

# Giving Exemption Certificates Their Due

by Timothy P. Noonan and Elizabeth Pascal



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This column often covers specific practice issues and insights based on what we see happening day to day in audits of our clients. This month we turn our focus to a sales tax issue regarding exclusions and exemptions from tax. More specifically, we will look at the respect (or lack thereof) given to exemption certificates in ongoing sales tax audits. That we're writing a column on this issue should tell you something — namely that in many recent sales tax audits, auditors have not been giving exemption certificates their due respect. This article will examine those recent trends and provide some analysis as to how to combat those difficulties if they arise during an audit.

As with most of these columns, the focus of the law and analysis will be on New York's rules. But most states have a similar scheme in place regarding the resale exclusion, sales tax exemptions generally, and exemption certificates. So to a large extent the issues and analysis in this article will be relevant anywhere.

## Background

For ease of reference, let's focus the analysis on exclusions from tax regarding the resale exclusion. A purchase of tangible personal property from a New York seller is excluded from sales tax when that

property will be resold in its present form or as a physical component of some other tangible property.<sup>1</sup> That is commonly known as the resale exclusion. New York, like most other states, won't tax sales for resale. To relieve the vendor of its responsibility to collect sales tax, the purchaser must complete a Form ST-120 (a resale certificate) and provide it to the vendor no later than 90 days after the delivery of the property.<sup>2</sup> According to the regulation, a vendor that accepts the timely completed exemption certificate in good faith is "relieved from liability for failure to collect sales tax with respect to that transaction. The timely receipt of the certificate . . . will satisfy the vendor's burden of proving the nontaxability of the transaction and relieve the vendor of responsibility for collecting tax from the customer." The regulation goes on to define good faith as a lack of knowledge that the document is false or fraudulent. So long as "reasonable ordinary due care is exercised," the Department of Taxation and Finance will not impute knowledge to the seller.

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Although our focus for purposes of this discussion is on the resale exclusion generally and resale certificates specifically, the same concepts apply to other exemption certificates given to a vendor to document a sales tax exemption, including those for a contractor's purchases for capital improvements, items used in film production, purchases of energy used in the production of tangible personal property, and many other purchases exempt from sales tax under New York's tax laws. So keep that in mind as we review the issues related to resale certificates.

<sup>1</sup>Tax Law section 1101(b)(4).

<sup>2</sup>20 NYCRR section 532.4(b)(2).

### The Good-Faith Standard

The courts have uniformly interpreted the regulation on sales tax exemption certificates to mean that a vendor is insulated from liability for taxes on sales made under the certificate. In *Saf-tee Plumbing Corp. v. Tully*, the New York Supreme Court Appellate Department affirmed that the State Legislature intended to place the liability for tax payment with the purchaser rather than with a vendor that obtains exemption certificates in good faith.<sup>3</sup>

Lack of good faith exists only if the vendor had actual knowledge that the certificate is false or fraudulently presented. Even if the seller suspects that a sale to its customer might not fall within the resale exemption from sales tax, so long as there is no actual knowledge, the seller will not be held liable. In other words, the vendor has no obligation to investigate its customer, ask questions, or debate the taxability of the sale. In the seminal case on the issue, the New York Court of Appeals annulled a tax assessment against a vendor that had accepted resale certificates to exempt sales of its chemicals.<sup>4</sup> The vendor had noticed that some of its customers were in the dyeing, cleaning, and stamping businesses and thus might be consuming rather than reselling the chemicals. The vendor had also been informed by its own chemist that some of the chemicals sold to those customers did not ordinarily become part of other products. Nevertheless, the court held that the vendor had no knowledge of the actual uses of the chemicals and "as an unpaid tax collector" for the government, had no duty to investigate whether the customers were truly using the goods for exempt purposes.<sup>5</sup>

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Even in a case in which a vendor might have actual knowledge of the facts, if there is no actual knowledge that the transaction is taxable, no knowledge of the law will be imputed to the vendor. For example, in *Matter of Neal Andrews, Ltd.*,<sup>6</sup> the vendor sold kitchen and bath cabinetry, fixtures, and accessories from its showroom to interior decorators and architects and accepted a capital improvement sales tax exemption certificate from many of those customers. Even though neither the vendor nor the

customers were contractors, the company believed that its sales of items that would ultimately be installed as capital improvements were exempt from sales tax, and it therefore accepted the exemption certificates in good faith. The New York Tax Appeals Tribunal agreed. It held that even though as a matter of law a transaction is not exempt, the vendor will not be held liable if it accepts an exemption certificate for capital improvements believing in good faith that the certificate can be applied to the transaction at issue. Thus, a resale certificate can still be accepted in good faith as long as the vendor is unaware of the underlying legal issue. Ignorance of the law is, surprisingly, a pretty good excuse in this context! Once a valid certificate is received, vendors have no duty to police their customers and research the law to ensure that they have collected tax on every taxable transaction.

The tax department has said in its advisory opinions that if a seller receives a timely and properly completed exemption certificate, it is relieved of liability, and the burden of proving that the sale is not taxable rests solely with the customer.<sup>7</sup> However, the department has also said that if a vendor sells dinnerware and linens (presumably along with food items) to a restaurant, it would be responsible for collecting sales tax on the nonfood items if "the purchaser is a restaurant which is not in the business of selling dinnerware and linens."<sup>8</sup> Similarly, in the sale of cable to a wind farm to be used as an overhead conductor of electricity, the department said that the seller could not accept the purchaser's exemption certificate in good faith. The department concluded that the seller had actual knowledge as to how the cable would be used, despite the customer's claim that the cable constituted exempt production machinery or equipment to be incorporated into real property.<sup>9</sup> The department's position here seems to contradict the broad holdings in the case law and perhaps suggests why some of these exempt transactions are being audited.

