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Sales Tax Corner

Taxpayers Beware—Without an Exemption Certificate, Your Sales Might Not Be Exempt

By Ilya A. Lipin, Kent DeBruin, and Brian Baillie

In the United States, businesses with nexus in a particular state charge their customers sales tax on taxable transactions such as retail sales of tangible personal property or taxable services unless and until the proper exemption documentation—that is, an exemption certificate or a resale certificate—has been accepted in good faith from the purchaser. States generally provide many full or partial exemptions based on the nature of tangible personal property (*e.g.*, groceries, clothing) or the nature of its use (*e.g.*, manufacturing activities, purchase for resale), or the nature of the purchaser (*e.g.*, government agencies, nonprofits).

The party claiming the exemption has the burden of demonstrating compliance with the law. Tax exemption laws are generally strictly construed against the party seeking the exemption and in favor of taxing authorities. Thus, without proper and timely collected exemption certificates qualifying the purchase, taxing authorities may deem otherwise exempt sales taxable.

Issues with documenting exempt sales can lead to large tax audit assessments or the identification of potential exposures during due diligence related to a transaction. Following the Supreme Court's 2018 decision in *Wayfair*—a decision that led all states that impose sales tax to establish economic nexus thresholds—vendors have much broader economic nexus footprints and should analyze whether to charge sales tax or, for exempt transactions, whether to emphasize collection and validation of exemption certificates for documentation purposes.

This article highlights areas of prevalent noncompliance and often overlooked nuances, uses recent cases to illustrate the immediate need to improve exemption certificate documentation and retention policies, and provides best practice recommendations for sellers and buyers.

Sales to governments and Their Agencies

Any misunderstanding of a purchaser's status, or assuming that sales to the government or its agencies are exempt from sales tax, can result in an improper characterization of taxable sales as exempt.

Sales to the U.S. government are exempt from sales tax. However, sales to federal instrumentalities that are not owned by the United States, such as federal reserve banks, federal credit unions, and federal home loan banks, may be subject to sales

tax in some states. Contractors working with the federal government should understand the appropriate state sales tax rules because their customers' tax-exempt status might not automatically flow through to them as agents.

Special attention should be given to sales to state governments and agencies because some states—*e.g.*, Arizona, California, Hawaii, Minnesota, South Carolina, and Washington—tax sales to government agencies.

With construction contracts, government-supply contractors may issue resale certificates on their purchases from subcontractors—that is, they can purchase taxable products tax-free—if title to the purchased products passes to the government before use by the contractor. Subcontractors should not blindly rely on the status of companies working with the government. They should be aware of state-specific rules so they can properly determine whether their sales could be exempt and carefully document any exemption.

Sales to Nonprofits

Sales to nonprofits are generally taxable unless purchases are used for charitable purposes, or another exemption applies. Vendors should not assume that sales to nonprofits are automatically exempt and should request exemption certificates to document any exempt sales.

To qualify as an exempt organization for sales tax purposes and issue a valid exemption certificate, nonprofit organizations must comply with state procedural requirements related to registrations, including for sales and use tax, and operations. Because federal exemption status is not binding on the states, some jurisdictions, such as Pennsylvania, may require an organization to prove that it is a “purely public charity” institution that operates free from private profit motives. Other states, such as Alabama, California, and Oklahoma, generally do not provide a broad state sale and use tax exemption to nonprofit organizations.

Multi-Entity Purchasers

Sales tax is a transactional tax imposed on an entity-by-entity basis. In large organizations with numerous legal entities, one entity may make a purchase, but another issues an exemption certificate. Tax authorities may deem tax exemption certificates issued by the wrong entity invalid. In states with non-expiring certificates, vendors that have ongoing sales to the same organization should track that a previously collected certificate matches the purchasing entity. In the case of corporate changes, such as reorganizations or name or address changes, it

is important for vendors to request updated exemption certificates.

Timely Acceptance

Most states require exemption certificates to be issued at the time of the sale or shortly thereafter (*e.g.*, 30 or 90 days, depending on the state). Although many states allow taxpayers to collect exemption certificates from their customers retroactively (in the context of an audit or otherwise), the taxpayer bears the burden of proof regarding the exempt nature of its sales. If certificates are not obtained within prescribed periods or cannot be collected on request and provided during audit, tax authorities may consider them invalid and treat otherwise exempt transactions as taxable. Liabilities on audits have been known to arise if potentially exempt customers become unresponsive, are unwilling to provide an exemption certificate, or are no longer in business.

