

## Sales and Use Tax Audit Procedure Advertising

**Objective:** Discuss the application of sales and use tax as it applies to advertising.

### I. History

**Prior to 1977.** Advertising where the final product was tangible personal property was taxable.

**1977.** Virginia Supreme Court case (WTAR Radio-TV Corporation v. Commonwealth) allowed all advertising where the final product was tangible personal property to be taxed even if the property was used in radio or television broadcasting.

**7/1/86.** Major change. Code of Virginia 58.1-602 and 58.1-608(6)(e) [Presently recodified as 58.1-609.6(5)] (1) exempted media advertising from sales and use tax; (2) taxed all tangible personal property purchased by an advertising business to be used in media advertising. This new legislation supersedes the WTAR case.

**7/1/94.** Code of Virginia 58.1-609.6(4) amended to allow out-of-state advertising businesses to purchase printing from a Virginia printer exempt of the tax when the printing will be stored in Virginia for 12 months or less and shipped outside of Virginia. Virginia advertising businesses were still required to pay tax on all printing used in media advertising.

**7/1/95.** For period July 1, 1995 through June 30, 1997, Code of Virginia 58.1-609.6(4) amended to allow any advertising business to purchase printing from a Virginia printer exempt of the tax when the printing will be stored in Virginia for 12 months or less and shipped outside of Virginia.

### II. References

- A. Code of Virginia Section - **58.1-602, 58.1-609.6**
- B. Virginia Administrative Code (VAC) citations **23 VAC 10-210-41, 42, 43**
- C. Ruling Letters - **see attached**
  - P.D. 88-15** 1/4/88 - lists examples of media and non-media advertising
  - P.D. 88-90** 5/10/88 - lists examples of media and non-media
  - P.D. 88-245** 8/26/88 - sales of audio/video tapes and dubs
  - P.D. 88-304** 10/31/88 - examples of media and non-media
  - P.D. 88-309** 11/7/88 - additional examples of media and non-media

**P.D. 87-72** 2/27/87 - charges by professional photographer  
**P.D. 89-168** 5/22/89 - direct mail advertising  
**Ruling Letter** 6/28/91 - photography; stock photographs  
**Technical Memo** 5/24/91 - photographs used in advertising (Stock Photos)  
**P.D. 92-19** 4/14/92 - graphic design business  
**P.D. 93-134** 6/2/83 - mailing and printing service company  
**P.D. 94-198** 6/29/94 - advertising reprints  
**P.D. 94-316** 10/19/94 - sales of TPP and media advertising  
**P.D. 94-356** 11/23/94 - sign fabrication not creation of media advertising  
**P.D. 95-88** 4/28/95 - Nonprofit clients of advertising businesses  
**P.D. 95-317** 12/15/95 - Fees for reproduction of photos (stock photos)  
**Legislative Change** 7/1/95 Audio Visual Production

- D. Virginia Tax Bulletin **86-12, 93-7, 94-7**
- E. Applicable exemption certificate - **ST-10A, ST-10**
- F. Definitions: These definitions were developed by Tax Policy in conjunction with industry representatives. These definitions are to be considered work in process. Therefore the audit procedure will also have to be flexible and subject to change as the revised regulation is finalized.

**Advertisement** means a communication that is intended to promote or convey a desire to buy, use, sell, or patronize a product, service, business or idea. Communications which are not considered advertisements include polling and public surveys, employee relations and in-house communications, training programs, press releases and similar forms of business communications.

**Advertising** means the planning, creating, and placing of advertisements in media such as newspapers, magazines, billboards, broadcasting and other similar media. Advertising includes the providing of concept, writing, graphic and Internet and other electronic media design, mechanical art, photography and production supervision, and audiovisual production. Advertising differs from other forms of mass communications such as publishing, polling, training programs, press releases and other similar forms of business communications, in that it is intended to promote a desire to buy, use, or patronize a specific product, service, or business.

**Advertising business** means any person or group of persons providing advertising as defined in this regulation.

**Advertising campaign** means the plan or activities conducted by an advertising business to place advertising in the media in order to accomplish the specific advertising objective of the client.

**Direct mail** means mail consisting of advertising materials, appeals for donations, etc., sent simultaneously to the general public.

**De minimus usage rule** means a sale of non-advertising materials in conjunction with an advertising campaign where the tax on the non-advertising materials is no more than \$ 5.00.

**General public means** a broad segment of people, businesses, or other activities to which advertisements are communicated or distributed through the media, such a television or radio broadcasting audience, newspaper or magazine subscribers, electronic media subscribers, company or organization accounts receivable mailing list, political constituency mailing lists, or charitable organization contributor mailing lists.

**In-house advertising** means advertising produced by an entity to advertise, promote, or display its own product or service.

**Media** means any instrument or medium of mass communication directed toward and available to the general public as a whole. Media includes, but is not limited to newspapers, magazines, billboards, catalogs, direct mail, radio, television, cable television, trade shows, sales conferences and seminars, door-to-door sales programs, internet or other electronic interfaces, and other similar forms of mass communication. **Media** does not include promotional communications directed other than toward a wide audience, i.e., the general public.

### III. General

Whether the company under audit has purchased advertising or created advertising, it is necessary to determine what the advertising says and who the intended audience is in order to know how to tax it.

If the advertising is both promotional in nature and widely disseminated to the general public, then it is **media** advertising, the sale of which is **exempt** as a nontaxable service. If it does not meet **both** of those criteria, it is considered **non-media** and **taxable** as the sale of tangible personal property.

**Important Note:** Advertising agencies are generally audited in accordance with the regulations and these guidelines, even during a first audit. As agencies are often inconsistent in how they apply and pay tax, it is best to audit them in this manner. Audits are an excellent compliance tool in the area of advertising because there is such confusion about sales tax within this business.

### IV. Procedures

## A. SALES

When auditing an advertising agency, it's best to begin with sales in order to obtain a knowledge of who and where the clients are and what the jobs are. (Agencies usually refer to sales invoices as "client billings".)

Advertising agencies divide their work into "jobs". What makes a transaction taxable or exempt is the job in which that transaction occurs.

### Exempt sales by an advertising business

According to the sales tax regulations:

The tax does not apply to charges by an advertising business for professional services in the planning, creating or placing of Advertising in newspapers, magazines, billboards, direct mail, radio, television, or other media regardless of how such charges are computed by the advertising business and whether or not such business actually places the advertising in the media.

The "advertising" referred to here is media advertising. Some examples of exempt sales of **media advertising** by advertising businesses are

- Ads that will be placed in newspapers and magazines
- Brochures, letters, return envelopes, etc. for use in direct mail advertising (that is promotional in nature and widely disseminated)
- Advertising inserts or supplements distributed in nontaxable publications or through the mail
- Point-of-sale advertising devices, including display racks, animated and action pieces, posters, banners, table tents
- Promotional literature, leaflets or brochures for direct door-to door advertising or marketing campaigns
- Promotional materials (brochures, posters, etc.) to the public promoting trade shows, conferences and seminars
- Political advertising
- Corporate annual reports and prospectuses
- Commercials that appear on television or radio
- Production of art work, photography, music, scripts, recordings, and audio or video tapes for use in an advertising campaign
- Development of logos and other corporate identity programs

If a job falls into any of these categories, the charge is not taxable. (However, purchases for these jobs will, for the most part, be taxable.)

### Taxable sales by an advertising business

If **you** identify a job that does not seem to be both promotional and widely disseminated to the public generally, and it involves the sale of tangible personal property, then it is taxable. In ad agency billings, there is often a breakdown between creative (time) charges and production expenses (printing, etc.) The taxable sales price should include all creative services in connection with the sale. However, if an advertising business receives from its client in good faith a properly completed exemption certificate, the tax should not be charged.

Some examples of taxable **non-media** sales are:

- Administrative supplies (stationery, envelopes, business cards, etc.)
- Training films and materials
- Product manuals
- In-house communications such as employee newsletters or customer newsletters
- Price lists, order forms, restaurant menus, etc.
- Shareholders meeting notices and materials
- Photography, art work, computer graphics, logos, etc. for use other than in media advertising campaigns
- Reprints, without major changes, of previously created advertising brochures, catalogues, etc.
- Duplicate copies of advertising videos where the duplicates are made sometime after the creation of the original production

#### **Non-media items developed in connection with a media campaign**

If, in conjunction with a media advertising campaign, an agency includes what normally would be considered non-media items, the exemption will apply. For instance, the client has ordered a large direct mail campaign to promote their new product and will mail brochures to a large number of residents in the state. The agency designs the brochure, a personalized letter to accompany it on special letterhead, a matching envelope, and special business cards of salespeople the prospective customers can contact. If developed alone, the business cards and stationary would be considered taxable, but because they were developed for a media campaign, the sale of all these items would be exempt.

#### **Additional notes on sales**

- Who are "**advertising businesses**"?

"Advertising business" means any person or group of people providing the planning, creating, or placing of advertising in newspapers, magazines, billboards, broadcasting or other media, including without limitation, the providing of concept, writing, graphic design, mechanical art, photography

and production supervision. Therefore, an illustrator may be considered an advertising business; a photographer may be a person in business alone who supervises a number of freelance writers and artists who create advertising may also be considered an advertising business.

There are companies called "specialty advertisers" whose business it is to imprint logos, messages, etc. on novelty items such as pens, cups, bags, water bottles, etc. These specialty advertisers are usually treated as sellers of tangible personal property and not advertising businesses. Their charges for the sale of imprinted items are taxable.

Also, some printers will do layouts for flyers and simple brochures that customers use to advertise things for sale (to be put in windshields at supermarket parking lots, etc.) These "quick printer" businesses are generally not considered advertising business, but rather sellers of tangible personal property.

**Audio/video production companies** are businesses that produce radio and television commercials. Their charges for creation of advertising would be exempt. There was a major law change in 1995 regarding the application of sales tax to these companies. See attached legislative change.

- What is "**promotional in nature**?"

When reviewing sales or purchases of advertising items such as brochures, usually it's a good idea to look at the piece in question. Look at the layout and read the copy. Does it use selling words like "new and improved", "the best of its kind on the market", "your life will be changed"? Is it trying to induce the reader to buy the product or service being described? Or is it just conveying information ("We have moved. Our new address is...").

Bear in mind, though, that a promotional piece targeted to nuclear scientists may be worded a whole lot differently than one marketing soft drinks to teenagers.

Sometimes it just comes down to the auditor's best judgment.

- What is "**the public generally**"?

Just how wide an audience does the marketing campaign have to cover for it to be considered media advertising? A general rule of thumb is that if the ad is placed in a newspaper or magazine or is shown on television or played on the radio, it has reached the general public. This is the case regardless of what the magazine is or how small the radio listening audience is.

However, a **narrower audience** may be considered "the general public" if it is the general public that will use the product advertised. For instance,

manufacturers of industrial size heating and air conditioning systems will not be targeting their ad campaign to those shopping at Lowes. Their audience is probably large commercial building contractors, and a campaign targeted to those contractors would be considered disseminated to their general public. (This is called "Business-to-Business advertising".)

Finally, a campaign targeted to a list of **current customers** (members, etc.) is not usually considered to be disseminated to the public generally, but rather to a restricted audience, and would most likely be non-media. (However, if the client is VA Power, their customers really are the general public.)

- Look at **job folders**; key in **job numbers**.

Advertising agencies usually give each job a special designation, often a number/letter combination. It's important when keying sales exceptions (as well as purchases exceptions) to list the job number in the account number field. This will help match up purchases to sales, and assist the agency in collecting information about the job.

Also, many agencies maintain separate folders for each job that contain copies of client billings, purchases invoices and cost breakdowns. When beginning a review of sales, ask if the agency keeps such job folders; it is helpful to see all the information about a job in one place.

- Remember, **gray** is a prominent color when dealing with advertising

## **B. PURCHASES**

### **Taxable purchases for use in advertising**

Because advertising businesses are considered to be providing professional services, they are the users and consumers of all tangible personal property purchased for use in providing that service. Therefore, with certain exceptions, tax applies to all purchases by an advertising business including, without limitation, the following items:

- **Administrative items:** paper, ink, pencils, layout boards, blank audio and video tapes, equipment, office furniture and office supplies whether or not intended for distribution outside of Virginia
- **Promotional items:** pens, pencils, ash trays, calendars, balloons, t-shirts, and similar items which are part of an advertising campaign, whether or not such items are intended for distribution outside of Virginia

- **Printing:** before 7/1/95, all printing for use in an advertising campaign was **taxable** whether or not it was intended for distribution outside of Virginia (the exception was if printed outside of Virginia and never brought into the state). This is what the regulation states. However, the law has been changed and **after 7/1/95**, printing of advertising materials that will be stored for 12 months or less in Virginia is **exempt**. The same rules apply to printing done by direct mailing services, where if the printing is taxable, all services in connection with that printing (except postage) are also taxable
- **Stock Photographs:** when an advertiser purchases the right to use photographs maintained in an inventory kept by a photographer, stock photo business, advertising business, or other business, this does not represent the purchase of exempt photographic services and is taxable, regardless of whether the photo is to be used in a specific advertising campaign (distinguished from the exempt purchase of photographs **created** for a specific campaign)
- **Audio/visual production:** duplicates (dubs) of previously created audio/visual tapes purchased for the advertising agency's personal use constitute the purchase of tangible personal property and are taxable
- **Mailing lists:** advertising businesses often purchase mailing lists, usually on computer disks. These lists are taxable, unless they are customized in some way. If they are customized mailing lists, they are exempt. For instance, the agency purchases a taxable mailing list of all people in a certain ZIP code. However, if they want that list narrowed down to all people in a certain ZIP code making over \$70,000, that would be an exempt customized list.

### **Exempt purchases for use in advertising**

Purchases by an advertising business of concepts, writing, graphic design, mechanical art, audio/visual productions, photography and production supervision **created for a specific advertising campaign** are **exempt** from the tax when purchased from an entity deemed as an advertising business pursuant to this regulation. (However, in order to purchase tangible personal property without tax, a properly completed exemption certificate, Form ST-10A, must be furnished to the vendor.)

For example, an advertising agency goes to an audio/visual production company to produce a commercial, which will be shown on television promoting the client's product for sale. The charges by the production company are exempt of the tax, because they are in the business of creating advertising for a specific campaign. The same is true if a

photographer were hired to take slides for use in a magazine ad, or a graphic artist created an illustration for use on a billboard.

**Lettershop services:** services provided by a mailing service business such as printing names and addresses on preprinted letters, addressing envelopes, folding, inserting and mailing are **non-taxable services** (these are called "lettershop" services). However, as stated earlier, if the mailing service prints the letter in its entirety, it is treated like a printer and all services in connection with that printing job--sorting, formatting, printing, folding, and inserting--are taxable. Charges for postage are exempt. These businesses may also do disk conversion and printing of labels for sale to the advertising business. Both of these are taxable.

### **Purchases for resale**

Tangible personal property purchased for sale to clients in connection with a non-advertising campaign is not subject to the tax. This includes items that are actually conveyed to the client in the sale. For instance, an agency's purchase of printing of non-media brochures can be made without tax. (However, the purchases of photographs that will be used in the brochure, because they are not actually conveyed with the items, are taxable.) The agency should present a properly completed exemption certificate Form ST-10, indicating the purchase is for resale.

### **Auditing note**

When auditing an advertising business and sampling is used, purchases and sales should both be audited for the same year. Job numbers should always be listed, if possible.

### **In-house advertising**

A non-advertising business such as a manufacturer or a large retailer may have an advertising division within their corporation. This internal division operates to market their own products for sale. Purchases of materials, supplies and other tangible personal property by these divisions are **taxable** in the same manner as any other taxpayer.

If the division were to go to an advertising business such as a photographer or audio/visual production company for work to be created for a media advertising campaign, such purchases would be **exempt** (tax does not apply to charges by an advertising business for creation of advertising).

**Catalog exemption:** if the division completes a catalog, brochure or some other item which will be used in advertising and takes these to a printer, tax does not apply to these items--and any envelopes, containers and labels

used for packaging and mailing them-- if they are to be stored for 12 months or less in Virginia and then distributed outside of the state.

This exemption also applies if a company has an advertising agency design the advertising materials, but has the printing done themselves. The company is responsible for sales tax on printing of materials distributed in Virginia only.

**External clients:** when an in-house advertising staff provides advertising to external clients, including affiliated companies, it would be deemed an advertising business.

## **Sales and Use Tax Audit Procedure**

### **AIRCRAFT SALES AND USE TAX**

**Objective:** Discuss the application of aircraft sales and use tax.

#### **I. History**

Prior to **January 1, 1994**, scheduled air service was defined as "consisting of regularly scheduled flights to one or more Virginia airports at least five days per week."

**1995** legislation retroactive to **January 1, 1994**, redefined scheduled air service. The requirement for scheduled flights to one or more Virginia airports at least five days per week was reduced to one day per week.

#### **II. References**

- A. Code of Virginia Sections 58.1-609.3(6) and 58.1-1500 through 58.1-1510
- B. Virginia Regulations 630-11-1500 through 630-11-1510 (VAC 10-220-5 through 90); 630-10-6 (VAC 10-210-70); 630-10-6.2 (VAC 10-210-90); 630-10-7 (VAC 10-210-100).
- C. Ruling Letters: Public Document 92-251
- D. Virginia Tax Bulletin 91-4
- E. Court Case: Charles E. Smith Management vs. Department of Taxation of the Commonwealth of Virginia, et al (Virginia Supreme Court)
- F. Sample Letter to Taxpayer
- G. Virginia Aircraft Tax Worksheet
- H. Form AC-48, Audit Report
- I. Aircraft Tax Audit Manual "700-1 through 700-7" and attachments
- J. Applicable Exemption Certificates: ST-20

### III. Definitions

**Aircraft** - Any contrivance used or designed for untethered navigation or flight in the air by one or more persons at an altitude greater than 24 inches above the ground. Does not include parachutes or hang gliders.

**Dealer** - Any person owning five or more aircraft at any time during a calendar year which are held for resale or used for compensation.

**Scheduled Air Service** - Any scheduled service provided by a domestic or foreign air carrier operating pursuant to authority issued by the U.S. Department of Transportation and under federal aviation regulations. Such airlines must provide service on a continuing basis to one or more Virginia airports at least one day per week.

### IV. General

The Virginia aircraft sales and use tax is imposed at the rate of two percent upon the retail sale of every aircraft sold in this state, upon the nonexempt use in Virginia of any aircraft, and upon the lease, rental, or charter by a dealer as defined above who has properly applied for the dealer exclusion with the Tax Commissioner (see Aircraft Tax Reg. Sec. 630-11-1507). If a dealer elects to pay the two percent tax at the time of the purchase of the aircraft, the gross receipts from the lease, rental, or charter would not be taxable.

Form AST-1 is the form used for application for the dealer exclusion. The AST-2 is the Dealer's Aircraft Sales and use Tax Return. The AST-3 is the Virginia Aircraft Sales and use Tax Return filed by the aircraft purchaser.

All aircraft owned by Virginia residents must be licensed by the Department of Aviation and must pay the tax prior to licensure unless they have already paid aircraft tax or they meet some specific exemption. The basis for this statement is derived from Code of Virginia sections 58.1 (taxation) and 5.1 (aviation):

Section 5.1-5(a) - Every resident of this Commonwealth owning a civil aircraft, every non-resident owning a civil aircraft based in the Commonwealth...shall before the same is operated in this Commonwealth, obtain from the Department an aircraft license for such aircraft.

Section 58.1-1502 - There is hereby levied and imposed, in addition to all other taxes and fees of every kind now imposed by law, a tax upon the retail sale of every aircraft sold in the Commonwealth and upon the use in the Commonwealth of any aircraft required to be licensed by the Department of Aviation pursuant to 5.1-5.

Section 58.1-1506(A) - Except as provided in paragraph B, the tax on the sale or use of an aircraft required to be licensed by this Commonwealth shall be paid by

the purchaser or user of such aircraft and collected by the Commissioner prior to the time the owner applies to the Department of Aviation for, and obtains, a license therefor.

## **V. Procedures**

The 2% aircraft tax is computed on the gross purchase price of the aircraft without deduction for trade-in. As cited in the new Virginia Administrative Code 10-220-40, the Virginia aircraft sales and use tax does not apply to any aircraft sold or used by:

- 1) The United States government or any of its governmental agencies;
- 2) The Commonwealth of Virginia or any of its political subdivisions;
- 3) Any airline operating in intrastate, interstate, or foreign commerce as a common carrier providing regularly scheduled service to one or more Virginia airports at least one day a week on a continuing basis.

It should be noted that the new regulation does not reflect the 1995 legislative change effective January 1, 1994, that redefined scheduled air service.

Aircraft sales and use tax audit leads and information on those leads come from various sources:

- The "Annual Airport Survey" (required to be filed with the Department of Aviation) lists the aircraft based at each airport and the aircraft owners and is given to the Department of Taxation by the Department of Aviation.
- Aircraft tax audit referrals from the Miscellaneous Taxes Section of the Office of Customer Services.
- Auditor referrals.
- Leads forwarded by the Department of Aviation through their licensing information.
- The Federal Aviation Administration provides sales transaction information and serial and tail number information. The Department of Aviation will assist us with getting information from the FAA. Additionally, some ownership information can be found on the FAA's website under "www.landings.com".
- The airport's Fixed Base Operator (FBO) that manages the hangar spaces and provides maintenance and fuel to non-commercial aircraft.

As auditors conduct sales and use tax audits they should note and investigate any evidence that the business may own an aircraft. The review of assets may disclose ownership of an aircraft. Expenses incurred for hangar space, tie-down services, aircraft repairs and maintenance, and payments to a company for aircraft management may indicate ownership of an aircraft by the business.

The initial step in conducting an aircraft tax audit is to contact the taxpayer through a letter accompanied by a worksheet. The completed worksheet includes information such as purchase price of the aircraft; aircraft tax paid to another state, and length of time that the aircraft has been located in Virginia. When the worksheet is returned, all pertinent information should be verified by the auditor. Descriptions of aircraft can be obtained from the FAA in Oklahoma at (405) 954-3116. Valuation of the aircraft can be verified through Janice Cole with the Department of Taxation (financing documents or bill of sale also state the value). Tax paid can be checked on the STARS screen 8-03. Typically when tax is paid, the taxpayer receives a certificate of tax payment and notes are made on screen 8-03 indicating payment along with the tail number and serial number. In addition, the Department of Aviation can provide the auditor with payment information. Since the 8-03 screen is regularly purged, it is sometimes necessary to contact Aviation to verify payment and licensing of the aircraft.

Serial numbers for aircraft do not change but tail numbers, similar to auto license plates, can change. It is important to use both numbers as references. Serial numbers on the worksheet should be checked with those on the STARS screen 8-03 and on the Landings Internet website at [www.landings.com](http://www.landings.com), or with the Federal Aviation Administration.

Each district office should keep a current list of planes based in their region. This list should include the tail number, serial number, and the most recent owner's name and address. This list can be compared annually to the airport survey and Landings to identify aircraft sales to new owners and new aircraft located in the region.

The owner may claim that the aircraft was never located in Virginia. For verification, the auditor should review the aircraft's flight logs which can be obtained from the owner/operator. The flight log contains the flight history of the aircraft. If the aircraft regularly used a Virginia airport as a hub (e.g., flying from Virginia and back again), it would be taxable. Aircraft **based** in Virginia more than 60 days (need not be consecutive) in **any** 12-month period would also be taxable.

An aircraft may not be required to be licensed in Virginia; nevertheless, the aircraft tax must be paid if the aircraft was purchased in Virginia. Aircraft tax is due on aircraft used within the state, and not based upon residency of its owner.

Although both Dulles and National airports have Washington, D.C., mailing addresses, they are located in Virginia. Aircraft at these airports would be subject to the aircraft tax absent any statutory exemption.

In the case of leases, if total lease payments equal or exceed 80% of the aircraft's fair market value, the lessee is subject to the tax. Should lease payments be less than 80% of the aircraft's market value, the lessor is liable for the tax even if the lease is to a government agency.

Subsequent to the purchase of the aircraft, any purchases of supplies (e.g., repair parts, pilot charts) and taxable services (e.g., food service) would be subject to 4 1/2% retail sales and use tax (VAC 10-210-70). Charges for refurbishing or refitting an aircraft are also subject to the retail sales and use tax if the remodeling is a transaction separate and distinct from the original purchase.

The Office of Tax Policy has taken the position that the statute of limitations is three years for taxpayers who have filed returns and six years for those who have not filed, as is the case with the four and one-half percent retail sales and use tax.

## Sales and Use Tax Training

**Objective:** Discuss the application of sales and use tax as it applies to agriculture.

### I. History

With the 1966 Rules and Regulations, as with many sections of the Rules and Regulations booklet, the agriculture section was limited and generalized. Since that time the code of Virginia has changed only slightly, while the Rules and Regulations has grown tremendously. In the beginning, “agricultural products” was not defined, but today we have farmer-horse breeder, commercial tree farming, commercial fish farming, commercial worm farming. Also the Code of Virginia states that “Agricultural commodity,” for the purposes of this subdivision, means horticultural, poultry, and farm products, livestock and livestock products, and products derived from bees and bee keeping.

A substantial change in the regulation occurred effective July 1, 1979 with the introduction of the term “structural construction materials” and those items that were excluded from that definition. The term “structural construction materials” includes but is not limited to the following: silos; barns and sheds; storage bins (not portable); greenhouses, including plastic covered houses; permanent fencing; fuel oil storage tanks; electrical wiring, except for wiring running from special purpose equipment to an on-off switch; plumbing, except as part of special purpose equipment (e.g., water feeding system in poultry house); cattleguards; farrowing houses; and bulk tobacco curing barns. These items are therefore subject to tax.

The term “structural construction materials” specifically excludes the following but may also exclude other items: milking systems; feeding systems; heating systems; artificial insemination equipment, lighting fixtures in poultry houses used for the purpose of extending the daily feeding period of chickens; power outage and water pressure alarm systems; egg cooling equipment, including wall mounted egg coolers; ventilating equipment, to include air inlets, curtains and curtain cables, cords and related fixtures, pull-ups, winches, fans and fan belts, louvers, shutters, motors, static pressure gauges, thermostats and replacement parts; shade cloth; and irrigation lines and sprinkler heads. These items are therefore exempt from tax.

As amended in 1993, Va. Code 3.1-796.66 of the Comprehensive Animal Laws defines “livestock” to include:

Domestic or domesticated: bovine animals; equine animals; ovine animals; porcine animals; cervidae animals; capradae animals; animals of the genus Lama; ratites;

enclosed domesticated rabbits or hares raised for human food or fiber; or any other individual animal specifically raised for food or fiber, except companion animals.

Definitions: Bovine animals-belonging to the ox or cow family.  
Equine animals-belonging to the horse family.  
Ovine animals-characteristic of sheep.  
Porcine animals-resembling swine or a pig.  
Cervidae animals-resembling a deer.  
Caprae animals-belonging to the goat family.  
Genus Lama-llama, alpaca.  
Ratites-flightless birds

## II. References

- A. Code of Virginia Section 58.1-609.2 & 3.1-796.66 of the Comprehensive Animal Laws
- B. Virginia Administrative Code 23 VAC 10-210-50
- C. Ruling Letters
  - PD 00-126, Occasional sale 7/6/00
  - PD 99-85, Exempt tractor used in vineyard, prorated portion 4/22/99
  - PD 99-27, Feeding systems, bins and tanks 3/16/99
  - PD 98-197, Fencing materials 11/30/98
  - PD 98-8, Trailer and customized poult transport system 1/19/98
  - PD 97-454, Structural construction materials-hog parlor 11/14/97
  - PD 97-280, Two-way radios 6/24/97
  - PD 97-139, Veterinarian, prescription medicines and drugs 3/21/97
  - PD 97-27, Golf carts-agricultural uses 1/30/97
  - PD 97-17, Storage bins vs feeding systems 1/22/97
  - PD 96-349, Vaccination machines 11/27/96
  - PD 96-291, Agricultural cooperative association is not a farmer 10/17/96
  - PD 96-120, Rental of farm machinery 6/5/96
  - PD 96-69, Livestock wholesaler may be a farmer 4/26/96
  - PD 96-34, Farm vehicles 4/3/96
  - PD 95-33, Gravel and crushed stone 3/1/95
  - PD 94-324, Miniature horses 10/24/94
  - PD 94-311, Methyl bromide gas for weed control 10/5/94
  - PD 94-301, Farm service truck, lube truck, boom truck 9/29/94
  - PD 94-152, Ostrich farming, define "livestock" 5/16/94
  - PD 94-68, Operating grain buying station, equip to spread fertilizer 3/17/94
  - PD 93-100, Thoroughbred breeding and racing operation 4/12/93
  - PD 93-93, Computer operated irrigation controllers 4/2/93
  - PD 93-74, Show horses 3/18/93
  - PD 93-5, Amusement park and breeding facility 1/8/93

- PD 92-104, Cab covers 6/23/92
- PD 91-294, Thoroughbred horse breeding farm 11/19/91
- PD 91-174, Multi-state thoroughbred horse business 8/23/91
- PD 91-129, Breeder and trainer of race horses 7/22/91
- PD 91-116, Purchase of trees 7/9/91
- PD 90-113, Lessor of TPP-Agricultural 7/23/90
- PD 89-288, Storage tanks, parts and tobacco barns 89-288
- PD 89-223, Fish farming 8/24/89
- PD 89-125, Sale of prescription and nonprescription medicines 4/24/89
- PD 88-231, Supplies for horse breeding 7/29/88
- PD 87-156, Milking and feeding stalls 6/2/87
- PD 86-58, Silos 3/25/86
- PD 86-29, Delivery of horse outside the state 2/86

D. Applicable exemption certificate

- ST 15-Discontinued 9/81, old ST 15s are valid still (Should be replaced with ST 18)
- ST 18

### III. General

- A. Generally we are not auditing the farmer himself, rather we are auditing the farm supply dealers, farm implement & equipment dealers and farm bureaus. The agricultural exemption can be defined as broad. What is necessary for agricultural production is exempt. Many rules of agricultural auditing relate to other types of auditing, ie real property is taxable (except specific "structural construction materials"), tools used to repair farm equipment are taxable and so forth. As with other regulations the same item can be used in a taxable and also an exempt manner, ie light bulbs, temporary vs permanent fencing, tractor blade, parts for licensed and unlicensed vehicles used on the farm etc. Purchases may be taxable, exempt or proratable. A "custom farmer" does not enjoy the agricultural exemption. Custom farmers generally do not raise an agriculture product for sale. Instead they provide a "service" for farmers where the custom farmer has equipment to harvest crops for the farmer. These typically may be corn pickers, combines and hay balers.
- B. Only on a rare occasion would we audit an individual farmer. More compliance can be achieved by auditing the dealer as opposed to one individual.

#### **IV. Procedures**

##### Audits of Farmer

- A. Due to the nature of the farm business, it is recommended you perform a detail audit. Using the CCH amended agricultural exemption list as a guide, farm purchases may be totally exempt, totally taxable or may be prorated based upon the use. The statute may be opened to 6 years as the farmer may not be registered or may not have reported any tax in the last 3 years. It needs to be determined if the farmer is making any sales of products which may require a registration. The occasional sale provision applies to farmers as to any other business. There are programs in which members pay for a share of produce in advance of the growing season as an investment in the farm and receive produce deliveries through out the season. These membership fees, initiation dues, or annual fees which entitle the members of the group to tangible personal property are subject to the tax at the time the fees are paid. 23 VAC 10-210-6030 states "The use tax does not apply to livestock and livestock products, poultry and poultry products or farm and agricultural products, if produced by a farmer and used or consumed by him and the members of his family."

##### Audits of Supplier

- A. Upon contacting the taxpayer to be audited and doing a sample month, keep in mind the seasonal cycles of the farmer. There are the planting, growing and harvesting months to be considered when selecting the sample months. Obviously a selection by the STAUDN program would not take the seasons into consideration.
- B. Great care should be exercised on the examination of exemption certificates. Exemption certificates must be completely and correctly filled out. The ST-18, on the face of the exemption certificate, list the items which can be purchased exempt. Remember an exemption certificate that is accepted in good faith may not be scrutinized as closely as one received after the fact. Form ST-11A is for use by construction contractors to purchase tangible personal property necessary for agricultural production, to be affixed to real property (feeding, milking systems, lighting fixtures in poultry houses, etc.). The contractor must obtain the ST-11A from Richmond. The Form ST-18 is the proper certificate for use by both in state and out of state farmers. Structural construction materials for silos, barns, sheds and permanent fencing are subject to tax. Contrary to the belief of both farmers and dealers, the ST-18 Exemption Certificate is not a blanket exemption certificate. Generally

the auditor or the farmer may prorate items based on use. Normally the dealer would not prorate.

- C. Generally sampling is acceptable for parts and repair orders, while detailing is necessary for farm equipment due to invoice amounts (commonly referred to as whole goods). Any exempt whole good sales should be considered for a future letter campaign. The following information should be obtained for this purpose: name; address; invoice date; invoice amount; invoice number; description of property purchased. In a letter campaign we are attempting to find taxpayers who have signed an ST-18, but do not file a Farm Schedule F for federal income tax purposes. Thus they are not entitled to the exemption. We have found that a true farmer files a Farm Schedule F whereas, many weekend farmers and persons with 10-20 acre estates think they are farmers but, raise no agricultural product for sale. Also, in rare cases, large farms are incorporated and file a Schedule C. This is also acceptable in determining a true farmer. Sample letters are attached. Unofficial guidelines for tractor/implement dealer audits are attached.
- D. Special attention should be paid to audits of farmer-horse breeder in that they enjoy some exemptions that other farmers do not. Also, sales of horses require a thorough study.

The following excerpt is taken from Commerce Clearing House, Virginia Tax Reports, Sales and Use Section, either hard back edition or cd-rom. COPYRIGHT 2000, CCH Incorporated. Additions to or changes from the original printing by CCH are identified by ***bold, italicized and underlined print.***

CCH-ANNO, VA-TAXRPTR ¶60-250.13, **Agricultural exemptions listed.--  
Agricultural exemptions listed.--**

*I. Tangible personal property listed in Items A through H below is exempt from the Virginia retail sales and use tax when purchased by a farmer for his use in agricultural production for market--(These exemptions do not apply to purchases for personal or family use or consumption as distinguished from purchases for use or consumption in agricultural production for market. A farmer who is not engaged in the business of producing agricultural products for market cannot claim any agricultural exemption.)*

A. Commercial feeds and seeds purchased by a farmer for his use in agricultural production for market.

Feed for breeding and other livestock

Feed for poultry

Seeds

B. Fertilizers and liming materials purchased by a farmer for his use in agricultural production for market.

C. Poultry purchased by a farmer for his use in agricultural production for market.

Baby chicks

Ducklings

Geese

Guineas

Hatching eggs

Turkey poults

D. Agricultural chemicals such as herbicides, pesticides, insecticides, fungicides, defoliants, disinfectants, and cleaning materials purchased by a farmer for his use in agricultural production for market.

E. Fuel for drying or curing crops purchased by a farmer for his use in agricultural production for market.

F. Twine and containers, including bags and wrapping materials, purchased by a farmer for his use in agricultural production for market.

G. Farm machinery and equipment, and parts therefor, purchased by a farmer for his use in agricultural production for market.

Automatic feeding and watering equipment for poultry and livestock *including electrical wiring to on/off switch*

*Bush hog or like equipment used on a farm to cut over existing pasture land*

*Cab covers for farm equipment and machinery when attached at factory or added later*

Dusting and spraying equipment

Farm water systems for poultry and livestock

Feed grinders and mixers

*Front-end loader attached to a farm tractor when attached at factory or added later*

Grading and packaging equipment for agricultural products

Grain and hay drying machinery

Grain and seed cleaning machinery

Hand operated pruning equipment, power pruning equipment and power saws for use exclusively in pruning fruit and nut trees.

Milking machines **including electrical wiring to on/off switch**

Bulk milk tanks and pipeline milking systems

Compressors for milking machines

**Generator (including portable) to operate milk machines or other exempt agricultural machinery**

Milk cans

Milk coolers

Strainers and milk buckets

Parts for unlicensed vehicles used exclusively on the farm **Parts for unlicensed farm vehicles as well as farm vehicles licensed as such Restrictions such as the transportation of agricultural products to market and personal non-farm use would be subject to proration by the farmer**

Peanut pickers and peanut drying machinery

Portable bins or tanks for use in feeding poultry and livestock (Bins and tanks for storage of agricultural products for market are taxable)

Portable elevator machinery used to load harvested crops into storage facilities on the farm

Portable irrigation equipment

Scales **portable only**

**Power steering for agricultural equipment and machinery**

**Pruning equipment and chainsaws when used by orchardmen, christmas tree farmer, vineyard**

Silo unloading and conveyor machinery

H. Other agricultural items purchased by a farmer for his use in agricultural production for market.

Baler twine

**Bobcat type machinery used to clean dairy barn, poultry, etc**

**Brooms and other commodities for use in cleaning dairy barns, hog parlors, poultry houses and other buildings used to produce an agricultural product for market**

**Clippers, shears, and grooming tools used on livestock that will become an agricultural product for market**

Covering materials, such as canvas or plastic, or the like, for farm crops and farm supplies.

**Ear tags, neck chains, ID tags or adhesive stickers**

**Fluorescent lamps and bulbs and light fixtures used in feeding poultry**

**Freezers when used to hold dead animals**

Fuel, oil, grease, and antifreeze for farm machinery or unlicensed vehicles used on the farm **as well as farm vehicles licensed as such**

Grain shovels, hay forks, hoes, scoops **for use in cleaning dairy barns, hog parlors, poultry houses and other buildings used to produce an agricultural product for market**

**Hot water heater for use in dairy barn**

**Leaf blowers to clean chicken houses**

Litter and/or bedding material for poultry and livestock

**Obstetrical gloves and chains used in removing a calf at birth**

Paint for farm machinery (Paint for any building or structure that is a part of real estate is taxable)

**Portable heater for use in a milking barn**

**Posthole digger for planting fruit and nut trees**

Poultry and hog equipment such as heaters, light bulbs, and brooders

**Posts and wire for grape arbors**

**Power washers for cleaning the dairy barn, farrowing houses or poultry house**

**Machinery used to clear land for future farming(machinery used to construct ponds, roads or make other real property improvements would be taxable)**

Rental of farm equipment such as tobacco heaters

Repair items for storage and production facilities (Repair items for any building or structure that is a part of real estate or for bins and tanks used for storage of agricultural products for market, are taxable)

Seeders

Seed stocks and plants

Self feeders and waterers for poultry and livestock

**Space heaters for dairy barns for benefit of milking**

**Signs and safety reflectors attached to farm machinery when passing over public roads**

**Supplies used in brooder construction and repair (but not applicable to building itself) or sanitation control**

**Supplies used in incubator repairs or sanitation**

Temporary portable fencing material such as metal posts or stakes, strand-wire, and electric fence controllers that will not become a part of real estate

**Tillers used in the poultry house to mix litter**

Tires, batteries and tubes for tractors and farm machinery

Tires, batteries, tubes and truck covers for unlicensed vehicles used on the farm **as well as farm vehicles licensed as such**

Tobacco bed covers

Veterinary supplies for poultry or livestock

Welding rods which become a part of farm machinery and equipment.

**2, 3, 4, and 6 wheelers, golf carts and similar equipment used to herd livestock, gather eggs in a poultry operation, transportation of feed or hay around the farm would be**

**exempt. However, the use of this equipment to go from one field to another to check on crops, general farm transportation, performing maintenance or permanent fence repairs would be taxable. In the case of both exempt and taxable uses of this equipment, the tax may be prorated based on the use**

II. No farmer may claim any agricultural exemption with respect to the purchase of any of the items of tangible personal property listed below:

**Air tanks**

**Antifreeze testers, battery charges**

**Backhoe attachments for tractors**

Bins and tanks for storage of agricultural products for market

Building materials, including lumber, bricks, cement, paint, and nails, for use in building or repairing any building or structure (barn, chicken house, shed, silo, etc.) that is a part of real estate.

**Cement mixer operated off a power take-off on farm tractor**

**Compressors for use in maintenance of equipment**

Dog and cat food

Electrical and plumbing supplies and fixtures for the home or any farm tenant building

Fertilizer and liming material for lawn or family garden use

Freezer bags or containers for home use

Fuel oil for heating the home or a farm tenant house **changed to fuel oil for farm tenant house(unless paid for by tenant) Fuel oil is exempt for residential heating except for the 1% in some localities**

**Guns and ammo**

Hand tools such as hammers, wrenches, screw drivers, pliers

Home garden, lawn, or farm shop tools

Lawn mowers, hand or powered **are taxable (Riding lawn mowers with blade attachments to clean litter from chicken houses, etc, are exempt if that is the exclusive use, otherwise prorate taxable portion)**

**Lightweight mowers (finishing mowers)**

**Luxury items which are not agricultural supplies such as radios, tape decks, air conditioning, and other items when bought separately or added to the tractor solely for the benefit or comfort of the farmer are taxable. If, however, these items were part of the tractor when bought new, the items would be exempt (power steering would be exempt if added at a later date)**

Oils, lubricants, tires, batteries, tubes, antifreeze, repair parts, or any other items of tangible personal property for use in or on any licensed vehicle (**excluding vehicles with farm use tags**)

Oxygen, acetylene, and welding equipment used to repair farm machinery and equipment

Permanent fencing material that will become a part of real estate

**Post hole digger/auger to erect fence**

**Power washers for cleaning farm equipment**

**Protective equipment (example: goggles)**

Plants and shrubbery for garden or lawn

**Ramps**

Rotary tiller for family garden use

**Snowblower, blades or other equipment used to clear or maintain roads**

Soaps, fly sprays, rat killers and other insecticides or pesticides used on or around the home or farm tenant house

**Space heater for shop, etc.**

**Tire filling units**

Twine or rope for home or farm tenant house use

Water pumps and systems for home or a farm tenant house

**Weed eaters**

Wood saws (**see pruning equipment in exempt section**)

**Work gloves, work clothes and plastic aprons used in a dairy barn or pen to keep clothes clean, also plastic shoe covering for prevention of disease transmission from one poultry house to another**

Any other item not used by a farmer in agricultural production for market.

*Memorandum of Sales and Use Tax Division, October 20, 1966 (as revised October 1, 1967, and February, 1971).*

## Unofficial Guidelines For Tractor/Implement Dealers

Bale Spears and forks-exempt

Balers-exempt

Billy Goat Vacuum-taxable

Blades/Box Scrapers-exempt if used exclusively to clean dairy barn or poultry house, or if used to clean land for future production, otherwise prorate. Taxable for any other use on real property. (roads etc)

Bobcats-Basically same rules as tractors and backhoes.

Bushhogs/rotary cutters/finishing mowers/grooming mowers-depends on use. Exempt uses are clearing land and to cut over existing pasture. Also exempt if used exclusively on land on which agricultural production takes place. However, finishing mowers are almost always taxable. Mowing around farm building and poultry houses is taxable.

Cab Covers-exempt

Chain Saw-See pruning equipment listed below.

Dusting and Spraying Equipment-exempt

Filing fees/Processing Fees-If item is taxable then fee is taxable.

Front End Loaders, Backhoes, Bulldozers, Motor Graders-Uses such as clearing land(rocks and stumps) cleaning out barns and lots for manure would be exempt. The same equipment for any building of roads or ponds would be taxable. Proration may be necessary.

Generators-If used to run poultry or dairy equipment exempt (These would be large generators). Small ones (portable) generally costing \$1,000.00 or less would be generally taxable.

Harrows-exempt(Normally used to cultivate the soil)

Hay Unroller-exempt

Lawnmowers/Brush Cutters(Gravelly-Goat etc)-taxable except if a riding mower with a blade to clean litter in poultry house. Exemption is exclusive use, otherwise prorate.

Leaf Blowers and other Blowers(Back Pack)-only exempt if used in poultry house.

MoCo's-(Mower Conditioner)-exempt(Normally used to condition hay).

Parking Stand-exempt if equipment is exempt (Normally used to hold up equipment ie a stand to hold up a travel trailer).

Portable Elevators-exempt (Normally used to move grain or hay).

Post Hole Diggers-exempt for vineyard for planting trellis post and orchard for planting fruit trees. All others taxable as used for real property construction. Ie fencepost.

Power Steering, A/C, 2 Way Radio, Tape Decks and AM/FM Radios for tractors-power steering is always exempt, other items listed are exempt only if purchased with the tractor but taxable if added later.

Power Washers-exempts for dairy barn, barrowing house and poultry house. All others taxable.

Pruning Equipment/Chain Saws-exempt to orchard, vineyard and tree farmers.. Exempt if used to clear land for future farming. Taxable to all others.

Reflective Safety Sign-exempt

Space Heaters-exempt if used in dairy barn or chicken house to heat livestock and poultry. Another exempt use would be to keep pipes from freezing in the dairy barn or poultry house. Taxable if used for comfort.

Snow Blowers-always taxable.

Spreaders/Befco Rear Discharge-for agricultural use exempt. Otherwise prorate or tax.

Tillers-exempt if used exclusively in poultry house, otherwise prorate. All others taxable.

Utility Carts/Trailers-exempt if used to haul agricultural products.

Weedeaters-taxable(Mowing around poultry houses and other farm buildings is a taxable use).

Welders-taxable as used in maintenance.

2, 3, 4, and 6 Wheelers, Golf Carts, Gators-See attached letter.

Those items listed as exempt is assuming that the purchaser can file a Federal Schedule F. (Some farms are corporations and would be exempt filing a Schedule C). Filing of these schedules is prima-facie evidence that these taxpayers are entitled to the exemption.

The above listing is based on written and verbal opinions issued by the department as of this date. Changes may be made by legislation and/or opinions from the Tax Commissioner. Persons wishing rulings relative to agriculture not covered above are encouraged to write the Tax Commissioner stating all facts.

Updated 8/28/2000

## Sales and Use Tax Audit Procedure

### Auctioneers, Agents, Factors

**Objective:** Discuss the application of sales and use tax as it applies to Auctioneers, Agents, and Factors selling tangible personal property.

#### I. References

- A. Code of Virginia Sections 58.1-603 & 58.1-602
- B. Virginia Administrative Code VAC 10-210-140 Auctioneers  
VAC 10-210-1080 Occasional sales
- C. Ruling Letters PD 88-335 Auctioneers--Auction Conducted by Non-Profit  
PD 95-294 Public School Fund Raising Auction

#### II. General

- A. Sales of tangible personal property at auctions are taxable. Auctioneers, agents, or factors must collect sales tax on the gross sales price of each taxable sale, even if title to the property being sold rests with another person. "Gross sales price" is the price for which property is sold, without any deduction for commissions, service charges or expenses.
- B. Exceptions
  - 1. An auctioneer, agent, or factor who sells substantially all the assets of a liquidating or reorganizing business which qualifies as an "occasional sale" is not liable for collection or payment of the tax provided the sale occurs in 3 days or less.
  - 2. PD 88-335 An auctioneer would not be deemed in the business of selling at retail if he gratuitously bid calls an auction which is actually conducted by a nonprofit organization, i.e. the auctioneer has no direct association with the money being collected, registration, clerking, etc.
  - 3. PD 95-294 The Dept of Taxation has also determined that under very limited circumstances an auctioneer may make sales without collecting the tax such as a public school fund raising auction provided the auctioneer has no direct association with the money being collected, registration, clerking, etc.

### **III. Procedures**

When auditing auctioneers the main concerns would be if all sales have been accounted for, and were any exempt i.e. occasional sales, certificate of exemptions. Normally there will be acceptable accounting and the audit trail will discover any problems.

In the case of little or no records, you use the normal checkbook and bank statement audit search. Deposits can lead you to trace real estate sales, commissions, other rentals, and other income. Payments can lead you to newspaper advertising where the auctioneer advertised for auctions. If this doesn't lock in on auction sales then the auditor can go to the newspapers and get copies of auction advertising which would provide an adequate audit trail.

The main problem auditors' find with auctioneers is the reverse, that is you're auditing a business, such as a contractor, and a sales invoice from an auction has no sales tax. Usually someone at the audit can clarify if the sale was an "occasional" type or other. If this doesn't satisfy the auditor then the question should be presented to the auctioneer. Typically the correct answer can be determined, but it's still a judgment call by the auditor. In all cases the proper documentation should be made for the auctioneer to become an audit candidate.

The same scenario exists for an auction that takes place outside Virginia and the property purchased is brought or shipped to Virginia. If it was "occasional" based on VA law then it would be exempt. One extra lead in this situation is how the item purchased was delivered. The transaction may have been exempted because of the interstate commerce rule, thus making it taxable in VA.

## Sales and Use Tax Audit Procedure Audit Selection

Revised 10-2007

**Objective:** Discuss the application of sales and use tax as it applies to audit selection.

### I. General

The auditor is to conduct field audits of the taxes administered by the Department in order to determine taxpayer compliance. The ultimate goal is to have total compliance with the tax laws. Taxpayers selected for audit are those deemed to be in non-compliance. It is the auditor's job to identify those taxpayers most in need of audit.

### II. Procedures

A. There are two steps prior to the selection of audit candidates:

1. Identification
2. Research

B. Identification - There are several sources used to identify audit candidates.

1. Audit recommendations - These taxpayers have been identified by other auditors or other employees who have evidence of activity in Virginia or some of type of taxpayer error.
2. Recurring audits - Based upon the results of the previous audit, these taxpayers were selected as potential candidates.
3. Taxpayers with a large volume of exempt sales.
4. New businesses.

5. Business types - These traditionally have proven to be good audit candidates.
  - a. Manufacturers
  - b. Contractors
  - c. Professionals/service providers
6. Auditor experience and expertise - with time and experience auditors develop a sixth sense and are able to identify viable candidates.
7. AUDAP, and other Departmental reports and databases of registered taxpayers. The records in the databases can be queried and/or sorted by selected criteria in order to provide a useful listing for the identification of audit candidates.
8. Complaints from the public
9. Income tax returns
10. Information gathered from other agencies and states -
  - a. DMV
  - b. Commissioner of Revenue
  - c. IRS
  - d. VEC
  - e. ABC Board
  - f. SEATA Nexus Questionnaires
11. Other outside sources include the following:
  - a. Media - This includes newspapers, radio, television and billboards. Look for advertisements, advertising inserts, news articles or segments on businesses.
  - b. Dodge reports - These list contractors doing business or bidding to perform construction contracts in Virginia.
  - c. Business journals and other publications.

C. Research - Once taxpayers have been identified as potential audit candidates, the auditor must use the resources available to him to determine if a taxpayer is actually a viable candidate for audit. This requires thorough research. This is the most important step in the selection process. Sources include:

1. **STARS** - The department's primary source of information is STARS and the related reports generated from STARS.

a. Most research begins with the registration screens. Through review of these screens you may identify other candidates, and other tax types audits.

(i) 2-02 Identify all registrations for a particular name.

(ii) 2-03 Once you have all the account numbers, identify the tax types associated with each account number, the address, and social security numbers of the owners. You may also discover a different trade name or legal name. Look for other accounts under these names.

(iii) 2-04 - Provides a list of registration numbers associated with a consolidated filer.

(iv) 2-01 - Check BLD's, ELD's.

(v) 2-16, 2-17 Check for related entities of the business and it's owners.

b. Payment/billing

(i) 3-01, 3-02 - These screens will provide payment records, including a detail of the local tax allocation.

(ii) 3-27 - VA-6 Inquiry - The amount of withholding paid to Virginia and the number of W2's sent to Virginia is an indicator of the size of business and/or its activity in Virginia.

(iii) 4-01 - The account status may identify trouble/delinquent accounts.

c. Tax returns

- (i) 5-01, 5-02 - provide return detail for withholding and corporate taxes which will indicate activity in Virginia. Corporate return detail shows if the business is showing a profit or loss and how much income is being apportioned to Virginia.
  - (ii) 5-03 - The detail of the sales tax returns indicates the volume of gross sales, exempt sales and personal use reported. Fluctuations in sales can be identified by reviewing the returns. Filing errors may be more obvious. Reporting errors can be identified when return totals for a particular time span are compared to other sources such as the income tax return.
- d. Collection tracking - 8-03 - Collection history may provide additional information.
- e. Audit
- (i) 9-06 - Audit cross-reference - Provides a listing of prior audit activity for a particular account number.
  - (ii) 9-07 - Results of previous audit - This will identify the areas of deficiency on the prior audit -sales, purchases and/or assets. Were issues contested, and subsequently revised?

## **2. AR/SEIBEL -**

### **a. IRMS Research – Audit Case Management System Overview**

The Siebel Audit Case Management System (ACM) is a sub-system of the Siebel Customer Relationship Management application. ACM is directly integrated with ADVANTAGE Revenue (AR), Professional Audit Support System (PASS) and the Compliance Repository (CR). PASS uses models to query various criteria to identify potential audit candidates from data included in CR. While PASS and CR are not available to auditors in the field, much of this information is available in ACM. Also keep in mind that ACM system is also utilized by our desk/office auditor staff so there are many fields and some view tabs that are not used by field auditors.

### **b. Siebel Research**

**There are two different Siebel applications for field auditors – Server Siebel (Siebel web-client) on TAX servers and Remote Siebel that resides on the local laptop. For research purposes, you should always use Server Siebel. (Most of the detail Siebel screens are not populated in Remote Siebel.) The following information can be found in Server Siebel:**

- On the Audit Cases screen, query the FEIN to determine the audit history of a particular customer

This results in a list of all audit cases for a particular customer

- All cases 2004 and forward
- Includes work paper archive for cases processed after August 2005
  
- Select the specific case that you wish to view – there is much information in the Audit Case Detail applet:
- Demographic information
- Case Type – Audit or Revised Audit
- Case Tax Type
- Compliance Code
- Description and Comment fields
- Tax Account Number
- Legacy Tax Account Number, if any
- Case Status
- Date Case Created
- Audit Span Period
- Waiver Information, if entered by auditor
- Recurring Audit Indicator and Date
- Audit Team Members

Go the Determination view tab to see the audit results for those audits closed under ACM

Go to the Work papers view tab to review those audits closed under ACM

- If you were part of the original audit team, you can go to Remote Siebel and query for the specific case, go to the Work paper view tab and then click the Review button.
- You can do this even if you deleted the work paper file from your laptop
- It is possible that you may have to synchronize before viewing the audit

If you were NOT part of the original audit team, in Server Siebel go to the Attachment view tab and download the most recent \*.zip file to your local laptop.

- UnZip it in the normal Audit Workbench path in the appropriate application folder
- Use the file name for folder name choice from the WinZip menu
- Then open the appropriate Audit Workbench application from the desktop to view the audit.
- It is not possible to view audits directly from Server Siebel

See M:\OCR\Audit Archives for audit work papers for audits closed between 2002 and July 2005

Go to the Attachment view tab to ensure that you see files that may not have been included in the system generated \*.zip and \*.det files

- Some of the more common file you might expect to see are \*.doc, \*.xls, \*.mdb, \*.jpg and \*.pdf files.

Go to the Audit Trail view tab

- A history of most fields on the Audit Case Detail applet that were changed while the audit was open can be seen here
- Some work units use the Description and Comment fields to record a series of notations
- Each comment is recorded in full on the Audit Trail

Go to the Siebel Consolidated screen

- View the Activities associated to your customer
- Can access all incoming communications here
- View the various flags such as bankruptcy, active CACSG case, etc.

Go to the Siebel Customers screen

- Go to the Tax Accounts view tab
- Verify that the tax account you want to audit is listed there and that your audit span period is within the listed BLD/ELD
- A new audit case cannot be created until the tax account information is properly listed in Siebel

Go to the Compliance Repository view tab to see what source information is available.

- Besides TAX data, there are usually entries from VEC and DMV that may have helpful information

### c. AR Research

While research in ACM and Siebel can provide useful information, AR provides the best data to determine a customer's tax compliance. In the ideal situation, each customer will have only one Customer Profile, with all tax accounts associated to it. Since AR is the TAX system of record, all demographic and financial transactions are recorded here.

- Start your research at the Customer Profile

- If you are already in Server Siebel, there are “AR-Customer Profile” hot buttons on most Siebel applets that take you directly to the same customer in AR
- If not already in Siebel, simply query AR by FEIN, name, etc.
- The Entity type is identified in the window title bar of the Customer Profile

From the Customer menu you can:

- View Affiliations
- This is important to determine parent/child relationships for corporations and for determining the tax accounts to which an individual is affiliated
- View Relationships
- For individuals, usually the spouse is the only relationship
- See Affiliations – where ties to businesses display
- View Bill Summary
- Besides outstanding and paid bills, non-filers are also noted
- View Notes
- Any notes made by TAX reps are viewed here
- If you add a note be sure to identify the specific tax account and the period(s) to which the note applies
- View AR Correspondence
- All incoming correspondence is viewed in Siebel, but outgoing correspondence is viewed in the application where it was created
- View Customer History
- History is system generated

View the Address Manager

- The various addresses will tell you where the business is located, where the records are kept, where the mail is sent, etc.
- View the Business Location Manager (located in the Address Manager menu) to learn trade names, localities and association dates

View the Tax Account

- Totals tab is the default tab
- Shows calendar year totals for tax paid
- This is great for CU tax accounts because you can compare actual tax amounts between years
- For ST and UT, however, you can only see the total tax paid
- There is no way to see span totals in AR for just CU
- View Tax Account Entries Tax Type tab has information such as the BLD, ELD, current filing status, seasonal filing status, combined or consolidated status, the old STARS number, if any, and other valuable data
- Contact tab should list the specific contact for the specific tax account as well as telephone and fax numbers

From the Periods tab you can view the balances of the individual Tax Account Periods (TAPs) or access a TAP

From the Tax Account Menu you can:

- View Tax Account Entries
- Very helpful to get a quick overview of the entire tax account without having to view each individual TAP separately
- Shows all entries for all TAPs
- Double click a column heading and the display will automatically sort by that column heading
- Great for trying to figure out on what TAP a Stop has been placed.

View the Tax Account History

- General History includes BLD and ELD changes, etc.
- Address History is important for multiple location audits
- Only place where closed business locations display

Go to an individual TAP

- Details for each period are located here including all financial entries (returns, payments, bills, stops, offsets, additional interest, etc.)
- Currently the AR TAP filter is OFF by default
- Therefore, all entries are visible
- You may want to use the Tax Account Period menu to turn the filter ON to eliminate offsetting entries
- This step can make the TAP easier to understand
- Many windows are not expandable in AR, but the Tax Account / Periods window and the TAP / Entries window are
- By pulling down the windows to the maximum vertical length you can see much more information without having to scroll
- If you access the return, you can go to the Return menu and select View Form to view the actual scanned document

The Transaction Search is very helpful in these situations:

- Need to view the return for each month
- Use the Transaction Search icon and query for the FEIN, the specific tax, and use Returns for the transaction type
- You can further limit to a specific period if desired
- Please note the CU, Sales and UT are distinct taxes for this search
- Saves several steps compared to going into each TAP to view the return
- Find returns that are work listed
- Use the Transaction Search icon and query for the FEIN, all tax types and choose Work list Items as the transaction type
- If you locate work listed returns you cannot save any changes to the return, but you are able to view the return to obtain figures
- Search for W-2 forms

- No prior W-2 forms were transferred from STARS so 2005 is first year available
  - Click File, Close All to obtain a blank AR window – The Tax Information menu is now available
  - Select W-2 Information and enter the required information
  - Can query for all company W-2s or for an individual's SSN
3. Compare information provided - results of last audit to current filings; amount of WH to amount of CU or volume of sales; gross receipts per income tax returns to sales tax returns; tax reported to tax reported by similar businesses.
  4. Inquiries - ask other auditors, employees, and local officials about their knowledge of the particular business in order to get a general feel for the business. Contact the business and ask questions.

#### D. Make selection

Weigh all the information you have reviewed in order to determine the feasibility of the candidate - revenue potential vs. time and other costs.

Keep in mind that an audit candidate does not have to have a large revenue potential to be a good candidate. Small audits that can be done in a short amount of time are good candidates, too.

## **Sales and Use Tax Audit Procedure**

### **AUDIT TECHNIQUES**

**Objective:** Discuss the application of sales and use tax as it applies to audit techniques.

#### **I. References**

- A. Ruling Letter PD 91-276, Commissioner's Ruling dated October 29, 1991.

#### **II. General**

- A. This section is a discussion of questions to ask, records to examine, and issues to think about. There are different approaches that can be used to accomplish our work. Use this outline to consider how you can improve your skills at gathering the information needed in an efficient manner.

#### **III. Procedures**

- A. Auditor should thoroughly research an audit candidate to determine the feasibility of the audit. The following information should be reviewed:
  - 1. Prior audit history - Check STARS screen 9-06. Locate prior audit file. Read prior audit file. Read audit comments and any letters written to the taxpayer.
  - 2. Stars Research
    - (a) Screen 2-01/2-03 - Make sure all registration information is accurate. If not, be sure to correct it before the audit is completed.
    - (b) Screen 5-03 - Return statistics for the audit period. Patterns of gross sales, exempt sales, and use tax accruals can provide clues to non-compliance.
    - (c) Screen 4-01 - Outstanding bills and nonfilers should be discussed with the taxpayer. Nonfiler periods should be included in the audit, and penalized. Statutory Assessment periods (code 131 bills) should also be included, and penalized. If the Statutory

Assessments have been paid, give the taxpayer credit on the audit for the amounts paid in the month paid. Any unpaid balances on the assessments should be abated just prior to the audit assessment.

3. Audit recommendation information - Where did this audit candidate come from? What are the areas of compliance associated with this type of taxpayer? Review the rules & regs, and ruling letters.

B. Contact taxpayer and find out about the business.

1. If the taxpayer has been previously audited, inquire about changes that have occurred since the prior audit.

Has there been any turnover/reassignment of personnel?

What procedures have been implemented to improve compliance?

Has there been any change in the flow of transactions due to technological enhancements or automation?

2. What is the record environment?

How are the source documents filed?

Sales invoices filed by invoice number.

Sales invoices filed by customer, by year.

Purchase invoices filed by voucher number.

Purchase invoices filed by vendor, by year.

How many invoices in an average month?

How many drawers of purchase invoices in a year?

Are fixed assets filed separately? Are they all in one place? Are the construction in process projects in a separate file?

3. Request records to be available at the beginning of the audit.

(a) Fixed Assets - Typically, the auditor will request these records to review first. Capital project folders - both closed and open projects, depreciation schedule, or other fixed asset listing, federal forms 4562 and 4797.

(b) Sales - Sales invoices, sales journals, exemption certificates, sales tax report(computerized), sales tax returns and worksheets.

- (c) Purchases - Purchase invoices, accounts payable registers, chart of accounts (voucher system), sales tax returns with detail of purchases reported, cash disbursements, check ledgers.
- (d) Contractors - There are two basic ways contractors typically organize purchases:
  - (1) job cost files - all purchases charged to a particular project are filed together. This is the best situation.
  - (2) purchases filed by vendor- This requires asking for the job cost ledgers that list the vendors for a particular job. Most job cost ledgers include the invoice number. This speeds cross referencing to the vendor purchase files.
- (e) Important Considerations:

Taxable customers far outweigh exempt.

Dollar amount of average invoice.

Number of invoices per month.

Are computer printouts of monthly sales journals available?

Are there "by state" sales reports available?

Are there contract files or sales territory reports to isolate Virginia sales?

Are there reports of charges to expense accounts? Is a vendor name included? Is a cross reference present?

C. Understand the flow of transactions from the source document to the sales tax return. Think of a sales tax return as a river with many tributaries. Be sure all the tributaries are accounted for. Be sure that the transaction in each tributary is completely understood.

1. Sales - Invoices to sales journal to sales tax worksheet.

- (a) What intermediate reports are available?
- (b) Are sales journals available that include the data needed to conduct the audit?
  - tax charged on invoice
  - separate freight and/or non taxable labor charges
  - where taxpayer is multi-state, can the Virginia sales be readily identified?
  - invoice number and date included

If this information is available, the sales journal can be used instead of invoices to begin your examination.

2. Purchases and fixed assets - Identify the list that use tax accrual comes from. Are there any percentages or amounts taken straight from general ledger expense accounts included in the use tax accrual? If so, you must find out why this is being done. There might be a valid reason based on a previous audit. Are fixed assets accounted for as a separate amount? Are there separate files for fixed assets?

Does an accounts payable register or monthly expense ledger exist that has purchase invoice information? These intermediate reports may enable the auditor to eliminate certain vendors from further examination.

3. Filing Procedures - Identify all personnel involved in filing the return. Have each person explain their part in the return filing process. It is very important to take your time and listen to these explanations. Do all the tributaries flow to the river every month?

Questions to consider:

Who makes the taxability decision concerning purchases - purchasing or accounts payable?

Who decides if a sale is exempt - sales/marketing, the accounting or credit department?

Identify each step in the process of accumulating the final amounts reported (sales and purchases) Where do these amounts come from?

What is added to these amounts at each step?

What is the next step?

It is helpful to think of this procedure in terms of the names of the people involved in the process.

Are there formal or informal policies concerning sales or purchase taxability?

- D. Scope of the audit. The scope of the audit is the amount of time, the number of records, and the areas of non-compliance.

Many small tasks have been mentioned in sections A-C above. Many questions have been asked and answered. The process of going through this checklist need not consume a great deal of time. Some of the answers are self-evident, others require careful questioning of the taxpayer. In order to make a good decision on the scope of the audit all these questions (and more) must be answered.

The taxpayer has been interviewed, the nature of the business is understood, the records have been inventoried, and the transactions flow has been explained. Now it is time to determine the scope of the audit.

1. Multi-generational audits- Research on a multi-generational audit can very well determine the scope of the audit. Some large audits, where no change in business or personnel has taken place, demand a certain sampling period, or have other peculiarities that must be accommodated. All the questions and considerations outlined in B and C should be used for every audit.
2. Sales - Sampling is the preferred method here. There may be cases where a first time audit with few invoices (300 a month) and large average sales price may command a full audit. Reasoning being: large liability potential may be skewed, record base is not too large, and taxpayer may be better served with a complete audit.

A more typical sales audit involves a large number of transactions, relatively small dollar amounts (under \$200) and minimal compliance opportunity. This situation, of course, should be sampled.

3. Purchases - The number of transactions is the important factor here. One year sample period is common, owing to the manner of filing purchase invoices.

Two types of liability - There are two actions that cause tax liability:

- 1) The taxability decision - the decision to charge or pay tax is wrong. This is the decision most easily sampled.
- 2) The remittance problem - This occurs when tax amounts are incorrectly accumulated, transferred, or otherwise not brought forward to the sales tax return. These types of transactions are not easily sampled.

The agenda - the scope of the audit becomes the minimum work to be performed

- E. The Test of Time - When should an audit be terminated? The first answer to this question is: the audit should be terminated at a minimum, when the original "scope of the audit" work is completed. In order to maintain integrity in the result, the work set out must be completed. There may very well be circumstances that demand expanding the sample period or examining more detailed records because of a larger remittance problem.

### Questions to ask when considering termination

Have a representative number of transactions been reviewed based on the total number of transactions, number of exempt sales, number of exceptions?

Has the taxpayer provided all the documents requested?

What is the cost benefit of the time expended?

Where is the next logical termination juncture?

Are the compliance problems complicated issues or merely simple mistakes?

Can the exceptions compiled at this point be used to bring the taxpayer into compliance?

- F. Post Audit Conference - The taxpayer is your customer. The post audit conference is your opportunity to serve your customer. It is your obligation to fully disclose to the taxpayer several items:

the exceptions discovered in the examination

the audit computations including interest and/or penalty

the areas of non-compliance based on the rules & regulations

explanation of the correct rules and procedures

respond to questions concerning changes in taxpayer

procedures

After the post audit conference there are other important tasks:

Be sure to summarize conference in the audit comments

If necessary, write the taxpayer a letter explaining changes to be made for future compliance. Why is this needed? Taxpayer may have indicated that remediation of taxpayer procedures is not likely. This letter puts the taxpayer on notice and provides a file document for future audit.

## **Sales and Use Tax Audit Procedure**

### **BAD DEBTS**

**Objective:** Discuss the application of sales and use tax as it applies to bad debts.

#### **I. References**

- A. Code of Virginia Section 58.1-621
- B. Virginia Regulation 630-10-11 (23 VAC 10-210-160)
- C. Ruling Letters PD 94-153, 94-358, 94-372

#### **II. General**

- A. Section 58.1-621 of the Code of Virginia provides that a dealer may claim a credit for "the amount of sales or use tax previously returned and paid on accounts which are owed to the dealer and which have been found to be worthless ...." This section further indicates that amounts "for which a credit has been taken that are thereafter in whole or in part paid to the dealer shall be included in the first return filed after such collection."
- B. No credit may exceed the amount of sales price which is actually uncollectible. Prior payments made to the dealer on a debt which is subsequently determined to be uncollectible must be allocated to the sales price, sales tax and other nontaxable charges based on the percentage that those charges represent to the total debt originally owed.
- C. If the dealer receives reimbursement for bad debts from a guarantor for a sale made to a customer, then no bad debt deduction is allowed. A taxable sale does not depend on the source of the reimbursement.
- D. All amounts recovered through collection efforts must be reported back without any deduction for collection costs incurred.

#### **III. Procedures**

- A. Verify all deductions for bad debts reported on the sales tax returns. For prior years, the bad debts will be included in deductions on the dealer's federal income tax returns. For current periods, the dealer will have documentation such as a bankruptcy notice supporting amounts deemed worthless.

- B. Once it has been determined that the bad debts are legitimate, the auditor must analyze the amounts deducted to determine if any portion is not attributable to taxable sales. In order to take the deduction on the sales tax returns, the deduction must be computed on each bad debt, not based on a percentage of sales.

A review of the original document, and payments made, if any, is necessary in order to determine the actual amount of the deduction allowed. For example:

Dealer makes the following sale:

Parts	\$100.00
Labor	35.00
Freight	<u>15.00</u>
Subtotal	\$150.00
Tax	<u>4.50</u>
<b>Total</b>	<b><u>\$154.50</u></b>

The customer's current account balance is \$114.50, which reflects a payment at the time of purchase of \$50.00 and finance charges added of \$10.00. The debt is now determined to be uncollectible.

The amount that may be deducted on the sales tax is \$67.64.

An allocation of the amount previously collected must be computed.

Parts	\$100.00	$100/154.50 \times \$50.00 =$	\$32.36
Labor	35.00	$35/154.50 \times \$50.00 =$	11.33
Freight	<u>15.00</u>	$15/154.50 \times \$50.00 =$	4.85
Subtotal	\$150.00		
Tax	<u>4.50</u>	$4.5/154.50 \times \$50.00 =$	<u>1.46</u>
<b>Total</b>	<b><u>\$154.50</u></b>		<b><u>\$50.00</u></b>

Amount of sales price for computing the credit is	\$100.00
	<u>- 32.36</u>
	<b><u>\$67.64</u></b>

- C. Analyze any collections of bad debts. These should be reported on the dealer's sales tax returns when recovered. No reduction for costs of collection is allowed.

In the previous example, suppose a collection agency remits a \$50.00 payment to the dealer after the account has been written off and bad debt deduction has been taken on the sales tax return. The agency actually collected \$55.00 and retained 10% as a collection fee.

The dealer would need to report additional sales of \$32.49.

Outstanding debt prior to write-off:

Parts	\$67.64	$67.64/114.50 \times \$55.00$	=	\$32.49
Labor	23.67	$23.67/114.50 \times \$55.00$	=	11.37
Freight	10.15	$10.15/114.50 \times \$55.00$	=	4.88
Finance	10.00	$10.00/114.50 \times \$55.00$	=	4.80
Tax	<u>3.04</u>	$3.04/114.50 \times \$55.00$	=	<u>1.46</u>
Total	<b><u>\$114.50</u></b>			<b><u>\$55.00</u></b>

- D. Penalty applies to taxes collected, not remitted. Failure to report subsequent collections of bad debts and to deduct bad debts at the proper amounts, are subject to penalty.

## **Sales and Use Tax Audit Procedure Banks**

**Objective:** Discuss the application of sales and use tax as it applies to Banks.

### **I. History**

#### **P.D. 95-159 - June 16, 1995.**

In certain situations allows a third party to collect and remit sales tax on behalf of dealers selling their product.

### **II. References**

A. Code of Virginia Section - 58.1-203, 58.1-612

B. Virginia Administrative Code - 23 VAC 10-210-170  
23 VAC 10-210-840  
23 VAC 10-210-460  
23 VAC 10-210-4040  
23 VAC 10-210-6010

C. Ruling Letters AGO 55--85, P.D. 86-103, P.D. 88-243, P.D. 91-12, P.D. 91-142, P.D. 91-166, P.D. 94-207, P.D. 94-230, P.D. 94-271, P.D. 95-72, P.D. 95-159, P.D. 95-207, P.D. 96-184

E. Applicable exemption certificate ST-10 for companies engaged in the lease or rental of tangible personal property.

### **III. General**

A. The tax applies to purchases of tangible personal property by all national and state banks for their use and consumption.

When any bank engages in selling, leasing or renting tangible personal property to consumers, it must register as a dealer and collect and pay the tax to the Department of Taxation.

Taxable sales by banks include, but are not limited to, sales of checks and checkbooks; silverware; savings or piggy banks; repossessed merchandise; gold and silver coins or bars for investment purposes; and charges for the lease or rental of tangible personal property.

The rental of safe deposit boxes is not subject to the tax.

## IV. Procedures

### A. Pre Audit

When auditing a bank the initial concern should be to gain a **complete** understanding of the corporate structure. Banks typically have many separate subsidiaries and divisions. A request should be made of the Taxpayer to supply the auditor with a list of all subsidiaries and business operations for the audit period. The Corporate Income Tax returns should be reviewed for corporate structure. Many banks will have divisions or separate entities to perform a portion of the banks operations such as: Construction, Property Management, Credit Card, Leasing, etc. The auditor must make certain that all applicable records are reviewed for each operation. The review of the corporate structure will usually raise questions such as:

1. Are all of the purchases done through a single division or are some divisions responsible for their own purchases? Commonly, property or construction divisions will do some of their own purchasing. These records may be kept separately. Some Banks have divisions that purchase all office supplies and invoice the other divisions and branches and charge sales tax. This procedure has been approved for some Banks (see Department letter dated June 16, 1986).

2. Banks often foreclose on businesses (for example, golf courses) and continue the operations. If the bank continues the operation it is responsible for reporting any sales and use taxes.

3. Does the Bank sell more than three assets per year? It's a good bet that they do. Sales to employees of old furniture and the like is common.

4. Does the Bank transfer, sell, or lease assets between related entities and are they properly taxed? (see P.D. 9-271).

5. Has the Bank sold any branches or divisions? The occasional sale exemption may apply in some circumstances (see P.D. 91-12,91-142), However if the bank is in the business of selling assets (more than three per year) they are required to collect tax on the selling price of the tangible personal property. Conversely the purchase of branches or divisions should be reviewed for any possible liability.

6. If the Bank has a leasing division or subsidiary it should be collecting tax on leases of tangible personal property.

7. Tangible personal property sales from the Resolution Trust Corporation are subject to sales tax; however, states cannot constitutionally impose a direct tax on the United States government or its instrumentalities. This does not exempt the purchaser of tangible personal property from the use tax however (see internal memo dated March 18, 1992).

## **B. SALES**

All sales of tangible personal property by banks are subject to sales and use tax. Types of sales to be cognizant of are as follows:

1. Check sales: The reporting of tax of check sales has been simplified by allowing the check printers to collect and remit the tax on behalf of the bank (see P.D. 95-159). Check printers who sign a sales tax collection agreement with the Department of Taxation would be allowed to collect the tax on behalf of the institution.
2. Sales of fixed assets. Many banks make a sufficient number of sales of fixed assets to be required to register and collect sales tax. In addition to reviewing individual asset sales, sales of divisions or groups of assets, reorganizations and spin off type sales should be carefully reviewed. The occasional sale exemption may apply in some cases but each incident should be reviewed to determine the proper application of tax. Tax-free reorganizations governed by IRC Sec 368(a)(1)(D) are exempt from sales tax. Each of these types of sales should be carefully reviewed. There are several Public Documents that deal with these type of transactions but each is individual and should be examined on its own merits.
3. Leases. Banks often have lease departments or subsidiaries. 23 VAC 10-210-80 applies to these transactions.
4. Microfilm. In providing checking account services banks may supply their customers with account information on microfilm. The "true object" test must be applied in these sales. Generally sales of multiple copies of microfilm will be subject to the tax (see P.D. 94-230).

## **C. PURCHASES**

Banks are subject to use tax on all purchases of tangible personal property. There is no exemption specifically except for purchases for resale. Banks purchase a wide array of property and services some of which are specifically tailored to financial institutions. Some types of purchases banks typically make are as follows:

1. Financial services. Companies that provide banks with financial services such as loan processing, checking account statements, credit authorization services, etc. sometime include in their invoicing charges for monthly equipment rental. Taxability is determined by the "true object test" and is enumerated in several Public Documents (P.D. 88-243, 96-184, 94-230). There is a wide variety of this type of transaction and each must be reviewed on its individual merit.
2. Software. The auditor needs to obtain a copy of the software agreement to make a determination on taxability. Many specialized

software packages are sold to banks and the only efficient way to understand what is being purchased is to read the agreements. In some cases you may request that the Bank contact the vendor and provide a description of the invoices in writing to assist in the decision making process.

3. Bank Equipment. The decision here is to determine if bank equipment is tangible or real property. P. D. 94-207 lists various types of equipment and the treatment by the Tax Department. P.D. 91-166 also addresses several different types of equipment and states the Departments position. In this P.D. it is apparent that the treatment of ATM's is dependent on the type of installation. There are several large vendors of bank equipment who properly charge tax on sales of tangible personal property; however there are also many smaller, independent suppliers who are not as well versed in the treatment of sales of bank equipment. Security systems should be looked at to see if they are monitored or non monitored systems.

