Practical guide for exemption certificate management

Tax exempt sales are frequently the target of sales tax audits, and problems with exemption certificates can financially cripple a company. This makes the exemption certificate review process an essential part of exempt sales management.

How often and when you undertake an exemption certificate review depends upon the materiality of your exempt customer sales. Whenever you do a review, though, you have three choices for getting it done:

- Complete the exemption certificate review process annually.
- Outsource the task.
- Use software to simplify the process.

This guide will provide practical information which will help you determine which approach is the most appropriate for you.

CERTIFICATE FRAMEWORK

What is an Exemption Certificate?

An exemption certificate is a legal document presented by a buyer to a seller declaring that the buyer is exempted from sales tax by statute. Exemptions are granted to the buyer either because of their classification or based upon how a product or service is used. As a starting point, you should be familiar with certificate types, exempt entities and use classifications and how this information applies to your company.

These are the more common elements of each:
- Type: multi-state, state specific, partial or blanket and resale
- Common exempt entities: government, school, hospital, not-for profit, direct pay, resale, manufacturing and agricultural
- Use classifications: sale for resale, special use

Any customer claiming exemption from sales tax should be prepared to furnish an exemption certificate.

You are responsible for determining whether the certificate is valid.

What makes an exemption certificate invalid?

The certificate is not valid if it is...
• ...missing a signature or does not include a signature of an accepted signer.
• ...missing an issue date, misdated or outdated.
• ... an incorrect claim type or any certificate not accepted “in good faith.”
• ...any document not recognized by the state authority in the form of a letter, email or government license.

• ...includes an entity name or address other than the direct buyer and seller.
• ...missing an “In Good Standing” number, using incorrect configuration, or showing a State ID number applicable to other states.

**REVIEW PROCESS**

**Step 1: Certificate Retrieval**

Have your exemption certificates on hand and use the list above to separate valid certificates from invalid certificates. Create a spreadsheet to record your certificates by customer name, states claimed, exemption type and date issued. Flag each customer exemption as valid or invalid.

This spreadsheet will be a work-in-process and it is used as a management tool.

In deciding whether to conduct this step yourself, to outsource, or to use software, you should consider these guidelines:

- **Self-managed**: If your list is small and you do not have “Use Classifications” to compare against your products and services, you may be comfortable doing this step manually.
- **Outsourced**: If any of these situations obtains, you should consider outsourcing;
  - You’re not sure if a client’s claims are aligned with state statutes or if the certificate is valid.
  - Your exemption spreadsheet is large and you have limited resources for management.
  - You offer products and services that are component parts in a fabricated product.
- **Software**: If you see that automated retrieval and storage would save you time, you’re a good candidate for software designed to simplify the process. If you sell into the manufacturing, medical, food and utility industries, you’re likely to save significant time with appropriate software.

**Step 2: Exempt Sales Report**

Generate a list of exempt customers from your invoicing system showing sales for the last three years by state and by customer. This list may be at the invoice level if exemption status applies to the whole invoice. If certain line items are exempt while others are taxable, you will need to provide these details.

Here are guidelines for this step:

- **Self-managed**: If you have the internal resources to generate sales and custom reports, you can manage this step yourself.
- **Outsourced**: If you need a third party to create reports, you will need to outsource this step; usually this service is provided by the VAR that placed the accounting software with your company.
- **Software**: Not a function of software.
**Step 3: Exemption Accountability**

Next you will compare your exempted invoice reports to the exemptions certificates spreadsheet you prepared in Step 1 and identify invalid or missing certificates. The variance between valid certificates on hand and exempt status applied will identify the customers you’ll need to contact in the next stage. Based upon the materiality of your invoices, you may want to organize your exemption collection process by customer, or to use a top-down approach by jurisdiction.

You should use these criteria when deciding how to manage this step:

- **Self-managed**: If you are comfortable, weighing the exposure to the actual cost of compliance, and if you have the time to manage this step, you can do it yourself manually.
- **Outsourced**: If you need assistance covering the unknowns like closed businesses, dated customers or taxpayers not in “Good Standing,” it makes sense to outsource.
- **Software**: Automating the comparisons with full automation and reporting can save significant time, reduce potential error and provide a good return on investment. If you have large amounts of data to compare, you should consider the use of appropriate software.

**Step 4: Information Campaign**

It is recommended that you start a communication campaign with your exempt customers. Your communication frequency, method and message will vary, based on the nature of your business and your customers.

However, you should send a notification letter with matching certificate immediately to your customers who are classified as exempt but do not have a valid certificate. Customers who have not responded within 45 days should receive a second letter requesting guidance or to expect that their exemption status will be removed at a specified date.

If no response is received, change the customer’s status. Document this communication and maintain a correspondence file.

You should consider the following factors with this step:

- **Self-managed**: If the list is manageable and you have experience with this task, you may choose to manage this step yourself.
- **Outsourced**: If you are not sure about the communication language or you do not have time to manage correspondence, it makes sense to outsource this step. If you not are comfortable with exemption statutes or with discussing state regulations with your customers, you should outsource this part of the job.
- **Software**: If the campaign list is sizable, you can fully automate the notification message and frequency with appropriate software.

**Step 5: Certificate Validation and Warehouse**

Whenever you receive a valid certificate from a customer, update your exemption spreadsheet, and save an image or warehouse a paper copy of the exemption certificate. You will need to keep the certificate in a centralized location, electronically and physically. If the certificate is invalid,
communicate with the customer, identify the issue and request correction by a specific date, as described above.

You should consider the following factors with this step:

- **Self-managed:** It can be economical to handle this process yourself, if you have time.
- **Outsourced:** If you are not sure about renewal periods for specific authorities, you may need expert assistance. If you’re not sure how to address customers who short pay invoices or reject your request for exemption certificates, you may be more comfortable outsourcing this step.
- **Software:** If you wish to automate the collection and renewal process, including automated synchronization between exemption claim, invoicing and reporting, software is your best option.

### Step 6: Policy Development

Your sales team, accounts receivable and tax departments should work together to create written policies and procedures around exemption certificate management. This should include procedures around exemption recognition, collection, correspondence and rejection.

You should consider the following factors with this step:

- **Self-managed:** If you are a smaller business, you can operate as a single authority over the procedure.
- **Outsourced:** If you are not familiar with policy development and certificate organization and sequencing, you may wish to outsource. This option includes interviewing departments and creating working flow procedures for each task.
- **Software:** Not a function of software.

### Step 7: Audit Defense

Audits are a possibility for any taxpayer. How quickly you can furnish valid exemption certificates will determine both your work load and the audit findings. The goal is to mitigate both.

These are useful criteria for determining how to handle this step:

- **Self-managed:** If you are comfortable negotiating with auditors, understand state statutes and can quickly produce a validate exemption certificate, you can manage this step yourself. Auditors will set a delivery date – usually 60 days. If you’ve followed the steps above, you should be able to meet the deadline.
- **Outsourced:** If you are new to the audit process, it makes sense to outsource the defense.
- **Software:** If your exemption certificate count is large enough that it will be difficult to produce all the documents within 60 days, software can significantly shorten turnaround time. If you are interested in supporting the audit remotely, or you need a tool to support statistical sampling, software is your best option.