

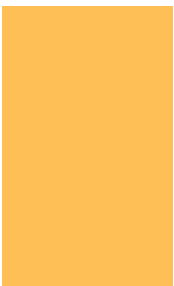


Sales and Use Taxes — An Introduction to the Basics for Card Program Administrators

Purchasing Cards

This guide introduces sales and use tax issues and options as related to the use of a commercial card account for procuring goods and services. It is not intended to provide tax, legal, or accounting advice. Before using this information to establish policies to determine the taxability or exemption of transactions, suppliers, or cardholders, it is recommended that you review it thoroughly with your tax, accounting, and/or legal advisors.

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Introduction

As consumers, most people are familiar with sales tax. When an individual consumer goes to a supplier, purchases items, and pays what is charged, the amount frequently includes sales tax on some items and not on others. It is the supplier's responsibility to correctly charge tax on items that are taxable and not charge tax on items that are tax-exempt.

While many of the principles of sales tax that apply to an individual consumer also apply to corporate consumers, the corporation's management of sales tax must consider a number of other factors. Among the most important of which is that, unlike the individual, corporations are regularly audited by state taxing authorities to verify their proper payment of sales and use tax on their purchases.

Corporate compliance with sales and use tax requirements has evolved over many years of experience with regular state audits. Some organizations have implemented a manual transaction-by-transaction review process in accounts payable (A/P) while others have automated the tax process in a variety of enterprise software applications. The use of purchasing cards adds a new dimension to this tax compliance process. Purchasing card transactions represent a more cost-effective approach to procurement and provide a range of alternatives to address the associated sales and use tax requirements. For purposes of this discussion, any card used for the procurement of goods and services is referred to as a purchasing card. This will include, for example, a "one card" where a single card is used as payment for the purchase of goods and services, travel, and other expenses.

The goal of this introduction to sales and use tax is to help the reader understand:

- The fundamental rules and concepts that regulate the imposition of sales and use tax;
- The roles and responsibilities of the parties involved in a sale: the purchaser, supplier, and state(s);
- The responsibilities of the corporate purchaser in managing their compliance with sales tax and use tax rules; and,
- A basic approach to managing sales and use tax compliance in a purchasing card program.

Sales Tax Basics

■ What is a sales tax?

The sales tax is generally the largest source of tax revenue in the states where it is imposed. It is a tax imposed on the sale of taxable items and is calculated as a percentage of the sales price. For example, if \$20 worth of taxable items is purchased, and the state imposes a sales tax of 6 percent, the total amount collected by the supplier from the purchaser would be \$21.20 (\$20 plus \$1.20 of sales tax).

■ Who imposes the sales tax?

A sales tax may be imposed by states and other local jurisdictions. Currently, the only states that do not impose a sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon. All of the remaining states impose some form of sales tax. Because the sales tax is imposed at the state level, the list of items that are taxable in each state is different. For example, clothing may be taxable in one state and not another. States frequently apply the tax to support industries or commercial activities that are a significant part of the state economy. In states where mining or manufacturing is a major part of the economy, the tax may be structured to provide more favorable sales tax treatment to items purchased and used in those industries.

■ How is the tax rate determined?

The tax is owed to the state where the goods are delivered and used – commonly referred to as the "destination" state. For example, if the customer visits a supplier's location and makes a purchase (a point-of-sale purchase), the tax is collected at the sales tax rate in the state where the supplier and purchaser are located. If the purchaser order goods (i.e., a phone or Internet order) and the purchaser is in State A and the

supplier is in State B, and the goods are being delivered to the purchaser in State A, then the transaction is subject to the sales tax in State A. The general rule for determining the correct rate to apply to a transaction is to apply the rate applicable in the destination state.

■ **What types of transactions are taxed?**

The most obvious occurrence of sales tax is on a sale of tangible personal property. An item is considered tangible personal property if it is not real property, such as land or buildings and not intangible property, such as stocks, money, bonds, etc. Sales tax is also imposed on the payments for the lease or rental of tangible personal property that would be taxable if purchased. For example if the purchase of a computer were taxable, the payments to lease or rent the computer would also be subject to tax. Assume the computer could be purchased for \$6,000, and the sales tax rate is 6 percent. When purchased, the supplier will collect the \$6,000 purchase price plus \$360 of sales tax for a total of \$6,360. If the computer was leased instead of purchased and the monthly lease payment was \$800, the total monthly payment would have to include \$48 of sales tax for a total monthly lease payment of \$848.

