



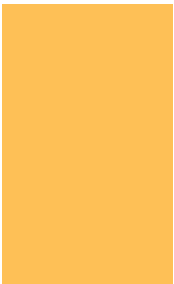
# A Discussion of Approaches to Sales and Use Tax Compliance for Commercial Card Transactions

Commercial 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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## I. Introduction

Commercial cards may be implemented as a purchasing card program or a “one card” program that includes the purchasing card functionality.<sup>1</sup> For ease of understanding, any card, including a “one card” used for procurement of goods and services, is referred to as a purchasing card in the body of this document. Since their market introduction in the 1980s, purchasing cards have established themselves as an important tool in a cost-effective procurement strategy. The dollar volume of transactions on purchasing cards has grown from approximately \$40.0 billion in 2001 to over \$80.0 billion in 2003 and is predicted to reach \$160.0 billion by 2007.<sup>2</sup> Initially targeted to the purchase of low-dollar/high-volume maintenance repair and operating (MRO) supplies, the range of purchases made with purchasing cards has expanded to include: direct materials; manufacturing equipment such as hand tools and replacement parts; services and other higher dollar purchases.

As purchasing card programs have grown, the importance of implementing a process to meet the state and local requirements for sales and use tax compliance has increased. These tax requirements are not new and are the same compliance obligations that must be met in the traditional procurement process. There is, however an opportunity in the purchasing card program to develop a tax-compliance approach that does not rely on the traditional paper documents. Efficient solutions reduce the amount of human intervention necessary to make sales and use tax decisions and use the range of electronic data passed with each card transaction. Efficient solutions also balance the administrative burden required to calculate the use tax with the cost of implementing the tax determination process.

This white paper introduces the sales and use tax principles that must be understood before building an effective tax-compliance approach. These principles are described in the context of purchasing card transactions and the data and processes that support tax decision-making. The text describes the taxpayer’s sales and use tax-compliance responsibilities in the procurement process, tax issues relating to purchases made with a purchasing card and discusses various approaches to achieving sales tax compliance for purchasing card transactions.

Throughout this document, emphasis will be placed on three dimensions of tax compliance:

- **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

## II. The Sales and Use Tax Issue

The purchaser’s sales tax-compliance requirement can be simply stated:

A purchaser must be able to demonstrate to the taxing authority that sales tax has been paid when taxable items are purchased. If sales tax has not been paid and the item purchased is not exempt from tax, the purchaser must demonstrate that the use tax has been accrued and remitted to the taxing authority.<sup>3</sup>

While the requirements may seem relatively clear, developing a process that accurately documents the payment of sales tax or the accrual of use tax requires a thoughtful review of the items purchased and the jurisdictions where the cards are used. This is especially true, since each state establishes its sales and use tax policies independently from other

jurisdictions, so a taxable item in one state may be exempt in another.<sup>4</sup> There are efforts underway to develop a more consistent application of sales taxes across the states and the more than 6,500 taxing jurisdictions.<sup>5</sup> However, it is doubtful in the near future that there will be a uniform nationwide sales tax scheme.<sup>6</sup> As a result, sales and use tax compliance will continue to be a state-by-state determination.

Developing an understanding of sales and use tax concepts and their application is the first step in building and managing a successful sales tax-compliance strategy for a purchasing card program.

### A. The Imposition of Sales Tax

Generally, sales tax is imposed on the 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. The term “sale” is broadly defined to include installment and credit sales, leases, and rentals.

The amount of tax is based on the amount of consideration paid for an item multiplied by a sales tax rate established by the taxing authority. In addition to the state sales tax, local taxes may also be imposed on a transaction. For states that impose a sales tax, rates may range from a high of 7.0% in Rhode Island to a low of 2.9% in Colorado.<sup>7</sup> Local rates may range from as high as 7.0% to less than 1.0%.<sup>8</sup> Combined, state and local taxes can exceed 10%.<sup>9</sup> Finally, some states, such as Alaska,<sup>10</sup> Delaware, Montana, New Hampshire and Oregon do not impose a state sales or use tax on any transactions.<sup>11</sup>

The definition of a taxable sale varies by state, but most states’ definitions generally include the following:

- Transfer of title or possession of taxable tangible personal property for consideration; and,
- Rental, lease, exchange, or barter of taxable tangible personal property.

For example, if the purchase of an office copier is taxable, the purchaser would pay the supplier the purchase price, \$5,000 plus the sales tax (assume a tax rate of 7 percent) of \$350 (7 percent of \$5,000). If the purchaser leased the copier for \$600 per month, \$42 (7 percent of \$600) of tax would be paid on each of the lease payments for a total of \$642 per month.

States may also designate certain services as taxable.<sup>12</sup> Some of the more common services subject to tax include building cleaning and maintenance, window washing, lawn maintenance, and landscaping.

### B. Exemptions from Sales Tax

Items exempt from sales tax are established by the state and vary by state. While the specific exempt items may be different from state to state, there are basically three reasons why a transaction may be exempt from sales tax:

**1. Statutory Exemption** – 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: raw materials,<sup>13</sup> equipment used in manufacturing<sup>14</sup> 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.<sup>15</sup> Commonly exempt services include repair labor, legal consultation, and accounting services.