## Sales and Use Tax Audit Procedure Catalogs and Other Printed Material

**Objective:** Discuss the application of sales and use tax as it applies to catalogs and other printed material.

### I. History

**7/1/76 to 7/1/77.** The catalog exemption was enacted to provide relief to direct mail operations which contracted with Virginia printers to produce catalogs and similar items. The statute wording was very broad and included advertising and promotional materials, catalogs, envelopes, etc.

**7/1/77 and after.** The catalog statute was amended to narrow the scope of the exemption to catalogs and other printed materials thereby making printed advertising materials such as pencils, pens, grocery store displays, matchbooks, calendars, etc. taxable.

**7/1/79 and after.** The catalog statute was amended to provide exemption for the purchase of raw paper by a non-printer when the paper will be furnished to a printer for fabrication into catalogs or other printed materials that advertise the sale of tangible personal property which will be stored in Virginia for 12 months or less and be distributed for use outside Virginia.

**7/1/86 and after.** Letters, brochures, reports, and similar printed materials, etc. were added to the statute and the wording "used in the advertising of tangible personal property for sale" was dropped. The exemption for these additional items was set to expire 6/30/90 but became a permanent part of the statute in 1989.

**7/1/94 and after.** The catalog exemption was expanded to include (without an expiration date) any advertising business located outside Virginia which purchases printing from a printer within the state when such purchases are stored for twelve months or less in Virginia and distributed for use outside the state.

**7/1/95 and after.** The catalog exemption was expanded to include (with an expiration date of 6/30/97 extended in 1997 to 6/30/02) any advertising business which purchases printing from a printer within Virginia when such purchases would have been exempt under Code of Virginia § 58.1-609.6(3) (newspaper/magazine exemption) or § 58.1-609.6(4) (catalog exemption).

## II. References

### A. Code of Virginia Sections

58.1-602	Definition of "Advertising"
58.1-609.6(3)	Newspaper/Magazine Exemption
58.1-609.6(4)	Catalog Exemption
58.1-609.6(5)	Advertising Exemption
58.1-609.10(4)	Interstate Commerce Exemption

### B. Virginia Administrative Code

23 VAC 10-210-41	Advertising businesses.
23 VAC 10-210-43	In-house advertising.
23 VAC 10-210-260	Catalogs and other printed materials.
23 VAC 10-210-780	Interstate & foreign commerce
23 VAC 10-210-3010	Printing.

### C. Ruling Letters

P.D. 97-248	Virginia Mailing House
P.D. 97-61	Exercise of Right or Power in Direct Mailings
P.D. 96-148	Advertising -Regulations Are Not Retroactive
P.D. 96-63	Interstate Commerce, Constructive Possession
P.D. 95-216	Service in Connection With a Sale Is Taxable
P.D. 95-185	Distribution of Catalogs In & Out of Virginia
P.D. 95-112	Form ST10A & Estimated Percentages
P.D. 94-294	Interstate Commerce
P.D. 94-266	"Use" in Virginia
P.D. 94-248	CD-ROM Exempt
P.D. 94-239	Swatch Cards Not Printed Material
P.D. 93-217	Constructive Possession
P.D. 93-162	Administrative Supplies
P.D. 92-112	Labels
P.D. 91-30	Videotape Not Printed Material
P.D. 91-26	Advertising Rules - Old
P.D. 90-220	Postage Exempt When Separately Stated
P.D. 90-218	Labels Taxable
P.D. 89-99	Transactions In & Out of Virginia
P.D. 88-62	Old Advertising Rules
P.D. 87-243	Estimating Taxable Percentages
P.D. 87-200	Interstate Commerce
P.D. 86-103	Interstate Commerce
P.D. 86-9	Service in Connection With a Sale Is Taxable
¶201-194	Photographs Meet Definition
¶201-088	"Use" in Virginia

D. Virginia Tax Bulletin 93-7 - Printing Purchased by Advertising Agencies  
(Old Rules)

E. Applicable exemption certificate - ST-10A

### III. Definitions

The following words or terms are useful in understanding the catalog statute. While all businesses are now more equally treated under this statute, prior to 1994 and 1995 there were substantial differences for advertising businesses.

**"Administrative supplies"** as defined in Code of Virginia § 58.1-609.6(4) "includes, but is not limited to, letterhead, envelopes, and other stationery; and invoices, billing forms, payroll forms, price lists, time cards, computer cards, and similar supplies. This definition is expanded in the catalogs and other printed materials regulation to include, but not be limited to ". . . certificates, business cards, diplomas, and awards. The term also includes supplies for internal use by the purchaser, such as menus, calendars, datebooks, desk reminders, appointment books, and employee newsletters." The printing regulation also includes "other house organs." But even administrative supplies may be exempt when they become an integral part of exempt printed materials. The printing regulation in paragraph H states that ". . . letterhead upon which fundraising or promotional letters are printed, return envelopes enclosed with fundraising letters, and price lists enclosed within catalogs advertising tangible personal property for sale or resale are not taxable." (P.D. 93-162)

**"Advertising"** as defined in Code of Virginia § 58.1-602 ". . . means the planning, creating, or placing of advertising in newspapers, magazines, billboards, broadcasting and other media, including without limitation, the providing of concept, writing, graphic design, mechanical art, photography and production supervision. Any person providing advertising as defined herein shall be deemed to be the user or consumer of all tangible personal property purchased for use in such advertising."

**"Advertising business"** as defined in the advertising regulation ". . . means any person or group of persons providing 'advertising'. . . ."

**"Other printed materials"** as defined in the catalog regulation ". . . means items which are similar to catalogs and which are used in advertising tangible personal property for sale. Brochures, leaflets, and similar items are examples of other printed materials, but price lists, merchandising displays, floor racks and similar items are not." It is important to remember that prior to 1986, § 58.1-609.6(4) read "[c]atalogs and other printed materials. . . ." Since 1986 it reads "[c]atalogs, letters, brochures, reports, and similar printed

materials. . . ." Similar printed materials can include items that would be taxable under the definition of other printed materials.

**"Similar printed materials"** as defined in the catalog regulation ". . . means printed materials used for promotional purposes, except administrative supplies." Paragraph H of the printing regulation gives examples of printed materials that are exempt from the tax.

- Fund raising and promotional letters, circulars, folders, brochures, and pamphlets, including those for charitable, political, and religious purposes;
- Corporate stockholder meeting notices;
- Proxy materials and enclosed proxy cards;
- Meeting and convention promotional materials;
- A business prospectus;
- Corporate monthly, quarterly, and annual stockholder reports;
- Announcements, invitations, and informational pieces for external promotional purposes;
- Greeting cards, brochures, menus, calendars, datebooks, desk reminders, appointment books, art prints, and posters for external promotional purposes; and
- Printed point-of-purchase sales devices, including display racks, animated and action pieces, posters and banners.

**"A sale in interstate commerce"** as explained in the interstate and foreign commerce regulation means "a sale. . . when title or possession to the property being sold passes to the purchaser outside of Virginia and no use of the property is made within Virginia." Regulation 23 VAC 10-210-780 gives four examples to which the tax does not apply. Further clarification can be found in P.D. 86-103, P.D. 87-200, P.D. 93-217, P.D. 94-266, P.D. 94-294, P.D. 96-63, and ¶201-088.

#### **IV. General**

##### **A. Code of Virginia § 58.1-609.6(4)**

Because the catalog regulation 23 VAC 10-210-260 was last amended in

1987 and does not take into account subsequent statute changes, the statute, itself, provides the best overall summary of the extent of the exemption.

Catalogs, letters, brochures, reports, and similar printed materials, except administrative supplies, the envelopes, containers and labels used for packaging and mailing same, and paper furnished to a printer for fabrication into such printed materials, when stored for twelve months or less in the Commonwealth and distributed for use without the Commonwealth.

At this point the statute defines "administrative supplies" which is described in Section III. The statute is actually straightforward and relatively easy to interpret except that the advertising statute and regulations specifically tax advertising businesses on these types of purchases. This will be discussed in Section V. Effective 7/1/94, the statute was expanded so that Virginia printing and direct mail houses would not be put at a competitive disadvantage when dealing with out-of-state advertising businesses. The statute continues:

Notwithstanding the provisions of subdivision 5 [the advertising exemption] of this section or the definition of "advertising" contained in § 58.1-602, (i) any advertising business located outside the Commonwealth which purchases printing from a printer within the Commonwealth shall not be deemed the user or consumer of the printed materials when such purchases would have been exempt under this subdivision. . . .

There was another legislative change the following year (effective 7/1/95) which put Virginia advertising businesses on parity with all other companies **when making purchases from a Virginia printer**. This, in effect, has given a competitive advantage to Virginia printers since the exemption is limited to purchases from an instate printer. Any printing purchased from an out-of-state printer is 100% taxable when constructive delivery takes place in Virginia (i.e., a Virginia mailing house) or if delivery is made to the purchaser's Virginia location, regardless of its eventual distribution.

. . . and (ii) from July 1, 1995 through June 30, 2002, any advertising business which purchases printing from a printer within the Commonwealth shall not be deemed the user or consumer of the printed materials when such purchases would have been exempt under subdivision 3 [newspaper/magazine exemption] or this subdivision, provided that the advertising agency shall certify to the Tax

Commissioner, upon request, that such printed material was distributed outside the Commonwealth and such certification shall be retained as a part of the transaction record and shall be subject to further review by the Tax Commissioner.

Note the unusual wording of this section that states the Commissioner can request certification that the printed material was actually distributed outside Virginia. This section of the exemption has a "sunset provision" that has already been extended once to 6/30/02.

## V. Procedures

For purposes of this training, transactions are discussed from the viewpoint of the purchaser. It is also assumed that all examples meet the limitations set out in § 58.1-609.6(4) for catalogs and similar printed materials and occur under current law unless otherwise stated. The examples deal strictly with the application of the Virginia sales tax law to catalogs and similar printed materials. Furthermore, the terms "taxable" and "exempt" are also limited to Virginia sales tax - another state's tax may well apply. Except for the procedures discussed in section D, all transactions should be considered purchased by other than an advertising business. Finally, delivery, whether actual or constructive, is often the crucial criteria that will determine the taxability of catalogs and similar printed materials. (Location! Location! Location!)

The treatment of sales by the seller can readily be inferred from the purchase scenarios, but will not be specifically addressed. If catalogs and similar printed materials are sold **for resale** (to other than advertising businesses), the purchaser can provide a Form ST-10 to purchase such resale materials exempt, whether they meet the § 58.1-609.6(4) limitations or not.

### A. Purchases

When auditing a business which has purchased catalogs, etc., it is important for the auditor to answer five questions - **who**, **what**, **where**, **when**, and **how**. Each question is important and can turn an otherwise exempt transaction into a taxable situation. Strict construction is the rule.

- Who is purchasing the materials in question? (Is it an advertiser or non-advertiser?)
- What is being purchased? (Does it qualify for exemption under the definitions?)
- Where is it being distributed from and where is it going? (Location is important as you will see below.)

- When is it leaving the state? (Remember storage in Virginia has to be twelve months or less.)
- How is the distribution made? (Is it interstate commerce or not?)

1. Printing, Mailing Services and Catalogs, Etc.

- a. When separately stated, postage is exempt from the sales tax. (P.D. 90-220)
- b. Mailing services (i.e., folding, stapling, stuffing, delivery to the post office) are ordinarily nontaxable. However, when the services include the provision of tangible personal property, the entire charge becomes taxable. This is further explained in 23 VAC 10-210-4000 "Sales price". The printing of non-customized mailing labels by a mailing service which are then placed on the materials provided by the customer would make all service charges taxable except separately stated postage or delivery. Printing the materials that the customer wants mailed or distributed will also make such services taxable. The next section explains the exemption for catalogs, etc. (P.D. 86-9, P.D. 90-218, P.D. 92-112, P.D. 95-216)
- c. The Code provides an exemption from the sales tax for catalogs, letters, brochures, reports, and similar printed materials (**except administrative supplies**), the envelopes, containers and labels used for packaging and mailing the same and paper furnished to a printer for fabrication into such printed materials, when stored for twelve months or less in Virginia and distributed for use outside Virginia. (Review the Section III definitions for "similar printed materials", "other printed materials" and "administrative supplies".) If these conditions are met there is no sales tax liability as long as Form ST-10A is provided to the mailing service or printer.
- d. "Printed material" can advertise tangible personal property for sale or be promotional or instructional in nature.

2. Use of Form ST-10A

By providing Form ST-10A to the vendor, the customer may purchase all catalogs exempt that are stored for twelve months or less in the state and distributed outside of Virginia . If the customer knows what items are taxable at the time of purchase, sales tax may be paid to the printer/ mailing service or consumer use tax may be

accrued and remitted directly to the state. If it is unknown how the catalogs will be distributed, the customer may submit an Form ST-10A to the vendor, purchase all catalogs exempt and remit consumer use tax on those delivered in the state or stored in the state for more than 12 months. If it is impractical to determine exact numbers, an estimated percentage of Virginia delivered catalogs may be used. Printing for the customer's own use or consumption within Virginia and storage in the state for longer than twelve months should be taken into consideration when determining percentages. (P.D. 87-243, P.D. 95-112)

3. CD-ROMs, Videotapes, Swatch Cards & Pictures - Printed Material?

Catalogs on CD-ROM are treated as printed material while instructional videotapes are not. Swatch cards (material swatches attached to cards with descriptive print) are not printed material but a furniture company's finished pictures of furniture lines with specifications are. Go figure! (P.D. 94-248, P.D. 91-30, P.D. 94-239, CCH ¶201-194)

4. Catalogs and Other Printed Materials - The Regulation

23 VAC 10-210-260, the catalog regulation provides for the exemption of certain printed materials when the following three conditions are met:

- The materials will be stored in Virginia for less than 12 months. (§ 58-1-609.6(4) wording is "twelve months or less.")
- The materials will be distributed for use outside Virginia; and
- The materials will be used for advertising the sale of tangible personal property.

Note: The scope of the last condition has been broadened since 1986 with the removal from the statute of the wording "used in the advertising of tangible personal property for sale." The public documents have consistently ruled, however, that the printed materials still must be promotional or informational in nature to qualify.

5. In-house Advertising Department

An in-house advertising department is only an advertising business when performing out-of-house jobs, therefore the general exemption is available for in-house work as long as it meets the definition of

catalogs, etc., is stored in Virginia 12 months or less, and is distributed for use outside of Virginia.

B. Transactions that Occur Within Virginia (Except Advertising Businesses)

There are several types of transactions concerning the distribution of materials defined in the catalog section and meeting the time limitation that can occur within Virginia. These refer to the taxability of the purchase or production of catalogs, etc.

1. Virginia business distributing from their Virginia location:
  - Delivered through interstate commerce out of state: EXEMPT  
Including delivery out of state by the Virginia business' own truck
  - Delivered in Virginia: TAXABLE
2. Virginia business using Virginia printer and/or Virginia mailing company:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE
3. Virginia business using out-of-state printer and a Virginia mailing company:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE
4. Out-of-state business using Virginia printer and/or Virginia mailing company:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE
5. Out-of-state business using an out-of-state printer and a Virginia mailing company:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE

(P.D. 89-99, P.D. 95-185, P.D. 97-248)

### C. Transactions that Occur Outside Virginia (Except Advertising Businesses)

There are several types of transactions concerning the distribution of materials defined in the catalog section and meeting the time limitation which occur outside Virginia. These refer to the taxability of the purchase of the catalogs. . . **and delivered to other than the purchaser's business.**

1. Virginia business using out-of-state printer and/or mailing company:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: EXEMPT \*
2. Virginia business using a Virginia printer and an out-of-state mailing company:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: EXEMPT \*
3. Out-of-state business using out-of-state printer and/or mailing company:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: EXEMPT \*
4. Out-of-state business using a Virginia printer and an out-of-state mailing company:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: EXEMPT \*

\* Note: Even though the catalogs are being delivered into Virginia, the purchaser has exercised no right or power over them in Virginia. (P.D. 95-185, P.D. 97-61)

### D. Advertising Businesses

Under the statutory definition of advertising, an advertising business is a service provider and is considered "to be the user or consumer of all tangible personal property purchased for use in such advertising." Because of this specific language, prior to the 1994 and 1995 statute amendments all advertising businesses were precluded from taking

advantage of the catalog exemption. Consequently, all purchases of printing by an advertising business were taxable. First, effective 7/1/94 the statute was expanded to allow any advertising business located outside Virginia to purchase printing exempt from a **Virginia printer** as long as the printing meets the definition and limitations for catalogs, etc. Then, effective 7/1/95 another amendment was passed that extended the catalog exemption as well as printed materials exempt under § 58.1-609.6(3) (the newspaper exemption) to Virginia advertising businesses when the printed material is purchased from a **Virginia printer**. These printed materials, likewise, have to be stored in Virginia for 12 months or less and distributed for use outside the state. Neither amendment was retroactive and the 1995 amendment currently has an expiration date of 6/30/02. Purchases by a Virginia advertising business from an out-of-state printer remain 100% taxable when the printing is delivered to the advertising business in Virginia or to a Virginia mailing house, regardless of its eventual distribution. (P.D. 96-148) When auditing for periods before 7/1/95, review and follow Tax Bulletin 93-7 and the regulations on advertising businesses. (The catalog exemption has always been available for nonmedia advertising jobs by advertising businesses.) The following examples reflect current law.

1. Out-of-state advertising business using Virginia printer:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE
2. Virginia advertising business using Virginia printer:
  - Delivered through interstate commerce out of state: EXEMPT
  - Delivered in Virginia: TAXABLE
3. Out-of-state advertising business using out-of-state printer:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: EXEMPT
4. Virginia advertising business using out-of-state printer:
  - Remaining out of state: EXEMPT
  - Delivered in Virginia: TAXABLE

## **Sales and Use Tax Audit Procedure**

### **EXEMPTION CERTIFICATES**

**Objectives:** Discuss the types of exemption certificates currently available, general and specific procedures for dealing with exemption certificates in audits, and comment on the most commonly used certificates.

#### **I. References**

- A. Code of Virginia Section 58.1-623
- B. Virginia Administrative Code 23 VAC 10-210-280
- C. Tax Bulletin 99-9 (PD-99-164)
- D. Legislative Summary 2003 (PD 03-54)
- E. Legislative Summary 2004 (PD 04-40)
- F. Ruling Letters PD 98-29, PD 04-3, PD 04-205

#### **II. Types of Certificates**

ST-10 Resale Certificate typically used by dealers for the exempt purchase of items for resale or lease.

ST-10A Multipurpose certificate used by purchasers of catalogs and similar printed materials for temporary storage in Virginia, by purchasers delivering goods to a factor or export agent, by purchasers of advertising supplements, and by purchasers of advertising.

ST-10B Used by handicapped persons for the purchase of special equipment for installation on a motor vehicle.

ST-11 Multipurpose certificate used by manufacturers, miners, printers and other industrial processors. Certified pollution control equipment as well as property qualifying for the research and development exemption may also be purchased exempt using this certificate.

ST-11A Used by contractors and non-manufacturers for the specific purpose noted on this certificate.

ST-12 Used by Virginia, political subdivisions of Virginia, and the United States government. This certificate is **not** valid for use by states other than Virginia, political subdivisions of those states, or national governments other than the United States.

ST-13 Used for seven specific medical related exemptions.

ST-13A Used by non-profit churches. Non profit churches also have the option of applying for a numbered exemption certificate with a broader exemption.

ST-14 Exclusively used by Out-of-State-Dealers who purchase property in Virginia for immediate transportation out of Virginia for resale outside this state. This is not a “blanket” certificate in the way that an ST-10 is a blanket certificate. A separate ST-14 is required for each sale.

ST-14A Used by Out-of-State dealers or brokers who purchase livestock in Virginia for immediate transportation out of Virginia for resale. Unlike the ST-14, this is a “blanket” certificate and the selling livestock dealer need have only one properly executed certificate on file for the out-of-state dealer or broker.

ST-15 Used by **Individuals** to purchase heating oil, propane, firewood, or coal for domestic consumption exempt of the **State** sales tax. The local tax may continue to be charged, depending on whether the specific locality in which fuel dealer is located has adopted an ordinance specifically exempting fuels purchased by individuals for domestic consumption.

ST-16 Used by watermen who extract fish, bivalves, or crustaceans from waters for commercial purposes.

ST-17 Used by harvesters of forest products.

ST-18 Used by farmers for the purchase of property used in producing agricultural products for market.

ST-19 Multipurpose certificate used by shipping (as in boat) lines engaged in interstate or foreign commerce, ship builders, companies engaged in building, converting, or repairing ships or vessels used or to be used in interstate or foreign commerce.

ST-20 Used by certain public service corporations, commercial radio and television companies, motion picture theatres, cable television systems, certain airlines, and taxicab operators.

ST-20A Used by production companies, program producers, radio, television and cable TV companies, and other entities engaged in the production and creation of exempt audiovisual works and the licensing, distribution, and broadcast of the same.

Numbered Certificates issued by the Department – On July 1, 2000 the Department began to issue numbered exemption certificates to those nonprofit organizations, excepting churches, who had previously been

granted exemption and had met certain informational filing requirements. Effective July 1, 2004, all Internal Revenue Code (IRC) § 501(c)(3) and charitable § 501(c)(4) organizations can qualify for a sales and use tax exemption if they meet certain eligibility criteria. Nonprofit organizations that held a valid exemption certificate issued by the Department of Taxation prior to July 1, 2004 will remain exempt until their exemption expires, at which time they will be required to reapply for exemption under the new process. Nonprofit churches have the option of continuing to use the ST-13A or applying for a numbered certificate of exemption and enjoying a broader exemption

### **III. Generally**

- A. A dealer is to collect sales tax on otherwise taxable transactions, unless he accepts a valid exemption certificate from the purchaser.
- B. The dealer must act in good faith and exercise reasonable care and judgment to prevent the receiving of a false, fraudulent or bad faith exemption certificate.
- C. A certificate that is incomplete, invalid, infirm or inconsistent on its face is never acceptable.

### **III. Audit Procedures**

- A. If the taxpayer's exemption certificates are not in order, allow sufficient time (thirty days maximum is suggested) to obtain the certificates from his customers.
- B. The absence of an exemption certificate at the moment of the transaction indicates that such a certificate was never accepted "in good faith." Such a certificate must be confirmed by the Department as valid and proper for the specific transaction under review.
- C. Incomplete certificates, i.e., certificates lacking any of the following are invalid:
  - 1. Date
  - 2. Signature
  - 3. Indication of use (box checked)
  - 4. Registration number where required
  - 5. Names and addresses of the supplier and the customer

- D. The purchase made and the manner in which it is made must be consistent with the language of the exemption certificate. For example,
  - 1. An ST-10 prohibits its use by a contractor.
  - 2. An ST-12 indicates that an official purchase order is required.
- E. First generation audits are considered an opportunity to educate the taxpayer. Where a properly executed exemption certificate is on file, it should be honored. Properly executed certificates that subsequent events (Repeal of Exemption) have made invalid should be revoked. The taxpayer should be instructed as to what items are not included in the exemption or what laws have recently changed. The audit comments should contain a summary of the items discussed in this area. Comments will be available to future auditors, through research of the M drive audit archive, for subsequent audits and the taxpayer will be held responsible for a greater understanding of the matters discussed.

#### **IV. Comments on Commonly Used Certificates of Exemption:**

- A. ST-10 The fundamental question a dealer must ask is: Do I reasonably believe that the purchaser is going to resell or lease the item for which this ST-10 is being offered? If the answer is no, the sales tax should be charged.
- B. ST-11 Manufacturers purchase many items that can be used in both taxable and/or exempt ways. It is often difficult to determine taxability from the dealer's perspective. One should accept a properly executed ST-11 in these cases. Where the auditor suspects that the purchaser is not truly a manufacturer or the exemption has been misused, an audit recommendation should be made to the appropriate district office.
- C. ST-12 The language of the ST-12 indicates that a government purchase order is required in order to use it. Cash sales exempted under an ST-12 are always suspect. Credit card sales to the United States may be exempt if the credit of the Federal Government is bound rather than that of its employee.
- D. ST-13A Smaller churches will probably use this certificate rather than apply for a numbered exemption certificate. The church exemption under this certificate is more limited than that available under a numbered exemption certificate. Structural construction materials are not exempt to churches under this certificate. (for information on numbered exemption certificates see the section on Non-Profit Organizations)

- E. ST-18 The agricultural exemption is broad but it has its limits. For example, the farmer must be producing products for the market, not for his/her personal use, and not custom farming for someone else. Furthermore, the property purchased must be used in agricultural production. Lawn mowers for the farmer's personal use do not qualify for the exemption. Structural construction materials are specifically identified on the ST-18 as not qualifying for the exemption.
- F. ST-20 This certificate was recently revised to reflect the loss of the exemption by certain public service corporations and certain airlines. Effective 9-1-04, House Bill 5018 (Chapter 3, 2004 Special Session I) eliminates the sales tax exemptions for certain public service corporations including electric suppliers, gas utilities, water and sewer utilities, telecommunications companies, telephone companies and common carriers of property or passengers by motor vehicle. Also, the manufacturing exemption will not apply to machinery, tools and equipment used by a public service corporation in the generation of electric power, except for raw materials, including fuel.
- G. Numbered exemption certificates. Upon application, review, and approval, Nonprofit organizations are issued numbered exemption certificates. The exemption varies by the type of organization and the details of the organization's exemption are detailed on its numbered certificate. Nonprofit 501(c)(3) and 501(c)(4) organizations that wish to apply for or renew their exemption can find the instructions on the department's web site at [http://www.tax.virginia.gov/web\\_pdfs/npinst.pdf](http://www.tax.virginia.gov/web_pdfs/npinst.pdf) and the application at [http://www.tax.virginia.gov/web\\_pdfs/npappl.pdf](http://www.tax.virginia.gov/web_pdfs/npappl.pdf).

**VI Useful Ruling Letters**

<u>PD 00-91</u>	<u>Multipurpose or multi-jurisdictional exemption certificates</u>
<u>PD 97-19</u>	<u>Use of the ST-10/foreign certificate by Out-of-State dealers</u>
<u>PD 96-324</u>	<u>Valid registration numbers vs. FEIN</u>
<u>PD 95-316</u>	<u>Generic exemption certificates</u>

## **Sales and Use Tax Audit Procedure**

### **Certificate of Registration**

**Objective:** Discuss the application of sales and use tax as it applies to the certificate of registration.

#### **I. History**

There have been no significant changes in the sales and use tax law pertaining to the certificate of registration.

#### **II. References**

- A. Code of Virginia Section 58.1-613 & 58.1-203
- B. Virginia Regulation 23 VAC 10-210-290  
23 VAC 10-210-460  
23 VAC 10-210-1090  
23 VAC 10-210-3090  
23 VAC 10-210-6010  
23 VAC 10-210-6040 through 23 VAC 10-210-6043
- C. Ruling Letters -PD 98-24, February 13, 1998  
PD 89-328, November 20, 1989
- D. Virginia Tax Bulletin - Adm Rul 55-85
- E. Applicable forms - Form R-1 and instructions R-4.
- F. Additional references - User's Guide for Registration Procedures &  
Business Registration Guide

#### **III. General**

A. The Virginia Retail Sales and Use Tax Act requires every individual, partnership, corporation, etc. desiring to engage in or conduct business as a dealer to apply for a certificate of registration. (See 23 VAC 10-210-460 for the definition of a dealer.) An out of state dealer who did not have the obligation to obtain a registration could voluntarily do so for the benefit of his customers.

#### **IV. Procedures**

- (1) First, determine what the business entity type is. (Sole proprietorship, general partnership, limited partnership, corporation, etc.) See Business Registration Guide for definitions of entities.

- (2) Complete and submit Form R-1. This form can be used to apply for all Virginia taxes; however, for the sales and use tax, a separate application is required for each location. The certificate of registration must be displayed at the location of the business.
  - (3) A new certificate of registration is required if a business changes the entity type. The following are examples of changes that require an application for a new certificate of registration:
    - (a) Sole proprietorship becomes a corporation or a partnership
    - (b) Corporation becomes a sole proprietorship or a partnership
    - (c) Partnership becomes a sole proprietorship or a corporation
    - (d) Partnership no longer has any of the original partners that were on the original certificate of registration application.
- By making these requirements, the department is able to identify those persons responsible for the payment of the taxes.
- (4) Any dealer who has two or more business locations for which he is required to hold a certificate of registration within the same locality may elect to file a single combined return for all locations within that locality.
  - (5) Any dealer who has five or more business locations for which he is required to hold a certificate of registration within the state may request permission to file a consolidated return to report and remit sales and use tax for all locations; however, he agrees to separately account for and report sales and use tax for each locality.

A change in address would only require a revised certificate of registration. Should the business cease to exist, the certificate of registration expires and should be returned to the Department of Taxation.

## Sales and Use Tax Audit Procedure

### CHURCHES

**Objective:** Discuss the application of sales and use tax as it applies to nonprofit Churches.

#### I. History

Effective 7/1/84, the nonprofit Church exemption was extended to tangible personal property used in libraries, offices, meeting or counseling rooms and other rooms of public church buildings to carry out the work of the church and its related ministries, including kindergartens, elementary and secondary schools. (Virginia Tax Bulletin 83-12)

Effective 7/1/86, the exemption was expanded to select items for use outside the public buildings. Specifically, baptisteries affixed to realty, gifts for use outside the public buildings, and purchases of bulletins, programs, newspapers, and newsletters for distribution outside the public church building were exempted. (1986 Legislative Summary)

Effective 7/1/87, House Bill 1256 expanded the existing exemptions for nonprofit churches to provide an exemption for food, disposable serving items, cleaning supplies, and teaching materials used by a nonprofit church, or organization composed of several nonprofit churches, such as a diocese, synod or conference, in the operation of camps or conference centers, provided such items are used in carrying out the work of the church(es). However, the exemption does not apply to purchases of food, disposable serving items, etc., used or consumed while the church camp or conference center is being utilized by non-church related functions, such as business groups, governmental organizations, civic groups and other groups not affiliated with the church. (Virginia Tax Bulletin 87-4)

Effective 7/1/95, legislation clarified that purchases of food by nonprofit churches for distribution as gifts outside the public church building are exempt from sales and use tax. (1995 Legislative Summary)

Effective 7/1/97, the definition of tax exempt organization in Title 58.1-1 was changed by HB 1562 of the 1997 General Assembly to *"Tax exempt organization" or "an organization exempt from taxation under § 501 (c) of the Internal Revenue Code" means any corporation, partnership, organization or trust which has received written notice of its exempt status from the Internal Revenue Service, if such notice is required by the Internal Revenue Service to obtain exempt status.*" (Va Code 58.1-1)

In PO 97-107 the Commissioner dealt with the effect of this on church exemption.

Effective 7-1-99, churches were specifically exempted from the new reporting requirements established by the General Assembly for nonprofit organizations exempt from the sales and use tax. (1999 Legislative Summary and Tax Bulletin 99-9).

Effective 7-1-04, an administrative process was created by the 2003 General Assembly establishing standard criteria for the granting of sales and use tax exemptions to nonprofit organizations. (2003 Legislative Summary)

Effective 7-1-04, the 2004 General Assembly clarified the impact on churches of the administrative process created by 2003 General Assembly. Churches are given the option of continuing to issue the ST-13a or satisfying more stringent reporting criteria for nonprofit entities and being issued a numbered exemption certificate that was not limited by the language of the ST -13a. Churches that elect to use the ST-13a will be entitled to the traditional exemption specified for churches under 58.1-609.10(16). (2004 Legislative Summary)

**Effective 7-01-04, the exemption from collecting sales tax on fundraising sales currently enjoyed by organizations is grandfathered. This exemption is now available to any other organization that is within the same class of an entity that was exempt from collecting sales tax as of June 30, 2003. (2004 Legislative Summary)**

**Effective July 1, 2004 - Any entity that was exempt from paying sales and use tax for the purchase of services, as of June 30, 2003, shall continue to be exempt from such payment, provided that it follows the exemption criteria set forth in 58.1-609.11. (House Bill 2100, SB 1105) (2005 Legislative Summary)**

## II. References

A. **Code of Virginia Section 58.1-609.10(16) for the traditional church exemption or 58.1-609.11 for the expanded exemption that is available under the new process. The media related exemption is found at 58.1-609.6 (6). Current code supplements should be reviewed for changes to these sections.**

B. 23 VAC 10-210-310 for the traditional exemption available under the ST13a. If the church has been issued a numbered exemption certificate the details of the exemption will be outlined in the certificate.

C. Legislative Summaries: 2005, 2004, 2003, 1999, 1995, and 1986

D. Virginia Tax Bulletins: 99-9,87-4,86-8, 83-12, and 05-4.

- E. Ruling Letters:
- PD 05-9 Worship Service and Church Building
  - PD 97-107 Effect of HB 1562 of 1997 General Assembly
  - PD 96-196 Sales of food by churches
  - PD 95-115 Denominational Governing Body
  - PD 95-54 Automotive Parts
  - PD 94-237 Christian Ministry Camp
  - PD 94-11 Church Affiliated Day Care Center
  - PD 93-204 Church Operated Swimming Pool
  - PD 93-177 Campground Facilities
  - PD 91-157 Roman Catholic Church: Education Programs-Marriage
  - PD 92-55 Property Purchased By Churches-Conference Center
  - PD 90-164 Administrative Governing Body (see also PD 95-115)
  - PD 90-66 Mobile Food Bank-Church Parking Lots
  - PD 90-36 Building Materials
  - PD 89-331 Food for Distribution
  - PD 89-176 Camp Meeting
  - PD 89-174 Rentals: Church Christmas Play
  - PD 88-216 Items Used in Public Church Buildings
  - PD 88-85 Church Provided Prison Ministry
  - PD 88-14 Conference Center
  - PD 87-65 Meals Sold at Cost By Church
  - PD 86-109 Non Profit Religious Shelter
  - Ruling of Commissioner: Administrative & Clerical Assistance to Churches.
- F. Applicable exemption certificates-ST13-A or numbered exemption certificate issued by the Department

### **III. General**

- A. Under the traditional church exemption, a church enjoys a limited exemption from the tax on purchases of tangible personal property used in carrying out the work of the church or churches. Code of Virginia 58.1609.10(16) states that a church is exempt from tax on the purchases of tangible personal property if the church is conducted not for profit and exempt under IRC 501 (c) (3), or exempt from local taxation on real property pursuant to Code of Virginia 58.1-3606. The code section then goes on to discuss the limitations of what may be purchased exempt under the section. These limitations are discussed below in section IV.
- B. If a church applies for and receives a numbered exemption certificate as a nonprofit entity under Code section 58.1-609.11, it receives a broader exemption than the traditional church exemption. The

limitations of the church exemption contained in section 58.1-609.10(16) do not apply. As a qualifying nonprofit entity, there is no restriction on the types of tangible personal property that may be purchased exempt. Taxable services are still taxable, however.

C. Neither exemption applies to churches operating for profit.

#### **IV. Traditional Church Exemption. (ST-13a)**

##### **Purchases by Churches**

Under 58-1-609.10(16) the exemption extends only to purchases by a nonprofit church of tangible personal property for:

1. Use in religious worship services by a congregation or church membership while meeting together in a single location. A religious service includes regularly scheduled church services as well as weddings, bar mitzvahs, bat mitzvahs, baptisms, christenings, funerals, and special services
2. Use in libraries, offices, meeting or counseling rooms or other rooms in the public church buildings used in carrying out the work of the church and its related ministries, including kindergarten, elementary and secondary schools. (PD 94-11 exempts church day-care, preschool activities)
3. Gifts, including food, for distribution outside the public church building.
4. Food, disposable-serving items, cleaning supplies and teaching materials used in the operation of camps or conference centers by the church or organization composed of churches exempt under 58.1-609.10(16) used in carrying out the work of the church or churches.

##### **Examples of exempt purchases (ST-13a)**

Acolyte robes  
Administrative supplies (letterheads, envelopes, office supplies, etc.) Altar cushions and cloths  
Baptism, marriage, and membership certificates  
Baptismal font and Baptisteries  
Bibles and bible stands  
Bulletins, programs, newspapers, and newsletters, which do not contain paid advertising (including paper and ink used to print these)  
Candles and candelabra used at the location of the worship service  
Carpeting used at the location of the worship service (except glued-down

carpeting)  
Choir robes  
Cleaning equipment and supplies  
Communion supplies and tables  
Curtains  
Flags used at the location of the worship service  
Flowers, plants, live or artificial, and accessories thereto used at the location of the worship service  
Fuel oil  
Funeral pall  
Gifts, including food baskets, for distribution outside the public church building  
Hymnals and hymnal racks  
Light bulbs used at the location of the worship service  
Kitchen equipment that is not incorporated into realty  
Microphones and public address system used in the worship service except when incorporated into realty  
Musical instruments (e.g., organ, piano, hand bells)  
Nametags for ushers and guests, and attendance records  
Offering envelopes  
Office machinery and equipment  
Pews, cushions, chairs, or other seating systems  
Portable heaters and fans and window air conditioners used at the location of the worship service  
Prayer books  
Pulpit, lectern, pulpit lamp  
Rosaries, crosses, crucifixes  
Sheet music  
Systems to assist persons who are hearing impaired, except when used in the recording or reproduction of church services  
Tallithim  
Torahs  
Vestments for ecclesiastical celebrants  
Wafers, bread, wine, grape juice used in communion services  
Yarmulkes

### **Taxable purchases for Church under 58.1-609.10(16)**

Generally, purchases of tangible personal property not used in the sanctuary, libraries, offices, meeting or counseling rooms, or other rooms in the public church buildings used in carrying out the work of the church are taxable. There have been some recent exceptions to this. In PD 05-9 a church was exempted for purchases used in a religious service at a single location that was not a public church building.

Generally, purchases that are affixed or become a part of the real estate are taxable. Baptisteries are the exception. Baptisteries, which will be incorporated into real estate at the public church building and used in the

religious services of a non-profit church, are exempt.

Construction and building materials purchased for use in real estate construction, reconstruction, installation, or repair to a church are taxable. If the materials are furnished by the church to the contractor for incorporation into realty, and the church did not pay tax on the materials, the contractor, as a consumer of the materials, must pay the use tax directly to the department, irrespective of whether or not any right, title, or interest in the materials become vested by the contractor. (Code of Virginia 58.1-610(b)) (PD 90-36)

Recording devices such as equipment, tools, supplies, or other tangible personal property used in any form of recording or reproducing of church services are taxable. If a single item is used for recording church services and providing hearing assistance in church service, the entire sales price is taxable.

Examples of recording and reproduction items may include, but not limited to:

- Amplifiers, microphones, speakers, and wires
- Cassette tapes and tape players, except when used for religious education
- Tools and testing equipment
- Tape or disk duplicating devices
- Audio/visual cameras
- Television broadcasting cameras
- Radio and television transmitting devices
- Photographic cameras, film, developing supplies

Other taxable purchases made by a church are:

- Any property used in the church parsonage
- Any property used on church trips, picnics, or similar outings outside a public church building
- Any property used in maintenance of church grounds, including without limitation, lawn mowers, trees, shrubs, grass seed, and fertilizer
- Tool sheds and picnic shelters
- Stained glass windows, lighting fixtures, and other property which, when installed, becomes a part of realty
- Bulletins, programs, newspapers that contain paid advertising (including paper and ink used in printing)
- Heating and air conditioning equipment, which is a part of realty
- Kitchen equipment that is a part of realty
- Repair parts, accessories, oil, and similar items for use in motor vehicles including church buses and vans (PO 95-54)
- Taxable services such as meals, lodging, etc.

Purchases made by the minister from his own funds, purchases by affiliated religious associations, and purchases by church members or others for donation to the church are subject to the tax.

## SALES BY CHURCHES

Generally, churches that make retail sales of tangible personal property must register as dealers, collect and remit the tax to the department. Such sales may include cassette tapes, audio/visual tapes, books, photo directories, jewelry, and items sold at yard sales and bazaars.

If there are fewer than three such sales per calendar year, the sale may be exempt as an occasional sale. Check VAC 10-210-1080 to determine if the sales could qualify as an occasional sale.

If a church sells food for which a profit is realized, and it is not an occasional sale, the church should collect and remit the tax. In this instance, the church may purchase the food exempt using a ST-10. (i.e. Fund raising dinners, spaghetti dinner, youth group, etc.)

For food only, if the sales price charged for food is completely offset by the cost of the food, and the church does not realize a profit, the church is not required to register, collect, and remit the tax to the department. The church must pay the tax to its vendors on the cost price of the food purchased.  
(PD 87-65)

## CAMPS AND CONFERENCE CENTERS

**Purchases.** The tax does not apply to purchases for **church related activities** of food (including beverages), disposable serving items (such as paper plates, cups, napkins, plastic eating utensils), cleaning supplies, and teaching materials used or consumed in operating camps or conference centers by a church or a organization composed of churches that are exempt from sales and use tax and which are used in carrying out the work of the church or churches. All other tangible personal property purchased for the operation of camps and conference centers are taxable. (PD 96-196, PD 94-237, PD 93-177, PD 92-55, PD 89-176, PD 88-14) (Virginia Tax Bulletin 87-4)

### Sales

**Lodging.** Charges by the church camp or conference center for rooms, lodging, and accommodations are taxable, as provided in 23 VAC 10- 210-730. The church must register as a dealer, collect the tax on the amount of the charge, and remit the tax to the department. Tangible personal property used and consumed in providing rooms, lodging, and accommodations are taxable at the time of purchase.

**Meals.** The sales price of the meals sold to participants is taxable. The church must register, collect, and remit the tax to the department. Food provided in the meals, as well as, paper place mats, plastic ware, and similar items furnished with the meals and disposed after the use by only one person, may be purchased exempt of the tax using a ST-10.

**Camp fees.** Camp fees, which cover expenses, incurred to provide meals, lodging, and camp activities are exempt from the tax. The camp may purchase these items using a ST-13A.

**Non-church related activities.** Food, disposable service items, teaching materials, or cleaning supplies purchased by a church or organization of churches for use in operating camp and conference centers in **non-church related activities** are generally taxable. Some examples of non-related church activities may be the renting of the facility for conferences, retreats, business groups, governmental organizations, and civic groups.

(Virginia Tax Bulletin 87-4) The camp must accrue and pay tax on items consumed in these non-church related activities.

#### V Nonprofit Entity - Numbered Exemption Certificate

Under Code Section 58.1-609.11, a church that files an application with the Department and meets the applicable criteria will be issued a numbered exemption certificate. This certificate confirms that the church qualifies for the nonprofit exemption and has both an issued date and an expiration date. Under this exemption the church may purchase all tangible personal property exempt. The exemption does not extend to the purchase of taxable services, such as meals or lodging.

Sales by this type of nonprofit entity, sufficient in number to exceed those allowed for an occasional sale, are taxable. The church must register as dealer and then collect and remit the tax to the Department as any other dealer would. There is no preferential treatment.

## **Sales and Use Tax Audit Procedure**

### **OVER COLLECTION AND ERRONEOUS COLLECTION**

**Objective:** Discuss the application of sales and use tax as it applies to over collection and erroneous collection of tax by dealers.

#### **I. References**

- A. Code of Virginia Section 58.1-625. 58.1-16
- B. Virginia Administrative Code 23 VAC 10-210-340
- C. Ruling Letters PD 94-80, Commissioner's Ruling dated March 4, 1985, PD 94-195, Commissioner's Ruling dated June 23, 1994, PD 85-55, Commissioner's Ruling dated March 4, 1985.

#### **II. General**

- A. All sales and use tax collected by the dealer must be remitted to the Department of Taxation. This includes over collected taxes, tax collected on nontaxable transactions, and collection of the wrong state's tax on Virginia transactions. Over collected taxes do not include taxes collected in accordance with the bracket system for sales transactions of \$5.00 or less.

#### **III. Procedures**

- A. Any dealer collecting the sales and use tax on nontaxable transactions must remit the sales tax to the Department of Taxation unless it can show that the tax has been refunded to the customer. Such nontaxable transactions include exempt sales and out-of-state sales.
- B. Any dealer who over collects the tax must remit any amount over collected to the state. This includes wrong state's tax collected on Virginia transactions.
  - (a.) The "Gross Up" method must be used in order to calculate the taxable measure amount to enter in the exceptions list. The sales price on an invoice is increased to a taxable amount that, when multiplied by the Virginia tax rate, results in the amount of tax charged on the invoice. Generally, this taxable measure is computed by dividing the tax collected by the Virginia rate.

- C. Compare tax collected to tax reported. Sometimes the taxpayer will utilize a method of reporting sales which inaccurately reports sales tax actually collected.

## Sales and Use Tax Audit Procedure

### Contractor

**Objective:** To provide information on the application of Virginia sales and use tax to real estate contractors, dual role contractors, and contractors deemed to be retailers.

#### I. References

- A. Code of Virginia Section 58.1-610, 58.1-609.1(4), 58.1-609.2(1), 58.1-609.3(1-4), 58.1-609.6(2), and 58.1-609.8(2)
- B. Virginia Administrative Code VAC 10-210-410
- C. Ruling Letters PD 93-23, PD 93-91, PD 94-104, PD 94-195, PD 94-207, PD 94-334, PD 95-32, PD 95-62, PD 95-154, PD 95-204, PD 95-260, PD 95-295, PD 96-4, and PD 96-24
- D. Virginia Tax Bulletin 92-2
- E. Applicable exemption certificate ST-11A - Limited to certain classifications of jobs. Contractor must make application to the Office Services Division, furnishing the name, address, location or premises where the property is to be installed, and the projected completion date of the project, along with a complete description of the property to be installed. Once the information has been reviewed and approved, the contractor will be provided with the appropriate restricted exemption certificate to use in making the purchases for the project tax exempt. The contractor is expected to code the invoices for the materials, so that they may be readily identified by an auditor as relating to the exempt project.

#### II. General

- A. Unless otherwise noted, the law treats every contractor as the user or consumer of all tangible personal property furnished to him or by him in connection with real property construction, reconstruction, installation, repair, and similar contracts. A contractor, whether a prime contractor or a subcontractor, does not pass the sales or use tax on to anyone else as a tax. He takes the amount of tax paid in consideration when submitting bids.
- B. Contractors may use form ST-11A to purchase tax exempt materials used in the performance of the following contracts:

1. Personal property purchased by a contractor which is used solely in another state or in a foreign country, which could be purchased by such contractor for such use free from sales tax in such other state or foreign country, and which is stored temporarily in Virginia pending shipment to such state or country (Va. Code 58.1-609.3(1)).
2. Machinery or component parts that are to be used directly in manufacturing products for sale or resale, when the contractor contracts to purchase and install such machinery for a manufacturer (Va. Code 58.1-609.3(2)).
3. Tangible personal property for a farmer, necessary for agricultural production, to be affixed to real property owned or leased by the farmer engaged in agricultural production for market. Structural construction materials are not exempt from the tax (Va. Code 58.1-609.2(1)).
4. State certified pollution control equipment and/or facilities used primarily for abating or preventing pollution of the atmosphere, or waters of the Commonwealth of Virginia (Va. Code 58.1-609.3(9)).
5. Baptisteries purchased by churches organized not for profit and which are exempt from taxation under § 501 (c) (3) of the Internal Revenue Code, or whose real property is exempt from local taxation pursuant to the provisions of § 58.1-3606 (Va. Code 58.1-609.8(2)).

### **III. Procedures**

- A. In order to classify a taxpayer as a using or consuming contractor, we must begin by defining real property. Real property typically means land along with its natural resources, such as timber, coal, ore, and precious stone, and structures permanently affixed to the land, such as houses and other buildings, but does not include temporary buildings or structures. To determine whether tangible personal property becomes real property after being affixed to realty, three general tests are applied: See Transcontinental Gas Pipe Line Corp. v. Prince William County, 210 Va. 550 (1970)
  1. Annexation of the property to realty
  2. Adaptation to the use or purpose to which that part of the realty with which the property is connected is appropriated, and
  3. The intention of the parties involved, with the intention of the party making the annexation being the chief test to be considered in whether tangible personal property becomes realty.

Some examples of using and consuming contractors are:

1. A dealer/installer of swimming pools, both above and in-ground, and decking. Sales without installation would remain sales of tangible personal property. (Ruling Letter dated 4/12/90, [Redacted])

2. A dealer/installer of monitored security systems is providing an exempt service and is responsible for paying sales tax on all equipment and materials used in providing this service. Conversely, the sale of non-monitored security systems represents a taxable sale of tangible personal property. If the dealer/installer should contract with a contractor to install security systems in new homes being built by the contractor, and at a later time, contract with the homeowner to provide the monitoring services, then two separate transactions have taken place. The sale to the contractor of a security system, which is not monitored at the present time and is subject to Virginia sales tax, and the providing of monitoring services, which is non-taxable, to the homeowner. (P.D. 96-4)

Likewise, a contractor who contracts to build a jail, and, as a part of that contract, to install electronic cell bar walls, electronic doors, and a non-monitored security system which includes numerous video cameras, t v monitors, and other electronic components, would still be deemed the user or consumer of all materials and equipment used in the performance of the contract. The contractor is not a dealer/installer but rather a user/consumer of the electronic components.

3. Retailers are deemed to be using and consuming contractors with respect to their purchase of installation supplies, i.e. sand, gravel, concrete, steel pipe, etc. used to install satellite systems. (Ruling letter dated 7/7/88, [Redacted]) Conversely, sales of satellite dishes, descramblers, control boxes, remote controls, receivers and like components, are sales of tangible personal property.

B. A person who is a using or consuming contractor may also be engaged in the business of selling tangible personal property to customers, including contractors, for use or consumption by them. If so, the person is a dealer with respect to such sales, and is required to obtain a Certificate of Registration.

After obtaining a Certificate of Registration as a dealer, a contractor may purchase the tangible personal property to be resold under a resale exemption certificate. He may not purchase under a resale exemption certificate any tangible personal property which he knows at the time of purchase will be furnished by him in connection with any specific contract.. If such a person, as a using or consuming contractor, removes from his sales inventory for use in the performance of any contract any tangible personal property purchased

under a resale certificate, he must include the cost to him of such tangible personal property on his dealer's return and pay the tax.

- C. A dual role contractor is a manufacturer, processor or miner who operates in a dual capacity of fabricating tangible personal property for sale or resale and fabricating for his own use and consumption in the performance of real property construction contracts. Such dual role contractors shall follow a primary purpose rule based on gross receipts in determining sales and use tax application. If 50% or more of the contractor's gross receipts are derived from sales of tangible personal property, the contractor shall apply the tax according to paragraph (1) below. If 50% or more of the contractor's gross receipts are derived from real property construction contracts, the contractor shall apply the tax according to paragraph (2) below.

The primary purpose test is computed annually either on a fiscal or calendar year basis provided that the same basis is used consistently from year to year by the Taxpayer. The primary purpose rule is computed separately for each facility of a company located in or doing business in Virginia. For such facilities, the primary purpose rule will apply to gross receipts regardless of whether they are from Virginia or non-Virginia sources. (P.D. 93-91)

1. Any person who is principally fabricating tangible personal property for sale or resale should collect and remit the tax based upon the total amount for which tangible personal property and services are sold, except that charges for labor and services rendered in installing, applying, remodeling or repairing property sold may be excluded from the tax when separately stated or charged. In addition, any person who withdraws tangible personal property from inventory for use and consumption in the performance of real property construction contracts is liable for the tax based on the fabricated cost price of the tangible personal property withdrawn. Fabricated cost price is computed by totaling the cost of materials, labor, and overhead charged to work in process.
2. Any person who is principally fabricating tangible personal property for his own use and consumption in real property construction contracts is classified as a using or consuming contractor and must pay the tax on the cost price of the raw materials which make up such fabricated property. The tax must be paid at the time of purchase to all suppliers who are authorized to collect the tax. In instances where the supplier is not authorized to collect the tax or fails to collect the tax, the tax must be remitted directly to the Department of Taxation on Form ST-7, Consumer's Use Tax Return. In addition, persons who sell tangible personal property to consumers must register, collect, and pay the tax on the retail selling

price of the tangible personal property. Such person is entitled to purchase exempt from the tax only that tangible personal property which can be identified at the time of purchase as purchases for resale.

- D. A person selling and installing tangible personal property that becomes real property after installation is generally considered a contractor, except that a retailer selling and installing fences, venetian blinds, window shades, awnings, storm windows and doors, floor coverings (as distinguished from floors themselves), cabinets, kitchen equipment, window air conditioning units or other like or comparable items is not classified as a using or consuming contractor with respect to them.

For purposes of this subsection only, a "retailer" shall be deemed to be any person who maintains a retail or wholesale place of business, an inventory of the aforementioned items and/or materials which enter into or become a component part of the aforementioned items, and who performs installation as a part of or incidental to the sale of the aforementioned items. As so defined, a retailer is not classified as a using or consuming contractor with respect to installations of the aforementioned items. A retailer must treat such transactions as taxable sales except that installation charges when separately stated on an invoice are exempt from tax. Note: No distinction is made between in-state and out-of-state retailers.

Persons who are not classified as retailers within the definition set forth above and who sell and install fences, venetian blinds, etc., are deemed to be contractors and must pay the sales tax on such items at the time of purchase.

**Both retailers and contractors are deemed to be the users or consumers of supplies used in installing tangible personal property that becomes real property after installation. Therefore, retailers and contractors are subject to the tax on their purchases of tacks, stripping, glue, cement, and other supplies purchased.**

During the pre-audit conference with the contractor or his representative, the auditor should determine the contractor's business activities. The contractor may be a general contractor, subcontractor, retailer, dual role contractor, dealer-installer, or any combination of the above. This determination will dictate how the audit should proceed and the audit techniques to be employed by the auditor.

A contractor's books of original entry may be similar to those of a retailer or manufacturer. The purchase journal and/or cash disbursements journal may show material purchases charged to inventory or directly to specific job numbers. The sales journal may

reflect progress billings on various jobs and sales of tangible personal property.

The general ledger may include several accounts peculiar to a contractor who wishes to set-up as a liability the contracts he is obligated to perform, and the discharge of that liability, as the job progresses and the progress billings are made.

Subsidiary records may include:

1. Contract register with columns for contract numbers, owner's name, job location, brief description of the job, type of contract, total amount of the contract, and date completed.
2. Contract job cost journal showing in columns such items as material cost, labor, overhead, subcontracts, etc., for various jobs in process and a total for all jobs in process to date for a particular accounting period. Job cost ledger cards may also be kept.
3. Requisition journal recording materials and fixtures withdrawn from inventory through requisitions.
4. Job cost folders containing plans and specifications, estimates of cost, copy of the contract, copies of purchase invoices charged directly to the job, copies of requisitions for materials withdrawn from inventory, and time cards for both in-plant and job-site labor.
5. Files of purchase invoices.
6. State and federal tax returns.

Auditors should always verify that tax charged to contractors is Virginia sales tax when delivery is taken in Virginia. This is especially important when auditing an out-of-state contractor who is working in the state. Often, out-of-state contractors will purchase from out-of-state suppliers who may or may not be registered to collect Virginia sales tax. Also some suppliers, both in state and out-of-state, collect tax based on the contractor's address instead of point of delivery. (P.D. 94-195)

The fixed assets of contractors should be audited in detail. Again, this is very important when auditing an out-of-state contractor. Some states may not tax certain fixed assets of contractors, nevertheless, they would be subject to Virginia consumer's use tax when brought into Virginia.

## **Sales and Use Tax Audit Procedure**

### **SALES TAX CHARGED AND PAID IN ERROR**

**Objective:** Discuss the application of sales and use tax as it applies to taxes paid in error.

#### **I. References**

- A. Code of Virginia Section 58.1-611, 58.1-609.10(4).
- B. Virginia Regulation 630-10-29, 630-10-51 (VAC 10-210-450 , VAC 10-210-780)
- C. Ruling Letters PD 87-227, Commissioner's Ruling dated October 14, 1987, PD 94-195, Commissioner's Ruling dated June 23, 1994.

#### **II. General**

- A. Section 58.1-611 of the Code of Virginia provides for a credit against the taxes imposed by the Commonwealth with respect to a person's use of tangible personal property in the Commonwealth for taxes paid in the state of purchase.
- B. Section 58.1-609.10(4) exempts from sales and use tax the delivery of tangible personal property outside the Commonwealth for use or consumption outside the state.
- C. Virginia Regulations 630-10-51 provides examples of transactions in interstate and foreign commerce to which the tax does not apply.

#### **III. Procedures**

- A. The interstate commerce exemption cannot be used to exempt transactions in which delivery of items purchased by the taxpayer occurs within Virginia. No credit is allowed for taxes erroneously charged or incorrectly paid to another state. The taxpayer must apply to the out-of-state seller for a refund.
- B. In some instances where the taxpayer has either been charged the wrong state's tax or no tax at all, the taxpayer will remit Virginia tax to the vendor with his payment. These transactions should be included in the audit exceptions and the taxpayer must apply to the vendor, whether in-state or not, or registered or not, for a refund of the tax paid.  
Taxpayer has made a purchase, and is now a dealer, by definition. 630-10-29.1 d. states, "the term 'dealer' includes every person who:

SALES TAX CHARGED AND PAID IN ERROR

Page - 89

has...used, consumed or distributed, or stored for use or consumption in this state, tangible personal property and who cannot prove that the tax has been paid on the sale at retail...".

The taxpayer was not charged the correct Virginia Sales Tax and "cannot prove that the tax has been paid". Voluntarily including the correct Virginia Sales Tax with the payment to the vendor does not assure that the tax was remitted to the Department.

See PD 94-165.

## Sales and Use Tax Audit Procedure DEALER

**Objective:** Discuss the application of sales and use tax as it applies to definition of dealer and nexus.

### I. References

- A. Code of Virginia Section 58.1-612  
Code of Virginia Section 2.2-4321.1
- B. Virginia Administrative Code 23 VAC 10-210-460
- C. Ruling Letters PD 93-240  
PD 94-10  
PD 94-62  
PD 95-250  
PD 97-81  
PD 00-53  
PD 04-4

### II. General

- A. Sales tax is collectible from all persons who meet the definition of a dealer and who have sufficient activity within the Commonwealth.

### III. Procedures

- A. Determine if the person meets the definition of a dealer through inquiry and examination of the business activity. The Code and the Rules and Regulations provide a list of all persons who meet the definition a dealer.
  - 1. Persons who manufacture or produce tangible personal property for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
  - 2. Persons who import or cause to be imported into this state tangible personal property for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
  - 3. Persons who sell at retail, or who offer for sale at retail, or who have in their possession for sale at retail, or for use, consumption or distribution or for storage to be used or consumed in this state, tangible personal property.

4. Persons who have sold at retail, used, consumed, distributed, or stored for use or consumption in this state, tangible personal property and who cannot prove that the tax has been paid on the sale at retail, the use, consumption, distribution or storage of the tangible personal property.
5. Persons who lease or rent, or who are lessees or rentees of, tangible personal property for a consideration, without transfer of title thereto.
6. Persons who, as representatives or agents, solicit, receive, and accept orders for delivery into Virginia for an out-of-state principal who refuses to register as a dealer.
7. Persons who become liable to and owe Virginia any amount of tax imposed by Virginia, whether they hold, or are required to hold, a certificate of registration.

B. Determine if the dealer has sufficient activity in Virginia to require registration and collection of the tax.

**1. Maintains or has within this state, directly or through an agent or subsidiary, an office, warehouse or place of business of any nature. Two factors are necessary for an agency relationship to exist.**

2. Solicits business in this state by employees, independent contractors, agents or other representatives.
3. Advertises in this state by any of the following methods:
  - (a) In newspapers or other periodicals printed and published in this state.
  - (b) On billboards or posters located in this state.
  - (c) Through continuous, regular, seasonal, or systematic solicitations broadcast or relayed from a transmitter within Virginia or distributed from a location in Virginia.
  - (d) Through materials distributed in this state by means other than the United States mail, except for continuous, regular, seasonal, or systematic solicitations in which the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in Virginia or benefits from the location in Virginia of authorized installation, servicing, or repair facilities.

**4. Makes regular deliveries within this state. There are two conditions that must be present.**

(a) Deliveries must be by other than a common carrier. e.g., dealer truck or contract carrier.

- (b) There must be more than 12 deliveries in a calendar year.
5. Is owned or controlled by the same interests which own or control a business located within Virginia.

6. Has a franchisee or licensee operating under the same trade name in this Commonwealth if the franchisee or licensee is required to obtain a certificate of registration.
7. Owns tangible personal property that is rented or leased to a consumer in this Commonwealth, or offers tangible personal property, on approval, to consumers in this Commonwealth.

**C. Two factors are necessary for an agency relationship to exist.**

- (a) First, the agent must be subject to the principal's control, with regard to the work to be done and the manner of performing it. Actual control is not the test; it is the right to control that is determinative.
  - (b) Second, the work has to be done on the business of the principal or for his benefit.
- D. The dealer must perform one of the listed activities to require registration and collection of the tax.
- E. Nexus does not exist for an out-of-state seller whose only presence in Virginia is the use of a computer server to create or maintain a site on the Internet.
- F. Out-of-state persons who contract with a commercial printer in Virginia are not required to register solely because of their contractual relationship with the printer if their activities are limited to the following:
- (a) Owning or leasing tangible or intangible property at the printer's premises which is used solely in connection with the printing contract with that person.
  - (b) Selling property printed at and shipped or distributed from the printer's premises.
  - (c) Activities in connection with the printing contract with the person performed by or on behalf of that person at the printer's premises.
  - (d) Activities in connection with the printing contract with the person performed by the printer within Virginia for or on behalf of that person.
- G. State agencies are prohibited from purchasing goods or services from vendors who are required to collect use tax on goods delivered into Virginia but refuse to do so. They are also prohibited from purchasing goods or services from vendors who are affiliated with such businesses.

## Sales and Use Tax Audit Procedure

### CASH VS. ACCRUAL

**Objective:** Discuss the application of sales and use tax as it applies to cash basis taxpayers.

#### I. References

- A. Code of Virginia Sections 58.1-603.5, 58.1-615, 58.1-616.
- B. Virginia Administrative Code 23 VAC 10-210-480
- C. Ruling Letters Ruling of Commissioner dated June 6, 1983; Memorandum dated September 25, 1974.

#### II. General

- A. Section 58.1-603.5 of the Code requires that the sales tax paid by retailers be computed on gross sales. Gross sales are defined as the sum total of retail sales. A sale for the purpose of determining gross sales is defined as "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property and any rendition of a taxable service for a consideration."
- B. Sections 58.1-615 and 58.1-616 require that dealers file a return and pay the sales or use tax on or before the twentieth day of the month for the gross sales of the previous month. Sales tax must be paid on every sale, whether the sale is an installment sale, charge sale, or cash sale. For purposes of the sales tax laws, the sale is complete in any case.

#### III. Procedures

- A. Determine that the taxpayer is reporting on a cash basis. There are different methods to determine the liability based upon the volume of the records, the dollar amount of the invoices, and the detail of records available.
- B. There are two areas of liability:

- (1) The current accounts receivables represent sales that have not been reported on any sales tax return. These should be entered in the unremitted sales exceptions list during the month of the actual sale.
- (2) No additional tax is due on charge sales made during the audit period that have already been paid and reported. A debit entry is made in the sales exceptions list in the month of the actual sale, and a credit entry is made in the month reported. A review of detailed accounts receivable for the audit period can be used to identify sale and payment dates. Also, a detail list including sales dates may accompany the sales tax return worksheets each month.

Penalty, as applied below, and interest, are to be assessed from the time the tax on the sales was due to the time the tax was actually remitted.

- C. On first audits, no penalty should be imposed on any sales tax previously remitted on the cash basis. Penalty will apply to unreported sales tax, i.e., tax on the current accounts receivables. The taxpayer should be instructed to remit on an accrual basis in the future.

On subsequent audits, penalty should be applied to all payments that were not reported or remitted on the return covering the month in which the sale was made. A debit entry should be made in the unremitted sales exceptions list in the month of the sale, and a credit entry should be made in the miscellaneous sales exceptions list in the month of the remittance.

This method will correctly compute the interest due. Penalty will also be computed correctly for the unreported sales, and for sales that were reported six months or more after the original sale (30% penalty is due). A manual calculation of penalty is required for all other sales that were remitted late.

## Sales and Use Tax Training

### Direct Payment Permit

**Objective:** Discuss the application of sales and use tax as it applies to the dealer's discount for holders of the direct payment permit.

#### **I. History**

The court ruled in Reynolds Metals Company v. Commonwealth of Virginia, Department of Taxation, that holders of a direct payment permit who were also registered dealers were entitled to the dealer's discount.

#### **II. References**

- A. Code of Virginia Section: 58.1-622 – Dealer's Discount, 58.1-624 – Direct Payment Permit
- B. Virginia Administrative Code: 23 VAC 10-210-485–Dealer's compensation or discount, 23 VAC 10- 210-510-Direct Payment Permits
- C. Ruling Letters 01-11 – Direct Pay Permit; Dealer discount
- D. Applicable exemption certificate – ST-21

**III. General** – The Tax Commissioner, upon application, may issue a direct payment permit to manufacturers, mine operators and public service corporations. This permit allows a person subject to the tax to pay that tax directly to the Department instead of to its vendor. This permit is used in situations in which the applicant finds it impossible to determine at the time of purchase how the company will use the property and, therefore, whether a tax will be due on that purchase. The holder of the direct payment permit is entitled to the dealer's discount if it is a registered dealer, that is, has a certificate of registration in addition to the direct payment permit and provided the Direct Payment Permit Sales and Use Tax Return, Form ST-6, is timely filed and paid.

# Sales and Use Tax Audit Procedure

## Fabrication

**Objective:** Discuss the application of sales and use tax as it applies to fabrication and fabrication services.

### I. History

The concept of fabrication and fabrication labor has been integral to Virginia sales and use tax since the beginning. Fabrication labor is specifically mentioned in the Instructions to Dealers published by the Department on July 1, 1966.

### II. References

- A. Code of Virginia Section 58.1-203 & 58.1-602 B.
- B. Virginia Administrative Code 23 VAC 10-210-560 Fabrication
  - 23 VAC 10-210-410 Contractors respecting real estate
  - 23 VAC 10-210-920 Manufacturing and processing

#### C. Ruling Letters

PD 98-75	Primary Purpose Test-Fabricated Products
PD 97-137	Services-Separately Stated Charges
PD 96-222	CD Fabrication- Data Conversion
PD 94-264	Manufacturing-Fabricated Steel
PD 91-301	Fabrication by Subcontractor
PD 87-137	Fabrication by a Third Party
PD 86-242	Fabrication-Lumber
PD 86-22	Fabricators-Conversion of Word Processing Diskettes

### III. General

- A. Fabrication is not defined in that portion of the Virginia Code devoted to Sales and Use tax. Some general definitions of the word given by Webster are "to construct, manufacture, invent, or create." The word describes a broad range of human activities. Clearly a definition peculiar to sales tax is needed.

*For a tax definition of fabrication we look to the regulation 23 VAC 10-210-560 where the Commissioner, under the authority granted by Virginia Code 58.1-203, has provided us with one. For tax purposes, fabrication is "An operation which changes the form or state of tangible personal property..." It is key to note in this definition that a change in the form or the state of the tangible personal property occurs. This distinguishes fabrication (the creation of something new) from repair (the restoration of something old). This definition is still quite broad and can be used to describe activities ranging in scale from portrait painting to industrial production.*

*A fabricator who is regularly engaged in the fabrication of tangible personal property for sale at retail must collect and pay the tax on the sales price of the of the property.*

*The fabrication of tangible personal property for consumers who furnish the materials used is specifically included in the definition of "Sale" in Virginia Code Section 58.1-602. The effect of this section is to make taxable separately stated labor charges for the creation of something new while separately stated labor charges for the restoration of something old (repair labor) would be exempted as a service under Virginia Code Section 58.1-609.5 (2).*

This distinction, that something **new has been created**, is key for differentiating between potentially taxable fabrication labor and other forms of labor qualifying for the service exemptions granted by 58.1609.5 (2). The sawing of a board, for example, creates two new shorter boards. A change in the form or state of the original board has occurred. The labor charge for sawing the board is taxable.

- B. A fabricator may fabricate product for resale or they may fabricate product for their own use. Fabricators who are also industrial manufacturers may qualify for the production exemptions set out on 23 VAC 10-210-920 as well as the resale exemption on raw materials and component parts if they are fabricating product for resale. Fabricators who fabricate product for their own use do not enjoy either the production or resale exemptions.

Fabricators sometimes operate in a dual-capacity and fabricate both for sale and for their own use. The tax application to this situation varies significantly depending on the primary purpose of the fabricator's activities as well as the nature of the fabricator's business. The primary purpose of the fabricator's activities is based on an analysis of the gross receipts of the fabricator. If more than 50 % of the gross receipts of the fabricator are the result of sales of product then the fabricator may

purchase raw materials, component parts, and other materials that go into the product under a resale exemption. In addition, if the fabricator is also qualifies as an industrial processor, then the production exemption would

also be available for purchases of equipment used directly in the production process in same manner as any other industrial processor.

When withdrawals from such a fabricator's inventory take place, normally for use or consumption by the fabricator, a use tax liability is created. That use tax liability is computed on the fabricated cost price of the materials withdrawn. The fabricated cost price is computed by totaling the cost of materials, freight in, labor, and overhead charged to work in process attributable to the product withdrawn.

On the other hand, if a fabricator primarily produces product for their own use or consumption, they would lose all production exemptions. In addition they would only be able to claim a resale exemption on those raw materials and component parts that could be identified at the time of purchase as being purchased for resale. If such identification was impossible, the fabricator would pay the tax at the time of purchase as well as charge the tax at the time of sale.

The application of the tax to fabricators, particularly manufacturers, processors, and miners, is discussed in detail in 23 VAC 10-210-410 C, D, E & F as well as in the Contractor portion of this training manual

#### IV. **Procedures**

- A. Initially, when reviewing the overall operation ask if there is a change of form or state in tangible personal property occurring? If so, then some form of fabricating activity is taking place.
- B. Next, since so many fabricating activities have their own separate regulation that describes the particular activity in much more specific terms, determine if such a regulation exists. For example, manufacturers would be audited under the provisions of 23 VAC 10-210-920, while real estate contractors would be done under the provisions of 23 VAC 210-410. They are both fabricators since they are both changing the form or state of tangible personal property, but their tax treatments are quite different.
- C. Finally, If no specific regulation exists for the particular fabricating activity encountered, apply the provisions of 23 VAC 10-210-560. Be alert to the numerous personal service exemptions contained in Virginia Code

Section 58.1-609.5 as well as other industry specific exemptions. A search of public documents for the specific activity is sometimes warranted since some apparent fabricating activities have been "deemed" by the Commissioner to be service in nature.

## Sales and Use Tax Audit Procedures

### Floor Coverings / Flooring

Objective: To provide information on the application of Virginia sales and use tax on floor coverings.

#### I. References:

- A. Code of Virginia Section 58.1-610 D
- B. Virginia Administration Code 23 VAC 10-210-410 G
- C. Ruling Letter P.D. 98-139
- D. Ruling Letter P.D. 89-252
- E. Tax Bulletin 92-7

#### II. General:

The application of the tax on floor coverings is set forth in the Code of Virginia Section 58.1-610 D and the Virginia Administrative Code 23VAC 10-210-410 G. Both discuss the application of tax to materials used by contractors in the performance of their contract jobs. The regulations and bulletin provide that "floor coverings" are distinguished from "floors" themselves and are defined to include rugs, mats, padding, wall-to-wall carpets when installed by the tack strip or stretch-in methods, and other floor coverings which are not glued, cemented, or otherwise permanently attached to the floor below. Floor coverings, which are glued, cemented, or otherwise permanently attached to the floor below, are deemed to be floors.

Persons who sell and install floor coverings are considered either a retailer or contractor. A person is considered a retailer of floor coverings if such person maintains a retail or wholesale place of business, an inventory of floor coverings or their component parts, and if that person performs installation as part of the sale of the floor coverings. The sale of "floor coverings," as described above, by a retailer constitutes retail sales and the retailer must collect the tax on the sales price of the floor coverings. A retailer selling and installing "floors" is deemed a using and consuming contractor with respect to the floors and must pay the use tax on the cost price of the floor covering. In both instances, the retailer must pay the use tax on materials used in the installation of floor coverings.

A person selling and installing floor coverings, who is not a retailer, is considered a using and consuming contractor with respect to such items, regardless of the method in which the floor covering is installed. The contractor is subject to the tax on the costs of all materials used in the performance of the contract work and the tax is not collected from the purchaser.

The tax does not apply to installation charges when separately stated on the invoice under Code of Virginia § 58.1-609.5(2), copy enclosed. If the installation charge is not separately stated, the tax must be computed on the total invoice charge.

#### III. Procedures:

**Contractor** (No retail or wholesale place of business with no inventory)

This type of business is considered a using and consuming contractor with respect to floor coverings, regardless of the method in which the floor covering is installed. The contractor is subject to the tax on the costs of all materials used in the performance of the contract work and the tax is not collected from the purchaser.

**Retailer** (Has a retail or wholesale place of business and inventory)

## Fabrication

Page -6

A retailer shall be deemed to be any person who maintains a retail or wholesale place of business, an inventory of floor coverings and/or materials which enter into or become a component part of the aforementioned items, and who perform installation as part of the sale of such items.

Permanent "Double-Stick" Carpet, Tile and Laminate Installation: Due to the fact that both the cushion and the carpet are permanently glued down, this would be classified as contract work.

Releasable "Double-Stick" Carpet, and Laminate Installation: Due to the fact that the carpet is attached to the cushion using a releasable adhesive, this would be considered a floor covering and classified as a retail sale.

Permanent Modular Carpet Installation: Due to the fact that the carpet tiles are permanently glued down and the entire substrate is covered with permanent adhesive, this would be considered contract work.

Releasable Full Spread Modular Carpet and Laminate Installation: If the carpet can be removed without material injury to the carpet/Laminate or to the real estate, this would be considered a floor covering and considered as a retail sale.

Releasable Grid System Modular Carpet Installation: The carpet can be removed with no damage to the substrate. If this were the case, this would be classified as a floor covering and considered as a retail sale.

Releasable Perimeter Glue Carpet Installation: The fact that this is a loose lay installation with only releasable adhesive used on the perimeter of the carpet, this would be classified as a floor covering and considered as a retail sale.

Floating Floors: This consists of tongue and groove planks that are glued together to create a sheet of laminate flooring. The flooring is laid on top of the layer of foam and secured by moldings around the perimeter. This type of flooring is distinguished from the floor themselves and is considered a retail sale.

P.D. 98-139

October 6, 1998

Re: Request for Ruling: Retail Sales and Use Tax

Dear

This is in reply to your letter of September 11, 1998, in which you seek information on the application of the retail sales and use tax to (the "Taxpayer").

**FACTS**

The Taxpayer is a retailer who sells and installs floor coverings. One type of flooring it sells, laminate flooring materials or "floating floors," consists of tongue and groove planks that are glued together to create a sheet of laminate flooring. The flooring is laid on top of a layer of foam and secured by moldings around the perimeter. The flooring is not secured to the sub floor or the floor below. You question the application of the tax to the laminate flooring.

#### **RULING**

The application of the tax to floor coverings is set forth in Code of Virginia § 58.1-610 and Title 23 of the Virginia Administrative Code (VAC) 10-210-410. Tax Bulletin 92-7, issued September 15, 1992 (copy enclosed), also addresses the application of the sales tax to floor coverings.

"Floor coverings" are distinguished from "floors" themselves and are defined to include rugs, mats, padding, and wall-to-wall carpets when installed by the tack strip or stretch-in methods, and other floor coverings that are not glued, cemented, or otherwise permanently attached to the floor below. Floor coverings that are glued, cemented, or otherwise permanently attached to the floor below are deemed to be floors.

Fabrication  
Page -8

P.D. 98-139  
October 6, 1998  
Page 2

The laminate flooring described in this case is not glued down, cemented, or otherwise permanently attached to the floor below. Consequently, the laminate flooring is considered a floor covering and not a floor. The sale of a floor covering is considered a retail sale, and the seller must collect the tax from its customers on the sales price. Accordingly, the Taxpayer must collect sales tax from its customers on its sales of laminate flooring or "floating floors."

The tax does not apply to the installation charges when separately stated on the invoice. See Code of Virginia § 58.1-609.5(2). If the installation charge is not separately stated, the tax must be computed on the total invoice charge. Please note that the Taxpayer must pay tax on materials used in the installation of its floor coverings.

I hope this has responded to your inquiry. If you have additional questions, please contact \_\_\_\_\_ in the Office of Tax Policy at \_\_\_\_\_.

Sincerely,

Danny M. Payne  
Tax Commissioner

Enclosure

OTP/17527J

September 21, 1989

P.D. 89-252

Fabrication

Page -9

Re: Ruling Request/Sales and Use Tax

Dear

This will reply to your letter of April 27, 1989 requesting a ruling on the sales tax application to various methods of carpet installation.

The application of the tax to floor covering dealers is set forth in Virginia Retail Sales and Use Regulation 630-10-27(G) (copy enclosed). Persons selling and installing floor covering which becomes permanently affixed to the floors below are considered to be the using or consuming contractor with respect to such items.

A person who installs floor coverings may be either a contractor or a retailer. Floor coverings, as distinguished from the floors themselves, include rugs, mats, padding, wall-to-wall carpet and any other floor covering not permanently affixed to the floor below. A retailer shall be deemed to be any person who maintains a retail or wholesale place of business, an inventory of the aforementioned and/or materials which enter into or become a component part of the aforementioned items, and who perform installation as part of the sale of such items. I will now address the specific situations as outlined in your letter.

