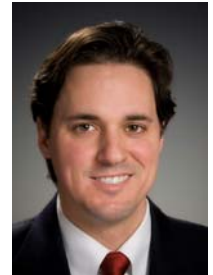


The Nuts and Bolts of Sales Tax Issues for Exempt Organizations

by Timothy P. Noonan

All right, so maybe this isn't the sexiest article I've ever written, but sales tax practitioners — particularly those who ply their trade in New York — will definitely find it useful. So often in day-to-day tax practice, whether it be in audits or planning, issues involving exempt organizations arise. This article should serve as a handy reference guide for many of the issues and questions that I have seen come up in my practice over the years.



And while you may accuse me of being lazy, there really isn't much in the way of footnoting that needs to be done here. That's because the source of almost all the rules here comes right from New York's regulations, mostly 20 NYCRR section 529. So unless I cite otherwise, the authority for most of the information presented in this article will be coming from that regulation.

Overview

First, we should examine the types of entities that we can call exempt organizations under New York's rules. There are several categories of organizations, including the state of New York and its agencies, instrumentalities, and political subdivisions; the federal government; the United Nations; not-for-profit religious, charitable, and scientific organizations; some New York Indian tribes; veterans' organizations; not-for-profit health maintenance organizations; and cooperative and foreign corporations operating in New York.

Most of the issues arising in everyday practice involve state or federal agencies and charitable organizations, so this article will focus primarily on the rules affecting those types of entities.

Sales 'by or to'

The most important thing to remember, if you remember anything from this article, is that absent some exceptions, sales "by or to" exempt organizations are not subject to tax. Thus, in all cases, purchases to exempt organizations will be exempt provided the entity qualifies for the exemption and presents the proper documentation on purchase. Sales by those entities will also be nontaxable in most cases, with one very important exception: Sales by New York, the federal government, and the United Nations remain taxable if they are of a kind ordinarily sold by private persons.

That limitation does not apply, however, to nonprofit entities, veterans' organizations, or Indian tribes. Instead, these organizations do enjoy sales tax exemptions on their sales unless the sales take place through a "shop or store" operated by that entity or relate to the sale of food or drink in a restaurant, tavern, or other establishment operated by the entity. We'll talk a little more about this shop or store rule below.

Certification Requirements

Whatever the case, different certification requirements exist depending on the type of entity involved. For instance, New York and its instrumentalities, agencies, and so on; the federal government; and any foreign governments are not required to separately apply for tax-exempt status with the tax department. They are automatically treated as exempt entities because of their status.

However, entities claiming a not-for-profit exemption, veterans' organization exemption, or Indian nation or tribe exemption all are required to qualify by applying with the tax department. And contrary to what seems to be the popular belief, the fact that an organization is exempt from federal income tax under Internal Revenue Code section

501(c) does not automatically entitle the organization to exempt status. IRC section 501(c)(3) entities are still required to make application to New York to obtain an exemption.

Exempt State and Federal Entities

The state exemption covers New York and any agency, instrumentality, authority, commission, independent board, or public corporation created by an act of the State Legislature and any public corporation created under an agreement or compact with another state or Canada. The federal exemption applies to an agency, affiliate, commission, or independent board created by an act of Congress for public purposes. However, the District of Columbia and states and their subdivisions are *not* treated as agencies or instrumentalities of the United States are subject to tax on their purchases and sales in New York. The same applies to foreign governments.

On purchases, exempt New York state governmental entities are not required to apply for an exemption certificate or present one on purchase. Instead, the entity must issue a governmental purchase order or other appropriate exemption documentation. That alone will suffice to obtain an exemption.

Sales, however, receive different treatment. The exemption does apply when the federal or state entity is a vendor of tangible personal property or services to the extent that the property or those services are of a kind ordinarily sold by private persons. The regulations contain a few examples:

Example: A county clerk sells tax maps, copies of ordinances, and certified copies of documents. The sale of those items is not taxable because the items are not normally sold by private persons.

Example: A New York governmental entity sells surplus vehicles at an auction. The receipts from those sales are subject to the sales and use tax.

Interestingly, though, this issue likely raises the most headaches for those unfortunate enough to be the purchasers of items from state or federal entities. Indeed, what would happen if the federal government makes a sale that is of the nature ordinarily sold by private persons but fails to collect tax? Is an auditor going to issue a sales tax bill to the federal government? That seems unlikely, since presumably New York has no power to require the federal government to collect New York state sales taxes. Nonetheless, when a transaction is taxable but the federal government entity fails to collect the tax, the purchaser would be required to pay the tax directly to the Department of Taxation and Finance.

