Bad Exemption Certificates and How to Work Your Way Out

By Judy Vorndran*

Judy Vorndran reminds us of the importance of exemption certificates, warns us of the risks of poor documentation, and emphasizes the advantages of an "audit-ready exemption management system."

When it comes to exemption certificates, the law often sides with the tax authority or auditor over taxpayers. Simply put, if a vendor does not collect the tax on a transaction—any transaction—the vendor needs to have proper exemption certificate (certificate) documentation. Vendors who do not gather or maintain proper certificates are exposed, and costs can climb fast when certificates are missing, invalid or expired.

States are looking hard at traditional wholesalers, manufacturers and exempt entities as they enforce *Wayfair's* economic presence laws and expand their revenue base to offset COVID-19-related shortfalls. Greater scrutiny means more aggressive audits on registered taxpayers, who are seeing that even small mistakes can compound quickly to material amounts. At one business, a single sale with $800 in uncollected tax and no current exemption certificate grew to nearly $60,000 in assessments, penalties and interest under audit. The assessment breaks down to an $800 charge extrapolated over a 36-month audit period, becoming $28,800. This $28,800 is then multiplied by two—to account for penalties and interest in the jurisdiction—for a total charge nearing $60,000.

The size of the risk related to exemption certificates alone can be hard to lock down. Since audit results are not public record, the consequences of failing to properly obtain and manage certificates is not well-documented. The true cost of mismanaging certificates may also be hard to separate from other errors identified under audit, such as errors in tax rates and the tax base. Assessments, penalties and interest vary widely across state and local tax jurisdictions as well, from as little as Nebraska's 10% of the estimated penalty rate on uncollected taxes and a five-year lookback on unregistered taxpayers to as much as Kentucky, where unregistered

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taxpayers have an unlimited lookback and are assessed 50% of the estimated penalty rate for uncollected tax.

Past Methods That Fall Short

Conceptually, vendors understand the need to collect certificates for transactions with customers they know are exempt. Exemptions are state specific; a valid certificate in one state cannot be universally applied to all states. Details on a state-by-state basis that are mismanaged, overlooked or improperly vetted invalidate the certificate. For example, sometimes we see a Code Sec. 501(c)(3) federal tax exemption letter incorrectly treated as a sales tax exemption certificate. Entry errors are also common, including misidentified states, unsigned documents, and FEIN numbers input rather than the taxpayer account number on file with the state.

The threat of punitive penalties is meant to encourage voluntary compliance and how taxpayers choose to manage certificates is a key to reducing exposure. Taxpayers typically have adopted certain methods to minimize the impact of audit findings related to certificates, some of which may no longer help a taxpayer escape liability. “Rolling the dice,” where a taxpayer takes the chance that they will escape material charges related to an audit, is less likely with *Wayfair* enforcement increasing eyes on all sales transactions and upping the chances that auditors will uncover missing, incomplete and invalid forms or certificates under audit. In addition, penalized taxpayers may no longer see those charges being waived for a first audit as in the past. For example, the home rule city of Denver used to waive 100% of penalties for first-time audits but now typically waives only two-thirds of the penalties.

Contemporaneous certifications, the practice of gathering certificates concurrent with an audit, have been a common method of dealing with invalid exemption certificates. Here again, today’s auditors are less forgiving. For each invalid or expired certificate, the auditor can disallow the exemption. That being said, a contemporaneous campaign when a taxpayer is under the “audit gun” can be better than nothing!

Audit-Ready Certificate System

The current enforcement environment puts the onus on taxpayers to have an audit-ready exemption management system at all times. Exemptions, like sales tax in general, are not “set it and forget it.” In another taxpayer case, a statewide service company came under audit. The company was diligent about getting certificates when a new customer was onboarded but failed to update and revalidate certificates over time. A record of the certificates was kept in a shared electronic file but was not integrated into the company’s billing system. With no system in place to track certificate expiration dates, or whether purchases were exempt on a case-by-case basis, the billing system treated these customers as universally exempt. Once a vendor was deemed exempt, it was exempt for all purchases indefinitely. City auditors ultimately assessed the taxpayer about $200,000 for missing and invalid certificates dating back up to five years, too far back for the taxpayer to remediate uncollected taxes and forms.

