



Manufacturing tax tips:

Reduce audit risk and
boost accuracy



CCH® SureTax®

When it comes to sales and use tax, manufacturers and distributors generally face complex and unique obligations.

In this paper, we examine some of the most important aspects that may affect a company's sales and use tax liability. In particular, we focus on exemptions, research and development, transfers, and trade shows. Along with exemptions, we cover the tracking of exempt certificates and why it is critical to provide proof of the exemption. Then, we look at the sales tax nexus to review where taxes may be due and how the Supreme Court's Wayfair decision has affected sales tax nexus, and how that can affect your obligations.

The paper concludes with steps you can take to reduce your overall sales and use tax risk and liability.

TABLE OF CONTENTS

- 3 Manufacturers and distributors defined
Importance of exemptions to manufacturers and distributors
- 4 Types of exemptions
Resellers exemption
- 5 Manufacturing exemptions
Keeping track of exemption rules
- 6 Machinery and equipment
- 8 Research and development
- 9 Interplant transfers
- 10 Tradeshow and inventory withdrawal
Understanding economic nexus and where to file
- 11 Protect your business from sales and use tax risk
Steps you can take now to be ready for a sales tax audit
- 12 CCH® SureTax®





Manufacturers and distributors defined

Manufacturers

Manufacturing is typically defined as an operation of producing a new product, article, or commodity that is different, and that has a distinctive name, character, or use from raw material, and that is intended to be sold either as a finished product or a component of a future finished product.

Not all manufacturers use raw materials in their processes, of course. Some, like automobile manufacturers, buy parts or components from suppliers and then manufacture, machine, or fabricate those parts into a new, complete product. These companies still operate as “manufacturers”, as defined by tax authorities.

NOTE: Certain industries that do manufacture goods, such as pharmaceuticals, tech, and construction, face industry-specific tax rules that will not be covered in depth in this white paper.

Distributors

Distributors, for tax and legal purposes, are often defined as any individual, partnership, corporation, association, or other legal relationship that stands between the manufacturer and the retail seller in purchases, consignments, or contracts for sale of consumer goods.

Importance of exemptions to manufacturers and distributors

In most states, sales and use taxes are imposed on selling all tangible personal property and certain specified services unless specifically exempt from this tax under state law. Full and partial exemptions from sales and use taxes may be available and can be especially important to qualified manufacturers and distributors to stay compliant with the regulations.



Types of exemptions

Exemptions to sales and use taxes are expressed in several ways: (1) explicitly, e.g., items considered a part of the manufacturing process; (2) as exceptions to the definition of a taxable sale or tangible personal property; or (3) as exclusions from a taxable category of transactions.

Exemptions may be granted based on the nature of the product (such as food), the type of transaction (such as a resale), or the nature of the entity selling or buying the product (such as a charitable organization).

Examples include:

- Resellers exemption
- Manufacturing exemptions
- Machinery
- Raw materials
- Industrial supplies
- Industrial tools
- Entity exemptions
- Product/service exemptions
- Tax holidays
- Enterprise zones
- Special Incentives

Resellers exemption

Sales tax, in general, is imposed on the final consumer. So, sales for resale are generally exempt from sales or use tax. Sales tax applies only to retail sales, generally defined as a sale for any purpose other than resale in the regular course of business, while the use tax is generally imposed on the storage, use, or other consumption in the state where the tangible personal property was purchased from.

Drop-shipment sales

Drop shipment transactions are more complex than typical two-party transactions because they involve three parties — the seller of the product, the drop-shipper supplier, and the customer— in potentially three different states with three different sets of sale and use tax rules.

Before the Supreme Court's Wayfair decision, it was relatively safe for drop shippers to accept out-of-state resale certificates from companies that did not have physical presence nexus in the customer's state. Now, companies selling products through drop shippers may create a "less-visible" filing requirement in many additional states because of economic nexus.

Drop-shipping is a retail fulfillment method where the seller doesn't keep the products it sells in stock. Instead, when a seller sells a product, it purchases the item from a third party and has it shipped directly to the customer. As a result, the merchant never sees or handles the product.

Manufacturing exemptions

Each state defines the manufacturing process differently for the purpose of a machinery and equipment exemption, so manufacturing exemptions present many opportunities and challenges depending on the state and must be researched separately.

Several states offer a use-based exemption from tax (or a reduced rate) for machinery and equipment used in the manufacturing process. Every state is different, but these exemptions often require certain “tests” to qualify:

- **Percentage of usage**
Qualifying items must be used in manufacturing for a statutorily-determined amount of time that varies by state.
- **New and expanding operations**
Some states limit use-based exemptions to items that are part of a new manufacturing operation, or that expand the existing manufacturing process. Under this requirement, machinery or equipment for repairs would not qualify under some states’ provisions.
- **Partial exemptions**
Many states provide partial exemptions.
- **Minimum dollar amount/Minimum useful life**
Some states establish a minimum dollar amount, and/or useful economic lifespan.