Permanent "Double-Stick" Broadloom Carpet Installation: Due to the fact that both the cushion and the carpet are permanently glued down, this would be classified as contract work.

Releasable "Double-Stick" Broadloom Carpet Installation: Due to the fact that the carpet is attached to the cushion using a releasable adhesive, this would be considered a floor covering.

Permanent Modular Carpet Installation: Due to the fact that the carpet tiles are permanently glued down and the entire substrate is covered with permanent adhesive, this would be considered contract work.

Releasable Full Spread Modular Carpet Installation: If the carpet can be removed without material injury to the carpet or to the real estate, this would be considered a floor covering.

Fabrication

Page -11

Releasable Grid System Modular Carpet Installation: From the information provided, it appears that the carpet can be removed with no damage to the substrate. If this were the case, this would be classified as a floor covering.

Releasable Perimeter Glue Broadloom Carpet Installation: The fact that this is a loose lay installation with only releasable adhesive used on the perimeter of the carpet, this would be classified as a floor covering. In answer to your question concerning the invoicing to your customers, no sales tax would be shown on the invoice for contract work. Instead your corporation would be responsible for the sales or use tax on all material used to perform contract work. This tax may be taken into account when bidding on contract jobs. When making retail sales, the tax does not apply to installation charges when separately stated on the invoice. If the installation charge is not separately stated, the tax must be computed on the total charge.

I hope this has answered all of your questions. If you should have any further questions, please feel free to contact this department.

Sincerely,

W. H. Forst  
Tax Commissioner

## **Sales and Use Tax Audit Procedure Landscapers and Nurserymen**

**Objective:** Discuss the application of sales and use tax as it applies to landscapers and nurserymen.

### **I. History**

**Prior to 1996.** The department has consistently treated landscapers who sell and transplant trees, shrubs, plants and like items as dealer/installers making retail sales.

**1996 and after.** Due to a large number of contested audits and taxpayer inquiries, a short moratorium on audits of landscaping companies was in effect while the interpretation of the regulation was reevaluated. After exploring the possibility of allowing landscapers to operate solely as contractors under 23 VAC 10-210-410, it was decided, because of industry opposition and the new problems which would be created, to retain the established interpretation. The moratorium was lifted and audits may be performed on landscaping companies and nurserymen.

### **II. References**

#### **A. Code of Virginia Sections**

- 58.1-609.2(1) Agriculture exemption.
- 58.1-609.5(9) Maintenance contracts.

#### **B. Virginia Administrative Code**

- 23 VAC 10-210-50 Agriculture.
- 23 VAC 10-210-610 Florists and nurserymen.
- 23 VAC 10-210-910 Maintenance contracts and Warranty plans.

#### **C. Ruling Letters:**

- P.D. 97-320 Tax must be separately stated on invoice.
- P.D. 96-181 Contractor held taxable on sod when sold/installed by sub.
- P.D. 96-71 Plant replacement maintenance contract is taxable at 50%.
- " " " Landscaper is retailer for trees, shrubs, etc. - not contractor.
- P.D. 96-68 Tax must be charged on the total of a lump sum billing.
- P.D. 96-19 Plant replacement maintenance contract is taxable at 50%.
- P.D. 94-73 Tax must be charged on the total of a lump sum billing.
- P.D. 93-158 Plant replacement maintenance contract is taxable.
- P.D. 88-78 Gen. Contractor owes tax on trees sold & installed by a sub.
- P.D. 87-172 Landscaper may show one lump sum total for all plants.

- " " " Landscaper is retailer for trees, shrubs, etc. - not contractor.
- P.D. 86-214 Maintenance contract w/o plant replacement gtd. is service.
- P.D. 86-58 Immovable silos are taxable.
- P.D. 84-126 Tests to determine if tpp becomes real property after install.
- P.D. 82-153 Exempt items for greenhouse facilities.
- ¶200-694 (CCH) Plastic covered greenhouse is taxed as is the plastic.

D. Virginia Tax Bulletin 95-8 - Parts and Labor Maintenance Contracts

E. Applicable exemption certificates:   ST-10 Resale Certificate  
  ST-18 Farmer's Certificate

### III. General

A. 23 VAC 10-210-610) - Florists and Nurserymen.

The first three paragraphs of this regulation describe the general tax treatment of landscapers and nursery men as follows:

1. Paragraph (A) - Retail Sales

"The tax applies to retail sales of flowers, potted plants, shrubbery, nursery stock, sod, wreaths, bouquets, and similar items."

2. Paragraph (B) - Transplanting

"When a nurseryman, florist or other person makes retail sales of shrubbery and similar items, and as a part of the transaction agrees to transplant them on the land of the purchaser for a lump sum, the tax applies to the total charge. The tax does not apply to the charge for transplanting if the charge is separately stated on the invoice."

3. Paragraph (C) - Landscape Contractors

"Any landscaper, nurseryman, or contractor who goes beyond the sale and planting of shrubbery, sod, etc. and contracts to grade, seed and fertilize lawns or to provide periodic fertilizing or weed killing treatments is deemed to be a consumer of all tangible personal property used in performing such service and must pay the tax on such property at the time of purchase. The charge to the customer for providing the service is not subject to the tax."

B. Working Definitions

"Landscaper" is used generically to indicate a landscape contractor, nurseryman or other person who performs landscaping.

"Landscape contractor" refers to any landscaper, nurseryman, or other person as described in paragraph (C) of the regulation. A true landscape contractor does not have a retail business such as a garden center. The primary business usually involves grading, seeding, fertilizing and maintaining existing lawns as well as establishing lawns and landscaping for new construction. In addition, a landscape contractor often sells many of the items specifically designated as retail sales under paragraph (A) of the regulation. A landscape contractor seldom grows any of his nursery stock.

"Listed items" references the items in paragraph (A) of the regulation which are specifically designated as retail sales.

"Nurseryman" designates any landscaper or other person who grows some or all of the listed items which are sold to customers; or someone who operates a retail or wholesale business which carries a stock of such items. A nurseryman who grows nursery stock for market enjoys the agriculture exemption set out in 23 VAC 10-210-50. A nurseryman also acts as a landscape contractor anytime he goes beyond the sale and planting of shrubbery, sod, etc. and enters into landscape contracts as described in paragraph (C) of the regulation.

#### C. General Taxability of Landscapers

Landscapers, whether landscape contractors or nurserymen, are treated equally under 23 VAC 10-210-610 and long-standing department policy. They must register and charge sales tax whenever they make sales of the listed items. When landscapers go beyond the sale of these items and act as landscape contractors to grade, seed and/or fertilize lawns, they are treated as consuming contractors with respect to their purchases of seed, fertilizer, mulch, straw and for all of their tools supplies and equipment. Being treated as a landscape contractor in no way negates the requirement that landscapers charge tax to their customers on the retail sales of listed items.

### IV. Procedures

#### A. First Audit

The sales tax registration status of the landscaper during the period under audit determines how the audit will be conducted.

##### 1. Landscaper not Registered to Collect Sales Tax - First Audit

A landscaper who is not registered to collect sales tax or is only registered to remit consumer use tax will be audited as the business was

operated during the audit period and then "turned around." Normally this will result in auditing the unregistered landscaper as a contractor. Most often these audits will be on those companies commonly thought of as landscape contractors. Tax will be assessed on purchases on which no tax was paid to the vendor and on which no consumer use tax was remitted by the landscaper. Of course, a landscaper should be held liable for any over the counter retail sales, which would include the sale of mulch, topsoil, etc. that was delivered with no contractor services involved. These transactions should be shown as sales exceptions. The taxpayer should be instructed on the proper procedure for requesting a refund of sales tax paid to their supplier on these resale items. The audit comments should note how the business was operated and confirm that the landscaper was informed of the correct operating procedures. Lack of such comments can jeopardize the application of penalty in future audits. These special instructions should also be noted in the letter to the taxpayer at the conclusion on the audit.

## 2. Landscaper Registered to Collect Sales Tax - First Audit

A landscaper who is registered to collect sales tax should be held accountable for the proper business operation as described in 23 VAC 10-210-610. As a registered dealer, the landscaper should have been aware of the correct method of operation.

## 3. Penalty - First Audit

For the first audit, penalty is waived unless fraud is involved.

# B. Issues Regarding the Taxability of Landscape Contractors

## 1. Retailer and Contractor

A landscape contractor often operates in a dual capacity - as a retailer and as a contractor. Even if the listed items are included as part of a landscape contract, a landscape contractor is always a retailer for sale of such items. A landscape contractor cannot be a using or consuming contractor of the listed items.

## 2. Exemption Certificates - Landscape Contractors

A landscape contractor may use Form ST-10 to purchase listed items exempt from the tax. Tax must be charged to customers on all sales of listed items unless a valid certificate of exemption is received. Valid exemption certificates can be provided by federal, state and local governments, and other customers which are statutorily exempt for the purchase of tpp. The department will issue nonprofit organizations a

certificate of exemption on Department of Taxation letterhead. The certificate contains an exemption number and nonprofits are instructed to provide vendors with a copy of the certificate. A resale certificate (ST-10) can never be accepted in good faith for sales of listed items which the landscaper transplants. It is also imperative that landscapers realize the difference between making an exempt retail sale and fulfilling the service portion of a landscape contract. While acting as a consuming landscape contractor, the landscaper is responsible for the tax on seed, fertilizer, etc. The sales tax exemption status of the customer is not relevant to purchases of items used and consumed by landscape contractors.

### 3. Purchases by Landscape Contractors

A landscape contractor's resale exemption is valid only for direct resale purchases. Any purchases of installation supplies (i.e., top soil, peat moss, fertilizer, mulch, stakes and wire) and equipment (i.e., shovel, rake, auger, backhoe) are taxable to the landscape contractor at the time of purchase or upon withdrawal from an exempt resale inventory.

### 4. Lump Sum Contracts and Invoices

A landscape contractor who bills a lump sum amount which includes charges for any listed items (even if the listed items are not the majority of the charge) is required to charge tax on the total bill. If transplanting charges are separately stated, they are excluded from the taxable sale. P.D. 87-172 explains that "if the taxpayer prefers not to list the exact amount charged for each plant or shrub being sold to its customers in connection with its landscape contracts, it may list in a lump sum the total amount charged for all such items sold and thereby avoid disclosing the exact amount being charged for any particular item." Although a landscape contractor's invoice should show the proper breakdown between top and transplanting or installation labor, the auditor can accept categorized figures from a quote sheet or contract (if the customer was provided a copy).

### 5. Similar Items

23 VAC 10-210-610(A) requires that a landscaper be treated as a retailer of listed items including any similar items. Most likely the regulation's intent was to include in the term "similar items" only those items which are live or were grown. Although many of these items appear to become real property when transplanted, the definition of "retail sale" found in Code of Virginia §58.1-602 states that all sales for resale must be made in strict compliance with the regulations. The regulation is very clear on the taxability of the listed items. This approach also ensures that a landscape contractor and a nurseryman enjoy the same treatment under the

regulation. (Imagine how difficult it would be to audit a nurseryman if a "produced cost" had to be determined for the products, which he grows.)

#### 6. What TPP becomes Real Property when Installed by a Landscape Contractor?

The auditor also has to determine the tax status of tpp installed by a landscape contractor which are not similar items. P.D. 84-126 explains the tests set forth by the Virginia Supreme Court in *Transcontinental Gas Pipe Line Corporation v. Prince William County*, 210 Va. 550 (1970). (Note: P.D.84-126 erroneously shows the year of the court case as 1969.)

The classification of property as real estate or as tangible personal property is to be determined by the law of fixtures . . . three general tests are applied in order to determine whether an item of personal property placed upon realty becomes itself realty. They are:

- (1) annexation of the property to the realty
- (2) [adaptation] to the use or purpose to which that part of the realty with which the property is connected is appropriated, and
- (3) the intention of the parties . . .

The intention of the party making the annexation is the chief test to be considered . . .

With these tests in mind, most tpp (other than listed items) installed by a landscape contractor becomes real property. A landscape contractor must pay tax at the time of purchase or the withdrawal from an exempt resale inventory when installing items such as landscape timbers, edging, walkways (gravel, rock, slate, etc.), decks, decorative boulders and other similar items. If the intent is for permanent installation, the landscape contractor is considered a consuming contractor with respect to real property. The classification of other items such as a decorative pond or a fountain is more open for interpretation. For example, if hard wired or plumbed in, it would most likely be considered realty after installation. If each winter it must be brought indoors to protect from freezing, then it would retain its status as tpp.

### C. Issues Regarding the Taxability of Nurserymen

#### 1. Nurserymen vs. Landscape Contractors

A nurseryman is usually more familiar with making retail sales than a landscape contractor and is probably already registered to collect sales

tax before being chosen as an audit candidate. Nurserymen become landscape contractors whenever they enter into landscape contracts or perform grading, seeding, fertilizing, etc., therefore all of the issues already discussed apply equally to them. The nurseryman, however, enjoys the agricultural exemption if he grows nursery stock for market.

## 2. 23 VAC 10-210-50 - Agriculture Exemption

The agriculture exemption is available to the nurseryman who is considered a farmer when growing his plants or nursery stock. The agriculture regulation states in paragraph (A) that

[t]he tax does not apply to . . . seed, plants, fertilizers, liming materials, . . . agricultural chemicals, . . . farm machinery, and agricultural supplies sold to farmers for use in agricultural production for market. Also, effective July 1, 1979, the tax does not apply to tangible personal property, except structural construction materials, necessary for use in agricultural production for market when sold to or purchased by a farmer or contractor or furnished to a contractor by a farmer to be affixed to real property owned or leased by a farmer . . .

The term "structural construction materials" includes but is not limited to the following: silos; barns and sheds; storage bins (not portable); greenhouses, including plastic covered houses; permanent fencing; fuel oil storage tanks; electrical wiring, except wiring running from special purpose equipment to an on-off switch, plumbing, except as part of special purpose equipment. . . . These items are therefore subject to tax.

The term "structural construction materials" specifically excludes the following but may also exclude other items: . . . heating systems; . . . power outage and water pressure alarm systems; . . . ventilating equipment, to include air inlets, curtains and curtain cables, cords and related fixtures, pull-ups, winches, fans and fan belts, louvers, shutters, motors, static pressure gauges, thermostats and replacement parts; shade cloth; and irrigation lines and sprinkler heads. These items are therefore exempt from tax.

## 3. Exemption Certificates - Nurserymen

A nurseryman uses the ST-10 resale exemption to buy products for resale. In addition, a nurseryman should use the ST-18 exemption certificate to make purchases which fall under the agriculture exemption. Exempt purchases would include such things as seedlings, potting soil, black plastic ground cover, mulch, vermiculite, pots, weed killer, pruning

shears, irrigation or misting systems, heating and ventilation systems if they are for the survival of the plants, tillers and other farm equipment directly used in growing the nurseryman's products. (It is important to limit the definition of excluded structural construction materials to those items within or attached to an agricultural building.) If a contractor installs exempt attachments to realty, he must contact the department to obtain an ST-11A. Also because of the agriculture exemption, a nurseryman is more likely than a landscape contractor to have made improper exempt purchases.

#### 4. Greenhouses and Shade Cloth

Please note that greenhouses, including plastic covered houses, are specifically designated as taxable structural construction materials. This includes the plastic covering itself. However, plastic shade cloth hanging inside a greenhouse is specifically excluded from the term structural construction materials and is exempt. Shade cloth used in the fields would also be exempt.

#### 5. Withdrawals from Exempt Resale Inventories

Nurserymen are more likely than landscape contractors to have exempt resale inventories of consumable supplies such as mulch, topsoil, fertilizer etc. If the nurseryman has a retail business, these items are often sold over the counter. It is important for the auditor to determine whether consumer use tax is being accrued and remitted on withdrawals from such inventories.

#### D. Mulch, Top Soil, Stone and other TPP Delivered in Bulk

A landscape contractor is only a consuming contractor when "installing" items delivered to customers. Therefore, all sales of mulch, topsoil, stone and other tpp delivered in bulk are taxable retail sales if they are delivered without being spread. When a landscaper dumps a load of mulch in the driveway and drives away leaving the customer responsible for its distribution, the landscaper must charge his customer the tax. Conversely, if the landscaper spreads the mulch, he is acting as a consuming contractor and must pay the tax at the time of purchase or upon the withdrawal from an exempt resale inventory. When acting as a consuming contractor, the customer is not charged tax.

#### E. Plant Maintenance Contracts

Plant maintenance contracts, which only provide for the regular watering, fertilizing, mulching, pruning, etc., are service contracts not subject to the tax. Plant maintenance contracts, which include any of the above

services and in addition contain a plant replacement guarantee, are "parts and labor maintenance contracts" covered under 23 VAC 10-210-910 and Virginia Tax Bulletin 95-8. Prior to January 1, 1996, such contracts were taxable at 100% of the total cost of the contract. After January 1, 1996, these contracts are taxed at one-half (50%) of the total charge. The auditor will have to take this statute change into account when extrapolating a purchase sample including taxable maintenance contracts. This can be accomplished by using the "Multisam" program. A landscaper may purchase or withdraw replacement plants from an exempt resale inventory without incurring a consumer use tax liability. Consumable items and installation or transplanting supplies and equipment are subject to the tax at the time of purchase or withdrawal from an exempt resale inventory.

#### F. Sale of Equipment and Occasional Purchases

A registered landscaper cannot make an occasional sale of equipment if it was used in the activity for which he is required to hold a certificate of registration unless the business is sold, reorganized or liquidated. A landscaper not required to be registered can probably make an occasional sale of equipment as long as no more than three sales are made in any one year period. Any landscaper, however, would be able to make an exempt occasional purchase if the occasional sale was made by a person not required to be registered to collect sales tax (i.e., a contractor or a farmer).

#### G. Records

Most nurserymen keep adequate records. Landscape contractors are somewhat less consistent. They often use only a small number of suppliers, therefore, duplicate purchase invoices may be available from vendors. It is not unusual to find that sales invoices are lacking in detail. Landscapers must be instructed on the importance of providing their customers and retaining for themselves detailed invoices and contracts. Without proper documentation it is sometimes impossible for the auditor to determine whether a landscaper has made a retail sale or acted as a landscape contractor. If only a lump sum invoice exists, the tax applies to the total charge. However, if the customer has been provided with a contract or quote which shows the breakdown of the lump sum, the auditor should make use of this categorization to determine any tax liability.

**Sales and Use Tax Training**  
**Food Tax Reduction Program**

**Objective:** Discuss the application of sales and use tax as it applies to the Food Tax Reduction Program.

References

- A. Code of Virginia Section 58.1-611.1
- B. Virginia Tax Bulletin 99-11
- C. Ruling Letter – P.D. 01-20. 01-10
- D. Video Conference Questions & Answers

**II. General**

- A. For purposes of the Virginia sales and use tax reduction for food purchased for human consumption as enacted by the 1999 Virginia General Assembly, the definition of “food purchased for human consumption” includes most staple grocery food items and cold prepared foods packaged for home consumption. Specifically excluded from the definition are alcoholic beverages, tobacco, and prepared hot foods sold for immediate consumption.
- B. “Food purchased for home consumption” means food for home consumption by humans, as defined under the Food Stamp Act of 1977, 7 U.S.C 2012..
- C. The first rate reduction was effective January 1, 2000. The following table illustrates the implementation of the state sales and use tax rate reduction.

<u>Effective Date</u>	<u>State Tax Rate</u>	<u>Local Tax Rate</u>	<u>Total Tax Rate</u>
Jan 1, 2000	3.0%	1.0%	4.0%
April 1, 2001	2.5%	1.0%	3.5%
April 1, 2002	2.0%	1.0%	3.0%
April 1, 2003	1.5%	1.0%	2.5%

**Note:** The rate reductions scheduled for April 1, 2001, 2002, 2003 are conditional upon prescribed revenue growth requirements set out in the legislation. The Dept of Taxation will know no later than December of each year whether a rate reduction scheduled for the following April will take effect and issue the proper notification to dealers and the public. The second rate reduction did not take effect on April 1, 2001.

## Procedures

### A. First audit of taxpayer(seller) under the Food Tax Reduction Program

Determine which items have been identified as “food purchased for human consumption”. Start with testing register tapes to identify items that may not qualify for the reduction. Note such items and discuss with T/P. Since this is a new occurrence and the item should have been coded as taxable, please advise T/P to immediately change the item(s) to taxable and do not hold T/P for the error in the audit. Advise that in any subsequent audit the same type errors will be held taxable and the appropriate tax assessed.

When testing the register tapes, verify the “total” tax from the tapes as posted to the daily closing sheets, then to the monthly closing sheets and to the sales tax return.

As always, when auditing a retail food store, verify the handling of food stamps and WIC coupons. With the food tax reduction, new problems may arise.

If no register tapes or no registers used at all, use the best information obtainable.

### B. Second and further generation audits under the Food Tax Reduction Program

Same procedures as (A) above, but if items are identified as not qualifying under the Program the T/P is to be held liable for the error(s) and assessed the appropriate tax.

### C. Miscellaneous items to note

- 1- Retailer classifications. VA Tax Bulletin 99-11 list the type of retailers who should charge the reduced sales tax rate, such as bakeries, cafes, cafeterias etc..
2. Exceptions. Some vendors are presumed sellers of food for immediate consumption and may not impose the reduced sales tax rate on sales of eligible foods. All sales are fully taxable at the 4.5% rate. P.D. 99-11 lists those sellers to include caterers, concession vendors, etc.

3. Fast food/restaurants. Only those foods deemed eligible under the federal food stamp program may be sold at the reduced sales tax rate.
4. Samples and giveaways. Samples, free distributions, and giveaways of eligible food products by food wholesalers and retailers are subject to the reduced sales and use tax rate unless otherwise exempt from the tax.
5. Gift transactions. These are the three party transactions and are eligible for the reduced tax rate.

D. Consumer Use Tax Audits

Business establishments are required to pay the consumers use tax on untaxed purchases of tangible personal property for use in Virginia, which are not otherwise exempt of the tax. Under the Food Tax Reduction Program, businesses should pay the reduced sales tax rate on untaxed purchases of eligible food products.

The same applies to individuals on purchases of more than \$100 in a calendar year.

## **Sales and Use Tax Audit Procedure**

### **GOVERNMENT CONTRACTORS**

**Objective:** Discuss the application of sales and use tax to government contractors.

#### **I. History**

In **January 1986**, an emergency regulation was issued to provide an exemption for innovative high technology industries. Government contractors involved in research and development in innovative technology may qualify for this exemption.

#### **II. References**

- A. Code of Virginia Section 58.1-609.1
- B. Virginia Administrative Code: VAC 10-210-410J and VAC 10-210-693; VAC 10-210-3070 through 3074; VAC 10-210-690 through 692; VAC 10-210-760 through 766; VAC 10-210-920.
- C. Ruling Letters: Public Documents 88-159, 88-249, 89-154, 89-206, 91-247, 92-4, 92-179, 93-20, 93-170, 93-181, 93-186 93-191, 93-203 93-238, 93-241, 94-115, 94-140, 94-155, 94-201, 94-218, 94-231, 94-238, 94-267 94-270, 94-334, 94-335, 95-16, 95-28 95-42 95-77 95-80, 95-82, 95-91, 95-97, 95-99, 95-124, 95-139, 95-293, 95-313, 95-314, 95-323, 95-329, 95-333, 96-23, 96-48, 01-6.
- D. Virginia Tax Bulletins 86-5 and 95-8
- E. Court Cases: U.S. vs. New Mexico, et al (U.S. Supreme Court); U.S. and Hercules vs. W.H. Forst, State Tax Commissioner, et al (U.S. District Court for the Western District of VA).
- F. Handout on Contract Types, "Chapter 6, 6-000 Contract Types"
- G. Applicable Exemption Certificates: ST-10, ST-11, ST-12

### III. Significant Terms

**DCAA** - Defense Contract Audit Agency. Audits government contractors for compliance with Federal Acquisition Regulations.

**FAR** - Federal Acquisition Regulations. FAR are used by all federal executive agencies for acquisition of supplies and services with appropriated funds. FAR, together with agency supplemental regulations (such as the Department of Defense FAR Supplement that applies to all Defense agencies), should be the primary guideline for the contractor's conduct in administering the contract.

**Statement of Work (SOW)** - A general statement of the overall objective of the government contract. The statement should be a primary source for determining the "true object" (service vs. sale of tangible personal property) of the contract.

**RFP** - Request for Proposal. A document developed by the government to apprise the prospective bidder of the type of contract the government requires, such as the general specifications of the items or services to be provided. Usually, the RFP is not a classified document.

**Contracting Officer** - A government employee who oversees the progress of a government contract and works with the contractor to facilitate progress and completion of a contract.

**TWR** - Technical Work Request. Task orders within a contract.

Reference information-There is a wealth of federal government contractor information available online. For example, the FAR can be found at [www.arnet.gov/far](http://www.arnet.gov/far).

**ID/IQ** – Indefinite Delivery / Indefinite Quantity

### IV. General

A government contractor may operate as a retailer or service provider based upon the "true object" of the contract. When the "true object" of the contract involves a sale of tangible personal property, the contractor may purchase the resale inventory with an ST-10 certificate of exemption.

A government contractor who performs a service and in conjunction therewith furnishes some tangible personal property is deemed to be the consumer of all such property and is not entitled to exemption on the grounds that a governmental entity is a party to the contract. This is true even though title to the property

provided may pass to the government and/or the contractor may be fully and directly reimbursed by the government.

Contractors providing services are the consumers of all equipment and supplies absent any statutory exemptions such as research and development.

## V. Procedures

During the pre-audit conference and tour, the auditor should determine if the contractor makes sales of tangible personal property. If such sales are to customers other than the government, the sales transactions should be reviewed to ensure proper application of tax. For example, sales by the contractor to other government contractors are not entitled to the exemption afforded the U.S. government. Such sales are taxable in the absence of an exemption certificate. The contractor can purchase resale inventory exempt from tax using the ST-10 form.

In those cases when the contractor provides services to the government, the relevant contracts must be reviewed to verify consumer use tax compliance. The "true object" test must be applied when examining contracts by reviewing the "statement of work (SOW)." The SOW will explain the scope of the contract and the product or service to be provided by the contractor. An analysis of the SOW is essential in determining the "true object" of the transaction.

When reviewing the SOW, the auditor should be aware of potential manufacturing, resale, or research and development exemptions. An example of a resale contract would involve the sale of a computer system to the government; a service contract, however, may include furnishing, operating, and maintaining the computer system. The auditor must determine if the government entered into the contract for the purpose of securing tangible personal property or to obtain services from the contractor.

The amount of funding for labor as opposed to equipment is not the controlling factor in determining the "true object" of the contract. For example:

Equipment	\$10,000,000.00
Direct Labor	1,000,000.00
Indirect Labor	<u>1,000,000.00</u>
TOTAL	\$12,000,000.00

In this particular contract, the resale exemption does not apply solely on the basis of the percentage of funds allocated to equipment. This contract states deliverables of \$10 million and labor costs of \$2 million. Without further clarification from the

SOW, the auditor cannot make a determination as to the "true object" of the contract and the tax implications

In reviewing the SOW, the auditor should focus on key terms such as "operate," "maintain," or "manage." Such terminology would indicate a service contract and purchases charged to that contract may be fully taxable to the contractor absent another exemption such as R&D.

If it has been determined that the contractor is providing services to the government, emphasis is placed on reviewing expense purchases as well as asset acquisitions. Expense purchases examination includes both direct charges to the contract and indirect charges.

Sample periods should be chosen to include a fair representation of contract activity during the audit period. One of two methods may be utilized to conduct an examination of direct charges. A criterion for selecting a method is for the auditor to determine the number of contracts as opposed to the volume of purchase invoices. If the number of contracts to be reviewed is minimal, one method would be to examine the SOW for each contract prior to reviewing purchase invoices. Should the auditor determine that a particular contract is for the provision of a service, any purchases of tangible personal property directly charged to that contract would be taxable to the contractor absent an R&D exemption. If a specific contract is for the procurement of tangible personal property, the inventory items can be purchased tax-exempt with an ST-10 form.

An alternate method is to first examine purchase invoices prior to reviewing the contracts. This approach would be appropriate should the number of contracts be voluminous, or in those cases when the auditor has been denied access to the contracts for reasons such as lack of security clearance. This method would involve listing any direct charges as taxable to the contractor until the appropriate contracts are reviewed to determine the "true object."

When listing the purchase exceptions it is important to include the contract number and as much information as possible, such as the following (non-inclusive):

- account number
- purchase order number
- cost center number
- department number
- invoice number

Additionally, a complete description of the item being purchased will expedite completion of the audit.

As mentioned previously, in the absence of a security clearance, classified contracts may not be available for review by the auditor. In this situation, the auditor should consult the audit supervisor for guidance. The "burden of proof" ruling provides that the "burden of proof" is on the business to show that a particular transaction is exempt from tax. In the absence of proper records/documentation, the Department can hold the transaction as fully taxable. The audit supervisor may, therefore, decide to include all purchases of tangible personal property charged to the classified contract as taxable to the contractor. The other option is for the audit supervisor to assign a Department employee with appropriate security clearance to review the classified contracts and determine the tax implications.

A careful analysis of contracts is essential. In many cases, contractors erroneously believe that they are exempt from Virginia sales and use tax due to their contractual relationship with government agencies. In addition, some contractors have operations in multiple jurisdictions with differing tax implications which contributes to the contractor's misunderstandings. Also, government contractors are sometimes authorized to access government funds through a procedure known as "advanced funding." The U.S. Supreme Court has ruled in *United States v. New Mexico, et al*, that "immunity does not result merely because the tax is paid with government funds through such a procedure as 'advanced funding'." In these situations, the auditor should carefully scrutinize the contract between the United States and the contractor. Should the contractor exercise control over the funds, the exemption afforded to the government does not extend to the contractor (see P.D. 91-247). The auditor must have knowledge of the government contractor's total operations in order to ensure proper application of the tax.

**It is important to note that in determining the "true object" of a contract, the Department has consistently ruled that the determination is made at the overall contract level and not at the "task" level. Tasks under a contract can and do have their own statements of work, and the contractor may supply the auditor with the statement of work for the task that the property is purchased under rather than the overall contract.**

**There is, however, a January 4, 2001 ruling (PD 01-6) that identifies a government contracting situation where the auditor would apply the "true object" test at the task level rather than the contract level. The following is a description of this contracting arrangement.**

#### **ID/IQ (Indefinite Delivery / Indefinite Quantity Contracts)**

**A brief description of ID/IQ contracts and how the auditor should recognize and handle sales tax issues is included here. It is recommended that the auditor review PD 01-6 to gain a more complete understanding of the subject.**

The basic contracting arrangement involves the government contractor, General Services Administration (GSA), and GSA's client agencies (government agencies). GSA will execute a very broadly written contract with a government contractor – the ID/IQ contract. This contract can include hourly

rates for labor categories along with other general provisions for supplies and services and will specify that all supplies and services will be ordered by individual delivery orders (tasks). After this broad contract between the contractor and GSA is executed, the contractor can solicit GSA's client agencies for business or the client agencies can approach the contractor to arrange for supplies or services addressed in the overall contract. If a client agency and the contractor agree to do business, the work (which may be for the provision of property, services, or both) will be provided to the client agency under authority of individual delivery orders or tasks.

*It should be noted that there can be many tasks or delivery orders under a single overall contract between GSA and the contractor. Additionally, there can be multiple client agencies doing business and letting out tasks under the contract.*

Based on PD 01-6, the Department has ruled that in the contracting arrangement described above, the application of the "true object" test will be based on individual delivery orders or tasks and not on the underlying contract between GSA and the contractor. If the "true object" of the delivery order issued pursuant to the GSA contract is for the provision of services, the Taxpayer will be deemed the user of consumer of all tangible personal property used in performing the services. If, however, the "true object" of the delivery order is for the sale of property to the government, the Taxpayer may purchase that property exempt of tax for resale.

Again, the auditor is encouraged to review PD 01-6 for additional information regarding this area of government contracting.



- C. If the manufacturer, as listed above, is not in Virginia then the tax is payable by the **shipper**. A shipper is any person in this state who sells or ships outside the state by railroad, truck, barge, boat or by any other means of transportation any forest product or products in an unmanufactured condition, whether as an owner, lessee, woodyard operator concessionaire, agent or contractor.
- D. Forest products include logs, timber, puplwood, excelsior wood, chemical wood, wood chips, bolts, billets, crossties, switch ties, mine ties, poles, piles, fuel wood, post, all cooperage products, tan bark and any and all other types of forest products, except dead chestnut wood.
- E. The Forest Products Tax is not applicable to any forest products harvested outside of Virginia nor on forest products manufactured in Virginia from timber harvested from outside of Virginia.
- F. There are two exemptions for Forest Products Tax:
  - 1) Forest products that are cut by an individual owner from their own property for their own use. Own use means in the construction or repair of their structures, buildings or improvements; or for their home consumption (i.e. firewood); or for use by them in processing their farm products.
  - 2) Forest products that are severed and used by the State educational institutions for the experimentation in teaching about forestry if the product is severed from land owned by the state.
- G. Every taxpayer that is subject to Forest Products Tax is required to keep their records for three (3) years following the date the tax is reported. The records must separate the forest products into the various categories on which the tax applies. It is a class 4 misdemeanor for any person who fails to file a return, keep the required records or refuse to permit examination of their records.

**The following are the tax rates for forest products:**

<u>products</u>	<u>tax rates</u>
lumber	pine-\$1.15 per 1000 feet board measure hardwood-22.5¢ per 1000 feet board measure
logs	pine-\$1.15 per 1000 feet log scale other species-22.5¢ per 1000 feet log scale
veneer logs	pine-\$1.15 per 1000 feet log scale other species-22.5¢ per 1000 feet log scale

pulpwood, excelsior wood, chemical wood, bolts and billets, fuel wood and other products customarily sold by the cord	pine-47.5¢ per standard cord of 128 cubic ft other species-11.25¢ per standard cord of 128 cubic ft
chips manufactured from round wood and customarily sold by the pound	pine-.986¢ per 100 lbs. other species-.234¢ per 100 lbs.
railroad crossties	pine-3.8¢ per piece other species-1¢ per piece
post, mine ties, mine props, round mine collars and other types of timber used in connection with mining and ordinarily sold by the piece pieces	pine-4' or less, 38¢ per 100 pieces other species-4' length or less, 9¢ per 100 pieces pine-over 4' but not over 8', 61.75¢ per 100 other species-over 4' but not over 8', 14.25¢ per 100 pieces pine-over 8', 76¢ per 100 pieces other species-over 8', 18¢ per 100 pieces
t/p may elect to pay taxes on products in this item as follows:	pine-\$1.045 per 1000 lineal ft. other species-24.75¢ per 1000 lineal ft.
pilings and poles of all types	2.31% invoice value f.o.b. loading point
keg staves	pine-3.8¢ per standard 400" bundle other species-1.5¢ per standard 400" bundle
keg heads	pine-11.5¢ per 100 heads other species-4.5¢ per 100 heads
tight cooperage	4.5¢ per 100 staves
tight cooperage	9¢ per 100 heads
any other type of forest product not enumerated above	the Tax Commissioner shall determine a fair unit tax rate, based on the cubic foot wood volume relationship between the product and the cubic foot volume of

1000 ft board measure of pine when the product is pine or on the unit rate of hardwood lumber when the product is a species other than pine

annual tax for small manufacturers of rough lumber

300,000 to 500,000 board feet-\$460.00  
less than 300,000 board feet-\$230.00

There is a provision for alternative rates in the regulations booklet. This provision is for use if the General Assembly fails to appropriate from the general fund an amount at least equal to the revenue estimated to be collected from the pine reforestation program. Please see the regulation booklet for these rates.

### III. Procedures

When doing a sales & use tax audit on a business that sells or buys any of the items listed above then the forest products tax may apply.

#### **Some of the businesses that will be subject to the forest products tax:**

Loggers: If they sell chips to anyone whether the chips will be used as fuel, landscaping or any other type of use. If they ship whole logs to anyone outside of Virginia. If they sell firewood directly to a consumer.

Sawmills: If they buy whole logs from a logger or woodyard.

Woodyards: If they ship any of the whole logs to a concern outside of Virginia. If they sell chips from a whole tree.

Papermills: If they buy the whole logs from the logger or woodyard.

A manufacturer that uses logs as their raw material will be prime candidates for paying the forest products tax. The tax is computed on board feet or on weight, depending on the product, being manufactured or shipped. Most logs are bought by a weight measure. This will need to be converted into a board feet measurement for some of the tax rates. There is currently no standard conversion rate. The manufacturer that you are auditing will need to give you the board feet or measurements for each product being taxed.

Forest products tax is a Quarterly tax. The quarters end on March 31, June 30, September 30 and December 31. The tax is due within 30 days of the end of the quarter. Some small manufacturers can pay an **annual** tax. The tax for these dealers is due within 30 days of the last day of December.

You will need to account for which locality the forest product was manufactured in or shipped out of. At least 50% of the tax collected is to returned to the locality from which the tax was collected.

Currently there is no audit report for forest products. When doing an audit use the forest products tax return, Form 1034 or 1035, depending on the size of the business. The interest can be computed manually or thru STARS. Penalty may apply but the regulations do allow for the penalty to be waived at the Department of Taxation's discretion.



- P.D. 86-116-92-220-95-131 - Determination of whether clinic is an integral part of a nonprofit hospital
- P.D. 87-204-87-291-94-74-94-150 - Taxability of nonprofit hospital cooperative and corporations
- P.D. 88-151 - Taxability of "Group Medical Practice" as a clinic
- P.D. 88-166 - Purchases of oxygen by a nonprofit nursing home are not deemed to be exempt D.M.E.
- P.D. 89-254 - Sales of controlled drugs to various medical facilities
- P.D. 91-43 - Sales by nursing homes of supplies to its residents
- P.D. 92-97 - Drug purchases by clinic through affiliated pharmacy
- P.D. 92-172 - Taxability of purchases by home health care operation
- P.D. 93-46 - Taxability of a "life care facility's" non-licensed portion of operations
- P.D. 93-82 - Intermediate care facility licensed by the Virginia Department of Mental Health and Mental Retardation
- P.D. 95-70 - Food and meal purchases by nonprofit hospital consumed by individuals other than its patients
- P.D. 95-309 - Purchases by taxable nursing home of vaccines to vaccinate employees
- P.D. 96-64 - Taxability of dietary/nutritional supplements
- P.D. 00-89 - Taxability of profit home care cooperative formed by Nonprofit hospitals

D. Exemption Certificate –

The ST-13 has been revised as of July 2001 and should be used by the specific purchasers listed and for the specific items and products listed on the exemption certificate form. The ST-13 should not be used by nonprofit hospitals, nonprofit hospital cooperatives and nonprofit hospital corporations, nonprofit nursing homes, nonprofit adult homes, and other nonprofit medical facilities that are entitled to exemptions. These entities are provided an exemption letter and registration number by the

department, which should be provided to their vendors to make tax-exempt purchases.

Effective 7/1/2004 – **all** nonprofit organizations that qualify for the expanded Non Profit exemption must apply and obtain the Non Profit Exemption Letter from TAX. This letter should be provided to their vendors to make tax-exempt purchases.

## II. Generally

- A. Hospitals/Nursing homes (profit and not for profit) - Nonprofit hospitals and nonprofit licensed nursing homes are exempt on purchases for their own use and consumption, while profit hospitals and nursing homes are taxable on all purchases of T.P.P. used or consumed in connection with their operation (except items which specifically qualify for exemption such as DME, medicines & drugs) Any divisions making sales must register as a dealer and collect and pay the tax. Effective 7/1/98, all purchases of nonprescription and proprietary medicines are exempt regardless of the purchaser. Effective 7/1/00, the medicines and drugs exemption was expanded to include medicines and drugs purchased by any licensed hospital. Effective 7/1/06, the medicines and drug exemption was again expanded to include for-profit nursing homes, clinics and similar corporations (see Controlled Drugs/Medicine Procedures)
- B. Hospital Cooperative and Hospital Corporations - Only nonprofit cooperative and hospital corporations who provide services exclusively to nonprofit hospitals are exempt from the tax. All others are taxable.
- C. Clinics - Only clinics which are an integral part of a nonprofit hospital or itself licensed as a hospital and conducted not for profit are exempt. All other clinics are subject to tax except for items exempted under other code sections.
- D. Home for Adults (profit and not for profit) - Only nonprofit homes for adults as defined by Virginia Code Section 63.1-172A are exempt. All other homes for the care and maintenance of children, adults and other persons are taxable.
- E. Physicians Offices - Physicians are considered the consumer of all purchases used in providing their medical services. There are three main exceptions to this - purchases of controlled drugs and dialysis equipment/ supplies used in their practice, purchases of nonprescription and proprietary medicines and purchases of exempt durable medical equipment when purchased on behalf of a specific patient. Any physician who regularly makes sales of T.P.P. must register as a dealer and collect and pay the tax on retail sales.

**NOTE:** All facilities, regardless of the taxability on all other items, may purchase hemodialysis and peritoneal dialysis equipment and supplies exempt of the tax. This does not include general supplies but supplies specifically for dialysis equipment and treatment.

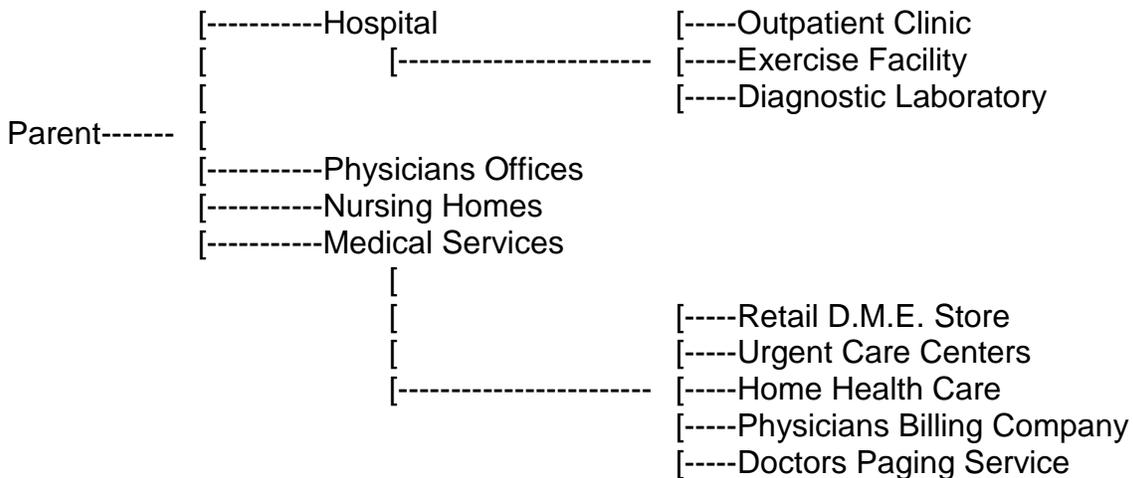
**NOTE:** There are also exemptions for other specific nonprofit medical facilities, refer to 58.1-609.7.

**NOTE:** Effective 7/1/98 all nonprescription and proprietary medicines will be exempt from sales and use tax. "Nonprescription drugs" include any substance or mixtures of substances containing medicines or drugs for which no prescription is required and which are generally sold for internal or topical use in the cure, mitigation, treatment, or prevention of disease in human beings. "Proprietary medicines" are any nonprescription drug sold to the general public under the brand name or trade name of the manufacturer and does not contain any controlled substance or marijuana. The exemption does not apply to cosmetics.

**NOTE:** The auditor needs to keep in mind that although a medical facility may be deemed taxable – other exemptions such as those under Controlled Drugs or DME may apply.

**III. Procedures**

OVERVIEW: In examining various medical facilities, it is important to understand the changes, which have occurred in the last decade in the health care industry. In the past, it was common to perform an audit on an independent medical facility. With the trend in recent years changing towards the concept of "Managed Health Care", there are many more multi-level health care corporations involving many types of health care facilities. The following is an organization chart typical of such an organization:



**It is imperative to ascertain whether the entities are profit or nonprofit as this will determine the taxability of the entity. The auditor should examine the state licenses (i.e. Department of Health, Department of Social Services) held by any of the facilities. The**

**auditor must examine the relationship between the various entities to determine the taxability of each facility and possible taxable transactions between them. In addition, the organizational chart, federal tax returns, chart of accounts and general ledgers can assist the auditor in the determination of taxable areas. Also, an examination of all the tax registrations, both sales tax and withholding, will assist in this analysis.**

**A. Hospitals and Nursing Homes - (Profit and Not for Profit)**

**Profit** - Profit hospitals and profit nursing homes are taxable on all purchases of tangible personal property used in the provision of their medical services. Effective 7/98 purchases of nonprescription and proprietary medicines are exempt regardless of the purchaser. Also, effective 7/00, the exemption for medicines and drugs have been expanded to include purchases by any licensed hospital. The exemptions for durable medical equipment and prosthetic devices would still apply for purchases made on behalf of individuals. The purchases of prescription medicine and drugs by profit hospitals **prior to 7/00** are taxable. The purchases of drugs by profit nursing homes **prior to 7/06** are also taxable. When any of the divisions or departments are selling T.P.P., it must register and collect the tax.

One clarification needs to be made regarding the acquisition of blood products from the American Red Cross. This transaction is to be treated as a nontaxable service. The Red Cross obtains the blood from donors, screens the blood and then separates it for distribution to various medical facilities. In addition to blood, the charges in connection with tissue, bones and organs are nontaxable services.

**Nonprofit** - A non-profit hospital or nursing home is exempt on all purchases of tangible personal property for use in providing their medical services. Any purchases of controlled drugs are exempt and purchases of D.M.E. and prosthetic devices are also exempt whether purchased for a specific patient or in bulk. As with for-profit, when any divisions or departments are selling T.P.P., it must register and collect the tax. Also, the department's policy of performing three year audits on any nonprofit organizations must be followed. There are still areas in which a nonprofit hospital or nursing home could have liability.

A 2001 court ruling in Chesapeake Hospital Authority v. Department of Taxation applies the nonprofit hospital exemption to a nonprofit hospital's purchases of raw food products for preparation by its dietary department for consumption at the hospital facility by medical staff, hospital meeting participants and volunteers. The exemption does not apply to catered meals purchased by a nonprofit hospital from an outside vendor. Therefore, the auditor should sample such catered transactions from outside suppliers to determine if liability exists in this area.

**The auditor should note that external transfers or sales from the hospital or nursing homes to other entities (related and non-related) could be taxable as well. If the transfers are to inter-related companies, the transfers are usually handled internally with the transactions posted in the general ledger**

The sale of fixed assets is also an area of possible liability for nonprofit hospitals and nonprofit licensed nursing homes. The sale would be exempt if they met the "occasional sale rule" of three or less sales per year. With constant changes in technology, many medical facilities are continually updating their equipment. Sometimes, these are sales to related companies, both exempt and taxable.

Another area for these nonprofit facilities to incur possible liability is in the sale of T.P.P. Some departments may go beyond their services to the hospital and make sales to other entities. In addition to services, they could also have sales of printing or audio-visual slides. If this is the case, then the hospital's department or division must be registered and instructed in the proper method for charging and reporting sales tax. Most likely, the purchases would have been bought exempt under the hospital exemption, so only the sales would have to be examined. This does not negate the exemption for the operating expenses of this department or division of the nonprofit facility.

With regards to nonprofit nursing homes, it is important to compare their licenses with the total operation of the facility. As related to P.D. 93-46, only licensed nursing homes and homes for adults licensed with the Virginia Department of Social Services are allowed the exemption. In this case, part of the nonprofit care facility, the cottages, were not licensed as either. Therefore, a portion of their purchases was assessed as consumable to the taxable cottages. Pro-ration, based on the number of cottage residents to total residents was used when the taxpayer could not substantiate who had consumed certain purchases. In some nursing homes, only a portion of their available beds is licensed and this same auditing procedure would be applicable.

#### B. Hospital Cooperatives and Hospital Corporations

In order to qualify for the exemption, the taxpayer must be organized as a nonprofit hospital cooperative or a nonprofit hospital corporation and structure its operations to provided services exclusively to nonprofit hospitals. The exemption shall not apply when services *of any kind* or *to any extent* are provided to other than nonprofit hospitals. There have been many cases where a taxpayer met one of the two qualifications but was denied the exemption because they did not meet both.

While determining the first qualification, the structure of the organization, is relatively easy; the second stipulation may require more investigation. The auditor must look at the taxpayer's A/R ledgers and billing records to determine who the corporation is actually servicing. There have been several cases where exemption was denied due to the nonprofit hospital cooperative or corporation providing what may have seemed inconsequential services to other entities.

There have been several documented cases involving nonprofit hospitals grouping together to procure and operate M.R.I. equipment. In one case, the nonprofit hospitals formed a general partnership and therefore, it was not entitled to the exemption (P.D. 87-204). In addition to this point, the partnership planned on providing services on an outpatient basis for which patients were billed directly. As such, the second qualification, of providing services exclusively to the nonprofit hospitals that created it, did not apply as well. In P.D. 87-291, the taxpayer was comprised of four nonprofit health care systems. It was a nonprofit organization and was organized as a corporation, therefore the first test for exemption was met. This letter further clarifies the second portion of the exemption in that the taxpayer should make all billings for M.R.I. services directly to nonprofit hospitals rather than the individual patients served by the hospitals. The ruling also notes that the exemption does not apply if services are provided to nonprofit health care organizations other than hospitals.

**In other situations, a nonprofit corporation was organized as the controlling affiliate (parent corporation) for several nonprofit hospitals and also the sole member of various other nonprofit health care related organizations. The exemption was denied because its activities go beyond the ownership and support of nonprofit hospitals (P.D. 94-74). In P.D. 94-150, a nonprofit corporation which provided billing services for four nonprofit hospitals was denied the exemption because the corporation also contracted with physicians of the hospitals to provide services. Therefore, both tests for qualification had not been met.**

### C. Clinics

**There are only two instances in which a clinic will qualify for the sales tax exemption. If a clinic is conducted not for profit and is licensed as a hospital by the Department of Health, it will qualify for this exemption. All profit clinics are subject to the tax. The only other situation in which a clinic will be eligible for the exemption is when the clinic is an integral part of a nonprofit hospital. The relationship between the clinic and hospital must be examined to make this determination. Several areas which must be analyzed are the corporate structure, billing practices and the question of whose credit is bound. The physical location of a clinic in relation to its affiliated hospital may be part of the analysis but is not a determining factor (P.D. 93-82).**

In P.D. 92-220, a pediatric outpatient clinic, exempt from federal income taxation under 501(c)(3), was deemed to be an integral part of a nonprofit hospital and therefore extended the exemption. The clinic was not separately incorporated but rather was a part of a nonprofit hospital. This ruling further denied exemptions to some separately incorporated nonprofit affiliates which supported the clinic and its operations. Another ruling, P.D. 86-116, emphasizes that though a nonprofit clinic and nonprofit hospital have a close working relationship, this alone does not render the taxpayer an integral part of the hospital. Although the clinic had both financial and contractual ties to the nonprofit hospital, it was a separate corporation and therefore, was not an integral part of the hospital.

In some audits, determining whether a medical facility is a clinic or a group physician's practice will have a significant impact on the taxability of bulk purchases of controlled drugs. If the facility is a clinic, not qualified for the exemption, then all bulk purchases of controlled drugs are taxable (prior to 7/06). In contrast, a group medical practice can purchase drugs for use in the professional practice exempt from taxation. Basically, the physician's exemption for controlled drugs applies regardless of how the practice is organized as long as the shareholders and operators are all licensed physicians engaged in the practice of medicine.

Some taxable clinics actually have "mini-pharmacies" in their locations as a convenience to their patients. When their physicians write a prescription, the patients can elect to have it filled by this internal pharmacy. In order for the "retail" drug exemption to apply, the seller must hold a special certificate from the Board of Pharmacy which allows them to "sell" drugs. Normally, a clinic's pharmacy is not licensed as noted above and only provide this service to their own patients. This is considered an extension of their medical services and the clinic would be taxable on all bulk drug purchases (prior to 7/06).

#### D. Home for Adults (Profit and Not For Profit)

This exemption applies only to homes licensed as a home for adults by the Virginia Department of Social Services and conducted not for profit. Any home, profit or nonprofit, which is not licensed as noted, and provides the care and maintenance of children or other persons, are taxable on all purchases of tangible personal property. Some retirement communities operate several types of facilities within their organization. A close examination of their licenses will assist the auditor in determining which portions, if any, are subject to the tax (P.D. 93-46).

#### E. Physicians Offices

Generally, physicians offices are considered the consumer of all tangible personal property used in providing their services. There are three main exceptions to this - purchases of controlled drugs and dialysis equipment/ supplies used in their practice, purchases of nonprescription and proprietary medicines and purchases of exempt durable medical equipment when purchased on behalf of a specific patient. The physician's exemption for controlled drugs applies regardless of whether the practice is organized as a sole proprietorship, partnership of professional corporation, or any type of corporation in which the shareholders and operators are all licensed physicians engaged in the practice of medicine. Physicians may also purchase durable medical equipment or prosthetic devices on behalf of a specific patient. Bulk purchases of D.M.E. or similar devices are subject to the tax even if they are later dispense to or modified for specific patients.

Physicians who regularly engage in the sale of T.P.P. must register for sales tax and collect and remit the tax based on those sales. Some physicians, because of their rural location, will obtain a license from the Board of Pharmacy, in effect acting as pharmacists. In cases such as this, the physician may purchase items for resale but must report any use tax on items (except controlled drugs) for use in his professional practice. Also, some dermatologists offer skin care and cosmetic products to their patients. These products are not deemed to be drugs or medicines and the sales are not considered part of their medical services. Therefore, the dermatologist is operating as a retailer and must register to collect the tax. Another example of taxable sales is the selling of vitamins, minerals or nutritional food supplements in conjunction with a physician's weight loss program. (P.D. 96-64).

(NOTE: Additional information on medicines, controlled drugs, and D.M.E. purchases on behalf of a specific patient are addressed in that section of the training manual.)

#### *V. Use of ST-13 Exemption Certificates*

The ST-13 has been revised as of August 2001 and should be used by the specific purchasers listed and for the specific items and products listed on the exemption certificate form.

The ST-13 should not be used by nonprofit hospitals, nonprofit hospital cooperatives and nonprofit hospital corporations, nonprofit nursing homes, nonprofit adult homes, and other nonprofit medical facilities that are entitled to exemptions. These entities are provided an exemption letter and registration number by the department which should be provided to their vendors to make tax exempt purchases.

Effective 7/1/2004 – **all** nonprofit organizations that qualify for the expanded Non Profit exemption must apply and obtain the Non Profit Exemption Letter from TAX. This letter should be provided to their vendors to make tax-exempt purchases.

## Sales and Use Audit Procedures HOTELS, MOTELS, TOURIST CAMPS, ETC.

**Objective:** Discuss the application of sales and use tax as it applies to Hotels, motels, tourist camps, etc.

### I. References

- A. Code of Virginia Section- 58.1-203. Regulations and rulings. and 58.1-609.5(8) Service exemptions. (8) " the sale or charges for any room or rooms....for more than ninety continuous days..." of the Code of Virginia
- B. Virginia Administrative Code 23 VAC 10-210-730. Hotels, motels, tourist camps, etc.
- C. Ruling Letters
  - P.D. 96-306, 96-295, 95-172, & 88-72, Charges for long-distance phone calls taxable
  - P.D. 97-229, 97-150 90-225, Lodging Federal Employees, taxable
  - P.D. 91-143, Temporary Lodgings of Shipbuilders, taxable
  - P.D. 98-206 & 92-120, Comprehensive List of Transactions Related to Hotels w/references
  - P.D. 97-229, 97-150 & 93-133, Use of Credit Card by Government Employee - taxable
  - P.D. 96-55 & 93-167, Hotel Contract with Government Agency, taxable (less than 90 days)
  - P.D. 96-23 & 94-60, Meals furnished to non-restaurant employees
  - P.D. 94-107, Purchases with I.M.P.A.C. Credit Card, exempt, 4/12/94
  - P.D. 96-379, 96-295, 95-322 & 95-17, Green fees in connection with hotel services
  - P.D. 96-3, Reservation services, taxable
  - P.D. 98-148, 97-229, & 96-23, Meals and lodging sold to state and local employees
  - P.D. 98-206 Rental of Property
  - P.D. 99-221 Ice sculptures
  - P.D. 99-31 Internet, Special event services
  - P.D. 98-117 Amenities, Complimentary breakfast
  - P.D. 99-254, 98-31, 95-237, 90-32, 88-41, 84-262 & 82-205 Conference room rentals
  - P.D. 95-307 & 86-156 Veterans Organization, Lodgings and Accommodations
  - P.D. 96-3, 91-219 & 87-268, Transient Accommodations--Food Purchases of Bed and Breakfast Inns
  - P.D. 92-120 & 88-41, Transient Accommodations--Setup Charges,
  - P.D. 98-148, 96-135, 90-208, 89-291, 88-277 & 88-121, Virginia and its

Political Subdivisions – Meals and Lodging

- P.D. 97-274, 93-177, 90-195, 90-186 & 90-23, Girl Scouts and Boy Scouts- Purchases of restaurant or banquet meals, or hotel, motel, or campground accommodations
- P.D. 96-297, 96-3, 95-158 & 91-219, Transient Accommodations--Bed and Breakfast Operation

D. Applicable exemption certificate

- ST-10- Resale Exemption Certificate- may be use by registered dealers to purchase items that are for resale
- ST-12- and "supported by the required official purchase order"

\*\* Diplomats may be exempt in certain instances. See Diplomatic Exemption Program form (rev. 4/98)

\* \* Exempt Federal Government Credit Cards. Information to follow.

E. Additional Reference Source--Northern VA Office, Michael H. Mitchell, CPA , Senior Auditor and other audit staff members, extensive guidelines on hotels & motels, they have most exposure to both diplomats and various governmental employees

**II. General**

A. The tax applies to the sale or charge for any room or rooms, lodgings or accommodations furnished to transients by any hotel, motel, inn, tourist camp, tourist cabin, camping grounds, club, extended stay hotels, or other similar place. The tax applies to all sales of tpp by such businesses.

“Corporate housing” refers to apartment units in residential apartment buildings that have been furnished and offer a wide range of a la carte furnishings and service options. Guests have the comforts of home in a private residential setting, typically with a 30-day stay.

“Serviced apartments” operate more like a hotel, with onsite hospitality staff, a 24-hour front desk, daily maid service, and accommodations for both daily and longer stays.

B. Accommodations furnished for 90 continuous days. The tax does not apply, however, to rooms, lodgings or accommodations supplied to a guest for a period of 90 continuous days or more. The 90-day continuous stay is not restricted to the same room. After a transient has occupied a room or received other accommodations for 90 continuous days or more,

the dealer furnishing the room or other accommodation may refund any sales tax actually collected from the person. In filing a subsequent return with the Department of Taxation, the dealer may deduct from gross sales in the place provided the amount of the charges for which the tax was refunded.

Agreements for the availability of a certain number of accommodations of 90 days continuous days or more are exempt at the time of the agreement.

- C. Charges in connection with accommodations. Any additional charges made in connection with the rental of a room or other lodging or accommodations are deemed to be a part of the charge for the room and are subject to the tax. For example, additional charges for movies, local telephone calls and similar services are subject to the tax. Charges for television programming by satellite or cable made to hotel customers are exempt provided that the charges are separately stated and title to the receipts vest with the provider (and not the hotel) at all times. In such event, the receipts are not a part of the overall compensation the hotel receives from the rental of the rooms; rather, the hotel is merely the collection agent of the provider. (PD 86-117)
- D. Purchases. Purchases of furniture, fixtures, linens, towels, carpeting, drapes, and amenities for use in guestrooms (i.e. toiletries such as soap, shampoo, etc.) are taxable at the time of purchase. This would also include flowers used for decoration, which are later kept by the guest.

Purchases of audio visual equipment, or rental for subsequent rental to guest (without operator), are for resale, provided that the price charged by the hotel for the accommodations will not depend on any A/V equipment provided to the guest. The hotel must make a separate charge to the guest for providing A/V equipment and collect the tax on that charge. (PD 95-287)

Newspapers and magazines distributed for free, and purchased by subscription directly from the publishers, are not subject to the tax. (PD 91-188)

- E. Computerized reservation systems. The charge to a hotel, motel or similar business for a computerized reservation system which includes, within a single contract, the provision of a printer or similar hardware and a charge for the use of the system based upon frequency of usage or number of rooms, is deemed to be a service transaction. There is no tax is applicable to charges for such service. The entity providing the service must pay tax on any tpp used in the provision of the service.

### III. Procedures

The auditor should look for any exempt sales that a hotel or motel makes to confirm whether they should have been exempted. In particular sales to governmental employees or agencies or Nonprofit Organizations should be examined. State and local governmental agencies or employees are not exempt on their purchases of hotel or motel meals or lodging, P.D. 88-72 "No exemption is provided for state and local government employee purchases of meals or lodging whether purchases are pursuant to required official purchase orders or not." This differs from the law on Federal Employees.

Federal Employees are exempt from tax on meals and lodging only under certain circumstances. An exemption is provided for federal government purchases of meals and lodging when they are made pursuant to official purchase orders or with an official government credit card that bills the government directly.

Look for an St-12 with a required official purchase order attached for sales to federal agencies. The purchase must be made by the federal governmental agency itself, where the government is directly billed or the proper government credit card is used. What is an acceptable governmental credit card? Acceptable cards are an American Express Card with the Exempt prefix numbers 3783 9...which indicates a card that is directly billed to the government, although it will still have the name of the employee on the card at the bottom left. Also, an I.M.P.A.C. Visa card issued in the name of the United States is acceptable. It is not required that a TP maintain a copy of the card in their Certificate of Exemption file.

Many governmental employees are issued governmental credit cards, but this does not mean they are exempt from meals and lodging. This card will look just like an exempt card except for the number (the first 5 prefix differs) for example may read 3783 7(taxable card) versus 3783 9 (exempt card--with the 3783 9 prefix) both cards will have the individuals name and the agency they represent. The taxable cards (3783 7) are used by the employees and they are subsequently reimbursed by their agency, but the government is not directly billed.

Foreign Diplomats may also be exempt to various extents on their purchases and the auditor should look for the Office of Foreign Missions US Department of State cards. Each card is color coded with a stripe that distinguishes various level of exemption. Each TAX District Office has a copy of the Department of State form that has examples of the cards. The tp should obtain the exemption card number from diplomats, annotate it on the record of the sale, and a photocopy of the diplomat's

exemption card is desirable, but not required provided that the number has been annotated. Foreign diplomats who qualify for the exemption on taxable services are exempt when hosting a group of non-diplomats. (P.D. 95-17)

Most Nonprofit Organizations are taxable on purchases of meals and lodging. Exemption certificates should be examined closely to see if the wording for the particular organization includes services or meals and lodging. The Red Cross is treated as a federal governmental agency, subject to the same rules as federal agencies and use of the ST-12.

Scouting organizations are not exempt from the tax on restaurant or banquet meals and hotel, motel or campground accommodations. There is no general exemption from the Virginia retail sales and use tax for nonprofit organizations. A hotel that sold meals and lodging to nonprofit organizations was subject to sales tax even though the organization held an exemption certificate since meals and lodging are not considered tangible personal property, but rather, taxable services. However, if a organization qualified for an exemption from tax for services, and the certificate contained language to that effect an exempt sale would be valid. Churches are taxable on purchases that do not meet the wording of their exemption certificate. Therefore, based on strict construction, tpp, meals, and services used outside of the public church buildings are taxable.

Schools enjoy several exemptions, which are detailed in another section of this manual. Generally, they are taxable on meals and lodging. An exception to this would be an organization such as "Close Up". This is a "Education institute" that teaches civics and meets all the criteria of "certain educational institutions" specified in the regulations under schools. They are exempt on both tpp and services i.e.. lodging and meals when the property or services are purchased by the educational institution. \*\*\*Remember, that "Educational institutions" are distinct from "Schools and colleges". Schools and colleges are taxable on meals and lodging.

Areas in sales that have been problems in prior audits include: catering, equipment rentals, telephone charges, and miscellaneous items. Catering is covered in another area of this manual, but it involves issues related to taxable services provided in conjunction with the sale of tpp and the gratuity issue of discretionary (non-taxable) versus non-discretionary (taxable).

Equipment rented by a restaurant for its own use in preparing and serving meals, such as kitchen equipment, tablecloths, and similar items are taxable and may not be purchased under a Certificate of Exemption.

Also, the tp should apply tax to the total charge for an event including the cost of labor, equipment, supplies or other services provided in connection with its catering service, whether separately stated or not.

Look for add- on- costs by hotels for various services connected to the sale of lodging or accommodations. Sales price is defined in VAC 10-21-4000 as , "the total amount for which tpp or taxable services are sold and includes any services in connection with such sale." Examples would be: added charges for movies (other than nontaxable programming), telephone charges other than long-distance toll charges, whale watching fees, golf fees etc. if they are sold in connection with the room rental.

Toll charges for long-distance telephone calls (without markup) are not subject to the tax. However, additional charges for telephone calls are subject to the tax. The auditor should inquire as to how the hotel or motel bills for telephone calls. A company may have additional charges added on to the billing for number of calls made, local charges for long distance calls, and various other similar charges associated with the phone usage. Toll charges for long distance calls are charges made by the long distance carrier and are independent of the local call charges. An examination of a bill from the phone company will itemize toll charges for long distance calls. Additional amounts billed by the hotel are taxable.

The auditor should examine billings from the telephone company to the hotel/motel and compare them to the taxpayer's charges to their customers. Look for any telephone charges made to the customer that are not long distance toll charges. Also, it would be helpful to look at information brochures etc. that a hotel/motel makes available to their guest. Usually, they will give information as to the company's policy and procedures in terms of phone charges and usage that will identify any charges associated with phone calls.

Many hotels and motels use computerized reservation systems. The charge for a computerized reservation system which includes, within a single contract, the provision of hardware and charges for the use of the system is deemed to be a service transaction.

Exemptions for employee meals pertain only to meals furnished to restaurant employees as part of wages. Meals provided by employers to other than restaurant or food service operation employees are subject to the tax.

Purchases of food and non-alcoholic beverages for the preparation of complimentary breakfasts are not taxable. These items can be purchased with a resale exemption certificate, since the costs of the complimentary services are included in the taxable room rental charges.

## Corporate Housing/Serviced Apartments

The new global economy has a highly mobile workforce. More companies are placing staff and consultants on “short-term assignments,” a corporate term for a business trip that is more than one month but does not require relocation. The growth of this form of travel has spurred demand for a new lodging product – corporate housing/serviced apartments. Analysts speculate that the potential for this type of lodging is between 10 to 15 percent of the total hotel demand.

Hospitality companies may operate in one or more of the following:

1. The company may own an entire apartment community.
2. The company may lease a block of apartments in an established residential apartment community.
3. The company may have an agreement with select residential apartment communities to lease apartments on a “as needed” basis.

The department has previously determined that only a person primarily engaged in the business of “regularly” furnishing accommodations to transients must collect the tax on such occasional rental of an apartment for less than 90 days to represent the “regular” furnishing of transient accommodations.

The department has been consistent in not applying the tax to such rentals pending the establishment of definitive policy guidelines.

The department is currently reviewing its policy with respect to this issue, and until any change in this policy is finalized and communicated to the industry, **NO TAX SHOULD BE ASSESSED ON SUCH RENTALS.**

## **Sales and Use Tax Audit Procedure**

### **COMPUTERS**

**Objective:** Discuss the application of sales and use tax to computer hardware and software.

#### **I. History**

Prior to **July 1, 1986**: Computer programs sold as tangible personal property and related services were taxable.

Effective **July 1, 1986**: Custom programs are considered to be services and tax exempt. Prewritten ("canned") computer programs are taxable; however, the separately stated charges for modification of prewritten programs are exempt.

Effective **January 1, 1996**: Maintenance contracts invoiced on or after 1/1/96 which provide for both replacement parts and labor are subject to tax upon one-half of the total charge. Prior to this date, tax applies to the total charge for such contracts.

#### **II. References**

A. Code of Virginia Sections 58.1-602 and 58.1-609.5(6)(7)(9)

B. Virginia Administrative Code VAC 10-210-760 through 766; VAC 10-210-840; VAC 10-210-910; VAC 10-210-920; VAC 10-210-3070 through 3074; and VAC 10-210-4040.

C. Ruling Letters: Public Documents 86-169; 87-88; 87-209; 88-20; 88-211; 88-339; 89-179; 91-20; 91-102; 91-190; 91-256; 92-196; 93-157; 93-230; 93-237; 94-12; 94-70; 94-209; 94-251; 95-30; 95-134; 95-286; 96-14; 96-66, 96-193.

D. Memorandum from Steven Schwartz dated April 9, 1992.

E. Virginia Tax Bulletins: 86-5 and 95-8

F. Applicable Exemption Certificates: ST-10 and ST-11

### III. Definitions, ref: VAC 10-210-763

A "**custom program**" is a computer program that is specifically designed and developed only for one customer.

A "**prewritten program**" is a computer program that is prepared, held, or existing for general or repeated sale or lease, including a computer program developed for in-house use and subsequently sold or leased to unrelated third parties.

### IV. General

The sale, lease, rental, or licensing of **prewritten programs** sold in tangible form is taxable. Custom software programs are specifically excluded in the Code of Virginia from the definition of tangible personal property. As a result, **custom software** is treated as a non-taxable service. The definition of a custom program does not include modifying a prewritten program or combining two or more prewritten programs.

Tangible personal property used in the development of custom software qualifies for the research and development exemption if it is used directly and exclusively in the development of the software. Custom software is not tangible personal property and cannot qualify for the industrial manufacturing exemption.

The production of prewritten software for sale or resale qualifies for the industrial manufacturing exemption. The research and development exemption applies to the purchase of equipment and supplies used directly and exclusively in developing a prewritten software program.

Separately stated labor or service charges in connection with the modification of prewritten computer software are not taxable. The industrial manufacturing exemption is not available for equipment used to modify prewritten computer software because the processing performed is not industrial in nature. The research exemption may be available for tangible personal property used directly and exclusively to modify prewritten software programs to perform new tasks as described in VAC 10-210-3070 to 3074.

Maintenance contracts which include repair parts, upgrades, or updates in the form of tangible personal property are taxable. Contracts invoiced on or after January 1, 1996, are taxable on 50% of the total amount.

## V. Procedures

### A. Computer Hardware

The initial step in conducting an audit of a company that sells and installs computer hardware is to schedule a pre-audit conference and a tour of the facility. The auditor should make a determination if the taxpayer is entitled to the manufacturing exemption.

When a computer reseller goes beyond the configuration and testing of system components (e.g., CPU, monitors, modems, printers) and actually integrates the system (e.g., assembling boards in CPU), they may qualify for the manufacturing exemption as described in VAC 10-210-920. The auditor should refer to the manufacturing regulation when examining fixed asset and expense purchases of computer manufacturers.

Computer resellers may purchase equipment for their resale inventory tax exempt using the ST-10. The auditor should be aware that certain purchases charged to inventory may not be entitled to the resale exemption. Items such as tools, cable affixed to real estate, and similar installation materials are taxable when purchased by the retailer/installer.

Sales and purchases should be reviewed in the same manner as audits of similar retailers of tangible personal property. Exemption certificates should be reviewed to support any tax exempt sales.

### B. Computer Software

Conducting audits of computer software dealers should begin with an understanding of the type of software being generated and sold. The business may provide custom, prewritten, and/or modified prewritten software programs.

Custom software is designed and developed for only one customer and is considered a non-taxable service. Sales of additional copies of custom software are taxable. Custom programs originally developed for in-house use and then marketed for resale become taxable. The auditor should review sales invoices and contracts to verify if the taxpayer is selling additional copies. When conducting audits of custom software developers, the major focus will be on asset acquisitions and expense purchases.

The innovative technology regulation (VAC 10-210-760 through 766) allows for the research and development (R&D) exemption on purchases made for use **directly** and **exclusively** in the development of custom software; such purchases do not qualify for the manufacturing exemption.

The auditor must take special care in classifying purchases for the R&D exemption. Equipment must be used directly and exclusively in R&D (e.g., software used to write new code) to enjoy the exemption. Equipment used to encode the diskette with a program that has already been developed, or hardware used by researchers for use in software development and also for administrative purposes (e.g., word processing) is taxable.

The auditor should note that the current R&D regulation allows for "**de minimis**" usage. In accordance with VAC 10-210-3071, when research property is used in a taxable manner, it will continue to be exempt from the tax if the taxable use is de minimis in nature. Taxable use of the property is considered de minimis if the taxable usage of the property (i) does not involve a continuous or ongoing operation; (ii) does not follow a consistent pattern, i.e., weekly, monthly, quarterly, etc.; (iii) is occasional in nature, occurring no more than three times; and (iv) in total, accounts for no more than three days.

Computer hardware with mixed usage (taxable and exempt) is not exempt under R&D. The software installed on this same equipment and used directly and exclusively for R&D would meet the requirements for exemption. To determine the exclusiveness of hardware, the auditor can request a tour and visually check the software installed on the equipment. This will assist in determining if the equipment has other uses, such as administrative. Also, the auditor should ask questions as to who has access to a system. If a PC is networked to a system used by the entire staff and not strictly R&D engineers, the system will not qualify for the exclusive use status. The auditor should analyze software purchases for exclusiveness by obtaining descriptions of usage from purchase orders, reviewing account codes charged, and interviewing the contact person.

Prewritten ("canned") software is developed for repeated sale or lease and considered taxable. The combining of two or more prewritten programs is not considered custom. The auditor should examine the sales for tax application; exemption certificates should be reviewed to support exempt sales.

Development of prewritten software for sale or resale qualifies for the industrial manufacturing exemption. Tangible personal property used directly in the production of the software can be purchased exempt. However, computer software developed for in-house use is not considered industrial manufacturing. The tax applies to the sale of prewritten programs. Separately stated charges for the modification or alteration of the program would be exempt. In addition, separately stated installation charges would also be exempt.

A prewritten ("canned") program, which is sold and transferred over data lines rather than in tangible form, is an exempt transaction.

### C. System Sales

Initially, the auditor should determine whether a business that provides integrated systems is a retailer and/or manufacturer and if custom and/or prewritten programs are being developed. Sample periods should be selected with consideration given to types of sales. The auditor may need to review more sample periods to ensure that all types of sales are included in the audit.

When a computer reseller purchases a software license and resells copies, consumer use tax is due on the original license fee as it is not being resold. The dealer must collect tax on the sale of the copies delivered on tangible media.

If a dealer installs a system and lap links the installation of the software along with the customer receiving tangible copies of the program, then separately stated charges for the program are taxable.

Labor charges (e.g., system configuration), not including installation or modification fees, are sometimes separately stated. These charges are considered part of the "sales price" or "gross proceeds" and would be fully taxable. For example:

WIN 486 equipment	\$3,000.00	-	taxable
System configuration	1,000.00	-	taxable
1 pkg Lotus 1-2-3	300.00	-	taxable
1 pkg Works for Windows	150.00	-	taxable
3 hours modification to prewritten program	<u>300.00</u>	-	exempt
TOTAL	\$4,750.00		

### D. Training

Charges for training are generally exempt; however, services in connection with a sale of tangible personal property are taxable. For example, a sales agreement for standardized software may include separate invoicing for on-site training, consulting services, and travel time. As part of a sale of tangible personal property, each invoice is taxable. (Ref. PD 96-193)

The auditor should be aware of businesses conducting training seminars and purchasing training packages. Frequently, they pay royalties for

training books and software for each customer/student. When invoicing for the seminars, if the materials are not separately stated and invoiced to the customer as a taxable sale of tangible personal property, then the business is considered the consumer of the materials and must remit tax on the purchase price.

#### E. Repairs and Maintenance

Computer hardware maintenance and repair is taxable when parts are included. Software maintenance may include upgrades, updates, and support. When upgrades and updates are transferred via diskette or other tangible format, it constitutes the transfer of tangible personal property and is taxable. When upgrades and updates are transferred via modem (electronically), they are not taxable. If a programmer updates/upgrades a program without any transfer of tangible personal property, the updating/upgrading fee is a non-taxable service.

Computer maintenance, repairs, and support can be invoiced in various formats as follows (non-inclusive):

Hardware and software maintenance contract	exempt
- labor only	
Hardware maintenance contract	100% taxable prior to
1/1/96	
- parts & labor	50% taxable on or after
1/1/96	
Hardware maintenance contract	100% taxable
- parts only	
"Time and materials" repair	labor exempt, parts
taxable	
- labor separately stated	
"Time and materials" repair	100% taxable
- labor NOT separately stated	
Software support contract	100% taxable prior to
1/1/96	
- including updates, upgrades, and	50% taxable on or after
1/1/96	
phone support	
Software "hotline" phone support	exempt
(no transfer of tangible personal property)	

It is essential for the auditor to examine both the invoices and the contract documents to properly apply the tax.

F. Licensing Agreements

The licensing of prewritten computer software constitutes a taxable sale or lease when the licensing agreement conveys not only the right to use computer software but also the software itself in tangible form. A license agreement that includes a software program and related documentation is subject to the tax. In addition, license fees and charges for source coding the software are taxable.

G. Additional Information

Database on-line services are non-taxable. Firms offering electronic mail and Internet access are also offering a non-taxable service and are considered the consumer of all tangible personal property purchased in performing these services.

Firms performing data conversion from one format to another on tangible media are making taxable retail sales. The auditor must apply the "true object" test to determine if the customer wants to obtain tangible property or the company's services.

## Sales and Use Tax Audit Procedure

### Leases or Rentals

**Objective:** Discuss the application of sales and use tax as it applies to leasing or rental companies.

#### I. History

**Prior to 01/01/96 .** Total gross proceeds from the lease or rental of tangible personal property were taxable.

**01/01/96 and after.** Separately stated transportation charges for the picking up of leased or rented tangible personal property are exempt.