Taxpayers should make it a priority to properly vet exempt customers to avoid unwittingly giving up profits under audit. This starts with the first line of defense, the sales team. For the sales team to know whether their customers are exempt, they must be trained to ask the right questions, review collected certificates and ensure certificates are accurate and correct. Accounting personnel also need training to oversee the process as transactions move from billing into the accounting system. Proper training helps all parties understand what is required and the best process for protecting the company and customers from tax risk.

For taxpayers with more than 200 certificates under management, it is time to get automated and internally manage those certificates so they are easy to search by state, customer, expiration date and the like. Thankfully, sales tax automation has come a long way since I started practicing in this area over 25 years ago, and taxpayers can reboot how they collect, manage, validate and archive certificates with available exemption certificate document management systems.

Reducing and remediating exposure is easier with an audit-ready certificate system. For example, the way to compliance for taxpayers subject to economic nexus with no registration and improper certificates is generally through a Voluntary Disclosure Agreement (VDA). The process may include an email campaign through a certificate management product where the tax collector (*i.e.*, vendor) asks buyers for new and updated certificates. When making the move to an audit-ready certificate management system, taxpayers should keep any paper files documenting certificates for at least six years in case called upon to demonstrate past compliance under audit, even if no one at the business can make heads or tails out of the paperwork.

With the spotlight on *Wayfair*, vendors and buyers are more aware than ever of the need for properly managed exemption certificates. With this awareness, vendors are getting less push back in asking for and timely receiving these documents from buyers. So, collect the tax at the time of the transaction or get an exemption certificate at the start of a buying relationship, then maintain that certificate management system on an audit-ready basis to reduce exposure and cost.

Exhibit 1. Common Questions

We commonly get asked the following questions, shared here in no particular order.

- **Question.** If I am doing business with an exempt entity, do I get to step into the shoes of that exempt entity?
  Answer. No.

- **Question.** How do I, the buyer, get a certificate to provide to the vendor?
  Answer. Register. If you do not register in a jurisdiction where the purchase is made, you should be forced to pay the tax.

- **Question.** I am buying these items on behalf of a non-profit. Shouldn't this purchase be exempt?
  Answer. No. The church must be the buyer of record, not the volunteer picking up the goods. Documentation with the state must be proffered to substantiate an exempt position and the church must attest to that. The same goes for individuals buying on behalf of a school. They need to use school funds to make the purchase and not their own. Certificates and payments matter when it comes to sales tax exemptions.

Exhibit 2. Taxable Sales in States with Nexus for Unregistered Taxpayers

When a business participates in a jurisdiction's voluntary disclosure program, typically the jurisdiction will look back to the prior 36–48 months for sales tax purposes but can go back as far as 10 years. When unregistered businesses get "caught," the state may go back as long as it wants because no statute of limitations has been established. Often states have administrative lookback periods of 7–10 years, which also vary by jurisdiction (*see* Chart 1).