**2. Use-Based Exemption and Direct-Pay-Permits** – Some items may be exempted by a state 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.<sup>16</sup> Some taxpayers, usually manufacturers, may obtain a Direct-Pay-Permit from the state taxing authority. A Direct-Pay-Permit allows the purchaser to make all purchases exempt from tax. The purchaser is then obligated to make a determination of the manufacturing company's use tax obligation on each of their purchases, since they are not charged sales tax. Some states allow Direct-Pay-Permits because the taxability of their purchases will vary based on use, and it is difficult for the supplier to make a sales tax determination.

**3. Tax Exempt Organizations** – 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.

To take advantage of a use-based exemption or if the purchaser is purchasing for a tax-exempt organization, the purchaser must provide the supplier with an exemption certificate describing the reason the sale is exempt from tax.<sup>17</sup> If an exemption certificate is not provided by the purchaser, the supplier is generally obligated to collect tax on the transactions.

When a properly completed exemption certificate or statement is furnished to a supplier, the burden of proof as to non-taxability of a receipt is shifted to the purchaser. The supplier will not be required to collect tax from a purchaser who furnishes a certificate of resale, an exempt organization statement, or other exemption certificate in proper form, unless the purchaser's certificate of authority had been suspended, revoked, or has expired.<sup>18</sup> Many states provide "fill in" exemption certificates that can be completed and utilized by purchasers in the state. Information that is commonly required in an exemption certificate includes:

- date prepared,
- name and address of the purchaser,
- name and address of the supplier,
- tax identification number of the purchaser
- signature of the purchaser, and
- reason for the exemption.

### **C. Supplier's Collection of Sales Tax**

While it is generally the responsibility of the supplier to collect the sales tax on the sale of all taxable goods, there are several situations where the supplier will not collect tax from the purchaser. These situations include the sale of items designated by sales tax law as exempt and the sale of items where the purchaser has provided an exemption certificate to the supplier. Another situation where the supplier will not collect sales tax occurs when there is a sale of items that will be delivered to a state where the supplier does not have nexus and is not authorized to collect sales tax.

Nexus is a legal term that measures the minimum required connection or relationship between a taxing jurisdiction and a supplier. There must be a sufficient connection or nexus between a supplier and the state that is seeking to tax the activities of the supplier in order for a state to require the supplier to collect the tax.<sup>19</sup> If nexus is established, the supplier must register with the state and collect sales tax.<sup>20</sup> Nexus is determined by the amount of

contact or physical presence a supplier has in any state and is generally based on the presence of employees, agents, or property in the state. In a situation where the supplier has a sales location or warehouse in the state of delivery, sales representatives traveling to the state, or some other form of physical presence in the state, the supplier has nexus and is required to collect sales tax.<sup>21</sup>

To further illustrate this concept, in a transaction between a purchaser and a supplier located in the same state (an in-state transaction), it can generally be assumed that the supplier will correctly collect the sales tax. For example, if the item is taxable, the supplier will collect the tax, if the item is not taxable, no tax will be collected, and if the purchaser provides an exemption certificate, no tax will be collected. However, when the transaction is between a purchaser and a supplier in another state (an out-of-state transaction), no assumption can be made about the supplier's collection of tax. If the supplier does not have nexus with the destination state, the supplier will not register with the tax authority and tax will not be collected.

Examples:

- Purchaser in State A buys office supplies from a supplier in State A. Unless the purchaser presents an exemption certificate, the supplier will be registered with the state and collect sales tax on the transaction.
- Purchaser in State A buys office supplies from a supplier in State B. The supplier will only collect tax on the transaction if the supplier has nexus and is registered to collect tax in State A.

#### **D. The Imposition of Use Tax**

When the sales tax is not collected on an otherwise taxable transaction, the purchaser must comply with their state's use tax requirements. The use tax is a complement to the sales tax and is imposed on taxable items delivered into a state when no other state's sales tax has been previously collected.<sup>22</sup> When a sales tax has not been collected on goods delivered to the purchaser, the purchaser is obligated to accrue a use tax that is then remitted to the taxing authority in the state where the goods were received. While the use tax obligation exists for both individuals and corporations, compliance with use tax rules is more aggressive in the corporate environment because of the greater amount of use tax owed by corporate taxpayers and the frequency of state sales and use tax audits. The existence of use tax prevents a purchaser from making purchases from out-of-state suppliers who do not collect tax, thus placing the in-state suppliers that are required to collect sales tax at a competitive disadvantage.

The use tax often applies to a variety of transactions. For example:

Assume that a Purchaser in State A placed a \$500 telephone order for office supplies with supplier in State B. The supplier's only location is a sales office and warehouse in their home state, State B. The goods were delivered to the purchaser in State A via the U.S. mail. Since the supplier has no physical presence in State A, they have not registered to collect tax in State A.