#### II. References

- A. Code of Virginia Section 58.1-203, 58.1-602, 58.1-603, 58.1-603(2), 58.1-603(3), 58.1-609.5(7), 58.1-609.6(6), 58.1-609.10(3)
- B. Virginia Administrative Code 23 VAC 10-210-5030, 23 VAC 10-210-840, 23 VAC 10-210-3030, 23 VAC 10-210-4000
- C. Ruling Letters P.D. 95-189, P.D. 95-47, P.D. 91-241, P.D. 95-246, P.D. 95-223, P.D. 87-241, P.D. 89-139, P.D. 94-90, P.D. 91-266, ADMN RUL 55-85, P.D. 96-66
- D. Virginia Tax Bulletin 95-7
- E. Applicable exemption certificate ST-10-For companies engaged in the lease or rental of tangible personal property.

#### III. General

- A. A person engaged in the business of leasing or renting tangible personal property (TTP DEFINED CODE OF VIRGINIA 58.1-602, VR 630-10-

102.1,23 VAC 10-210-5030) to others is required to register as a dealer and collect and pay the tax on gross proceeds (DEFINED CODE OF VIRGINIA 58.1-602,VR 630-10-57,23 VAC 10-210-840).

- B. Tangible personal property for future use by a person for taxable lease or rental may be purchased tax exempt under a certificate of exemption (CODE OF VIRGINIA 58.1-609.10(3),VR 630-10-57,23 VAC 10-210-840,ST-10 EXEMPTION CERTIFICATE).
- C. The term "lease" or "rental" does not include the leasing, renting or licensing of copyright audio or video tapes and films for public exhibition at motion picture theatres or by licensed radio and television stations (CODE OF VIRGINIA 58.1-609.6(6),23 VAC 10-210-3030,VTB 95-5,ST-20A EXEMPTION CERTIFICATE).

#### **IV. Procedures**

A. When auditing look for all untaxed charges on invoicing. Reading the lease or rental agreement can help determine what charges the lessor has agreed to pay.

B. Some examples of taxable gross proceeds charges.

1. Finance and interest charges. (CODE OF VIRGINIA 58.1-602,23 VAC 10-210-840, 23 VAC 10-210-4000, P.D. 95-189).

2. Insurance charges. (CODE OF VIRGINIA 58.1-602, 23 VAC 10-210-840(A) and (B), P.D. 95-47).

3. Personal property tax charges. (CODE OF VIRGINIA 58.1-602, 58.1-603(2), 23 VAC 10-210-840(A) and (B), P.D. 91-241).

4. Assembly and disassembly charges. (CODE OF VIRGINIA 58.1-602, 23 VAC 10-210-840, 23 VAC 10-210-4000,P.D. 95-189).

5. Fees to pick up leased property . Taxable until 1/1/96 after 1/1/96 exempt if separately stated. Fees to pick up lease payments are taxable (VIRGINIA TAX BULLETIN 95-7, P.D. 95-246).

6. Combined lease of real and personal property. The portion of the lease payment attributable to personal property is taxable. A taxpayer who cannot determine the taxable portion of the lease payment may pay the tax on 28% of the lease payment for restaurant operation. (CODE OF VIRGINIA 58.1-602, 23 VAC 10-210-840, P.D. 95-223).

7. Charges for parts used to repair leased equipment when the repair was performed by the lessor and billed to the lessee. CODE OF VIRGINIA 58.1-602(17), 58.1-603(3), 23 VAC 10-210-840, 23 VAC 10-210-4000, P.D. 87-241).

8. Leases or rentals of machinery or equipment without operator is taxable, with operator exempt. (CODE OF VIRGINIA 58.1-608(2), 23VAC 10-210-840, P.D. 89-139).

9. Lease purchase agreement typically occurs when taxpayer contracts with a financing company to purchase equipment and lease the equipment to the taxpayer. Usually at the end of the lease, taxpayer has an option to purchase the equipment. (CODE OF VIRGINIA 58.1-602, 23 VAC 10- 210-840, P.D. 94-90).

10. Lease-backs occur when a taxpayer purchases tangible personal property, sells the tangible personal property to another company, and leases the property back from the company.

If the taxpayer purchases the property, makes no use of the property, sells the property to another company, and leases the property back from the company, the taxpayer may purchase the property exempt of the tax using form ST-10. The lease payments for the property is taxable.

If the taxpayer purchases and uses the property, he must pay the tax on the purchase price of the property. If at a later date, he sells the property to another company and enters into a leaseback arrangement, he must pay the tax on the lease payments. Because two separate transactions have occurred, there would be no relief from double taxation. (CODE OF VIRGINIA 58.1-609.10(3), P.D. 91-266, ADMN RUL 55-85).

10 (A). Conditional sales contracts and lease agreements. Under conditional sales contract, title passes to the buyer automatically in the same manner as any other sale of tangible personal property. In a lease agreement the payments are spread over the term of the lease, and title does not pass to the lessee. For sales and use tax purposes, a conditional sales contract is treated in the same manner as any other sale of tangible personal property, while the tax payments on a lease are spread over the term of the lease. (P. D. 96-263)

Page - 63

11. Computer software licensing fees are taxable. (CODE OF VIRGINIA 58.1-602, 58.1-609.5(7),58.1-603, P.D. 96-66).

## Sales and Use Tax Training

### Convenience Stores

#### Inadequate Records/Purchase & Sales Mark-Up

**Objective:** Introduce the auditor to areas of consideration, audit techniques and procedure for convenience stores.

#### I. History

Convenience store growth is increasing; there was a 5-percent increase in store count in 1999 for a total of 119,400 nationwide according to a census performed by Trade Dimensions. Convenience Store News, a trade publication, reports an increase of 18-percent between the years 1995 and 1999. Convenience store sales increased by \$48 billion to \$234 billion in 1999, a 25.8-percent jump. A convenience store may sell anything from gasoline to live plants to farm supplies to money orders.

#### II. References

- A. Convenience Store News, "Industry Report 2000"
- B. Virginia Administrative Code 23 VAC 10-210-340 Collection of the tax by dealers.
- C. Purchase Markup P.D. 00-46, 99-28, 97-303, 97-298, 95-320, 94-213
- D. Sales Markup P.D. 98-72
- E. Virginia Tax Bulletin 99-11 Food Tax Reduction Program. Note: The rate reduction scheduled for April 1, 2001 did not take effect due to revenue requirements.
- F. Rentals: VAC 10-210-840, P.D. 99-22, 84-89  
P.D. 91-166 ATM Machines  
P.D. 91-98 Tanning bed rentals
- G. Virginia Tax Bulletin 98-4 Nonprescription Drugs: Nonprescription Drug Exemption Teleconference Questions and Answers Summary.

#### III. General

Because of the wide variety of items sold at a convenience store, these audits present a challenge. Preaudit activities are important to give a "heads up" on the operations. The dealer may be on a commission basis for gasoline, newspaper sales, vending machines. Some departmentalized areas such as books and magazines or hardware may be on a consignment basis.

It is characteristic of convenience stores to make purchases such as bread, milk, snacks, etc. from the cash drawer. Some convenience stores are on a program with a convenience store specialty supplier for their grocery purchases. Grocery items may be prepriced when they are delivered. A convenience store may purchase some items from chain grocery stores when they run specials for resale at their "convenience" pricing.

Most convenience stores sell lottery products. Usually, there is a separate cash register for lottery and a separate bank account from which drafts are made in payment of lottery purchases. Lottery sales may not be included in gross sales on the sales tax return.

Most convenience stores now serve prepared food and prepackaged foods as well. Be aware of the Food Tax Reduction Program which may affect how sales are reported. Reference: Tax Bulletin 99-11, Question and Answer Summary-Food Reduction Program.

Video rentals and tanning bed rentals are also seen occasionally at convenience stores. There are also a growing number of convenience stores with ATM's located in the store.

#### **IV. Procedures**

##### **A. Pre-Audit Activities**

Schedule returns information from 5-03 screen

Request a copy of the income tax returns for the years being audited from Central Files

Request ABC reports to use in comparing purchases/sales, if needed

Request lottery sales/purchase information from Department of Lottery, if needed

Visit the store to observe - store location (is it in a high traffic area?), store layout, vending machines located outside the premises, number of gas pumps, etc.

Develop a questionnaire containing information about the business, how the records are kept, etc. (see example)

Develop a unit price list from which mark-up will be figured (see example)

Develop a records request

##### **B. Areas of Consideration**

A comparative review of sales reported by year and an analysis of the income tax returns are very advantageous in determining potential audit issues. Compare the figures reported on the sales tax returns with the income tax return and note any differences. Use these differences to compare lottery and gasoline sales to Department of Lottery records and

records that the taxpayer may have. Does the income tax return show a loss or profit? If the return shows a loss, how did the taxpayer live?

Determining the Percentage of Markup will give a possible indication that either cost of goods is overstated or sales are understated. A tendency to understate sales rather than overstate costs is usually encountered. Computing the Percentage of Markup is a good way to determine if an audit will be productive. Using the income tax returns, compute the Percentage of Markup for each potential audit year in the following manner:

$$\frac{\text{Gross Sales} - \text{Cost of Goods Sold}}{\text{Cost of Goods Sold}} = \text{Percentage of Markup}$$

Example: Gross Sales of \$19,645.44 with a Cost of Goods Sold of \$15,348.00 equals 28% (.28) markup.

How does each year compare with the other? Care must be taken to observe whether supplies are included in Cost of Goods Sold or separately claimed as operating expenses as this may affect the markup percentage. Our experience has shown that the Percentage of Markup for convenience stores after allowance for theft is generally above 25%. Use this percentage as a guideline when figuring the markup on the face of the income tax return. If the percentages are below this range, chances are that an audit is warranted.

### C. The Initial Interview

The initial interview is important in determining how you proceed with the audit. Conduct the initial interview with the owner. If the owner does not work in the store, the manager, or person who is responsible for the day to day management of the store should also be interviewed. Ensure that questions are specifically stated and geared directly toward the taxpayer's situation. It is a good practice to pre-plan your questions prior to your meeting with the taxpayer. Allow for expected and unexpected responses. Ask open-ended questions, requiring a response other than yes or no, to allow the taxpayer an opportunity to respond to the questions, and allow you an opportunity for follow-up questions or responses. Document taxpayer responses accurately in your workpapers. Have the taxpayer sign a copy of your questionnaire that he did respond in the manner that you recorded. It is important to tie down all known sources of income during the initial interview.

Ask the taxpayer what his percentage of markup is. Ask what items he sells the most. Does the taxpayer accept food stamps? What portion of his sales does he believe are attributable to food stamps? How are inventories valued? If there is a deli in the store, ask how selling prices

are determined. What does he think the markup is on the deli? Deli markup can be as much as 200% and is most always 100% and greater. Agree upon a reasonable percentage of markup for the deli. Ask about whether deli supplies are taken from the store inventory and how deli sales are handled (remember there may be a local food tax issue in addition to the reduction of state sales tax issue).

After the initial interview, complete your unit price schedule. Walk around the store, recording the selling price of a sampling of items from the various departments. Convenience stores usually sell more cigarettes, beer, and soft drinks, so be sure to get unit prices of most brands in these categories.

#### D. Reviewing the Records

Many small businesses use a single entry bookkeeping system. This system may consist of a ledger, journal, and cash book or only a cash book. If the taxpayer has this sort of books, you will need to examine purchase invoices, bills, receipts and cash register tapes.

Among the items that should be requested from the taxpayer are purchase invoices received from his suppliers and cash tickets for purchases paid for by cash. Prepare a spreadsheet for each year showing vendor by month. Scheduling a year's purchases on a spreadsheet will allow you to spot any "holes" in the purchase pattern. As you schedule the invoices, notice how often the beer vendor, bread vendor, grocery vendor, etc. service the store. This will also assist you in determining if you have all the invoices. If there are missing purchases, contact the vendor to get their accounts receivable history on the taxpayer. Make a separate schedule for deli purchases as the markup for deli is much higher than the rest of the store.

Note that many suppliers who specialize in convenience stores show the markup on their invoices. As you examine these invoices look for any equipment purchases or supply purchases which may have been made from these suppliers. In examining the overall purchase invoices, you may also find items purchased for the taxpayer's own use which have been included in the records of the business.

Use invoices within the past one or two months to complete your unit price list cost side. This will pair the sales/cost prices. Figure the markup percentage on each item and average overall markup. How does this compare with the analysis of the income tax return and the percentage the taxpayer gave you?

As a cross check, examine cash register tapes. Look for suspicious "Voids" and "No Sale" rings. One experience with a taxpayer showed as

many as fifty “No Sale” rings per day. His explanation of “keeping the keys in the cash register” didn’t pan out when it was found that his markup percentage was less than 15%.

A bank deposit analysis may also be helpful. Sales of equipment or other fixed assets which may be taxable may be uncovered in this analysis. Compare bank deposits (allow for deposits in transit) plus cash paid outs with sales reported; and with your marked up sales.

#### *E. Making the Adjustment*

Once you feel you have all the purchases and have determined a reasonable overall average markup, you can use your purchase schedules to compute taxable sales. To purchases from your purchase schedules, add beginning inventory at cost and subtract ending inventory at cost. The result is cost of goods sold for the year. Inventories are shown on the income tax return in the cost of goods sold section.

You can use the overall average markup percentage to mark up the purchases; or mark them up by category. For example, if your purchase spreadsheet shows the purchases are heavily weighted toward beer and cigarettes, you may use an average of all the beer markup percentages for beer purchases; an average of all the cigarette markup percentages for the cigarette purchases; and the remaining overall average on the balance of purchases. An example using overall markup percentage to mark up the purchases is as follows: Purchases totaling \$15,348.00 marked up 28% (.28) would equal sales of \$19,645.44. Computation would be  $\$15,348.00 \times 1.28 = \$19,645.44$

Be sure to make an allowance for theft. One to three percent of purchases is usually adequate depending on store size. If the taxpayer says he has had break-ins, he should have a copy of a police report as documentation. Show these adjustments as a reduction of cost of goods sold on your working papers. Also ask about withdrawals from inventory for his own use which would be taxable at cost.

Mark up the deli purchases using the markup you agreed upon with the taxpayer. If deli purchases are withdrawn from inventory, you must agree on an amount with the taxpayer and then mark it up.

Enter the difference between your marked up purchase schedules and taxable sales reported on the return by month. Remember to include other outright taxable sales such as video rentals.

Penalty would apply for sales tax collected but not remitted.

#### F. Sales Markup

Occasionally, when comparing income tax returns to sales tax returns, the sales reported on the income tax return is greater than reported on the sales tax return. After an analysis to determine if there were commissions or other income included in the sales which should be separated, a sales markup may be done.

The difference between the income tax return sales and sales tax return sales may be spread evenly throughout the twelve months; or allocated by month based on your analysis.

Penalty would apply for sales tax collected but not remitted.

In an instance where the sales tax return sales are greater than the income tax return sales, an adjustment to the income tax return would be warranted if no explanation can be given.

*Examples of Interview Questions*

1. When did you begin your business?
2. What is your expertise/experience in this field?
3. What is your educational background?
4. Who usually operates the business? Who operates the business when the usual operator is on vacation or sick?
5. How many locations do you have?
6. Did you acquire or dispose of any business assets during the past three years?
7. Do you own or rent the real estate? How much is the rent?
8. What types of products do you sell? Do you rent videos, tanning beds, or any other tangible personal property?
9. What are the hours and days of operation?
10. How many employees or independent contractors do you have? Family members? Duties of each? How do they get paid; by the hour, week, etc.? By cash or payroll check?
11. Do you keep tabs or accounts for any customers?
12. What are the hours of the deli? What do you sell the most of from the deli?
13. How do you account for sales taxes on a daily basis?
14. What types of reports are prepared for the business? Who prepares them?
15. What type of records are available for purchases?
16. Do suppliers offer kickbacks or rebates? How are they recorded?
17. What type of payment is accepted? (i.e. cash only, credit cards, checks, food stamps, WIC coupons, trade coupons)
18. How many bank accounts (checking & savings) do you have, both business and personal?
19. What are the sources of funds deposited into each account? Were there regular transfers between accounts?

20. Did you have any income which was not deposited in a bank account?
21. How much money do you keep in the register(s)?
22. Who makes the deposits?
23. What percentage of cash receipts are deposited?
24. Is any cash removed for personal use or expense?
25. Did you borrow any money for business or personal use during the year?
26. Do you have any non-taxable sources of income?
27. What method of accounting do you use? Cash, accrual, other
28. What type of bookkeeping system do you keep?
29. Who maintains the daily accounting records? Is this the same person who does the banking?
30. What records are used to prepare the sales tax returns?
31. Who prepares the sales tax returns?
32. Are all sales included in the gross sales reported?
33. What is the mark-up percentage for sales? Deli? Other?
34. What inventory valuation method is used? Cost? Lower of cost or market?
35. How often is an inventory taken?
36. Do you have food stamp sales? Do you have records of the dealer's reimbursement?
37. Has there been any theft or loss of product or other property?
38. Do you "give away" any products?
39. Do you remove any products for personal consumption?
40. Do you keep track of how many deli items are sold each day?
41. Who has access to the cash register(s)?

42. Is access to the register tapes restricted? To whom?

43. Are beginning and ending cash register transaction numbers compared?

44. Is the cash reconciled to the register tapes and deposited to the bank intact?

45. How are expenses for the business paid?

46. Are any expenses paid in cash? If so, how are these amounts accounted for?

Example of Unit Price List

<i>Item</i>	<i>Shelf Price</i>	<i>Cost Price</i>	<i>Markup</i>
Pepsi 20 oz	1.09	.69	.579
Pepsi 2 liter	.99	.58	.706
Dr. Pepper 16 oz	.89	.48	.854
Budweiser 12/6 cans	3.29	2.21	.488
Budweiser 12/24 cans	5.99	3.84	.559
Pet Milk 1/gal	2.39	1.99	.201
Kraft Cheese 10/slice	1.89	1.58	.196
Chef Boyardee Spaghetti	1.59	1.31	.213
	18.12	12.68	.429

## **Sales and Use Tax Audit Procedure Manufacturing and Fabricating**

**Objective:** Discuss the application of sales and use tax as it applies to manufacturers and fabricators

### **I. History**

Since Sales & Use tax Inception in 1966 hundreds of audits, taxpayers letters, commissioners rulings, and many court cases, producing millions of dollars in audit assessments, have been based upon the Virginia code sections pertaining to manufactures and fabricators, The Virginia Manufactures Association, along with other interested parties, and the department have traditionally worked together in producing the laws, rules and regulations governing these exemptions. In recent years only rules and regulations have been reinterpreted or clarified based on commissioners rulings. There have not been any changes to the law regarding these two types of activities during the current statue of limitations periods available for audit . For purposes of explanation current rules and regulations categorize manufacturing activities under three areas: administration, production and distribution.

### **II. References**

- A. Code of Virginia Section 58.1-602
- B. Virginia Administrative Code 23 VAC 10-210-920 & 23 VAC 10-210-560
- C. Ruling Letters (with public document numbers if applicable)

<u>P. D. # or Date:</u>	<u>Other type of document:</u>	<u>Subject:</u>
• 86-46		Ex prod forms,monitors
• 86-98		Packaging-containers
• 87-167		Production records
• 87-274		Repackaging
• 88-17		Cad/Cam-computers
• 88-127		Inventory withdrawals
• 90-15		Swatch cards
• 91-183		Steel, platforms, etc
• 91-291		Cad/Cam-computers
• 92-65		Maint gen & exempt
• 93-135		Quality control
• 93-238		Cooling tower chem
• 94-276		Truck/pit scales
• 95-43		Steel, platforms, etc

- |            |                         |                         |
|------------|-------------------------|-------------------------|
| • 95-140   |                         | Storage tanks           |
| • 95-278   |                         | HVAC equipment          |
| • 3-28-83  | Commissioner's Ruling   | Boiler chemicals        |
| • 8-03-89  | Technical Servs. letter | Bar coding              |
| • 9-29-92  | Commissioner's Ruling   | Boilers/air handling    |
| • 3-08-88  | Technical Servs. letter | Spray booths            |
| • 1-13-88  | Technical Servs. letter | Plant site              |
| • 9-23-88  | Technical Servs. letter | Quality control/testing |
| • 11-08-82 | Commissioners Ruling    | Fire Protection/prevent |
| • 10-24-85 | Commissioners Ruling    | Production forms        |
| • 1996     | CCH 64-352              | Pollution control       |

D. Applicable exemption certificate

**St-11, St-11a**

F. Definitions and explanations of key terminology.

- **TPP**-Tangible personal property.
- **Sic codes**-The Standard Industrial Classification Manual. This manual may be used by the auditor to help determine if a particular business activity is deemed to be industrial in nature and entitled to the processing exemptions. The SIC code is listed on the Federal Corporate Income tax return and also is available on the STARS system on the 2-03 screen. Generally businesses that fall in codes 10-14 and 20-29 are deemed to be industrial in nature.
- **Manufacturing**-for purposes this training document, shall include processing, converting and fabricating (other than fabricating for ones own use or consumption).
- **Fabrication**- The act of changing the physical state of TPP.
- **Fabricating for own use or consumption**-is not considered an exempt activity. For example, a welder who fabricates iron railing at his shop then installs them on the steps of an office building would not be entitled to the exemption. The Welder acted as a real estate contractor when he installed his fabricated items at the job site. Under Virginia regulations a contractor is considered the user or consumer of the TPP they affix to real property.
- **Administration**-there are no available processing exemptions in this area that includes: pre-production activities, marketing, managerial, record keeping and non operational aspects of manufacturing.
- **Production**-The production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed and conveyed to a warehouse at the production site.

- **Distribution**-the storage, distribution and transportation of goods after the production process. No manufacturing exemptions apply under this category. For example packaging equipment used to strap products for shipment that are not utilized at the final stage of production, but are used to package products after they have been conveyed to a finished goods warehouse for later shipment are not exempt.
- **Quality control**-particular industries may use different terminology such as QC or Quality assurance to denote this function . Generally QC is limited to production line testing. This means that to qualify for exemption the TPP used in QC must act directly on the product during the integrated manufacturing process. Off site testing or testing of finished products in the warehouse would not qualify for exemption. Testing or monitoring of manufacturing equipment is not considered an exempt activity.
- **Research and development**-items that are used exclusively (100%) in developing new or improving existing products. Improving equipment or machinery efficiency is not considered to be an exempt R & D function.
- **Preponderance**- by law the taxability of a particular item that is used both in a taxable and exempt manner is based upon its preponderance or percentage of time used in exempt Vs nonexempt activities . For example a forklift used more than 50% of the time in the handling of raw materials while being utilized in the warehouse for shipping less than 50% of its usage would be exempt. Generally preponderance only applies to identifiable single items of machinery, equipment or repair parts. Items that are not singular in nature like mass purchases of safety apparel such as gloves, or fuel used in processing as well as for heating are not considered for preponderance of use. For these types of items a percentage of taxable vs exempt usage may be used to determine the taxable amount of a particular purchase of TPP.
- **Plant site**- the exemption is limited to the particular singular plant location in a specific geographic location.
- **Stores and/or stores accounts**- Generally manufacturers physically warehouse (store) at the plant site repair parts (spares), small tools, maintenance and housekeeping supplies. For cost accounting purposes these items are charged to a suspense or prepaid expense accounts. When the items are withdrawn from stores the appropriate account or cost center is charged with the cost of the items withdrawn. This account must be carefully analyzed to determine if the sales tax or use tax accrued is accounted for correctly
- **Pollution control**- Pollution control facilities certified by the state certifying authority, The Department of Environment Quality (DEQ) are exempt. Only facilities that abate water or air pollution to the environment are considered for the exemption. DEQ forwards a copy of the certification to TAX . Tax then notifies the Taxpayer that they

are entitled to the exemption. To qualify for exemption the Taxpayer must have this approval letter from the Department.

- **Used directly-** When used in relation to manufacturing, processing, refining, or conversion, refers to those activities which are an integral part of the production of a product, including all steps of an integrated manufacturing or mining process, but not including ancillary activities such as general maintenance or administration.

### III. General

- A. The production exemption for fabricators and industrial manufacturers is broad and complex. The exemption applies to raw materials, machinery, manufacturing tools, repair parts, and fuel. Supplies used directly in manufacturing, safety wearing apparel furnished gratuitously to production employees, packaging materials, and TPP used directly. The area that exemptions are applicable begins with the handling and storage of raw materials at the plant site and ends with the finished product being placed in the warehouse or plant storage area. Just because items of TPP are used in these specified areas does not mean that they are exempt. The exemption applies to only those items used directly in a integrated manufacturing process. The key to determining what is taxable or exempt during manufacturing is what is used or not used directly in the integrated process. For example, plant lighting in processing areas is not considered to be exempt as it does not act directly on the product.

### IV. Procedures

Fabricators and manufacturers are a diverse group. The Items produced and the processes involved vary from one manufacturer to another. There is no set way to audit a manufacturer. The auditor and audit methods utilized must be flexible. Generally the auditor will look at the following areas( this list is not all inclusive): sales, expensed purchases, fixed assets, stores, withdrawals from inventory and intercompany accounts.

Several things need to be done before the auditor begins to examine specific records at the audit site. The auditor needs to meet with the taxpayer's representative in order to ascertain exactly what is manufactured. A tour of the plant site should be scheduled so that the auditor has an idea of processes involved.

It should be determined that all the records necessary for the audit are available at the audit site. Inquiries should be made to determine that all purchasing functions for the audit site will be reviewed. Be on the lookout for purchases made by out of state corporate headquarters for a Virginia

plant site. Ask for general ledgers to check for journal entries used to record purchases and intercompany transfers. Be aware that taxpayers could be making payments by electronic transfer which does not require paper invoicing. Also be aware that manual checks may be utilized for payment of some types of transactions. Purchase orders and the voucher register( if applicable) should be reviewed to determine if all purchase records are seen by the auditor.

A chart of accounts or general ledger with a brief explanation should be used to help determine the taxability of audit exceptions. For fixed assets, work in process, or capital projects a list of open and closed jobs for the audit period should be obtained from the taxpayer.

The taxpayer's accrual system for use tax should be reviewed. If the taxpayer files a sales tax return or a direct pay return, these should be examined for correctness.

A review of the Federal and State Income Tax returns before starting the audit will give you details about corporate officers, Social security numbers, subsidiary companies and various other helpful facts (be sure to update stars information if necessary) . The review of the income tax return may disclose a problem resulting in an income tax audit.

### **Application of law and regulation--Administrative**

Administration is the managerial, sales, and nonoperational aspects of manufacturing and processing operations. TPP used in administrative activities are subject to the tax. Listed below are various questionable items found when auditing manufacturers:

1. Production records are taxable to a manufacturer. The recording charts and recording equipment which are use to generate production data from production equipment are taxable. Computer hardware and software in the manufacturing area that records production information is also taxable. (PD 86-46 & 87-167)
2. TPP withdrawn from a non taxed inventory and given away is taxable at the fabricated cost of the material. Textile manufacturers are a good example. They withdraw material to make swatches out of, send various lengths of material to prospective customers at no charge and also give completed garments to various charities. (PD 88-127)
3. Catalogs and other printed material used to advertise TPP for sale and are distributed within Virginia are taxable. Catalogs and other printed materials distributed outside Virginia within a 12 month period are exempt. Items in the "other printed material" category such as annual

reports usually will have a higher percentage of distribution in Virginia than catalogs. Rulers, mugs or other similar items are not considered printed material and are taxable. (PD 90-15)

### **Application of law and regulation--Production**

Production includes the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed for sale and conveyed to a warehouse at the plant site.

Listed below are various questionable items found when auditing manufacturers:

1. Boiler and cooling tower chemicals used to prevent pipe and equipment corrosion and plant growth are taxable as part of general maintenance. The chemicals are not used directly in manufacturing, but are used in preventative maintenance of production machinery. (Commissioners Ruling Letter 3/28/83 & PD 93-238)
2. Structural steel used for platforms and equipment supports is taxable unless the steel becomes a component part of exempt production machinery and does not become permanently affixed to realty. When freestanding steel legs or other supporting structures are attached to exempt machinery and used solely to support exempt machinery, and the machinery cannot be operated without such supports, then the steel is exempt from the sales tax. (PD 91-183 & 95-43)
3. Computer hardware and software used both in taxable and exempt manners are taxed based on their preponderance of use. (PD 90-15)
4. Swatches and swatch cards are taxable when used as a sales aids and are not given the same exemption as catalogs. (PD 90-15)
5. Packaging materials and shipping containers are exempt whether returnable or nonreturnable when used or consumed by an industrial manufacturer or processor of products for sale or resale. Any packaging or shipping container that restrains movement of the product in more than one plane is considered packaging. (PD 86-98)
6. Bar coding equipment when used for administrative or inventory control purposes is taxable. However, when bar coding equipment is used directly in the production process it is exempt. (Technical Services Letter 8/3/89)

7. Storage tanks used to store fuel are taxable. However, storage tanks used to store raw materials are exempt. (PD 95-140)
8. Boilers, chillers, air handling units and cooling towers used for employee comfort are taxable when purchased by the manufacturer or a contractor. The same equipment would be exempt to the manufacturer or contractor, with the use of a ST 11-A, when the equipment maintains critical temperature and humidity for the quality of the product being manufactured. (Commissioners Ruling Letter 9/29/92)
9. Air conditioning equipment used to cool manufacturing machinery is taxable. (PD 95-278)
10. Cleaning supplies used in general maintenance are taxable. However, cleaning supplies used to ensure the quality of the product are exempt. (PD 92-65)
11. CAD/CAM computers used for design or redesign purposes are taxable. CAD/CAM computers used to produce software which operates manufacturing machinery is tax exempt. (PD 88-17 & 91-291)
12. Spray booths are not used directly in manufacturing and are taxable. (Technical Services Letter 3/8/88)
13. Equipment used in a raw material warehouse not located at the manufacturing plant site is taxable. (Ruling letter 15) (Technical Services Letter) 1/13/88)
14. TPP used in production line testing and quality control is exempt. The exemption is restricted to the production line. Testing prior to manufacturing or subsequent to manufacturing is taxable. (Technical Services Letter)
15. Hoods used to remove fumes for employee comfort are taxable. (Commissioners Ruling Letter 12/23/87)
16. Fire prevention equipment attached to manufacturing equipment is taxable. (Commissioners Ruling Letter 11/8/82)
17. Printed forms used directly in the production process are exempt. Any form retained for production records is taxable. If the form is a multi-part form, it may be a percentage taxable item. (Commissioners Ruling Letter 10/24/85)

18. Computers used to monitor production equipment but don't control the equipment are taxable. Computers used to record manufacturing information are taxable. Computers used to monitor the product for quality purposes are exempt. (Commissioners Ruling Letter 3/14/86)

19. Electrical items, where more than 50% of the electricity passing through them is going to manufacturing equipment, are exempt. Where electrical items are purchased and placed into stock, a percentage of the stock items should be taxed.

20. Steam, air, or other process piping used more than 51% for processes directly in manufacturing are exempt. These same items are purchased and placed into stock, a percentage of the stock items should be taxed.

21. Pit truck scales are deemed to be real property and the tax should be paid by the contractor installing them. (PD 94-276) Other scales located in the plant may be taxable or exempt based on their use. A postage scale would be taxable. Scales used to weigh raw materials being measured for manufacturing purposes would be exempt.

22. Certified pollution control equipment and facilities are exempt. However, all such equipment is taxable until it has been certified. In performing audits, you must hold this equipment taxable until the dealer has obtained the proper certification. (CCH Reference 64-352)

23. Repackaging is industrial in nature when the packing operation substantially increases the marketability of the product being packaged. Any TPP used directly in the repackaging process would be exempt. (P D 87-274)

### **Application of law and regulation--Distribution**

Distribution is the transport or conveyance of products after the completion of production and is not part of manufacturing or processing. After production, if the product goes straight to a truck for shipment then there is no taxable property used in the handling of the product.

Listed below are various items to be aware of when auditing manufacturers:

1. Car bracing used to hold cargo in trucks or rail cars is taxable. Where 3/4" steel strapping is typically used for packaging, 1" or larger strapping is used most of the time for car bracing. Lumber and dunnage bags are also used as car bracing.

2. Forklifts used to place the manufactured product in the finished goods warehouse are tax exempt. Forklifts used to take the finished goods out of the warehouse for shipment are taxable. If the same forklift is used both in a taxable and an exempt manner, the preponderance of use rule will apply.

3. Where finished goods and raw material are both stored in the same warehouse, any equipment used will be taxable on its preponderance of use.

**The following is a list of items that are generally taxable:**

**Electrical Items:**

- cable trays
- F96T12CW-flourescent Lighting
- F72T12CW- fluorescent Lighting
- light bulbs
- machinery lights enabling operator to see
- Lighting Ballast
- contact cleaner
- wire markers
- Greenlee electrical tools
- voltmeters

**Equipment type items:**

- Hoist, cranes & chains for maintenance of production machinery
- free standing exhaust fans
- pipe cutters
- pipe threading machine
- HVAC for employee comfort
- vacuum systems for housekeeping purposes
- inventory bar code system
- computer equipment to design products
- calibration equipment
- catwalks and ladders
- repair parts and supply storage bins or racks
- Chart recorder, chart paper, and pens
- administrative computer hardware and software
- computers for inventory management
- dust covers
- guards
- wearing apparel for employee comfort
- portable dockboards

- raised or false flooring
- fire prevention equipment
- gas cylinder rental or demurrage charges on gas cylinders
- grinder machine and accessories used to sharpen production parts
- Pipe identification markers
- general maintenance equipment
- rail car leases
- off site packaging equipment
- off site quality control equipment

**Supply Items:**

- supply storage tanks
- boiler treatment chemicals
- chemical and additives that prolong the life of equipment
- fuel for comfort heating
- oil dry
- heat tape to prevent freezing
- acetylene, oxygen, argon-welding gases

## **Sales and Use Audit Procedure**

### **Restaurant / Bars Purchase Mark-Up**

**Objective:** Discuss the application of sales and use tax as it applies to purchase markup procedures for restaurant and bars.

#### **I. History**

The use of purchase markup procedures has always been based upon the lack of suitable records necessary to determine sale tax due.

#### **II. References**

- A. Code of Virginia Sections
  - 58.1-633 (Records)
  - 58.1-628 (Bracket System)
  - 58.1-625 (Sums held in trust)
  - 58.1-614(D) (Remit tax based on Gross Receipts)
  
- B. Virginia Administrative Code 23 VAC 10-210-470 (Dealers Records)  
23VAC 10-210-340 (Collection of tax).
  
- C. Ruling letters that are relevant to purchase markup procedures are:
  - P.D. 95-224
  - P.D. 95-162
  - P.D. 95-11
  - P.D. 95-61
  - P.D. 94-232
  - P.D. 94-213
  - P.D. 91-276
  - P.D. 87-183
  - P.D. 99-28
  - P.D. 97-303
  - P.D. 97-298
  - P.D. 96-287
  - P.D. 97-149
  
- D. Exemption Certificate: ST-10 - For purchase of food and beverages to be resold.

### **III. General**

Purchase markup procedures are resorted to when restaurant / bars have failed to maintain suitable records for the determination of sales tax owed. The procedures allow the auditor to estimate taxable sales by marking up purchases with ratios derived from known cost and selling prices or industry standards. The portioned purchases of liquor and beer, along with limited sources of supply that occur with a bar make it especially effective. A restaurant's menu, though more troublesome, will provide good results; particularly, one which lends itself to portion control purchasing. In addition, industry standards provide known benchmarks, which act as a plausibility check for your results, and, may even be used alone to provide a quick and generally accurate result.

### **IV. Procedures**

It is already assumed that there are insufficient records maintained by the business. Therefore, the auditor needs to ascertain what records are available that will assist in performing a purchase markup. When mixed beverages are being sold the business is required to file a Mixed Beverage Annual Review report with "ABC". This is done on an annual basis. If the taxpayer does not have his most recent reports, copies can be obtained from "ABC". The information in the report is provided by the business and purports to be an accurate reflection of the business. The report categorizes sales by mixed beverage, beer & wine, and food for a twelve-month period. It also provides total purchases for each category. This information is useful in several regards. First, it provides sales information with which to verify what has been reported to TAX. Secondly, it provides total purchases, per category, which is useful to have in summary form. And third, it enables the auditor to calculate the Cost of Goods Sold for each category as reported by the business; thereby, providing a quick figure with which to judge the reasonableness of the sales numbers contained in the report. This in itself is a tremendous aid for the auditor. For, given that the purchase figures are correct, the auditor may preemptively conclude either that sales have accurately been reported, albeit with poor records being retained, or that something is amiss and further effort is required. Thus, the auditor has a tool that either confirms the need for a complete purchase markup or allows for the procedure to be aborted before much effort has been expended. After all, the auditor is most concerned with underreported sales and not just the exercise of reconstructing sales. Except, of course, for instances where no sales have been reported at all.

After the "ABC" report has been reviewed, purchase invoices need to be obtained. There is only one legitimate source for liquor purchases. That is the ABC store which serves that particular business area. Beer & wine purchases are almost exclusively made from the few large beer & wine wholesalers that serve the area. The business owner is required by ABC to keep liquor purchase information on the premises. However, if it is felt that the records are incomplete or unavailable for

review, the auditor may obtain copies of all liquor purchases from the ABC store serving the business. This will be in the form of actual invoices showing the type, quantity, and price of liquor purchased. In like manner, beer & wine wholesalers may be contacted for information concerning their products. Instead of actual invoices, they will provide summary reports showing quantities and sales dollars by product on a monthly basis. These reports usually cover the current and prior year. An ABC agent can facilitate gathering the aforementioned information.

Once the purchase information has been obtained, the total purchase amounts provided on the Mixed Beverage Annual Review report can be verified. The auditor now knows how much alcohol has come into the business and at what prices. Therefore, it needs to be determined at what serving sizes and prices the business sold the alcohol. This is best accomplished by interview with the business owner or manager on the initial visit to the location. At that time, posted prices and bar setup may be observed while discussing the following:

What serving size for liquor is used? Is it one ounce, ounce and a quarter, what?

Is a measured type of system in use or is it free pour?

At what price is liquor sold at for well, call, and premium brands?

Is there a happy hour?

Are just well brands used at happy hour?

What prices are used at happy hour?

What size glass is used for draft beer?

What size are the pitchers?

What are the regular prices?

What are the happy hour prices?

What about bottled beer?

How much is domestic?

How much is import and premium?

Are there any reduced prices with bottled beer?

Are happy hour records kept?

Are Z-tapes kept from the cash register?

Are the Z-tapes consecutively numbered?

How many cash registers are there?

How are daily sales recorded?

Are daily sheets used and maintained?

These questions provide the answers you will need to perform your calculations and also establish the degree of record keeping the business has maintained. In order to facilitate organizing this information the following questionnaire should be used and then maintained as a statement of record as to certain facts pertaining to the taxpayer's business.

### General Audit Information Questionnaire

Business Name: \_\_\_\_\_ Registration # \_\_\_\_\_

Trade Name: \_\_\_\_\_ Type of establishment: \_\_\_\_\_

Street Address: \_\_\_\_\_ City/Town, State and Zip \_\_\_\_\_

Type of location of establishment: \_\_\_\_\_  
(Shopping center, Downtown, etc...)

Days/Hours of Operation: Days \_\_\_\_\_ Hours \_\_\_\_\_ .

Food percentage sold: \_\_\_\_\_ . Menu provided: yes \_\_\_ no \_\_\_ .  
Does taxpayer have copies of old menus: yes \_\_\_ no \_\_\_ .

#### Miscellaneous Sales:

Cover Charges – Are cover charges imposed? yes \_\_\_ no \_\_\_ .

Records for cover charges kept? Yes \_\_\_ no \_\_\_ .

How long have cover charges been in effect? \_\_\_\_\_ .

Days / Hours cover charges are imposed: Days: \_\_\_\_\_ Hours: \_\_\_\_\_ .

Cover charge imposed: \$\_\_\_\_\_ per person, \$\_\_\_\_\_ per couple. If different amounts are charged for different times of days, please note: \_\_\_\_\_ .

Is anything other than admission included in cover charges? Yes / No.  
Please note: \_\_\_\_\_ .

#### Other Miscellaneous Sales:

Pool tables / Video Games / souvenirs – Does the applicant or licensee have pool tables or video games or sell souvenirs (such as hats or T-shirts)? Yes/No.

If yes, list type(s): \_\_\_\_\_ .

Are records for these sales maintained? Yes / No

If records for miscellaneous sales are not kept, approximately how much money is taken in per week from these sales: \$ \_\_\_\_\_ .

Alcoholic Beverage Sales

Happy Hours (reduced pricing)

Are there periods when reduced prices are charged? Yes / no

Are Happy Hour records maintained? Yes / no

Days and times of Happy Hours: Days of Week: \_\_\_\_\_ Hours: \_\_\_\_\_ .

How long have these Happy Hour times been in effect? \_\_\_\_\_ .

If Happy Hour records are not maintained, obtain the percentage of total alcohol sales derived from Happy Hour. \_\_\_\_\_%.

How is liquor dispensed: Free pour \_\_\_\_\_ Gun system \_\_\_\_\_ Measured pour \_\_\_\_\_ .

Serving Sizes of Alcoholic Beverages:

Summary of Serving Sizes and Prices for Alcoholic Beverages

Item	Regular Serving size (in oz.)	Regular Price	Happy Hour Serving size (in oz.)	Happy Hour Price
Domestic Bottle Beer				
Imported Bottle Beer				
Other Bottled Beer (more than 12 oz.)				
Other Bottled Beer (less than 12 oz.)				
Draft-Glass				
Draft-Pitcher				
Wine sold by bottle.				
Wine sold by glass.				
Mixed Beverages	Amount of liquor used in ounces.	Regular price	Amount of liquor used in ounces.	Happy Hour Price
House Brands				
Call Brands				

<b>Premium Brands</b>				
<b>Exotic Drinks</b>				

Normally restaurants use the cost of each brand to determine the sale price. Example: 750ml bottles that cost from \$0.00 - \$10.00 are considered house brands, bottles that cost \$10.01 - \$18.00 are considered call brands, etc. Determine the price structure for House, Call, Premium and Exotic brands.

Document the price structure in the chart below:

**Mixed Beverage Pricing Structure**

House Brand	
Call Brand	
Premium Brand	
Exotic Brand	

Is sales tax included in the price for a drink: yes / no

Is sales tax separately charged when a drink is bought: yes / no

Are daily sheets used and maintained: yes / no

Are Z-tapes kept from the cash register: yes / no

Are the Z-tapes consecutively numbered: yes / no

Person providing the information for this questionnaire:

Name: \_\_\_\_\_ Title: \_\_\_\_\_ Date: \_\_\_\_\_

Date of interview: \_\_\_\_\_ Auditor's Signature: \_\_\_\_\_

The auditor is now prepared to begin constructing worksheets which will put the accumulated information into meaningful form. The goal is to produce a cost of goods sold ratio per category which, in turn, can be applied to the total purchases per category which results in a sales figure based on known facts. This entails arranging the information in such a manner so that the relationship between actual costs and selling prices produces the COGS ratio necessary to project sales based on purchases. This is not as complicated as it sounds, though it is somewhat time consuming. Examples of such worksheets are attached.

There are certain other considerations that have to be taken into account when constructing the worksheets. First and foremost is the issue of the sales tax itself. Is sales tax included in the price of alcohol beverages? Can sales tax be included in the price of alcohol beverages? When constructing the worksheets, the sale prices used should be net of tax. This allows a true GOGS ratio to be developed based on the actual cost and selling prices of the product itself. The sales generated by the worksheets will be taxable sales. To begin with, when purchase markup procedures need to be utilized, adequate records may not be available to substantiate the handling of sales tax. And, as a practical matter, many, if not most restaurant/bars regard the selling price of alcohol beverages to include sales tax. When you order a drink at the bar you pay \$2.25 or whatever. You do not pay \$2.25 plus tax. When they report their monthly sales, they back out the tax from their gross alcohol beverage sales and report the result as taxable sales. What is our department's position on this? Code of Virginia Sec. 58.1-625 provides that a dealer is required to separately state the amount of the tax and add the tax to the sales price or charge. Title 23 VAC 10-210-340(A) further provides that identification of the tax by a separate writing or symbol is not required provided that the amount of the tax is shown as a separate item on the record of transaction. However, Code of Virginia Sec. 58.1-614(D) provides that when a dealer is able to demonstrate to the satisfaction of the Tax Commissioner that it is impractical to collect the tax in accordance with the bracket system it may be authorized to remit an amount based on a percentage of gross receipts which takes into account the inclusion of the sales tax. So, it appears that, yes, tax must be accounted for separately, but, it may be included in the sales price. The caveat is if the Tax Commissioner grants the taxpayer authorization to do so. However, if the taxpayer includes the tax in the sales price of the alcohol beverages without first obtaining the Tax Commissioner's authorization, the total price received for the drink is not considered to contain sales tax. Either way, use net taxable prices, as best can be determined to perform your calculations.

Another factor, which must be considered, is spillage. How much should be allowed for overpouring, foamy beer, breakage, and theft? The bar owner will claim he's being robbed blind and that overpouring is rampant. But where's his documentation and inventory count sheets to show the shortfalls? The fact is some spillage does occur.

The following spillage figures, per the ABC, should be utilized in providing an allowance:

- Free-pour liquor and wine -----8%
- Gun-dispensed liquor -----5%
- Beer & Wine by individual container -----5%
- Draft Keg beer ----- No spillage allowed.

Another issue of concern is that of weighting. What percentage of total sales does each broad category represent. That is, how many sales dollars are attributed to regular prices and how many to happy hour prices. Ideally there are at least some register tapes which can provide some guidance. In addition, the auditor has information provided by the questionnaire previously attained with which to establish a ratio. Lacking that, an arbitrary number can be tried using the length of time of the happy hour as compared to the total time the business operates.

So, the auditor strives to construct worksheets that recreate past activity as accurately as possible.

In regard to food, ABC regulations require that the food and nonalcoholic beverage sales must account for at least 45% of the gross sales of mixed beverages and food. The main tool available for use is the menu itself. It presents the product along with its selling price. What remains to be determined is the cost of the product. Lack of variety on the menu becomes a plus when attempting to analyze it. There are fewer main selections and probably fewer vendors involved. In any case, the procedure is similar to that of alcohol. The auditor determines the cost per portion and relates that to the selling price. The resulting GOGS percentage for the various entrees are then weighted to establish an overall COGS. This can be extremely tedious and time consuming. It is much simpler and just as effective to spot check one or two main entrees against what the Industry considers standard for that type menu. This spot checking allows the auditor to confirm where the business stands on the Industry's scale. An even simpler approach is to allow a somewhat high COGS, say 40 to 45 percent, which covers virtually any restaurant scenario and go with that. Say a restaurant/bar has food purchases of \$100.00. If you divide that \$100.00 by 40 percent you arrive at \$250.00. If the business has reported food sales of at least \$250.00, you may assume that reported sales are correct. This provides for a built in waste factor in addition to being simple to apply. Copies of historical restaurant ratios are attached.

To summarize, each restaurant/bar strives to be unique. One way they do this is by the pricing of the product they sell. Some are family oriented with "family" prices. Others aim at being known as fine dining establishments where price is not the concern. Yet, for others, low prices and simple surroundings attract their clientele. Not to be left out, are those places where concerns of food and prices are secondary to the patrons seeking drink and entertainment. Each type of place has its own price structure. While they can be categorized and grouped with similar type operations, each place must be examined in the context of its own price structure. This is not to mean that industry standards cannot be utilized. These standards are a great help. For, if a business is not meeting certain standards for any length of time, it ceases to be a viable business.

Purchase markup procedures are a means to recreate the past sales history of a particular business. As such, actual price information is utilized in conjunction with known or estimated factors to achieve its outcome. Though complete accuracy is sought, the reality of the situation often requires negotiation. The auditor's sense of fairness in evaluating circumstances cannot be overly stressed.

**Additional comments:**

1. Experience has shown that nightclubs, go-go bars and independently run restaurant/bars are the most likely to underreport sales.
2. While it is not carved in stone; the following GOGS ratios provide ballpark numbers to evaluate the Mixed Beverage Annual Review: Liquor - 20%, Beer & Wine - 25%, Food - 45%. If the evaluation of the Mixed Beverage Annual Review shows substantially higher numbers, further investigation is required. It may be that the business only charges low prices or it may indicate that sales have been underreported.
3. The COGS ratio is the relation of cost to sales ( \$40.00 cost divided by \$100.00 sales equals 40 percent COGS. The inverse of COGS is the markup factor ( 1 divided by 40 percent equals 2.5) Therefore, purchases may either be divided by the COGS percentage ( \$40.00 cost divided by 40 percent equal \$100.00 sales) or purchases may be multiplied by the markup factor ( \$40.00 cost times 2.5 equals \$100.00 sales).
4. A place of business, which sells only beer, is required to have at least \$2000.00 worth of food sales per month by the ABC.
5. Happy Hour time frames cannot extend past 9:00 p.m..
6. Separate happy hour records are supposed to be maintained by the business. In practice, this usually takes the form of designated keys on the cash register which segregates happy hour sales on the register tape.



### **Review of steps involved in purchase markup:**

- Check ABC report if Applicable (MBAR)
- Verify if totals reported to ABC contain Sales Tax
- Verify if totals are the same used for reporting Sales Tax
- Make note of the COGS percentage per report

Obtain Beer and Liquor purchases:

- Contact beer distributors
- Contact ABC

Determine selling prices of beverages

Establish COGS for different categories

- Regular price for liquor
- Happy hour price for liquor
- Regular price for beer
- Happy hour price for beer
- Back out tax from price if required
- Allowance for spillage is factored into all calculations

Weight COGS

Determine how much of each category is sold for:

- Liquor (Well, Call, Premium) and beer (bottles, draft)
- Determine percentage of happy hour pricing versus regular pricing

Divide COGS into total purchases for liquor & beer.

Compare resulting figure with what was reported.

## **Steps to determine if purchase markup is necessary:**

Review records that are available from the department.

- Payment record.
- Outstanding bills.
- Non-filers.

Once an auditor arrives at the taxpayers to perform the audit, a determination will be made if sufficient records are available. Do they have cash register tapes, balance sheets, profit and loss statements, general ledgers, sales journal, purchase invoices and check register?

If they do have sufficient records, you will review these records and determine if the proper amount of tax has been paid on purchases and collected and remitted to the Commonwealth.

To ensure that the proper amount has been submitted, you will have to review the cost of goods sold figure. This can be done by dividing purchases for resale by gross sales which will give you cost of goods sold percentage. If this is in line with established guideline figures then the audit is complete.

If the cost of goods sold percentage is high then you must look into the reasons why.

Establish what the selling price is for the different beverages.

If the selling price is low, then that might explain why the cost of goods sold percentage is high.

If the selling price is average for the industry, then that should alert you of possible under reporting of sales.

Even if the taxpayer has all the records necessary to perform the audit there is no way of knowing if all sales were rung up on the cash register or if the cash register was totaled prior to closing. This leads the auditor to question the validity of the records that were given to him.

## **Sales and Use Tax Audit Procedure CATERERS**

**Objective:** Discuss the application of sales and use tax as it applies to **Caterers**.

### **I. References**

- A. Code of Virginia Section 58.1-203 (Note: There is no specific Code related to caterers.
- B. Virginia Administrative Code 23 10-210-930
- C. Ruling Letters
  - Letter dated 6/24/96: Gratuity Charges-Caterer
  - PD 04-223 Item Transferred to Customers - Exempt
  - PD 96-109 Box Lunches-State & Local Governments
  - PD 96-10 Meals Purchased & Sold by Local Governments
  - PD 94-39 Catering Supplies & Equipment
  - PD 93-58 Catering Supplies
  - PD 93-33 Labor Charges of Caterer
  - PD 93-16 Catering Supplies & Equipment
  - PD 92-156 Leases & Rentals-Catering Supplies
  - PD 89-167 Labor Charges by Catering Service
  - PD 88-147 Personnel Supplied by Caterer
  - PD 87-247 Catered Student Meals-Educational Institution
  - PD 87-245 Purchase of Catered Food For Use At County Sponsored Event
  - Ruling of Commissioner-Dated 11/07/84: Meals & Catering Services Provided by Non-Profit State University
  - Ruling of Commissioner-Dated 01/12/82: Meals Purchased by Gov't
- D. Virginia Tax Bulletin 92-10
- E. Applicable exemption certificate: ST-10

### **II. General**

- A. Retail sales by caterers are taxable, including charges for cover, labor, minimum, service, set-up, cleaning, non discretionary tips, etc. Virginia Code 58.1-602 defines sales price as the total amount for which tpp or **services are sold, including any services that are part of the sale.** The only items excluded from the sale price are any cash discounts allowed and taken or finance charges, carrying charges, service charges or interest from credit extended on sales of tpp under conditional sales contracts. (PD 93-33)

- B. Items purchased or leased by a caterer for its own use in preparing and serving meals are taxable to the caterer at the time of purchase and are also subject to tax as part of the sales price to the customer.

### **III. Procedures**

#### **Purchases**

Equipment and supplies leased or purchased by a caterer, for its own use and consumption in preparing and serving meals, are taxable. Examples of some items subject to the tax are:

- Kitchen equipment & supplies
- Cloth linens such as table cloths and napkins
- Serving trays
- Serving utensils
- Serving dishes
- Plates/China
- Glassware
- Silverware
- Tables
- Chairs

The tax is applicable at the time of purchase or rental and must be paid to the vendor. These items were not sold to customers as part of the meals, but instead were consumed by the caterer in providing the meals. The caterer would charge the sales tax on the entire cost of the meals including all charges associated with the providing of the meals, even if separately stated. (PD 93-33, PD 92-156, PD 89-167, PD 88-147, Tax Bulletin 92-10)

The application of the tax to a caterer's purchase or rental of tpp for use in providing food service and the subsequent taxation of the caterer's total charge to its customer for the provision of such services does not constitute double taxation in that these are two separate and distinct transactions for purposes of the application of the sales and use tax. (PD 94-39)

Purchases of items furnished with meals and disposed of after use by a customer are considered part of the meal and may be purchased **exempt** under a Resale Exemption Certificate (ST-10). These items include:

- Disposable paper doilies
- Disposable paper placemats
- Plastic eating utensils, plates, cups, and lids
- Plastic or paper bags
- Disposable serving trays
- Straws
- Paper napkins
- Other similar items

### Policy change

Effective January 1, 2005, the Department will change its policy regarding the application of the sales and use tax to certain purchases by caterers. Effective for purchases made on and after January 1, 2005, items intended to be transferred to the customer will no longer be taxable to the caterer, *i.e.*, the caterer will not be required to pay tax at the time of purchase. Instead, items intended to be transferred to the customer may be purchased for resale by presenting a valid and complete resale certificate of exemption (Form ST-10). Items eligible to be purchased for resale include: party accessories, including invitations, favors and decorations, flowers and flower arrangements, ice sculptures and similar items. In addition, a caterer may rent for resale tables, chairs, tents, gazebos, arches, and similar equipment when such items are obtained on behalf of the customer and the charge for such rented items is passed on to the customer.

### **SALES**

The tax is to be collected on the total amount billed to a customers, including labor, personnel, set-up, cleaning, serving, equipment & supplies used in the provision of the service, flowers, and any other similar items, **even if separately stated on the invoice**. All charges for services provided in conjunction with the provision of food services are subject to the sales tax. This also includes non discretionary tips added by the caterer, including a "minimum" amount of gratuity. (Letter dated 6/24/96, PD 89-167, PD 88-147)

## **SALES TO GOVERNMENTS**

Code of Virginia 58.1-609.1(4) provides an exemption from the sales tax for purchases of tpp by the federal, state and local governments of Virginia. VAC 10-210-690 (VR 630-10-45) provides further guidance on the application of the exemption. VAC 10-210-690 (B) states that charges for catered events are subject to the tax when paid for by the state or local government or public institution of learning, or employees of such, regardless of whether the purchases are made pursuant to required official purchase orders. VAC 10-210-690(B) also provides that the purchases of meals (catering) by the **federal government are exempt provided they are pursuant to an official purchase order.** (Letter dated 6/24/96, PD 96-109, PD 96-10, PD 87-247, PD 87-245, Letter dated 11/07/84, Letter dated 01/12/82)

The department has consistently held sales of meals to local governments and state agencies for consumption by individuals as taxable. However, Public Document 87-245 illustrates one situation in which the sales of food/catered services would be exempt because the food was served to inmates housed in a jail facility operated by a local government.

When auditing an entity that provides catering to local and state governments, taxation has generally been the rule, with only certain exceptions made. The auditor should check for current rulings or changes in law concerning meals/catering to local and state governments. As of this writing, (9/96) there is currently litigation concerning the sales of meals/catering to a non profit college/university. The issue being litigated is the sale of meals for faculty meetings, conferences, etc.

Meals/catering sold in a county run cafeteria to interdepartmental divisions are subject to sales tax since the meals were not consumed by the tax-exempt county. (PD 96-10)

A school, college, certain educational institution and other institutions of learning must collect the sales tax on retail sales of meals to students and others if the price of the meal is not included in room, board or tuition charges or fees. Also catered meals may be purchased exempt of the sales tax if the price of the meals were included in room, board and tuition set by an institution of learning as defined in VAC 10-210-4020. (PD 87-247, Lettered dated 11/07/84)

# Rulings of the Tax Commissioner

**Document  
Number:**

04-223

**Tax Type:** Retail Sales and Use Tax  
**Brief Description:** Caterer; tangible personal property use in the preparation & serving food  
**Topics:** Property Subject to Tax; Taxable Transactions  
**Date Issued:** 12/30/2004

--

December 30, 2004

Re: Request for Ruling: Retail Sales and Use Tax

Dear \*\*\*\*\*:

This is in reply to your letter in which you request a ruling regarding the application of the retail sales and use tax to purchases made by \*\*\*\*\* (the "Taxpayer"). I apologize for the delay in responding to your letter.

## **FACTS**

The Taxpayer is a catering business and questions the application of the tax to purchases of perishable goods and disposable items made in connection with the provision of catering services. The purchases in question are not reusable and transfer to the customer.

## **RULING**

### Current policy

Title 23 of the Virginia Administrative Code (VAC) 10-210-930 addresses the application of the tax to purchases by restaurants in connection with the provision of meals and provides in section F that "[p]aper doilies, paper placemats, plastic silverware, bags and similar items furnished with meals and which are disposed of after use by only one customer are also considered a part of a meal and can be purchased exempt under a Resale Certificate of Exemption." In addition, the regulation provides that "[o]ther items purchased by a restaurant for its own use in preparing and serving meals, such as kitchen equipment, plates, glasses, silverware, tablecloths, and similar items are taxable

and may not be purchased under a Certificate of Exemption."

In applying the above regulation to caterers, the Department's established policy is that a caterer is the taxable consumer of all items and supplies used in connection with providing a meal, except that the food itself and related disposable items may be purchased under the resale exemption. Therefore, the Taxpayer may purchase for resale the food and disposable items that transfer to the customer and are not reusable.

The tax must be paid on all other purchases made in connection with the provision of catered food. The application of the tax to purchases by caterers is set out in a number of prior rulings of the Tax Commissioner, including Public Documents 89-187 (5/22/89) and 93-33 (2/24/93). In addition, Virginia Tax Bulletin 92-10 (11/4/92) discusses the application of the tax to providers of meals, including caterers.

### Policy change

Effective January 1, 2005, the Department will change its policy regarding the application of the sales and use tax to certain purchases by caterers. Effective for purchases made on and after January 1, 2005, items intended to be transferred to the customer will no longer be taxable to the caterer, *i.e.*, the caterer will not be required to pay tax at the time of purchase. Instead, items intended to be transferred to the customer may be purchased for resale by presenting a valid and complete resale certificate of exemption (Form ST-10). Items eligible to be purchased for resale include: party accessories, including invitations, favors and decorations, flowers and flower arrangements, ice sculptures and similar items. In addition, a caterer may rent for resale tables, chairs, tents, gazebos, arches, and similar equipment when such items are obtained on behalf of the customer and the charge for such rented items is passed on to the customer.

It is important to note that the caterer must document all purchases and rentals of the aforementioned items for resale purposes. The charges to the customer for such items must be separately stated on the invoice to the customer. It must be evident that the charges being incurred by the caterer for the customer are the same charges that are being passed on to the customer and on which tax is collected from the customer.

The caterer will continue to pay the tax on purchases of tangible personal property for its use in the preparation and serving of food as under the current policy. In addition, the caterer must pay the tax on purchases of reusable items.

The regulation, public documents and Tax Bulletin cited are available on-line in the Department's Tax Policy Library, located at [www.policylibrary.tax.virginia.gov](http://www.policylibrary.tax.virginia.gov). If you have any questions regarding this ruling, you may contact \*\*\*\*\* in the Office of Policy and Administration, Appeals and Rulings, at \*\*\*\*\*.

Sincerely,  
Kenneth W. Thorson  
Tax Commissioner

**Sales and Use Tax Audit Procedure**  
**Controlled Drugs, Medicines, Durable Medical Equipment, Nonprescription**  
**Drugs and Proprietary Medicines**  
**Revised 8/2006**

**Objective:** Discuss the application of the sales and use tax as it applies to controlled drugs, medicines, durable medical equipment, prosthetic devices, nonprescription drugs and proprietary medicines.

**I. References**

- A. Code of Virginia Section 58.1-609.7 (1) (2) (3)(15)(20)
- B. Virginia Administrative Code VAC 10-210-940 (C)(E)(F)(G)
- C. Applicable Caselaw

Northern Virginia Doctors Hospital Corporation v. Department of Taxation - Exemption for drugs sold to a for-profit hospital by a pharmacy upon written order of a physician.

Bluefield Sanitarium, Inc v. Department of Taxation - Taxability of drugs purchased by a for-profit hospital's pharmacy for distribution by work order of physician to patients.

Bio-Medical Applications of Roanoke Inc. v. Department of Taxation – Purchase of drugs by a clinic to treat patients. Drugs held taxable.

Sentara Enterprises Inc v. Virginia Department of Taxation – drugs purchased and sold through clinics to patients of the clinics are taxable similar to Bluefield Sanitarium.

Effective 7/1/06, the medicines and drugs exemption was expanded to include medicines and drugs purchased by for-profit nursing homes, clinics and similar corporations.

Effective 7/1/00, the medicines and drugs exemption was expanded to include medicines and drugs purchased by licensed hospitals. Drug purchases are exempt for any licensed profit hospital from 7/00 forward.

Effective 7/1/98 all nonprescription and proprietary medicines are exempt from sales and use tax. “Nonprescription drugs” include any substance or mixtures of substances containing medicines or drugs for which no prescription is required and which are generally sold for internal or topical use in the cure, mitigation, treatment, or prevention of disease in human beings. “Proprietary medicines” are any nonprescription drug sold to the general public under the brand name or trade name of the manufacturer and does not contain any controlled substance or marijuana. The exemption does not apply to cosmetics.

D. Ruling Letters

- P.D. 84-63 - Definition of Controlled Drug
- P.D. 91-24 - Supplies used with feeding equipment, ostomy supplies and liquid nutrients
- P.D. 91-43 -Third party billings – medicaid, medicare - Liquid nutrition sold on prescription for use in enteral and parenteral feeding equipment. See PD 92-118 and 95-182.
- P.D. 92-67 - Vitamins, minerals and food supplements.
- P.D. 92-97 - Drugs sold to clinics by affiliated pharmacy
- P.D. 92-118 -Various medical supplies, Third party billing See P.D. 91-43, P.D. 95-182
- P.D. 94-109 - Breast and chin implants
- Commissioners Ruling (4/25/94) - Clarification on implants for cosmetic purposes
- P.D. 95-182 - Changes in legislation regarding third party billings. Department of Medical Assistance Service reimbursement for medical supplies. See PD 91-43, 92-118.
- P.D. 95-266 - Infusion pumps and documentation required for D.M.E. "bought for an individual"
- P.D. 96-47 - Exemption for drugs and fluids used in chemotherapy treatments
- P.D. 96-64 - Taxability of dietary/nutritional supplements
- P.D. 97-253 - Sales to physicians, drug samples, sales to***

---

Veterinarians

- P.D. 97-488 - Taxability of acupuncture supplies
- P.D. 98-98 - Exemption for Nonprescription Drugs and Proprietary Medicines
  - P.D. 99-32 -Taxability of homeopathic medicines, astringents, natural foods and supplements
  - P.D. 00-203 – Taxability of bath additive products
- P.D. 92-172 - Home infusion therapy pharmacy's purchase of controlled drugs is taxable as part of the rendition of services.
  - P.D.97-322 - Pharmacy corporation's provision of controlled drugs to affiliated hospitals is a service similar to Bluefield Sanitarium. See also PD 04-118. 04-49
  - P.D. 00-47 - Pharmacy corporation's provision of controlled drugs to hospital is a service similar to Bluefield Sanitarium. Pharmacy not a retail establishment
  - P.D. 00-215 – Bulk Purchase of DEM later modified for a specific patient.

P.D. 03-1 - Distinction between medical "drug" and medical "device"

P.D. 03-30 - Taxability of spas & hot tubs

P.D. 04-116 – Agency relationship between clinic and a  
management

Company

P.D.04-136 – DMAS exemptions as it applies to nutritional  
supplements

P.D. 05-106 – Taxability of installed wheelchair lift

P.D. 05-135 - Determining whether item meets non prescription drug exemption - Metamucil

E. Tax Bulletin 98-4 (5/15/98) – Exemption for Nonprescription Drugs & Proprietary Medicines

F. Nonprescription Drug Exemption Teleconference Question & Answer Summary

G. Exemption Certificate - ST-13 (Effective July 1, 2001 a letter with a ten digit number ending with E, will be issued by the Department to qualified non-profit organizations)

## II. Generally

A. Controlled Medicines and Drugs - The sale of controlled medicines or drugs, including oxygen, pursuant to a written prescription of physicians and dentists are exempt from tax. Purchases by physicians (for use in their professional practice), Nonprofit hospitals and nonprofit nursing homes are also exempt. Licensed retail pharmacies may purchase controlled drugs under the resale exemption. Effective July 1, 2000, any licensed hospital may purchase medicines and drugs for its use and consumption exempt of the tax. Effective July 1, 2006, the tax exemption for medicines and drugs was again expanded to include purchases by for-profit nursing homes, clinics, and similar corporations. Effective July 1, 1996 an exemption is provided for samples of pharmaceutical products and their packaging distributed free of charge in Virginia to authorized recipients in accordance with the Federal Food, Drug and Cosmetic Act. The term controlled drugs is further restricted to drugs under Schedules I-VI of the Virginia Control Act, Sections 54.1-3446 through 54.1-3456. Generally, controlled drugs and prescription drugs are synonymous in Virginia.

B. Durable Medical Equipment (D.M.E.) - The exemption for D.M.E. applies to those general categories listed in the regulations or other specific items, which meet the definition below. These D.M.E. items must be purchased by an individual or on their behalf in order to qualify for the exemption. They also must meet 4 criteria: (1) can withstand repeated use (2) is primarily and customarily used to serve a medical purpose (3) generally is not useful to a person in the absence of illness or injury; and

(4) is appropriate for use in the home. See Code of VA 58.1-609.7 (2). Bulk purchases by health care providers for later distribution to patients do not qualify for the exemption.

- C. Prosthetic Devices - The exemption for prosthetic devices applies specifically to those devices purchased by and on behalf of an individual for use by that individual. Bulk purchases for later use or modification are taxable if no other exemption applies (such as that of a nonprofit hospital).
- D. Nonprescription drugs and proprietary medicines – Effective July 1, 1998 the sale of nonprescription drugs and proprietary medicines are exempt from retail sales and use tax. The exemption is applicable regardless of the nature of the purchaser. These may be purchased tax-exempt by individuals, physicians, medical facilities, and all other entities. In addition, effective July 1, 1998, samples of nonprescription drugs and proprietary medicines distributed free of charge by the manufacturer are exempt from the sales and use tax. The exemption includes packaging materials and constituent elements and ingredients. The exemption does not apply to cosmetics.

### **III Definitions**

- A. Controlled Drugs - Shall mean those drugs itemized under Virginia Code Sections 54.1-3446 through 54.1-3456, but shall include only medicines and drugs and not devices.
- B. Prosthetic Devices - Shall mean devices, which replace a missing part or function of the body and shall include any supplies physically connected to such devices (i.e. ostomy supplies but does not include general supplies such as tape and gauze).
- C. Prescription - Shall mean and include an order for drugs and medical supplies, written, signed or transmitted by word of mouth, telephone, telegraph, or other means of communication to a pharmacist by a duly licensed physician...or other practitioner, authorized by law to prescribe and administer such drugs or medical supplies.
- D. Durable Medical Equipment - is that which:
  - 1. Can withstand repeated use
  - 2. Is primarily and customarily used to serve a medical purpose
  - 3. Generally is not useful to a person in the absence of illness or injury
  - 4. Is appropriate for use in the home

(NOTE: All 4 criteria must be met for an item to be deemed D.M.E.)

- E. Prescription Drug – shall mean any drug required by federal law or regulation to be dispensed only pursuant to a prescription, including finished dosage forms and active ingredients subject to the federal Food, Drug, and Cosmetic Act. (Code of Virginia § 54.1 – 3401)
- F. Nonprescription Drugs – Shall mean any substance or mixture of substances containing medicines or drugs for which no prescription is required and which are generally sold for internal or topical use in the cure, mitigation, treatment, or prevention of diseases in human beings.
- G. Proprietary medicines – Shall mean any nonprescription drug sold to the general public under the brand name or trade name of the manufacturer and which does not contain any controlled substance or marijuana.

#### **IV. Procedures**

- A. Medicines and Drugs - The exemption for medicines and controlled drugs is "purchaser specific". In order for the exemption to apply, purchases of controlled drugs and medicines must be made by an exempt entity, a licensed pharmacy, or purchased pursuant to a physician's prescription. First, the auditor will determine the taxability of the purchaser of the drugs or medicines. The auditor should note that the exemptions for medicines and drugs has been expanded several times and therefore the timing of purchases may be a important factor. If the purchaser is an exempted medical facility or a licensed pharmacy, all purchases of drugs and medicines will be exempt and no further examination of the drug purchases is required. The exemptions for various medical facilities are outlined in P.D. 89-254 and also detailed under medical facilities/health care providers. If the purchaser is a taxable entity, then the auditor will decide if the transaction meets one of the other criteria for exemption. The auditor should also keep in mind the legislative change in 7/1/98 previously noted exempting all sales of nonprescription and proprietary medicines as well as the legislative changes in 2006.

The tax does not apply when the ultimate consumer or a taxable entity purchases drugs or medicines on a physician's or dentist's written or oral prescription provided it is reduced to writing. The issue before the Court in Northern Virginia Hospital was whether or not the issuance of drugs in that case constituted a sale of drugs on a "prescription or work order" of a licensed physician. The drugs were purchased by the hospitals patients on physician's work orders from a conventional pharmacy operating separate and apart from the hospital. The sale constituted a sale of drugs on a prescription or work order and the transactions were deemed tax exempt.

This contrasts with Department of Taxation vs Bluefield Sanitarium Inc in which a taxable entity purchased drugs in bulk for later distribution to its patients. Although some of the drugs may later be distributed to patients per a doctor's prescription, the bulk purchase by the taxable hospital was considered a taxable purchase necessary in the rendition of medical services to their patients. The distinction between drugs sold pursuant to a prescription and bulk purchases is also addressed in P.D. 92-97. Clinics that provide "internal" pharmacy sales to its patients did not satisfy the definition of a retail pharmacy operation and were taxable on all bulk drug purchases.

The auditor should be aware that there is a difference in "controlled drugs" and nonprescription drugs. "Controlled drugs" are those listed in Schedules I-VI of the Virginia Control Act, Sections 54.1-3446 through 54.1-3456. An easy method for determining if a drug is controlled is to look at the packaging materials for the drug. "Controlled drugs" all have a federal warning on them such as "...Federal Law prohibits the dispensing without prescription". Also, most injectables (sold in "cc" units) are controlled and therefore exempt. A recent ruling, P.D. 96-47, also specifically exempted normal saline (when dispensed intravenously), Zofran, and Decadron used in administering chemotherapy treatment. Most physicians keep a copy of the Physicians Desk Reference or "PDR" in their office. This is a helpful tool in identifying prescription/controlled substances.

The exemption would also include vitamins and minerals dispensed on a physician's prescription, but would not extend to vitamins or dietary supplements used in weight loss programs. (See P.D. 92-97) The controlled drug exemption does not apply to supplies and medical products, which are not normally, considered medicines.

In order to purchase drugs under the "resale" exemption, the seller or physician must hold a special certificate from the Board of Pharmacy, which allows them to "retail" drugs and fill prescriptions accordingly. In the case of a physician, use tax should be remitted on any items (other than controlled drugs) which are withdrawn from the resale inventory for their own use (PD 84-63). Some clinics actually have "mini-pharmacies" in their locations as a convenience to their patients. When their physicians write a prescription, the patients can elect to have it filled by this internal pharmacy. Normally, the clinics' pharmacies are not licensed as noted above and only provide this service to their own patients. This is considered an extension of their medical services and the resale exemption would not apply (P.D. 92-97).

(Effective 7/1/2006, all licensed hospitals, nursing homes and clinics and similar corporations are exempt on purchases of drugs and medicines)

- B. Durable Medical Equipment (D.M.E.) - The exemption for durable medical equipment only applies when the D.M.E. is purchased by or on behalf of an individual and it meets the definition of D.M.E. set forth in the regulations. An extensive list of D.M.E. is provided to assist in making this determination. The seller and purchaser of these products must maintain sufficient records to substantiate that the purchase was made for a specific individual's use. Also, legislation passed in 1995, has changed the taxability of purchases by a Medicaid recipient through a Department of Medical Assistance Service (D.M.A.S.) agreement. Examples of items that can be purchased tax exempt under the D.M.A.S. agreement are bandages, gauze dressings, incontinence products and wound care products.

D.M.E. is medical equipment which can withstand repeated use, is generally and customarily used to serve a medical purpose, is not useful to a person in the absence of illness or injury, and is appropriate for use in the home. If a product does not meet all four criteria, it cannot be exempted as D.M.E. For example, adult diapers are disposable and therefore cannot withstand repeated use, therefore the exemption does not apply (P.D. 92-118). Supplies, which are specifically designed for use with exempt D.M.E., are also extended the exemption. A good example of this is P.D. 92-24, which provides an exemption for tubes, pumps, and containers used in conjunction with enteral or parental feeding equipment.

Once it is determined that a specific medical item qualified as D.M.E., it must be verified that it was purchased by or on behalf of an individual for use by such individual. When taxable medical facilities and physicians purchase D.M.E. for their patients, they must maintain sufficient documentation to verify that it was bought for a specific patient. In many cases a patient's name appears on the purchase order and invoice, which is sufficient. If this is not the case, then the seller must obtain a signed statement from the purchaser certifying to the effect that the D.M.E. is purchased on behalf of a specific patient through a doctor's prescription or profit hospital's order and is for sole use by such patient. The seller must also retain a copy of the prescription or work order as part of the record of the transaction (P.D. 95-266). Bulk purchases for later distribution to patients by any physician or taxable facilities do not qualify for the exemption.

When an audit is being performed on medical facilities or D.M.E. retailers, the issue of third party billings may have to be addressed. In the past, the tax status of transactions in which an item is sold to an individual is determined at the time of the sale to the individual and is not effected by the source of reimbursement (P.D. 91-43). However, the tax due is not on the total charge submitted to the third party for reimbursement, but is

based on the actual reimbursement amount which is allocated to sales, nontaxed charges and tax based on the percentages to the original total charge (P.D. 95-182). Effective April 6, 1995, legislation was passed exempting from sales tax medical products and supplies such as bandages, gauze dressings, incontinence products and wound care products when purchased by a Medicaid recipient through a D.M.A.S. provider agreement. Billings to any other third party payers will continue to follow the procedures outlined previously.

- C. Prosthetic Devices - The exemption for prosthetic devices is similar to that for D.M.E. in that it only applies when the devices are purchased by or on behalf of an individual using these items. The same documentation requirements are required for these purchases as previously mentioned for D.M.E. The purchases of prosthetic devices are normally on a per patient basis due to the individual nature and use of the device.

The taxability of implants is an area that requires further comment. Implants, such as breast and chin, are considered exempt when purchased by a licensed physician (normally a plastic surgeon) on behalf of a patient, and are used in reconstructive surgery to replace a missing body part. However, implants used for cosmetic purposes do not meet the definition of "prosthetic device" (VAC 10-210-940(B)) and therefore do not qualify for exemption (P.D. 94-109 / PD 94-127). A general rule that should aid the auditor in making this distinction is that normally, insurance companies will not reimburse the physician when the surgery was performed for cosmetic purposes. Also, plastic surgeons will normally order an extra implant on behalf of the patient in case there is a defect, which might be discovered during surgery. If the original implants were exempt then this would extend to the extra implants purchased. Again, bulk purchases are not exempt from tax even if an item later is withdrawn from inventory and modified or fitted for a specific individual.

- D. Nonprescription Drugs and Proprietary Medicines – The exemption for nonprescription drugs and proprietary medicines is item specific. Who or what entity purchases the nonprescription drugs and proprietary medicines is not relevant because these medicines are always exempt. No exemption certificate is necessary.

