 years.
  - It is recommended that sellers update all certificates that don't otherwise expire every 3-5 years.
  - Retain all prior certificates that could be required under audit.

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## Resale Certificate

- Signed document which indicates that the purchaser intends to resell the goods. It is usually provided by a retailer to a wholesale dealer.
- Usually provided as “blanket” form. This means that the resale certificate applies to all items purchased from the vendor.
- Some states require their own specific certificate. Other states will accept the Multi-Jurisdictional Exemption Certificate or the Streamlined Sales Tax Exemption Certificate. Still others will allow a statement of resale on the purchase order.
- Some resale certificates expire. Update regularly.

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## Resale Certificate (cont.)

- Resale certificates expire in the following states:
  - Arizona
  - Connecticut
  - District of Columbia
  - Florida – exception for continuing business
  - Iowa
  - Louisiana
  - Maine
  - Michigan
  - North Dakota
  - South Dakota
  - Washington

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## Exempt Organization Certificates

- Document provided by the purchaser to the vendor indicating that the purchaser is a qualified exempt organization under the laws of the purchaser's state
- The federal IRS letter granting 501 exempt status generally does not meet the requirements for state purposes on its own.
- Just because an organization is exempt federally does not mean they are guaranteed an exemption from sales tax.
- The purchase must generally be made directly by the organization and paid for with the organization's funds.

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## Exempt Use Certificates

- Document provided by the purchaser to the vendor to substantiate a particular use of the goods purchased
- Types of Exempt Use Certificates
  - Manufacturing
  - Pollution Control
  - Agricultural
  - R&D
  - Prime Contractor
  - Capital Improvement

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## Exempt Use Certificates (cont.)

- In order for an exempt use certificate to be valid, a description of the use of the property is required. In some states, blanket certificates are not acceptable.
- Many states have special forms for the different types of exempt use. Exemptions claimed on incorrect forms may be considered invalid.

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## Direct Pay Certificates

- Provided when use of the goods is unknown at time of purchase
- Purchaser accepts responsibility to determine taxability/remit use tax
- Not every state provides for them
- Some states limit the types of items that can be purchased under the direct pay permit to those items where taxability is unknown.
- Sellers must obtain from purchaser

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## Exemption Certificate Maintenance Best Practices

- Get certificates for all claimed exemptions including in states where you aren't registered to ensure you don't incur liability if you exceed economic nexus thresholds
- Match customer names in your system with customer names on the certificates
- At a minimum, confirm the right number format for the exemption number
- Some states provide ability to validate certificates, or require it
- Maryland, Kansas and North Carolina provide online verification tools.

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## Exemption Certificate Issuance Best Practices

- Keep track of who you have issued exemption certificates to.
  - If the law changes, and you need to rescind or modify your exemption certificate, you'll know who to contact.
  - This can also help you get out of an audit assessment.
- Post-Wayfair, it is important to do a thorough review of your purchases from suppliers and to continue to monitor this.
  - Companies may now be collecting tax because you haven't issued them an exemption certificate since they weren't charging tax pre-Wayfair.
  - Make sure all exemptions you're entitled to are being honored.

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## ➤ Exemption Certificate Management Tools

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### System Integration

- Integration of an exemption certificate system into the tax calculation system provides a reliable, effective way to manage sales tax
- Factors to consider when choosing a system include
  - System capabilities
  - Customer sophistication and knowledge
  - Positive and negative aspects of each system
  - Time constraints
  - Cost constraints

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## System Integration (cont.)

- Integrating exemptions and ERPs
  - ERPs usually have a tax/no tax flag on the customer master file
    - No partial exemptions
    - Exempt status does not transfer to alternate customer numbers that may be the same legal entity
    - Typically required to be set on every ship to location of the customer in the state
  - Minimal employee training required
  - Convenient but inflexible

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## System Integration (cont.)

- POS system integration
  - Typically consists of a key or option built into the system to override tax
    - Simple and effective, but prone to human errors
    - Do not support blanket certificates
    - Inconvenient for frequent customers

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## System Integration (cont.)

- Tax Systems
  - Individually programmed to reflect company specific decisions
    - Limited risk
    - Many safeguards
    - Customer data stored in multiple system
  - Requires input prior to order/invoice processing

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## Exemption Certificate Management Tools

- Systems that manage your customer's exempt status, documentation and exempt jurisdictions
- Highly flexible
- Provides reporting and communication options with customers

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## Exemption Certificate Management Tools (cont.)

- Form Packages
  - There are a number of sources to obtain blank forms that can be used to prepare exemption certificates
  - Many states provide blank forms on their website
  - There are vendors that provide either form packages in electronic or paper medium to customers.
  - Some electronic forms packages provide key entry capability.

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## Exemption Certificate Management Tools (cont.)

- Validation Packages
  - Some systems provide scanning and validation
  - Generally provide reporting functionality
  - Some provide interfaces to tax calculation packages
  - Data will need to be interfaced into the tax calculation or billing system

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## Exemption Certificate Management Tools (cont.)

- Calculation System Interactive Packages
  - Most tax calculation packages include an exemption certificate entry component
  - In some products, there is the ability to cross reference to a scanned copy of the certificate
  - Reporting capability is limited and can't provide the same level of functionality as the validation packages
  - Many calculation systems have validation packages as an additional product offering

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## Exemption Certificate Management Tools (cont.)

- Hosted and Service Solutions
  - Some providers offer a service component where they will manage the request, renewal and approval processes
  - Application is usually hosted and maintained on provider's servers
  - Customer accesses software remotely to provide certificate to provider

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## Exemption Certificate Management Tools (cont.)

- Exemption Management Vendors
  - Avalara: <https://www.avalara.com/us/en/products/exemption-certificates.html>
  - E-Doc Solutions: <https://www.edocsolutions.com/>
  - Second Decimal (Ryan): <http://seconddecimal.com/controlpoint.html>
  - Sovos: <https://sovos.com/products/tax-determination/certmanager/>
  - Thomson Reuters: <https://tax.thomsonreuters.com/en/onesource/indirect-tax/certificate-manager>
  - Vertex: <https://www.vertexinc.com/solutions/products/vertex-exemption-certificate-manager>

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