- **What is the purchaser's use tax responsibility?**

Since the supplier did not collect State A's 7 percent sales tax, the purchaser is obligated to calculate, accrue and remit the use tax to State A. The purchaser accrues the \$35 use tax (7 percent of \$500) and remits it to the taxing authority with the filing of their monthly sales and use tax return.



■ **What if the purchase is made over the Internet?**

Since there is no exception made for items purchased over the Internet, the sales tax must be paid, or the use tax must be accrued the same as any catalog or telephone order. There is no special exemption from sales or use tax just because an order was placed over the Internet.

■ **What if the purchaser traveled to State B, made the purchase, and returned to State A with the goods?**

Since the purchase is made in State B, the supplier collects State B's tax at the point-of-sale. If State A allows a credit for tax paid to State B and the tax paid to State B is greater than or equal to the tax that would have been paid in State A, no accrual is necessary.

When sales tax has already been paid by the purchaser in one state, and the goods are brought into another state for use, some states allow a use tax credit for the sales taxes paid on the same property in another state.<sup>23</sup> If the sales tax paid is greater than the use tax accrual, there is no further use tax obligation. This will generally, but not always, prevent the double payment of the tax.

**E. Sales and Use Tax Audits**

States generally audit sales tax compliance for corporate taxpayers on a regular basis since sales and use tax is one of the states' most significant sources of revenue. On average, states generated approximately 35 percent of all revenue through the imposition and collection of sales and use taxes.<sup>24</sup> The frequency of sales and use tax audits is generally determined by the state's statute of limitations with audits scheduled to occur within the statutory period. State statutes of limitation range from three years in many states to up to six years in Florida.<sup>25</sup>

As the sales and use tax laws vary from state to state, each state's approach to auditing will also vary. Some states rely on statistical approaches, and others focus on transaction reviews. The process used by auditors to review transactions will also vary based on the type of transaction. State auditors will generally begin the audit with a review of the taxpayer's detailed accounting records or general ledger accounts to determine the transactions that will be reviewed. Generally, the nature of the general ledger accounts selected for audit will be those that present the greatest possibility of sales and use tax errors.<sup>26</sup> Additionally, based on the analysis of the general ledger, auditors will generally divide the audit into capital and expense transactions.

Capital assets are generally those items that will be in service more than 12 months (i.e., machinery or equipment), carried on the purchaser's books and depreciated over time. Expensed transactions are generally those items with a useful life of less than 12 months (i.e., hand tools and office supplies) and are expensed when purchased. Purchases of capital or fixed assets are generally reviewed completely while auditors generally will use a sampling approach to review the expense transactions.<sup>27</sup> The sampling approach may be a block sample (i.e., all transactions in a given time period) or a stratified random sample that identifies a varying number of transactions based on the dollar amount. The auditor reviews the receipts or other documentation relating to the identified transactions and determines whether the correct amount of tax was paid or accrued. The amount of assessment, if any, on the capital items is determined by the amount of underpayments identified. The amount of assessment, if any, on the expense transactions is based on the errors found in the sample and projected to the total of all such purchases made during the audit period. The state will assess interest and sometimes penalties depending on the magnitude of the underpayment.

### III. Planning for Tax Compliance on Purchasing Card Transactions

The goal of any tax-compliance plan is to document that sales tax was paid to the supplier at the time of purchase or, if the supplier did not collect tax, that the proper amount of use tax was accrued. In the traditional paper invoice environment, this can be a time-consuming endeavor. Typically, accounts payable personnel physically review invoices and, based on criteria normally provided by the corporate tax department, determine the taxability of the items purchased. Once taxability is determined, the accounts payable personnel determine if the supplier charged the proper amount of sales tax. If the proper amount of tax is not charged, they will compute and accrue the proper amount of use tax and note such amount on the face of the invoice. Due to the number of taxability decisions that are made, the process is time consuming and susceptible to human error. If the invoicing process is automated, taxability software may make the taxability decision based on additional data entered by accounts payable personnel on each transaction during the procure-to-pay process.

While tax determinations on purchasing card transactions may not have the benefit of the typical data available in a purchase order/invoice system, there are transactions that will provide additional data that may support a use tax decision. Purchasing card data consists of three types of data relevant for tax determinations:

- **Level I** – Basic transaction data with no separate statement of tax;
- **Level II** – All of the Level I data plus the separate statement of tax if collected by the supplier in addition to an optional customer reference field; and
- **Level III** – All the data of Level II plus the detail on individual items purchased (invoice data).

While enhanced data can be valuable, and transactions that contain tax data can eliminate the need to analyze a transaction for the use tax accrual, it is important to remember that even if every supplier upgraded to Level II or Level III, the use tax analysis and the calculation of an accrual would still be required. Enhanced data provides a tax answer *only* when the supplier has collected the sales tax. In many transactions, even though the supplier has upgraded their systems and passes enhanced data, no tax will be reported, because the supplier has no obligation to collect the tax in the destination state where the goods are delivered.