The auditor must determine whether an item purchased is a nonprescription drug or proprietary medicine. The department considers three factors to determine if a product falls within the scope of the exemption: (1) Is the item a nonprescription drug (i.e., is the product a substance or mixture of substances containing medicines or drugs for which no prescription is required; (2) is the product for topical or internal use; and (3) is the product for the cure, mitigation, treatment, or prevention of a disease in human beings. (See Nonprescription Drug

exemption Teleconference Questions & Answer Summary) If the taxpayer is computerized, you may be able to go into its software and determine if these drugs and medicines are marked as tax exempt. Cosmetics, toilet articles, food products, and supplements, devices, vitamins and mineral concentrates sold as dietary supplements or adjuncts are taxable. If the taxpayer is not computerized, each individual sale must be examined to insure tax is not charged on the exempt medicines but is charged on the taxable items. Retail dealers making sales of nonprescription drugs and proprietary medicines must keep records segregating purchases and sales of exempt items.

If tax is being charged on nonprescription drugs and proprietary medicines the auditor must insure that this sales tax is being remitted to the state. No refund is to be made to the retailer until it demonstrates that it has refunded this overcollection of sales tax to the corresponding customer(s).

Effective July 1, 1998 samples of nonprescription drugs and proprietary medicines distributed free of charge by the manufacturer, including packaging materials and constituent elements and ingredients are exempt from sales and use tax

At the conclusion of the audit, the auditor should ensure the taxpayer is operating in accordance with the law change effective July 1, 1998 as it applies to nonprescription drugs.

#### *V. Use of ST-13 Exemption Certificates*

The ST-13 has been revised as of July 2001 and should be used by the specific purchasers listed and for the specific items and products listed on the exemption certificate form.

The ST-13 should not be used by nonprofit hospitals, nonprofit hospital cooperatives and nonprofit hospital corporations, nonprofit nursing homes, nonprofit adult homes, and other nonprofit medical facilities that are entitled to exemptions. These entities are provided an exemption letter and registration number by the department, which should be provided to their vendors to make tax exempt purchases.

Effective 7/1/2004 – **all** nonprofit organizations that qualify for the expanded Non Profit exemption must apply and obtain the Non Profit Exemption Letter from TAX. This letter should be provided to their vendors to make tax-exempt purchases.

## Sales and Use Tax Audit Procedure Mining and Mineral Processing

**Objective:** Discuss the application of sales and use tax as it applies to mining and mineral processing.

### I. History

**Prior to March 1983.** Mining and mineral processing was a part of manufacturing and processing.

**March 1983.** A separate section of the Retail Sales and Use Tax Regulations was created for mining and mineral processing, and included gas and oil well drilling.

**September 7, 1984 and after.** Commonwealth of Virginia v. Wellmore Coal Corporation modified the interpretation of *used directly*.

**July 1985 and after.** The Code of Virginia was amended to include in the definition of the term “used directly” in relation to mining, any reclamation activity of the land previously mined by the mining company required by state or federal law.

**July 1, 1994 and after.** Gas and oil well drilling was removed from the mining and mineral processing exemption.

### II. References

Code of Virginia Section 58.1-602 and 609.3.2

Virginia Administrative Code 23 VAC 10-210-960

<u>Ruling Letters</u>	<u>PD 92-236</u>	<u>PD 95-187</u>
	PD 95-321	PD 96-16

Commonwealth of Virginia v. Wellmore Coal Corporation

Applicable exemption certificate ST-11, ST-11A

**III. General**

- A. Code of Virginia Section 609.3.2 exempts machinery or tools or repair parts therefor or replacements thereof, fuel, power, energy, or supplies, used directly in processing, manufacturing, refining, mining or converting products for sale or resale. Machinery, tools and equipment, or repair parts therefor or replacements thereof, shall be exempt if the preponderance of their use is directly in processing, manufacturing, refining, mining or converting products for sale or resale.

B. *Definitions*

"Used directly," refers to all steps of the integrated mining process, but does not include ancillary activities such as general maintenance or administration. It also includes reclamation activities required by state or federal law when performed by the mining company on land which it has previously mined.

The fact that particular property may be considered essential to the conduct of the business of mining or mineral processing because its use is required either by law or by practical necessity does not, of itself, mean that the property is used directly in mining or mineral processing.

Mining and processing are separate and distinct activities. If the ore or mineral excavated is subject to further mineral processing, the exemption continues.

"Mining" means both deep and strip mining, quarrying, and other industrial removal of natural resources, minerals, or mineral aggregates from the earth. It does not include the extraction from tailing piles which because of technological advances in processing have become economic mineral deposits.

Direct use in mining begins with the drilling of the shaft in deep mining or the removal of the overburden in strip mining, auger mining or quarrying and ends with the conveyance of the mined product to storage or stockpile at the mine site.

"Mineral processing," is the preparation, refining or concentrating of the ore, resource or mineral subsequent to extraction and prior to distribution for sale and includes cleaning, grading, washing, cracking, crushing, refining and similar processing of the mineral or resource.

**Direct use in mining processing begins with the handling and storage of the raw material at the processing plant site and ends with the conveyance of the processed product to storage at a stockpile at the plant site.**

*Exploration*

**Exploration is the search for economic deposits of minerals, ore or coal, and includes the mapping and design of the mine site. All tangible personal property used in exploration is subject to the tax, including drilling equipment used to test the earth and surveying equipment.**

**D. Site Preparation**

Site preparation is the preparation of the mine and includes the removal of the overburden, the clearing of the land at the mine site, construction of access roads, and the construction of tunnels, shafts, and passageways in underground mines.

Removal of the overburden in surface mining operations and at the opening of a deep mine tunnel are part of the mining process, and tangible personal property used in these removal processes is not subject to the tax. Construction of tunnels, shafts, and passageways in underground mines is also an exempt activity.

Other land clearing activities at the mine site or the mineral processing plant site, such as for the construction of a processing plant or office buildings, and the construction and maintenance of access roads, are not a part of mining and property used in such activities is subject to the tax.

*E. Extraction*

Extraction is the actual removal of the mineral, ore or natural resource from the earth. It includes severing of the mineral, hauling the mine product from the mine face to a stockpile at the mine site for storage, and reconstruction of tunnels, shafts, and passageways in deep mines. Tangible personal property used directly in extraction is not subject to the tax.

Such items include digging, blasting, and extracting equipment, mine roof support materials, drainage pumps used within the mine, ventilation and dust control equipment used in the mines, transportation devices and equipment used to haul extracted product from the mine face or pit to a stockpile located outside the mine or pit, personnel and supply cars, fuel, supplies, lubricants and repair or replacement parts for exempt equipment, telephones used within the mine, and protective apparel and protective materials furnished to production employees.

In Commonwealth v. Wellmore Coal Corporation, it was ruled that methanometers and first aid supplies are also protective materials and are therefor exempt.

Items found to be both essential and used immediately in deep mining, may not meet the direct use test in surface mining. In PD 95-231 the Tax Commissioner upheld the taxing of water trucks used to control dust in surface mining, although dusting control equipment used in deep mining is exempt. He did, however, rule that because of the broad expanse of land involved in a surface mining operation, two-way radio systems used to coordinate work from different areas of the job site are exempt.

Mining does not include the extraction from tailing piles. No mining or processing occurs in this process. It does not entail the severance or extraction of minerals from the earth as extraction from the mine has already occurred, and no further processing occurs.

F. Transportation from the mine site

Transportation of the mined product to another location other than for further mining processing is taxable. When the mine and mineral processing plant is owned and operated by the same person, transportation from the mine site to the mineral processing site is an exempt activity.

Prior to the Wellmore court case, all road building and maintenance equipment and supplies, and automotive parts, tires and supplies used on licensed vehicles were taxable. If the mine and the mineral processing sites were not connected by a private transportation system, they were deemed to be two separate sites and the transportation between the two was taxable.

The Virginia Supreme Court in Wellmore ruled that transporting the coal to the tipple is part of the mining process. Exempt transportation is not limited to the transportation occurring at the plant site. The Court ruled that repair parts and supplies for all trucks used to haul coal between mines and the tipple are exempt. Materials used to build and maintain coal haul roads are used directly in the process of mining and are not taxable. The road maintenance materials facilitate transportation of the coal from the mines to the tipple for processing.

#### G. Mineral Processing

Mineral processing begins with the handling and storage of the raw material at the processing plant site and ends with the conveyance of the processed product to storage at a stockpile at the plant site. It was ruled in the Wellmore Court Case that weighing of the coal at the tipple, or processing site, is a part of processing because it constitutes handling of raw materials.

Tangible personal property used to clean, grade, wash, crack, crush, and similarly process the mineral or resource is exempt.

Plant construction and administration are not a part of mineral processing and are taxable activities.

Construction materials such as concrete, structural steel, and roofing which become permanently incorporated into the processing plant, and machinery and tools used in the construction of the plant are subject to the tax.

Steel or similar supports which are component parts of exempt processing equipment or machinery and which do not become permanently affixed to realty are not subject to tax. Concrete foundations onto which such supports are bolted, floors on which machinery rests, and structures housing equipment and machinery are not used directly in processing and are subject to the tax.

Inspection and testing to determine the quality of the product and to determine if the product meets industry standard is deemed to be a part of mining and mineral processing and is an exempt activity.

Any testing not related to product quality control is not part of mining or mineral processing and is a taxable activity. Examples of taxable research are efficiency surveys, management studies, consumer surveys, economic surveys, advertising, or promotions.

#### **H. Refuse**

**Transportation of a waste product from the processing plant to a waste dump at the plant site is a part of production line quality control and is included in mineral processing. Systems used to transport the waste product from the production line at the processing plant to the dump are not subject to tax provided the dump is located at the processing plant site and the transportation to the dump is continuous and without interruption. The dump must be connected to the processing plant via a private transportation system entirely owned or leased by the processor. If public roadways or transportation systems are used between the processing plant and the dump, no exemption is available for property used to convey the waste between the two sites.**

**In PD-236, the Tax Commissioner ruled that materials used in the construction of refuse hauling roads are taxable. Only roads used in the transportation of coal for further processing are exempt.**

#### **I. Repairs and Maintenance**

Repair and maintenance is the repair of machinery, tools and equipment, routine maintenance in order to insure that machinery and equipment are in good working order, and the repair and maintenance of offices, outbuildings, and other real or tangible personal property connected with the operation of the mine.

Repair and maintenance is not mining. Therefore, repair and maintenance facilities, including tools, supplies, machinery and equipment used in performing repair and maintenance work are subject to the tax.

Replacement and repair parts for exempt machinery and equipment, as well as operating supplies which are actively and continually consumed in the operation of exempt machinery and equipment, are deemed used directly in mining and mineral processing and are not subject to the tax.

Machinery and tools used by the person engaged in mining or mineral processing to fabricate exempt machinery or equipment are exempt from the tax if the preponderance of their use is in an exempt manner.

#### J. Distribution

Distribution is the transport or conveyance after the completion of mining or processing of the product and is not a part of mining or mineral processing. It includes the storage of the product subsequent to its extraction (other than for further processing) or processing, and the actual transport of the product for sale. All tangible personal property used to convey, transport, handle or store the product is taxable.

#### K. Reclamation

Reclamation is the restoration or conversion of mined land to a stable condition and the ongoing restoration or conversion of land currently being mined prior to total site reclamation. The process includes recontouring, reseeding, and reforesting the land. Reclamation activities required by state or federal law are a part of the mining process when performed by a mining company on land which it has previously

mined. Reclamation activities which are not required by federal or state law are not a part of mining and tangible personal property used in such activities is subject to the tax.

The Tax Commissioner ruled in PD 95-187 that, although required by law, the reclamation of access roads, refuse areas and areas other than the land that was actually mined, is not considered part of the mining process.

#### L. Pollution Control

Any property or facility which has been certified by the Department of Environmental Quality as being used primarily for the purpose of preventing or abating air or water pollution is not subject to the tax. This is applicable to both real and tangible personal property. Only certified property or facilities qualify for exemption.

Tangible personal property used in or at settling ponds, refuse areas and other spoil areas are typically used to prevent or abate pollution. Once certified, such property is exempt.

#### M. Contracted Activities

The mining and mineral processing exemption extends to persons engaged in any phase of mining or mineral processing, provided such activities qualify for exemption. This requires that activities be performed at the mine or mineral processing plant site.

In PD 96-16, the Tax Commissioner ruled that a trucking company under contract to haul coal from the mine to the tipples with a coal company who owns both the mine and the processing facility may purchase trucks and truck parts tax exempt.

#### N. Preponderance of Use

When a single item of tangible personal property is used in both exempt and taxable activities, the sales and use tax shall apply in full when the preponderance of the item's use (fifty percent or more) is in taxable activities. Likewise, the item will be totally exempt from the tax if the preponderance of its use is in exempt activities.

### *IV. Audit Procedures*

When auditing coal mining companies, the auditor will primarily reviewing expensed purchases and fixed assets. Typically the only sales requiring review are disposals of fixed assets.

Begin with a discussion of the taxpayer's operation. Some mining companies perform all the functions of mining and mineral processing. Others perform only the mining function. Others will contract out such functions as extraction, coal hauling, and reclamation. The taxpayer may have locations both within and without Virginia.

Request a listing of all the taxpayer's related companies. The listing should include a brief description of each company's business and the location of the business operation. It is not unusual for a coal company to have several related mining companies, as well as non-mining entities. Utilize the taxpayer's income tax returns to verify that the listing is complete.

Determine the type of mines, such as deep or strip, that the taxpayer operates and the type of facilities owned by the taxpayer. Schedule a tour of the facilities prior to reviewing invoices so that areas of potential liability such as clean coal stock piles, loadouts, refuse haul roads, repair shops,

bathhouses and administrative buildings can be identified. Especially note which pieces of heavy equipment are being used in taxable areas.

Review the disposals of fixed assets for possible taxable sales.

Determine how each item listed on the depreciation schedule or other fixed asset listing is being used. Determine the preponderance of use for items used in both taxable and exempt activities. The burden of proof is on the taxpayer to document that an item's use is more than 50% exempt. Assets used indirectly in mining transferred from a related company may be taxable at their current value if no tax was paid on the original purchase. The use of the asset may have changed, making it taxable, or it may have been transferred from a non-Virginia location where the item enjoyed a sales tax exemption.

Purchases of equipment used to abate or control air or water pollution must be certified in order to be exempt. The taxpayer should provide documentation that the equipment has been certified, or obtain certification during the audit. If not, the equipment should be taxed.

Some expensed items purchased by the taxpayer may be exempt or taxable depending upon their use. For example, stone for refuse haul roads is taxable, but stone purchased for use on coal haul roads is exempt. When reviewing purchase invoices, a chart of accounts or general ledger with a brief account description should be used to help determine the taxability of expensed purchases. Information written on the purchase order or on the invoice itself may assist the auditor in determining how an item is used. If the accounts or descriptions are too general or if the items are purchased in bulk, the items should be taxed at an agreed to percentage. Fuel and other supplies identified as being purchased for a particular piece of equipment should be prorated even though the equipment, itself, may be totally taxable or exempt because of the preponderance of its use.

## **Sales and Use Tax Audit Procedure Auto Dealers and Auto Repair Shops**

**Objective:** Discuss the application of sales and use tax (retail sales tax) as it applies to auto dealers and auto repair shops.

### **I. History**

**1/1/90 and after.** Tire Tax was imposed.

**1/1/95 and after.** As a result of Tax Bulletin 94-10, all dealers in the business of selling tires, anti-freeze, motor oil, and other like automotive accessories, who charge a disposal fee in connection with the sale of such items, are required to collect the retail sales tax on the disposal fee, even if it is separately stated. By contrast, dealers who provide disposal services totally independent of the sale or provision of tpp are deemed to be providing a nontaxable service. Taxable fees on which no retail sales tax was charged should not be listed or extrapolated prior to 1/1/95.

**1/1/96 and after.** Code of Virginia § 58.1-609.5(9) subjects parts and labor maintenance agreements to the retail sales tax at one-half (50%) of the total charge.

**12/96 and after.** The department's position on certain shop supplies transferred to customers changed. Transferable bulk supplies can now be purchased exempt if they are included in a taxable one price charge or shown separately as a taxable line item on the customer invoice. Since this is a change in interpretation, it applies on a prospective basis. There is no change regarding shop supplies that are not transferred to the customer.

### **I. References**

#### **A. Code of Virginia Sections**

58.1-602	Definition of "Motor Vehicle"
58.1-609.1(2)	Motor Vehicle Exemption
58.1-609.3(10)	Limited Exemption for Taxicab Operators
58.1-609.5(2)	Repair Labor Exemption
58.1-609.5(9)	Parts & Labor Maintenance Contracts
58.1-609.7(6)	Special Equipment-Handicapped

B. Virginia Regulations

23 VAC 10-210-10	(VR630-10-1)	Adjustments, replacements and warranties.
23 VAC 10-210-910	(VR630-10-62.1)	Maintenance contracts and warranty plans.
23 VAC 10-210-990	(VR630-10-67)	Motor vehicle sales, leases, and rentals, repair and replacement parts and maintenance materials; taxicabs.
23 VAC 10-210-1000	(VR630-10-68)	Motor vehicle dealers.
23 VAC 10-210-1020	(VR630-10-70)	Motor vehicle refinishers, painters and car washers.
23 VAC 10-210-3050	(VR630-10-90)	Repair businesses.
23 VAC 10-210-4000	(VR630-10-95)	"Sales price" and "cost price."
23 VAC 10-210-4040	(VR630-10-97.1)	Services.

C. Ruling Letters

P.D. 97-73	Environmental charges for disposal or recycling are taxable.
P.D. 97-51	No DMV tax was paid so trailer rental was subject to 4.5%.
P.D. 96-392	Automotive refinishers = service - consume all supplies.
P.D. 96-389	Transferable bulk supplies may be purchased exempt.
P.D. 96-342	Vehicle painting facility must pay tax on paint purchases.
P.D. 96-331	Treatment of monitoring services and tracking devices.
P.D. 96-318	Treatment of undercoating and paint & fabric protectors.
P.D. 96-157	4.5% tax due on mobile office rental if no DMV tax paid.
P.D. 96-34	Farm licensed vehicle - may require proration by farmer.
P.D. 95-327	Vehicle pricing guides sold on subscription are exempt
P.D. 95-73	Sale of maintenance contract to common carrier is exempt.
P.D. 95-54	Automotive parts sales to churches are taxable.
P.D. 95-14	After vehicle is titled, upfittings subject to 4.5% tax.
P.D. 94-301	Parts for farm service vehicles are taxable.
P.D. 94-6	Replacement parts for long term lease vehicles are taxable.
P.D. 91-14	Motor oil used in maintenance of rental vehicles is exempt.
P.D. 89-294	Special equip. exempt if purchased by handicapped driver.
P.D. 89-115	Limited exemption for taxicab operators - paint is taxable.
P.D. 88-299	Computer database modem access is non-taxable service.
P.D. 88-210	Extended service agreement deductible is not taxable.
P.D. 88-20	Computer pricing update is taxable if transferred on disks.
P.D. 87-275	Shop supplies taxable at purchase+warranty deductibles.
P.D. 87-264	Taxed warranty plans-transactions between dealer & issuer.
P.D. 87-262	Repair parts exempt if replaced under mfr. warranty.
P.D. 87-261	Shop supply charge not taxable to customers.
P.D. 87-94	Extended warranty plans sold by the dealer are taxable.

- P.D. 86-150 Insurance companies must pay tax on policyholder parts.
- P.D. 86-118 Taxability of demonstrator motor vehicles.

D. Virginia Tax Bulletins

- 95-8 Parts and Labor Maintenance Contracts
- 94-10 Application of the Sales Tax to Disposal Fees on Waste Tires and Other Environmentally Hazardous Materials

E. Applicable exemption certificate: ST-10 Resale Certificate

**III. General**

A. Description of a Motor Vehicle Dealer and Scope of Training

The auditor should view an automotive dealership as a collection of specialized automotive shops operating as one business. The dealer is involved with some or all of the following: (1) the sale, lease, and rental of new or used cars and trucks, (2) the sale of auto parts, (3) auto repairs and service, and (4) auto body shop repairs. Since most automotive businesses fall into one of these categories, the training will focus on the operation of motor vehicle dealers, in effect, looking at the operating procedures of most automotive companies. These activities sometimes have unique procedures and different tax treatments. When examined individually, however, none is particularly difficult to audit. Excerpts from several relevant regulations illustrate this point.

B. 23 VAC 10-210-990 - Motor Vehicle Sales, Leases, and Rentals, Repair and Replacement Parts, and Maintenance Materials; Taxicabs

- Paragraph (A) states that "[s]ales, leases, and rentals of motor vehicles are not subject to the retail sales and use tax provided they are subject to the Virginia motor vehicle sales and use [DMV] tax . . . and further provided that such tax has been paid."
- Paragraph (B) describes motor vehicles subject to the DMV tax.
- Paragraph (C) allows a dealer, lessor or renter of motor vehicles to purchase under a Resale Exemption Certificate, Form ST-10 ". . . repair and replacement parts and accessories and oil and grease installed on a motor vehicle before or at the time of sale, lease or rental which are included in the sales price for measuring the [DMV] tax or the retail sales and use tax."

- Paragraph (D) sets out that "[m]aintenance materials such as soaps, cleaners, etc., used on motor vehicles prior to or in preparation for sale, lease or rental are subject to the retail sales and use tax."
- Paragraph (E) describes the limited exemption for taxicab operators.

C. 23 VAC 10-210-1000 - Motor Vehicle Dealers

Over the counter sales of parts and accessories by motor vehicle dealers are subject to the retail sales tax as are parts used to repair customers' motor vehicles. Charges for repair labor, however, are not taxable when billed separately. "The tax does not apply to the exchange of parts under a warranty or guarantee if no charge is made. However, the tax applies to any difference charged for parts so exchanged." This regulation's last paragraph explains that "[t]he tax does not apply to a handicapped person's purchase of special equipment which will be installed on a motor vehicle to enable him to operate the motor vehicle."

D. 23 VAC 10-210-1020 - Motor Vehicle Refinishers, Painters . . .

"Motor vehicle refinishers and painters are engaged primarily in rendering personal services, and their gross receipts are not subject to the tax. However, they are the consumers of the materials used in their business and are required to pay tax on their purchases. When refinishers and painters go beyond the rendition of services and sell tangible personal property such as accessories, parts, seatcovers, etc., they are required to register and collect and pay the tax on those retail sales."

E. 23 VAC 10-210-3050 - Repair Businesses

The retail sale of auto parts is subject to the retail sales tax and repair labor is exempt only when separately stated. This regulation also addresses purchases. "Replacement parts, materials and supplies which are transferred to the customer may be purchased under certificates of exemption. The tax must be paid on equipment, tools and all other tangible personal property used in performing the repair work."

#### **IV. Procedures for the Sale, Lease or Rental of New and Used Vehicles**

A. Motor Vehicles Subject to the DMV Tax

Code of Virginia § 58.1-602 defines "motor vehicle" by referring to the DMV definition found in § 58.1-2401. Importantly § 58.1-602 only exempts a motor vehicle from the retail sales tax if upon its sale ". . . all applicable motor vehicle sales and use taxes have been paid." 23 VAC

10-210-990(B) provides a partial listing of vehicles subject to the DMV tax which includes "vehicles that are self-propelled or designed for self-propulsion and every vehicle drawn by or designed to be drawn by a motor vehicle, including mobile homes and every device in, upon or by which, any person or property is, or can be, transported or drawn upon a highway, but excepting devices moved by human or animal power, . . . and vehicles, other than mobile homes used in Virginia but not required to be licensed by the state." Please note that off-road vehicles not subject to safety inspections and not required to be titled in Virginia are excluded from the definition of "motor vehicle" and are therefore subject to the retail sales tax. Mobile offices are also excluded from the term "motor vehicle." (See Section VIII, Paragraph E for more information on mobile offices.)

#### B. Sale of Motor Vehicles

Code of Virginia § 58.1-609.1(2) exempts the sale, lease or rental of any motor vehicle which is subject to the DMV tax provided the tax has been paid. Any accessories added to a vehicle prior to or at the time of the sale which are included in the DMV tax computation may be purchased by the dealer under the resale exemption. Any sales of parts or accessories after titling which were not included in the DMV tax computation are subject to the retail sales tax. Note that all sales of extended warranty plans and vehicle service contracts by motor vehicle dealers are subject to the retail sales tax. (See Section IV, Paragraph F - Sales of Extended Warranty Plans and Vehicle Service Contracts.)

#### C. Daily Rentals vs. Long-term Lease

For audit purposes, the handling of the DMV tax determines whether a vehicle is a daily rental vehicle (i.e., an airport "rent-a-car") or a long-term lease vehicle (i.e., a 1 to 4 year lease). The gross proceeds of a daily rental vehicle are subject to the DMV tax which is added to the quoted rate and collected from the customer. The rental vehicle plus all repair parts and routine service supplies which actually become part of the vehicle (i.e., a replacement headlight, oil, antifreeze) may be purchased by the dealer under the resale exemption. A long-term lease vehicle, however, is titled to the leasing company (the lessor) which pays the DMV tax on the purchase price of the vehicle including any accessories added to the vehicle prior to titling. The monthly lease payments are not subject to either the DMV tax or the retail sales tax. The lessor is considered the user and consumer of any accessories (i.e., cruise control, air conditioning or upgraded sound system) added to a long-term lease vehicle after the DMV tax is computed and for any repair parts and routine service supplies purchased for the vehicle during the life of the lease. The auditor should check fleet car, truck and trailer leases which

can include a provision for some or all maintenance. This provision is rarely found in an individual retail lease.

#### D. Preparation of New or Used Motor Vehicles for Sale, Lease or Rental

23 VAC 10-210-990 exempts those items sold as a component part of a motor vehicle. Purchases of these items by the dealer may be made under the resale exemption. Exempt purchases would include accessories and supplies such as anti-theft devices, floor mats, motor oil, antifreeze, windshield washer fluid, etc. (Note that a used car dealer who is not registered for sales tax may use its DMV number on an ST-10.) The dealer is the consumer of all maintenance materials and equipment used to prepare the vehicle for sale, lease or rental. Retail sales tax should be paid at the time of purchase or when any such item is withdrawn from an exempt resale inventory. Examples of taxable materials are soaps, cleaners, rags, brushes, sponges, buffers, vacuum cleaners, etc. Preparation materials which adhere to or are absorbed by the vehicle (i.e., waxes, leather and fabric treatments, etc.) may be purchased by the dealer exclusive of retail sales tax because they are incorporated into the vehicle. Promotional items such as key tags, personalized paper floor mats, logo umbrellas, etc. are considered taxable to the dealer under the advertising regulation (even though they are "sold" with the car).

#### E. Demonstrators and Executive Vehicles

Accessories, repair parts and routine service supplies are taxable if purchased by a dealer for a vehicle used in a taxable manner. This includes demonstrators which are ordinarily driven by employees of a dealer (see P.D. 86-118), executive vehicles driven by dealership owners or management and loaner vehicles. Even though they may remain in the new or used vehicle inventory and are always for sale, the dealer is considered to be operating the vehicle for his own use and denied the resale exemption. Once the vehicle is no longer being used in a taxable manner and is being prepared for sale, the resale exemption becomes available to the dealer.

#### F. Sales of Extended Warranty Plans and Vehicle Service Contracts

The department revised its treatment of extended warranty plans and vehicle service contracts (plans) in 1987. P.D. 87-94 explains the rationale of this change and is extensively quoted below. This public document deals with plans offered for sale by automobile dealers in connection with the sale of new and used motor vehicles.

Code of Virginia § 58.1-609.5(1) "provides an exemption from the sale

and use tax for insurance . . . transactions which involve sales as inconsequential elements for which no separate charges are made. . . ."

In addition, 23 VAC 10-210-910 "provides in pertinent part that '[e]xtended warranty plans issued by an insurance company regulated by the Bureau of Insurance of the State Corporation Commission are insurance transactions and are not subject to the tax."

"[I]t has been determined that [plans] which identify the seller, dealer or manufacturer as the guarantor, (the party generally identified as 'We' in the contract), against certain specified motor vehicle breakdowns, are not considered contracts of insurance subject to licensure or regulation by the Bureau of Insurance. This is true . . . notwithstanding that such contracts might also be issued through an insurance agent or underwritten by an insurance company which is licensed or regulated by the Bureau."

"However, [plans] which identify some party outside the manufacturing/sales chain as the 'We' guaranteeing against the covered breakdowns are generally considered by the Bureau of Insurance to be contracts of insurance subject to regulation and licensure by the Bureau."

"[T]he total sales price of all extended warranty plans and/or vehicle service contracts issued by Virginia automobile dealers is subject to tax . . . at the time of sale to customers and the dealers must report such tax collected to the department when filing their monthly retail sales and use tax returns." Plans are subject to the retail sales tax - not the DMV tax.

Prior to January 1, 1996, plans were subject to the retail sales tax at 100% of the total charge to the customer. After January 1, 1996, plans are taxed at one-half (50%) of the total charge. (Refer to Virginia Tax Bulletin 95-8.) The auditor will have to take this statute change into account when extrapolating a purchase sample including taxable plans. This can be accomplished by using the Multisam program.

#### G. When DMV Tax is Erroneously Charged

It is good practice to check several "deal" files (dealer term referring to the paperwork connected with an individual sale and trade, if any) to see if the dealer is including sales subject to the retail sales tax in the DMV tax calculation. If this occurs, a significant understatement in the taxable sales reported on the ST-9 is possible, especially if an extended warranty plan or vehicle service contract is taxed incorrectly. The correct retail sales tax should be held in the audit but no penalty should be applied to this audit liability if the DMV tax was paid. The dealer can be advised to contact DMV to inquire about a refund.

#### H. Motor Vehicles are Subject to the Retail Tax when No DMV Tax is Paid

23 VAC 10-210-990 discusses the retail sales tax exemption of motor vehicles subject to the DMV tax. The DMV tax is generally paid by the purchaser when a new title is issued. The phrase ". . . and further provided that such tax has been paid" was added to the regulation to subject motor vehicles to the retail sales tax in situations when the DMV tax would normally apply but was not paid. For example, old cars are often sold to individuals for parts or restoration. If the purchaser does not title the car, he is liable for the retail consumer use tax. However, most sales between individuals (or when the seller is not registered to collect the retail sales tax) would fall under the occasional sale rule. If a dealer gives the purchaser a properly executed title, he is not required to collect the retail sales tax. Conversely, if a dealer does not provide the purchaser with a properly executed title, he is required to collect the retail sales tax unless the sale would otherwise be exempt. It is important for the auditor to understand that a vehicle that is subject to the DMV regulations, but exempted from the DMV tax, is not subject to the retail sales tax. For example, DMV exempts the sale of a motor vehicle designed for the transportation of ten or more passengers when purchased by and for the use of a nonprofit church. The sale of such a motor vehicle creates no retail sales tax liability.

### V. Procedures for the Sale of Auto Parts

#### A. Sale of Auto Parts

The retail sale of parts is taxable. At a dealership, there is almost always a separate accounting for parts sales. Sales are invoiced to customers on parts tickets or counter tickets which usually have their own numbering sequence and are filed by ticket number. The auditor should check that all periods within the sample are present to ensure that a package of tickets was not used out of sequence. Since revenue figures should be readily available for parts sales, it is appropriate to use them and the Multisam program during the audit write-up to project any parts liability. Code parts sales in the key field to a unique "S#" (#=1-5) as they are entered to designate this area of the audit. Part withdrawals from an exempt resale inventory to a dealer's inventory of motor vehicles, for internal use, for customer repairs and warranty repairs are covered in section VI.

#### B. Exemption Certificates - Parts

Some parts departments have every exemption certificate they have ever

accepted. Ask if the dealer is willing to go through the certificates and pull the ones which have been active during the audit period. Stress that no certificates should be discarded at this point. After the audit is completed, suggest that the "dead" exemption certificates be destroyed (or at least filed separately from the active customers). This will prevent the next auditor from being confronted with huge exemption files. There are many customers who can provide valid exemption certificates including federal, state and local governments, common carriers, farmers, auto parts stores, garages, service stations and other dealers. Parts departments are often lax in reviewing exemption certificates so many may not be valid on their face. The church exemption (ST-13A), for example, cannot be accepted in good faith, even on a first audit. Likewise, ST-10s with FEIN numbers are never valid. Remember, however, that a used car dealer can use his DMV number on the ST-10 to purchase parts to recondition cars for sale.

#### C. Cash Sales

It is not unusual to find parts tickets which have "Cash Sale" as the only customer identification. This is acceptable for taxable sales but not for exempt sales. If the dealer cannot identify the specific customer of an exempt cash sale, such sale should be assumed to have been subject to the retail sales tax and included in the audit.

#### D. Cash Discounts

At a motor vehicle dealer, cash discounts on account are usually only offered to customers of the parts department. The auditor should verify that any cash discounts offered by the dealer are being accounted for correctly.

#### E. Purchases of Taxable and Exempt Inventories

Purchases of parts for dealer resale inventories may be made under a resale exemption. Most dealers keep strict control on these inventories and all withdrawals are recorded. Many dealers include some consumable items (i.e., oil dry, razor blades, parts cleaner, etc.) in the parts inventory. The auditor must determine how the dealer is operating. Some dealers buy everything which goes into an inventory exempt because at the time of purchase it is not known if the item will be resold or consumed by the dealer. Other dealers attempt to correctly pay or accrue retail sales tax on all consumable purchases (even though they may occasionally sell such items over the counter). In the latter scenario there is no consumer use tax liability when these already taxed items are withdrawn from the inventory. If the dealer has purchased everything exempt and has accrued no consumer use tax upon the withdrawal of

self-consumed supplies, it is probably best for the auditor to pick up any liability from the purchase invoices. If the dealer has been accruing consumer use tax upon the withdrawal of self consumed supplies and the auditor is comfortable with the dealer's understanding of the regulations and the degree of internal control, it is probably easier to audit the inventory withdrawals (usually shown on parts tickets and/or repair orders - see section VI) and to ignore the purchase of these items. If a parts ticket is generated for self-consumed withdrawals, the auditor must determine if it is priced out at retail or cost. Consumer use tax is only due on the dealer's cost.

## **VI. Procedures for an Auto Repair Shop**

### **A. Auto Repair Shop Sales**

A motor vehicle dealer's auto repair shop sales are almost always accounted for separately. Auto repair shop sales are usually divided into three areas: (1) the repair of vehicles for which the customer is responsible for payment, (2) warranty repairs for which the vehicle manufacturer, dealer or issuer of an extended warranty plan or vehicle service contract is responsible for payment and (3) internal repairs which include any work on the dealer's own vehicles or motor vehicles in the new and/or used inventories. Auto repair shops usually invoice their customers on repair orders or R.O.s. One repair order could conceivably include all three areas. In this instance, many dealers print separate repair orders for each area using the same repair order number. The customer usually only sees the price details for those items for which he pays. Repair orders usually have their own numbering sequence and are filed by repair order number. This can impact a sales sample since repair orders can sometimes remain open for weeks before the repair is completed. The auditor may need to examine earlier numbers to find repair orders which were closed during the sample period. The auditor should also check that all periods within the sample are included to ensure that a package of repair orders was not used out of sequence. Since revenue figures should be readily available for auto repair sales, it is appropriate to use them and the Multisam program during the audit write-up to project any auto repair liability. Code such sales in the key field to a unique "S#" (#=1-5) as they are entered to designate this area of the audit.

### **B. Exemption Certificates - Auto Repair Shop**

There are many exemption certificates which may be accepted for vehicle repairs. Governments, nonprofit schools and common carriers are examples of customers who can present valid exemption certificates.

The resale exemption is also appropriate when another dealer or repair business has sublet work done on their customer's vehicle. (See Section VI, Paragraph E - Sublet Repairs.) Many dealers keep all exemption certificates in the parts department. While a resale exemption may be valid for the purchase of parts from the parts department (i.e., by an auto parts store), the exemption is not valid when the same customer brings their own business vehicle (i.e., a parts delivery truck) for service. Since such a certificate could not have been accepted in good faith for the repair, the dealer should be held liable for any inappropriate exempt sales.

C. Separately Stated Repair Labor and Fabrication Labor

Code of Virginia § 58.1-609.5(2), 23 VAC 10-210-1000, 23 VAC 10-210-3050, 23 VAC 10-210-4000 and 23 VAC 10-210-4040 all refer to the exemption for separately stated repair labor. If only one price is quoted which includes both parts and repair labor, then the retail sales tax will apply to the total charge. The auditor also needs to verify that taxable fabrication labor is not being treated as exempt repair labor. This occurs most frequently in specialty repair shops where, for instance, instead of repairing an existing drive shaft, a new one is fabricated.

D. Coupon and Discount Programs

Most motor vehicle dealers offer coupon or other discount programs. The auditor needs to verify that such discounts are being accounted for correctly. Often the discount is credited to separately stated labor so there is no retail sales tax impact. If the offer is for a free service such as an oil change, then the dealer becomes responsible for consumer use tax on any supplies (oil and filter) withdrawn from an exempt resale inventory.

E. Sublet Repairs - Auto Repair Shop

Sublet repairs occur when the dealer sends a part from a customer's vehicle or the vehicle itself to be worked on at another repair shop. Some dealers also show towing charges in this category. The dealer should provide the sublet shop with an ST-10 if tpp is involved. If the sublet repair is strictly labor (i.e., grinding valves by a machine shop) and is described as such on the repair order, then no retail sales tax applies to the sublet repair. If the sublet repair is for both parts and labor and only one price is quoted on the repair order, then retail sales tax must be charged on the entire sublet repair. A good method of accounting for sublet repairs is for the dealer to itemize the sublet parts (which do not have to be identified as sublet) in the parts sales area of the repair order. The customer is then taxed on the correct (and often marked-up) price. In this method, only exempt sublet repair labor or services are shown in

the sublet area of the repair order. If the dealer erroneously pays tax to the sublet shop, he is not relieved from charging his customer the retail sales tax. On a first audit, however, the auditor may choose to pick up the difference in retail sales tax (as taxable measure) between the amount of tax paid to the sublet repair shop and the tax which the customer should have been charged. This method should be utilized only if the dealer (who benefits from it) is willing to pull the necessary sublet shop invoices to verify the amount of retail sales tax paid. Alternatively and in subsequent audits, if the sublet is not identifiable as a service only charge, the entire amount should be picked up as taxable in the audit until the dealer can prove otherwise. Since no credit is allowed for any tax paid to the sublet business, the dealer can be advised to seek a refund of any such tax directly from the sublet company.

#### F. Manufacturer's Warranty and Dealer Guarantees

There is no sales or consumer use tax liability on parts or accessories withdrawn from an exempt resale inventory for replacement or exchange under a manufacturer's warranty or dealer guarantee as long as there is no charge to the customer. 23 VAC 10-210-10 states that the "tax must be computed on the actual additional amount, if any, paid to the dealer for the new article." The auditor needs to establish what, if any, guarantees are offered by the dealer. Even if no formal guarantee exists, there is usually an implied guarantee of between 30 and 90 days. If the dealer does not have a formal guarantee exceeding this period, any replacements withdrawn from an exempt resale inventory and given to the customer should be considered subject to consumer use tax. The dealer was under no obligation to make the free replacement and did so at his own discretion.

#### G. Extended Warranty Plan Transactions and Customer Deductibles

If retail sales tax was charged at the time of sale of an extended warranty plan or vehicle service contract (plan), and the plan requires that the customer pay a deductible amount for a covered repair, such deductible amount is not subject to the retail sales tax. Likewise, if the dealer bills the issuer of such a taxed plan for reimbursement, there is no retail sales tax due. Plan transactions become extremely complicated because they seldom cover all of the repairs. Obviously, parts not covered by the plan are taxable to the vehicle owner.

#### H. Internal Repair Orders

Most internal repair orders are for the preparation of vehicles for sale. Because the parts and accessories used in this activity are exempt under the resale exemption, no consumer use tax liability exists. There will be

relatively few internal repair orders for company owned vehicles (i.e., a tow truck, parts truck or executive vehicle). TPP listed on these repair orders is subject to consumer use tax. Since internal repair orders frequently show prices at cost, the taxable amount is usually easy to determine. The internal repair order is often the only record of the withdrawal of these items for the dealer's own use. However, the auditor must be aware that a dealer may have paid tax at the time of purchase on some items shown on an internal repair order.

#### I. Transferable Bulk Supplies

Effective December 1996, the department changed its position regarding transferable bulk supplies. Transferable bulk supplies include such items as brake fluid, grease and lubricants, windshield washer fluid, anti-freeze, power steering fluid and transmission fluid. Additionally automotive adhesives and sealants, including gasket seal; automotive light bulbs and electrical wire for automotive repairs; and small automotive hardware, including nuts, bolts, washers, cotter pins and similar items would be considered transferable bulk supplies. Previously such items which were not separately listed on the customer invoice were generally treated as shop supplies. The dealer was expected to pay tax at the time of purchase or when such items were withdrawn from an exempt inventory. P.D. 96-389 describes two acceptable alternatives where transferable bulk supplies can be purchased exempt of tax and then tax charged to the customer upon their sale. (Obviously, any withdrawal for the dealer's own use of transferable bulk supplies is subject to consumer use tax.)

**Flat Fee Charges:** The [T/P's] method of invoicing includes, for a flat fee, all parts, supplies, materials, and labor. It is therefore evident that the Transferable Bulk Supplies and other parts transferred to the customer are properly taxed at the time of the sale. At the same time, the customer is aware the entire charge is subject to the tax.

**Separately Stated Charges:** . . . In the event the [T/P] decides to separately state parts and labor on its invoices, it will be required to separately state the sales price of Transferable Bulk Supplies on the invoices to customers and add the tax on this charge. This is because [tpp] which has been purchased exempt for resale must be taxed when it is sold at retail. Also, by separately stating the Transferable Bulk Supplies on the invoice, the customer knows that it is a taxable component of the . . . total charge.

P.D. 389 continues by stating that these charges can be reasonable estimates.

Obviously, it would be excessively burdensome to calculate the sales price for such items as grease and brake pad adhesives. The [T/P] may therefore calculate the sales price of the Transferable Bulk Supplies by using a reasonable estimate which reflects the sales price. For example, the separate charge for these Transferable Bulk Supplies can be listed on the invoice as a percentage of the total bill or some other reasonable estimate which reflects the sales price of these items.

Regardless of how the [T/P] might reasonably estimate the charge for Transferable Bulk Supplies, this charge must appear as a separate item on the invoice to customers. . . Also the tax must be added on the charge for Transferable Bulk Supplies (just as the tax is added on the sale of any other parts.)

Unless either of these two methods are used, the items listed above would continue to be treated as consumable shop supplies.

#### J. Shop Supplies

Motor vehicle repair shops and dealers are required to pay retail sales tax or accrue and remit consumer use tax on consumable supplies used in repairing or servicing customer vehicles. Repair shops often attempt to recoup such costs by charging customers an amount (usually a percentage of the labor charges) called "shop supplies." Tax should not be charged to the customer for such shop supplies. Items normally considered shop supplies are cleaning supplies (including rags, drop cloths, floor sweep, mops and buckets); paper/plastic seat covers; work clothes, tools, equipment and machinery used in repair work (including repair and replacement parts and supplies for that equipment); soaps, degreasers, and thinners; and sand paper, steel wool, and emery cloth; and other similar items that are not transferred to customers.

#### K. Purchases by Auto Repair Shops

All purchases, except for immediate resale or those placed into an exempt resale inventory, are subject to the retail sales tax. The auditor should determine if retail sales tax was paid on expense items as well as tools, computer diagnostic equipment, and other assets. In-ground lifts (if installed by the seller) are usually considered real property transactions. Most lifts are now surface mounted and retain their identity as tpp.

### **VII. Procedures for an Auto Body Shop**

#### A. Auto Body Shop Sales

Most motor vehicle dealers track body shop sales separately. Body shop sales are divided into non-taxable services (i.e., the painting of a vehicle) and taxable sales of parts and accessories. Customers are usually invoiced on repair orders or R.O.s which normally use a numbering sequence different than those in the dealer repair shop. Repair orders are normally filed in numerical sequence. As with auto repair shops, this can impact the sales sample since body shop repair orders can sometimes remain open for months before the repair is completed. The auditor may need to examine earlier numbers to find repair orders which were closed during the sample period. The auditor should also check that all periods within the sample are included to ensure that a package of repair orders was not used out of sequence. Since revenue figures should be readily available for auto body sales, it is appropriate to use them and the Multisam program during the audit write-up to project any auto repair liability. Code such sales in the key field to a unique "S#" (#=1-5) as they are entered to designate this area of the audit.

B. Motor Vehicle Refinishers and Painters Provide Personal Services

23 VAC 10-210-1020 clearly states that motor vehicle refinishers and painters provide personal services. Their charges to customers for these services are not subject to the retail sales tax. Such service providers are the consumers of all materials used in providing the service (i.e., body filler, sandpaper, masking tape and paper, cleaners, and paint). Tax must be paid at the time of purchase by an independent body shop. If paint is purchased directly for the body shop by a dealer, retail sales tax must be paid at the time of purchase. If paint is placed in an exempt resale inventory because it is not known at the time of purchase whether paint will be used by the dealer or resold, then retail sales tax is due at the time of withdrawal. Paint cannot be billed to the customer as a part on a repair order, however, it is not unusual to find body shops which charge their customers retail sales tax on paint. In a first audit, the auditor may "turnaround" this practice at the conclusion of the audit. If this is done, any exempt sales of paint on repair orders should be picked up at cost and any inventory of paint purchased exclusive of retail sales tax should be taxed.

C. Shop Supplies

As with auto repair shops, a separately stated charge for shop supplies (usually a percentage of the labor charges) is often invoiced to the customer to recoup the cost of consumable items incurred by the motor vehicle refinisher. These shop supply charges are not taxable to the customer. This is true even after December 1996 when the issue of transferable bulk supplies was addressed. Because motor vehicles

refinishers and painters render personal services, they are required to pay the tax on their purchases of all material and supplies used in their business regardless that such materials and supplies (i.e., body putty, paint, etc.) are transferred to the customer.

D. Taxable Sales by Auto Body Shops

23 VAC 10-210-1020 clearly addresses taxable sales by motor vehicle refinishers and painters. "When [they] go beyond the rendition of services and sell tangible personal property such as accessories, parts, seatcovers, etc., they are required to register and collect and pay the tax on those retail sales." Auto body shops repairing accident damage may buy repair parts (a fender, a hood, window glass, etc.) under a resale exemption.

E. Sublet Repairs - Auto Body Shops

Refer to the sublet repair discussion in section VI. Sublet charges are usually more substantial in body shops - particularly when accident damage repairs are involved.

F. Insurance Transactions

The requirement to collect retail sales tax on repair transactions applies to transactions paid for in whole or in part by insurance companies. Insurance companies enjoy no exemption from retail sales tax when paying for work performed on their policyholder's vehicles. The retail sales tax applies to all sales of parts, accessories, etc. Body shops normally give binding estimates which list all parts and repairs that will be required. The body shop repair order is usually a duplicate of the estimate. If additional parts are needed and the parts allocation is increased on the repair order, the retail sales tax applies to the larger amount.

G. Purchases by Auto Body Shops

Purchases by auto body shops are always taxable except for parts for resale and sublet work which are itemized on the repair order. The auditor should verify that retail sales tax has been paid on expensive machines such as frame straighteners, color match computers and paint booths.

**VIII. Miscellaneous Procedures**

A. Franchise Dealer Records

Any franchise dealer (GM, Chrysler, Ford, etc.) is required by the manufacturer to keep its records using a uniform accounting system including the chart of accounts and financial statement formats. These are a great tool to use for sales tax payable figures as well as purchase and sale figures for each category audited.

B. Computerized Sales Records

Most motor vehicle dealers are highly computerized. While the original parts tickets, repair orders and other sales documents are usually readily available, it is often easier to examine existing computer printouts. Dealer personnel may be flexible enough to create reports or printouts of the exact information which an auditor requests. Instead of buying preprinted forms, dealers routinely have computers directly print parts tickets and repair orders. Computers have made auditing faster if for no other reason than the documents are always legible. Computers, however, can mask obvious programming errors. Most auto dealers use an industry wide system of account codes. Someone at the dealer probably entered the tax status of each code into the computer. This can result in retail sales tax never being charged on certain codes. The auditor could find, for example, that parts sales to employees are never taxed.

C. Purchase Records

Most motor vehicle dealers continue to follow the industry standard of filing expense purchases in monthly vendor envelopes. These envelopes are arranged alphabetically within each month. While these envelopes slow the auditor's work, it allows flexibility in choosing samples containing non-contiguous months. Assets are usually filed separately. The auditor should inquire about leased or financed equipment. These usually are large dollar purchases which may not be filed with other invoices.

D. Gross Sales as Shown of the ST-9s

It is proper to include vehicle sales in the gross sales figure reported on the ST-9. These vehicle sales should also be deducted as exempt sales. Sometimes dealers do not follow the correct procedure and report no vehicle sales on the ST-9. If the ST-9 gross sales figures are used for extrapolation purposes, the auditor should confirm that a consistent method of reporting was followed throughout the audit period. If not, adjustments must be made to make the monthly figures compatible.

E. Mobile Office Rentals

P.D. 96-157 addresses the taxability of mobile office rentals. In January

1987, DMV removed "mobile office" from the definition of "motor vehicle" but specifically imposed a 2% tax on the sales price of each mobile office **sold** in Virginia. Since mobile offices are no longer defined as motor vehicles, the DMV tax on motor vehicle rentals has not applied since 1987. If the 2% DMV tax was paid at the time of purchase of a mobile office by the owner, then the lease or rental is not subject to the 4.5% retail sales tax. Conversely, if the 2% DMV tax was not paid at the time of purchase by the owner, then the monthly charges for the mobile office rental are subject to the 4.5% retail sales tax. The burden of proof rests with the lessee (person using the mobile office) as described in P.D. 96-157.

For future rentals of mobile offices, the [T/P] should request proof from the renter that the 2% [DMV] tax has been paid on the purchase price of the mobile office. The [T/P] should then retain such proof with the records of the transactions for at least 3 years beyond the closing date of the rental.

#### F. Vehicle Pricing Guides

As the result of an unfavorable ruling in Carr v. Department of Taxation in 1995, the department has been forced to change its position on the taxability of subscription pricing guides (i.e., N.A.D.A.) which list the current market values of used cars. The department now considers that these guides fall under the exemption provided by Code of Virginia § 58.1-609.6(3). The guides are considered to be publications available for general distribution to the public and meet the interval test provided in the statute. Subscription sales qualify for exemption from the retail sales tax; however, sales of the guides at retail will remain taxable. Subscription pricing guides published four or more times per year should not be included in any future audit.

#### G. Computer Database Service

P.D. 88-299 addresses the taxability of a user-initiated database service. Dealers are provided with access to a database which contains information on inventory, pricing, location, and availability of automobiles by way of leased equipment. Each month the dealer receives a monthly hard copy of the information retrieved and a monthly subscription fee is charged. The customer charge for access to the database is exempt, since the true object of the transactions is the provision of a service. The lease or rental of computer equipment by dealers or their receipt of information on hard copy in connection with this service does not change the exempt status of the transactions. Although the lease of computer equipment to customers in connection with the database service is not taxed to the dealers, the database company is required to pay use tax.

#### H. Alarm Systems and Motor Vehicle Security and Tracking Devices

P.D. 96-331 addresses the taxability of alarm systems and specifically deals with the new type of security system that is monitored through a satellite uplink. The charge for monitoring services is exempt from tax. Other services provided on a cost-per-use basis, such as unlocking customer's doors, locating lost vehicles, trip planning and giving directions are also exempt from tax. In the P.D., the t/p sells its product through independent dealers. Since the t/p rather than its independent dealer, monitors the system, the sale of the security system is subject to the DMV tax if installed prior to titling or the retail sales tax if installed afterward. However when the t/p sells its products (which it monitors) through the mail, it is providing a personal service as described in the burglar alarm regulation.

#### I. Limited Exemption for Taxicab Operators

Code of Virginia § 58.1-609.3(10) states that the retail sales tax does not apply to "[p]arts, tires, meters and dispatch radios sold or leased to taxicab operators for use or consumption directly in the rendition of their services." It was the intent of the General Assembly to limit the scope of exemption for taxicab operators. 23 VAC 10-210-990(E) further limits the exemption by stating that "[a]ccessories, maintenance materials, and all other tangible personal property purchased by a taxicab operator are subject to the retail sales and use tax." Since the term "parts" is not specifically defined, it must be read in the context of the rest of the statute thereby taking on a very narrow connotation. For example P.D. 89-115 ruled that paint purchased by a taxi company to maintain its fleet of cabs was not exempt from retail sales tax. If the dealer has not previously been informed by the department of the limited nature of the exemption and had an ST-20 exemption certificate at the time of the sale, such certificate should be considered to have been accepted in good faith.

#### J. Special Equipment for Handicapped Drivers

Code of Virginia § 58.1-609.7(6) states that the retail sales tax does not apply to "[s]pecial equipment installed on a motor vehicle when purchased by a handicapped person to enable such person to operate the motor vehicle." Under Virginia's strict interpretation of statutes, the equipment must be purchased by the handicapped person and also enable the person to operate the vehicle. Therefore, the purchase of a wheelchair lift by parents of a handicapped youngster which allows the child to ride in a vehicle does not fall within the statute. If an ST-10B exemption certificate was on file at the time of an improper exempt sale of special equipment, such certificate should be considered to have been

accepted in good faith if the dealer has not previously been informed by the department of the limited nature of the exemption.

K. Litter Tax

Motor vehicle dealers are liable for the \$10.00 annual litter tax since the tax is imposed on any person who wholesales, distributes or retails motor vehicle parts. If the dealer services drink and/or snack machines available to the general public, the additional \$15.00 tax (imposed on a wholesaler, distributor or retailer of groceries, soft drinks or carbonated waters) applies. If the dealer only receives a commission from a vending company, the additional \$15.00 would not apply.

L. Tire Tax

The auditor should be aware of the tire tax status of the dealer. Many dealers do not inventory tires and sublet work to retail tire stores. In this case it is proper for the dealer to pay the tire tax to the tire store. If the dealer has significant retail tire sales, a tire tax registration is required. (Refer to the tire tax statutes, regulations and tax bulletins for details.)

M. Farm Licensed Vehicles

P.D. 96-34 addresses purchases by a farmer for a vehicle specifically licensed by the DMV as a "farm vehicle." In this limited circumstance a dealer can accept a valid ST-18 exemption certificate for purchases of tires and other accessories for farm vehicles by a farmer engaged in agricultural production for market. However, if the "farm licensed vehicle" is used for both taxable and exempt purposes, the farmer must accrue and report tax on the parts based on the percentage of time the vehicle is used in a taxable manner. For example, transportation of agricultural products to market is a taxable use. This in no way alters the department's position that all purchases of tires and other accessories for a vehicle having a normal DMV license (even if used on a farm) are subject to the retail sales tax.

## **Sales and Use Tax Audit Procedure**

### **Newspapers, Magazines, Periodicals and Other Publications**

**Objective:** Discuss the application of sales and use tax as it applies to publications.

#### **I. History**

**Prior to 07/01/95, sales of backcopies of publications by the publisher or his agent were taxable.**

**Effective 07/01/95 such sales are exempt. Sales of backcopies by anyone other than the publisher or his agent remain taxable.**

#### **II. References**

- A. Code of Virginia Sections 58.1-609.3.2.(v) and 58.1-609.6(3)
- B. Virginia Administrative Code 23 VAC 10-210-1060, 23 VAC 10-210-920.
- C. Ruling Letters - Commissioner's Ruling dated March 11, 1991, PD 94-152, PD 94-248
- D. Virginia Tax Bulletin - None
- E. Applicable exemption certificate - ST-11

#### **III. General**

- A. Sales. The sales and use tax does not apply to the retail sale of any publication issued daily, or regularly at average intervals not exceeding three months, except that newstand sales of the publications are taxable.
- B. Purchases. The sales and use tax does not apply to purchases of equipment, printing or supplies used directly to produce a publication as defined below whether sold at retail or distributed at no cost.
- C. Definitions.
  - 1. *Publication* shall mean any written compilation of information available to the general public. It does not include general reference materials and their periodic updates.

2. *Newsstand* shall mean a definite place of business at which newspapers or magazines are sold, but does not include coin-operated newspaper boxes.

- D. Advertising inserts or supplements and other printed matter distributed with or as a part of a nontaxable publication are not subject to the tax.
- E. The purchase of other printed matter and materials distributed with or as a part of a nontaxable publication is subject to the tax unless otherwise specifically exempted.

#### **IV. Procedures**

- A. Purchases. The industrial manufacturing exemption is extended to publishers as provided for in the Code of Virginia Section 58.1-609.3.2(v) - The retail sales and use tax does not apply to equipment, printing, or supplies used directly to produce a publication as described in Section 58.1-609.6(3) whether it is ultimately sold at retail or for resale or distribution at no cost.

Publication as described in Section 58.1-609.6(3) is any publication issued daily, or regularly at average intervals not exceeding three months, and advertising supplements and any other printed matter ultimately distributed with or part of such publications. Newsstand sales of the same are taxable.

"Used directly" is defined in 23 Virginia Administrative Code (VAC) 10-210-920 as "those activities that are an integral part of the production of a product, including all steps of an integrated manufacturing process, but not including incidental activities such as general maintenance, management, and administration.

Thus, when reviewing purchases, the auditor should follow the guidelines for auditing manufacturers and processors. Items used in pre-production activities, or used indirectly in production, cannot be purchased exempt of the tax by publishers.

B. Sales. All newsstand sales of publications are taxable. Sales of backcopies of exempt publications by the publisher or his agent are also exempt. In determining if the subscription sale of a publication is exempt, the auditor must refer to the following guidelines.

1. Exempt Publications. In order to be exempt from the retail sales and use tax, a newspaper, magazine, periodical or other publication must be a publication, as previously defined, and be issued at the required intervals, i.e.,

(a) It must be a compilation of information,

and

(b) it must be available to the general public,

and

(c) it must be issued daily, or regularly at average intervals not exceeding three months.

A publication which contains articles, news stories, and letters to the editor is consistent with the definition of a publication.

2. General Reference Materials. General reference materials and their periodic updates are not considered exempt publications. Reference materials include loose-leaf reference volumes published annually and updated periodically. They also include "reporters" which are devoted to matters of a specialized interest. General reference materials are not limited to publications that are supplemented with periodic updates.

3. Advertising Magazines The General Assembly intended for advertising to be outside the scope of the exemption granted for publications. Thus advertising magazines, such as those advertising homes for sale, are not exempt publications.

Advertising supplements ultimately distributed with or as a part of exempt publications are exempt.

4. Publications on CD-Rom. The exemption for publications is applicable regardless of the medium of the publication - whether it is in the traditional print format or in microform(microfilm and microfiche) or CD-Rom.

Provided (i) the printed version of a publication meets the exemption criteria, (ii) the taxpayer makes such available in microform or CD-Rom on a subscription basis with a frequency of delivery at least four times a year, and (iii) subscribers receive the microforms of CD-Rom at the normal subscription interval, sales of microforms, etc., are nontaxable.

Additionally, copies of articles sent via electronic means (fax, internet, or other electronic means) are not taxable since no tangible personal property is conveyed in providing this information.

## Sales and Use Tax Audit Procedure Nonprofit Organizations

**Objective:** Discuss the application of sales and use tax as it applies to nonprofit organizations (excluding churches).

### I. History:

**Prior to July 1 2004:** Non-profit organizations exempt from sales and use tax were specifically set forth in Code of Virginia §§ 58.1-608.1 and 58.1-609.1 through 609.13. These organizations were typically exempt from federal and state income taxes, and served educational, medical, civic, religious, charitable or cultural purposes. They obtained their sales and use tax exemption through the General Assembly. They used Form ST13 or ST13A (for churches) to make exempt purchases of tangible personal property and services.

**On and after July 1, 2004:** Legislation enacted by the 2003 General Assembly, effective July 1, 2004, authorized the Department of Taxation to implement a new process by which nonprofit organizations obtain sales and use tax exemptions. Exemptions in existence on June 30, 2003 were grandfathered until a set expiration date between July 1, 2004 and July 1, 2008. All organizations must reapply for an exemption under the new process when their exemption expires. If their applications are approved, the organizations are issued a nonprofit letter of exemption.

II. **Reference:** Code of Virginia § 58.1-609.11, Subsections A through G  
VAC 10-210-1070, 1071, and 1072  
Virginia Tax Bulletin 05-04  
Virginia Tax Bulletin 08-11  
Virginia Tax Bulletin 09-08

### III. General

Exempt nonprofit organizations fall into four broad categories:

1. educational
2. medical
3. civic and community service
4. cultural

The following expiration schedule is applicable to nonprofit organizations that held an exemption on June 30, 2003.

civic and community service (first half)	July 1, 2004
civic and community service (second half)	July 1, 2005
cultural and miscellaneous	July 1, 2006
educational	July 1, 2007
medical	July 1, 2008

All nonprofit organizations must reapply for an exemption when their exemption certificates expire. A nonprofit organization must meet all the applicable criteria below in order to qualify for an exemption.

- A. The organization must be exempt from federal income taxes under either §§501(c)(3) or 501(c)(4) of the IRC. The organization may qualify if it has annual gross receipts of less than \$5,000 and is organized for at least one of the purposes set forth in IRC §§501(c)(3) or(c)(4).
- B. The organization's administrative expenses, including salaries and fundraising expenses, must not exceed 40% of its annual gross revenue.
- C. The organization must provide proof of compliance with Chapter 5 of Title 57 (relating to solicitation of contributions) of the Code of Virginia for organizations subject to these provisions.
- D. An organization with annual gross revenues of \$750,000 or greater in the previous year, must provide a copy of its financial review performed by an independent certified public accountant. For an organization with annual gross revenues of \$1,000,000 or greater in the previous year, the Department of Taxation will determine whether the organization must provide a copy of a financial review or a full financial audit performed by an independent certified public accountant.
- E. If the organization is required to file Federal Form 990 or 990EZ, it must provide a copy of the form to the Department of Taxation.
- F. If the organization is not required to file Form 990 or 990 EZ, it must provide 1) a list of the Board of Directors, or other responsible agents of the organization composed of at least two individuals, with physical addresses where the individuals can be found, and 2) the location where the financial records of the organization are available for public inspection.

IV. Extent of the Exemption

*The duration of each exemption granted by the Department of Taxation shall be for a period of five to seven years. The new exemption will cover purchases of tangible personal property only, with the following exceptions:*

- A. Any nonprofit entity granted an exemption from paying sales and use tax is exempt from collecting sales and use tax if it is within the same class of organizations that were exempt from collecting sales and use tax on June 30, 2003.

**Below is a listing of nonprofit organizations exempt from collecting sales and use tax.**

Programs for the blind, the deaf, the hearing impaired, and drug abusers  
Organizations that provide aid and assistance for musically talented children of Virginia

**Vascular Organizations**

Cancer Organizations  
Diabetes Organizations  
Donations to Food Banks  
Volunteer Fire Departments and Rescue Squads  
Provide Food Packages at Reduced Prices  
Virginia Federation of Humane Societies  
Nonprofit Foundation for training and education in law enforcement  
Lung Organizations  
Volunteer Medical Service Organizations  
Nutrition Programs  
Supports Public Libraries  
Physical Education Programs  
School Fundraising for Elementary or Secondary (PTA's)  
Noncommercial Educational Telecommunications Entity  
Nonsectarian Youth Organizations  
Youth Symphony Orchestras

- B. Any nonprofit entity granted an exemption from paying sales and use tax on purchases of tangible personal property, which was exempt as of June 30, 2003 from paying sales and use tax on its purchases of taxable services, shall continue to be exempt from paying sales and use tax for the purchase of services.

**Below is a listing of nonprofit organizations that are exempt from paying sales and use tax on taxable services.**

**A Presidential Classroom for Your Americans Inc**

**Close Up Foundation**

**College Entrance Examination – The College Board**

Future Business Leaders of America

Horatio Alger Association of Distinguished Americans

Junior Achievement of Central Virginia, Inc

Junior Achievement of Greater Hampton Roads, Inc

Junior Achievement, Inc

Skills USA-Vica, Inc

- C. Effective October 1, 2008, any organization exempt from federal income taxes under IRC §501(c) can make sales of 1) food, prepared food and meals and 2) sales of tickets to events that include the provision of food, prepared food and meals without collecting tax provided the following requirements are met.
1. The organization must not be required to register as a dealer.
  2. The organization must pay sales tax to its vendors.
  3. The organization must not hold such events on more than 12 occasions per year.
  4. The organization must use any profits from the sales of food or event tickets solely to support the organization or for donation to another IRC §501(c) organization.
  5. The organization must maintain records for three years after each event to verify these requirements.

This exemption applies to all nonprofit organizations. An organization may count a fundraising occasion as one event, provided it does not extend beyond a seven-day consecutive period. Every seven-day consecutive period thereafter shall constitute an additional event.

- D. Effective July 1, 2009, any organization exempt from federal income taxes under either §§501(c)(3) or 501(c)(4) of the IRC, or who has annual gross receipts of less than \$5,000 and is organized for at least one of the purposes set forth in IRC §§501(c)(3) or(c)(4), can make sales of 1) food, prepared food and meals and 2) sales of tickets to events that include the provision of food, prepared food and meals without collecting tax, provided it does not hold such events on more than 23 occasions per year.

This exemption applies to any nonprofit organization eligible to be granted a nonprofit exemption on its purchases pursuant to Code of Virginia §58.1-609.11. However, the organization is not required to apply for or be granted a letter of exemption in order to qualify for this exemption.

## V. Procedures

Prior approval from the Executive Assistant for Audits in the Office of Compliance is required before initiating an audit of a nonprofit organization.

- A. If approval is granted, the organization should have a copy of its (SE) exemption letter. The letter indicates the entity's exemption number, which is in the format: SE followed by FEIN number (9 digits), followed by F (legal FEIN) or C (created #), followed by the expiration date (8 digits (mo/day/year) with no spaces or hyphens within the number.

Example: SE9900112223CO6302008

The letter will indicate the extent of the exemption:

1. Exempt purchases of tangible personal property.
2. Exempt sales.
3. Exempt purchases of taxable services.

The auditor should examine sales and purchases to determine if the nonprofit entity is making exempt purchases and sales in accordance with its specific exemption.

- B. When reviewing exempt sales made to nonprofit entities, the vendor should have a copy of the (SE) exemption letter and/or a valid ST-13 Certificate of Exemption on file. The ST-13 is no longer valid after the expiration date listed on Page 2.

If the vendor does not have a copy of the exemption letter, check the nonprofit database to determine if an exemption has been granted to the organization. If the organization is not on the database, sales made to this entity after the expiration date on Page 2 are taxable. Sales made after the expiration date on the exemption letter are also taxable.

## **Sales and Use Tax Audit Procedure**

### **OCCASIONAL SALES**

**Objective:** Discuss the application of sales and use tax as it applies to occasional sales.

#### **I. References**

- A. Code of Virginia Sections 58.1-602, 58.1-609.10(2)
- B. Virginia Administrative Code 23 VA 10-210-570, 23 VAC 10-210-1072, 23 VAC 10-210-1080.

**C. Ruling Letters PD 91-290, PD 93-164, PD 93-178, PD 94-21, PD 94-35, PD 94-134, PD 94-143, PD 94-61, PD 95-21, PD 95-79, PD 95-302, PD 96-5, PD 96-75, PD 97-199, PD 00-1.**

- D. Court Case      Steuart Petroleum Co. v. Virginia Department of Taxation

#### **II. General**

- A. The tax does not apply to an occasional sale provided the sale or exchange is not one of a series of sales or exchanges sufficient in number, scope, and character to constitute an activity requiring the holding of a certificate of registration.
- B. The occasional sale exemption is based the premise that persons not regularly engaged in making retail sales should not be required to register and collect the tax on occasional or isolated sales. A fundamental characteristic of an occasional sale is that it lacks continuity and regularity and it occurs without being expected or without design.
- C. The occasional sale exemption is not founded on nexus or other issues relating to interstate commerce, but rather on limited sales activity. Nexus is an issue that relates to a seller's obligation to collect the tax. The absence of nexus does not in itself negate the purchaser's responsibility to pay the use tax if such is due.
- D. Occasional sale is defined as one of the following:

- (1) A sale by a person who is engaged in sales three or fewer separate occasions per calendar year. Sales at fairs, flea markets, carnivals and circuses are not occasional sales.
  - (2) A sale of tangible personal property not held or used by the seller in the course of an activity for which he is required to hold a certificate of registration.
  - (3) The sale or exchange of all or substantially all the assets of any business.
  - (4) The reorganization or liquidation of any business.
- E. Sales by nonprofit organizations may qualify for the occasional sale exemption provided sales are made on three or fewer separate occasions per calendar year, and the duration of each sale is for no more than a few days.
- F. If a transaction qualifies as an occasional sale, the purchaser is not liable for any use tax.
- G. A purchaser meets the definition of a dealer when he causes tangible personal property to be imported into the Commonwealth for his own use or consumption. **Generally** no occasional sale exemption is allowed on purchases from out-of-state. **Reference PD 93-164.**

### III. Procedures

- A. Analyze the transaction. Obtain detailed information from the taxpayer regarding the terms and nature of the sale. Determine if the transaction meets the definition of an occasional sale. If the auditor is unable to make a determination, the transaction should be taxed, and the taxpayer should request a ruling from the Tax Commissioner.
- B. The transaction must first meet the "number, scope, and character" criteria:
  - (1) The taxpayer must generally make sales on three or fewer occasions each year.

If the taxpayer has made more than three sales in a calendar year, the auditor must determine if the sales occurred unexpectedly and without design, and were truly occasional in nature. If so, the taxpayer becomes a dealer and is required to collect tax beginning on the date of the fourth sale. If not, the taxpayer is a dealer effective on the date of his first sale.

(2) If the transaction is an integral, although infrequent, part of the taxpayer's activities, it may not qualify as an occasional sale.

- (3) The duration of a sale must be for no more than a few days. Otherwise the taxpayer is deemed a retailer as he may be in competition with businesses or other organizations required to collect sales tax.
- (4) A sale otherwise defined as an occasional sale will not be exempt if it does not meet the "number, scope, and character" criteria. The Department has historically determined that if the sale of all or substantially all the assets of a business requires several transactions over an extended period of time to many different purchasers, it does not qualify as an exempt occasional sale. The Department has relied on the "three or fewer" sales provision to deny the occasional sale exemption in many such instances.

In the *Steuart Petroleum* court case, the Court stated that an evaluation of the scope and character of such transactions should be conducted in order to place the number of asset sales in their proper context.

The Court stated that in the instant case, all the assets of a division were sold pursuant to an orderly plan of liquidation - there was no piecemeal disposition. Five packages, as determined by geographic location, were sold over a nine-month period - there were not dozens of buyers bidding over several years.

The Court determined that the scope and character of these sales fall within the intent of the General Assembly to shield such transactions from sales tax. As a result the orderly liquidation of a business over a twelve-month period should qualify for the occasional sale exemption.

**C. A registered dealer is not allowed an occasional sale exemption for the mere fact that the article sold differs in the type or class from the products he normally sells. For example, a dealer who operates a convenience store is not allowed an occasional sale exemption for the sale of a cash register.**

The property sold must not be used in the activity for which the dealer is required to be registered. For example, a bank which holds a certificate of registration for the sale of checks, checkbooks, and reclaimed property may make an exempt occasional sale of data processing equipment used by its Information Services Division.

In the case where a lessor sells all of its leased equipment, which represents all of the lessor's assets, to the lessee, the terms of the lease agreement will determine if the sale qualifies as an occasional sale. If the equipment is sold through some provision in the lease agreement allowing for the sale of the leased equipment prior to the end of the lease period, it would not qualify as an occasional sale. If the sale is made outside the terms of the lease contract, it would qualify as an occasional sale as the equipment represented all the assets of the lessor's leasing business.

- D. The sale or exchange of all or substantially all the assets of any business is an exempt occasional sale if the sale represents the sale of all or substantially all the assets of the seller's business **in Virginia**. The seller may continue to operate like businesses in other states.

A separate legal entity is a separate and distinct business. For example, a corporation may make an exempt occasional sale of all its assets in Virginia, although it holds an interest in a joint venture which continues to operate in Virginia.

A disposition of a separate and distinct activity of a multifaceted business operation may qualify as the sale of all or substantially all the assets of a business. In determining if a division of a business is separate and distinct from the business, certain criteria must be met:

- (1) Each division must have a completely separate set of books which are separately maintained.
- (2) Separate bank accounts must be maintained.
- (3) Employees must be active in only one division.
- (4) Divisions must be separately housed.
- (5) Each division must have its own fixed assets which are not used interchangeably.

- E. The transfer of assets from one business to newly-formed subsidiaries in exchange for all of the issued and outstanding shares of stock of those subsidiaries qualifies for nonrecognition of income under Internal Revenue Code (I.R.C.) Section 351. This tax-exempt reorganization of assets for stock is a qualifying "reorganization" for purposes of the occasional sale exemption. This includes the sale of a business through a series of transfers, each of which qualifies for nonrecognition of income under I.R.C. Section 351 as the tax-exempt reorganization of assets for stock.

## **Sales and Use Tax Audit Procedure**

### **PENALTIES AND INTEREST**

**Objective:** Discuss the application of sales and use tax as it applies to penalties and interest.

#### **I. References**

- A. Code of Virginia Section 58.1-635
- B. Virginia Administrative Code 23 VAC 10-210-2030  
23 VAC 10-210-2032
- C. Ruling Letters PD 95-59  
PD 00-98  
PD 04-76
- D. Addendum to 23 VAC 10-210-2032 (Alternative Method of Computing Use Tax Compliance Ratio) See PD 00-115
- E. Code of Virginia Section 58.1-1840.1 Virginia Tax Amnesty Program Effective 07-01-03

#### **II. General**

- A. The application of interest to all audit deficiencies is mandatory. It accrues at the rate established in Section 6621 of the Internal Revenue Code, as amended, plus 2.0%.
- B. Penalty is typically not applied to first generation audits unless
  1. the taxpayer was previously notified in writing, but failed to follow instructions; or
  2. the taxpayer collected tax, but failed to remit it; or
  3. indications of fraud exist.

- C. In addition to the instances listed above for first generation audits, the application of penalty on second and subsequent audits is generally based upon the taxpayer's compliance ratio.
1. The compliance ratio is calculated by dividing the measure reported by the total of the measure reported plus the measure found. Measure reported does not include any measure on which tax was paid directly to the vendor by the taxpayer. The purpose of the use tax compliance ratio is to measure how well a taxpayer complied with the Virginia tax laws requiring accruing and remitting the tax on untaxed purchases.
  2. On second generation audits the taxpayer's compliance ratios must meet or exceed 85% for sales tax and 60% for use tax in order to avoid the application of penalty.
  3. On third and subsequent audits penalty will apply unless the taxpayer's compliance ratios meet or exceed 85% for both sales and use taxes.
  4. **NEW:** The taxpayer can apply for penalty relief for all second and subsequent audits using the alternative method of computing use tax compliance. The alternative method allows taxpayers to include the measure upon which sales tax was paid to vendors in the compliance ratio calculation. The alternative method can be applied for all retail sales and use tax audit assessments issued on and after October 1, 1999. The compliance ratio is calculated by dividing the use measure reported plus the sales tax measure paid to vendors by the use measure reported plus the sales tax measure paid to vendors plus the deficiency. **It is the taxpayer's responsibility to compute the Alternative Method calculations and provide the auditor with documentation supporting the computation within 60 days of the audit assessment.** The taxpayer **must** compute the ratio based on a review of the same period used to compute the compliance ratio. If the compliance ratio computed under the alternative method meets or exceeds the established threshold the penalty will not apply and should be abated.
- D. Penalty may be waived
1. On audit deficiencies occurring in new areas not covered on prior audits.
  2. In instances where the taxpayer has relied on information provided by the Department.

3. In instances where exceptional mitigating circumstances exist.
  4. If the taxpayer chooses to use the Alternative Method of Computing Use Tax Compliance. It is the taxpayer's responsibility to complete the Alternate Method calculations and provide the auditor with documentation supporting the computation within 60 days of the audit assessment. The Alternate Method can only be used on assessments issued on and after October 1, 1999.
- E. Fraud penalty of 50% will apply in cases where the taxpayer filed false or fraudulent returns with the intent to defraud the Commonwealth. The Code of Virginia states that under reporting gross sales, gross proceeds, or cost price by 50% or more is prima facie evidence of intent to defraud. In practice, it requires additional substantial evidence to support that the taxpayer's under reporting was intentional.

If a taxpayer does not register to collect sales tax, but collects it, and does not remit it, the fraud penalty will apply.

### III. July 1, 2003 the Virginia Tax Amnesty Program Established

#### A. Amnesty program – Background:

The 2003 Virginia General Assembly passed legislation creating an amnesty program that was held September 2, 2003 through November 4, 2003. Any taxes owed, whether previously billed or not, were eligible for this program provided that the tax period was for April 2003 or prior (calendar year 2001 and prior for Individual and Corporate Income and calendar year 2002 and prior for Litter Tax) and the bill, if assessed, was at least 90 days old as of the first day of Amnesty. Any Amnesty eligible amounts that were not satisfied during the Amnesty window may be assessed an Amnesty Penalty that is equal to 20% of the outstanding tax amount. **If an audit contains outstanding tax that would have been eligible for Amnesty (including Consumer Use Tax), the Amnesty Penalty applies because of the failure to report and pay this liability during Amnesty.**

#### B. Application of Amnesty Penalty:

The Amnesty Penalty of 20% is in addition to other statutory penalties for late or fraudulent filing. **Subject to the guidelines established by the Tax Commissioner for audits, the Amnesty Penalty is only applied to those audits that are otherwise subject to penalty and only for those**

**periods that were eligible for Amnesty.**

**IV. Procedures**

- A. The sales and use tax audit program automatically calculates the compliance ratio. The auditor should take care to ensure that the audit reflects the correct payment record information and that the exceptions have been properly coded. If gross sales must be altered for extrapolation purposes, an adjusting entry needs to be made so that total taxable sales reported is correct.
- B. The sales and use tax audit program automatically calculates the additional tax measure required for the taxpayer to achieve the Alternative Method of Computing Use Tax Compliance.
- C. The auditor should be aware that the audit sequence number does not necessarily correspond with the audit generation. Using the wrong audit generation number may result in an erroneous application or waiver of penalty.
- D. If the taxpayer reports delinquent tax on a current return following the auditor's initial contact to schedule an audit, penalty, if applicable, and interest should be computed on the late payment. The auditor should enter the taxable measures as exceptions in the period in which they should have been reported. Then the payment should be transferred from the current return to the audit assessment.