Each of these qualifying tests are often complex, and the regulations vary across states. Because of this, manufacturers and their tax advisors must understand:

- What is tax exempt in all relevant taxing jurisdictions.
- How the equipment/machinery must be used to make it tax exempt.

Keeping track of exemption rules

Keep in mind that the burden of proving that a purchase qualifies for exemption rests with the purchaser.

- *Understand all qualifications before claiming any exemption;*
- *Provide the appropriate exemption certificates to suppliers;*
- *Keep complete and adequate records.*

If there is a dispute, a purchaser must substantiate its qualifications to the tax authorities. In an audit, the state tax auditor generally need not prove that a purchase does not qualify for exemption; the purchaser must prove it does. A purchaser who issues a false or fraudulent exemption certificate will be held liable for payment of tax, penalties, and interest and may also be subject to both civil and criminal penalties.



States also provide exemptions for certain types of ...

- *entities, e.g. tax-exempt organizations;*
- *products, e.g., food;*
- *services, e.g., healthcare;*
- *special incentives, e.g., tax holidays and enterprise zones.*

Each state has different rules and must be researched.



Machinery and equipment

Most of states and the District of Columbia that collect sales and use tax offer a use-based exemption to manufacturers on the purchase of machinery and equipment used directly in the manufacturing process. Most of these states offer a use-based exemption from tax, while three states offer a reduced rate.

Why are use-based tax exemptions provided to manufacturers, and how do they work?

In order to entice businesses into the state to create jobs, states look for ways to tax manufacturers less than other states and localities do. One example is the use-based exemption.

The use-based exemption doesn't apply to the materials, supplies, or parts used in the manufacturing process because manufacturers are reselling these materials, and are able to purchase them exempt from sales tax using a "resale certificate."

If these special manufacturing exemptions did not exist, this machinery and equipment could be taxed under sales tax at the point of sale to the manufacturer.

In order to qualify for the use-based exemption when buying this equipment and machinery, the manufacturer must present a use-based exemption certificate or has it on file with suppliers; otherwise, the seller of the machinery will be required to add sales tax to the transaction. In this scenario, where you present your use-based exemption certificate, the seller assumes that the exemption certificate applies to all items associated with the transaction and does not apply sales tax. Later, if you fail to pay use tax on items that do not qualify for this use-based exemption, you may be subject to audits and then, therefore, penalties and interest, in addition to owing the tax obligation.

When a state exempts machinery/equipment, the state regulates what is exempt and for what uses specifically.



In addition to requiring that the equipment or machinery be used directly in the manufacturing process, other limitations usually associated with use-based exemptions include:

- **Percentage of actual usage**

Tax jurisdictions that offer use-based exemptions stipulate the usage requirements of the applicable qualifying item, which usually includes terms such as primary, majority, predominately, exclusively, and even a preponderance of the time. The requirement, regardless of the term, will usually range from 51 percent to 100 percent usage. The usage percentage is very important to ascertain because some states will allow a qualifying item to be used both in a taxable use as well as an exempt use, but some states will require a qualifying item to be used exclusively in the exempt activity.

- **New and expanding operations**

Some tax authorities limit use-based exemptions to items that are part of a new manufacturing operation or that expand the existing manufacturing process, meaning that machinery and or equipment acquired to replace or repair a worn-out piece of machinery, or one that has become obsolete, would not qualify under some states' exemption provisions. Some states, such as California, Iowa, and New York, do not impose the new and expanding qualification, while others, such as Arkansas, provide partial exemptions on certain qualifying repair uses.

- **Minimum dollar amount or minimum useful life**

Another limitation associated with use-based exemptions is the establishment of a minimum dollar amount and/or useful economic life. A typical minimum dollar requirement might be \$100–\$500.

A typical range of a minimum economic life might be from one to three years. For example, the state of Utah requires “an economic life of at least three years.” These limitations complicate the determination as to what qualifies.

For instance, here's an example of applying the "new and expanding operations" limitation above. Under some states' use-based exemptions, a bolt is exempt only in certain situations. So, if a company takes bolts (the “equipment”) and uses them to build a new manufacturing operation (the “limitation”), many states will say that's tax-exempt. But if the same company uses bolts to replace some of the original bolts in the machinery, those fall under “repair of machinery and equipment.” In some states, the bolts used in the repairs would not qualify for the use-based exemption, and the manufacturer, which bought the bolts with its use-based certification, would need to remit use tax.





As previously mentioned, it is critical that manufacturers understand:

- What is tax-exempt in all relevant taxing jurisdictions.
- How the equipment/machinery must be used to make it tax-exempt.