A variety of these and other factors may make it impractical to use an existing compliance process to manage the taxability of the purchasing card purchases. Some of these factors may include:

- It is not cost-effective to physically review receipts from all purchasing card transactions;
- Electronic data passed with a purchasing card transaction may not provide the level of detail available in the traditional paper invoice procurement process, and
- Enhanced data that displays tax paid is not always passed or may sometimes be inaccurately passed from the supplier.

Assuming there is no cost-effective way for the tax department to physically determine whether sales tax was collected on each purchasing card transaction (i.e., look at transaction receipts or enter additional data for each transaction in an automated process) and calculate the tax accrual where appropriate, the alternative is to employ an approach that estimates the use tax that is due based on some underlying taxability assumptions.<sup>28</sup> In using an estimation approach, a variety of acceptable compliance alternatives may exist.<sup>29</sup>



Some of these compliance alternatives generally include:

### **A. Incorporate Purchasing Card Transactions into an Existing Use Tax Estimation Approach**

The organization may already have a tax-compliance approach in place that can successfully incorporate the purchasing card transactions. For example, some corporations use a statistical approach to report use tax accruals on noncapital purchases. In this situation, the organization has performed an analysis of its expenditures and determined an appropriate factor, based on an analysis of historical purchases. The factor represents the percentage of dollars spent in the sampled population where a use tax accrual is required. Going forward, the periodic amount of purchases can be multiplied by the factor and the jurisdiction's tax rate to calculate and estimate the amount of use tax due without reviewing the detailed documentation for each transaction.

If the organization uses such a statistical approach to estimate the use tax accrual on the noncapital expenditures in the traditional procurement process, it may be appropriate to include the purchasing card transactions in the calculation. If the purchasing card transactions are included in the calculation, there may be no additional tasks required to comply with the state's use tax requirements.

### **B. Apply Statistical Sampling to the Purchasing Card Transactions**

If a corporation does not already utilize a statistical approach to estimate its use tax accrual in the traditional procurement process, it may be appropriate to develop, with the corporate tax department, a statistical approach for estimating the amount of use tax due on purchasing card transactions. In a statistical sampling approach, a sample, large enough to establish an acceptable level of accuracy, is taken from the population of purchasing card transactions. Each transaction in the sample is reviewed, and a taxability determination is made. Based on the amount of use tax accrued on the sample, a factor is computed and applied to purchasing card transactions on a monthly basis. The estimated amount of the use tax liability is determined by multiplying the dollar amount of purchasing card transactions by the calculated factor.

Example:

During a three-year period, \$14 million of purchasing card purchases were made in State A, and no process for calculating an accrual of use tax was in place. A sample large enough to produce a 90 percent degree of accuracy was taken from the population of the card transactions. After review of the sample, an underpayment rate of 6 percent was calculated. The tax rate in State A is 8 percent. The tax rate of 8 percent multiplied by the error rate of 6 percent yields a factor of 0.0048. Applying the factor to the population ( $\$14,000,000 \times 0.0048$ ) produces an estimated accrual of \$67,200. The factor can be applied on a monthly basis to the future transactions.

This approach can be most effective when:

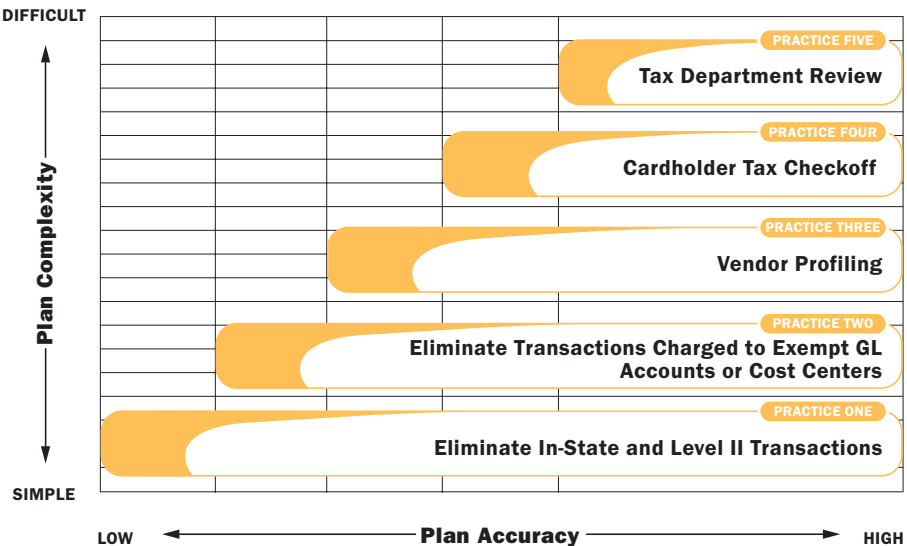
- The purchasing card sample is large enough to establish statistical accuracy;
- The type of transactions in the purchasing card sample are similar over time, meaning that there is no dramatic shift in the type of purchases allowed on the card;
- The sample is updated periodically or when there is a significant change in the spending pattern; and,
- There is no reason to believe that the statistical approach significantly underestimated the amount of use tax due.