In addition to the tax imposed on tangible personal property, tax may also be imposed on services. Some commonly taxable services include office cleaning, building maintenance, window washing, and lawn care.

Use Tax Basics

Not all suppliers collect sales tax on all transactions. One reason may be that the items purchased are tax-exempt. Another reason may be that a supplier is located in a different state from the purchaser (an out-of-state supplier) and may not be authorized to collect tax in the destination state or state where the purchaser is located. When sales tax is not collected by the supplier, it becomes the obligation of the purchaser to determine whether use tax is owed on the purchase.

The use tax, referred to as a compensating use tax in some states, supplements and complements the sales tax. It is owed to a state when a taxable item, on which tax has not been paid, is brought into the state to be used. If the use tax did not exist, customers could avoid tax on a transaction by purchasing items from an out-of-state supplier and having them delivered into their state. Customers would be more inclined to avoid in-state suppliers and purchase from out-of-state suppliers in order to lower their cost of goods. This would clearly put the in-state suppliers at a competitive price disadvantage in the marketplace and would be disruptive to commerce in and between the states. The use tax attempts to reduce this disparity and level the playing field between in-state and out-of-state suppliers.

The following examples illustrate when the use tax may or may not apply. For these transactions, assume that Customer in State A (where the sales/use tax rate is 5 percent) places a phone order for \$3,000 of office supplies from Supplier in State B (where the sales tax rate is 7 percent). All of the Supplier's employees, sales agents, and locations are in State B, and the Supplier is not registered to collect tax in State A.

1. Supplier ships the office supplies to the Customer and bills the Customer \$3,000 and does not collect State B's sales tax. Because office supplies are taxable in State A, Customer is obligated to accrue \$150 of use tax.
2. Customer places another order for \$500 of bottled water from Supplier and is billed \$500. Since bottled water is not taxable in State A, Customer will not accrue use tax.
3. Customer places the order for office supplies over the Internet. Since Customer has purchased a taxable item on which the Supplier did not collect tax the Customer must accrue the \$150 of use tax. Internet orders receive no special tax treatment and are taxable like any other purchase.



4. Customer travels to Supplier's location in State B and purchases \$3,000 of office supplies. Supplier correctly charges State B's 7 percent sales tax and collects \$3,000 plus \$210 tax on Customer's purchase. Customer returns with the office supplies to State A. Customer owes no use tax, because sales tax was correctly paid on the transaction at the point-of-sale in State B. Use tax applies only when the sales tax was not paid.

While the obligation to pay the use tax generally applies to both individual and corporate taxpayers, corporations are under much closer scrutiny by state tax authorities that regularly audit their compliance. Corporations generally take their obligation to accrue the use tax and remit it to the state taxing authority quite seriously. Corporations implement a variety of processes to ensure that they are in compliance with the use tax requirements. In many organizations the use tax determination becomes part of the A/P process. Whether automated or manual, the process generally requires:

- identification of invoices with no sales tax;
- determination of whether the items purchased are taxable or exempt;
- selection of the appropriate tax rate based on the destination state of the items purchased;
- calculation of the amount of use tax owed (purchase price multiplied by the use tax rate); and finally,
- periodic (usually monthly) remittance of the accrued use tax to the state taxing authority.

States generally do not aggressively enforce use tax requirements on individuals unless there is evidence of very large dollar transactions and an individual's failure to accrue and remit the use tax. States may offer individuals an opportunity to self-report and pay any use tax owed with the filing of the individual's income tax return.

Supplier's Sales Tax Collection Responsibility

Suppliers are only required to collect tax in states where they have nexus. Nexus is a legal term. Nexus describes the contact or presence a supplier may have with a state that allows the state to require that the supplier collect the state's sales tax. If the supplier has no nexus in the destination state, the state has no basis on which to exert its jurisdiction over the supplier and require it to collect sales tax.

As a general rule, an out-of-state supplier is deemed to have nexus in a state for sales tax purposes if it has regular and systematic contacts with the state, generally through employees, agents (e.g., sales representatives) or property located in the state. For example, a supplier will charge sales tax in the states where it has stores, employees, or sales agents contacting potential or existing customers. This means that when a person makes a purchase in a store, sales tax is charged. However, when a purchase is made from a supplier that has no presence in the state where the goods will be delivered, the supplier has no obligation to register to collect the tax in the destination state and no tax will be charged.