CHART 1. TAXABLE SALES IN STATES WITH NEXUS FOR UNREGISTERED TAXPAYERS

State	Comprehensive State and Local Tax (Tax Foundation, Jan. 1, 2021)	Failure to File Penalties (CCH, Jan. 29, 2021)
Alabama	9.22%	Greater of 10% of tax due or $50
Arizona	8.40%	4.5% of tax due per month or fraction (maximum 25%)
Arkansas	9.51%	5% of tax due per month or fraction (maximum 35%)
California	8.68%	10% of tax due
Colorado	7.72%	Greater of 10% of tax due plus 0.5% of tax due per month (maximum 18%) or $15
Connecticut	6.35%	Greater of 15% of tax due or $50
District of Columbia	6.00%	5% of tax due per month or fraction (maximum 25%)
Florida	7.08%	10% of tax due (minimum of $50)
Georgia	7.32%	Greater of 5% of tax due or $5 per 30 days (maximum 25% or $25)
Hawaii	4.44%	5% of tax due per month or fraction (maximum 25%)
Idaho	6.03%	Greater of 5% of tax due per month (maximum 25%) or $10
Illinois	8.82%	2% of tax due (maximum $250)
Indiana	7.00%	10% of tax due
Iowa	6.94%	10% of tax due
Kansas	8.69%	1% of tax due per month or fraction (maximum 24%)
Kentucky	6.00%	Greater of 2% of tax due per 30 days or fraction (maximum 20%) or $10
Louisiana	9.52%	5% of tax due per 30 days or fraction (maximum 25%)
Maine	5.50%	Greater of 10% of tax due or $25

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State	Comprehensive State and Local Tax (Tax Foundation, Jan. 1, 2021)	Failure to File Penalties (CCH, Jan. 29, 2021)
Maryland	6.00%	No penalty for failure to file by due date
Massachusetts	6.25%	1% of tax due per month or fraction (maximum 25%)
Michigan	6.00%	5% of tax due if filed within two months and additional 5% of tax due per month or fraction after two months (maximum 25%)
Minnesota	7.46%	5% of tax due
Mississippi	7.07%	10% of tax due
Missouri	8.25%	5% of tax due per month or fraction (maximum 25%)
Nebraska	6.94%	Greater of 10% of tax due or $25
Nevada	8.23%	10% of tax due
New Jersey	6.60%	$100 plus 5% of tax due per month or fraction (maximum of 25%)
New Mexico	7.83%	Greater of 2% of tax due per month or fraction (maximum 20%) or $5
New York	8.52%	10% of tax due for the first month plus 1% per month or fraction (maximum 30% and minimum of $50), if the return is late by 60 days or less
North Carolina	6.98%	5% of tax due if the failure is for not more than one month, with an additional 5% for each additional month, or fraction (maximum 25% in aggregate) or $5, whichever is greater
North Dakota	6.96%	Greater of 5% of tax due per month or fraction (maximum 25%) or $5
Ohio	7.23%	Greater of 10% of tax due or $50
Oklahoma	8.95%	25% of tax due if not filed within 10 days after written demand
Pennsylvania	6.34%	Greater of 5% of tax due per month or fraction (maximum 25%) or $2
Rhode Island	7.00%	10% of tax due
South Carolina	7.46%	5% of tax due if the failure is for not more than one month, with an additional 5% for each additional month or fraction of the month (maximum 25%)
South Dakota	6.40%	Greater of 10% of tax due or $10
Tennessee	9.55%	Greater of 5% of tax due per 30 days or fraction (maximum 25%) or $15
Texas	8.19%	Greater of 5% (plus additional 5% if more than 30 days late) or $1
Utah	7.19%	Greater of 10% of tax due or $20
Vermont	6.24%	5% of tax due per month or fraction (maximum 25%)
Virginia	5.73%	Greater of 6% of tax due per month or fraction (maximum 30%) or $10
Washington	9.23%	Assessment penalty applies—5% of tax the department has determined to be due, increased to 15% if not paid by the date in the notice, and increased to 25% if not paid by 30 days following the due date in the notice (minimum $5)
West Virginia	6.50%	5% of tax due per month or fraction (maximum 25%)
Wisconsin	5.43%	5% of tax due per month or fraction (maximum 25%)
Wyoming	5.33%	$10 ($25 if not filed within 30 days of notice to file)

Note. *Sales tax rates, rules, and regulations change frequently. This chart is for informational purposes only and does not provide legal or tax advice. The information in this chart may be out of date, and it is subject to change. Consult a qualified tax professional to determine the applicability of this information to you.*

ENDNOTE

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