While there is a significant time investment associated with establishing the sample and reviewing transactions, this approach can be an effective tax management tool in the right environment.

**C. Apply the Visa Purchasing Card Tax Model**

Originally developed from the Visa Sales and Use Tax Best Practice study, the Visa Purchasing Card Tax Model (Tax Model) provides an alternative to the statistical approach for use tax estimation. This approach uses a series of tax logic filters, based on fundamental sales tax principles, to eliminate transactions where it is likely that tax has been paid. The approach combines characteristics of the transaction with sales and use tax principles to eliminate from the use tax accrual calculation the transactions where it is reasonable to assume that sales tax was paid. After the Tax Model analysis eliminates the transactions where the supplier collected the sales tax, a use tax accrual is calculated for the remaining transactions. In the Tax Model approach, the accuracy of the accrual will increase with more rigorous implementation of each step of the Tax Model. The challenge, however, is determining the most cost-effective combination of the practices employed in the analysis to achieve an accurate use tax accrual.

The practices described in the Tax Model analysis are optional and can be implemented in any combination. The adopted practices of the Tax Model are applied to the population of purchasing card transactions for each destination state, which is assumed to be the state where the cardholder is located.



**Practice One – Eliminate In-State and Level II Transactions**

The data necessary to determine whether a transaction is in-state (both the cardholder and supplier are located in the same state) is based on a review of the Level I transaction data. In most states, like California, the in-state supplier has the legal duty to collect the sales tax.<sup>30</sup> This means that when the cardholder and the supplier are located in the same state, the correct amount of sales tax should have been collected by the supplier at the point-of-sale. Sales tax would have been collected on the items that are taxable, and the exempt items would have been appropriately exempted. Since the supplier is under a legal obligation to collect the tax, these in-state transactions can be excluded from the calculation of the use tax accrual.





Level II data provides the separate display of sales tax collected by the supplier. Level II data is available only with suppliers who have implemented Level II enhanced data capabilities. Transactions, whether in-state or out-of-state that display Level II tax data, can also be eliminated to the extent the tax data passed by the supplier appears accurate. Inaccuracies may exist in tax data reported in the transaction record when the tax amount is manually entered at the point-of-sale. When relying on Level II data to eliminate transactions from the use tax accrual, the purchaser should review the accuracy of the tax reported by the supplier. This can be done by periodically testing a sample of the Level II transactions and verifying that the tax is correctly reported.

At this point, the in-state transactions and out-of-state transactions displaying Level II tax data have been eliminated, leaving a transaction population of out-of-state transactions where there is no evidence of tax collected. The accrual could be computed utilizing this out-of-state population without further review. However, because some out-of-state suppliers collect tax and because some transactions with out-of-state suppliers may be exempt; the amount of the accrual calculated at this point would most likely exceed the actual amount of tax due. Depending on the characteristics of the remaining transactions, there may be value in performing additional analysis that could reduce the amount of the use tax accrual by eliminating more transactions where sales tax has been collected by the supplier. Further analysis of the remaining transactions has value if the cost of further review is less than the reduction of the use tax owed.

### **Practice Two – Eliminate Transactions Charged to Exempt General Ledger Accounts or Cost Centers**

Some of the purchases remaining in the population of transactions with the out-of-state suppliers may be charged to a general ledger (GL) account code or cost center composed of items that are exempt from tax. The designation of the GL account or cost center may be based either on the cardholder's default account code or another allocation made by the cardholder. Examples of such transactions exempt in certain jurisdictions might include:

- Hand tools or repair parts charged to a cost center for manufacturing activities that are purchased in a state with an exemption for equipment used in manufacturing;
- Professional fees such as legal or accounting;<sup>31</sup>
- Items purchased for resale to customers and charged to an inventory account;<sup>32</sup>
- Payment of memberships in professional organizations or association dues;<sup>33</sup>
- Purchases of food or catering, or other meeting support services; or
- Temporary help services.

When automated and used in conjunction with Practice One, this practice increases accuracy and reduces audit exposure without significantly increasing the complexity of the purchasing card program. Combining Practice One and Two, however, may not be sufficient to achieve the perfect balance between accuracy and complexity. If no further analysis was performed, the accrual will be calculated on all the remaining transactions, and use tax will be accrued on transactions where sales tax was already paid. It is appropriate at this point to determine whether it would be cost-effective to perform further analysis or accept the over-accrual of the tax.