It is important for the corporate purchaser to understand the concept of nexus so that the purchaser can anticipate which vendors are likely to charge the sales tax. When the purchaser can use the nexus concept to identify suppliers likely to charge sales tax, the risk of accruing use tax on a transaction where the sales tax has already been collected is reduced.

The following examples illustrate when a supplier's nexus in a state will create an obligation for the supplier to collect a state's sales tax. For these questions, assume the supplier has a location and employees only in the state of California and therefore has nexus only in California.

Sales and Use Tax Exemptions

1. In which states will the Supplier be required to collect sales tax?

California is the only state where Supplier will be required to collect tax.

2. What is the Supplier's tax-collection responsibility if a Customer's order is sent through the mail to Customer's location in Illinois?

The Supplier has no obligation to collect sales tax in Illinois. When Customer sees that no tax was collected, Customer will be obligated to accrue the Illinois use tax.

3. What if the Supplier delivers the goods in its own truck driven by its own employee to the Customer in Illinois?

Since the Supplier now has an employee (the driver) and property (the truck) in the state of Illinois, Supplier will have nexus and will be required to collect the Illinois sales tax. If Supplier fails to collect the Illinois sales tax, Customer will be obligated to accrue the use tax.

4. What if the Supplier has a warehouse in Illinois, but the Customer orders the goods from the Supplier's retail location in California?

Supplier ships the goods to the Customer. The warehouse in Illinois establishes Supplier's nexus in the state of Illinois and obligates Supplier to collect the Illinois sales tax.

States are responsible for determining the items and services that will be subject to sales tax and the items and services that will be exempt from sales tax. Since this determination is made independently by each of the states imposing a sales tax, taxable and exempt items will vary significantly between each of the states. While the specific items may be different from state to state, there are basically three reasons why a transaction may be exempt from sales tax:

- Some items may be identified by a state's legislative body as exempt. Some of the items that have been made exempt by some states include: items purchased for the purpose of resale (e.g., a store's inventory); certain types of food (e.g., unprepared foods like milk, fruit, flour, sugar, etc., but not snack foods, soft drinks, or food prepared and served in restaurants); prescription medication; and bottled water.
- Some items may be exempt based on the manner in which they are used. For example, a table saw, normally taxable, may be exempt in a state providing a sales tax exemption to manufacturers purchasing tools and equipment used in the manufacturing process.
- Some types of organizations may be exempt under federal or state law from sales tax. Common examples of organizations exempt from the state sales tax include agencies of the Federal Government, certain charitable organizations, schools, and religious organizations.

When an item is deemed exempt by the state, it is generally the supplier's responsibility to understand which items are taxable, which are not, and collect the tax accordingly. This may not be a complex determination for a retailer of office supplies where virtually all items sold are taxable. However, the tax determination can be a daunting responsibility for a grocer or variety store where the retailer must establish and maintain the tax status of thousands of items.

When an item is exempt based on the way it will be used by the purchaser, it is the purchaser's responsibility to provide the supplier with a certificate of tax exemption. A supplier will generally not exempt an otherwise taxable item without being provided with the exemption certificate. Suppliers require the exemption certificate before exempting an item or transaction because, when audited, the supplier is responsible for paying the tax on sales where tax was due but not collected and supplier does not have an exemption certificate from the purchaser.

Similar to the exemption based on use, an exempt organization must also provide the supplier with an exemption certificate before the goods will be sold exempt from sales tax.



Tax Planning Basics for Purchasing Cards

There are several approaches available to a company planning for sales and use tax compliance in a purchasing card program. These alternatives include:

- using specially designed sales and use tax software to calculate the use tax,
- including the purchasing card transactions with the company's existing tax process, or
- developing a use tax estimation process.

The approach selected must take into consideration that, in some cases, tax decisions on purchasing card transactions must be made without the same amount of transaction detail that is available in the traditional procurement process. For example, purchasing card transactions do not always provide the type of line-item detail found on the traditional invoice. Without item descriptions, transaction data such as vendor name, vendor location, cost center, and others can be used in the tax decision-making process.

For purposes of this introduction, we will narrow our focus to managing the calculation of a use tax accrual through application of the basic sales tax principles we have reviewed thus far. A more thorough discussion of other approaches to calculating use tax for purchasing card transactions is contained in Visa's Sales and Use Tax White Paper: *A Discussion of Approaches to Sales and Use Tax Compliance for Commercial Card Transactions*.