### Points to Take Away

Whatever the case, here are some general points we can take from the cases and issues discussed above:

- If a properly completed certificate is timely accepted in good faith, a vendor is *insulated* from liability for taxes on sales made in accordance with/under the certificate.
- Lack of good faith exists only if the vendor has *actual knowledge* that the certificate is false or fraudulently presented.

<sup>3</sup>77 A.D. 2d 1, 3 (3rd Dept. 1980).

<sup>4</sup>American Cyanamid and Chemical Corp. v. Joseph, 308 N.Y. 259 (1955).

<sup>5</sup>Id. at 262-263.

<sup>6</sup>New York Tax Appeals Tribunal (1988).

<sup>7</sup>TSB-A-97(78)S (Dec. 4, 1997).

<sup>8</sup>TSB-A-99(42)S (Nov. 3, 1999).

<sup>9</sup>TSB-A-06(25)S (Dec. 19, 2006).

- Without actual knowledge, no knowledge of the facts (for example, whether someone claiming to be a contractor is in fact a contractor) will be imputed to the vendor.
- Even when actual knowledge of the facts exists, no knowledge of the law will be imputed to a vendor.
- A vendor has no duty to investigate its customer, ask questions, or debate the taxability of the sale. Its only obligation is to accept a properly completed and timely certificate in good faith.

These points are particularly important given the frequency with which sales tax exemption certificates are questioned under audit. And given the realities of operating a business, the existing vendor-friendly regulations and case law in this area make sense. For example, think of a vendor with a successful restaurant supply business. It has a product inventory of over 10,000 items and more than 4,000 customers annually. Many of the customers provide the vendor with blanket resale exemption certificates for items used in packaging or separately resold to customers. Given the large number of transactions in a day, the vendor relies on its customers to identify the items that are exempt from sales tax. If the vendor had the burden to demonstrate that each of the transactions for which it accepted the resale certificate was not subject to sales tax, it would be impossible for it to run its business. Yet that is exactly what some auditors are suggesting vendors must do!

### Absence of a Proper Certificate

Sometimes, however, the problem with an exemption or resale certificate isn't that it wasn't accepted in good faith. Instead, to get around the protections of the good-faith rules, auditors sometimes attack the validity of a certificate on its face. They argue that it wasn't filled out correctly, or that the taxpayer names are incorrect, or that it wasn't received within 90 days, and so forth.

So what happens then?

Unfortunately, if the auditors are right and the certificate is faulty, it can't be used to satisfy the vendor's requirement to support its noncollection of sales taxes. That being said, all is not lost. The law and regulations make it clear that the absence of an exemption certificate doesn't make an otherwise nontaxable transaction a taxable one. All it means is that the vendor has the burden to prove that the transaction wasn't subject to tax. So in the case of a faulty resale exemption certificate, a vendor must use evidence such as purchase contracts, sales invoices, verification from the purchaser, proof of shipment, and any other credible evidence of resale to demonstrate that the merchandise was resold. Generally, sellers that can offer a combination of accurate sales invoices and evidence from the purchaser,

whether testimonial or through documents, were most successful at proving the exempt nature of the sale without a valid exemption certificate. For example, in *RAC Corp. v. Gallman*,<sup>10</sup> the appellate division accepted the nontaxability of a sale, even though the purchaser did not present a resale exemption certificate at all. Because the purchaser provided the seller with a letter certifying that it intended to resell the property, the court found that "all that was required was that the certificate contain a statement *to the effect* that the property was purchased for resale, and this the subject certificate does."<sup>11</sup> But when a seller has no valid exemption certificate and cannot provide any concrete evidence that a sale was for resale, the courts have generally rejected the validity of the sales tax exemption.<sup>12</sup>

**The absence of an exemption certificate doesn't make an otherwise nontaxable transaction a taxable one. All it means is that the vendor has the burden to prove that the transaction wasn't subject to tax.**

As with the properly completed but invalid certificates discussed in the previous section, it appears that the law simply requires that vendors make a good-faith effort to comply with the sales tax laws and regulations. Auditors may try to require more, but ultimately the legal requirements for vendors are less burdensome than the auditors would have us believe.

### Conclusion

Few areas of the tax law are more difficult and confusing than the sales tax. And as unpaid sales tax collectors, vendors need all the help they can get. Exemption certificates are powerful tools that can and should be used to their fullest extent to help on audit. Practitioners' job is to ensure sales tax auditors understand that.

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<sup>10</sup>331 N.Y.S. 2d 945, 39 A.D. 2d 57 (3d Dept. 1972).

<sup>11</sup>*Id.*

<sup>12</sup>See, e.g. *Savemart, Inc. v. State Tax Comm'n*, 482 N.Y.S. 2d 150, 105 A.D. 2d 1001 (3d Dept. 1984) (finding that a vendor that purchased 9,600 television sets could not rely solely on the number of items purchased to demonstrate that the items were purchased for resale).