### **Practice Three – Supplier Profiling**

Some out-of-state suppliers may have nexus in the destination state and, as a result, may collect sales tax. While it is not practical to review all out-of-state purchases, there are several effective approaches to identifying these tax collecting suppliers who do not pass

Level II data and eliminate them from the use tax accrual calculation:

- Review suppliers with whom cardholders make the largest volume of purchases. The specifics of this approach vary with the spending patterns of each program, but the objective is to classify the largest dollar value of transactions while reviewing a manageable number of suppliers. For example, a decision may be made to review the out-of-state suppliers whose purchases equal 20 percent or more of the annual purchasing card spend. Once this population of suppliers has been reviewed and it has been determined which suppliers collect and which do not, the program may choose to review the next 10 percent. The program may continue to review suppliers until a point is reached where the cost of further review outweighs the benefit of further refining the accrual.
- In a situation where there is extensive use of a network of preferred suppliers, the classification process is simplified. In a preferred supplier situation, the tax collection activities of the supplier can be determined even before the cardholders begin to make purchases.
- In situations where virtual accounts (sometimes referred to ghost accounts or ghost cards) are used, the supplier where the account is established can be surveyed to determine the states where the supplier is registered to collect tax. If purchases will be delivered into states where the supplier does not collect tax, alternate documentation will be required from the supplier to make an accurate use tax accrual.

At this point, there is another cost-benefit analysis of whether a significant reduction in the amount of the use tax accrual could be achieved with further analysis. If a review of the remaining transactions indicates that there are a large number of transactions where sales tax has been paid, additional analysis as described in Practice Four may eliminate them from the use tax accrual.

#### **Practice Four – Cardholder Tax Checkoff**

While it is generally acknowledged that it is best to limit the tax responsibilities of the cardholders, there are certain situations where the cardholder's use of a tax check box may be appropriate. In the typical tax check-off process, the cardholder reviews receipts during online reconciliation and checks a box if the correct amount of tax was collected by the supplier on the transaction. In some programs, the actual tax collected is entered rather than using a check box. Transactions where the box has been checked or the tax has been entered can be eliminated from the use tax accrual. Practically, this practice can only be implemented with cardholders who have access to online reconciliation. This access may be directly with the cardholder or through someone like an administrator who performs the online reconciliation for a group of cardholders.

Generally, this approach provides the most value when limited to cardholders whose purchases present significant tax issues, such as persons purchasing exempt or larger-ticket items. This extra step for the cardholder does not add value when the taxability of the cardholder's transactions can be determined through the previous steps in the Tax Model analysis.

Cardholder training is critical to the success of Practice Four. The cardholder must clearly understand how the Checkoff is to be used. For example, the cardholder must know where to look for the tax amount. This will frequently appear only on the itemized receipt from the supplier. It will not appear on the credit card receipt. Also, the cardholder must understand the taxability of the items purchased, so that when exempt items are purchased, the box is checked indicating that the correct amount of tax was charged and no use tax accrual is necessary.



Since Practice Four requires an extra effort from the cardholder, there should be a convincing cost/benefit argument to be made for implementing this extra step.

**Practice Five – Tax Department Review**

Depending on the spending patterns of the purchasing card program, there may be certain exceptional transactions where it is helpful for the tax department to make the tax determination. These transactions are limited and by far an exception to this estimation approach. Examples of these transactions might include: (1) situations where emergency equipment outside the traditional spend is purchased; or (2) purchases where the dollar amount of the transaction exceeds an amount where the tax department is comfortable with the estimation approach. Generally, the types of transactions where the tax department may want to perform a review should be pre-determined by the tax department working with the purchasing card program administrator. These transactions would be removed from the transaction population in Practice One.

**IV. Calculating Tax Due**

Once the principles of the Tax Model have been applied and the transactions where it is assumed that tax has been charged have been eliminated, the dollar amount of the remaining transactions can be totaled and the appropriate use tax can be calculated. The use tax calculation must be made on a state-by-state basis as determined by the state of the cardholder. If the program only files sales tax returns in a limited number of states, this calculation can be made manually or in a spreadsheet-based application.

If the program has significant expenditures in a large number of jurisdictions, it may be appropriate to automate the calculation. This again may be accomplished through a spreadsheet program or the use of tax-compliance software. In some circumstances this calculation may be automated through the organization’s existing compliance process.

**V. Documenting Tax Compliance for Purchasing Card Transactions**

Critical to establishing an effective tax management process is the retention of source documents and electronic transaction records that describe the characteristics of a transaction. This is true whether the purchase was made through the traditional invoice process or made with a purchasing card.

For any transaction audited by a state taxing authority, the job of the auditor is to verify that the correct sales tax was paid or the proper use tax was accrued. In the invoice-based purchasing process, the auditor will review a variety of transaction documentation from purchase orders and invoices to supplier receipts. When reviewing a purchasing card program, the auditor will focus on the transaction statements and the transaction receipts. Also accepted in most jurisdictions are scanned copies of receipts or Level II and Level III electronic data that displays the tax collected.<sup>34</sup>

In purchasing card programs where a tax accrual is made, the auditor will verify the accuracy of the accrual calculation and review transactions not included in the calculation to verify that sales tax was charged. If a receipt is not retained, and there is no other proof that tax was collected, the auditor will impose an assessment of tax on the transaction. This underscores the value of encouraging cardholders’ retention of adequate transaction documentation.

Generally, the most effective policies for receipt retention include:

- A review of cardholder compliance with receipt retention policies by the program administrator or internal audit;
- Consequences for cardholders who do not retain receipts; and

- Central collection of monthly statements and receipts. This is critical, since a cardholder who transfers or leaves the firm may dispose of receipts leaving all of the transactions subject to a tax assessment if audited.