This Tax Model takes a conservative approach to reviewing the transactions and begins by assuming that all transactions require a use tax calculation. No transaction is eliminated from the potential accrual unless there is a reason to believe that, more likely than not, sales tax was collected by the supplier. There is no manual review of individual transactions in this particular example. Rather, transactions are grouped by certain characteristics based on the data passed with the transaction and the likelihood that sales tax was charged is evaluated.

Assume that MyCo, Inc. is a manufacturer of hand tools based in Illinois. The company has 700 cardholders located in Illinois who spent approximately \$800,000 last month in 4,000 transactions. The goal of the review of these transactions is to eliminate as many of the 4,000 transactions as possible where it is reasonable to believe that the purchaser paid the sales tax. Use tax will be accrued on all the remaining transactions.

Step 1 – Eliminate from the use tax accrual the transactions where the Illinois cardholders made purchases from suppliers in Illinois, an in-state transaction. This assumes that when an in-state supplier sells to an in-state customer, tax will be charged unless the item is exempt or the purchaser has provided an exemption certificate. In reviewing the month's transaction data, 500 transactions were identified as in-state, and these are eliminated from the use tax accrual. Further analysis is needed on the 3,500 remaining transactions with the remaining out-of-state vendors.

Step 2 – Eliminate from the use tax accrual the transactions with out-of-state suppliers passing a tax amount with the transaction data. In addition to the basic data (Level I) that is passed with a transaction, some vendors have upgraded their card-processing capabilities to Level II, which includes passing the amount of tax charged on the transaction. If the Level II data displays a sales tax amount that was paid to the supplier, then these transactions are eliminated from the use tax accrual. In the review of the remaining 3,500 transactions, 800 transactions displayed Level II data showing that sales tax was collected by the supplier. The 2,700 remaining transactions will require further analysis.

Step 3 – Eliminate other out-of-state suppliers who collect tax and suppliers who sell items that are exempt based on how they are used at MyCo. SupplierCo Office Products is MyCo's preferred provider of office supplies. SupplierCo's headquarters and fulfillment center are located in Texas and it appears as a Texas supplier on cardholder statements. However, SupplierCo maintains sales offices in every state and, as a result, has nexus in all states and collects tax in all states. Another supplier, Mfg-Supply, Inc., located in

Kansas, sells drill bits and other tools used in MyCo's manufacturing process. Since the use of those tools in the manufacturing process makes them exempt, transactions with Mfg.-Supply, Inc. can also be eliminated. There are 200 transactions with SupplierCo and 400 with Mfg.-Supply for a total of 600 transactions eliminated from the accrual calculation, leaving 2,100 transactions for further analysis.

Step 4 – Eliminate transactions based on the Merchant Category Code (MCC) of the supplier. MCC codes are assigned to suppliers at the time they register to accept cards for payment and are a standardized list of supplier classifications. One category of transactions that might be eliminated from the use tax accrual based on MCC code is purchases of fuel at gas stations. We know that no matter where fuel is purchased, tax will be collected, since it is included in the price charged at the pump. Another example of exempt transactions may be dues paid to membership organizations. The analysis of transactions based on MCC codes identified 100 transactions that could be eliminated from the use tax accrual, leaving 2,000 transactions.

Step 5 – Calculate the amount of use tax owed on the remaining transactions. After the relevant transactions have been eliminated, 2,000 remain. MyCo calculates the amount of the remaining transactions for a total of \$50,000. MyCo calculates the amount of the use tax accrual using the 7 percent rate applicable at its location. MyCo remits use tax to Illinois in the amount of \$3,500 for the card transactions.

Conclusion

The purpose of this document is to provide an introduction to the basic concepts of sales and use tax. These concepts were illustrated in an example of how card transactions might be analyzed for the accrual of the use tax. Understanding the application of these concepts is a first-step in developing an efficient and cost-effective tax compliance plan.

This understanding also provides a foundation to begin discussions within the organization about planning for the organization's tax compliance in the card process. A more detailed discussion of the tax concepts and tax compliance options is contained in Visa's Sales and Use Tax White Paper: *A Discussion of Approaches to Sales and Use Tax Compliance for Commercial Card Transactions*.