If the return on which the additional tax was paid is included in the audit period, the payment should be excluded from the measure reported for calculation of the compliance ratios.

- E. Care and sound judgment should be used in the waiver of penalty except as indicated by the taxpayer's compliance ratio. A change in personnel, a change in vendors, or reorganization of a company does not represent circumstances mitigating the application of penalty.

The mere fact that an area was not an issue on a prior audit does not make it a new issue for penalty purposes. A change in the Department's treatment of a certain area without proper publication (Tax Bulletin), or the

expansion of the taxpayer into a different class and nature of business may constitute new issues.

- F. Fifty per cent penalty should be assessed on audits when it can be supported that the taxpayer's intent is to defraud the Commonwealth.
  
- G. In most instances, with the Audit Supervisor's approval, it is best to apply penalty as indicated by the Compliance ratio, and allow the Office of Policy and Administration, Appeals and Rulings to make the final determination.

## **Sales and Use Tax Audit Procedure**

Prefabricated & Modular Homes

**Objective:** Discuss the application of sales and use tax as it applies to  
**Prefabricated house sections & Modular homes**

### **I. References**

- A. Code of Virginia Section: 58.1-203  
58.1-602  
58.1-610.1

**B. Virginia Administrative Code: 23 VAC 10-210-2080**

23 VAC 10-210-410(E)

- C. Ruling Letters (give public document number):
  - 12/20/89          Dual role operator
  - 02/10/93        Dual role operator
  - PD 94-104       Sales price subject to sales tax
  - PD 96-024       Real property v tangible property
  - PD 98-161       Purchase of modular homes

- D. Applicable exemption certificate:  
ST-10>materials bought for re-sale

**ST-11> manufacturing equipment**

ST-21>direct payment permit

- E. Tax Bulletins: VTB 00-3. Effective July 1, 2000

### **II. General**

- A. The sale of prefabricated modular house sections or units by manufactures and other vendors, without installation, are sales of tangible personal property and the tax generally applies to the sales price unless sold for resale purposes only.

Prefabricated modular house sections or units are generally constructed at a single site away from the intended erection site. The sections or units are generally constructed in a manufacturing type setting. This means that the taxpayer has a raw material inventory, a production line and a finished goods inventory.

Prefabricated modular house sections or units are different than "mobile homes" which are subject to the Motor Vehicles sales tax that is administered by the Division of Motor Vehicles. Mobile homes are generally built on a chassis with wheels that may be towed on the road and are built to HUD specifications.

**III. NEW:** As of July 1, 2000 the following applies when auditing a Modular Homes Manufacturer or Retailer:

**“Sec. 58.1-610.1. Modular building manufacturers and retailers**

**The retail sale of a modular building, as defined by Section 58.1-602, by a modular building manufacturer or modular building retailer, as defined by Section 58.1-602, shall be subject to the tax authorized by this chapter upon sixty percent of the retail sales price. If the modular building manufacturer has paid such tax on the cost price of materials incorporated in a modular building that has been constructed for sale without installation, it may credit against the tax shown to be due on the return the amount of sales or use tax paid on the cost of materials used in fabricating such a modular building.”**

**This new law only applies to the Sale of Modular Homes or Buildings without installation by the seller. Prior to July 1, 2000, a Modular Home Manufacturer or Retailer should be audited as prescribed below.**

**IV. Procedures-** Prior to July 1,2000

When auditing a manufacturer of prefabricated modular house sections or units, you will first need to determine the scope of their operation.

- Does the taxpayer "set" the sections or units with their own employees or do they subcontract it out?
- Are there any sales of sections or units that the taxpayer does not set?
- Does the taxpayer have any out of state sales?
- Is the manufacturer reimbursing, refunding or in any way returning to its customers all of the installation/set-up fees that it charges customers?

Sales – Prior to July 1, 2000

***Sales without installation:*** If the taxpayer is only manufacturing the sections or units and is not setting/installing the sections or units and does not hire someone to perform any part of the installation then the sales tax needs to be charged on the sales price. The taxpayer should

be buying all materials that go into the units or sections without the Virginia sales tax. The taxpayer may be entitled to the manufacture exemption on their machinery, equipment and tools used to manufacture the sections or units.

***Sales with installation:*** If the taxpayer is manufacturing the section or units and primarily affixes these sections or units to permanent foundations or hires someone to perform such installation tasks, then the taxpayer must pay the tax on the materials used in manufacturing the sections or units. The taxpayer would not generally be entitled to the manufacturing exemption on their machinery, equipment or tools. Basically, the taxpayer would be treated as a using and consuming contractor.

***Dual Role:*** If the taxpayer is doing both, sales with and without installation, and if the taxpayer has a common raw materials inventory, then the auditor needs to follow the primary purpose rule, that is based on the gross receipts in determining the sales tax application. Basically, the auditor needs to compare the receipts for the units or sections sold without being set or installed by the taxpayer to the receipts for the sections or units that were set or installed by the taxpayer. The primary purpose rule would need to be used for each year in the audit period.

***Primarily fabricator/seller:*** If in comparing, it is found that the dealer is selling more units without setting them, then the dealer should be treated as a manufacturer and the sales tax would apply to the sales price on all of these units. The taxpayer may purchase the materials without the sales tax. On the units that the taxpayer sets, they are liable for the tax on the fabricated cost of the unit or sections. The fabricated cost is computed by totaling the cost of the materials, labor and overhead.

***Primarily fabricator/contractor:*** If the taxpayer is setting more units, then the taxpayer should be treated as a contractor and pay the sales tax on the cost price of the materials. However, if the taxpayer does sell any units without setting them, then they will still need to charge the sales tax on the sales price of the unit. There is no credit given for any sales or use tax paid on the materials that went into the manufacturing of these units.

In reviewing the sales, the auditor should note any sales into the S.E.A.T.A. states, especially the sales on which the taxpayer did not set or install. The auditor should also advise the taxpayer that they might be liable for additional sales tax on the materials used in out of state sales in which the taxpayer did the setting.

For sales (without installation by the seller) as of July 1, 2000 forward, the taxpayer would charge tax on only 60% of the selling price. If the taxpayer paid tax on any of the materials that went into the manufacturing of the modular home sold, then they would be due credit for those taxes only.

For sales (with installation by the manufacturer) as of July 1, 2000, and thereafter, the modular housing manufacturer would be liable for the tax based on the cost price of materials only. If actual cost cannot be determined exactly, sixty percent of the sales price (exclusive of installation and delivery charges) is an acceptable substitute to use as cost price. **Note** - Concerning withdrawal from inventory issues, the fabricated cost price concept of 23 VAC 10-210-410(E) does not apply to modular houses constructed after the law change effective on and after July 1, 2000.

### **Purchases** – Prior to July 1, 2000

Like sales, in auditing a manufacturer of prefabricated modular sections or units, you will need to determine what type of operation the taxpayer has. Is the taxpayer a manufacturer? A contractor? Both?

Once the determination has been made for sales, the purchase part of the audit follows right along. If the taxpayer is a primarily a fabricator/seller, then the manufacturing exemptions apply to materials, equipment, machinery, etc. If the taxpayer is primarily a fabricator/contractor, then there are no exemptions for material, machinery, equipment, etc. It is possible for the taxpayer to be eligible for the manufacturing exemption one year but not the next because an increase in installation sales may cause its status to change to primarily that of a real property contractor. If the taxpayer is deemed to be primarily a fabricator/seller in the first year of the audit and purchases equipment used to build the units, the equipment could be bought without the Virginia sales tax. If in the second year of the audit, the taxpayer is acting primarily as a contractor, then the equipment bought in the previous year would be subject to the sales tax on the fair market value. If in the third year the taxpayer is primarily a fabricator/seller, there are no provisions in the regulations for a credit on the sales tax paid during the previous year on the equipment or machinery.

However, as of July 1, 2000, the taxpayer is due a credit for sales and use tax paid only on materials used in fabricating a unit or home sold without installation.

Regardless of the taxpayer's operation, the equipment and supplies used to set or install the sections or units onto permanent foundation will be taxable.

**Direct payment permits** – Prior to July 1, 2000

If the taxpayer cannot determine at the time of purchase whether an item will be used in a unit for sale (without installation) or in a unit that will be set, then they may want to apply for a direct payment permit. A direct payment permit (ST-21) allows the taxpayer to purchase items without the Virginia sales tax. The taxpayer would be responsible to make sure that the localities in which the items are purchased do not lose any local sales tax.

Depending on the taxpayer's operation would determine how the taxpayer reports the sales tax. The sales tax would be charged, collected and reported on all Virginia retail sales that the taxpayer did not set or install. The taxpayer would report the sales tax on the fabricated cost of any units installed by the taxpayer if they were primarily operating as a fabricator/seller. The taxpayer would only report the sales tax on the material cost if they were operating primarily as a contractor.

## **Sales and Use Tax Audit Procedure**

### **Printing and Printers**

**Objective:** Discuss the application of sales and use tax as it applies to: printing and printers.

#### **I. References**

- A. Code of Virginia Section 58.1-602, 58.1-603, 58.1-609.3(2), 58.1-609.3(11), 58.1-609.6(3), 58.1-609.6(4).
- B. Virginia Administrative Code 23 VAC 10-210-3010
- C. Ruling Letters - Public Documents 96-278, 95-216, 96-324, 96-180, 97-54, 88-50, 96-380, 82-26, 96-327, 96-33, 95-218, 90-79, 89-159, 95-185, 96-304, 97-65, 97-387.
- D. Virginia Tax Bulletin 93-7
- E. Applicable exemption certificate ST10-A

#### **III. General**

- A. Sales of printing delivered in Virginia are generally subject to the sales tax. However, an exemption exists for certain printed materials, other than administrative supplies, stored for 12 months or less in Virginia for distribution in other states.
- B. The printing of tangible personal property for sale or resale is considered industrial manufacturing and, as a result, the exemption for industrial materials applies (VAC 10-210-920).

#### **IV. Procedures**

- A. Before an audit can be completed with regard to printing, there must be a determination as to what type of printing is being performed. There are three types of printing defined in VAC 10-210-3010: Custom printing; Consumer printing; and Publisher printing. Each classification has its own tax guidelines.
  - 1). Custom printing is the production or fabrication of printed matter in accordance with customer specifications for the customer's own use or consumption. Generally, the sale of custom printing represents the taxable sale of tangible personal property. The tax is computed on the total invoice charge made on the transaction including any service

charges made in connection with the sale of the printed matter (eg. plate charges, imprinting charges, folding charges, etc.). The tax is also applicable to custom printing charges in instances where the customer furnishes the printing stock.

Purchases by the printer of items which become part of the printed matter for sale or resale are not subject to the tax (eg. ink, printing stock, staples, stapling wire, binding twine, glue, etc.). Purchases by the printer of items used directly in the production of custom printing are similarly not subject to the tax (eg. printing plates, dies and mats, printing presses and their repair parts, typesetting, etc.). The tax does not apply to paper, ink, and other materials furnished to a custom printer that will become a component or ingredient part of products fabricated by the printer.

2). Consumer printing is the production or fabrication of printed matter for one's own use or consumption and not for resale. The manufacturing exemptions do not apply to consumer printing since there is no sale or resale. Although the manufacturing exemptions do not apply, other exemptions may be applicable to the purchases made by individuals engaged in consumer printing (eg. certain printed materials when stored for 12 months or less in Virginia and distributed for use outside the state).

3). Publisher printing is the printing of books, newspapers, magazines or other periodicals for sale or resale by the publisher-printer and includes the printing of a "publication" (as defined in VAC 10-210-1060) which is distributed free of charge. A publisher-printer making retail sales of books, etc., must add tax to the charge. However, the sale of any publication issued at regular intervals not exceeding three months is exempt from the tax, except as to the newsstand sales thereof (Note: as of 7/1/95, the term "newsstand sales" does not include sales of back copies of publications by the publisher or his agent).

The tax applies to purchases by publisher-printers in the same manner as custom printing. However, the manufacturing exemptions available to publisher-printers are broader in that they apply to the necessary ancillary activities of newspaper and magazine printing when such activities are performed by the publisher of any newspaper or magazine. Also, based on 58.1-609.3(2)(v), a publisher is entitled to the industrial exemptions on equipment, printing or supplies used directly to produce a publication whether it is sold at retail or for distribution at no cost. This means that a publisher can subcontract out the printing of its publication and still receive an exemption on the printing charges.

B. Although it is easy for taxpayers to understand that the sale of printing represents the taxable sale of tangible personal property, there are exemptions that apply to the purchase of printed materials that require

some diligence on the part of a taxpayer to interpret and organize. Under 58.1-609.6(4) there is an exemption for catalogs, letters, brochures, reports, and similar printed materials, and the paper furnished to a printer for fabrication into such printed materials, when stored for 12 months or less in the Commonwealth and distributed for use outside of the Commonwealth. This exemption also applies to the envelopes, containers, and labels used to package and mail such printed materials. The only exception to this exemption is for "administrative supplies." The term "administrative supplies" includes, but is not limited to, letterhead, envelopes, other stationery, invoices, billing forms, payroll forms, price lists, time cards, computer cards, certificates, business cards, diplomas, and awards. The term also includes supplies for internal use by the purchaser, such as menus, calendars, datebooks, desk reminders, appointment books, employee newsletters, and other house organs.

The confusing part of this exemption is that some "administrative supplies" may qualify for exemption if they become an integral part of the exempt printed materials described above. For example, letterhead upon which fundraising or promotional letters are printed, return envelopes enclosed with fundraising letters, and price lists enclosed within catalogs advertising tangible personal property for sale or resale are not taxable. Also, as mentioned earlier, there are some items such as menus, calendars, datebooks, appointment books, etc., that are taxable "administrative supplies" when purchased for internal use by a taxpayer. However, the same items may be exempt when used for external promotional purposes.

The key to determining whether certain printed materials are taxable or exempt is not in the product itself, but in the intended use of such product. Basically, if an item is for internal use and it is received in Virginia, it is taxable. This is true even though the item may be distributed for use outside of Virginia within 12 months (eg. a corporate office in Virginia receives desk planners to be distributed to their employees both within and without Virginia). Conversely, if an item is for external promotional purposes and will be distributed for use outside of Virginia within 12 months, it is exempt.

Below is a list of printed materials that would qualify for exemption when stored in Virginia for 12 months or less and mailed to or distributed outside of Virginia (this list is merely illustrative and is not designed to be all inclusive):

Fund raising and promotional letters, circulars, folders, brochures, and pamphlets, including those for charitable, political, and religious purposes;

Corporate stockholder meeting notices;

Proxy materials and enclosed proxy cards;

Meeting and convention promotional materials;

A business prospectus;

Corporate monthly, quarterly, and annual stockholder reports;

Announcements, invitations, and informational pieces for external promotional purposes;

Greeting cards, brochures, menus, calendars, datebooks, desk reminders, appointment books, art prints, and posters for external promotional purposes;

Printed point-of-purchase sales devices, including display racks, animated and action pieces, posters and banners.

- C. Up until 7/1/95, advertising businesses were not entitled to the exemption on printed materials described above. Based on a legislative change, advertising businesses now enjoy the same exemption. The exemption for advertising businesses is valid through 6/30/02.
- D. Generally speaking, the use of photocopy and photostat machines to make reproductions of customer furnished originals is not considered to be printing in the industrial sense. Taxpayers who operate such "quick copy" establishments must pay tax on the machinery and tools used in their business. Such taxpayers may purchase exempt from the tax only those items, such as paper, that will become ingredient or component parts of the finished products they sell. The sale of photocopies and photostats represents a taxable sale of tangible personal property.

The primary exception to the "quick copy" scenario mentioned above is the use of high speed electrostatic duplicators. Under 58.1-609.3(11), taxpayers who are engaged primarily in the printing or photocopying of products for sale or resale may purchase high speed electrostatic duplicators (or other types of high speed duplicators) exempt of the tax. A high speed duplicator is one that has a printing capacity of 4,000 impressions or more per hour (ie. slightly more than 1 copy per second).

- E. One area of particular note is the application of printing to direct mail agencies. Direct mail agencies typically use laser printing to "personalize" fund raising letters for their customers. Laser personalization consists of incorporating variable information into an

existing letter copy in order to personalize the letter for each individual recipient. Based on P.D. 97-65 and P.D. 97-387, when a customer provides printing stock to a direct mail agency and the agency provides personalization services which cause each printed piece to be unique in nature, the transaction is deemed to be an exempt service. However, if the direct mail agency provides the printing stock, the transaction would be taxable. Most direct mail agencies will argue that their customers provide all of the printing stock.

The department appears to be making a distinction between the services provided by direct mail agencies from similar services provided by traditional printers. If a traditional printer were to take customer furnished printing stock and perform the same personalization services as a direct mail agency, the transaction would represent printing in the traditional sense.

Since direct mail agencies are considered to be providing a nontaxable service, they are not entitled to the manufacturing exemptions on the supplies and equipment they use.

- F. The following public documents contain rulings and situations relevant to printing and printers:

P.D. 96-380. Taxpayer held liable for the tax on stickers enclosed with their product shipments. The stickers were provided free of charge to the taxpayer's customers and were designed for placement in their customer's automobile windows to display the taxpayer's business. In this case, the stickers do not qualify as exempt promotional materials since they only display the taxpayer's business and do not advertise tangible personal property for sale. The stickers are considered to be taxable "administrative supplies" since they are similar to business cards that are used to display a taxpayer's business. Also, the total purchase of the stickers is taxable regardless of the fact that the stickers may be shipped to another state. First use of the stickers is deemed to be made in Virginia.

P.D. 82-26 (Referenced in P.D. 96-327). The manufacturing exemption was extended to a printer's subprocessing activity in which a printing cylinder was dechromed, de-etched and replated with copper in preparation for subsequent use.

P.D. 96-33 (see also P.D. 95-218). A printer was held liable for the tax on a laser printer used to make proof copies of their printed product. Proof copies are sent to the taxpayer's clients for approval. Once a proof is approved or modified, the proof is sent to an image setter where a film is produced from the image that will result in the making of the printing

plate. The proofing process is deemed to be part of a taxable pre-production process.

P.D. 90-79. Taxpayer, a magazine publisher, may purchase photographic prints exempt of the tax if those prints are actually used in the magazine. The purchase of prints that are not used in the magazine are taxable. Also, camera film and supplies used by the taxpayer to take photographs are taxable since they are used in preproduction activities.

P.D. 89-159. Printing services rendered for the publisher of a free newspaper were not taxable. The taxpayer published the newspaper, but contracted with an outside party to do the printing. The publisher was entitled to an exemption for purchases used in industrial manufacturing.

P.D. 95-185. Taxpayer was not liable for the tax on promotional brochures purchased from Virginia and out-of-state printers and delivered directly to an out-of-state mailing house for distribution. In this particular case, the taxpayer made no use of the brochures in Virginia. However, the taxpayer is liable for the tax on promotional brochures purchased from Virginia or out-of-state printers and delivered to a Virginia mailing house. The tax would be due on that portion of the brochures mailed to Virginia residents.

Ruling of Commissioner, 6/6/85. Taxpayer, a newspaper publisher, may purchase camera film, developing chemicals, and proof paper exempt of the tax if such supplies are used to photograph a page layout for use in making printing plates. However, these same items would be taxable if they were used by the taxpayer to take pictures in the field for inclusion in the newspaper.

P.D. 96-304. Taxpayer, a newspaper publisher, must pay tax on batteries used to generate power to shut down production machinery and equipment in case of a power outage in order to protect the machinery from damage. While the batteries may be essential to the operation of the business in the case of a power outage, they are not directly used in the actual production of the tangible personal property.

Taxpayer is also liable for the tax on a press cleaner used after every press run to clean ink, grease and particles off of the press in order to improve the quality of the newspaper printed. The cleaner is used once at the end of the production day to clean the parts that have been removed from the press. The cleaner, in this case, is not "actively and continuously" used in maintaining exempt production machinery.

Finally, the taxpayer must pay tax on computers used by their editorial staff to write their stories. The computers are used to enter news and

editorial data. The data is then electronically converted into another software system used by the copy desk editors for electronic pagination. While the computers are an essential part of the production and printing process, they are not an immediate part of the actual production of the newspaper.

P.D. 97-54. The sale of printing and cutting dies by a box manufacturer are taxable. Although the manufacturer could purchase the dies or the materials used to make the dies exempt of the tax, since it used them directly in manufacturing products for resale, subsequent sales of the dies by the manufacturer were held taxable because they constituted retail sales to customers who were not actually using the dies in an exempt manufacturing process or for some other exempt purpose. See also P.D. 96-180 & P.D. 96-324.

P.D. 88-50. A counting system attached to a printing press was subject to the sales and use tax. The counting system was used to supply press operators with an accurate count of production as well as to produce skid tickets and management reports. However, there is no indication that the system was used to direct or control production line operations.

P.D. 95-216. Taxpayer is liable for the tax on cutting, folding, and converting charges made in connection with their purchase of printed materials. These charges represent services in connection with the sale of tangible personal property and are therefore taxable.

P.D. 96-278. Taxpayer, an industrial printer, is liable for the tax on cylinder pallets used to store printing cylinders and to transport such cylinders between the production line and the storage area. Although the cylinder pallets are needed to protect the etchings on the cylinders during transport and storage, at no time are the pallets used in production line testing or quality control activities. Rather, these pallets only serve an indirect role in protecting the integrity of the product by protecting the printing cylinder before it is used in the production of the product.

P.D. 97-65. The department has traditionally held that the printing of multiple documents of a like nature qualify as the sale of tangible personal property, even when such printing is performed on customer owned paper stock. However, when a customer provides the printing stock to a direct mail agency, and the agency performs data manipulation or "personalization" services which causes each printed piece to be unique in nature, the transaction is deemed to be an exempt service.

- G. The taxpayer records needed to perform an audit on printing or printers are no different than most other audits. Sales invoices should be checked closely to verify the shipping destination and to make sure that the printer is charging the sales tax on the total invoice charges. If there are exempt printing sales, the exemption certificates should be reviewed carefully for accuracy and completion. Also, the corporate income tax returns and sales journals are necessary to verify that all of a printer's retail sales have been reported to the state.

## Sales and Use Tax Audit Procedure

### 43- PUBLIC UTILITIES

**Objective:** Discuss the application of sales and use tax as it applies to Public Utilities

#### I. References

- A. Code of Virginia Section - 58.1-609.3
- B. Virginia Administrative Code 23 VAC 10-210-3020
- C. Public Documents: 87-276  
89-274  
89-335  
89-346  
90-068  
91-005  
91-064
- D. Applicable exemption certificate - ST-20
- E. Public Service Corporation Exemption Repeal 2004 Guidelines (PD 04-122)

#### II. General

Public utilities, as defined within sections 56-232 and 56-265.1 of the Code of Virginia, which are engaged in the generation, transmission and/or distribution of electricity, water, natural or manufactured gas are exempt from the tax. **Prior to September 1, 2004**, these entities operated under a certificate of convenience and necessity issued by the State Corporation Commission. Electric and gas companies used the Uniform System of Accounts which can be found in the FERC (Federal Energy Regulatory Commission) reference book. This book details the accounts and what items should be a part of the account.

Please note that the company may use FERC accounts that are not listed in the sales and use tax regulations section. **This does not mean that those accounts should not be reviewed and a ruling determination made as to its taxability.**

Usually there are associated companies, subsidiaries and/or holding companies making retail sales, intercompany/ intracompany transactions, as well as various services which may be offered. These should be defined and determined so you will be able to make an educated decision as to the taxability.

The primary focus is the interpretation of "direct."

Regulation 23 VAC 10-210-3020 defines direct usage. It refers to activities that are an integral part of the rendition of a public utility service...but not including incidental functions such as administration and management. It further states..."used directly...are those which are **both** indispensable to the actual provision of a utility service **and** used or consumed immediately in the performance of such service. The fact that a particular item **may** be considered essential to the rendering of a public utility service because its use is required either by law or practical necessity does not, of itself, mean that the property is used directly in the rendition of a public utility service."

Explanation of the regulations' footnotes to accounts. The footnotes indicate accounts which have variable taxable items.

Footnote 1 - pertains to fuel.

*Exempt* when in production/distribution process.

*Taxable* for property used in transportation of fuel from point of acquisition, administrative and purchasing and handling activities.

Footnote 2 - pertains to resale.

*Exempt* for purchases made for resale. Sales tax should be collected on all sales unless an exemption certificate is received from the purchaser.

Footnote 3 - pertains to areas equally exempt and taxable.

This usually is an inventory withdrawal or vehicles.

Footnote 4 - pertains to exempt categories with taxable properties.

Most purchases would be exempt however structures and general maintenance equipment and administration, record keeping and safety would be taxable properties.

Footnote 4 is one you will refer to constantly as the accounts have such a broad application. The application is analogous to manufacturing. The major difference is that **proration** applies to public utilities. Preponderance does not apply.

Footnote 5 - pertains to transportation equipment.

Exempt property would be those vehicles that are specifically designed or equipped for use in the production, transmission and distribution systems.

Water and sewage companies as well as some gas distributors, may not use the Uniform Systems of Accounts as provided by the Federal Energy Regulatory Commission. If they have a certificate of convenience and necessity by the State Corporation Commission and pay on their gross receipts, they are considered a public service company and fall within these regulations.

**Effective September 1, 2004**, the retail sales and use tax exemption available to public utilities for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was repealed. Those public utilities losing their exemption included electric suppliers, telecommunications companies, certain telephone companies, gas, water, and sewer utilities. In addition, to the extent public utilities generating electric power, qualify for the manufacturing exemption under *Code of Va. 58.1-609.3(2)*, they will be prohibited from claiming the manufacturing exemption, except for raw materials that are consumed in the production of electricity, including fuel.

### **Transitional Rules**

The following rules are provided to clarify when purchases or leases of tangible personal property, previously exempt from the retail sales tax, are subject to the tax.

#### Taxable

Tangible personal property purchased on and after September 1, 2004

Tangible personal property delivered to a purchaser and paid for on or after September 1, 2004, regardless of when the property was ordered.

Installment sales, when the date the contract is entered into are on or after September 1, 2004.

#### Exempt

Tangible personal property ordered, delivered and paid for prior to September 1, 2004.

Tangible personal property ordered and delivered prior to September 1, 2004 but paid for on or after September 1, 2004.

Installment sales, when the date the contract is entered into is prior to September 1, 2004, regardless of when the property is delivered or when payment is made.

Long-term Leasing Contracts

Notwithstanding the September 1, 2004 repeal of the public utilities exemption, no sales and use tax will be imposed on the lease payments for any tangible personal property leased pursuant to a bona fide contract that was entered into before March 1, 2004, provided that such tangible personal property was delivered to or placed into service by a public utility on or before September 1, 2004.

Inventory on Hand

Tangible personal property purchased prior to September 1, 2004, under the public utilities exemption, and placed in a tax-exempt inventory, will not lose its exempt status with the repeal of the public utilities exemption effective September 1, 2004. Such property will also maintain its exempt status upon the withdrawal from inventory and put in use in a taxable manner.

Temporary Storage

Effective September 1, 2004, tangible personal property brought into and stored in Virginia by a public utility, regardless of the fact the tangible personal property may be used out-of-state in an exempt capacity is subject to tax. For example, if a public utility has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia would be subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public utility and brought into Virginia and remitted by the 20<sup>th</sup> day of the month following the month of acquisition or importation into Virginia.

Direct Payment Permits

Effective September 1, 2004 all direct payment permits issued to public utilities losing their exemption were cancelled. Holders of direct pay permits are required to notify each of their vendors that the permit has been cancelled and future purchases are subject to the tax.

Front-End Agreements

Any and all front-end agreements currently in force between TAX and any public utility were cancelled effective September 1, 2004.

Other Exemptions

Other sales tax exemptions that may be available include, but are not limited to the exemption for research and development, certified pollution control equipment, resale and for tangible personal property for use or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

**III. Procedures for Audit Periods prior to September 1, 2004**

A. The initial steps for pre-audit would be:

1. Review previous audit
2. Review ruling letters
3. Obtain FERC book
4. Review registration data for all accounts known

B. The initial steps for pre-audit conference would be:

1. Determine if the uniform standard of accounts is used
2. Determine the principal activities (Generation, distribution and/or transmission)
3. Determine if regulated by SCC (State Corporation Commission) certificate of convenience and necessity
4. Determine how capital and expenses are recorded
5. Obtain sales tax returns, federal returns, Form 10k, FERC Form 1.
6. Ask about associated companies, holding companies, etc.
7. Request: Chart of accounts, general ledgers, journal entries, manual checks, sales journals, list of vehicles, furniture, fixtures and equipment as well as capital jobs (construction work in process), off-road fuel reports, retired assets, and pollution control certifications.

8. Questions would include: What type of sales do you make? How are invoices retained and coded? How is inventory accounted for (purchases, withdrawals, adjustments)? Where are the locations and the various activities? Are there contractor relationships? Is there a laboratory? Are there R & D projects?

C. Areas to review during audit

Chart of accounts - the chart of accounts is usually the same as those listed in our regulations book. They may have added an extension to represent a specific area, location or department.

Review their accounts noting those which are both 100% taxable as well as those footnoted as shown in the regs. Look them up in the FERC book to find out what the account represents. For example: **184** in the regs indicate "clearing accounts." Most of the companies use this account for their vehicles. Account **107** is a construction work in process account. As you will note, this account is not shown in our regs.

It is also necessary to determine where employee sales, purchases for resale, and disposed of items are recorded.

Expenses - sample or detail

Determine the size of the records and what financial statements you will want to use should you decide to sample the general expense purchases. This would follow the same procedure as a regular sales and use tax audit.

How are invoices, purchase orders retained?

If there are no invoices available, the check register, a detail general ledger or purchase journal will be necessary. You also need to review the sales tax payable account for accruals and the process it flows through to the return.

Stores, Materials issue or inventory withdrawals

These are usually accounted for by a monthly report which shows the item(s), the requisitioner and the cost. An allocation of expense is recorded with a journal entry. You will need to review the list of items withdrawn as well as the area or department to which the items are charged.

Public service companies feel that everything they use is part of the rendition of their service. Which of course it is, but that does not of itself make it exempt.

### Vehicles

Obtain a listing of vehicles and make a determination as to how and where the vehicles and equipment are used.

A review of the type of vehicle will give you a reasonable guide. For instance, a trencher, backhoe, thumper truck, bucket truck, cherry picker, and crane will be exempt (unless you determine they are using them for some other type of activity). The fuel that would be used for these types of vehicles would be exempt as well.

The tractors, power saws, light trucks, automobiles, and vans would or could be administrative. (If you determine they are using them in some exempt function, then you will need to decide on a proration percentage. Be sure the percentage is based on reasonable factors and is measurable.)

Any accessories, parts, or supplies purchased in bulk for stock would need to be prorated unless there is an inventory log kept which could be used to determine the vehicles these items were used on.

There are multiple uses for vehicles and equipment depending on the company and the services provided. Some of the uses could be as follows:

*Right of way* - this is usually a function that requires purchases of land, surveying, perhaps clearing brush - this would be administrative.

*Staking* - this is usually marking where utility lines will be placed – administrative.

*Surveying, engineering, customer service, meter reading* - these functions are administrative - unless they perform exempt functions as well (Usually this is very minute, if at all. However, it would require a proration if applicable).

### Equipment

This can be very confusing. As a rule, equipment that provides a record and/or analysis is considered to be used in an administrative function. This can mean that a percentage would apply to purchases for the equipment. Paper for the printers or equipment however, would be fully taxable.

Fault recorders would be taxable to the extent of their administrative use. Hot sticks are exempt. (These are used to disrupt power for work on lines). The covers for the hot sticks that are used to hold the instrument for protection at a substation would be taxable.

### General purchases

Linesmen equipment such as gloves (these are usually special as they protect against shock), knee guards, hats and their tools are exempt. However, the urinals, tool bag or bucket, coolers, and water would be taxable.

Landscaping materials are taxable even though they insist that an open hole is dangerous. We realize that they do not try to make it look pretty, but it is not used or consumed immediately in the rendition of providing the service.

Stakes, marking flags, paint, ribbons, manuals, maps, markers, locks, pads which are not attached to exempt equipment, numbers, tags, animal protection items, fire and safety alarms and general maintenance items are all considered taxable.

Purchases for meter readers would be taxable. There are sophisticated readers/scanners which require maintenance contracts and computerized software. These would be taxable as applicable.

Items purchased for certified pollution control projects of course would be exempt as applicable.

R & D as well as laboratory purchases would be exempt as the statute and regulations apply to these functions.

General maintenance purchases would be taxable. The exception would be purchases for exempt equipment such as oil for transformers, the paint for transformers that is specially manufactured for their use, as well as tools and materials used in exempt functions.

An example of personal use would be water heater repair as shown on the example enclosed. While the company provides a switch on a subscribing customer's water heater, the service they offer would be that of a contractor. As such, the materials used in the repair would be taxable to the company as the consumer.

### Capital

Usually the furniture, fixtures and administrative equipment are coded under the 390 series. However, it is possible to have exempt items such as radios for vehicles in one of these accounts.

Capital projects are usually those which require construction and are capitalized at the completion of the project or the end of the accounting period.

The jobs can have blueprints, marking paint, stakes, security, safety and other general items recorded in the capital account as part of the cost of the job. Office trailer rentals, port-a-potty rentals, rental of equipment which would be taxable. Materials for the construction of a building would be taxable as would fences, gratings, foundations and other structures. Be aware that there may also be items charged to the project from their inventory which need to be reviewed as to their use and taxability.

### Tours

A tour is recommended. Especially at a remote location where you cannot observe the activities. The stores warehouse would be a recommended tour **after** reviewing the items in inventory. This will allow you to ask pertinent questions to determine the usage as well as the unique terms or names of the items. Each company has their own language.

### Sales

Verify the sales tax reported to the sales tax payable account. Verify the accuracy of the local tax and the various locations, if applicable.

Sample or detail sales reviewing the invoices, transactions and documentation. Also verify the exemption certificates for those taxable sales which were not charged sales tax.

If a refund was applied for from DMV for off-road fuel, ensure it has been included on the sales tax return. Verify the deductions or exempt transactions as well.

There may be inter-company leases or sales which need to be reviewed. A journal entry is usually used to record this, but invoices to the associated company are also used.

The revenue accounts are usually in the 400 series. Review these accounts to determine the sources of revenue.

Co-generation companies manufacture steam or energy for other companies. Unless they are granted a certificate of convenience and necessity by the State Corporation Commission, they will at least qualify as a manufacturer if more than 50% of their product is for resale. (See Commissioner's ruling letter dated November 21, 1989.)

## **IV. Procedures for Audit Periods Beginning September 1, 2004**

A. The initial steps for pre-audit would be:

1. Review previous audit
  2. Review ruling letters
  3. Obtain Chart of Accounts
  4. Review registration data for all accounts known
- B. The initial steps for pre-audit conference would be:
1. Determine how capital and expenses are recorded
  2. Obtain sales tax returns, federal returns, Form 10k, FERC Form 1.
  3. Ask about associated companies, holding companies, etc.
  4. Request: Chart of accounts, general ledgers, journal entries, manual checks, sales journals, list of vehicles, furniture, fixtures and equipment as well as capital jobs (construction work in process), off-road fuel reports, retired assets, and pollution control certifications.

5. Questions would include: What type of sales do you make? How are invoices retained and coded? How is inventory accounted for (purchases, withdrawals, adjustments)? Where are the locations and the various activities? Are there contractor relationships? Is there a laboratory? Are there R & D projects? Are there pollution control projects?

C. Areas to review during audit

Chart of Accounts

Review their accounts for accounts in which there would be purchases of tangible personal property.

It is also necessary to determine where employee sales, purchases for resale, and disposed of items are recorded.

Expenses - sample or detail

Determine the size of the records and what financial statements you will want to use should you decide to sample the general expense purchases. This would follow the same procedure as a regular sales and use tax audit.

How are invoices, purchase orders retained?

If there are no invoices available, the check register, a detail general ledger or purchase journal will be necessary. You also need to review the sales tax payable account for accruals and the process it flows through to the return.

Stores, Materials issue or inventory withdrawals

These are usually accounted for by a monthly report which shows the item(s), the requisitioner and the cost. An allocation of expense is recorded with a journal entry. You will need to review the list of items withdrawn as well as the area or department to which the items are charged. Items in inventory purchased prior to September 1, 2004 are exempt until withdrawn from inventory and put in use in a taxable manner.

Raw Material and Fuel Purchases

**Raw materials and fuel that are consumed in the production of electricity are exempt. Rail car leases are taxable. These purchases may be both included in the fuel purchases account.**

### Exempt General Purchases

Items purchased for certified pollution control projects of course would be exempt as applicable.

R & D as well as laboratory purchases would be exempt as the statute and regulations apply to these functions.

### Tours

A tour is recommended. Especially at a remote location where you cannot observe the activities. This will allow you to ask pertinent questions to determine the usage as well as the unique terms or names of the items. Each company has its own language.

### Sales

Verify the sales tax reported to the sales tax payable account. Verify the accuracy of the local tax and the various locations, if applicable.

Sample or detail sales reviewing the invoices, transactions and documentation. Also verify the exemption certificates for those taxable sales which were not charged sales tax.

If a refund was applied for from DMV for off-road fuel, ensure it has been included on the sales tax return.

There may be intercompany leases or sales which need to be reviewed. A journal entry is usually used to record this, but invoices to the associated company are also used.

Revenue the revenue accounts.

Co-generation companies manufacture steam or energy for other companies. Unless they are granted a certificate of convenience and necessity by the State Corporation Commission, they will at least qualify as a manufacturer if more than 50% of their product is for resale. (See Commissioner's ruling letter dated November 21, 1989.)

## **Sales and Use Tax Audit Procedure**

### **Radio and television broadcasting**

**Objective:** Discuss the application of sales and use tax as it applies to radio and television broadcasting.

#### **I. History**

**7/1/76.** Code of Virginia §58-441.3 (d) Effective, 7/1/76 when a station leases a film for showing, such film is exempt since in accordance with amended Code §58-441.3 (d) the terms "lease or rental" do not encompass the leasing, renting or licensing of copyright audio or video tapes, and films for public exhibitions at motion pictures or by licensed radio and television station.

**Prior to 1977.** Code of Virginia §58-441.6 (j) The broadcasting exemption applied only to broadcasting equipment and accessories used directly to disseminate the signal into the air. The Tax Department maintained the position that the broadcasting exemption applied to live broadcasting and not programming or pre-production activities.

**1977.** Code of Virginia §58-441.6 (j) Virginia Supreme Court Case (WTAR Radio - TV Corporation v. Commonwealth of Virginia) upheld that (1) Broadcasting means transmitting a signal into the air. An exemption continued to be allowed for equipment, parts or accessories used to disseminate the signal into the air for a live broadcast. The Court Case also upheld the Department's position that programming and pre-production activities remained a taxable function. (2) The second issue concerned the production of advertisements by a broadcasting company. The ruling stated that the true object of a customer purchasing a taped advertisement was to seek tangible personal property and not the service. (3) The Broadcaster argued that the taped advertisement remained in their possession and was available to the customer upon request. The Court deemed that the total charge (including studio time, art work, dubs and acting (talent) would be subject to sales tax.

**7/1/95. Code of Virginia §58.1- 609.6 (a,b)** amended for the period July, 1995 through June 30,1997. Broad exemption provided to entities engaged in the production, use, purchase, sale, or lease of audio visual tapes for licensure, distribution, broadcast, commercial exhibition or reproduction or use in producing another exempt audiovisual work. Examples of such entities include, but are not limited to, program producers, (i.e., radio, television and cable companies), film and audiovisual tape production companies, advertisers and others. An exemption also extends to the equipment, parts and accessories used or to be used in the production of exempt audio-visual works.

## **II. References**

- A. Code of Virginia §58- 441.3, §58-441.6 (j), §58.1-608 (6 b) §58.1-609. 6 (2), §58.1-609.6.(6 a,b) - New legislation effective 7/1/95
- B. Virginia Administrative Code 23 VAC 10-210-3030
- C. Ruling Letters
  - PD 87-219
  - PD 88-331
  - PD 93-96
  - PD 94-51
- D. Private ruling letters dated:
  - 2-13-80 - antennas, transformers, cameras, control room equipment, lease of copyright tapes.
  - 12-28-83 - Sales of fabricated video tapes
- E. Virginia Tax Bulletin
  - 95-5 - Production of audiovisual tapes/films exempt
- F. Applicable exemption certificate
  - St-20 Purchase of tangible personal property
  - St-20 A Purchases of production equipment for audiovisual tapes/film
- G. Court Case
  - WTAR - TV Corporation v. Commonwealth of Virginia

### **III. General**

- A. Radio and television companies enjoy an exemption for equipment, parts, accessories, and towers used directly to broadcast. Broadcasting concerns must be regulated and supervised by the Federal Communications Commission.
- B. Broadcasting has been defined as disseminating a signal into the air and is considered an exempt function. Programming preparation and news gathering activities remain taxable.
- C. Broadcasting companies involved in audiovisual production enjoy a broad exemption on purchases of tangible personal property used in the production of audiovisual works for licensure, distribution, broadcast, etc. If audiovisual work is not used for licensure, distribution, broadcast, etc., purchases of tangible personal property are taxable.
- D. Disclaimer: The exemption given to audiovisual companies as of 7/1/95 could impact existing laws for radio and tv broadcasters as it relates to exempt, taxable and proratable purchases. Presently, the full extent of this impact is not known.

### **IV. Procedures**

#### **A. Sales**

Broadcasters may produce and sell video tapes or films. The production of the video tapes fall within two categories, media or non-media. Media tapes are exempt from sales tax. Examples of media films include tv advertising, made-for-tv movies, feature films, documentaries, radio programs, etc.

Non-media tapes have been defined as films produced for in house training, weddings, accidents, corporate meetings, product description tapes, etc. These types of films are taxable based upon the sales price of the film.

## **B. Purchases**

Note: The following procedures have been written in accordance with the existing rules and regulations for broadcasters. The new exemption given to audiovisual companies is a much broader exemption than the existing exemption given to broadcasters. The equipment and accessories used by broadcasters that also produce audiovisual tapes and films may have multiple uses. Determining the taxable, exempt or proratable status of such equipment and accessories may change.

### **General**

A tour of the broadcasting facility with a technical engineer provides useful insight in determining the various uses of broadcast equipment. It is important to ask questions concerning the use of the equipment and accessories because some equipment may need to be prorated for use tax.

Some departments which will be under review in broadcasting companies may include weather, news, sales, graphics, control room, studio, editing, research, tape storage and administration.

A review should be made of the chart of accounts and purchases journal. The chart of accounts may be subdivided by departments, cost centers or general ledger coding. It may be necessary to review the general ledger for intercompany purchases. Purchases may be taxable, exempt or proratable.

### **Exempt Purchases**

The sales tax regulations have historically exempted broadcasting equipment that is used to disseminate a signal into the air. Exempt equipment and accessories includes, but are not limited to, towers, satellite receivers, antennas, studio cameras and microphones (used for live broadcast).

### **Taxable Purchases**

Programming, news gathering, and administration purchases are deemed to be taxable. Purchases of equipment and supplies that are not used directly to transmit a signal are also taxable. Examples include, but are not limited to, the purchase of studio furniture and lighting, news sets, interview sets, weather centers, air conditioning, heating, computers, tape carts and storage systems, weather maps, ear phones, blank tapes and reel degaussers (tape head cleaners).

### **Proratable Purchases**

When the same equipment and accessories are used for transmitting the signal as well as for news gathering, preparation and programming the purchases should be prorated. Examples include, but are not limited to, weather computers, routing equipment, cables, monitors, field cameras (if shooting live and taped features), tape players and recorders, audio equipment, and batteries.

# Sales and Use Tax Audit Procedure

## 45\_Cable Companies

**Objective:** Discuss the application of sales and use tax as it applies to Cable TV Companies

### I. History

**1975.** Virginia Supreme Court case (Winchester TV Cable Company v. State Tax Commissioner) ruled that the actual use of equipment determines whether it qualifies for the broadcasting exemption not merely its capability.

**1977.** Virginia Supreme Court case (WTAR Radio-TV Corporation v. Commonwealth of Virginia) ruled that a television station's purchase of production items, including lighting and videotape equipment, film and props, is subject to sales and use tax.

**3/19/80.** Virginia Tax Bulletin 80-3; House Bill 960: The broadcasting exemption was granted to Cable Companies.

**1988.** Advertising insertion equipment is determined to be exempt. (PD-88-205) when the equipment automatically disseminates commercial advertisements and monitors and adjusts program signals. This differs from Commissioner's ruling in 87-208.

**7/1/95.** For period July 1, 1995 through June 30, 1997, Code of Virginia 58.1-609.6(6) amended to allow for the exemption from tax for entities engaged in the production, use, purchase, sale or lease of audiovisual tapes for licenser, distribution, broadcast, reproduction or use in producing another **exempt** audiovisual work. The exemption covers not only the production services and incidental tangible personal property but also equipment, parts, and accessories.

Most if not all of the cable companies also provide broadband internet service and digital phone service. Please refer to the information on Internet service providers and telecommunications for how these areas of their business shall be treated. Remember that in September 2004 the telecommunications industry lost their tax exempt status.

### II. References

- A. Code of Virginia Section 58-441.6(J), 58.1-608(6B), 58.1-609.6.
- B. Virginia Administrative Code 23 VAC 10-210-3030.
- C. Ruling Letters
  - PD-95-193 Cable Television System Defined
  - PD-95-165 Production Equipment Exemption
  - PD-94-51 Blank Tapes
  - PD-93-205 Cable Equipment
  - PD-90-184 Tangible Personal Property
  - PD-90-48 Hand-held Remotes
  
  - PD-88-331 Scrambled Signals, Pay Per View
  - PD-88-230 Hand-held Remote
  - PD-88-205 Advertising insertion Equipment
  - PD-87-208 Remote Converters, Tools, Test Equipment
  - PD-96-7 Cable Television Equipment

- PD-04-89 Cable Internet Service
- PD-96-3-2 Cable Equipment

D. Virginia Tax Bulletins

- 95-5 Production Equipment Exemption (PD-95-165)
- 84-8 Redefines Personal Property (PD-84-112)
- 84-7 Redefines Personal Property (PD-84-72)
- 83-3 Cable Television Property (PD-83-94)
- 80-3 Broadcast Exemption to Cable Companies

E. Applicable exemption certificate

- ST-20 Purchase of TPP
- ST-20A Production Equipment

F. Private letter rulings

- June 4, 1993 Broadcasting accessories

G. VA Supreme Court Cases

- WTAR Radio-TV Corporation
- Winchester TV Cable Co.

H. House Bill 960 Broadcasting exemption; Virginia Tax Bulletin 80-3

### III. General

- A. 58.1-609.6(2) of the Code of Virginia, interpreted by tax regulation 23 VAC 10-210-3030, provides an exemption from sales and use tax for:

Broadcasting equipment and *accessories* used **directly** in the amplification, transmission and distribution of a signal by a cable company.

In short, if the signal passes through it, it is probably exempt.

- B. Accessories do not have to qualify to the same degree as equipment but "they must be a part of, joined to, and render exempt equipment more perfect in disseminating or distributing a signal".(PD-93-205)

- C. The broadcasting exemption is available only to cable companies that are regulated by the FCC.

- D. Production equipment used to produce exempt audiovisual work is exempt. Exempt audiovisual work includes made for TV movies, feature films, documentaries for broadcast, commercials for public viewing, video tapes for TV. Taxable works would be in-house training films, corporate meetings, films for other than commercial broadcast.

### IV. Procedures

#### A. Sales

Cable companies are considered the providers of a service and any equipment that is leased or rented is considered an inconsequential element of the service and is not taxable. For example equipment rental such as satellite dishes, converter boxes, or remote controls when included with cable services are exempt from tax. Equipment that is leased or rented without the provision of cable service is taxable.

The Cable industry is rapidly moving into new areas of telecommunications and has begun selling equipment. Tax should be collected on the sale of any equipment or tangible personal property sold.

## **B. Purchases**

The chart of accounts is usually the best place to start identifying taxable purchases. Cable companies purchase so many "high tech" items, often the chart of accounts number is the only clue to its purpose. There are often inventory accounts in the current assets section which are debited as supplies and equipment are purchased. Locate the taxable accounts such as **installation parts**; hardware accounts that would include **cable ties** and **conduits**, also the equipment account for **remote controls**. The expense accounts should also be reviewed for **shop supplies** and **service materials**.

Another useful tool when reviewing purchase invoices is the parts manuals. Locate the employee who orders parts and equipment. They often have on hand cable equipment books that not only describe the part, it's purpose, but also include a sketch or picture. Hand-held remotes for example, may be listed on the invoice by a stock number such as ABC-2005. You need to identify items listed by a number, don't assume parts listed by a number are exempt. Now that we have the internet available to us, it is also helpful to look up their vendors on line to see pictures and explanations of items purchased. Search can be done by vendor or item.

A tour of the cable facilities will also help identify taxable and non-taxable areas.

## **Exempt Purchases**

Broadcasting equipment: Examples of exempt broadcasting equipment which amplify and disseminate the signal are the head-end equipment, amplification equipment, towers, satellite receivers and power supply equipment. Distribution test equipment used in the analysis, adjustment and monitoring of the outgoing cable signal is also exempt.

Parts and accessories: Parts and accessories that render exempt equipment more perfect in disseminating or distributing a signal are: transistors, integrated circuits, amps, capacitors, inserters, *positive* traps, power supply equipment and backup batteries, lock boxes, converter boxes, F-fitting boots, locking terminators, strand and strand link, and advertising insertion equipment. Housing such as the CATV pedestals including closures and stakes, breaker boxes including their parts and accessories and junction boxes are also exempt.

Production equipment, accessories, and incidental TPP: Examples of production equipment are cameras, lighting equipment, cranes and booms, dubbing editing and sound recording equipment. Incidental tangible personal property would be items such as props, scripts, design and artistic supplies, and wardrobes.

## **Taxable Purchases**

Equipment: Examples of taxable equipment are the air conditioning and heating to maintain the integrity of the broadcasting equipment, **computers** and other equipment used for administrative purposes, **tools** and **testing equipment** used to locate cables, and hand-held **remotes**. Whereas the locking terminator is an exempt item the locking terminator **tool** to install or remove one is taxable.

Parts and Accessories: Examples of parts and accessories that are taxable are: attachments such as **cable hangers** and **ties**, installation parts and accessories such as **roka clips**, **drive pins**, **trim and cove molding**, and **wall plates**, locking and security mechanisms and

attachments, drop tags, **equipment racks** and **equipment housing**, **grounding material**, **conduit** which may be listed as PVC or interduct, and **strand maps**. Also **support brackets** and **hooks, deadends, markers and negative traps** that scramble the signal. The traps when not identified as either positive or negative may be identified by the channel number. You will need to ask which channels use negative traps.

Production equipment, accessories and TPP: Examples of taxable production items are **office equipment** and supplies, chairs used for convenience purposes, and **location tents**. Taxable production equipment would be items such as **air conditioning/heating** to maintain the integrity of equipment, **computers** and other administrative equipment.

## Sales and Use Tax Audit Procedure Research and Development

The authority for the Sales and Use Tax exemption derives from 58.1-609.3(5) of the Code of Virginia, which states:

The tax imposed by this chapter or pursuant to the authority granted in §§ 58.1-603, 58.1-604, 58.1-605 and 58.1-606 shall not apply to the following:

“Tangible personal property purchased for use or consumption directly and exclusively in basic research or research and development in the experimental or laboratory sense.”

From this code section derives the Sales and Use Tax Regulations, 23 VAC 10-210-3070B, which states, in part:

“The tax does not apply to tangible personal property purchased or leased and used directly and exclusively for research in the experimental or laboratory sense.”

Definitions (23 VAC 10-210-3070):

“Basic research” means a systematic study or search in a scientific or technical field of endeavor with the ultimate goal of advancing knowledge or technology in that field. The development of a tangible product or process need not occur in basic research activities. Examples of basic research activities include medical, chemical, or biological experiments conducted in a laboratory environment.

“Direct use” means those activities which are an integral part of basic research or research and development activities, including all steps of these activities, but not including secondary activities such as administration, general maintenance, product marketing, and other activities collateral to the actual research process.

“Exclusive use” means items are used solely in basic research or research and development activities.

“Experimental sense” means work is conducted through tests, trials, tentative procedures, or policies adopted under controlled conditions to discover, confirm, or disprove something doubtful.

**“Laboratory sense” means work is conducted in a place equipped for experimental study in a science and providing an opportunity for experimentation, observation, or practice in a field of basic scientific or traditional physical science research.**

“Research” means basic research and research and development as defined in this section.

“Research and development” means a systematic study or search directed toward new knowledge or new understanding of a particular scientific or technical subject and the gradual transformation of this new knowledge or new understanding into a usable product or process. Research and development must have as its ultimate goal: (i) the development of new products; (ii) the improvement of existing products; or (iii) the development of new uses for existing products. Research and development does not include the modification of a product merely to meet customer specifications unless the modification is carried out under experimental or laboratory conditions in order to improve the product generally or develop a new use for the product.

Research does not include testing or inspection of material or products for quality control; however, in the case of an industrial manufacturer, processor, refiner or converter, testing and inspection for quality control is deemed to be an exempt activity under 23 VAC 10-210-920. Additionally, research does not include environmental analysis, testing of samples for chemical or other content, operations research, feasibility studies, efficiency surveys, management studies, consumer surveys, economic surveys, research in the social sciences, metaphysical studies, advertising, promotions, or research in connection with literary, historical, or similar projects.

**Extent of the research exemption. [Refer to 23 VAC 10-210-3071.]**

To qualify for the exemption, the tangible personal property leased or purchased must be “used directly and exclusively” in an actual research process. This process should be in the “experimental or laboratory sense.” The exemption begins with the handling and storage of raw materials and supplies at the research facility and ending after the last step of the research process when the products of the research process are stored at the research facility.

To be exempt the item, material, or supply must be used directly and exclusively in the research process.

Some items may be required but may not be “used directly”. When a single item is used in both an exempt and non-exempt activity, it is not deemed to be “used exclusively” in research activities and is taxable. An example of this would be a computer system that is used to both analyze laboratory tests to determine the validity of the laboratory findings, but also used to perform other regular functions, such as management reports, grant reports, and other non-research activities. In this instance, the computer would be taxable. Pro-rata, percentage of exempt usage or preponderance of use of an item is not permitted.

An exception to the exclusivity test is the “de minimis usage” rule. When research property is used in a taxable manner, it will only be exempt from the tax if the taxable use is de minimis in nature. Taxable use of the property is considered de minimis if the taxable usage of the property (1) does not involve a continuous or ongoing operation; (2) does not follow a consistent pattern, i.e. weekly, monthly, quarterly, etc.; (3) is occasional in nature occurring no more than three times; and (4) in total, accounts for no more than three days.

An example of de minimis usage would be a computer used in research and to generate a one time report that took three or less days to produce and is not an ongoing usage, i.e. monthly, weekly, quarterly, etc. In this case, the use of the computer to generate this report would be considered de minimis usage and the computer would not lose its exemption.

However, if this same computer is used weekly to produce a report, as required by the conditions of a research grant, the usage would not be considered de minimis and the computer would lose its exempt status.

If an item, which originally qualified for the exempt status, due to its direct and exclusive use, is used in a taxable manner that is **not** considered de minimis, the use tax should be remitted on a Consumer Use Tax Return, Form ST-7, based on the purchase price of the item. If the conversion of the item to taxable use is six months after its original purchase date then the tax may be computed on the lower of the purchase price or the fair market value at the time of the taxable use.

The tangible personal property must be purchased or leased by the person, firm, corporation, or entity that actually performs the exempt research in order to qualify for the sales tax exemption. If the research equipment is purchased or leased by a party other than the person providing the research activity, the item would be taxable. This is true even if the equipment is donated or loaned to an exempt entity.

### **23 VAC 10-210-3072. Research; taxable and exempt items.**

Following are examples of taxable and exempt items used in research activities. These lists are exemplary and are not intended to be all inclusive.

#### **1. Taxable:**

- a. Desks, chairs, copy machines, calculators, file cabinets, typewriters, etc., used by administrative clerical personnel in support of research activities;
- b. Desks, chairs, copy machines, file cabinets, work benches, storage cabinets used to store research equipment, tools, and supplies, etc., used by research personnel;
- c. Heating and cooling equipment used to maintain an optimum temperature in a research facility when also used for general heating and cooling purposes;
- d. Items used in the publication of research findings;
- e. Items used in marketing new products resulting from research;
- f. Computer hardware and taxable prewritten or modified software when used for administrative and other activities collateral to actual research activities;
- g. Equipment and supplies for cleaning or sterilizing items used directly in research activities either before or after these activities;
- h. Equipment and supplies used to produce items that will be used directly in research activities;
- i. Technical books and journals purchased by a research facility for general reference and training purposes, or to keep research personnel informed of current scientific advancements, achievements, or events, and not purchased in connection with specific research activities.

#### **2. Exempt when used directly and exclusively in research:**

- a. Test tubes, flasks, reagents, microscopes, slides, and similar items;
- b. Electronic instrumentation and components, laboratory tables and equipment, tools, and similar items;
- c. Technical books and journals purchased by a research facility for use in performing background research for a specific research project;
- d. Paper and supplies used to record research findings during the actual research process;

- e. Computer hardware and software when used exclusively to store, retrieve, and process research data;
- f. Protective clothing provided gratuitously to employees engaged in research activities;
- g. Items used to transport or store research materials during and between various steps of research at the research facility;
- h. Heating and cooling equipment used to maintain the integrity of research materials;
- i. Repair parts for new equipment used during the field testing stage of research activities; and
- j. Drugs, chemicals, animals, and other raw materials, including the cabinets, shelves, or cages in which these items are stored.

**23 VAC 10-210-3073. Research; contractors.**

Generally, a contractor is the user and consumer of all tangible personal property furnished to or by him in connection with real property construction, reconstruction, installation, repair, and similar contracts as provided in 23 VAC 10-210-410. However, tangible personal property furnished to or by the contractor which will be used directly and exclusively in research is exempt from the tax. The contractor may purchase this property exempt of the tax by furnishing to the vendor a properly executed exemption certificate, Form ST-11A.

**23 VAC 10-210-3074. Research; use of exemption certificates.**

In making purchases for use in research, a person should furnish suppliers with a certificate of exemption, Form ST-11. However, these certificates should not be used in making purchases of items which are not directly and exclusively used in research. If the business gives a certificate of exemption and then uses some of the property purchased for purposes other than research, the business must remit the tax to the department as provided in 23 VAC 10-210-3071 D.

**APPLICATION**

There are numerous questions and situations that the auditor(s) must review with the taxpayer to fully determine the scope of the taxpayer's lab activity and if this activity qualifies the taxpayer for the R&D or research exemptions.

Usually the R&D question applies to a manufacturer's Virginia operations. So, the auditor should determine if the manufacturer has other locations and if so what is the nature of the research/lab activities done at the other locations. With many manufacturers their primary R&D site is not at a production site but at or near their corporate headquarters or in a technologically advanced area such as a university research facility.. Usually the lab at the production site is testing for different reasons.

These reasons can be:

1. Testing of raw materials and incoming supplies to determine if the item meets the manufacturer's specifications. This is not R&D but **may** qualify as in process Quality Control testing.
2. Testing to determine if the customer's product can be produced with a different material (maybe less costly) and still be within the customer's contracted price.

3. Testing to determine if the product produced would work in the customer's equipment. For example, can the print cartridge be changed to work in a different model printer? The research must produce a new product or a new use for the same product. In this instance neither requirement is met. It is not a new product or new use because it is still performing the same function.
4. Testing to determine that the manufacturer's product will meet all marketing specifications. (Does not qualify as R&D or Quality Control testing.)

The first thing the auditor must do is to determine why the taxpayer is conducting the testing. Is it true R&D testing or some other type of testing? Such as those mentioned above and therefore not qualifying for the R&D exemption.

Once the auditor verifies that the testing does meet the Sales and Use Regulations for R&D testing (see above), then, the auditor must review the lab procedures to ensure that the equipment and supplies purchased are being used directly and exclusively for the R&D testing.

These are two very important requirements:

1. Used directly. If the item is necessary, but is not used directly in conducting the lab tests, then the item is not exempt. The auditor should review each individual purchased item to ensure it meets this test. Furniture, storage cabinets, climate control equipment used for the comfort of the employees would be taxable, since they are not directly used in the R&D process.
2. Used exclusively. This is another important test. If a piece of lab equipment is used both in qualifying R&D research and in other non-qualifying testing, then the piece of equipment is not tax exempt since the use of that equipment was not exclusively for R&D unless the de minimis rule applies.

In summary, the auditor must ensure that the taxpayer conducting the R&D testing meets all of the Sales and Use Regulations to qualify for the exemption. It is not a matter of what the taxpayer considers their testing to be, but the regulation's definition. The rules are complex and very specific. The application will vary from industry to industry and from taxpayer to taxpayer. Keep in mind that with the growth of technology and varying testing environments the application of the R&D exemption can vary from audit to audit. With technological advances new relationships may be created in the R&D field. These entities are partnering to provide R&D services to the client. In this case the auditor must ensure that both entities meet all Sales and Use Tax requirements to determine which part of the exemption applies, if any, to each entity.



**“Sample Period”** means the portion of the audit period that is reviewed in detail in order to project the findings over the entire audit period. Depending on the volume of records, the sample period may be days, weeks, months or years.

**“Sample Base”** means the data chosen to reflect the sample period for projection purposes over the audit period. Sample base usually conforms to the population of the sample period; but may be any consistent data on which the dealer and the auditor agree to use. For example, a sales audit with the month of May as the sample period may use gross sales (population) for the month of May as sample base to be used to arrive at an error factor to compute a liability/refund against gross sales for the entire audit period. The use of sales (population) data as a sample base in a purchase audit is an example of an agreed upon base.

**“Block Sampling”** means the use of all transactions in a selected period of time, combination of time periods, numerical sequence, or alphabetical sequence as the test period from which the sample is based.

**“Statistical Sampling”** means either the use of random-based sampling selection criteria, usually mathematically chosen random transactions throughout the audit period as the test for compliance; or systematic sampling criteria using a fixed interval between selections, the first interval having a random start. A computer program may be used to define and select transactions included in the sample.

**“Structured Non-statistical Sampling,”** means the use of defined criteria chosen by agreement between the taxpayer and the auditor as the test for compliance. For example, a recurring expense purchase sample may be used which contains only certain general ledger accounts that are identified to contain taxable transactions.

**"Error Factor"** refers to the percentage of records sampled that do not comply with the Virginia Retail Sales and Use Tax Regulations or the Code of Virginia. The error factor is computed by dividing the additional taxable sales/purchases by the gross sales/expense purchases reported for the period in question. Also known as **“margin of error”**.

**"Extrapolate"** means to infer or estimate by extending or projecting known information.

**“Rollup Method”** means to extrapolate the error factor evenly throughout the audit period. This assumes no fluctuation in business and produces a measure that is the same for all the periods in the audit. For example, a three-month sample in a three-year (36 month) audit period produces an untaxed measure of \$5,040.00. Rollup method would extrapolate \$1,680.00 per month or \$60,480.00 measure for the period.

**"Fixed Assets,”** means depreciable property used in operating a business that will not be consumed or converted into cash or its equivalent during the current

accounting period. Fixed assets also include property deducted under IRC Section 179. Assets may be deducted under IRC Section 179 if they are purchased for use in the active conduct of a trade or business and meet certain criteria.

**"Recurring Expense Purchases"** means non-depreciable ongoing purchases used in the everyday operation of a business.

**"Withdrawals From Inventory"** means the removal of tangible personal property from an inventory of items for resale for purposes other than resale.

**"Front-End Agreement"** refers to an agreement between the taxpayer and the Department of Taxation where the taxpayer will remit additional taxes on certain categories or general ledger accounts based on a single or multiple percentages which are derived from the results of an audit (either detail or sampled) of the taxpayer's records for a predetermined period of time. Front-end agreements usually cover prospective audit periods and reduce the amount of time needed to perform an audit.

General

**Audit sampling is examining less than all of the records of an audit period to determine the audit liability. Audit sampling is a technique used to compress the time required to perform an audit, and to minimize the volume of records examined. Sampling may be used in all types of audits. An audit period assessment that is based on a sample period and assessed by the Department of Taxation is prima facie correct and valid. The burden of proof that the sample is incorrect is upon the taxpayer.**

An auditor should thoroughly "think through" the use of samples before beginning the audit. Audit sampling assumes that a rationally selected sample period is representative of the audit population. Consideration should be given to fluctuation in business and categories of transactions within the business as well as volume of records. The objective should be to choose sample periods that are representative of all transactions of the dealer in the audit period. Choose different periods for the different tax areas, if necessary.

In very large audits, the Department of Taxation has software that can aid in sampling. This software may be used with sales or purchases. An auditor experienced with the "Invoice Capture Tool" is available to work with field auditors on audits where the use of this software is beneficial. The software is used to stratify a population, or divide the population into relatively homogeneous subgroups called strata. These strata then may be sampled separately; the sample results may be evaluated separately, or combined, to provide an error factor for the total population. Whenever items of extremely high or low values or other unusual characteristics are segregated into separate populations, each population becomes more homogeneous. It is then easier to draw a representative sample from which a

smaller number of items may be examined in each strata than to sample the total population. In addition to increasing the efficiency of sampling procedures, stratification enables auditors to evaluate materiality and other characteristics of items and to apply different audit procedures to each stratum.

Fixed assets should not be included in the sampling procedure. These items are not purchases that have recurred during the audit period. Asset purchases which are expensed (IRC Section 179) should be detailed along with capitalized fixed assets. The depreciation schedule should show expensed asset purchases. Cross check Form 4562 from the federal income tax return; it will show the dollar value of Section 179 property and will clue the auditor to request purchase invoices for these items if not seen elsewhere.

## Procedures

### **TO SAMPLE OR NOT TO SAMPLE**

It is important to consider various aspects of the taxpayer's business when deciding on a sample audit. Some type of sample can usually be used on most businesses. An evaluation of the type of business and sampling opportunities should be done. The basic characteristics of the business and the method of reporting must be consistent throughout the audit period. If characteristics of the business change during the audit period, separate samples should be made for each specific period to determine the individual error factors for each period. A sample should contain sufficient transactions to produce an accurate error factor representative of the business as a whole.

Check the prior audit comments for the methods used by the prior auditor. Research payment record and returns data to get information on taxable and exempt sales and fluctuation of business. By entering data into the STAUDN returns data screen, the program can be used to identify potential sample periods using various criteria. Does the return data appear to be correct in that gross sales and exempt sales are being reported on the return rather than just taxable sales? Ask the question in the initial contact if there is doubt. This may affect the periods chosen for sampling. Is there any familiarity with the nature of the business and the type of customers (exempt versus taxable)? Is the taxpayer selling to industrial and commercial customers? Are the invoice amounts on average small amounts? Is this taxpayer a multi-state dealer? What portion of total sales are Virginia sales?

The auditor should use the initial contact to obtain information about the business that will aid in the decision of whether or not to use sampling and the methods of sampling that would be most effective to obtain an accurate result. Inquire about the volume, nature & seasonality of the business, volume and organization of records, changes in accounting methods, software, and personnel responsible for

administering taxes. Are invoices available in hard copy for will you be able to view them on computer screen? Some companies now have the capability to download information to disk for your viewing on your computer.

Suggest to the taxpayer that a sample audit could be done to minimize the number of records and time needed to do the audit. Time and effort are as important to the taxpayer as they are to the auditor. Discuss sampling and share with the taxpayer the statistics from the returns screen data. Ask the taxpayer to be thinking about sample period(s) that would be representative of the overall business during the proposed audit period and for which records are readily available. This will give him period(s) to consider and time to evaluate the sampling concept.

At the beginning of the audit, review sampling again. By this time, you have evaluated the possibilities and opportunities for sampling from your initial conversation with the taxpayer. Now is the time to firm up the sample period and consider methods. Be sure the dealer understands the mechanics of sampling and agrees to the months selected. Remember that taking the time to fully explain how the audit process works generates goodwill and makes finalization much easier for both parties. When a sample is performed, a signed sample agreement from the dealer detailing the sample period and extent of the sampling may be desirable. Signed sample agreements can defuse later challenges to the validity of the sample. The sample agreement should note the sample period and class of transactions being sampled (sales, purchases). The auditor should inform the taxpayer or his representative that signing a sample agreement does not jeopardize his right to contest or appeal any portion of the audit with which he is not in full agreement.

Exemption certificates should be examined before beginning sales samples. This examination will alert the auditor to large volume, exempt customers and also give a warning to potential liability based on the information contained on the exemption certificate as well as helping to identify which customers for which exemption certificates are not on file. Title 23 of the Virginia Administrative Code (VAC 10-210-280) explains that the burden of proving that the tax does not apply rests with a dealer unless he takes, in good faith from the purchaser or lessee, a certificate of exemption indicating that the property is exempt under the law. A certificate that is incomplete, invalid, infirm or inconsistent on its face is never acceptable. The regulation further provides that an exemption certificate cannot be used to make a tax-free purchase of any item of tangible personal property not covered by the exact wording of the certificate. Therefore, the seller must use reasonable care and judgement in selling tangible personal property exclusive of the tax, even when an exemption certificate from the purchaser is in his file. Furthermore, certificates of exemption obtained during or after an audit situation will be accepted only if the auditor can confirm that the customer's use of the certificate was valid and proper for the specific transaction.

## Sample Design

Sample design covers the method of selection, the sample structure and plans for analyzing and extrapolating the results. There are many ways in which a sample can be selected. If the volume of invoices is small, larger sample periods may be selected. Detail audits may be appropriate when they can be accomplished in a short time frame. This allows the auditor to examine all facets of the business, which may reveal other audit opportunities. A combination of methods may be the answer, depending on the circumstances.

### Records

Code of Virginia 58.1-633 requires every dealer “to keep and preserve suitable records of the sales, leases, or purchases . . . and such other books of account as may be necessary to determine the amount of tax due hereunder, and such other pertinent information as may be required by the Tax Commissioner”. When a dealer fails to maintain adequate records, the department is authorized by Code of Virginia 58.1-618 to use the best information available to reconstruct a dealer’s sales or purchases to determine whether a tax liability exists. A sample of records on hand may be used to reconstruct data for an audit. Cancelled checks, credit card statements, bank deposits, items of public record, or statements by the taxpayer may be used when there are no records available. Any sample projected on this basis is considered prima facie correct.

### Sales

How are the records organized? Block sampling is particularly useful in sales audits and is the historical method used by department auditors. If sales invoices are available by invoice number in date order, the sample period could be a block of invoices less than a year. Monthly sales journals give flexibility to examine one-month blocks and tie tax collected to returns. If the only invoice information available is by customer by year, the auditor may have to examine an entire year of invoices to see all invoices.

If the business is seasonal, both the auditor and the taxpayer must be satisfied that the time block is representative.

Statistical sampling is useful in sales audits where the volume of transactions is large. In the best of audit environments, a sample chosen based on the volume of the dealer is preferable. Usually, a one-month to three-month sample is adequate. When transactions are fairly consistent, choose an average month as a sample. A three-month sample selecting one month from each of the three years of the audit period, or using the high, low and average months as indicated by the return statistics are additional options. If you are auditing a particularly large business such as manufacturers or retailers, consider a much smaller sample, such as one week.

If there are different categories of sales where dollar amounts fluctuate, such as equipment sales, parts sales, and repair sales, you may want to use a combination of sample methods or a combination of sample and detail methods.

### Purchases

Review the chart of accounts to identify which accounts are used for charging taxable purchases. Make a note of construction-in-progress and other suspense accounts used to initially charge depreciable assets. These accounts should be examined for purchases, that may be reclassified and capitalized later. Negotiation with the taxpayer may be necessary to separate the items to be considered assets and those that may be included in the expense purchase sample. Also note inter-company accounts that may contain charges not seen elsewhere.

The method used for sampling purchases should be determined by the size of the taxpayer and their filing system. Many taxpayers file purchase invoices by vendor, by year. The year may be calendar or fiscal. If the volume of records is small, a one-year block sample may be advisable. By scheduling the audit near the end of the first six months of the year, the use of a six-month sample period instead of an entire year would be possible.

If purchase invoices are batched and filed by voucher number sequence or by pay dates, there is much more flexibility in negotiating a sample period with the taxpayer that is smaller than twelve months, and covering more than one year of the audit period. Statistical sampling is a good choice where the number of transactions is very large.

The general ledger detail or an accounts payable ledger for a chosen sample may be used to select invoices to be examined. This can save time over looking at all the invoices in a sample period. Use of the general ledger assures that you are seeing all the transactions during a certain period. This can be valuable when there are inter-company charges for which no invoice is present. Remember to consider withdrawals from inventory, which may or may not show up on the books of the taxpayer.

### Unusual Items

There is always the possibility that isolated errors may occur which are not typical of a taxpayer's operations. For an item to be removed from an audit sample, a taxpayer must establish that the transaction was an isolated event and not a normal part of its operations. Allow the taxpayer to produce documentation that this was an isolated event and not a part of his regular course of business.

Before any item of unusual circumstance is omitted from the sample, the auditor should thoroughly analyze and discuss the situation with the Audit Supervisor. Factors that should be taken into consideration before an item is excluded or included are: the size of the item is excessive compared to the normal items and occurs only at rare intervals; the sale or purchase is a type not ordinarily handled; or the item involves some unusual circumstance. Consider expanding the sample or

reaching a compromise that would be fair to the taxpayer and to the Department of Taxation.

### *Credits Against the Sample*

#### **Sales**

When conducting a sales audit the taxpayer has the legal right to bill its customers for the sales tax not originally collected. Those customers may have been audited, or they may have properly accrued the untaxed sale made to them. Most taxpayers feel that in this case, the exception should be removed from the sample; however, this is not a reason to remove the sale from the sample. A one-time credit is given on a separate schedule when it is established that a customer has paid the tax. This is done because there are likely similar transactions outside the sample period on which the tax has not been paid. To remove the exception would invalidate the sample. The likelihood that every other customer with a similar transaction in the other months of the sample accrued and paid the tax is remote.

### *Tax Collected in Error*

Taxpayers who have nexus in other states sometimes collect taxes from their customers based on the customer's location rather than the ship to location. This erroneously collected tax is remitted to the other state rather than Virginia. Any dealer who collects tax in excess of a 4 1/2% or 5% rate or who otherwise over collects the tax, is required to remit the over collection to the state. Virginia sales where the taxpayer has collected another state's tax are included in the sample using a measure amount to recover the amount of tax collected. If the taxpayer elects to research over collections and either refund or credit the customer's account, a credit may be taken on a future return.

### *Expense Purchases*

Sometimes it is impossible to trace accruals from the return to an invoice. In these instances, the best approach is to list all untaxed taxable purchases made during the sample period and all untaxed taxable fixed assets acquired during the entire audit period. Extrapolate the sample measure and give credit for the measure accrued on a separate schedule. This should produce an audit liability that allows for the following:

1. Inconsistent accrual of use tax.
2. Accrual of use tax based on a percentage of sales, or some fixed dollar amount.
3. Inability to identify the invoices and/or items accrued.

### **Tax Accrued in Error**

Taxpayers may accrue tax on nontaxable purchases. A credit is given on the sample schedule for any tax accrued in error during the sample period. If the

taxpayer accrued it in the sample period you examined, it is likely he accrued in other periods as well.

#### Tax Paid in Error

Many times, taxpayers do not check their invoices to determine that Virginia tax is being correctly charged by their vendors. No credit is given for another state's tax paid in error. It is the taxpayer's responsibility to get a refund from the vendor for any tax paid in error. The purchase is included in the sample as if it was an untaxed purchase.

#### Reporting the Results

##### Sample Bases or "Population" and Error Factor

Sales tax return data is usually used as the base for extrapolation of sales samples. If it is discovered that the taxpayer has reported only taxable sales on line 1 of the sales tax return, using sales data from financial statements may be a better alternative to using return data. Accounts payable totals are generally used for purchase samples. The STAUDN software uses the total of untaxed exceptions as the numerator of a fraction, of which the denominator is the total of the sample period data in the sample base, to arrive at an error factor which is then extrapolated or multiplied by the data for each month in the sample base. This gives the measure amount for the audit liability.

If a rollup is done (not recommended for sales), the base would be the same number for each of the months during the audit period. Rollups are used to project the same measure amount (and audit liability) for each month throughout the audit period.

*Error Factor Computation Example*

This example has been prepared to provide an illustration of how the error factor is computed from the sampling procedure, how it is applied to the sample base to determine the taxable measure, and the effects of "altering" the sample base.

In our example, the audit period is April 1998 – March 2001.

The taxpayer has provided a schedule of Accounts Payable debit TOTALS for each month of the audit period. These monthly totals will be used as the "Sample Base" or "Population" for extrapolation purposes. AP debit totals are generally acceptable for the base as they accurately reflect the trends and expenses for the company, and are readily available. From these monthly totals, our sample months (high, low, avg.) were selected for review. From each sample month, general expense purchase invoices are reviewed. All invoices where tax was not paid on the invoice or accrued and remitted to the State are listed as purchase exceptions.