Renewal Period

In the majority of states, including California, New York, North Carolina, and Pennsylvania, exemption certificates do not expire. However, some states require exemption certificates to be renewed to remain valid (*e.g.*, Alabama and Arizona—one year; Illinois—two years; Connecticut, Iowa, Oklahoma—three years; Florida, Maryland, Missouri, and Nevada—five years; and Massachusetts—10 years). Vendors should be aware of renewal period requirements and are encouraged to use technology solutions to alert appropriate staff about expiring certificates.

Multijurisdiction Exemption Certificates

States have been working with intergovernmental agencies and organizations, such as the Multistate Tax Commission (MTC) or the Streamline Sales Tax Governing Board, to create a uniform exemption certificate to simplify compliance obligations. However, there are risks and limitations associated with those multistate certificates. For instance, some states do not allow the use of multistate certificates, instead requiring the use of their own forms. Further, not all states allow the exemptions listed on the forms, and some might require the purchaser to be registered with a state to issue a valid exemption certificate. MTC certificates may not be used for reasons other than resale (*e.g.*, the ingredient or component exemption and manufacturing exemption cannot be claimed using the MTC's certificate).

Before accepting a multijurisdiction exemption certificate, vendors should check state-specific rules for limitations and review them for completeness.

Recent Court Cases Demonstrating the Need for Strict Compliance

Recently, missing, improper, or incomplete resale or exemption certificates have led to states assessing taxpayers on sales claimed to be exempt.

Rhode Island

In Administrative Decision #2022-20,¹ the Rhode Island Department of Revenue (DOR) upheld the assessment of tax, penalties, and interest against a seller for failure to follow the state's process for collecting a resale certificate.

As a member of the Streamlined Sales and Use Tax Agreement (SSUTA), Rhode Island has adopted the following procedures for collecting resale and other exemption certificates:

1. A seller must obtain documentation from a purchaser for a claimed exemption at the time of the sale.²
2. A seller may still be relieved of liability if it obtains a fully completed exemption certificate or captures the relevant data elements within 90 days of the sale.³
3. If the seller has not obtained an exemption certificate or all relevant data elements, it may, within 120 days of a request for substantiation by the state, either prove that the transaction was not subject to tax by other means or obtain a fully completed exemption certificate from the purchaser, taken in good faith.⁴

In this case, the exemption certificate was collected over 100 days after the sale, thus failing to meet the 90-day extension to obtain a certificate. Pointing to the law that provides for the precise timing and manner by which a resale certificate must be supplied, the DOR ruled that because the taxpayer had received the certificate, the 120-day extension also did not apply, and it upheld the assessment of tax, interest, and penalties.⁵ The DOR did not address the argument that the taxpayer accepted a late exemption certificate in good faith because the timing provisions were not followed.

Based on the ruling, if the seller had waited to obtain the resale certificate from the purchaser until requested by Rhode Island, then the transaction should have been exempt from sales tax (assuming the certificate was obtained in good faith). This ruling may encourage sellers in Rhode Island and other SSUTA states that do not collect exemption certificates within 90 days to wait until the

state requests that the seller do so, at which time the seller will have 120 days to comply. However, that practice has risks, such as customers not being responsive or ceasing their business operations, thus reducing the probability of obtaining the requested documentation.

District of Columbia

In *District Hospital Partners*,⁶ the D.C. Court of Appeals denied a refund of sales tax paid on the purchase of prepared meals that were resold by the operator of the George Washington University Hospital because of the failure to provide the vendor with a resale certificate at the time of purchase.

In D.C., if a tax exemption certificate is not furnished or obtained before the sale is consummated, the sale is considered a retail sale, with sales tax applying to the gross receipts.⁷ A party claiming an exemption from sales tax has the burden of proof.⁸

The taxpayer argued that if “a purchaser who fails to provide the required certificate and instead pays sales tax at the time of a purchase can nevertheless later obtain a refund by proving that the purchased items were intended for resale and in fact were resold.” However, in the Court's view, a failure to follow the form prescribed in the law and obtain an exemption certificate at the time of the sale has the “clear consequences” of treating sales as taxable. The Court said it is reasonable to require taxpayers to collect contemporaneous resale certificates rather than trying to subsequently verify the purpose of transactions, which would eliminate uniformity in the collection process and create the unnecessary burden for the taxing agency to examine each claimed exemption case by case.⁹

District Hospital Partners demonstrates that taxpayers should be vigilant in their purchases and timely issue exemption certificates when applicable. In reviewing refund claims, courts interpret statutes narrowly against the taxpayer and expect methodical compliance with the timing of issuing or obtaining an exemption certificate.