Purchasing Cards – Frequently Asked Questions

1. How should the tax department be involved in the purchasing card program?

The tax department should be included in the planning process for the purchasing card program as early as possible. This early involvement facilitates the determination of whether the purchasing card transactions can be included in the existing use tax accrual process or whether an alternative approach would be more appropriate. The tax department will likely consider such factors as spending volume, types of purchases, number of cards outstanding, and jurisdictions where the cards have been issued when developing a cost-effective tax management solution. The tax department should have the expertise and in-depth understanding of the tax rules needed to develop a solution that addresses three critical factors:

- **Taxability Management** – making sure that tax is properly paid or accrued on taxable purchases and exempt items are properly excluded from the tax calculation
- **Compliance Management** – validating that the tax solution implemented meets the requirements of the tax jurisdictions
- **Audit Management** – ensuring that the data is managed in a way that establishes a clearly auditable tax calculation and that necessary documents are retained to document the tax calculation

2. What is Level II and Level III data?

Level II and Level III refer to additional, or enhanced, transaction-level information available for some transactions. Supplier's who have made the necessary changes to their systems can pass this enhanced transaction data through the card systems. Level II includes the amount of sales tax collected by the merchant and allows the



purchaser to input additional information such as a cost-center or general ledger account code. Level III data will deliver Level II data and other information found on a traditional receipt, including the item descriptions, costs, and quantities, as applicable.

3. Why don't all merchants pass enhanced data?

Passing enhanced data requires that the merchant implement additional point-of-sale technology that requires an investment of resources. Merchants are more likely to pass enhanced data if there is a demand for the data expressed by their customers.

4. If all vendors passed enhanced data, would it still be necessary to calculate use tax?

No matter how detailed the purchasing card transaction data passed from the supplier is, a tax-compliance solution would still be required. Even in the traditional purchase order/invoice process, the tax department still manages a tax compliance process. The reason a tax compliance process must still be implemented is that not all vendors collect tax on otherwise taxable transactions. For example, a merchant who fills a customer's order and ships the goods out of state may not be required or authorized to collect tax in the destination state of the goods. Even if the out-of-state merchant passed enhanced data, no tax would be reported, because no tax was collected.

5. How does a Direct-Pay-Permit impact the procurement card transactions?

A Direct-Pay-Permit is issued to a taxpayer, usually a manufacturer, by a state taxing authority and allows the taxpayer to purchase all of their goods exempt from the payment of sales tax. An organization holding a Direct-Pay-Permit is responsible for accruing sales tax on all of their taxable purchases. In a traditional transaction, the merchant is made aware of the purchaser's exempt status by the exemption number printed on the purchase order. In a purchasing card transaction, the merchant may not be aware of the purchaser's exempt status and may charge tax on a taxable transaction. Since it is likely that some merchants will charge tax in spite of the Direct-Pay-Permit, it will be important to factor the payment of tax into the development of a tax compliance plan.

6. How accurate is the calculation of use tax using the Tax Model?

The underlying assumption of the Tax Model is that tax must be accrued on all transactions unless there is reason to believe that tax was already paid. Based on this assumption, most implementations of the Tax Model will tend to overestimate the amount of tax that should be accrued. This tendency to overestimate the amount of use tax owed reduces the risk of an auditor imposing a tax assessment and penalties during an audit. The program can manage the amount of any over-accrual of the use tax by carefully selecting the criteria used in identifying the tax paid transactions.

7. What documents should be retained to prove the payment of sales tax?

Generally, during a sales tax audit, the auditor will review a sample of receipts from the purchasing card transactions made during the period under audit. Since this review will be the foundation of the auditor's evaluation of the program's sales or use tax compliance, it is important that the program have a strong receipt retention policy. This means that cardholders should retain receipts provided by the merchant. In addition to paper receipts – electronic receipts, imaged receipts, and enhanced data will generally be accepted as proof of sales tax paid to the extent the tax reported is accurate, the electronic records are unaltered, and the auditor has the ability to verify the accuracy of the electronic records. Since sales tax documentation requirements vary from state to state, it is important to review the ability of the documentation policies to meet the requirements of each state where cardholders are located.

8. How is use tax managed in a “one card” program?

The principles of managing the use tax will remain the same regardless of the type of card used to make the purchases. In a one card situation however both the travel and entertainment (T&E) payments and the purchasing card payments are made on the same card. It will be important to identify the T&E transactions, since the appropriate taxes are collected when the payment is made. For example, sales and other taxes are collected on hotel charges at the point-of-sale in the jurisdiction where the hotel is located. The type of transaction is generally distinguished based on the MCC of the merchant. Based on the MCC, transactions with airlines, hotels, restaurants, and other travel-related expenditures can likely be eliminated from the use tax review. The remaining non-T&E transactions would be reviewed for the use tax accrual. This is also true if the card is used for Fleet transactions.