## VI. Conclusion

As the use of purchasing cards is expanding in efficient procure-to-pay programs, the need to understand and develop cost-effective sales and use tax solutions is growing. This white paper has addressed a range of sales and use tax issues and solutions within commercial card programs. The goal of sales and use tax compliance in purchasing card programs is to achieve effective tax management by taking advantage of the electronic data passed with each card transaction while limiting the costly human intervention necessary in the traditional procurement process. Some of the methods discussed include: incorporating the card transactions into the existing tax estimation approach, applying statistical sampling to commercial card transaction, and applying the Visa Best Practice Tax Model. By understanding the sales and use tax environment of the commercial card program, a sales and use tax management process can be implemented to efficiently and effectively address the tax-compliance issues.

- 1 The term “one card,” as used in the industry, refers to a card program where a single account may be used for procurement, travel and entertainment and/or fleet expenses, or any combination thereof.
- 2 The 2003 Purchasing card Benchmark Survey Results, Palmer, Richard (Eastern University); Gupta, Mahendra (Washington University), © RPMG Research Group.
- 3 (See California Revenue and Taxation Code § 6202, and California Regulations (18 CCR, Reg. 1685) for purchaser liability for use tax in California.); (See also Florida Stat. §212.07(8) (2002) for an example of this concept. The Florida statute in part states: “Any person who has purchased at retail, used, consumed, distributed, or stored for use or consumption in this state tangible personal property...and cannot prove that the tax levied by this chapter has been paid to his or her supplier, lessor, or other person is directly liable to the state for any tax, interest, or penalty due on any such taxable transaction.”). (FLA. STAT. ch. 212 § 212.07(8) (2002)).
- 4 For instance, the sale of newspapers and magazines are exempt from sales and use tax in New York and New Jersey (See New Jersey Publication ANJ-21), while that same sale in Florida would be subject to sales and use tax. (FLA. REGS. 12-A1.008(1)).
- 5 The Streamlined Sales Tax Project (SSTP) is a reform effort by state governments to simplify and modernize sales and use tax collection and administration. The SSTP developed the Uniform Sales and Use Tax Administration Act, intended to promote uniform sales and use tax laws among the states.
- 6 Christopher Swope, staff writer for *Governing*, states “[the Streamlined Sales Tax Project] has a way to go.” He continues by stating “there are many reasons to doubt that dozen of states and thousands of local governments could ever agree on anything, let alone something as touchy as taxes.” (Quoted from article written by Christopher Swopes, E-Taxes and Relevance, *Governing*, posted August 20, 2001).
- 7 (Rhode Island sales and use taxes are imposed on a statewide basis at the rate of 7.0%. (RI Gen Laws Sec. 44-18-18.); (In Colorado the rate of state sales tax is 2.9% (Ch. 298, Laws 2000; COLO. REV. STAT. § 39-26-106).)
- 8 The maximum local tax rate in Alaska is 7.00%. Of the states that have local tax rates, Wisconsin has the lowest local tax rate at .60%. (“Comparison of State and Local Retail Sales Taxes,” (January 2003), Source compiled by the Federal Tax Administrators from various sources) (Federation of Tax Administrators Homepage)).
- 9 The maximum state and local tax rate in Alabama is 11.00%. (“Comparison of State and Local Retail Sales Taxes,” (January 2003), Federation of Tax Administrators Compilation).
- 10 Alaska does not have a state sales tax, however, Alaskan cities and boroughs may levy local sales taxes from 1% to 6%. (“Comparison of State and Local Retail Sales Taxes,” (January 2003), (Federation of Tax Administrators Compilation)).
- 11 “Comparison of State and Local Retail Sales Taxes,” (January 1, 2003), (Federation of Tax Administrators Compilation).q
- 12 Most states exempt services from sales tax and sales tax only applies to those services specifically enumerated as subject to taxation. See Texas, where only services enumerated as “taxable services” are subject to sales tax. (TEX. TAX CODE § 151.010). Some examples of “taxable services” in Texas include: amusement services, personal services and debt collection services. (TEX. TAX CODE § 151.0101(a)). In New York, by contrast, sales tax is imposed on all services that are not specifically enumerated as provided in Section 1105 (b) and (c).(N.Y. COMP. CODES R. & REGS. tit. 20 § 525.2 (2003)).
- 13 See California Regulation §1525. “Tax does not apply to purchases of property to be incorporated into a manufactured article, such as raw materials becoming ingredients or components of the manufactured article.” (CAL. CODE REGS. tit. 18, §1525).
- 14 In New Jersey there is an exemption for machinery, apparatus or equipment used or consumed directly and primarily in the production of tangible personal property by manufacturing, processing, assembling, or refining (Sec. 54:32B-8.13).
- 15 (In California “sales of food for human consumption are generally exempt from tax unless sold in a heated condition (except hot bakery items or hot beverages, such as coffee, sold for separate price), served as meals, consumed at or on the sellers facilities, ordinarily sold for consumption on or near the seller’s parking facility, or sold for consumption where there is an admission charge.(CAL. REV. & TAX. § 6359).); (See Connecticut where certain articles of clothing are exempt. “Effective April 1, 2003, articles of clothing or footwear costing less than \$50 are exempt from sales and use tax.” (CONN. GEN. STAT. § 12-412).)
- 16 See Colorado where an exemption from sales and use tax is allowed for Farm machinery and equipment used primarily for production agriculture or state or federal agricultural programs. (COLO. REV. STAT. § 39-26-114 (20)(a)(I)).
- 17 For an example of a state’s exemption certificate requirements see New York’s exemption certificate requirements in New York Codes, Rules and Regulations. (N.Y. COMP. CODES R.& REGS. tit. 20 §532.4 (2003)).
- 18 Id.
- 19 General Motors Corp. v. Washington, 377 US 436 (1964).
- 20 The current doctrine on nexus in interstate transactions is set out in Complete Auto Transit, Inc. v. Brady, (430U.S. 274, 97 Sct 1076 (1977)). In Complete Auto, the Court established a four-part test for the constitutionality of a tax under the Commerce Clause.
- 21 Quill v. North Dakota, 504 U.S. 298 (1992).; Scripto, Inc. v. Carson, 362 U.S. 207 (1960).
- 22 See California Revenue & Taxation Code Sec. 6202 for an example of a use tax imposition statute and purchaser collection requirements.