For our example, the total untaxed purchase exceptions from the sample months are **\$270,517.83**.  
Our sample months are: May 1999, Feb. 2000, and Jan. 2001  
For our Original Computation, the sample "Population" from our sample period will be:

<u>Period</u>	<u>Total AP Debits</u>	<u>Total Exceptions</u>
9905	\$3,140,614.84	\$270,517.83
0002	\$4,510,766.69	
0101	<u>\$6,020,671.52</u>	
	\$13,672,053.05	

This represents the total Accounts Payable disbursements from the sample months  
The error factor is computed as follows:

$$\frac{\text{Total Exceptions}}{\text{Population}} = \text{Error Factor}$$

$$\frac{\$270,517.83}{\$13,672,053.05} = .019786189$$

The error factor from the sample periods indicates the percentage of the total disbursements that were not taxed.

It is assumed that there will be a similar rate of error in the remainder of the months of the entire audit period.

Therefore, the error factor from the sample periods is applied to the "Sample Base" for the entire audit period to determine the total taxable measure identified by the audit. With total AP for the audit period of \$170,902,694.17, the extrapolated total of \$3,382,513.01 now becomes the taxable measure (\$170,902,694.17 X .019786189).

For Computation Two, assume that the taxpayer requests that certain disbursements be removed from the extrapolation base, i.e.: salary, insurance, etc. since these represent non-taxable amounts. For the example, assume that these monthly disbursements are 13% of the total.

The error factor the second computation will be as follows:

<u>Period</u>	<u>Total AP Debits</u>	<u>Total Exceptions</u>
---------------	------------------------	-------------------------

9905	\$2,732,334.91	<u>\$270,517.83</u>	
0002	\$3,924,367.02	\$11,894,686.15	Population
0101	<u>\$5,237,984.22</u>		
	\$11,894,686.15		Error Factor <b>.022742746</b>

Reducing the AP by 13%, the AP total is \$148,685,343.93. The extrapolated taxable measure from Computation Two is \$3,381,513.01 ( $\$148,685,343.93 \times .022742746$ ). No difference from Computation One. Although it would seem at first thought, reducing the sample base will reduce the potential tax liability, the only thing that changes is the error factor. The net result is that the error factor went up, and you are now essentially taking a bigger "Bite" out of a smaller pie.

The most important factor in determining the computation of the audit is the total of untaxed exceptions. This total is what will determine the error factor to be used in the extrapolation of the sample base.

## Penalty

The application of penalty to audit deficiencies is mandatory and its application is generally based on the percentage of compliance determined by computing the dealer's compliance ratio. The compliance ratio for the sales or use tax is computed by using the following formula:

$$\frac{\text{Measure Reported}}{\text{Measure Reported} + \text{Measure Found}} = \text{Compliance Ratio}$$

“Measure reported,” means dollar amounts of sales or use measure reported on returns for the audit period. “Measure found,” means dollar amounts of additional sales or use measure disclosed by the audit. Separate ratios for sales and use taxes will be necessary if the audit contains deficiencies in both areas. The STAUDN software automatically computes compliance ratios based on returns data entered. Tax paid to vendors will not be included in the computation of the compliance ratio for the audit period. See Alternative Method for Computing Compliance Ratio for additional taxpayer options to avoid the penalty.

1. **First generation audits- Generally, penalty cannot be waived if any of the following conditions exist:**
  - a. The taxpayer has been previously notified in writing to collect tax on sales or to pay tax on purchases, but has failed to follow instructions; or
  - b. The taxpayer has collected the sales tax, but failed to remit to the Department of Taxation; or
  - c. There are indications of fraud in which the taxpayer has willfully evaded reporting and remitting the tax to the Department of Taxation.
2. **Second-generation audits-** Penalty will be applied unless the taxpayer's compliance ratios meet or exceed 85% for sales tax and 60% for use tax.
3. **All subsequent generation audits-** Penalty will be applied unless the taxpayer's compliance ratios meet or exceed 85% for sales tax and 85% for use tax.
4. **Alternative Penalty Method-** If penalty is applied based on the department's calculation of the use tax compliance ratio, the Taxpayer will have the option of calculating the use tax compliance ratio, under the Alternative Method, as follows:

$$\frac{\text{Measure Reported} + \text{Measure Paid to Vendors}}{\text{Ratio}} = \text{Compliance Ratio}$$

## Measure Reported + Measure Paid to Vendors + Measure Found

It is the Taxpayer's responsibility to compute the above compliance ratio and provide the auditor with documentation supporting the computation. The Taxpayer must compute the alternative ratio based on a review of purchases for the same period used by the auditor to compute the traditional compliance ratio. Tolerances for the Alternative Method will remain the same as those of the traditional compliance ratio.

If it is determined that use tax audit penalty is applicable based on the traditional compliance ratio calculations, the auditor will advise the Taxpayer. If the Taxpayer desires to recalculate the compliance under the Alternative Method, the auditor will assess the audit penalty as a contested issue. The Taxpayer must complete the Alternative Method calculations and provide the documentation to the auditor within 60 days of the audit assessment. If the use tax compliance falls within the acceptable tolerances based on the Alternative Method calculations, the audit penalty will be abated.

## Front-End Agreements

Front-End Agreements have traditionally been used for taxpayers that are manufacturers or holders of direct payment permits and are recurring three-year cycle audit candidates. The agreement covers the expense purchase portion of the audit. The taxpayer and the Department of Taxation agree that the tax will be paid "on the front end" rather than at audit time.

An audit is done and areas are identified where compliance is not being met. In the case of a manufacturer, the agreement may be to remit an additional amount of use tax based on the error factor in the audit; or an additional amount or percentage of use tax based on account transaction information. The direct payment permit holder may agree to remit tax based on the error factor of the audit, on accounts payable data, or, for certain accounts which were found to be totally taxable, tax would be remitted on the activity in these accounts. A written agreement is drafted and signed by both parties. In subsequent audits, the auditor does limited "testing" to determine that the agreement is being followed. This "testing" would also determine whether or not the percentages need to be adjusted for the next audit cycle. Negotiations with the taxpayer would fix the agreement for the subsequent audit period.

Fixed assets are audited in detail each audit period. Front End Agreements substantially reduce the amount of time needed to complete an audit.

# **INTRODUCTION**

The State of Virginia, Department of Taxation, has always had procedures for sampling in audits of sales and use tax. This manual will outline the auditing procedures used by the Department of Taxation. We have always used a block sampling as a basis of determining an error factor to compute an assessment. With the emergence of new technology, in conjunction with block sampling, we now use a software program (WIN. IDEA) to develop our samples, both statistical and non-statistical. We refer to this sampling program as ICT. Although systematic sampling and statistical sampling are a part of our ICT software, we elected to segregate systematic from statistical sampling in the manual to better assist the research of procedures by users of the manual.

## **AUDIT SAMPLING MANUAL**

The audit manual is divided into the following three sections:

1. **BLOCK SAMPLING-** This section covers all of the procedures to be followed in conducting an audit, especially where we would be using block sampling. Block Sampling being where we would select a certain block of time in the audit period and review all of the records in that period. This section also touches on sampling for front-end agreements.
2. **ICT SYSTEMATIC SAMPLING-** This section covers all of the procedures to be followed using the ICT program. This is where we take electronic files of information, manipulate the data and develop a sample to be used by the field auditor. Systematic sampling is where the system will select every “Nth” record. That is to say that if we want to look at 20 records out of 100, we would tell the system to select every 5<sup>th</sup> record.
3. **ICT STATISTICAL SAMPLING-** This section covers the procedures to be followed in performing a statistical sample using the ICT program. Whenever possible we will try to use statistical sampling as the main source for developing a sample to be used in a sales and use tax audit.

The following procedures manual will be the source document for field auditors to use when conducting audits. If you have any questions regarding these procedures, please contact your supervisor who will direct your questions to the Director of Auditing or the ICT Team Leader.

*Part A*

# **INVOICE CAPTURE TOOL (ICT) POLICIES AND PROCEDURES**

**Version 2.0**

**Last Modified**

**June 29, 2007**

## TABLE OF CONTENTS

1.....	OVERVIEW	2
2.....	ICT AUDIT CANDIDATE DETERMINATION	2
2.1.	Identifying ICT Audit Candidates .....	2
2.2.	Technical Feasibility for conducting an ICT Audit .....	3
2.3.	Data Format.....	4
3.....	SUCCESSFUL IDENTIFICATION OF AN ICT CANDIDATE .....	5
4.....	ICT AUDIT TEAM AND ROLES OF INDIVIDUAL PLAYERS .....	6
4.1.	ICT Auditor (Audit Team).....	7
4.2.	District Auditor (Audit Team).....	8
5.....	TECHNICAL ASPECTS OF THE ICT AUDIT PROCESS	9
6.....	ICT AUDIT RESULTS REVIEW AND EVALUATION	12

## 1. OVERVIEW

The Invoice Capture Tool (ICT) program introduced by the Office of Compliance in January 2000 will enhance the software that the Virginia TAX field audit staff uses. The current audit process involves extensive manual searching through taxpayer paper invoices. The ICT initiative will deliver software that will allow ICT auditors to receive this information electronically from taxpayers. Furthermore, this new software will significantly reduce the burden of the taxpayer, increase the accuracy of the audit, and decrease the time it takes for an auditor to complete an audit.

This document outlines the policies and procedures for the ICT audit program. The initial ICT rollout involves a limited number of TAX audit personnel. Through increased usage of the ICT software, TAX may consider expanding the ICT Audit Program. The purpose of the ICT Policies and Procedures is to provide a framework for the limited ICT rollout. As the ICT program evolves, the Policies and Procedures will be updated to incorporate any necessary changes to the ICT Audit Program

## 2. ICT AUDIT CANDIDATE DETERMINATION

### 2.1 Identifying ICT Audit Candidates

The first stage of the ICT Process involves the identification of audit candidates. The audit selection process employed by OOC involves the Audit Supervisors, District Auditors, and the TAX Audit Selection program for identifying ICT audit candidates. Using the Central Audit Selection program will permit the selected candidates to be assigned directly to the ICT Support Team (IST) for assignment to Audit personnel. Additionally, referrals from District Auditors, and Audit Supervisors will be used for identifying ICT audit candidates.

In addition to the centralized audit selection process, the following processes will also be used to identify ICT audit candidates.

- *Evaluate current audit inventory:* All District Audit Supervisors, and District Auditors will be encouraged to evaluate their current audit inventory to identify taxpayers that may qualify for an ICT audit.
- *Field audit leads:* District Audit Supervisors and District Auditors should evaluate new audit leads to identify taxpayers that may qualify for an ICT audit.
- *Collection referral audit leads:* All audit leads provided by Collection personnel should be reviewed and evaluated for qualifying as a possible ICT audit candidate.
- *Audits at the request of taxpayers:* All taxpayers that request an electronic audit will be considered as a potential ICT audit candidate. The ICT

Auditor, and the District Audit Supervisor will evaluate the feasibility of conducting an ICT audit on this taxpayer.

#### **A. Qualifying criteria for an ICT Audit Candidate**

Upon being assigned an audit, the District Auditor after reviewing the assignment, should immediately contact the taxpayer to coordinate and establish the audit schedule, and arrange for a pre-audit conference with the taxpayer. All field auditors will be trained on the policies and procedures employed by TAX for identifying and qualifying ICT audit candidates. Additionally, detailed documentation outlining the policies and procedures will accompany this training. The District Auditors will conduct their standard pre-audit conference and determine the feasibility for conducting an ICT audit.

After the successful identification of an audit candidate, the District Auditor must determine if the ICT program should be used to facilitate the audit process. It is the responsibility of the audit staff to determine if an individual audit candidates would be feasible for utilizing the ICT audit tool. Field auditors should consider the following issues when making the determination:

- Does the taxpayer have an automated chart of accounts?
- Is the taxpayer's general ledger updated from posted information?
- Is the taxpayer willing to download data?
- Does the taxpayer want to participate in an ICT audit?
- Will the use of the ICT audit program reduce the amount of time needed to complete the audit?
- Will the use of the ICT audit program reduce the amount of time needed to complete the audit?
- Has the taxpayer's accounting system been consistent for a known period of time (i.e. consistent accounting codes and methodology)?

### **2.2 Technical Feasibility for conducting an ICT Audit**

Upon the identification of a potential ICT audit candidate, the District Auditor will arrange a meeting with the ICT Auditor, and the Taxpayer to discuss the technical feasibility of using the ICT audit tool for conducting the audit. The District Auditor should directly contact the ICT Auditor when they are located in the same district. Otherwise, the District Auditor should contact the IST, who will then identify an ICT auditor in a neighboring district. This audit team (the District Auditor, and the ICT Auditor) will arrange a second pre-audit conference with the taxpayer to discuss the technical feasibility for applying the ICT software to the audit assignment.

The following factors should be considered when analyzing the technical feasibility for using the ICT audit program.

## 2.3 Data Format

The ICT software (IDEA) can work effectively with a wide array of data formats.

These formats include one or more of the following applications:

### *Application Data and Databases*

- Access
- Lotus 123
- Oracle
- Various accounting packages including Accpac, Simply accounting, Pegasus, Sage, and many others
- Btrieve
- Excel
- SQL Server
- Sybase
- Xbase (the DBF format from dbase, foxpro, and others)

### *Flat Files/ unformatted DATA*

- ASCII (fixed length and variable length)
- EBCDIC (fixed length)
- AS/400 DIF (Data interchange Format)
- ASCII Delimited
- EBCDIC (variable length ANSI/IBM)

Most software applications can effectively export a flat, or ASCII, file type. The ICT Auditor should work with the taxpayer to identify a usable file format.

### **1. File Size Limitations**

The largest file that IDEA can handle is 2.1 gigabytes, unless the auditor is working with ODBC data (application data – Excel and Access), in which case you can access files that are much larger. The 2.1 gig limit is a function of the operating system rather than a limitation of IDEA. The 32-bit version of IDEA will overcome this limitation. IDEA can handle files with up to 2.1 billion records and files with up to 32,766 fields per record.

For additional information, view IDEA website at [www.cica.ca/idea/v3faq.htm](http://www.cica.ca/idea/v3faq.htm) or the user manual accompanying the IDEA software.

## 2. Fields Available Electronically

The ICT Auditor must ensure that the appropriate data is available to effectively conduct the audit. The ICT and District Auditors should work with the taxpayer to identify the fields that are available electronically.

The following fields are required to perform an audit, based on gross sales:

1. Customer name and/or account number
2. Amount of sale
3. Sales tax collected (if any)
4. Ship to location
5. Date of sale
6. Description of the item sold

The following fields are required to perform an audit, based on purchases:

1. Vendor name and/or account number
2. Account number that the purchases are being charged to
3. Sales tax paid to vendor, when separately stated
4. Date of purchase
5. Cost of item
6. Description of item purchased
7. If no sales tax paid to vendor, is accrual being posted?

As documented in Section IV: (Technical Aspects of the ICT Audit Process), many of these fields can be directly imported into the STAUDN exceptions list. Additionally, many of these fields can facilitate the generation of an exceptions list in the ICT software, but may not need to be imported into STAUDN.

### 3. SUCCESSFUL IDENTIFICATION OF AN ICT CANDIDATE

#### *A. Recommendation to IST (**Audits** Outside the District of an ICT Auditor)*

Upon the successful identification of an ICT audit candidate from sources outside the district, the ICT Auditor will review the audit candidate with the District Audit Supervisor and will be notified who the District Auditor is that will be assigned the audit.

#### *B. Recommendation to IST (**Audits** within the District of an ICT Auditor)*

Upon the successful identification of an ICT audit within a District, the ICT Auditor will contact the auditor in charge of the assignment to discuss the details of how

the ICT audit procedures will be used. The District Auditor will follow the criteria outlined below for developing a potential ICT audit.

The IST will use the following criteria when approving an ICT audit candidate.

- Feedback from the District Auditor
- Documentation reviewed for the following:
  1. Business classification for the audit candidate
  2. Special audit issues and/or tax policy concerns regarding the business classification.
  3. Availability of ICT Auditor resources
  4. Geographic location of audit candidate
  5. Current inventory of the District where the ICT audit candidate is located
  6. Feedback from the District Audit Supervisor.

#### *4. ICT AUDIT TEAM AND ROLES OF INDIVIDUAL PLAYERS*

##### *A. Key Players in the ICT Audit Process*

The ICT audit process utilizes various personnel from the Office of Compliance. These individuals include:

- The District Audit Supervisor: Coordinates ICT audits with the District audit plan
- The District Audit Staff: All OOC audit personnel
- The ICT audit staff: Eight auditors, Five from the Central Regional area, One from the Western Regional area, and one from the Eastern Regional area, and one from the Interstate Audit unit. As the ICT program expands, additional auditors will be added.
- The ICT Support Team (IST) members are: Richard Dotson Director of Audits, Jim Mason, Team Leader, Ramin Amira, Mark Foster, Ken Shafer, Mindy Stembridge, Nancy Gimbert, Sara Shorter, Stewart Silhol will each perform the IST functions.

##### *B. ICT Support Team (IST)*

The primary objectives of the IST support team will be to ensure the standardized use of the ICT software, to identify new opportunities for the use of the ICT software, and to manage the expansion of the ICT program. Through the use of a centralized team, TAX can closely manage and assess the effectiveness of the use of this new auditing tool.

The IST will perform a wide array of tasks, to include:

- Measures of performance for the ICT program.

The team leader will provide the Director of Audits, a monthly report on the status of new ICT cases that were begun during the month. All ICT auditors will submit to their team leader, the identification of all new cases. The team leader will compile and consolidate, and forward the report to the Director of Audits. The report will also be forwarded to the IST support team.

At the completion of the fiscal year, each ICT Auditor will submit a completed timesavings report to the team leader. The report will be forwarded to the Assistant Tax Commissioner. Copies of this report will also be provided to the Director of Audits, and to the IST support team.

#### **4.1 ICT Auditor (Audit Team)**

The role of the ICT Auditor involves a wide array of technical and analytical processes. Through the course of the ICT training, auditors will learn to perform the tasks needed to electronically capture the taxpayer data and perform the requisite analysis. These tasks include:

- Understanding and, if necessary, defining the layout of the data
- Assessing the taxpayer's data file formats, and determining if any compatibility issues exist.
- Working with the taxpayers technology representatives to perform the data transfer
- Generating queries to extract specific records from the taxpayer's file
- Statistically analyze the taxpayer's file
- Importing and Exporting databases
- Working with external storage devices (i.e. Jaz drives and Superdisks) to facilitate the data importation process

The ICT Auditor will work with the District Auditor to perform the tasks needed to complete an audit. In addition to the aforementioned technical roles, the ICT Auditor will be responsible for:

- *Working with the field auditor to schedule ICT audits:* Upon being notified of a potential ICT audit assignment, the ICT auditor will work with the District Auditor to schedule a second pre-audit conference. The ICT audit team should gather sufficient information that will allow them to qualify the candidate as an ICT audit candidate. Additionally, the audit team will determine the overall audit schedule during the audit conference.
- *Working with field auditors to recommend ICT audit candidates:* Upon completion of the second pre-audit conference, the ICT Auditor should work with the field auditor to determine if the ICT software will benefit the audit process.

- *Reviews the results of the ICT analysis with the field auditor.* After generating an exceptions list using the ICT software, the ICT Auditor will review the list with the District Auditor. The ICT Auditor and the District Auditor will review the exceptions list, IDEA log file, and any additional documentation to ensure the results meet the audit strata defined by the audit team. Additionally, this information may be included in the final audit report.
- *Imports data into the STAUDN worksheet on the field auditor's laptop:* Upon agreeing on the exceptions list, the ICT Auditor will assist the District Auditor in importing the exceptions list into the District Auditor's STAUDN worksheet.

#### **4.2 District Auditor (Audit Team)**

District Auditors serve as the primary auditor on all ICT audit assignments. As the primary auditor, the District Auditor will be responsible for:

- Contacting the taxpayer to schedule a pre-audit conference, and schedule the audit
- Serve as the primary liaison between the taxpayer and the TAX Department
- Working with the taxpayer to arrange the data transfer
- Writing a confirmation letter (using approved template) to ensure the agreed upon approach and data requirements are explicitly documented
- Developing audit program and schedule
- Performing the audit field work
- Concluding the audit activities and review audit results with the taxpayer
- Generating the final audit reports
- Generating assessments, and/or refunds
- Coordinating the ICT audit assignments with the appropriate District Audit Supervisor

District Auditors serve as the primary link between the ICT audit program, and the taxpayers. To support the use of the ICT software, District Auditors need to communicate the benefits of the ICT program to the taxpayers, and should continuously try to identify potential ICT audit candidates. Upon identifying a potential ICT audit candidate, the District Auditor should contact the ICT Auditor to arrange a second pre-audit conference with the taxpayer. The District Auditor, and the ICT Auditor will work together to determine the feasibility for applying the ICT software on the identified potential ICT candidate.

As part of the ICT audit team, the District Auditor will work with the ICT Auditor; the District Auditor will import the data into the STAUDN audit template on their laptop computer. Furthermore, the District Auditor will complete the remainder of the audit activities, and present the results of the audit to the taxpayer. Although the District Auditor will report directly to the IST in Richmond, they will participate

in completing the assessment for the completed audit, (i.e. benefits, issues, and recommendations).

As a part of the ICT audit team, the District Auditors need to communicate the benefits of the ICT program to the taxpayers, and are to continuously try to identify potential ICT audit candidates. Upon identifying a potential ICT audit candidate, the District Auditor should contact an ICT Auditor, and arrange a second pre-audit conference with the taxpayer. The District Auditor, and the ICT Auditor will work together to determine the feasibility for applying the ICT software for all audit candidates.

As a part of the ICT Audit Team, the District Auditor will work with the ICT Auditor in the generation of an exceptions list. With the assistance from the ICT Auditor, the District Auditor will import the data into the STAUDN audit template on their laptop computer. Furthermore, the District Auditor will complete the remainder of the audit activities, and present the audit results to the taxpayer. Although the District Auditors will not report directly to the IST in Central Office, they will participate in the preparation of the assessment of the audit results (i.e. benefits, issues, and recommendations).

## *5. TECHNICAL ASPECTS OF THE ICT AUDIT PROCESS*

### *A. Data Retrieval*

During the second pre-audit conference, the ICT Auditor and the District Auditor will work with the taxpayer's technical team to discuss the data retrieval requirements. The audit team should consider the following:

- *File Format:* The audit team should work with the taxpayer's technical team to identify an acceptable format (Section I-C: Technical Feasibility of the ICT Audit). To facilitate the data importation process, the audit team should try to obtain a file in either an application file format (i.e. Access or Excel) or in a fixed ASCII file layout.
- *File Size:* The audit team must consider the file size limitations associated with a floppy diskette (1.44 MB) and a super floppy diskette (120MB).
- The above two storage devices will be available to the audit team when transferring files.
- *Taxpayer willingness to work with the super floppy drive:* When transferring data using a super floppy diskette, hardware drivers need to be installed on the source computer. Taxpayers must agree to use an external super floppy drive on their computer. Additionally, a representative responsible for the taxpayer's information system should perform the installation process.

## B. Data Analysis

When using the ICT software to generate the exceptions list, the auditor should consider the following:

- Target a small percentage of transaction volume to achieve a high percentage of dollar coverage.
- Data analysis and manipulation will be performed on like transactions.
- Completeness testing on all areas of ICT audits must be performed on the front end of the data manipulation process.
- The ICT Auditor will maintain a log of activities for each ICT audit assignment, which details file manipulation, file names, and data analysis. WIN IDEA produces a log file that tracks these activities.
- The ICT Auditor will provide the audit comments as they pertain to the data manipulation process. Per the District Auditor's discretion, the comments may be incorporated into the final audit report. The ICT Auditor will also maintain a copy of the comments in their own files.

The methodology employed when analyzing taxpayer data will be established as the ICT audit program matures. The ICT auditors should continuously communicate their data as identified and approved. This data will be documented in the Data Analysis section of the ICT Policies and Procedures.

## C. Import Data into STAUDN:

The STAUDN audit worksheet contains a file importation feature. Using this feature, the District Auditors can import the ICT produced output (i.e. the exceptions list) into STAUDN. This importation process will create new records in the taxpayer exceptions list. Note that this process appends the existing exceptions list, and does not write over the existing records.

Prior to importing the exceptions list into STAUDN, the ICT Auditor must perform the following critical steps:

- Review the exceptions list with the District Auditor. It is essential that the ICT Auditor and the District Auditor agree on the exceptions list prior to importing it into STAUDN.

**Identify and rename the fields in the ICT database to names recognized by STAUDN. STAUDN will only import fields that have specific names. The following table lists the fields that can be in the import file:**

<i>Field Name</i>	<i>Type</i>	<i>Description</i>	<i>Format</i>	<i>Notes</i>
Invoice Date	Date	Field holding, month Day, and year on invoice	any valid date format (preferably 4-diget Year	this field cannot be left blank
Measure	Test	Measure type for invoice		interface will have Auditor match values In this field to STAUDN measures Any blank values in this Field will also be Mapped to STAUDN
Locality	Text	Locality to use for Distribution		Must be blank or valid Numeric locality code
Invoice Amount	Currency	Amount on invoice	Can have \$'s if needed	this field cannot be Left blank
Account Number	Text	Account No. Used by Taxpayer		
Items	Text	Description of item on Invoice		
Invoice number	Text	Invoice number used by taxpayer		
Vendor name	Text			If blank, the invoice will be mapped to a New vendor named "Imported"
Comments	Text	Comments about invoice		
UD1	Text	Custom field 3		
UD2	Text	Custom field2		

NOTE: At a minimum, the INVOICE DATE and INVOICE AMOUNT fields must be included. My fields included in the files that are not listed above will simply be ignored.

- Export the approved exceptions list to an Access 2.5 file. This feature is located under File Export in the IDEA 3.0 software.
- Save the Access 2.5 file to a diskette.
- Import the Access 2.5 file into the District Auditor's STAUDN audit file. This function is located under File Import in the STAUDN work sheet.
- Identify the measures corresponding to individual exceptions. This procedure can be done during either the file importation process via the File Importation Wizard, or during the generation of an exceptions list in the ICT software.

*D. Return Taxpayer Data and Archive IDEA Files.*

After successfully importing the taxpayer data into STAUDN, and concluding all audit activities, the taxpayer data should be returned to the taxpayer in its original format. Additionally, all manipulations of the taxpayer data should be explained to the taxpayer placed onto the diskette sent into the TAX archive. These manipulations include all IDEA 3.0 audit files.

6. ICT AUDIT RESULTS REVIEW AND EVALUATION

**A. Overview**

**The review of the effectiveness of the ICT Audit Program is the responsibility of the ICT Support Team (IST) Team Leader. To support the achievements of the ICT Audit Program, standard criteria have been developed to assist the IST and TAX management, reviewing and evaluating the effectiveness of the ICT audit program. These criteria will track the monthly number of ICT audits begun, and the yearly savings in time.**

**B. ICT Report of Audit Results**

**At the completion of each ICT audit assignment, the ICT audit team will complete the ICT Savings Report on the Savings Report Form, and the Monthly List of new ICT audits by completing the following steps:**

- 1. This is accomplished by computing the number of actual invoices reviewed compared to the total population of invoices in the original file. This number is divided by 1000 (average**

**number of invoices reviewed per day) to determine the number of days saved.**

- 2. This number is combined with the number of records imported into STAUDN by the ICT auditor. This is computed by dividing the total number of records imported by 200 (average number of records keyed in one day).**
- 3. The two amounts will result in the total savings of time by using the ICT audit program. The amount of time is multiplied by \$300 (average value of time to complete an audit based on the past history of closed audits).**

### *C. Communicating the Results of the ICT Audit Program*

The ICT Audit Program involves many OOC resources. In addition to the ICT Auditors, all Audit Supervisors, and District Office Audit personnel will be involved in the ICT audit program. In an effort to involve all relevant personnel in the ICT audit program, the ICT Auditors, and the IST should continuously inform TAX management, the Audit Supervisors, and the District Auditors on the status, and the results of the program. The ICT Auditors will distribute the appropriate reports to management in the Office of Compliance, and the appropriate TAX personnel. In this manner the program will remain visible to all employees, and will promote the increased usage of the ICT audit program.

*Part B*

*STATISTICAL SAMPLING PROCEDURES*

## TABLE OF CONTENTS

	1..... Introduction	3
	2..... Starting a Statistical Sample	3
2.1 Objectives .....	<b>Error! Bookmark not defined.</b>	
2.2 Identifying Good Candidates for a Statistical Sample .....		3
2.3 The Benefits of a Statistical Sample .....		4
	3..... STATISTICAL SAMPLING FORMULAS AND EXPLANATIONS .....	4
	4..... GLOSSARY OF RELATED TERMS:	7
	5..... DEVELOPING THE STATISTICAL SAMPLE	8
5.1 Review and Verification .....		8
5.2 Sampling Form.....		9
5.3 Manipulating The Data.....		12
5.4 File Formats used by ICT.....		12
	6..... STATISTICAL SAMPLING GUIDELINES	12
6.1 Detailed Stratification .....		13
6.2 Number of Records to Sample.....		14
6.3 Detail Highest Dollar Stratum.....		14
6.4 Developing Four Stratum .....		14
	7..... CREATING THE SAMPLE	16
7.1 Credits within a Sample .....		17
	8..... Creating the Exception List for the Field Auditor	17

## 1. Introduction

The Virginia Department of Taxation uses statistical sampling, in conjunction with various other methods of sampling, where examination of 100% of the taxpayer's records is not feasible. This section will address the statistical sampling procedures used by the Department as part of our overall ICT (Invoice Capture Tool) program. The policies and procedures for the ICT program have all ready been established and approved. This section will become an addendum to the procedures for using ICT.

The objectives of the Department in incorporating the use of statistical sampling into our ICT program is to enhance our efficiency in performing audits that benefits both the State of Virginia as well as the taxpayers.

The procedures set forth in this section will be a guide to be followed by auditors in using statistical sampling methods in sales and use tax audits. Additionally, information contained in these procedures is not confidential in nature and may be used to explain to taxpayers the benefits of using statistical sampling.

## 3. Starting a Statistical Sample

### 2.1 Objectives

In this section we will discuss:

- Identifying good candidates for a statistical sample
- Explaining to taxpayers the benefits of a statistical sample

### 2.2 Identifying Good Candidates for a Statistical Sample

A good candidate for a statistical sample should have:

- A large volume of records. Sampling has long been accepted as a valid auditing technique where the volume of records from the taxpayer is too great to do a 100% review. We have traditionally used a block sampling method or a systematic sampling method using ICT in performing sales and use tax audits.
- The taxpayer must have complete records for the audit period. This is a requirement for performing statistical sampling. This is determined using the same standards we have always used found in our original procedures.
- Electronic data. This is a requirement for performing a statistical sample. It is essential that we have an accurate count of the total number of invoices in the population as well the capability to stratify the data on the invoice amount in order to improve sampling efficiency. Electronic data must also be verified to insure that all of the data has been captured

- Good Internal Controls. The auditor should verify that the taxpayer has good internal controls and has been consistent in the determination of the taxability of transactions

### 2.3 The Benefits of a Statistical Sample

The benefits to the taxpayer of a statistical sample include the following:

- Statistical sampling is the most accurate method of sampling. Other sampling methods should be used only if it is not a good candidate described above.
- The process of selecting records for examination is objective. The records in a statistical sample are selected randomly, ensuring that each record has the potential to be reviewed.
- Statistical sampling is much more efficient than other methods of sampling. This is especially true where the taxpayer has large volumes of records. Statistical samples typically require the auditor to look at fewer records and the taxpayer to pull fewer records.

## 3. STATISTICAL SAMPLING FORMULAS AND EXPLANATIONS

Examining the entire population of records in tax audits is unrealistic given time and resource constraints. Instead we can draw a valid random sample and use the sample results to project a statistically valid estimate. Here follows the methodology to be used in performing a statistical sample.

Firstly, sample size  $s$  is determined as:

$$s = \left( \frac{\sigma \cdot \Phi^{-1} \left( 1 - \frac{\alpha}{2} \right)}{m} \right)^2$$

The formula for sample size reveals, as intuition would suggest, that the sample size  $s$  increases as the margin of error  $m$  decreases, as the standard deviation  $\sigma$  increases, or as the significance level  $\alpha$  decreases (the inverse of the cumulative distribution function is monotonically increasing in its parameter).

Example:

Suppose we are interested in finding the rate at which sales tax is being incorrectly assessed, and we need to know how many records to randomly sample in order to be 95% sure (0.05 significance level) that our estimate is within 3% of the true error rate. In this case the variable we are trying to estimate (the error rate) is modeled as a Bernoulli<sup>1</sup> random variable. The true standard deviation of a Bernoulli random variable is given by:

$$\sigma = \sqrt{\rho \cdot (1 - \rho)}$$

where  $\rho$  is the probability that the tax was properly paid. Assuming  $\rho = 0.5$ , we have

---

<sup>1</sup> A Bernoulli random variable takes the value 1 with probability of success  $\rho$  and 0 with failure probability  $1 - \rho$ .

$$s = \left( \sqrt{0.5 \cdot (1 - 0.5)} \cdot \frac{\Phi^{-1}\left(1 - \frac{0.05}{2}\right)}{0.03} \right)^2 = 0.5 \cdot (1 - 0.5) \cdot \left(\frac{1.96}{0.03}\right)^2 = 1067.11$$

which should be rounded up to a sample size of 1068.

The following table shows how large the random sample should be for different combinations of confidence and margin of errors, and assuming a 50% probability of an event occurring<sup>2</sup>.

		Confidence Interval						
		70%	75%	80%	85%	90%	95%	99%
Margin of Error	5.0%	108	133	165	208	271	385	664
	4.5%	133	164	203	256	335	475	820
	4.0%	168	207	257	324	423	601	1,037
	3.5%	220	271	336	423	553	784	1,355
	3.0%	299	368	457	576	752	1,068	1,844
	2.5%	430	530	657	829	1,083	1,537	2,654
	2.0%	672	828	1,027	1,296	1,691	2,401	4,147
	1.5%	1,194	1,471	1,825	2,303	3,007	4,269	7,373

The sample sizes above can also serve as a baseline for sampling a continuous variable, as in the case of a dollar amount (for our purposes, a tax assessment –or credit. Here, *m* is the acceptable margin of error, in dollars, of the tax assessment).

After conducting the random sample, we should make sure that sample size was sufficiently large to achieve the desired combination of margin of error and confidence interval. To do so we re-calculate the sample size using the statistics collected from the sample. The procedure is illustrated below first for a simple random sample and then for a stratified random sample.

<sup>2</sup> Note that this is the most conservative figure because it maximizes the sample size. If we had prior information that made us believe that the responses were more skewed, say 75%, then our sample size wouldn't have to be as big (800 in our example above).

## Baseline: Simple Random Sample

Suppose we take a random sample of 1,068 out of a total population of 20,000 and we find that tax is underpaid in the sample by an average \$20 per item<sup>3</sup>. Then the projected total error is simply  $\$20 \cdot 20,000 = \$400,000$ .

Suppose the sample standard deviation  $\hat{\sigma}$  of underpayment is  $\$7.5$ <sup>4</sup>. For a simple random sample, the projected standard deviation of the total underpayment in the population is simply  $\hat{\sigma} \cdot n$ , or  $\$7.5 \cdot 20,000 = \$150,000$  in this example. We want to be 95% confident that, under repeated sampling, the \$400,000 tax assessment is within \$12,000 of the true tax owed (a 3% margin of error).

$$s = \left( 150,000 \cdot \frac{\Phi^{-1}\left(1 - \frac{0.05}{2}\right)}{12,000} \right)^2 = (12.5 \cdot 1.96)^2 = 600.25$$

Thus we find that a sample size of 601 would have met the precision goal. In fact, in this specific example we can be 95% confident that the tax assessment is within \$8,996 of the true tax owed<sup>5</sup>, a margin of error of about 2.25%. If we find that our goal was not met, we could either change our goals (in discussion with the taxpayer we can decide to increase the margin of error or the significance level) or draw a larger sample of magnitude equal to the recalculated sample size.

## Stratified Random Sample

While it is perfectly valid to draw a simple random sample from the entire population, stratified random sampling is more efficient (sample size being equal, you are more likely to reach your precision goals if you stratify). The method of stratified sampling is one where the population is divided into strata (i.e., based on dollar amounts). We have chosen to stratify the audit population into 5 strata. We use a 100% sampling rate on the highest dollar stratum. We sample 267 records (1068 divided by 4) in each of the other 4 strata. While it is valid to judgmentally determine the stratum cutoffs, our preferred method is to give each stratum equal weight by total dollars. Typically, this increases efficiency through a higher sampling rate for the strata containing high dollar items.

The average error amount in each stratum is used to project a total error. We can project each stratum separately and then add them up for a total. Alternatively, we can use the relative number of records in each strata to calculate a weighted average error amount and then multiply by the population size to arrive at a tax assessment estimate.

---

<sup>3</sup> The sample average  $\bar{x}$  is given by  $\bar{x} = \frac{1}{n} \cdot \sum_{i=1}^n x_i$  where  $x_i$  is the underpayment and  $n$  is the sample size.

<sup>4</sup> The sample standard deviation  $\hat{\sigma}$  is given by  $\hat{\sigma} = \sqrt{\frac{1}{n-1} \cdot \sum_{i=1}^n (x_i - \bar{x})^2}$

<sup>5</sup> Rearranging the sample size formula, we get  $m = \frac{\sigma \cdot \Phi^{-1}\left(1 - \frac{\alpha}{2}\right)}{\sqrt{s}} = \frac{150,000 \cdot 1.96}{\sqrt{1068}} = \$8,996$

To illustrate, suppose we stratified the population into four strata of equal dollar weight as follows: 8,000 records in the lowest dollar records stratum, 4,000 in the second, 2,000 in the third, and 1,000 in the fourth. Suppose we then sampled 267 from each stratum and found an average underpayment of \$1 in stratum one, \$5 in stratum two, \$20 in stratum three, and \$100 in stratum four, with corresponding standard deviations of \$0.2, \$1, \$2, and \$5. The fifth, the highest dollar stratum resulted in a tax assessment of \$200,000 (true, not estimated. The standard deviation is zero of course). The projected total tax assessment is then:

$$\$200,000 + (8,000 \cdot \$1) + (4,000 \cdot \$5) + (2,000 \cdot \$20) + (1,000 \cdot \$100) = \$368,000$$

or alternatively found using a weighted average:

$$\$200,000 + 15,000 \cdot \left( \frac{8}{15} \cdot 1 + \frac{4}{15} \cdot 5 + \frac{2}{15} \cdot 20 + \frac{1}{15} \cdot 100 \right) = \$200,000 + 15,000 \cdot \$11.2 = \$368,000$$

In a stratified random sample, the projected standard deviation of the total error in the population is found as:

$$\hat{\sigma} = \sqrt{\sum_{i=1}^4 N_i \cdot (N_i - n_i) \cdot \frac{\hat{\sigma}_i^2}{n_i}}$$

Where  $N_i$  is the total number of records in stratum  $i$  and  $n_i$  is the number of records sampled in stratum  $i$  (267). In our stratified random sample example above,

$$\hat{\sigma} = \sqrt{\left( 8,000 \cdot (8,000 - 267) \cdot \frac{\$0.2^2}{267} \right) + \dots + \left( 1,000 \cdot (1,000 - 267) \cdot \frac{\$5^2}{267} \right)} = \$185,751$$

Now we can determine whether the sample of 1,068 was large enough. We want to be 95% confident (0.05 significance level) that, under repeated sampling, this \$368,000 tax assessment is within \$11,040 of the true tax owed (a 3% margin of error).

$$s = \left( 185,751 \cdot \frac{\Phi^{-1}\left(1 - \frac{0.05}{2}\right)}{11,040} \right)^2 = (16.3 \cdot 1.96)^2 = 1,088$$

Thus we find that a sample size of 1088 is needed to meet the precision goal. We are left with the choice of sampling 20 more records or simply accept a slightly higher error rate –in this example, we can be 95% confident that the tax assessment is within \$11,140 of the true tax owed<sup>6</sup>, a margin of error of about 3.03%.

#### 4. GLOSSARY OF RELATED TERMS

**Random Sampling:** For a simple random sample, each item in the population has the same probability of being sampled. In stratified random sampling, each item in

---

<sup>6</sup> Rearranging the sample size formula, we get  $m = \frac{\sigma \cdot \Phi^{-1}\left(1 - \frac{\alpha}{2}\right)}{\sqrt{s}} = \frac{185,751 \cdot 1.96}{\sqrt{1068}} = \$11,140$

each stratum has the same probability of being sampled (but the probability might differ among strata).

**Stratified Random Sampling:** The population is divided into strata. A random sample is taken from each stratum. Stratifying the population based on dollar amounts can provide for more precise results as compared to a simple random sample of the entire population, the reason being that in a simple random sample low dollar items have a higher probability of being sampled.

**Weighted Average:** When the weights are the same, weighted average is the same as a simple arithmetic average. Weighted averages take into consideration the frequency of the class of records in order to compute an average. For example, consider a population divided into two strata, one with the 100 highest dollar records and one with 900 records. If the average tax assessment was found to be \$50 for the high dollar items and \$1 for the low dollar items, then the weighted average is  $5.9 \left( \frac{100}{1000} \cdot 50 + \frac{900}{1000} \cdot 1 \right)$ .

**Projection:** Projection is expanding the sample results to the entire population. To arrive at an estimate of total assessment, multiply the average error value in each stratum's random sample by the number of items in that stratum. The total population estimate is simply the sum of each stratum's projected error. This is algebraically identical to the result obtained from multiplying a weighted average of the strata's assessment by the total number of records in the population.

## 5. DEVELOPING THE STATISTICAL SAMPLE

An important point needs to be made here. The field auditor is in charge and is responsible for their individual audits. The ICT auditor's position is that of a consultant who is responsible for manipulating data to achieve an efficient and workable sample for the field auditor to use.

### 5.1 Review and Verification

The taxpayer should send the records to the field auditor. It is the responsibility of the field auditor to review the records to determine if they received the information they requested. The field auditor should verify that the account balances are correct and is in agreement with the G/L for the period, to assure that all records have been received.

The field auditor should also review the file to assure there is no incorrect information and that there are no blank fields in the file or extra rows with any additional information.

## 5.2 Sampling Form

One of the primary responsibilities of the field auditor will be to determine if the ICT program can be used for conducting an audit. The field auditor, during the initial audit conference and/or upon first arriving at the audit site, must ask the taxpayer if they can use the ICT program to develop the sample for the audit. The field auditor must complete the ICT justification form below for each prospective audit, (blank copy enclosed for reference).

The questions are to be asked of the taxpayer by the field auditor.

- Can records be provided in electronic data format in Excel spreadsheet or similar type format?
- Approximately how many records will be provided/
- What is the audit period to be covered?
- If ICT cannot be used, explain why it cannot.
- Give any additional information, and /or explanations as to how the auditor will use the ICT audit program, or why it cannot be used.

The field auditor will be required to complete this form for each audit. Once completed, the field auditor should scan the document into their audit folder in STAUDN and keep the paper copy in their audit folder (**See Form 1**).

**Form 1**

ICT Information Form

Acct #: <Account #>  
 Name: <Business Name>  
 Date: <Date>

Contact: <Contact Name>  
 Title: <Contact Title>  
 Auditor: <Auditor Name>

**PURPOSE: To document the use of Excel and IDEA software applications in the audit.  
 To be completed by auditor prior to starting the audit field work.**

- The use of ICT was discussed with the customer contact listed above. In addition, the customer was given a copy of the ICT Taxpayer Explanation handout. **(Required for ALL audits)**
  
- After discussion with my team lead or audit supervisor, it was determined that this audit case is not a good candidate for ICT because: (Mark all that apply – Explain as necessary)
  - Customer is not fully computerized
  - Prior audit history (company size / hours) not sufficient to utilize ICT procedures
  - Customer declines to use ICT procedures
  - Other/Explanation:
  
- The customer is interested in using ICT. The customer: (Mark all that apply – Explain as necessary)
  - Cannot** provide data in Excel or other suitable format
  - Can** provide data for at least one audit measure in Excel or other suitable format
  - Agrees to use ICT procedures for this audit
  - Other/Explanation:

If ICT to be used, provide the following information for each prospective ICT measure, account #, etc:

<u>Data Available</u>	<u>Measure Name, Acct # or Description</u>	<u>ICT Use Expected</u>	<u>Sample Period</u>	<u>Approx. # of Records</u>
Yes <input type="checkbox"/> No <input type="checkbox"/>	Sales	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Assets	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Purchases	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Other	Yes <input type="checkbox"/> No <input type="checkbox"/>		

Yes  No

Other

Yes  No

Additional Comments:

### 5.3 Manipulating The Data

Once the ICT auditor has received the file from the field auditor, it is their responsibility to develop the statistical sample. The ICT auditor will use the guidelines set forth in the following section to produce the statistical sample. The ICT auditor should evaluate the information received, to assure that a statistical sample can be done, and identify any extraordinary issues that need to be resolved before a sample is developed.

### 5.4 File Formats used by ICT

The ICT software (IDEA) can work effectively with a wide may of data formats. These formats include:

#### **Application Data and Databases**

- Access
- Lotus 123
- Oracle
- Various accounting packages  
Accpac, Simply accounting,  
Sage and many others
- Btrieve
- Excel
- SQL Server
- Sybase
- XBASE (the DBF format from  
Foxpro, and others)

#### **Flat Files /Unformatted Data**

- ASCII (fixed length and variable
- EBCDIC (fixed length)
- AS/400 DIF (Data Interchange
- ASCII Delimited
- EBCDIC (variable length)

Most software applications can effectively export a flat, or ASCII, file type. The ICT auditor should work with the taxpayer to identify a usable file format.

See page three of the ICT Procedure Manual for further information.

## ***6. STATISTICAL SAMPLING GUIDELINES***

When developing a statistical sample from virtually any size file of records, the auditor will use the following procedures to select a sample from the original population of records:

Initially, a detailed stratification should be done  
All negative amounts should be extracted out with only positive amounts remaining in the population. The negative amounts can be reviewed separately.

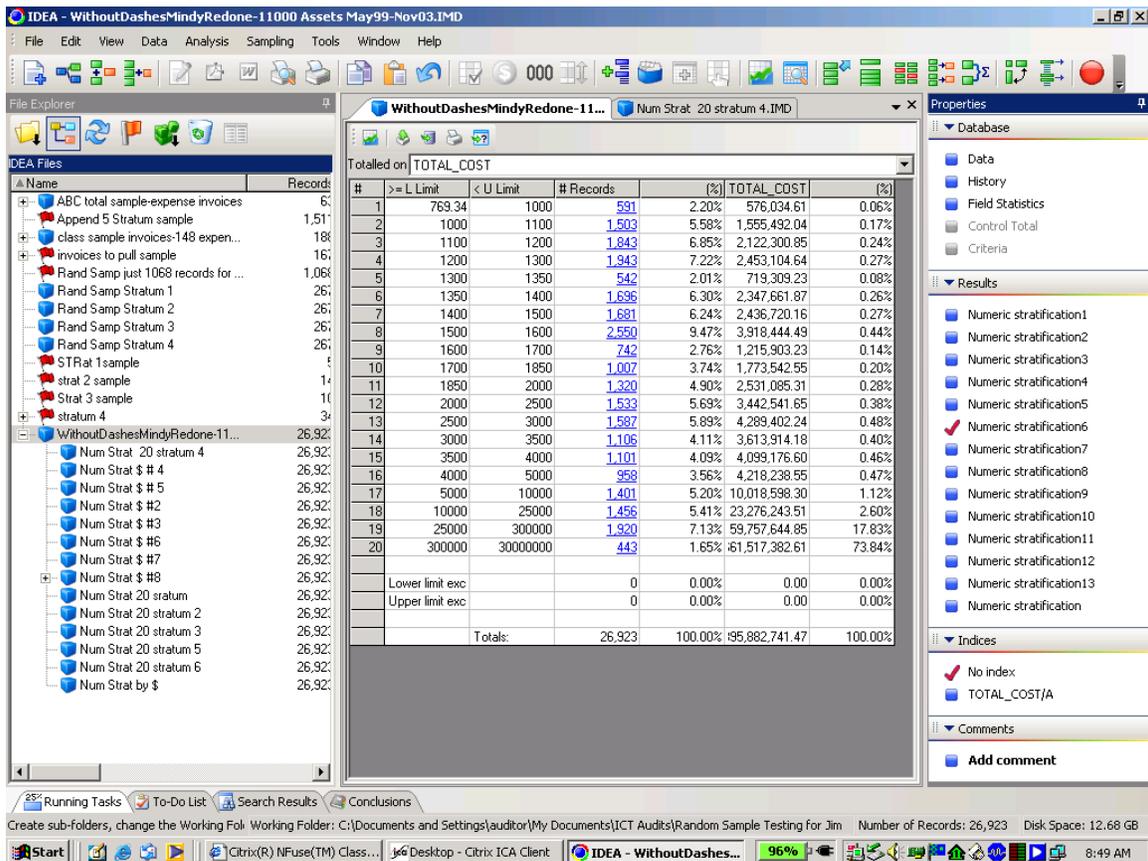
The auditor will use a total of 1068 records as specified by the table in Section 3. This is based on a Confidence level of 95% and a Margin of Error of 3%. The highest dollar stratum will be reviewed in detail For the remaining stratum, other than the highest dollar stratum, four equally weighted stratum should be developed For each of the four stratum 267 records will be selected as the sample. This totals the 1068 records that should be used

NOTE: Obviously some audits will not have enough records to support reviewing 1068 records. In this case, the auditor should use the alternative sampling methods of ICT systematic sampling or block sampling.

### 6.1 Detailed Stratification

A detailed stratification is a very important step in arriving at four equally weighted averages. This may mean that you have as many as 20 or more stratum. Each stratum should be finely defined so that we can develop the most accurate sample that we can (See Fig. 1).

Figure 1



## 6.2 Number of Records to Sample

Based on the statistical table in Section 3, when developing a statistical sample we will review a total of 1068 (not counting the highest dollar records). This sample size can be used for any population of records unless the population is too small to support reviewing this many records. The 1068 records will be selected from the final four strata and the number of records of the high dollar stratum will be added to this for the total sample.

## 6.3 Detail Highest Dollar Stratum

The highest dollar stratum will always be reviewed in detail. Whether you are sampling expense purchases or assets, it is important to segregate the highest dollar for review. This assures that in reviewing the high dollar level the auditor can be assured that the taxpayer and the State of Virginia are not subject to any abnormal error created by extrapolating from a smaller sample.

## 6.4 Developing Four Stratum

To develop four strata it will be necessary to take the remaining strata from the detailed stratification and use the percentages of the total dollars (farthest right column), then total all of the percentages and divide by four. This will give you your weighted average for each stratum. For example in **Fig. 2** below, the total of the percentages was 26.06%. Divided by 4 this would be approximately 6.52%. That means that each stratum should contain as close to 6.52% of the total dollars of your remaining strata. This will be achieved by starting at the first stratum and, based on the percent of total dollars, add the strata together until they equal close to 6.52%. That ends your first stratum. Repeat for the other three strata. Once the auditor completes this step, and then the auditor would rerun the stratification with the four new strata. Now that you have your four strata you are ready to draw your samples from the strata using the Stratified Random Sampling Program.

Fig.2

The screenshot displays the IDEA software interface. The main window shows a data table titled "WithoutDashesMindyRedone-11..." with the following data:

#	>= L Limit	< U Limit	# Records	(%)	TOTAL_COST	(%)
1	769.34	14000	23,698	88.02%	58,380,136.66	6.52%
2	14000	64500	1,920	7.13%	58,161,880.39	6.49%
3	64500	156000	588	2.18%	58,902,918.43	6.57%
4	156000	300000	274	1.02%	58,920,423.38	6.58%
Lower limit exc			0	0.00%	0.00	0.00%
Upper limit exc			443	1.65%	61,517,382.61	73.84%
Totals:			26,923	100.00%	195,882,741.47	100.00%

The interface also includes a File Explorer on the left showing a tree view of IDEA files, a Properties panel on the right with sections for Database, Results, and Indices, and a taskbar at the bottom showing the Windows Start button and various open applications.

## 7. CREATING THE SAMPLE

From your four stratum, using the stratified random sampling program, the auditor will select 267 records from each stratum and create a file. The auditor will then append these four files to the high dollar level file to create your total sample, (See **Fig. 3** below). By using 267 for each stratum, it will give you the total of 1068 records, which will be used in the statistical sampling procedure. An important note to follow in each stratum IDEA will give you a seed number. The auditor is to use the seed number the program provides for each stratum. The seed number is stored in your History and cannot be removed. This is important in case you should need to draw your 267 records from a stratum a second time.

Once the auditor has selected the sample from the four stratum, the auditor will need to append them to the file of the high dollar records to provide the one sample. Generally speaking the auditor should have a total sample of the 1068 records plus between 200 to 800 records for the high dollar file. When the auditor has appended all of the files, the auditor can then export the file back to the field auditor who can use it to begin their fieldwork.

**Fig. 3**

The screenshot displays the IDEA software interface. The main window shows a data table with the following columns: BUSINESS\_UNIT, DEPARTMENT, GL\_ACCOUNT, PROFILE, and ASSET. The table contains 35 rows of data, with the first row being a header row. The data rows show various business units and departments, all with a GL\_ACCOUNT of 15030000 and a PROFILE of PCEQ. The ASSET column contains values ranging from CNV0000 to 6175.

The interface also includes a File Explorer on the left side, showing a tree view of IDEA files. The tree view includes folders for 'ABC total sample-expense invoices', 'Append 5 Stratum sample', 'class sample invoices-148 expen...', 'invoices to pull sample', 'Rand Samp just 1068 records for ...', 'Rand Samp Stratum 1', 'Rand Samp Stratum 2', 'Rand Samp Stratum 3', 'Rand Samp Stratum 4', 'STRat 1 sample', 'strat 2 sample', 'Strat 3 sample', 'stratum 4', and 'WithoutDashesMindyRedone-11...'. The 'WithoutDashesMindyRedone-11...' folder is expanded, showing sub-folders for 'Num Strat 20 stratum 4', 'Num Strat \$ # 4', 'Num Strat \$ # 5', 'Num Strat \$ # 2', 'Num Strat \$ # 3', 'Num Strat \$ # 6', 'Num Strat \$ # 7', 'Num Strat \$ # 8', 'Num Strat 20 stratum', 'Num Strat 20 stratum 2', 'Num Strat 20 stratum 3', 'Num Strat 20 stratum 5', 'Num Strat 20 stratum 6', and 'Num Strat by \$'.

The Properties pane on the right side of the interface shows sections for Database, Results, and Indices. The Database section includes 'Data', 'History', 'Field Statistics', 'Control Total', and 'Criteria'. The Results section includes 'Numeric stratification1' through 'Numeric stratification13'. The Indices section includes 'No index' and 'TOTAL\_COST/A'. There is also an 'Add comment' button at the bottom of the Properties pane.

The status bar at the bottom of the window shows the following information: 'Working Folder: C:\Documents and Settings\auditor\My Documents\ICT Audits\Random Sample Testing for Jim', 'Number of Records: 26,923', and 'Disk Space: 12,68 GB'. The system tray shows the time as 8:46 AM and the date as 11/03/03.

## 7.1 Credits within a Sample

As a result of sampling, the auditor may encounter records where the taxpayer has paid tax to a vendor erroneously or they have accrued tax and paid it to the state erroneously. Regardless of which situation occurs, the auditor cannot remove the record from the sample and replace it with another record. Credits remain in the sample but each situation is handled in a different manner.

If the taxpayer has paid tax to a vendor erroneously, the record would be marked exempt (E) and the taxpayer would be told that they need to be refunded from the vendor for that invoice and any other like invoice.

If the taxpayer has accrued tax and remitted it to the state, then the auditor would treat this record in one of two methods. First, if the taxpayer wants to extrapolate the credit through the audit, then the auditor would mark this particular record that will be held in the audit as part of the final assessment record as taxable (T), but it would have a credit value. This would offset taxable exceptions held in the audit that creates an assessment. It would be extrapolated to the extent that the entire sample is extrapolated. If the taxpayer chooses this method, then they would have no claims for refund on any other invoices not sampled in the audit period.

If the taxpayer elects not to include the credit in the sample, then the auditor would mark the record as exempt (E). The taxpayer would then be able to review all invoices that are in statute and submit a refund request to the Department of Taxation.

### *8. Creating the Exception List for the Field Auditor*

Since the goal of using statistical sample is to capture all records for the audit period. It will only be necessary to gross up the error factor created from the sample by the total dollar value of the entire population. The ICT auditor, when entering data into STAUDN, can manipulate this information along with the exceptions noted.

If the sample period is less than the entire audit period, then the procedures above would be used and in addition the auditor would have to further extrapolate the results in STAUDN to determine the total assessment. The ICT auditor can manipulate the data in this situation as well to upload the data into STAUDN.

## Sales and Use Tax Audit Procedure

### SUCCESSOR LIABILITY

**Objective:** Discuss the application of sales and use tax as it applies to sale/quitting a business.

#### I. References

- A. Code of Virginia Section 58.1-629
- B. Virginia Administrative Code 23VAC 10-210-3090
- C. Ruling Letters 200-802 and 200-814; and Public Document 96-161

#### II. General

A taxpayer who purchases all of the stock of an existing business may be liable for sales and use tax owed by the seller unless certain precautions are taken as provided by Code of Virginia 58.1-629. A dealer is required to submit a final return and remit the applicable tax, penalty, and interest within 15 days of selling or quitting a business. The final return should note the name and address of the successor, if applicable.

When a business is sold, the purchaser must withhold sufficient funds to cover tax, penalty, and interest owed by the previous owner. The funds may not be released until the seller produces a receipt showing that all liability has been paid, or until the purchaser receives a certificate from the Department showing that no tax, penalty, or interest are due from the prior owner. If a purchaser fails to withhold funds, he or she may be personally liable for tax, penalty, and interest owed by the prior owner.

A certificate of registration may not be issued to a successor who has been notified by the Department that tax, penalty, and interest are due and unpaid by a prior owner until the amount is paid in full.

Virginia Code 58.1-629 applies only to sales and use tax. Furthermore, it applies only to those situations when a business is sold for a cash consideration. Successor liability may not be imposed when a business is sold for non-monetary assets such as stock or other property.

### **III. Procedures**

The applicability of successor liability should be evaluated as the situation arises. The auditor should evaluate the situation using the best information available to resolve the issue.

Items to look for when you suspect you may have a successor problem:

- Type of business-individual, partnership or corporation?
- What did purchaser buy?
- Obtain copy of sales agreement.
- Was there a sale?
- Is business at the location, is the name the same, is the successor a like business?
- Was the sale for cash or other consideration?
- Is there a contractual agreement to purchase debts?

**If there is a contractual agreement for the purchaser to be responsible for the debts of the seller, then the provision of successor in liability does not come into play.**

## **SUCCESSOR LIABILITY**

The policy of the Department of Taxation states that "in order to hold a successor of a business liable for unpaid sales tax under the provisions of Section 58.1-629, a sale must have taken place and purchase money must have changed hands. A taxpayer taking over a business abandoned by former owner does not fulfill the meaning of "successor" in that a sale of transfer of ownership did not take place and purchase money did not change hands. Furthermore, exchange of non-money items such as stock or land would not allow the Department to proceed against the successor."

## **PARTNERSHIP**

The liability of successor businesses depends on the facts. If a partnership adds or subtracts partners but continues without dissolving ( and all creditors must be paid if the partnership goes through dissolution) it is still liable for all debts and crimes committed before the change. If the partnership is dissolved and sold to another set of partners, the new partners may agree to assume the debts of the old, in which case both the old partners and the new partnership may be liable for debts, but the new partnership has no criminal liability.

## **CORPORATION**

Corporations may be dissolved, merged, consolidated or sold. In any of the last three, the successor should be liable for debts and subject to criminal prosecution rising from dealings of the old corporation. If the assets of a corporation are sold (rather than the stock), and the original corporation either stays in existence or is later dissolved, the liability for debts is not transferred unless there is an agreement to do so. However, it is illegal to sell all assets of a business without going through certain procedures to protect creditors.

## **Sales and Use Tax Audit Procedure**

### **Service vs Sales**

**Objective:** Discuss the application of sales and use tax as it applies to Services vs Sales.

#### **I. References**

- A. Code of Virginia Section 58.1-203 and 58.1-609.5(1)
- B. Virginia Administrative Code- 23 VAC 10-210-4040
- C. Ruling Letters
  - Ruling of Commissioner, Sales and Use--Definitions--"Sales Price"--Services--10/25/84
  - Ruling of Commissioner, Sales and Use--Definitions--"Tangible Personal Property"--Computer Software--, 2/8/85
  - Professional, Insurance or Personal Service Transactions, 2/15/85
  - 60-310.42, CCH, Conversion of word processing diskettes
  - P.D. 86-22., Conversion of Word Processing Diskettes, 1/16/86
  - P.D. 90-6., Calligraphy, 1/11/90
  - P.D. 90-218., Specialized Word Processing Products, 12/14/90
  - P.D. 91-185., Fax Services, 8/30/91
  - P.D. 91-207, Computer Software and Equipment--Price Updates Stored on Tapes or Diskettes, 9/6/91
  - P.D. 91-268., Architectural Blueprints--10/23/91
  - P.D. 92-13., Trash Bags for Garbage Collection, 4/1/92
  - P.D. 92-112., Word Processing Products. 6/24/92
  - P.D. 92-138., Multiple Real Estate Listing Service, 8/10/92
  - P.D. 92-159., Computer-Aided Drafting Designs, 8/27/92
  - P.D. 93-87., Video production company, 3/29/93
  - P.D. 93-139., Computer-generated lists, 6/4/93
  - P.D. 94-120., Mapping services, 4/20/94
  - P.D. 94-147., Resales--Warranty documents, 5/16/94
  - P.D. 94-156., Sales training seminars, 5/23/94
  - P.D. 94-230., Account reconciliation services, 7/28/94
  - P.D. 94-299., Duplicating services, 9/29/94
  - P.D. 94-315., Video clippings--Newspapers on CD-ROM, 10/18/94
  - P.D. 95-5., Insurance companies--Video tapes, 1/9/95
  - P.D. 95-15., Miscellaneous service enterprises--Abstracts, 1/27/95
  - P.D. 95-195., Medical records and legal depositions, 7/31/95
  - P.D. 95-234., Publishing and broadcasting--Videotapes, films or other audiovisual work, 9/8/95
  
  - P.D. 95-252., Computerized drafting services, 9/29/95
  - P.D. 95-265, Photocopied medical records, 10/17/95

- P.D. 95-270., Cleaning and laundry--Linen services, 10/24/95
- P.D. 95-286., Repair and installation, 11/7/95
- P.D. 95-300., Marketing services, 11/21/95
- P.D. 96-2., Telecommunications--Prepaid telephone cards, 1/4/96
- P.D. 96-67., Electrical services, 4/26/96
- State Leg- Summary, CCH 192-060.04, Contractors--Locksmiths
- State-Leg- Summary, CCH, 192-060.05, Contractors--Locksmiths

D. Applicable exemption certificate---ST-10--From 23 VAC 10-210-4040. Services. Section E. Final paragraph, "When making bulk purchases of items, some of which will be used in providing services and some of which will be used in making retail sales, a person may purchase all such items exempt from the tax using a ST-10. The person shall remit use tax on any tangible personal property purchased for resale but used in providing exempt services based on the cost price of the items used."

### **III. General**

A. Charges for services generally are exempt from the retail sales and use tax. However, services provided in connection with sales of tangible personal property are taxable.

B. Total charges for fabrication of tangible personal property for users or consumers on a special order for a consideration, including labor, even if charges for labor are separately stated --are taxable. (see 23 VAC 10-210-560)

C. Transaction involving both the sale of tangible personal property (tpp) and the provision of services, generally are either taxable or exempt on the full amount charged, regardless of whether the charges for the service and property components are separately stated. The "true object" test is used to determine the taxability of these transactions.

### **IV. Procedures**

In order to determine whether a particular transaction which involves both the rendering of a service and the provision of tpp constitutes an exempt service or a taxable retail sale, the "true object" of the transaction must be examined. If the object of the transaction is to secure a service and the tpp which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.

Additional factors, such as monetary significance, as when a CPA firm

buys a computer for a client in order to provide accounting services, need to be looked at to determine the "true object" along with the ownership status of the tpp in question. In this situation the CPA firm retains ownership of the computer, although the cost of the equipment is monetarily significant related to provision of the services the "true object" is the provision of the services to the client. The CPA firm should pay use tax on the purchase of the computer at the time of purchase. This example is comparable to data communications services, including equipment as listed below under, "2. Exempt. d. Data communications...".

In instances where both the services rendered and the property transferred are critical elements of a transaction, the degree of customization, uniqueness or specific services provided in connection with the product shall be considered in determining its appropriate tax status.

Examples of transactions in which the tax status is based on these factors:

1. Taxable.
  - a. Standard data lists, reports
  - b. Extra copies of reports, letters
  - c. Equipment rentals
  - d. Data communications equipment
2. Exempt.
  - a. Customized data lists, reports
  - b. Original letters, reports
  - c. Equipment rentals with operators
  - d. Data communications services, including equipment

Example. A taxpayer provides information retrieval services and in connection therewith leases or rents computer equipment to its customers. Charges for the retrieval service, which include charges for the lease or rental of the equipment, are exempt from the tax. However, if the tp leases or sells computer equipment to customers without the provision of the information services, such lease or sale is taxable.

To assist in determining whether transactions are services or sales the auditor should ask for or look for documents such as lease agreements, contracts, and related documents that describe the specifics of the service or sales agreement. Look for statements that include tpp as part of the agreement and other wording in the agreements that assist in defining the "true object" and indicate what the tp is entitled to receive or not receive.

A tp that is a service provider may also be making retail sales. Many traditional service providers (attorneys, doctors, CPA's etc.) are making significant purchases to support their services businesses and should be registered for Consumers Use Tax and or Sales Tax.

As an additional aid to determine the "true object of the buyer" test in distinguishing between sales of services and sales of tpp, determine whether the buyer's primary purpose is to acquire a tangible product. Example: An equipment rental situation where a customer does not take possession of the equipment and goes to the computer store to use the equipment. If the buyer's primary purpose is to acquire the tangible product (the computer) the contract is for the sale of tpp and is taxable. In this case the "true object" is to attain the use of the computer for the service it provides ("computer time") and not the actual tpp.

Common exempt services are:

1. Personal, professional, or insurance transactions which involve sales as inconsequential elements for which no separate charge is made
2. Separately stated services performed by repairmen
3. Separately stated labor or service charges for the repair, installation, application or remodeling of tangible personal property
4. Separately stated transportation charges
5. Separately stated charges for alterations to apparel, clothing and garments
6. Charges for gift wrapping services performed by a nonprofit organization
7. An amount separately charged for labor or services rendered in connection with the modification of prewritten programs
8. Computer programs that meet the requirement of "custom programs"

## Sales and Use Tax Audit Procedure

### Schools and Colleges, Certain Educational Institutions and Other Institutions of Learning

**Objective:** Discuss the application of sales and use tax as it applies to Schools and Colleges, certain educational institutions and other institutions of learning.

#### I. References

- A. Code of Virginia Section- 58.1-203 and 58.1-609.4(1),(2),(5) of the Code of Virginia
- B. Virginia Administrative Code-23 VAC 10-210-4020
- C. Ruling Letters (give public document number)
  - P.D. 89-290, Sales Made by School Store located in nonprofit school, Exempt, 10/27/89
  - P.D. 90-35, Yearbooks Sold to Schools, Exempt, 3/19/90
  - P.D. 91-23, Nonprofit Cooperative Preschool- Fund Raising Activities, Taxable/Exempt, 3/4/91
  - P.D. 91-168, Status of School that did not meet all criteria for exemption, Taxable, 8/15/91
  - P.D. 93-145, Nonprofit institution Riding Center purchases, Exempt, 6/23/93
  - P.D. 93-241, Scientific educational institution, Taxable, 12/28/93
  - P.D. 94-16, Nonprofit Corporation- Educational--Status??, Taxable- not exclusively..., 1/28/94
  - P.D. 94-343, Foundation promoting vocational-technical education, Taxable, 11/17/94
  - P.D. 95-100, Organization promoting education, Taxable, 5/4/95
  - P.D. 95-255, Professional education association, Taxable, 10/4/95
  - P.D. 96-6, Law student organization, Taxable, 2/28/96
  - P.D. 96-25, Schools-Lunches and tpp Sold by Nonprofit Schools, Exempt, 3/29/96
  - P.D. 96-53, Nonprofit organizations, private schools, and churches, Fundraising, Exempt, 4/19/96
  - P.D. 96-98, Food Served At College Events, Taxable, 5/24/96

D. Virginia Tax Bulletins

- TB 201-340, P.D. 86-208, Nonprofit Boarding School, Exempt, 10/17/86
  - TB 201-353, P.D. 86-222, Parent Teacher Association- Fund Raising Sales to School Organizations, Exempt, 11/3/86
  - TB 86-8, Parent Teacher Organization, Exempt, 6/1/86
  - TB 201-617, P.D. 88-92, School Yearbook Purchases, Exempt, 5/10/88
  - TB 201-707, P.D. 88-291, Parent Teacher Association--Book Fair, Taxable--book store not affiliated with a school, 10/27/88
  - TB 201-835, School in Formative Stages, Taxable, May claim refund after it becomes operational and meets criteria, 10/26/89
  - TB 202-520, PD 94-305, Information requirements, 9/30/94
  - TB 202-116, Public School Contracts, Sale and Installation of Public School Equipment, 4/1/92
- E. Applicable exemption certificate
- ST-13 (Blue) Nonprofit Organizations--Educational exemptions 1-4
  - ST-12 (Mint Green) (For use by the Commonwealth of Virginia, a political subdivision of the Commonwealth of Virginia, or the United States)

## II. General

- A. When conducted not for profit. The tax does not apply to sales of tpp to nonprofit schools, colleges and other institutions of learning for their use or consumption and paid for out of their funds. An "other institution of learning" must be similar to a college, that is, it must (a) employ a professionally-trained faculty; (b) enroll and graduate students on the basis of academic achievement; (c) prescribe courses of study; and (d) provide instruction at regular intervals over a reasonable period of time. The tax does apply to purchases by day care centers and other pre-grade school establishments other than kindergartens, unless otherwise exempt (church run).

Sales to institutions of learning owned and operated by the state have the same status as other sales to the state for its use or consumption. Sales of tpp to the United States, or to the Commonwealth of Virginia or its political subdivisions, are exempt from the tax if the purchases are pursuant to required official purchase orders to be paid out of public funds. Sales made without the required purchase orders and not paid for out of public funds are taxable. Sales to governmental employees for their own consumption or use in carrying out official government business are taxable.

Charges for meals, catered events, lodging, and other accommodations, such as meeting or conference rooms, are subject to the tax when paid for by the state or local government or public institutions of learning, or employees of such, regardless of whether the purchases are made pursuant to required official purchase orders.

- B. Educational institutions. \*\* This section provides a very restricted exemption. Colleges and Universities do not fall under this section.\*\* TPP and services (emphasis added- includes services, which differs from nonprofit schools, colleges and other institutions of learning, which are not exempt on services) may be purchased exempt from the tax by an educational institution doing business in the Commonwealth which (a) admits regularly enrolled high school and college students, and (b) provides a face-to-face educational experience in American government, a program which (i) leads toward the successful completion of courses in high school in United States history, civics, and problems of democracy, or (ii) which is acceptable for full credit towards an undergraduate or graduate level college degree, provided such institution is conducted not for profit. The property or services must be purchased by the educational institution. Individuals are not eligible for the exemption even if they are reimbursed by the institution for their expenditures. However, the exemption applies even if students, teachers or other educators participating in the institution's program use or consume the purchased property or services, including meals and lodging. The "Close Up" organization would be an example of an exempt "Educational institution". They are an organization in Northern Va that provides a civics program and meets all of the above criteria. Thus they are exempt on purchases of both tpp and services, such as meals and lodging.
- C. Public school system. The tax does not apply to purchases by public free schools for their use or consumption, provided purchases are made pursuant to official purchase orders to be paid for out of public funds. The tax applies to purchases not paid for out of public funds.
- D. Sales. The exemption does not extend to sales by the institution (other than school textbooks) For example, the institution must collect the tax on retail sales of meals to students or others if the price of the meals is not included in room, board or tuition charges or fees.\*\*\*exception-see school lunches, Section G.

- E. Independent associations. The tax does apply to sales to independent athletic and other such associations, whether or not affiliated with a nonprofit institution of learning (including state institutions). When these associations make retail sales, they should contact the Department to determine if they should register as a dealer.
  
- F. School Activity funds.
  - 1. On purchases of tpp paid for out of funds other than public funds or funds of the nonprofit institution of learning, the tax applies if the tpp is for the use of any school class, club, group, organization, association or individual. Such items cannot be purchased under certificates of exemption, and the tax must be paid to dealers. Examples would be : yearbooks, class rings, graduation gowns and caps, photos, school supplies, etc. for use by students.
  
  - 2. The tax does not apply to purchases of tpp by a school, such as athletic equipment, band instruments, etc. to be paid for out of school activity funds if the purchases become the property of the school. These items may be purchased under certificates of exemption.
  
- G. School lunches. The tax does not apply to school lunches sold and served to pupils and employees of schools and subsidized by government at any level. Equipment and supplies purchased by a school for its use in preparing and serving school lunches, and which become the property of the school, can be purchased under certificates of exemption.
  
- H. School textbooks. The tax does not apply to school textbooks sold by a local school board or its authorized agency. It also does not apply to school textbooks for use by students attending a college or other institution of learning not conducted for profit when sold (a) by such institution or (b) by any other dealer (provided such textbooks are certified by the institution as required course materials for its students).
  
- I. The tax does not apply to tpp purchased for use, consumption, or sale at retail by an elementary or secondary school conducted not for profit, or Parent Teacher Association or other group associated with an elementary or secondary school conducted not for profit for use in fund-raising activities, the net proceeds of which are contributed directly to the school or used to purchase certified school equipment, and certified school equipment purchased by such groups for contribution directly to the school.

## WHEN CONDUCTED FOR PROFIT

The tax applies to sales of tpp to schools, colleges and other institutions of learning when they are conducted for profit. They are required to pay the tax to their vendors at the time of purchase, unless their purchases are made for resale as dealers. All sales of tpp made by such institutions are taxable. In addition, these institutions must collect the tax on any retail sales of meals to students or others, if the price of the meals is not included in room, board, or tuition charges or fees.

### III. Procedures

During an audit of a vendor that deals with a school look at the exemption certificate files to validate exempt sales to schools and colleges, certain educational institutions and other institutions of learning. Insure that the purchases meet the wording of the certificate. Schools and colleges are not exempt on the purchases of items such as meals and lodging. Look for a ST-13 in the file for nonprofit schools that are not owned and operated by the state. An ST-12 should be on file for entities that are owned and operated by the state and have the same status as other sales to the state for its use or consumption.

Be aware of the current status of PTA's and similar organizations. Effective July 1987, but retroactive to July 1, 1986 the Virginia Code provides an exemption from the tax for, "tangible personal property purchased for use, consumption, or sale at retail by an elementary or secondary school conducted not for profit , for use in fund-raising activities, the net proceeds of which are contributed directly to the school or used to purchase certified school equipment...". Block 3 of the ST-13 covers this exemption.

This exemption (PTA and similar organizations) is unusual in that it applies to both purchases and sales of tpp in connection with fund-raising activities of nonprofit elementary or secondary schools and school-affiliated organizations. The statute further provides that sales of tpp (such as class rings, school photographs, pencils, notebooks, etc) by private vendors are exempted when any portion of the receipts from the sale are returned to the school in the form of a commission. This exemption for sales by private vendors is unique because it is the use of the funds resulting from the sale, and not the nature of the product being sold or the person/group purchasing the item, that determines whether the item is taxable.

Throughout the state, schools are under construction. Generally, contractors are subject to Virginia sales tax on the purchase of any property furnished and affixed to real estate under contracts with public school

systems. However, the sale of tpp directly to a public school system is exempt as a sale to a government entity, but taxable when sold to the contractor. A contractor has some exceptions to the general rule on the taxability of tpp purchased by them to use on public school contracts. Refer to TB 92-2 Contractors---Public School Contracts--4/1/92 for a complete discussion of this issue.

Remember in the area of schools and nonprofit categories in general that taxation is the rule and exemption is the exception. Insure that you read the exemption certificate or available tax ruling to determine the extent of the exemption for each entity. Does it provide for exemption on purchases of tpp? Services? Meals or lodging? Sales at retail?

The ST-12 should not be used for an exemption for a state other than Virginia. (It's use is limited to the Commonwealth, political subdivisions of the Commonwealth, or the Federal Government) The ST-13 should be used by other states, provided they meet the criteria of the certificate.

Insure that various organizations are actually a part of the school or college they are claiming affiliation to. Insure that purchases are made pursuant to official purchase orders to be paid for out of public funds. Individuals are not eligible for the exemption even if they are reimbursed by the institution for their expenditures.

Remember that "Certain Educational Institutions", such as "Close Up" may purchase both tpp and services exempt, including meals and lodging. These entities must meet all the requirements specified in the paragraph on Educational Institutions.

Colleges and universities are not in this category and are taxable on lodging and meals.