Another issue that we see in the context of exempt state agencies involves so-called affiliates of exempt organizations. Often groups associated with exempt organizations attempt to claim they are covered by an exempt entity status without understanding the scope of the exemption provided. A good example arises in the context of schools or other entities organized for educational purposes. Purchases and the sale by student councils, individual classrooms, or other "school groups" are not covered under the scope of the exempt organization's status. In those situations, individual students could theoretically create sales tax responsibilities for themselves, and the exempt organization itself risks revocation of its exempt status as a result of the misuse of its certificate or status by related or affiliated groups.

Charitable Organizations

The other primary category of exempt entities concerns charitable organizations. That exemption applies to any corporation, association, trust, community trust, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to test for public safety, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. However, an exemption applies to those entities only if:

- no part of the net earnings of that entity inures to the benefit of any shareholder or individual;
- no substantial part of its activities involves the carrying on of propaganda or other attempts to influence legislation; and

- the entity does not participate or intervene on behalf of a particular candidate in any political campaign for public office.

Unlike state or federal entities, other nonprofit entities are required to make a separate application to the tax department to obtain exempt status. The mere fact that an entity is organized as a nonprofit organization and operates on a nonprofit basis in and of itself does not exempt the entity.

Most importantly, however, once exempt status is obtained, the "by or to" rule generally applies across the board for charitable organizations. Thus, sales to charitable organizations remain exempt from tax when the organization is acting as purchaser. Moreover, the restriction placed on New York state and federal exempt entities regarding the nature of the products or services sold is not applicable to sales by entities exempt under this provision of the tax law. In other words, charitable organizations can sell T-shirts without collecting taxes, even though a T-shirt is the kind of thing sold by private persons or businesses. They can also sell candy bars, cars, toys, and so forth. It does not make a difference what the product is — the exemption is extensive.

Of course, this is sales tax, so there is always a "but." And the regulations contain an important qualifier: Sales by exempt religious, charitable, and other organizations are not excluded from sales tax if they consist of sales of tangible personal property through a shop or store operated by the entity. Under the regulations, a shop or store includes any place or establishment where goods are sold from display with a degree of regularity, frequency, and continuity, and any place where sales are made through a temporary shop or store located on the same premises as persons required to collect sales tax. Here are a couple examples from the regulations:

Example: An exempt organization owning a fleet of automobiles decides to sell at auction a number of the automobiles. The automobiles sold at the auction are not subject to sales tax (because the sales do not occur at a shop or store).

Example: An exempt organization operates a gift shop and bookstore. Sales made by that shop or store are taxable.

Example: A counter is placed in an enclosed area at the back of a church for purpose of displaying religious articles for sale. The counter is opened for business each week for two hours on a specific day, at which time a clerk is present. The counter is in a separate area used solely to display tangible personal property for sale and thus it is a shop or store.

Recent changes to the law have expanded that shop or store rule to cover something more than just a table in the back of church. With the prevalence of online sales, charitable organizations were able to avoid shop or store status since, like many online businesses, you didn't need a shop or a store or any physical place of business to sell products. Under the new law, sales of property made by a charitable organization with a degree of regularity, frequency, and continuity via the Internet, telephone, mail order, or other remote means will be taxable even if they do not occur out of a shop or store.¹ But what qualifies as a degree of regularity, frequency, and continuity by remote means? What if I have a Web site that is capable of making sales 24/7/365, but I only make one sale each month? The Web site gives me the ability to make sales regularly, frequently, or continuously, but my sales are actually pretty infrequent. What about seasonal sales? The law changes leave some of these questions unanswered.

Recent changes have also affected other sales by exempt organizations. Effective September 1, 2008, New York requires tax-exempt organizations to begin collecting sales tax on some sales. Under the new rules, exempt organizations must collect tax on the following:

- any lease or rental of tangible personal property;
- most utility services; and
- the maintaining, servicing, or repairing of real property.

