Sales and Use Tax Demystified

Retail sales taxes got their start in the United States during the Great Depression of the 1930s. As revenue from real property taxes collapsed, states converted a portion of their taxes to sales tax. The taxes began generating significant revenue that could be collected relatively easily.

Forty-five states and the District of Columbia impose a sales tax on retail sales and some services, as well as a use taxes on sales and services. There are approximately 8,019 state, county and city jurisdictions in the U.S. charging a sales or use tax.

Today, most states obtain the bulk of their revenue from sales taxes, not income taxes. For example, Texas receives more than 70% of general fund revenues from general and selective sales taxes. (Federal Reserve Bank of Dallas/Southwest Economy/May-June 2003)

The combined average tax rate, which adds the average rates imposed by states, counties and cities/districts, rose to 8.534 percent in 2003, the biggest single year increase since 1992.

In an effort to guard this revenue, states pursue audits, which may result in an assessment, including penalties and interest. Some states (such as Florida, Texas, and California) also tax services, not just tangible items. Businesses are required to collect sales taxes when the customer is in the same state or when the business has "nexus" in the customer's state.

Background

A **sales tax** is a levy placed by states on goods or services purchased from a business that has a physical presence in the same state as the consumer. A **use tax** is a compensating tax imposed by states to collect taxes on sales which do not take place in their state. The tax is meant to insure that all purchases are taxed, whether purchased locally or from out of state sellers. The use tax is the customer's responsibility to pay, but is increasingly being collected by vendors on their behalf.

Taxpayers located in one state are not required to collect sales or use taxes on behalf of a different state unless they are "doing business" in the other state. A business must have "substantial physical presence" – such as a sales force, distribution center, or warehouse – in a state to be considered "doing business", and therefore required by the state to collect sales tax. **Nexus** is the legal term which means connection to the state through a physical presence. The regular presence of a single sales person is enough to create tax nexus, therefore requiring the collection of sales tax. Different state and federal courts have inconsistent definitions of what it means to have sufficient connection to the state to be subject to tax, so the retailer needs to carefully review each state's requirements.

The concept of sales taxes seems simple but in reality can be very complex. Depending on the state, different items may be taxed at different rates. In some states, for example, food is not taxed. Clothing may have a lower tax than other items.

In some states the rates can vary by city and/or county, so businesses must keep records of sales in each city, county, as well as each state in which they do business.

Audit Exposure

According to Grant Thornton LLP's Building Business newsletter, "the Center on Budget and Policy Priorities, reports that some 30 states are projecting deficits for fiscal year 2005 totaling $39 billion to $41 billion. These budget deficits are causing states to turn up audit activity."

"State governments see increased business audit activity as one solution to fill the budget gap," says Bryan Neuendorf, a state and local tax partner with Grant Thornton's Kansas City, Mo., office.

Faced with budget cuts and deficiencies, states are becoming more aggressive about going after every penny possible.

Most states use several criteria in selecting businesses for an audit:

- Internal Revenue Service information.
- Information sharing programs with other states or other state agencies.
- Computer-based random selection.
- State Department of Revenue database information.
- Business publications, periodicals, journals, and directories.
- Business web sites

"Sales and use taxes have become a major piece of the California tax pie. Some businesses face greater exposure from such taxes than from federal and state income taxes combined. For such firms, a sales tax audit can mean the difference between surviving and going under." (Dan Davis, CPA, Arthur Consulting Group, Inc.'s website).

The following is from an article on CFO.com, “Stingers: the 2004 State Tax Survey”, dated January 5, 2004, by Tim Reason:

> *“When it comes to aggressively asserting sales-tax nexus, California has held the number-one slot since CFO conducted its first state-tax survey in 1996.*
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> *While no state comes near California’s dismal ranking, New Jersey placed a close second, once again making its first appearance among the top-five aggressive states. Its poor ranking in this category could simply reflect general corporate displeasure with the Garden State’s recent tax-law changes—which did not include sales-tax changes—but its prodigious leap to the number-two slot suggests its nexus unit has in fact been busier than in the past.*
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> *Although long considered an aggressive sales-tax collector, Texas is also a newcomer to the top five. The Lone Star State has recently toyed with such heretical ideas as a state income tax, but it hasn’t made significant changes to sales tax. Nonetheless, our survey results—and write-in comments—suggest that the state has significantly increased its nexus efforts. Brian Murphy, Grant Thornton’s partner in charge of state and local taxation, says Texas is among the many states that have recently beefed up their nexus units, an impression shared by one respondent who groused, “Texas must have an unlimited audit staff.” —T.R.”*

According to the CFO.com article, the five most aggressive states for asserting sales-tax nexus were California, New Jersey, New York, Massachusetts, and Texas.