- 23 See California Revenue and Taxation Code for an example of a statute allowing a use tax credit for sales tax paid to other states. The statute states, "Credit is allowed as an offset against a person's liability for California use tax on tangible personal property for any sales or use taxes imposed on that property and paid by that person to any other state, political subdivision thereof, or the District of Columbia." (CAL. REV. & TAX. § 6406).
- 24 John L. Mikesell, State Retail Sales Taxes in 1995: The Advantage of a Broad Base, 12 State Tax Notes 255 (Feb. 3, 1997).
- 25 A few of the states where the statute of limitations is three years if a return is filed include: California, Colorado and Illinois. In Florida, the statute of limitations is the "later of 3 years (5 years for taxes due before July 1, 1999) from the date the return is due, filed, or the tax is due; or 6 years from the later of the date a substantial underpayment of tax is made or a substantially incorrect return is filed. (FLA. STAT. ch. 95.091(3)(b)2).
- 26 California State Board of Equalization's Sales and Use Tax Audit Manual, Chapter 4, General Audit Procedures, Section 0406.10 "Examination of General Ledger Accounts".
- 27 California State Board of Equalization's Sales and Use Tax Audit Manual, Chapter 4, General Audit Procedures, Section 0408.25, "Examination of General Ledger Accounts".
- 28 (For an example of acceptable state audit sampling procedures see the California State Board of Equalization's Sales and Use Tax Audit Manual, Chapter 13 "Statistical Sampling."); (Also see Texas Taxes Audit Manual, Chapter 2, "Overview of the Sampling Process." (Revised 06/2003).)
- 29 For a summary of state sampling practices see Federation of Tax Administrators, Sampling for Sales and Use Tax Compliance, A Report of the Steering Committee: Task Force on EDI and Legal Issues for Tax Administrators, Appendix A, "Summary of State Sampling Techniques." (December 2002).
- 30 CAL. REV. & TAX. CODE § 6202(a).
- 31 In California, the performance of professional services is generally not taxable, however, providers of services are consumers of the tangible personal property they use in rendering service and must pay tax on their purchases. (CAL. CODE REGS., tit. 18, § 1501). See also New Jersey where professional or personal service transactions are exempt from sales tax. (Sec. 54:32B-2(e)).
- 32 Sales for resale are exempt from California sales and use tax. (CAL. REV. & TAX. CODE § 6007).; See also Florida's exemption for sales for resale. (FLA. STAT. § 212.02(15)(a)).
- 33 In New Jersey membership fees for professional organizations are exempt from tax. (N.J. Sales Tax Guide, Bulletin S&U-4, Rev. 5/03).
- 34 (In South Carolina, under Regulation 117-7, periodic statements provided by procurement card issuers to card users are acceptable (in lieu of retaining and providing invoices or individual charge card receipts) to document that the correct amount of sales or use tax (state and local) was paid provided the statements contain the requisite transaction level information required by the regulation. S. C. Dept. Rev., SC Revenue Advisory Bulletin #00-6, Aug. 7, 2000. (S.C. CODE REGS. 117-7).); (The New York State Department of Taxation and Finance's policy is that the record keeping requirements for businesses using P-cards is the same as the requirements if P-cards were not used. (New York State's Policy on Corporate Procurement Cards, Tax Homepage, published information dated September 1998).); (See Department of Illinois General Information Letter written by Martha P. Mote, Associate Counsel, which states "Level II data meets the regulation's requirements [for proving tax was paid] and no additional documentation is required on a transaction where Level II data is provided. (ST 99-0122- GIL).)