Alabama

In *Black Electrical Contractors*,¹⁰ the Alabama DOR denied a request for a sales and use tax exemption certificate for a government-entity project because the purchases at issue were made before the exemption was requested.

In Alabama, if a tax exemption certificate is not in existence or obtained before a purchase, the sale is considered a retail sale to which sales tax applies.

The taxpayer argued that as a subcontractor working on behalf of a governmental entity, it would qualify for the sales use and tax exemption for some purchases that were part of a governmental-entity project.¹¹ The Alabama

Tax Tribunal agreed that the taxpayer was a government subcontractor; however, focusing on the exact language of the instructions, it deemed the purchase invalid because the certificate was not in existence at the time the purchases in question were made.

Black Electrical Contractors establishes a strict policy whereby government subcontractors must obtain applicable exemption certificates before making purchases on behalf of governmental-entity projects. In reviewing exemption applications, courts interpret instructions strictly against the taxpayer and expect adherence to the timing for obtaining an exemption certificate.

Virginia

In a June 2022 ruling (22-101), the Virginia Tax Commissioner upheld the assessment of tax, penalties, and interest against a seller for failure to follow the commonwealth's processes for collecting a resale certificate.

Virginia has adopted the following procedures for collecting resale and other exemption certificates:

1. The dealer must obtain documentation from a purchaser, taken in good faith, indicating that the property is exempt under the law.
2. The certificate shall bear the taxpayer's name and address and the general character of the property sold, indicate the number of the certificate of registration, and be signed by the taxpayer.¹²

Because the taxpayer was unable to obtain an exemption or resale certificate from the purchaser, the good faith acceptance requirement could not be met, and the dealer was unable to prove that the sales were exempt. Based on those facts, the commissioner upheld the assessment.

Ruling 22-101 demonstrates that taxpayers should diligently collect and review resale certificates to ensure compliance. In performing diligence, the taxpayer should confirm that all information is completed as required and that the form is signed and dated.

Texas

The Texas Comptroller of Public Accounts has upheld the disallowance of some exemption and resale certificates that did not relate to the purchased services or were either incomplete or inconsistent with the taxpayer's contention that it was the reseller.¹³

Texas has adopted the following procedures for collecting and validating resale and other exemption certificates:

1. The two certificates have distinct purposes. A purchaser claiming an exemption for resale must issue a resale certificate.
2. The exemption certificate must include the purchaser's name, address, and signature; a description

of the item(s) to be purchased; the reason for the exemption from tax; the date; and the seller's name and address.¹⁴

The taxpayer protested the auditor's conclusion that several of the certificates did not meet the requirements necessary to be considered valid under Texas law. If a taxpayer seeks to establish that an exemption applies, its burden is to provide clear and convincing evidence of audit error.¹⁵

On appeal, the auditor agreed to accept one certificate related to garbage collection and adjusted the error rate accordingly. The remaining certificates were deemed invalid because they were a combination of untimely, for the wrong services, or the taxpayer's use did not qualify for resale.

The comptroller requires strict adherence, both to form and use, holding that incomplete, invalid, or misused certificates will not allow taxpayers to avail themselves of the benefits the certificates offer.

Mississippi

In *Toolpushers Supply Co.*,¹⁶ the Mississippi Court of Appeals ruled that a taxpayer did not have a "good faith" basis to believe that its sales were exempt wholesale sales.

Mississippi defines "wholesale sales" as the taxable sales of tangible personal property for resale in the regular line of business, *when made in good faith* to a retailer regularly selling or renting that property (emphasis added).¹⁷

The taxpayer sold various items to purchasers in the oil and gas industry. During the tax periods at issue, the taxpayer did not charge or remit sales tax on some of its sales because it considered them exempt wholesale sales. The taxpayer's business practice was to accept the presentation of a permit as a representation by the purchaser that it did not have to pay any retail sales tax on its purchases. The permit would then be entered into its accounting and point-of-sale system. Thereafter, any time the holder of that permit made a purchase, the taxpayer's system would not charge retail sales tax for that purchase.