The article further names the five worst states for being the most unfair in settling “gray issues” at the auditor level: New Jersey, California, Massachusetts, Illinois, and North Carolina.

“Businesses that are particularly vulnerable to sales and use tax audits are: grocery and convenience stores; restaurants; bars; liquor stores; manufacturers; printers; advertising agencies; sellers of vehicles, vessels and aircraft; leasing companies; people in high-tech industries, including sellers of computers, software, cell phones, and so on; and construction contractors.” (Dan Davis, CPA, Arthur Consulting Group’s website)

Penalties and Interest

Most states charge penalties and interest for late payments, underpayments, or not filing of sales and use taxes. For example, the current interest rate imposed by the California State Board of Equalization is 8% (.00667% per month). In Florida, there is a 10% late payment fee, a 5% per month late filing fee (up to 15%) and 1% interest per month.

Further, if a state believes a business has had nexus in the state for a long period of time, it probably will assess taxes, interest and penalties as far back as its statute of limitations allows.

States can also revoke the business' license and/or issue a tax warrant for the business owner's arrest. Beginning July 1, 2004 in Arkansas, if a taxpayer fails to file and pay for two months, the state will send a notice. If the situation is not remedied and remains delinquent for a third month, the state will close the business. They will keep the business closed until the taxes are paid, and will post a notice stating why the business is closed.

What to do?

The best course of action is to keep current on filing sales tax returns and payments (quarterly or monthly, depending on the state's requirements), and keep accurate and detailed sales records. A business must also keep current on the 700 to 900 total sales tax rate changes made by states and municipalities each year. These changes include rate increases/decreases as well as new sales and use taxes added to jurisdictions.

Record keeping is extremely important in the event of an audit. Records to be kept – usually as long as the state's statute of limitations – include sales invoices, paid bills, contracts, purchase orders, register tapes, bank statements, canceled checks, and similar original documents. Depreciation schedules and other fixed asset records should be kept. Other required records include documents supporting tax-exempt sales, such as resale and other exemption certificates, customer purchase orders, and freight bills indicating shipments to addresses outside of the state.

Keeping records and preparing and filing sales tax returns can be a major headache for the small business. It is labor intensive, tedious, and doesn't bring revenue to the bottom line, but can save money in the long run.

A sampling of bizarre but very real sales tax laws:

- In Minnesota, non-edible cake decorations are taxable, but edible cake decorations are exempt.
- In Tennessee, the sale of a good is subject not only to the state sales tax of 7%, but the local sales tax on the first $1,600, plus an additional state sales tax of 2.75% on the second $1,600, all of which cannot exceed $3,200 - potentially subjecting a sale to a 9.75% sales tax rate.
- In Illinois, cooking wine is taxable as an alcoholic beverage, even though it only contains a nominal amount of alcohol and, typically, is considered an "ingredient."
- In Texas, plain nuts are exempt "food," but once a candy coating is added, they become taxable "candy."
- Missouri does not impose a state level tax on utilities, but some Missouri localities impose a "domestic utilities tax" at a rate that is different from the local sales tax rate.
- In Rhode Island, fruit juice that is less than 100% pure is taxable. The exception is cranberry juice cocktail - a mixture of juice and water, or concentrate — which is exempt.
- In Massachusetts, a clothing item costing up to $175 is exempt from sales tax. However, any item costing $175.01 and above is subject to the 5% state sales tax.
- In New Jersey, naturally carbonated water is exempt, but artificially carbonated water is taxable.
- Maryland's unique rounding rules can potentially result in the collection of a sales tax rate as high as 8%, instead of the statutory 5% rate.
- In Pennsylvania, state and U.S. flags are not subject to tax, but if either is sold with "accessories" (i.e., a pole), the entire purchase becomes taxable.