Under these new rules, an exempt hospital's lease of radiology equipment to a group of doctors is taxable. Tax also applies to the hospital's charges to doctors for telephone answering services. Those new rules apply to nonprofit, charitable, educational, literary, scientific, and religious organizations; armed services posts; Indian nations; and most other organizations that were previously exempt from sales tax collection responsibilities. Affected organizations must register with the New York State Department of Taxation and Finance by filing Form DTF-17 immediately.

Application of Exempt Organization Provisions to Agents

In some situations, agents of exempt organizations can stand in the place of an exempt organization and make taxable purchases and sales. According to the tax department's Publication 765, the following six requirements must be satisfied for an agency relationship to exist with a governmental entity:

- The principal and agent must agree to create the relationship. The principal must authorize the agent to make purchases on the principal's behalf and legally bind the principal in all matters within the scope of the agency relationship. The agent must agree to act on the principal's behalf, subject to the principal's control.
- The agency agreement must be in writing.
- The written agreement must describe the scope of the agent's authority regarding making purchases.
- The principal must reserve to itself full control over both the desired result of the agency and the manner or means by which the agent performs its services.
- Generally, the principal must bear the risk of loss in each transaction or activity the agent undertakes under the authority granted to it as agent. This means that the principal must reimburse or indemnify the agent for expenses or liabilities incurred by the agent for its acts, when these acts are within the scope of the authority granted by the principal.
- The principal must authorize the agent to legally commit the credit of the governmental entity for the agent to make exempt purchases on the governmental entity's behalf.

Presumably, although Publication 765 refers only to agency arrangements with governmental entities, the same rules should apply to agents of nongovernmental entities such as charitable organizations.

Special Rules for Contractors

Finally, a note about exempt entity issues as they apply to contractors, because that is an active area in many ongoing sales tax audits. In some cases, a contractor can obtain an exemption for its purchases on jobs for exempt entities. But the exemption is not as broad as most people think. The issue here concerns whether the tangible personal property purchased by the contractor becomes "an integral component part of such structure or building." That is, if materials or supplies purchased by a contractor actually become part of the structure being built, a contractor can purchase the materials or supplies tax exempt. Thus, for example, nails, plasterboard, plywood, and bricks that become part of a building for an exempt organization are exempt. Cranes, bulldozers, hammers, and so on are not exempt.²

In documenting qualifications for that exemption, if the customer is a governmental entity, copies of signed contracts and government purchase orders are sufficient evidence to establish the exempt status of the job between the governmental entity and the contractor. If the customer is an organization other than a governmental entity, the contractor must obtain an exempt organization certificate from its customer and retain it as part of his records.

That often creates some confusion in the contracting context, since contractors question why their purchases of materials on tax-exempt jobs remain taxable. There often seems to be a belief in the industry that if a job is tax exempt, no tax is due by anybody. That, of course, is not consistent with the way the rules work. Unless materials are physically incorporated into the structure, the contractor will have to pay tax on purchases. However, there is one way around that

rule, and it again involves incorporation of agency issues. As in other contexts, an exempt organization can enter into an agency contract with the prime contractor and all subcontractors.³ In that situation, all purchases for the contract are exempt as long as the property or services purchased by the contractor or subcontractor are done so with the contractor acting as agent for the exempt organization. In addition to following the six requirements discussed in Publication 765 and detailed above, the following conditions must be met:

- purchases must be billed or invoiced by the vendor to the exempt organization or the contractor specifying that the contractor is acting as agent for the organization;
- payment must be made by the exempt organization directly to the vendor from a special fund created by the organization for this purpose;
- deliveries must be made to the job site, and when they are not, invoices must identify the place of delivery, the exempt organization's full name and address, and the job site location where the materials will ultimately be delivered for installation; and
- the contractor must provide the vendor with the exempt organization certification when acting as agent for such organization.

Thus, as in other areas, the use of agency provisions can be a helpful way of extending the scope of an organization's exempt tax status.

Conclusion

So this won't win the award for the most tantalizing or edgy article, but it still is good stuff. And practitioners need to know the basics of these rules. They come up in almost every sales tax audit, regardless of whether the taxpayer is an exempt entity. So pay attention, and some day you'll thank me when you find yourself referring back to this article to answer a question about exempt organizations.

* * * * *

FOOTNOTES

¹ Tax Law section 1116(b)(1)(ii), effective September 2008. See also TSB-M-08(5)S and TSB-M-08(15)S.

² 20 NYCRR section 541.3(d)(1).

³ 20 NYCRR section 541.3(d)(4).