The Court said the possession of the permit itself does not mean the business is excused from paying retail sales tax: It is the purpose for which each item is purchased that provides the exception. According to the Court's findings, for the sales at issue, there was no evidence that the purchasers were ever asked any questions about the nature of their business or the purpose for which each purchase was made, either before or after presenting the permit. The taxpayer said presenting the permit was a purchaser's implied representation that it was entitled to make purchases without paying retail sales tax. The Court disagreed with the taxpayer's argument that it was not

required to do anything more than have a “good faith” belief that the purchases were being made by a retailer that intended to resell or rent the items purchased in its regular line of business.

Sellers cannot simply accept an exemption certificate as evidence that they are not required to charge sales tax. They must make a “good faith” effort to review the exemption certificate and determine that it is properly completed before accepting it.

Best Practices

Sales and use tax exemption rules vary by state. Businesses should ensure they have processes in place to collect, validate, and retain exemption certificates in conjunction with completing the transaction to avoid having to collect the tax or deal with the issue on audit.

States are becoming stricter on both form and use, taking the position that if certificates are incomplete, invalid, or misused, taxpayers may not avail themselves of the benefits the certificates offer.

Affected businesses should consider various steps to meet their compliance obligations.

Sellers should:

- Establish processes to collect, review, validate, and store exemption certificates at a central location and request exemption certificates from customers as part of the onboarding process or contemporaneously with the purchase order.
- Collect any uncollected exemption certificates as soon as practicably possible; however, sellers in SSUTA

states should note the 90- and 120-day rules in R.I. DOR Administrative Decision #2022-20.

- Validate all certificates by comprehensively reviewing them for completeness, accuracy, and timeliness. It is the seller’s obligation to make a good faith effort to review the exemption certificate before accepting it. If a seller is required to be registered with the state to issue a valid certificate, its registration status must be confirmed.
- Monitor and timely update expiring certificates.
- Leverage technology to automate requests, manage and validate certificates, and respond to audit requests.

Buyers should:

- Establish processes to ensure exemption certificates are issued appropriately—with signatures—and that purchasing teams or others are not creating unknown use tax liabilities.
- Establish processes for renewing necessary certificates—particularly for those that are single-use or purchase-order dependent—and renew them annually with the state.
- Review exemption certificates that could become stale and revoke an applicable exemption. This may require coordination with your tax technology team to flag the location or customer appropriately.
- Ensure the proper state exemption certificate is issued. If using a multistate exemption certificate, confirm proper use and acceptance.
- Monitor business activity to determine if and when additional state registrations are required, and new certificates should be issued.

ENDNOTES

¹ R.I. Dept. of Revenue Administrative Decision #2022-20 (Dec. 22, 2022).

² R.I. Gen. Laws § 44-18.1-18(A)(1).

³ R.I. Gen. Laws § 44-18.1-18(C).

⁴ R.I. Gen. Laws § 44-18.1-18(C)(1).

⁵ See Decision #2022-20, *supra* note 1, at note 5 (“The 120 day extension applies when a taxpayer has not received a resale certificate and is asked for substantiation. The Taxpayer received a

resale certificate so the 120 day provision did not apply”).

⁶ *Dist. Hosp. Partners LP v. D.C.*, No. 22-TX-0088, (D.C. Cir. 2023).

⁷ D.C. Code Section 47-2010.

⁸ *Id.*

⁹ *Dist. Hosp. Partners*, No. 22-TX-0088.

¹⁰ *Black Electrical Contractors Inc. v. Alabama Dep’t of Rev.*, No. 20-753-JP (Ala. Tax. Trib. 2022).

¹¹ Ala. Code Section 40-9-14.1.

¹² 23 VAC 10-210-280(A).

¹³ Texas Comptroller of Public Accounts, Hearing No. 17,909 (Oct. 6, 2021).

¹⁴ Tex. Admin. Code tit. 34, §3.287(f).

¹⁵ 34 Tex. Admin. Code Section 1.26(c).

¹⁶ *Toolpushers Supply Co. v. Mississippi Depar’t of Rev.*, No. 2021-SA-01186-COA (Miss. Ct. App. 2023).

¹⁷ Miss. Code Ann. Section 27-65-5.

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