An important potential complication is that many municipalities within states differ in the use-based exemptions they provide. For example, some local jurisdictions will offer partial instead of full, use-based exemptions.

Research and development (R&D)

With R&D, a company is no longer using the equipment and machinery originally purchased under the use-based exemption to create something to be sold either as a finished product or a component of a future finished product. Instead, the manufacturer is using the equipment and machinery to determine how to expand product lines or improve products or processes. In this case, the manufacturer has become the consumer and may owe use tax.

The only way for taxing authorities to capture tax on the R&D process is through use tax because these items uniquely escape the sales taxes that would have been applied when sold as a finished good — and the manufacturing materials/equipment were exempt from taxes because of the manufacturer's use-based exemption certificate.

However, in some states, R&D, or a percentage of it, may be exempt from use tax. And there might be a divergence between state and local tax policy.

- Manufacturers are responsible for getting all of this right, including whether an R&D exemption exists and applies to their processes. This is sometimes particularly challenging, and manufacturers most often rely on their tax advisors for guidance.
- Manufacturers must properly accrue and remit use taxes on R&D to all taxing authorities in which they have nexus.



Interplant transfers

Interplant transfers occur when machinery, equipment or parts are transferred from one plant/factory to another. This should be an area of concern for manufacturers because these usually trigger “taxable events.” Tax Departments should be made aware whenever such a transfer takes place in order to assess the tax implications.

Consider this scenario: A taxable forklift is transferred from Plant A to Plant B. Plant B is in a different taxing jurisdiction from Plant A. Plant B has now taken a taxable item into a state where no tax was remitted. Consequently, the state where Plant B is located is owed tax.



1. What is the item’s current value, and does Plant B get to use the diminished value as the base on which to pay taxes? Some states will say “yes,” that the diminished value is the fair value of the equipment. The states that say “no,” and there are a handful of them, lead to the second concept.
2. Does the company get a credit for sales tax already paid to the state in which Plant A resides? Typically, when the state charges taxes based on the original purchase price, they allow the tax credit of what was already paid.

Here is another example, a piece of equipment or machinery that qualifies for a use-based exemption. Will the transfer of this item from one plant to another plant across state lines trigger tax in the second state?

The manufacturer needs to determine if the item still meets the use-base exemption in the receiving state and what the tax implications are.

Specifically, when the business examines the situation, the following criteria are evaluated:

- *Is this transaction a taxable event?*
- *What’s my tax base, current value, or original purchase price?*
- *What’s my tax rate?*
- *Do I get a refund from the original state?*
- *What do I owe the second state?*

What sometimes happens is that when the manufacturer is made aware of these transfers, it accrues and remits too much use tax in order to avoid penalties because they aren’t sure what the rules are and are motivated to ensure that the company avoids fees and penalties. This “insurance” approach has an immediate impact on cash reserves, as well as opportunity costs. Another contributing factor is that many businesses rely on basic, native-tax functionality within their ERP. Native sales and use tax capabilities within ERPs often lack the tools and content needed to meet the sophisticated and nuanced sales and use tax needs of most businesses.



Tradeshows and inventory withdrawal

Tradeshows and other situations that result in inventory withdrawal are particularly important to distributors, who need to be aware that inventory withdrawals should be taxed and often are not. This may expose a manufacturer/distributor to use tax violations, which often include penalties and interest.

Consider this scenario: A distributor buys inventory from a manufacturer. The distributor provides the manufacturer a resale certificate that states that the distributor will resell the item and is, therefore, not liable for sales tax. A sales rep at the distributor requests 50 widgets from inventory for a tradeshow or to send to potential customers to keep as samples.

The “withdrawal” is the event, and that creates a tax situation: the distributor has now become the end consumer of those widgets, as they will not be taxed in a sale. Therefore, the resale exemption from sales tax no longer applies to those units. Consequently, the distributor must accrue and remit use tax on those units.

While state use tax auditors look for these events, they are often unaware when one of these taxable events has taken place. This is likely because the tax authority team wasn’t made aware of the withdrawal.

Another complication: Some states require use tax on these “free” items when distributed to someone within their state boundaries, no matter where these units were withdrawn from. If the company already paid use tax on these inventory withdrawals in the home state, it brings up additional considerations, such as whether the company gets credit for the tax already paid in the home state.

Understanding economic nexus and where to file

The Supreme Court’s decision in *Wayfair* greatly expanded the ability of state and local governments to impose sales and use tax obligations on remote businesses. It did so by replacing the physical presence nexus standard with “economic presence” — the amount of economic activity occurring in the state. Every state that imposes a general sales tax has adopted the *Wayfair* economic nexus standard. The impact of *Wayfair* on remote retail businesses has been getting most of the attention, particularly as online and remote selling has become a key new way of conducting business during the pandemic.