## **Sales and Use Tax Audit Procedure Ship Repair**

### **I. History**

Prior to July 1, 1994 - The code Section 58.1-608 3d and Section 630-10-98 of the Virginia Rules and Regulations gave little detail into the auditing of ship repair concerns and other waterborne businesses. The manufacturing section of the Code and the Virginia Rules and Regulations was referenced when trying to determine the taxable and exempt status of particular items. Other waterborne businesses assumed a broad exemption for the purchase of consumable supplies and tools as well as items of tangible personal property which become an integral part of a ship or vessel.

July 1, 1994 And After - Virginia Regulation 630-10-98 detailed the statutory exemption and its application. Many terms were defined in order to clarify the exemption. Guidance was given to the ship repair industry in that although many accommodation services are necessary to the repair process, tangible personal property used in providing these services is taxable. Letter dated 6-20-96

The exemption provided to other waterborne concerns has also been confined to the exact wording of the statute. New Virginia Rules and Regulations Section 10-210-4050, Letter dated 7-31-95, P.D. 93-55.

### **II. References**

- |                                   |  |
|-----------------------------------|--|
| A. Code of Virginia               | 58.1-608 3d                            |
| B. Virginia Rules and Regulations | Old 630-10-98<br>New 10-210-4050       |
| C. Ruling Letters                 | P.D. 93-55<br>P.D. 92-140              |
| D. Opinion Letters                | 1) 6-20-96<br>2) 7-14-94<br>3) 7-31-95 |

### III. General

Shipbuilding, Conversion, and Repair - A close reading of the statute details the exemptions. The first exemption is for ships and/or vessels used or to be used exclusively or principally in interstate or foreign commerce. The repairs and alterations to such ships and/or vessels are exempt from the tax. Any item of tangible personal property that becomes an integral part of such ships or vessels is exempt from the tax. The second exemption concerns the supplies consumed aboard ships or vessels which ply the high seas either in inter-coastal trade between ports in this state and ports in other states of the United States or its territories or possessions or in foreign commerce between Virginia ports in this state and ports in foreign countries. These are two separate and distinct exemptions. A ship or vessel may receive the interstate or foreign commerce exemption on ship or vessel parts, but not receive the exemption on supplies because these ships or vessels do not ply the high seas. Another exemption is for tangible personal property used directly to repair these exempt ships or vessels. The important implication within the wording of the statute is that a business does not have to be a ship repair business to have the exemption on tangible personal property used directly in building, converting, or repairing of such ships or vessels. Persons engaged in the building, conversion, or repair of such vessels and/or ships, for example, shipyards receive an exemption similar to the manufacturing exemption. Shipyards receive an exemption for safety apparel given to workers directly involved in the ship building, conversion, or repair process. There is an exemption for the storage and handling of raw materials. Shipyards receive a broader exemption than businesses that may repair exempt ships or vessels from time to time. The separate exemptions will be dealt with below, as well as the general audit procedures for each concern.

An exemption is provided for those items "directly" used in the building, conversion, and repair of exempt ships or vessels. Many times all consumables and purchases that are charged directly to a job by the repair yard are exempted from the tax. The fact that an item can be directly charged to a job does not guarantee the tax exemption. Most repair yards have been quite prudent with the proper taxing of overhead accounts (with the exception of fuel oil). The direct charging of items to particular jobs is an area with significant tax exposure. For example, tangible personal property costed to temporary services including but not limited to: on site and off site berthing, temporary illumination, temporary electrical service, temporary phone service, and temporary sanitation service all constitute taxable areas. Items of tangible personal property used in providing such services would be taxable to the shipyard.

Other Waterborne Commerce (Tug Boat and Fuel Bunkering Companies) - Businesses which transverse the waterways have assumed that a broad exemption applies to their operations. There is an exemption for parts which become an integral part of ships or vessels involved principally or exclusively in interstate or

foreign commerce. Supplies consumed aboard a ship or vessel which ply the high seas in inter-coastal trade or foreign commerce are tax exempt. Tools and supplies used directly in repairing, converting, or building such ships or vessels are also tax exempt. This exemption only applies if the vessels or ships being repaired, built, or converted are principally or exclusively involved in interstate or foreign commerce or ply the high seas in inter-coastal trade between ports in the commonwealth and ports in other states or foreign commerce. For example, a vessel or ship which transverse the Chesapeake Bay and delivers goods or people from a location in Virginia to a location in another state would be exempt on parts which become an integral part of such ships or vessels and would be exempt on tools and supplies used in repairing, converting, or building such ships or vessels. The business would be taxable on consumable supplies (i.e., provisions, sanitation supplies etc.) which are consumed aboard the ship or vessel since the ship or vessel does not ply the high seas. See P.D. 93-55

#### **IV. Definitions**

Foreign Commerce - A business venture between persons in the United States and those in a foreign country.

High Seas - That portion of the ocean which is beyond the territorial jurisdiction of the United States. It does not include the Chesapeake Bay, inter-coastal waterways, or inland rivers or waterways.

Inter-coastal Trade - The exchange of goods or commodities between ports.

Interstate Commerce - A business venture between the people of two states.

Principally - Means more than 50%.

Used Directly - Those items which are both indispensable to the building, conversion, or repair process and which are used as an immediate part of such process.

## V. Procedure

Shipbuilding, Conversion, and Repair - A complete understanding of the accounting cost system is important to an audit of a shipbuilding, conversion, or repair facility. If individual tasks are not detailed in the contract a cost account titled temporary services should be noted. In the latter case all items of tangible personal property costed to such an account should be taxed. (See letter dated June 20, 1996)

The size of the facility is paramount to understanding the areas of audit concern. Large shipyards provide much more in the way of accommodation services than the smaller "down river" repair facilities. Many times the smaller repair concerns act as subcontractors to the larger yards.

Expense purchases, inventory withdrawals, assets, and sales should be reviewed when auditing a ship repair operation. Each area has potential tax exposure. Inventory withdrawals and purchases which are charged directly to a job many times have been exempted from the tax. Tangible personal property which provides for temporary services is taxable and is stated in the statute. By viewing the specifics of the contract many items can be deemed taxable or exempt. Normally each contract is divided into separate tasks with a detailed description. The accounting cost records are usually quite detailed and purchases as well as inventory withdrawals are accounted for in detail. Items can be taxable even though they may be costed to an exempt task. The nature of the item and its use must be understood clearly before a decision can be made on the tax status. Usually the above is most notable in the area of inventory withdrawals. Items withdrawn from inventory which are taxable are: coffee, cups, Gatorade, padlocks (for storage of tools and supplies), trash bags, office supplies, flashlight bulbs and batteries, temporary ID tags and wire (used to identify items removed from the ship and stored while repairs are ongoing), rat guards, protective coverings, etc.. The above list is not all inclusive. Given the voluminous nature of inventory withdrawals a workable sample is required. The items listed above can be charged to a task which is part of the repair process or a task which is not. Under either circumstance the nature of the products and their specific use determines their taxable status. Rags are an inventory item that is pro-rated. Lint free rags are normally exempt if they are charged to a repair task. These type of rags are often used to wipe turbines or dust sensitive parts of the ship or vessel. Regular cloth rags can be used to wipe part of the ship or vessel under repair or wipe tools or even workers hands. A 50 % pro-ration has been used in past audits of shipyards, unless a more accurate percentage is provided.

Purchases and inventory costed to overhead accounts as well as internal contracts should be viewed carefully. As with manufacturers, items used directly in the repair, building, or conversion process (i.e. cranes, welding machines, tools, the mechanical dry-dock, lathes, work platforms including man lifts and work platform barges) are exempt from the tax to the shipyard. Work scaffolding, man lifts, and work platform barges are indispensable to the repair, building, or conversion process. Replacement parts of exempt ships or vessels are also exempt. As with a

manufacturer, supplies and tools used to work on exempt machinery and equipment are taxable. For example, the rental of man lifts and the purchase of welding gases to repair the mechanical dry-dock would be taxable. Rags and cleaner used in crane maintenance would also be taxable as would replacement parts for piers and bulkheads in that these are real property. Vehicle parts are taxable if the vehicles are for over the road use as compared to vehicles which transport parts to be repaired throughout the yard to various shops. The latter is similar to the movement of inventory items within a manufacturing concern. The plant site test is not applicable to a ship repair facility. If a particular repair shop is located away from the yard, but is directly part of the repair, building, or converting of ships or vessels the exemption still applies. Many "down river" operations do not have a yard but are still directly involved in the repair, building, or conversion process. It is important to note that the section of the Rules and Regulations dealing with manufacturers should serve only as a "guide."

The income areas of sales and services should be reviewed for possible tax liability. As stated earlier a review of the contracts will identify taxable tasks. There may exist repair transactions involving taxable ships or vessels. In this case tax should be charged at retail on items which become an integral part of these ships or vessels and tangible personal property which sails with these ships or vessels. Fabrication labor involved in these transactions of taxable ships or vessels should also be taxed at retail. Some examples of these taxable ships or vessels are: tugs and barges owned by real estate contractors such as bridge builders, or pier and bulkhead construction companies, diving and salvage ships or vessels, yachts, and ships which leave a point in one state and return to that same point without docking in another state (dinner cruises). Consumables and supplies used directly in repairing, building, or converting the above taxable ships would still be exempt to the business which is primarily involved in shipbuilding, conversion, and repair.

Clarification should be made between businesses that are primarily shipbuilding, conversion, and repair operations and those businesses which may occasionally repair ships or vessels. For example a business which does other things besides ship repair, conversion, or building more than 50 % may repair exempt vessels and ships. Items used directly in this process can be purchased tax exempt. However, since this business is not primarily a shipyard, items such as workers' safety apparel would be taxable. Any work done on a taxable ship or vessel by a business not primarily involved in ship repair would be taxable. This business would be taxable on equipment and tools used directly in the building, conversion, and repair of these taxable ships or vessels. Items which become part of the ship or vessel or sail with the ship or vessel can of course be purchased tax exempt and taxed at retail.

Ship repair facilities may also be involved in some transactions which do not meet the definitions detailed in the statute. Miscellaneous sales of tangible personal property and the sale of fabricated items need to be audited. Other services which provide income to the yards such as the deactivation of a ship or vessel would be considered a taxable service and all tangible personal property consumed in

providing this service would be taxable in that deactivation does not meet the definition of repair, building, or conversion. In some ship repair and building facilities service contracts with the government are conducted. These contracts are usually for design or testing services. These transactions fall under the federal government contract guidelines.

Assets used directly in the building, repairing, or converting, of ships by a shipyard would be exempt from the tax. Assets which are used both in a taxable and exempt manner are governed by the preponderance of use calculation. This is most evident in the boilers that are used throughout the yard. The procedure to do a boiler function analysis and a fuel oil consumption analysis will be summarized below. Maintenance chemicals which are used in a boiler from time to time to impede mineral deposit build up would be taxable regardless of the taxable status of the boiler. Many times larger shipyards will have internal contracts which may include: the updating of facilities, the maintenance of parking lots, the relocation of certain shops, the refurbishing of the dry-docks, etc. These internal jobs should be detailed and analyzed in depth. Many consumables and supplies costed to these internal jobs would be taxable.

Fuel oil is a major consumable supply for a ship building and/or repair facility. Diesel fuel which is used to power exempt machinery would of course be tax exempt. Fuel oil used to run the boilers which produce steam used throughout the yard present a special problem. The steps to analyze fuel oil consumption are detailed below. If the analysis concludes that a particular boiler is used primarily for a taxable purposes then the boiler and its replacement parts would be taxable.

Fuel Oil - The following steps can be followed to determine the taxability of fuel oil when auditing a ship building and/or repair facility.

1. Determine accurate figures to use for the basis of calculating total taxable fuel oil, whether it be through actual invoices or monthly usage/cost reports to give you the gallons and cost of the amount of fuel oil purchased.
2. Arrive at the audit period and then pick a representative calendar year to use as a basis for comparison.
3. Determine the months of the year where the average mean temperatures below 55 degrees Fahrenheit. This can vary, based on audit site location, and it can be concluded that any excess over the mean average amount used each month was used strictly for heating purposes (shipboard, work buildings, and administrative buildings).
4. Take the other months (those where the temperature is above 55 degrees Fahrenheit), add the total amount of fuel oil purchased and divide by the same number to arrive at the average mean amount of fuel oil each month that is used for

some purpose other than heating. This figure now becomes the average monthly amount of fuel oil that will be used for the entire audit period.

5. Take all the "winter months" during the audit period and take the difference between the total amount of fuel oil purchased and the mean amount to come up with the taxable amount of fuel oil purchased during the audit period that can be directly linked to heating. You can then develop a monthly percentage in each of the winter months that is directly related to heat usage.
6. Since the primary purpose of fuel oil usage at a ship repair facility is for the production of steam, develop a comprehensive list of the various usage's of steam that the fuel oil is used for and determine the taxability of each.
7. From the list you come up with, determine a taxable percentage and an exempt percentage to apply to the monthly mean average amount for each month of the audit period. For the winter months, add the additional amount that was developed earlier and was determined to be heat related.
8. This now becomes the total amount of taxable fuel oil used during the audit period and these monthly amounts can be either cumulative or individually broken down into percentages by taking the amount of taxable monthly fuel oil and dividing that by the total amount purchased during the month.

Other Waterborne Commerce - The definitions listed above are important when dealing with other waterborne industries. A complete understanding of a business's operation is necessary. Vessel/ship logs detail the voyage history. This history must be analyzed to determine the application of the interstate/foreign commerce exemption as well as the high seas exemption. A ship or vessel which transverses the Chesapeake Bay, inter-coastal waterways, or inland rivers or waterways, but does not leave Virginia waters does not receive any of the exemptions detailed above. A waterborne operation must be analyzed ship by ship and vessel by vessel. A ship or vessel which transverses the Chesapeake Bay, inter-coastal waterways, or inland rivers and waters, and delivers goods or people from one state to another over 50 % of the time would be exempt on items which become an integral part of the ship or vessel, and on tangible personal property used directly in the building, repairing, or converting of such vessels or ships. However, supplies consumed aboard such ships or vessels (i.e. provisions for the crew, cleaning supplies, and fuel to operate machinery) would be taxable since these ships or vessels do not ply the high seas in inter-coastal trade or foreign commerce. Fuel used for propulsion of the ships would be exempt for all ships under the marine diesel statute.

**Sales and Use Tax Audit Procedure**

**Sign Manufacturing and Painting**

**Objective:** Discuss the application of sales and use tax as it applies to sign manufacturing and painting.

**I. History**

**Prior to July 1, 2005.** Any person who constructed and installed signs, billboards or similar items which, upon installation, became incorporated into realty, was a contractor with respect to such items. The person constructing and installing such items had to pay the tax on all property used in the construction and installation. A sign manufacturer who derived over 50% of his gross receipts from the fabrication of signage for his own use in real estate construction contracts was classified as a using and consuming contractor and had to pay the tax on the cost of all materials, supplies, and equipment used in the fabrication of such signs. He was not entitled to the manufacturing exemption.

**After July 1, 2005.** Manufactured signs, billboards and other similar items are reclassified as tangible personal property for retail sales and use tax purposes, regardless of whether such signs, billboards, or other items become affixed to real property upon installation.

**II. References**

- A. Code of Virginia §58.1-602 (Definitions), §58.1-609.3.2 (Commercial and industrial exemptions).
- B. Virginia Retail Sales and Use Tax Regulations 23 VAC 10-210-4070 (Sign manufacturers and painting), 23 VAC 10-210-920 (Manufacturing and processing).
- C. Public Document 96-133
- D. Exemption Certificates - ST-11 (Manufacturing)

**III. Generally - After July 1, 2005**

- A. Generally. The tax applies to the charge for the manufacture or fabrication of signs, outdoor boards, and similar items. The tax applies to the total charge for the finished product including the labor involved in the construction or painting of the sign, boards, etc. Any person who constructs

## **Sign Manufacturing and Painting**

### **Page - 39**

and installs signs, billboards or similar items which, upon installation, become incorporated into realty is considered a retailer with respect to such items. The tax does not apply to separately stated installation charges.

B. Sign painting. The tax does not apply to charges for painting signs on buildings, trucks, outdoor boards, windows, doors, etc. Materials and supplies used in performing such services are taxable at the time of purchase or withdrawal from an exempt inventory.

C. Neon, electric and like signs. Any person making sales at retail, leasing or renting electric, neon or other signs must collect the tax on the total charge for such sign, excluding any separately stated installation charges.

D. Maintenance and repair. If a seller or lessor of signs contracts to provide periodic maintenance or repair of signs, which involves providing both repair or replacement parts, and repair labor, the tax applies to one-half of the total charge. If the sale or lease of a sign includes, as a part of the sale, an agreement to provide maintenance or repair labor, the charge for such agreement must be included in the sales price of the sign.

#### **IV. Procedures - After July 1, 2005**

A. Purchases. All sign manufacturers are entitled to the processing exemption set forth in Code of Virginia §58.1-609.3.2. As such, raw materials and other components which become an integral part of the fabricated signs may be purchased exempt of the sales tax. The exemption also applies to machinery, equipment and supplies used directly in the manufacturing process.

Tangible personal property used indirectly in the production process, as well as items used in administration and distribution activities are subject to the sales tax.

Machinery, equipment, tools, supplies and materials used and consumed in the installation of signs are also subject to the sales tax.

B. Sales. The tax applies to the total charge for the finished product including labor involved in the construction or painting of the sign. The charge for replacement or repair parts is also taxable.

Installation charges are not subject to the tax provided the installation charges are separately stated.

## Sales and Use Tax Audit Procedure

STATUTE OF LIMITATIONS

**Objective:** Discuss the application of sales and use tax as it applies to the statute of limitations.

### I. References

- A. Code of Virginia Sections 58.1-104, 58.1-220, 58.1-634, 58.1-1820
- B. Virginia Regulation 10-20-150(B)
- C. Ruling Letter PD 96-65, PD 96-179, Statute of Limitations Table

### II. General

- A. As provided by Section 58.1-634 of the Code of Virginia, the statute of limitations for the assessment of sales and use tax is generally three years from the date on which such taxes are due.
- B. The statute of limitations for the assessment of sales and use tax may be expanded to six years if a false or fraudulent return has been filed, or the taxpayer has failed to file a return and reasonable cause exists that the taxpayer was required to file a return.
- C. The period for assessing taxes may be extended, if a waiver of time limitation on assessment of omitted taxes is executed on or before the expiration date of the statute of limitations by the taxpayer and the Tax Commissioner's representative.

### III. Procedures

- A. For all sales and use taxes, if no returns have been filed, the statute is six years.

For taxpayers that have been registered for less than three years, the statute may be extended to a maximum of six years if it is determined that the taxpayer was liable for the collection and/or remittance of taxes prior to registration.

If it is determined within the three year statute that the taxpayer failed to file a return for a period in which tax was due, the audit period may be extended to six years, but including only those months for which no return was filed.

- B. The fact that related corporations have filed returns does not prevent the Department from extending the statute beyond three years for an entity that has failed to file any returns.
- C. The Department is not prohibited from making an assessment of omitted taxes which were missed in a prior audit as long as the assessment is made within the statute of limitations and there exists no likelihood that a reassessment of tax has occurred.
- D. Waivers to extend the statute of limitations must be signed, by both the Tax Commissioner's representative and the taxpayer, on or before the date of expiration. ALL waivers are to be scanned into the STAUDN work papers.
- E. If the taxpayer fails or refuses to execute a waiver, a statutory, or estimated assessment may be made prior to the expiration of the statute in order to protect the audit liability. The assessment amount should include all potential liability due, as no additional assessment of taxes can be made on periods outside the statute. The assessment is to be subsequently adjusted to reflect the actual liability due.
- F. Assessments are deemed to be made when written notice has been delivered to the taxpayer by an employee of the Department or mailed to the taxpayer at his last known address. The taxpayer must receive an assessment or the assessment must be postmarked on or before the statute of limitations expires for any period covered in the assessment.
- G. If an audit assessment is revised and the revision lowers the liability, the existing assessment should not be abated in full and a new assessment issued. Periods covered by the new assessment may be out of statute on the date that the new assessment is issued. Rather, the existing assessment should be abated down to the correct liability. (see P.D 00-056)

## **Sales and Use Tax Audit Procedure**

### **TELECOMMUNICATION**

Revised 08/2006

**Objective:** Discuss the application of sales and use tax to telecommunication companies.

#### **I. History**

Prior to **January 1, 1989**: Both cellular phone and paging companies were taxable on purchases of equipment and supplies.

**January 1, 1989**: Through a legislative change, providers of cellular phone and paging services obtained a public utility exemption on property utilized directly in the rendition of communications services.

**July 1, 1995**: The State Corporation Commission deregulated paging companies and they lost their public utility exemption. Providers of cellular phone services continue to qualify for the public utility exemption.

**September 1, 2004**: The retail sales and use tax exemption available to public service corporations, a.k.a. public utility companies, for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was **repealed** for telecommunications companies (as defined in *Code of Virginia* Section 58.1-400.1), and certain telephone companies.

#### **II. References**

- A. *Code of Virginia* Sections: 58.1-609.3 and 58.1-400.1.D.2
- B. Virginia Administrative Code: VAC 10-210-3020 and VAC 10-210-5040
- C. Ruling Letters: Public Documents, (P.D.): 88-75, 88-115, 88-221, 89-156, 90-228, 92-137, 95-40, 95-71, 96-361, 97-225, 98-190, 99-124, 00-55 and 01-3.
- D. Virginia Supreme Court Case: *Commonwealth of Virginia vs. Community Motor Bus Company, Inc.*
- E. Applicable Exemption Certificates: ST-10 and ST-20
- F. Federal Communications Commission website [www.fcc.gov/wtb](http://www.fcc.gov/wtb)

G. *Code of Virginia* Section 58.1-609.3 Amended September 1, 2004

H. Ruling Letter: Public Document (P.D.) 04-122, Public Service Corporation Exemption Repeal Guidelines.

### III. General

#### A. Pre-September 1, 2004:

Telephone companies regulated as public utilities as defined in VAC 10-210-3020 (B) are entitled to an exemption on tangible personal property used directly in the rendition of their public service. Convenient or facilitative items are not exempt. Items which are essential to the operation of a business but not an immediate part of actual performance of public utility service (e.g., equipment used in customer billing) are not exempt.

**Paging companies are no longer public service corporations subject to a state franchise tax. Also, these businesses are generally no longer defined in 58.1-400.1 as telecommunication companies. Therefore, they are not generally eligible for sales and use tax exemption on purchases as of July 1, 1995. Charges for paging services are exempt.**

Cellular phone companies, although no longer certified and regulated by the State Corporation Commission, are defined as telecommunication companies in 58.1-400.1; therefore, cellular phone companies still enjoy the sales and use tax exemption as public utilities. Cellular services are exempt from sales and use tax.

**Retailers of communications equipment are entitled to purchase their equipment inventory under a ST-10 resale certificate of exemption. At the time of resale, tax is collected on the sales price to the final consumer unless otherwise exempt. Installation charges, if separately stated, are exempt. Retailers of communications equipment are treated as consumers of tools, cable affixed to real estate, and similar supplies used in the installation of communications systems.**

Digital personal communications service (PCS) companies are defined as telecommunication companies in 58.1-400.1 and are, therefore, entitled to the exemption under *Code of Virginia* 58.1-609.3(3).

#### B. Post-September 1, 2004:

Repeal of exemptions for public service corporations: Effective September 1, 2004, the retail sales and use tax exemption available to public service corporations, which includes telecommunication companies and certain telephone companies, for the purchase or lease of tangible personal property

used or consumed **directly** in the rendition of their public service was repealed.

Despite the loss of the public service corporation exemption, other overlapping exemptions may be available to a public service corporation. Other sales tax exemptions that may be available include, but are not limited to the exemption for research and development, resale, and for tangible personal property for the use or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

#### Contractor's Use Tax:

##### A. Pre-September 1, 2004:

Prior to September 1, 2004, contractors purchasing and installing exempt tangible personal property under contract with an exempt public service corporation were allowed to "stand in the shoes" of the exempt public service corporation and could purchase all such property tax exempt using a Construction Contractors Exemption Certificate (Form ST-11A).

##### B. Post-September 1, 2004:

This exemption no longer applies.

#### **IV. Procedures**

##### A. Telephone Utilities.

###### 1.) General Guidelines for Pre-September 1, 2004 Activities:

In auditing telecommunications companies, the auditor should first determine if the taxpayer is entitled to the exemption provided to telecommunications entities as provided by section 58.1-400.1 of the *Code of Virginia*. The Federal Communications Commission provides information regarding currently registered licensees at its website [www.fcc.gov/wtb](http://www.fcc.gov/wtb). The auditor should then verify if the company has obtained a direct payment permit from the Department of Taxation.

A pre-audit conference should be scheduled in order to establish parameters of the audit. A telephone utility is engaged in providing a non-taxable service; therefore, the audit will focus on consumer use tax compliance.

The typical telephone utility is a capital-intensive operation characterized by a large volume of purchases. Care should be taken to select sample periods that are representative as well as manageable in terms of the

number of records to be reviewed. An examination of the financial statement will aid in the selection of the audit sample. The "Uniform System of Accounts for Telephone Utilities" (VAC 10-210-3020) should be referenced in selecting accounts that may incur a consumer use tax liability. Certain accounts are either exempt or taxable based upon the use of the item; some of these accounts are footnoted in VAC 10-210-3020. Experience indicates that taxpayers frequently treat these footnoted accounts as being totally exempt; the possibility of non-compliance in this area is particularly high.

It should be noted that equipment and supplies essential to conducting the business are not necessarily tax exempt; only those items used directly (i.e. essential and used immediately) in providing the public service are entitled to the public utility exemption. For example, the following purchases are frequently encountered in telephone utility audits:

Exclusive R&D to develop new products and services	exempt
Coin-operated phone equipment	exempt
Fiber-optic cable	exempt
Central office switching equipment	exempt

*Repair service tools and equipment*      *exempt*

Computers used in billing and administration	taxable
Management information system	taxable
Vehicle parts for administrative use	taxable

The auditor should ensure that purchases of taxable items have not been misclassified by the taxpayer using an exempt account number. Should this problem occur, it will be necessary to review purchases charged to exempt account numbers in order to identify any misclassifications.

Certain companies may not use the "Uniform System of Accounts for Telephone Utilities." In those cases, all asset and expense accounts should be examined to verify if the purchases are utilized directly in the rendition of providing communications service.

When entering asset and purchase exceptions on the STAUD program, the auditor should include a complete description of the item in question. A description consisting of "equipment" or "supplies" is inadequate and will be of little assistance during the review process with the taxpayer. The uniform account number or the utility's internal system account number should be included on the exceptions list. Some firms may supply the auditor with information to translate their account numbers to the "Uniform System of Accounts for Telephone Utilities."

The vendor invoice will not always include a full description of the item being purchased. In those instances, the taxpayer's purchase order

frequently has additional information that may be useful in determining whether or not a purchase is taxable. A tour of the taxpayer's facility, including a discussion of equipment usage with engineers, will assist the auditor in determining the taxable status of equipment.

Equipment and supplies used in both exempt and taxable applications should be prorated and tax applied to the non-exempt portion of use.

Telephone utilities provide service to geographical areas comprising a number of cities and counties. Asset and purchase exceptions must therefore be allocated to the respective localities for proper allocation of local sales tax.

The taxpayer may have remitted use tax through either a direct payment permit or on a consumer use tax return. Accruals of use tax should be traced on a sample basis to the returns in order to verify payment of the tax.

Due to the complexity of telephone utility audits, it is important to make detailed notes concerning the taxpayer's operations and accounting procedures. Such information will expedite the resolution process during subsequent meetings with the taxpayer's representative. Additionally, the information will be useful in enabling the Appeals and Rulings office to address contested audit issues.

## 2.) General Guidelines for Post-September 1, 2004 Activities:

Remember when auditing a Post-September 2004 activity, the retail sales and use tax exemption that was available prior to that date is no longer applicable because of the repeal of the exemptions for public service corporations. There are still some overlapping sales tax exemptions that may be available, they include but are not limited to the exemption for research and development, resale, and for the sales of tangible personal property for the use or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

### B. Paging Companies.

When conducting audits of paging companies, the auditor needs to recognize the impact of deregulation effective July 1, 1995. Prior to deregulation, these companies were entitled to the exemptions provided to public utilities. As of July 1, 1995, they are taxable on **all** purchases of equipment and supplies. An exception may be possible, however, for entities that are authorized by the FCC to furnish commercial mobile

services in which the authorization includes cellular mobile radio communications services or digital PCS.

Subsequent to deregulation, all purchases of tangible personal property should be reviewed for proper application of the sales tax.

If an audit spans both regulated and deregulated periods, the auditor should select samples from each period. Different error factors should be computed and applied to the respective periods.

Paging company sales can occur as follows:

- (1) Retail sale of paging equipment without the paging service is generally taxable sale of tangible personal property.
- (2) Paging service contract, which does not include equipment, is a non-taxable service.
- (3) Paging service contract including equipment, which is returned at the end of the contract, is a non-taxable service.
- (4) Paging equipment is sold (i.e., not leased or rented which has a different tax result) at retail with a service contract, the equipment constitutes a taxable sale of tangible personal property and the charge for the service contract is non-taxable.

In review of sales, the auditor should identify equipment sales to ensure the proper application of the sales tax.

Since paging companies did not enjoy the retail sales and use tax exemption provided to public utilities after July 1, 1995, they are not affected by the repeal of the public service exemptions as of September 1, 2004.

#### C. Cellular Phone Companies.

##### 1.) Pre-September 1, 2004:

Cellular phone companies are treated as a public utility as of January 1, 1989, therefore, they are entitled to an exemption on tangible personal property used directly in the rendition of their public service.

##### 2.) Post-September 1, 2004:

Effective on and after September 1, 2004, however, cellular phone companies lost their retail sales and use tax exemption for the purchase or lease of tangible personal property that was used or consumed directly or indirectly in providing cellular phone service (e.g., antennas). Charges for cellular phone service are non-taxable. The auditor should review purchases in the same manner as a telephone utility. Please refer to Section V for the transitional rules for the repeal of the public service exemption.

### 3.) Taxability of Cellular Telephones:

Cellular telephones can be provided to the customer by an authorized dealer/retailer (agent for the cellular phone service provider) in one of the following scenarios:

- (1) Customer pays full price for their cellular phone; or
- (2) Customer purchases the cellular phone for a discounted sales price beginning as low as \$.01 upon signing a service contract with the service provider for whom the retailer is an agent. The agent receives a commission/rebate from the service provider for the signed service contract; or
- (3) Customer receives the cellular phone at no cost from the retailer upon signing a service contract. The service provider pays their agent a commission/rebate.

In Scenario 1, tax would apply to the total sales price of the phone. In Scenario 2, the tax only applies to the discounted sales price (Ref. P.D. 96-361). In Scenario 3, the retailer is required to remit use tax on the cost price of the telephone withdrawn from the resale inventory (Ref. P.D. 96-361).

Because of the rapidly changing nature of this industry, the auditor should seek guidance from the audit supervisor and evaluate whether prospective compliance on a first audit is necessary. Prospective compliance would not be justified if the taxpayer received a timely ruling on the matter, or if the law, regulations, or other public documents are reasonably clear on the tax application.

### D. Retailers of Telephone Equipment.

An audit of telephone equipment retailers should initially involve a review of sales transactions. This will allow the auditor to readily identify the types of equipment being sold and the applicable purchases entitled to a resale exemption.

The retailer may purchase telephone instruments and other inventory items under a resale certificate of exemption. The auditor should be aware that certain purchases charged to inventory may not be entitled to the resale exemption, such as cable affixed to real estate and similar installation materials.

Sales and purchases should be reviewed in the same manner as audits of similar retailers of tangible personal property. Exemption certificates should be reviewed to support any tax-exempt sales.

Retailers of telephone equipment were not effected by the repeal of the public service exemptions as of September 1, 2004.

#### E. Digital PCS

FCC authorization (license) to provide digital PCS is not the same as a **cellular license. These are separate and distinct licenses.**

#### **V. Transitional Rules for the Repeal of the Public Service Exemptions as of September 1, 2004. (Ref. P.D. 04-122).**

The following rules are provided to clarify when purchases or leases of tangible personal property, previously exempt from the retail sales tax, are subject to the tax.

##### Taxable:

- Tangible personal property purchased on and after September 1, 2004
- Tangible personal property delivered to a purchaser and paid for on or after September 1, 2004, regardless of when the property was ordered
- Installment sales, when the date the contract is entered into is on or after September 1, 2004

##### Exempt:

- Tangible personal property ordered, delivered and paid for prior to September 1, 2004
- Tangible personal property ordered and delivered prior to September 1, 2004, but paid for on or after September 1, 2004
- Installment sales, when the date the contract is entered into is prior to September 1, 2004, regardless of when the property is delivered or when payment is made

##### Long-term Leasing Contracts:

No sales and use tax will be imposed on the lease payments for any tangible personal property leased pursuant to a bona fide contract that was entered into on or before March 1, 2004, provided that such tangible personal property was delivered to or placed into service by a public service corporation on or before September 1, 2004. A "bona fide" contract is one that includes specific set terms and a payment schedule with a fixed duration.

Extension of Contracts:

The extension of a bona fide leasing contract does not constitute a new contract and such equipment would remain exempt if the original contract is extended, provided the original contract was entered into on or before March 1, 2004 and the extension is executed prior to September 1, 2004. Extension of a bona fide contract after September 1, 2004 constitutes a new contract and property leased under that contract will become taxable.

Other Changes in the Terms of a Contract:

Other changes in the terms of the contract, e.g., pricing, lease payments, finance charges, etc., will not change the exempt status of the tangible personal property provided the original contract was entered into on or before March 1, 2004 and the change to the bona fide contract is executed prior to September 1, 2004. Changes in terms occurring on or after September 1, 2004 shall be viewed as a new contract for purposes of taxation.

Assignment of a Contract:

The assignment of a bona fide contract does not constitute a new contract provided there is no change in the terms of the contract or the original contract terms are not extended as a result of the assignment.

Inventory on Hand:

Tangible personal property purchased prior to September 1, 2004, under the public service corporation exemption, and placed in a tax-exempt inventory, will not lose its exempt status with the repeal of the public service corporation exemption effective September 1, 2004. Such property will also maintain its exempt status upon the withdrawal from inventory and put in use in a taxable manner.

Temporary Storage:

Effective September 1, 2004, tangible personal property brought into and stored in Virginia by a public service corporation, regardless of the fact the tangible personal property may be used out-of-state in an exempt capacity is subject to the tax. For example, if a public service corporation has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia would be subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public service corporation and brought into Virginia and remitted by the 20<sup>th</sup> day of the month following the month of acquisition or importation into Virginia.

## Sales and Use tax Audit Procedures

### Motor Vehicle Carriers of Property

**Objective:** To discuss the application of sales and use to Motor Vehicle Carriers of Property.

**History:**

Prior to January 1, 1996, intrastate trucking was regulated by the State Corporation Commission (SCC) while interstate trucking was regulated by the Interstate Commerce Commission. A limited exemption existed for public service corporations engaged as common carriers of property by motor vehicle that were authorized to operate under a certificate of convenience and necessity that was issued by either the SCC or the ICC. No exemption existed for contract carriers. (Source: 23 VAC 10-210-370)

The 2001 General Assembly revised and reenacted those sections of the Virginia Code that deal with property and passengers operating for-hire on an intrastate basis by enacting Chapter 596. The bill was based on the recommendations of the Motor Carrier Reform Task Force of the Department of Motor Vehicles. The specifics for Motor Carriers of Property is contained Chapter 21 of Title 46 of the Virginia Code while those for passengers are contained in Chapter 20.

The Special Session I of the 2004 General Assembly adopted Chapter 3 amending § 58.1-609.3(3) to repeal the exemption previously granted to motor vehicle common carriers effective September 1, 2004.

**References:**

Current Virginia Code Sections Cited  
58.1-609.3(3)

Acts of the Assembly  
1995 Session, Chapters 744 & 803  
2001 Session, Chapter 596  
2004 Special Session 1, Chapter 3

Virginia Administrative Code  
23 VAC 10-210-370

Tax Commissioner Ruling  
PD 05-31

**Discussion:**

The original rationale behind exempting public service corporations (including common carriers) is that they perform a necessary service for the public good. Historically, the rates the public service corporations could charge were regulated by the SCC to provide the citizens of Virginia the needed services at a fair price. The public service corporation exemption reduces the final cost of the service, thereby assuring that the necessary level of services are available while allowing the providers a reasonable return on investment.

Deregulation of various industries, including the trucking industry, has led to the situation where rates are not controlled or set by government agencies. Carriers of property by motor vehicle that are not subject to rate regulations are free to charge what the market will bear in a fully competitive environment, and the original rationale for the exemption no longer exists.

Prior to September 1, 2004, § 58.1-609.3(3) exempted "...tangible personal property sold or leased to a public service corporation engaged in business as a common carrier of property or passengers by motor vehicle or railway, for use or consumption by such common carrier directly in rendition of its public service. Effective September 1, 2004, the words "motor vehicle or" were struck from this portion of the code. Effective that date, no exemption is available to a public service corporation engaged in business as a common carrier of property or passengers by motor vehicle.

Before September 1, 2004 a limited exemption existed for Motor Vehicle Common Carriers of property. Whether a Taxpayer is a common carrier of property for purposes of the exemption is determined by the provisions of *Va. Code* § 58.1-609.3 3, as it existed prior to September 1, 2004. In interpreting this statute, Title 23 of the Virginia Administrative Code 10-210-370 A states, "A common carrier must be authorized to operate under a certificate of convenience and necessity issued by the State Corporation Commission [SCC] or the Interstate Commerce Commission [ICC] in order to qualify for this exemption." Because of deregulation of the trucking industry, there is no longer any SCC or ICC authorization available for determining whether a carrier of property by motor vehicle is a common carrier. The terminology of the Department's regulation is no longer applicable therefore the wording of the statute must be analyzed to determine if the exemption is available.

To qualify for the exemption in *Va. Code* § 58.1-609.3 3, an entity must be a public service corporation. *Virginia Code* § 56-1 defines the term "public service corporation" to include: gas, pipeline, electric light, heat, power and water supply companies, sewer companies, telephone companies, telegraph companies, **and all persons authorized to transport passengers or property as a common carrier.** [Emphasis added.]

This definition incorporates a requirement for a Taxpayer to be "authorized" to provide the service (transport property as a common carrier) in order to be deemed a public service corporation.

In PD 05-31, the Commissioner discusses at length the necessity for “authorization” to transport property as a common carrier. In that ruling the Commissioner takes the position that a taxpayer who did not previously hold a Certificate as a common carrier with the ICC (Interstate Commerce Commission) or the SCC (State Corporation Commission) as required in the original language of the exemption does not qualify for the exemption. The Commissioner stated, “Without such authorization, the Taxpayer is not considered a public service corporation and, therefore, does not qualify for the exemption under *Va. Code* § 58.1-609.3 3.” In short, unless a common carrier had the ICC or SCC authorization, it does not have the operational authority to qualify for the exemption.

PD 05-31 goes on to discuss subsequent “registration” authorizations issued by the United States Department of Transportation's Federal Motor Carrier Safety Administration (FMCSA) and concludes that the authorization and "regulation" under the FMCSA do not rise to the levels associated with the rationale behind the original public service corporation exemption.

**Conclusion:**

In PD 05-31 the Tax Commissioner takes the position that in order for a motor vehicle common carrier of property to qualify for the exemption available prior to September 1, 2004, it must be a public service corporation “authorized to transport passengers or property as a common carrier.” The Commissioner does not accept the new registration requirements of FMCSA as a replacement for the former ICC certification. Any common carriers who were not public service corporations possessing ICC or SCC authorizations to transport passengers or property are not entitled to the former exemption for motor vehicles of property under *Va. Code* 58.1-609.3 (3).

**Procedure:**

Motor vehicle carriers of property, whether they claim to a "common carrier" or a "contract carrier" should be audited in the same manner after September 1, 2004. If a carrier claims to be an exempt common carrier prior to September 1, 2004 they must produce copies of the ICC or SCC certificates naming them as public service corporations authorized to transport passengers or property as a common carrier. They must have this ICC or SCC certification in order to qualify for the exemption. Subsequent authorizations or certifications by the FMSCA or similar bodies are of no effect.

If the carrier is registered for consumer use or sale/use tax and filing returns for periods in which there was a liability throughout the 36 months immediately prior to the beginning of the audit then the audit period will be three years. If the carrier is not registered or fails to file a return for a period in which a liability exists in the 36 months immediately prior to the beginning of the audit then the audit period may be extended to six years

The bulk of the tangible personal property used by a motor vehicle carrier of property can be grouped into four general areas of usage: administrative; maintenance and repair; transport of property; and, storage and temporary deposit. Following is a description of each type of activity.

**Administration:** Administration functions include billing, collecting, soliciting, purchasing, record keeping and employee comfort, convenience or pleasure. All tangible personal property used in administrative functions is subject to the tax.

**Repair and maintenance:** Tangible personal property used in the repair or maintenance of vehicles, equipment and real property (including the shop, terminal and parking lot) is included in this category. Machinery and tools and repair parts used to repair and maintain revenue producing vehicles and trucks used to service these vehicles (e.g. tow trucks) for common carriers possessing either the ICC or SCC certifications are not subject to the tax prior to September 1, 2004. Machinery and tools and repair parts for other vehicles (such as supervisor's cars) as well as for the parking lot or other real or tangible personal property are subject to the tax.

**Transport:** The transport function encompasses the actual performance of carrier duties, i.e., the receipt, pickup, over-the-road transport, delivery and protection of property, and similar functions essential in the transport of property. This includes property used on the transport vehicles as well as property used in loading, unloading and safeguarding cargo. Tangible personal property used in the transport function by public service corporations possessing either the ICC or SCC certifications as common carriers is used directly in the rendition of the public service and is not subject to the tax prior to September 1, 2004.

**Storage and temporary deposit:** The functions of storage and temporary deposit of tangible personal property are included in this category. Storage is the holding for safekeeping of tangible personal property. Temporary deposit is the temporary holding of tangible personal property prior to its subsequent transport by the carrier. Tangible personal property used in the storage function is subject to the tax regardless of the status of the carrier. Tangible personal property used in the temporary deposit function in conjunction with the common carrier function by public service corporations possessing either the ICC or SCC certifications as common carriers is not subject to the tax prior to September 1, 2004.

Because of the change in the law effective on September 1, 2004, particular attention should be directed to purchases in areas that were previously exempt by public service corporations who had authorization by the ICC or the SCC to transport passengers or property as a common carrier.

In the area of repair and maintenance activity, close attention should be paid to the following types of previously exempt purchases after September 1, 2004:

- Repair parts for transport and service vehicles
- Machinery and tools used in repairing transport and service vehicles
- Tires, tubes, batteries used in transport and service vehicles

Motor oil, grease, gear oil, lubricants, brake fluid, transmission fluid used in transport and service vehicles

Repair manuals for transport and service vehicles

Cleaning supplies, including soaps, detergents and waxes, used on transport or service vehicles

Testing equipment for transport and service vehicles

In the area of transport activity the following types of purchases should be closely scrutinized after September 1, 2004

Forklifts, conveyor systems, racks, hand trucks, coasters and similar equipment used in receiving, sorting and loading and unloading transport producing vehicles  
Equipment used on transport vehicles to maintain commodities at a constant temperature

Equipment for communication between offices and common carrier equipment

Indoor and outdoor scales for weighing cargo

Newsprint, sealing tape, cartons, barrels, wardrobes, straps, pallets, chains, ratchets, coupling and tying down equipment, chock, seals and dock levelers.

Waybills, freight bills, and bills of lading carried with the freight being transported

Driver log books

Reflectors, fire extinguishers, flares used on transport and service vehicles

Decals and Lettering

In the areas of storage and temporary deposit activity close attention should be paid the following types of purchases that are associated with the function of temporary deposit before September 1, 2004

Forklifts

Hand trucks

Packing materials

Crates

Dollies

Heating and cooling equipment used to maintain commodity at a constant temperature

Of course purchases in these areas for carriers who lack the necessary ICC and SCC authorization and therefore do not qualify for the exemption will be taxable before and after September 1, 2004

## **Sales and Use Tax Audit Procedure**

### **Vending Machine Sales**

**Objective:** Discuss the application of sales and use tax as it applies to **VENDING MACHINE**

**SALES; GENERALLY, DEALERS; REPORTING PROCEDURES,,**

#### **I. History**

Effective July 1, 1982, dealers engaged in the business of placing personal property

through vending machines were required to report under a new method.

Vending

machine dealers were required to file on the cost price or manufactured cost of tangible

personal property sold at 1% more than the regular sales tax rate in effect. The dealers

were now required to report on personal property sold using Form VM-2.

New dealers

should complete an application, Form VM 1 for each city or county in which machines

are placed.

Prior to July 1, 1982 dealers engaged in the business of placing vending machines

were taxed at the regular sales tax rate on the gross taxable sales (total selling

price of the items dispensed) using Form ST-9. Dealers were required to have a sales

tax registration for each city or county in which machines are placed.

#### **II. References**

**A. Code of Virginia Section**

**58.1-614**

**B. Virginia Regulation**

**Old**

VR 630-10-110 § 1

VR 630-10-110 § 2

VR 630-10-110 § 3

VR 630-10-110 § 4.

VM Sales ; generally	<b>NEW</b>	<b>23 VAC 10-210-6040</b>
dealers defined		<b>23 VAC 10-210-6041</b>
contract w/nonprofit organizations		<b>23 VAC 10-210-6042</b>
sales by other dealers		<b>23 VAC 10-210-6043</b>

- C. Ruling Letters** - P.D. 86-122 Coin operated amusement games (7/11/86)
- P.D. 87-199 Alternative reporting method approved (8/21/87)
- P.D. 89-286 Vending machines - leases or rentals subject to sales tax (10/27/89)
- P.D. 89-300 Adjustments to cost of goods sold/shortages allowed, 11/01/89
- P.D. 97-302 Sale of individually packaged food items from cardboard displays/honor boxes allowed to report 5.5% on whole-sale purchases. (7/11/97)

- D. Virginia Tax Bulletin** Sales and Use Tax Policy Statement 82-1, (June 1, 1982)
- Sales and Use Tax Policy Statement 82-6, (June 1, 1982)

- E. Applicable Exemption Certificate** - Tangible personal property purchased for resale through vending machines may be purchased exempt using (Form ST-10).

**III. General A.** Dealers engaged in the business of placing vending machines and selling tangible personal property through them are required to compute tax at 5.5% on the cost price of items purchased for sale through the vending machines. 58.1-614 (A) & (B) Vending machine dealers file a special return to report sales tax (Form VM-2)

through  
manufactured cost,  
**B.** Dealers who manufacture tangible personal property to be sold vending machines must compute tax at 5.5% on the (raw material cost plus labor and overhead).

determine the cost  
written request to the  
**C.** Dealers who are unable to maintain satisfactory records to price of goods purchased or manufactured, may submit a Commissioner for **authorization to remit upon gross receipts which takes into account the inclusion of the 4.5% sales tax.** 58.1-

614 (D)  
standard return  
Dealers who are authorized for this method must file the (Form ST-9).

**D.** Dealers who are engaged in the business of placing **vending machines**, all of which are **under contract to nonprofit organizations**, may deduct sales of 10 cents or less from gross receipts and divide the remaining balance by 1.045 to determine the amount of taxable sales upon which the tax is due and payable. 58.1-614 (C) Dealers who qualify for this method must file the standard sales tax return (Form ST-9)

which vending  
consolidated  
**E.** Dealers are required to file separate returns for each locality machines are placed unless the dealer has permission to file a return.

vending machines, but  
report tax on  
**F.** Dealers who are not engaged in the business of placing who use vending machines in their places of business must **gross taxable sales.**

#### IV. Procedures

dealer is to  
A pre-audit  
overall operation.

1. The first step in conducting an audit of a vending machine determine which method is being used in reporting sales.tax. conference is helpful in gaining knowledge of the dealers

their goods for sale,  
210-6040, 41, 42,  
often necessary as  
compute tax based on  
take **unauthorized**  
income).  
discounts which

2. It is clear that true Vending Machine businesses who place should operate under the guidelines provided under VAC 10-210-6040, 41, 42, in regards to reporting sales.taxes. An in depth analysis is these dealers may have trouble determining just how to the true cost price of items purchased for sale. Dealers may take **unauthorized deductions** from their cost of goods(e.g.,premium brand **Credits allowed** include inventory shortages, trade or other are netted against the invoice price.

merchandise  
tax on the  
placing dealer and  
210-6043  
being included in the  
overlooked.  
price of items  
proceeds/sales amount.

3. Dealers who use vending machines in their business to sell (e.g., service station operators, grocery stores, ) must report standard return (Form ST-9) This type of dealer is not a therefore subject to sales tax at the rate of 4.5%. VAC 10-210-6043 Carefully reviewing this area to insure that these sale are taxable sales calculations is suggested, as they are often Sales tax is calculated at the gross taxable sales(total selling despensed). This means tax is not included in gross

subject to the  
consumed and  
completed to assure

4. Purchases or leases of vending machines and repair parts are use tax at 4.5% and are considered tangible personal property not for resale. A careful review of this area should be

that compliance is being met.

**5.** STAUDN program to  
broken down by  
ST-49.  
the 3.5% state  
at the Vending

Vending machine audits can be completed by using the  
compute the local 1% tax by entering the monthly purchases  
locality codes to give accurate tax, penalty and interest on the  
A **manual ST-48 VM** can be easily completed by adding both  
TPI & local 1% TPI totals from the **automated ST-48** to arrive  
Machine figures 4.5% state TPI and 1% LOCAL TPI.

## Sales and Use Tax Audit Procedure Veterinarians

**Objective:** Discuss the application of sales and use tax as it applies to veterinarians

### **I. History**

Prior to July 1, 1987 The Department deemed veterinarians to be engaged in professional services. The veterinarian was to be the taxable consumer of all tangible personal property used in providing their service. If a veterinarian went beyond the rendition of their professional service and sold goods at retail he had to register for the sales tax and collect the tax from his/her customer if an inventory of tangible personal property was maintained to sell certain items independent of an office visit. The sale of identical products would be treated differently depending if an office visit or examination was part of the transaction (SEE BULLETIN 86-4). The logistic of the above procedure as well as the auditing of such a business proved to be quite difficult. After July 1, 1987 House Bill 1594 of the 1987 General Assembly stated that the tax should be paid on the cost price of controlled drugs as well as medicines, which are required to be dispensed on the prescription of a licensed veterinarian. These items may in turn be sold at retail exclusive of the tax regardless of whether the sale of such items is in conjunction with an office visit or examination. The only requirement is that the tax be paid on the cost price of the controlled drugs or prescribed medicines. Also, prescription diets fall into the same category as controlled drugs or prescribed medicines. The veterinarian would of course continue to pay the tax on consumable supplies and all capital purchases

The above changes made by House Bill 1594 had no effect on the sale of soaps, flea powders, leashes, collars, pet foods, and similar products. Such items should be purchased tax exempt and the tax collected at the full retail amount whether or not such sale is in conjunction with an office visit or examination.

All medicines, drugs, supplies, and equipment will be treated the same from one veterinarian to the other, in that the nature of the product determines how it is treated for tax purposes. Any withdrawal from an exempt retail inventory for kennel services or grooming services should be taxed at cost and the tax reported on line two of the ST-9.

### **II. References**

- A. Code of Virginia 58.1-609.7 (1)
- B. Virginia Administrative Code 23 VAC 10-210-6050
- C. Virginia Tax Bulletin 86-4  
Virginia Tax Bulletin 87-9
- D. Ruling Letter P.D. 87-251

E. Exemption Certificate ST10 for resale items only.

**III. Definitions**

CONTROLLED DRUGS – DRUGS WHICH ARE KEPT UNDER LOCK AND KEY SUCH AS NARCOTICS AND /OR AMPHETIMINES

PRESCRIBED MEDICINES –PRODUCTS WHICH CAN ONLY BE DISPENSED ON THE WRITTEN PRESCRIPTION OF A LICENSED VETERINARIAN

PRESCRIPTION DIETS-PET FOOD WHICH IS PRESCRIBED TO TREAT A SPECIFIC MEDICAL CONDITION

SUPPLY ITEMS-SUTCHURES, SPLINTS, OFFICE SUPPLIES, ETC.

OTHER RESALE PRODUCTS-SOAPS, POWDERS, VITAMINS, LEASES, COLLARS, AND PRODUCTS WHICH MAY BE LABELED “ONLY AVAILABLE THROUGH VETERINARIANS” BUT ARE RESALE ITEMS, AND REGULAR PET FOOD.

Procedure

If the veterinarian keeps an inventory of resale items such as soaps, flea treatments, etc, the veterinarian needs to be registered for the collection of the sales tax and the tax should be collected and reported on the retail sales value of the items. These items are treated as retail items regardless of whether the sale of such items is in conjunction with an office visit or examination. A complete understanding of the taxpayer's products is necessary to conduct an audit. A vendor may supply both items for resale and consumption. Purchases must be analyzed in detail for a complete understanding of the product line. The sale of specific products such as leashes, soaps, etc. should be taxed at the retail value. Sales journals, bank deposits, and customer's receipts should be analyzed to verify the tax collected was reported on the retail items. Capital acquisitions should be analyzed for the audit period. All equipment used in the practice is subject to the sales tax at cost. Purchases, sales, and assets, should be analyzed with a complete understanding of the nature of the products and their specific uses.

## Sales and Use Tax Audit Procedure Watercraft Tax vs. Sales Tax

**Objective:** Discuss the application of the 2% Virginia Watercraft Sales and Use Tax (Watercraft Tax) and the 4.5% Virginia Retail Sales and Use Tax (Retail Tax).

### I. History

**Prior to 1/1/82.** Watercraft were subject to the 4.5% retail tax.

**1/1/82 to 7/1/87.** Watercraft were exempted from the retail tax by Code of Virginia § 58.1-609(9) and became subject to the 2% watercraft tax. There was no maximum tax.

**7/1/87 to 7/1/90.** A \$1,000 maximum watercraft tax cap was in effect.

**7/1/90 and after.** The watercraft tax cap is increased to \$2,000. Based on the maximum tax limitation, all watercraft with a sales price of \$100,000 or more are subject to a maximum tax of \$2,000.

**7/1/94 and after.** The definition of "watercraft" is expanded to include any motor sold separately that is used to power a watercraft.

**1/1/98 and after.** The definition of "watercraft" is expanded to include any vessel on the water propelled by machinery whether or not the machinery is the principal source of propulsion. It also eliminates the size and horsepower requirements. Small motorboats, jet skis and small sailboats equipped with auxiliary motors are now watercraft under the statute. The definition of "dealer" was broadened to include any person who sells or offers to sell two or more watercraft within any twelve consecutive months. Previously a dealer was a person who held five or more watercraft for resale during a calendar year.

### II. References

#### A. Code of Virginia Sections

- 58.1-609.1(6) Retail tax exemption for motor fuels, diesel fuel, and clean special fuels for use in a boat or ship, upon which a fuel tax is refunded.
- 58.1-609.1(9) Exempts watercraft as defined in § 58.1-1401 from the retail tax.
- 58.1-609.2(4) Commercial waterman exemption from the retail tax.

58.1-609.3(4) Retail tax exemption for ships and vessels used or to be used principally in interstate or foreign commerce.

58.1-1400 through 58.1-1410 - Virginia Watercraft Sales and Use Tax.

58.1-1400 Title.  
58.1-1401 Definitions.  
58.1-1401.1 When motor deemed a watercraft.  
58.1-1402 Tax levied.  
58.1-1403 Basis of tax; estimate of tax; penalty for misrepresentation.  
58.1-1404 Exemptions  
58.1-1405 Time for payment of tax.  
58.1-1406 Dealers' certificates of registration.  
58.1-1407 Retention of documents.  
58.1-1408 Civil penalties and interest.  
58.1-1409 Credit against tax.  
58.1-1410 Disposition of funds.

B. Virginia Administrative Code (VAC)

23 VAC 10-210-351 Commercial waterman.  
23 VAC 10-210-4050 Ships and vessels used or to be used principally in inter-state or foreign commerce.  
23 VAC 10-210-6060 Watercraft sales, leases, and rentals; repair and replacement parts, and maintenance materials.

\* Note: This regulation was amended in 1994 and was not updated in the regulation booklets prior to the publication of the Virginia Administrative Code, Title 23 (23 VAC).

23 VAC 10-230-10	VR12.3.58-26.1	Virginia Watercraft Sales and Use Tax Regulations
through	through	
23 VAC 10-230-130**	VR12.3.58-685.50**	

\*\* Note: The watercraft tax regulations have not been updated since issued in 1982 (including those published in 23 VAC) and generally are not reflective of the current law. Nevertheless, they contain helpful examples of many transactions as well as definitions and descriptions not found elsewhere. The following are some facts which must be kept in mind when referring to the watercraft regulations:

1. The tax code was recodified in 1984 as Title 58.1.
2. The definition of "watercraft" has changed substantially. (Originally, the definition included references only to length and weight.)
3. The definition of "dealer" has changed.

4. There was no maximum tax cap when the watercraft tax was enacted. Later a \$1,000 cap was imposed and now the maximum tax limitation is \$2,000.
5. Motors used to power a watercraft and sold separately are now taxed as watercraft.
6. The late payment penalty has been increased to 6% per month.

23 VAC 10-230-10	(VR12.3.58-26.1)	Bad checks.
23 VAC 10-230-20	(VR12.3.58-441.6(kk))	Watercraft exclusion.
23 VAC 10-230-30	(VR12.3.58-685.40)	Definitions.
23 VAC 10-230-40	(VR12.3.58-685.41)	Tax levied.
23 VAC 10-230-50	(VR12.3.58-685.42)	Civil Penalties.
23 VAC 10-230-60	(VR12.3.58-685.43)	Dealer certificate of registration.
23 VAC 10-230-70	(VR12.3.58-685.44)	Dealer exclusion.
23 VAC 10-230-80	(VR12.3.58-685.45)	Other exemptions.
23 VAC 10-230-90	(VR12.3.58-685.46)	Payment of tax required for title.
23 VAC10-230-100	(VR12.3.58-685.47)	Value of watercraft and penalty for misrepresentation.
23 VAC 10-230-110	(VR12.3.58-685.48)	Retention of Documents.
23 VAC 10-230-120	(VR12.3.58-685.49)	Credit for payment of tax.
23 VAC 10-230-130	(VR12.3.58-685.50)	Allocation of funds.

### C. Ruling Letters

- P. D. 00-196 Undocumented vessels sold in Virginia
- P.D. 95-75 Barge has no motor so it is not a watercraft-retail tax applies.
- P.D. 93-155 Rentals of watercraft are taxed at 2%. Rentals of canoes and kayaks are taxed at 4.5%.
- P.D. 91-120 **\*\*Prior to 7/1/94\*\*** The purchase of a motor (watercraft purchased from one dealer and the motor from another) by a commercial waterman was exempt from both taxes.
- P.D. 90-213 Fishing vessels used by commercial watermen are exempt from the retail tax, but only watercraft constructed by a commercial waterman for his own use are specifically excluded from the watercraft tax.
- P.D. 88-176 Sales of interval ownership interests in watercraft are not subject to either tax, however the watercraft tax is due on the initial purchase of the watercraft.
- P.D. 86-187 A taxpayer who purchases a vessel without an engine need only remit 2% watercraft tax, provided he installs a motor of over 25 HP prior to initial titling. A dealer who

sells a boat that would be a watercraft if powered by a motor of over 25 HP is not required to collect the retail tax if he takes from the purchaser a written statement that such an engine will be installed upon the boat prior to obtaining a title.

P.D. 86-151 An association which chartered and maintained vessels for their owners and received a monthly fee as well as a percentage of the charter was not considered a watercraft dealer.

D. Virginia Tax Bulletin 97-5 Definition of Watercraft and Watercraft Dealer

Virginia Tax Bulletin 94-9 Application of the Watercraft Sales and Use Tax to the Sale of Boat Motors

E. 1997 Legislative Summary Definition of Watercraft-Expanded, Amended Clarified

F. Applicable exemption certificates: ST-10 Resale Certificate  
ST-16 Waterman Certificate

### III. General

A. Watercraft Tax is Imposed on the Purchaser

A 2% watercraft tax is imposed upon the purchaser of any watercraft sold in Virginia and upon the user of any watercraft not sold in Virginia, if required to be titled with the Department of Game and Inland Fisheries for use in Virginia.

B. General Description of a Watercraft subject to the Watercraft Tax

**Prior to 1/1/98:** A watercraft means any motor-powered boat 15 feet or more in length if powered by a motor in excess of 25 horsepower or any sail-powered boat in excess of 18 feet in length, but not boats that have valid marine titling documents issued by the U.S. Coast Guard. Effective 7/1/94 any motor purchased separately to be used to power a watercraft is subject to the watercraft tax.

**1/1/98 and after:** The motor-powered boat length and horsepower requirements were removed. A vessel need only be propelled by machinery. This machinery does not have to be the principal source of propulsion. The provision for a sail-powered boat remains unchanged.

### C. Watercraft Tax vs. Retail Tax

All transactions subject to watercraft tax are exempt from the retail tax; however, all watercraft not subject to the watercraft tax are subject to the retail tax. It is the intent of the sales and use tax laws to tax all marine vessels (unless otherwise exempt) according to one or the other tax rate (2% or 4.5%) but not both.

### D. Watercraft Dealers

Watercraft dealers are exempt from both the retail and watercraft taxes on purchases of watercraft for resale and also on purchases of watercraft for lease, charter or other use for compensation, but are subject to the watercraft tax on the gross receipts from lease, charter or other use. Gross receipts tax on the lease, charter or rental of watercraft is not separately stated.

## IV. Scope of Training

This training section deals with the application of the watercraft sales and use tax (referred to as watercraft tax) and the retail sales and use tax (referred to as retail tax). It is not the intention that auditors become familiar with all aspects of the watercraft tax. Instead, it is more important that the auditor know which tax applies and where to locate information needed to make the correct determination. For watercraft tax, the primary data source is the Chapter 14 of the Code of Virginia. Chapter 14 is relatively short and easier to read than most statutes. The list of code sections is included to make subjects easier to locate. Even though the watercraft tax regulations are seriously out of date (refer to footnote \*\* above), they are still a valuable source of information. A list of regulation titles is also included. Likewise, the older ruling letters must be read with the realization that significant changes have occurred in the years since 1982. While a few retail tax issues will be addressed, watercraft tax will be the main focus of this training section.

## V. Watercraft Tax Definitions

The following definitions are taken from the Code of Virginia § 58.1-1401 unless otherwise identified and are expanded upon by additional information contained in the regulation definitions or other sources.

**Prior to 1/1/98 - "Dealer"** means "any person who is in the regular business of selling watercraft. Any person who has held five or more watercraft for resale during the calendar year shall be deemed, for purposes of this chapter, a 'dealer.'"

**1/1/98 and after - "Dealer"** means "any watercraft dealer as defined in § 29.1-801." This definition includes any person who sells or offers to sell two or more watercraft within any twelve consecutive months.

The regulation definition of dealer is more general and adds that "the Commissioner may find such person to be a dealer." For the most part, a watercraft dealer is governed by the laws pertaining to the Dept. of Game and Inland Fisheries (DGIF). The decision to register with DGIF as a watercraft dealer is generally not voluntary. That is, if a person meets the definition of a "watercraft dealer" in Code of Virginia 29.1-801 (the Watercraft Dealer Licensing Act), that person must register with DGIF.

However, a watercraft dealer is not required to register with the Dept. of Taxation to collect and remit the Watercraft Sales and Use Tax on the sale of watercraft. Such registration (and the collection and remittance of the Watercraft Sales and Use Tax) is voluntary. If a watercraft dealer elects not to collect the Watercraft Sales and Use Tax, the tax is imposed on the purchaser.

**"Gross receipts"** means "the amount received for the lease, charter, or other use of any watercraft. The term shall include hourly rental, maintenance, and all other charges for use of any watercraft and charges for pilots crew, or other services, unless separately stated on the invoice. The term shall also include the amount by which the price estimated under § 58.1-1403 exceeds the charge actually made."

**"Sale"** means "any transfer of ownership or possession of a watercraft by exchange or barter, conditional or otherwise, in any manner. The term shall also include (i) a transaction whereby possession is transferred but title is retained by the seller as security, (ii) any lease or rental for a period of time substantially equal to the remaining life of the watercraft, and (iii) any lease or rental requiring total payments by the lessee during the lease or rental period which substantially equals the value of the watercraft. The term shall not include a transfer of ownership or possession made to secure the payment of an obligation." The regulation definition goes into detail about determining the remaining life and valuation of watercraft. It defines "substantially equal" to mean 80% or more. The regulation states that "[t]he same sale will not be subject to the tax more than once. However, unless it is an exempt transfer, each time a transfer of ownership or possession takes place, the new owner will be subject to the tax on the transfer." In addition, the regulation cites six types of transfers that the term sale does not include and provides three examples. Finally the regulation excludes from the term sale the "[t]ransfer of watercraft repair parts, accessories, attachments, and lubricants, not included in the same transaction with the transfer of the watercraft." Sales of all such tpp (except motors to power watercraft) are subject to the retail tax.

**"Sale price"** means "the total price paid for a watercraft and all attachments thereon and accessories thereto, exclusive of any federal manufacturer's excise tax, without any allowance or deduction for trade-ins or unpaid liens or encumbrances." The regulation definition of sale price includes additional information. "The terms 'attachments thereon' and 'accessories thereto' as used herein mean all [tpp] that is physically attached to watercraft, including installation charges, or property that is customarily used in watercraft, whether or not affixed to the structure of the watercraft, and which was transferred in the same transaction as the watercraft as a part of the watercraft sale. Such [tpp] transferred other than in the same transaction with the watercraft will be subject to the . . ." retail tax. In addition, "[c]harges for lettering and get-ready charges (cleaning, washing and preparing) are also included in the sale price when made in the same transaction with the watercraft transfer. However, excluded from the sale price are charges for federal manufacturer's excise tax, registration and titling fees, insurance, and gasoline, when separately stated on the invoice." Note that the base for computing the watercraft tax excludes manufacturer's excise taxes, but not retailer's excise taxes. Thus any federal "luxury tax" on a watercraft is included in the base for computing the watercraft tax since it is classified as a retailer's tax.

**Prior to 1/1/98 - "Watercraft"** means "any contrivance (i) used or which is capable of being used as a means of transportation on water, (ii) which is fifteen feet or more in overall length measured along the centerline and (iii) which is powered by a motor in excess of twenty-five horsepower. The term shall also include any sail-powered vessel (i) used or which is capable of being used as a means of transportation on water and (ii) which is in excess of eighteen feet in length measured along the centerline. The term shall not include a seaplane on the water or a watercraft which has a valid marine titling document issued by the United States Coast Guard."

**1/1/98 and after - "Watercraft"** means any vessel propelled by machinery whether or not the machinery is the principal source of propulsion. The term shall also include any sail-powered vessel, which is in excess of eighteen feet in length measured along the centerline. The term shall not include a seaplane on the water or a watercraft which has a valid marine titling document issued by the United States Coast Guard."

The first paragraph of the regulation definition contains the superseded definition of "watercraft" and should be ignored; however, the second and third paragraphs contain information about documented vessels. Code of Virginia § 58.1-1401.1, in effect, adds to the definition of watercraft and is entitled "When motor deemed a watercraft." It became effective on 7/1/94 and states that "[a]ny motor used to power a watercraft as defined in § 58.1-

1401 and sold separately from such watercraft shall be deemed a watercraft for purposes of this chapter."

**"Person"** as defined by the regulation "[m]eans every natural person, firm, partnership, association, corporation, or other entity."

## **VI. Procedures**

### **A. Application of the Watercraft Tax to the Sale of Boat Motors**

Virginia Tax Bulletin 94-9 deals with the 1994 statute in which any motor that powers a watercraft and sold separately from the watercraft, is itself deemed a watercraft. The explanation is very good and the examples clarify the intent of the statute. The auditor should read and understand this bulletin because it has far reaching implications. A registered watercraft dealer will only collect the 2% watercraft tax on such a motor. A retail dealer still collects the 4.5% tax but the customer who purchased the motor for a watercraft can obtain a partial refund from the Department of Taxation by completing the "WCT Refund" request.

### **B. Watercraft Tax Levied - Code of Virginia § 58.1-1402**

This statute describes how the amount of tax to be collected is determined:

1. 2% of the sale price of each watercraft sold in Virginia.
2. 2% of the sale price of each watercraft not sold in Virginia but required to be titled in Virginia. However, if the watercraft is first required to be titled in Virginia six months or more after its acquisition, the tax shall be 2% of the market value of such watercraft at the time it is titled.
3. 2% of the gross receipts from the lease, charter or other use of any watercraft by a registered dealer. Note: effective January 1, 1998 watercraft includes small motorboats and jet skis.

This code section also contains the \$2,000 maximum tax limitation. The regulation corresponding to the statute states that the current market value includes "the cost of any modifications, improvements or additions subsequent to initial acquisition." The regulation has paragraphs titled "Each Transaction Taxable," "Requirement to be Titled," and "Current Market Value." The regulation also contains a paragraph titled "Occasional Sale" which states that the watercraft tax applies to an occasional sale. "Occasional sale means a sale of a watercraft by anyone not a dealer in watercraft."

C. Watercraft Tax Exemptions - Code of Virginia § 58.1-1404

Prior to 1/1/98, the statute contained six exemptions. Beginning 1/1/98 and after there are five. (Refer to the code section for more details.)

1. Sales to federal, state and local governments and sales to insurance companies for the sole purpose of settling a claim.

2. **Before 1/1/98:** Any person who owned a watercraft prior to 1/1/82.

**1/1/98 and after:** Any person who was the owner of a watercraft which was not required to be titled prior to 1/1/98 can apply for a title without incurring the watercraft tax.

3. Any watercraft constructed by a commercial waterman for his own use. (Note: The exemption, as it pertains to commercial watermen, is only applicable when the actual vessel is constructed by the waterman for his own use. There is no exemption from the watercraft tax for watercraft purchased by or constructed by a boat yard on behalf of a commercial waterman.)

4. Any registered dealer in watercraft is exempt from the tax imposed in paragraphs 1 and 2 of § 58.1-1402. A registered dealer is also exempt from the titling requirement in § 62.1-186.2 (prior to 1/1/98) or § 29.1-713 (beginning 1/1/98 and after).

5. **Before 1/1/98:** Any watercraft sold or used for which no title is required, unless the owner of such watercraft chooses to apply for a title. This exemption was removed effective 1/1/98.

**1/1/98:** This exemption was removed from the statute.

6. Any watercraft purchased by and for the use of a volunteer sea rescue squad, volunteer fire department or a volunteer rescue squad. (All are required to be nonprofit.)

The following statement is found at the end of the exemption regulation: "Note: The exemptions of this section do not apply with respect to rentals, leases or charters in the case of a dealer who pays a gross receipts tax under the dealer exclusion, as the gross receipts tax is levied on the dealer and not upon the renter, lessee, or other user."

D. Watercraft Dealers - Code of Virginia § 58.1-1406

Paragraph A of the statute states that "[e]very person who qualifies as a

dealer. . . and desires to transfer ownership without obtaining a certificate of title, shall file with the Tax Commissioner an application for a certificate of registration for each place of business in the Commonwealth." This statute implies the voluntary nature of a dealer's decision to register for the watercraft tax. Once registered, however, the watercraft dealer must act in strict compliance with all of the statutes, especially concerning leasing or renting of watercraft. Because a watercraft dealer is subject to tax on his gross receipts, the watercraft tax is imposed on the dealer instead of the renter or lessee. Therefore, the exemptions found in Code of Virginia § 58.1-1404 are not applicable. For example, gross receipts from rentals, leases or charters to the federal, state or local governments must be included in the dealer's gross receipts and are subject to the watercraft tax. Most active dealers of watercraft agree to register for watercraft tax because as paragraph E states: "Only those dealers who hold a current certificate of registration hereunder shall be authorized to transfer ownership of a watercraft without obtaining a certificate of title therein, and paying the tax imposed by this chapter." The dealer exclusion regulation contains useful information regarding watercraft dealers not found in the statutes and is generally accurate. A watercraft dealer may purchase watercraft for subsequent lease, rental or sale exempt of the tax. Also, paragraph C of 23 VAC 10-210-6060 states that "[r]epair and replacement parts and accessories installed on a watercraft at the time of sale, or on leased or rented watercraft, that are included in the sales price for computing the [watercraft tax] or in gross receipts from a lease or rental are exempt from the [retail tax]. Such items may be purchased by a dealer, as defined in § 58.1-1401 of the Code of Virginia and the accompanying regulations, exclusive of the [retail tax] when a resale exemption certificate, Form ST-10, is presented at the time of sale. Repair parts purchased by nondealers for installation on watercraft are not exempted from the tax."

#### E. Coast Guard Documented Vessels

The statute specifically exempts from the watercraft definition any watercraft which has a valid marine document issued by the United States Coast Guard. The regulation definition discusses this topic in more detail. "Marine documentation is issued by the United States Coast Guard to the owner(s) of vessels or watercraft as evidence of ownership in such vessels or watercraft. Valid documentation becomes void upon sale and must be reinstated in the name(s) of the purchaser(s). Therefore, for purposes of this chapter, no watercraft will be considered to have a valid marine document when purchased . . ." in Virginia. Conversely, vessels which are purchased and documented outside Virginia, but brought into this state for use with valid documentation are exempt from the 2% watercraft tax, but subject to the 4.5% retail tax. However, Virginia will give credit for valid sales type taxes paid to another

state. (Refer to Code of Virginia § 58.1-1409.) Note that there is no maximum tax limitation for the retail tax.

F. Commercial Watermen are Usually Liable for Watercraft Tax

A commercial waterman enjoys an extensive (but not complete) exemption from the retail tax. 23 VAC 10-210-351 was broadened in 1994. Items such as boats, boat motors, parts, machinery, tools, equipment, etc. are exempt from the retail tax when purchased by a commercial waterman who can present a valid ST-16. There is a provision for proration of the retail tax if a commercial waterman's use of an item is not entirely exempt. There is no exemption from watercraft tax for commercial waterman except when a commercial waterman actually constructs a watercraft for his own use. Prior to 1/1/98 a commercial fishing vessel under fifteen feet in length or a longer vessel which is powered by a motor of 25 HP or less, does not meet the watercraft definition and is not subject to the watercraft tax. Such boats would also be exempt from the retail tax. Beginning 1/1/98 and after, however, any machine powered vessel (regardless of length or amount of horsepower) is defined as a watercraft. Accordingly, a purchase of any powered boat by a commercial waterman is subject to the 2% watercraft tax. Since 7/1/94, a commercial waterman is taxed on a motor that powers a watercraft. This was probably an unintended result of the enactment of Code of Virginia § 58.1-1401.1.

G. Watercraft Records

Code of Virginia § 58.1-1403 requires every watercraft buyer be provided with an invoice signed by the seller or his representative, which states the sales price. Paragraph C of this section sets out the department's remedies when an invoice does not exist or a misrepresentation occurs. Code of Virginia § 58.1-1407 requires that any invoice(s) be kept by the seller for three years following the sale.

H. Ships or Vessels Used or to be Used Exclusively or Principally in Interstate or Foreign Commerce are Exempt from the Retail Tax

Such vessels are exempt by Code of Virginia § 58.1-609.3(4) from the retail tax. They are described in 23 VAC 10-210-4050. These vessels are usually exempt from the watercraft tax because they have valid Coast Guard documentation or are not required to be titled in Virginia. (Refer to the regulation)

I. Retail Tax Exemption for Boat or Ship Fuels

Code of Virginia § 58.1-609.1(6) exempts "[m]otor fuels, diesel fuel, and clean special fuels for use in a boat or ship, upon which a fuel tax is refunded. . . ."

## **Sales and Use Tax Audit Procedure**

### **Seata**

**Objective:** Discuss the application of sales and use tax as it applies to SEATA.

#### **I. History**

The Southeastern Association of Tax Administrators (SEATA) was established in 1951. In 1987 a number of SEATA members entered into an agreement for the reciprocal exchange of sales and use tax information. The agreement was designed to provide for and facilitate the exchange of information between SEATA states, in order to increase compliance with each state's sales and use tax laws.

#### **II. General**

A. The following states are members of SEATA:

Arkansas	Kentucky	South Carolina
Alabama	Louisiana	Tennessee
Florida	Mississippi	Virginia
Georgia	North Carolina	West Virginia

B. Representatives from the different states meet periodically to analyze exchanged information. Information is provided by member states on a quarterly basis :

1. A report of sales tax cases closed within the quarter exceeding \$100,000.
2. A report of corporate income tax cases with changes in adjustment factors.
3. Hard copy of information reports that are completed by the taxpayer and the auditor.
4. Schedule of untaxed sales transactions.

#### **III. Procedures**

- A. SEATA information should be gathered on all sales and use tax and corporate income tax audits whenever the taxpayer conducts business in any of the SEATA states.
- B. Attached is a copy of the SEATA Nexus Questionnaire. The taxpayer is to complete the front page of the form. It asks the taxpayer to list information such as identifying registration numbers, business activity descriptions and questions relating to the establishment of nexus with SEATA states.

If the taxpayer refuses to complete the form, the auditor should complete the front as best as possible.

- C. The back of the form is to be completed by the auditor. The block requiring registration information for other SEATA states is very important, particularly if use tax is being accrued for other states and registration with those states is questionable.

The bottom part of the back of the form contains a block for collecting data related to specific transactions and should be completed if the taxpayer conducts business in any SEATA state exceeding \$250,000.

NOTE: The sales and use tax audit program allows the auditor to enter transactions, and print a list of the transactions and an information exchange form. Utilizing the audit program eliminates the need to complete the blocks on the back of the Nexus Questionnaire.