However, the sales and use tax impact on companies in key nonretail industries, e.g., manufacturers and distributors, should not be overlooked by businesses in those industries and their tax advisors. Many of these businesses likely need to register in more states than ever before and comply with a whole new set of different state-determined exemption rules. As state Departments of Revenue have increased sales and use tax enforcement to enhance revenue collections, manufacturers and distributors are often targets for sales and use tax enforcement.



Protect your business from sales and use tax risk

Failure to accurately manage sales and use tax compliance is likely to have serious consequences for manufacturers and wholesalers, particularly in this post-Wayfair and rapidly growing remote selling environment where states and municipalities have significantly increased their sales and use tax enforcement efforts to place more focus on areas where they are likely to see an increased “ROI” on their audit investment dollars. This heightened enforcement includes comprehensive audits with costly, often unanticipated sales and use tax bills that could be draconian, especially for small-to-mid-size manufacturing and distribution businesses.

Steps you can take now to be ready for a sales tax audit

1. Get a Nexus Study to understand where you have sales and use tax nexus and where to focus.
2. Assess the benefits of working with a third-party provider to help navigate sales tax nexus, registrations, changes in exemption compliance management requirements, and tax base changes.
3. Make sure all your exempt certificates are up-to-date and complete
4. Establish and reinforce a people, process, and technology (PPT) approach.
5. Understand the role of automation in ensuring accuracy, integrating tax data and documentation, and keeping your company in compliance.
6. Consider cloud-based technology that integrates directly with your ERP.
7. If your company has sales tax nexus in a state where you are not registered, it may go back several years, and a huge tax bill could await you.
8. Consider filing a voluntary disclosure agreement or participating in an amnesty program to limit your liability and exposure and significantly reduce penalties and interest related to unpaid tax liabilities if those states permit.

CCH® SureTax®

On-cloud sales and use tax automation platform

CCH® SureTax® is an end-to-end sales and use tax software platform designed to take the complexity out of taxability determination, calculations, and compliance by offering a simple, intuitive interface to manage sales and use taxes, all within one platform. Here are just a few of the reasons it has become a go-to resource for manufacturers and distributors:



- 1** Our tax research process is SOC (System and Organization Controls) 1 and SOC 2-compliant. Wolters Kluwer's experienced tax research team constantly monitors legislation changes and ensures the tax rates and rules in CCH SureTax are always up to date.
- 2** All implementations are done with the involvement of experienced tax experts that make sure all unique requirements are met.
- 3** Easily monitor sales tax nexus thresholds, manage sales tax exempt certificates, prepare sales and use tax returns and file them in-house, or with the help of our Managed Services that can act as an extension of your tax team.
- 4** Do not underpay or overpay use tax with our Use Tax Optimization Managed Services.
- 5** Simplify sales as use tax management from tax determination to compliance — all within one platform.



Automate sales tax

Lets you skip error-prone, time-consuming manual entry with end-to-end tools for sales tax management.



Automatically apply proper taxability to products

Enables you to properly categorize what you sell, including tax-exempt items, and more.



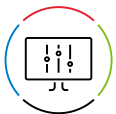
Manage compliance

Keeps your team current with critical information about state rates and sales tax holidays, just for starters.



Effortlessly track exemption sales

Makes it easy to document non-taxed transactions and track proof of exemption certificates.



Capitalize on tax rebates

Helps you leverage opportunities for rebates for sales taxes paid on-time in full in states that offer this opportunity.



Mark Friedlich, CPA CA
Vice President, US Government Affairs,
Wolters Kluwer Tax & Accounting

Mark Friedlich, the renowned tax expert, is a tax lawyer and CPA. As the Vice President of US Government Affairs at Wolters Kluwer Tax & Accounting, Mark has been a consistent thought leader in the tax community and advisor to government taxing authorities and businesses. Mark is a retired PwC Managing Tax Partner. He is a member U.S. Senate Finance Committee's Chief Tax Counsel's Advisory Board, and advisor to 14 state taxing authorities and the HMRC on VAT policy in the UK. He has been a member of the IRS Advisory Council. Mark was recognized as one of Accounting Today's Top 100 Most Influential Tax and Accounting Experts.

About Wolters Kluwer

Wolters Kluwer (EURONEXT: WKL) is a global leader in information, software solutions and services for professionals in healthcare; tax and accounting; financial and corporate compliance; legal and regulatory; corporate performance and ESG. We help our customers make critical decisions every day by providing expert solutions that combine deep domain knowledge with technology and services. Wolters Kluwer reported 2024 annual revenues of €5.9 billion. The group serves customers in over 180 countries, maintains operations in over 40 countries, and employs approximately 20,000 people worldwide. The company is headquartered in Alphen aan den Rijn, the Netherlands.

For more information, visit www.suretax.com, follow us on [LinkedIn](#) and [YouTube](#).

CCH-SalesCorporateTeam@wolterskluwer.com

