In 1980, confronted by a slump in sales of bulldozers and loaders, heavy equipment salesman Don Kotula set up shop in his garage as Northern Hydraulics, selling cylinders, valves and how-to manuals for log splitters by mail.

A year later, the company opened its first store in Burnsville, Minn.; 10 years later it launched a manufacturing business, NorthStar, specializing in heavy-duty versions of some of its products.

In 1998, the company changed its name to Northern Tool + Equipment. Today Northern Tool, still owned and run by the Kotula family, has 95 stores in 19 states, a booming online sales operation and annual revenues of $1.5 billion.

As the business has grown in size, it has grown in complexity as well, and like other multi-state, multichannel retailers — i.e., practically any retailer of significant size today — one area of burgeoning complexity has to do with taxes. Over the past decade or so, states have become increasingly vigilant about collecting retail sales tax. That has been seen most prominently in the ongoing legislative and litigation battle over whether states can require out-of-state online sellers to collect sales tax from purchases made by their resident.

In Northern Tool’s case, however, the complication is more about the wide range of customers who are not required to pay sales tax regardless of whether the purchase is local or online. Organizations exempt from state sales taxes include the federal government and its agencies, state and local governments and their agencies, nonprofits and charitable, religious and educational groups and organizations.

Sales of goods intended for resale are also exempt, assuming the reseller is licensed and can provide a resale certificate for the ship-to state.

ESTABLISHING A NEXUS

There are other situations that warrant a sales tax exemption, and a vast multiplicity of taxing authorities, state
and local, that not only create tax rules but amend them. According to an independent 2016 study conducted by tax content analysts at cloud-based automated tax management system provider Avalara, in 2015 there were more than 428,000 changes to tax rules nationwide. Adherence to the rules is ascertained by audit, and any taxing entity — particularly a state — in which a retailer has established a physical presence such as its headquarters, an office, store or warehouse, can audit that retailer’s tax-exempt sales records and impose fines and penalties for noncompliance.

**DOCUMENTATION REQUIRED**

“When it comes to selling exempt,” Mike Maselli says, “if you don’t have the right documentation in place to show why you didn’t charge tax, you, the seller, are liable for the tax plus penalties plus any other fines involved.”

Maselli is senior director of product management at Avalara; its client companies include Adidas, Birkenstock and Northern Tool + Equipment.

Retailer audits are extremely common, and the consequences of being found liable for noncompliance are not trivial. “There’s a third-party study that shows the average audit assessment is $144,000,” Maselli says, “and we have some companies that in the past have been fined 10 times that much.”

At Northern Tool, the paperwork load for exempt transactions is considerable. “We have over 300,000 exempt customers,” says Jason Davenport, Northern Tool’s sales tax manager, “and last year, just in retail, we did about 160,000 tax-exempt transactions.”

To successfully pass an audit, a retailer such as Northern Tool must be able to produce a properly filled-out and registered current tax exemption certificate for any or all customers involved in any or all of these transactions.

Until five years ago, Northern Tool was managing the paperwork mandated by this requirement by hand. “It was all manual,” Davenport says. “We had file cabinet after file cabinet filled with thousands — tens of thousands — of pieces of paper.”

This is still an all-too-common approach, Maselli says. “Some companies don’t provide any online capability for someone to digitally create an exemption certificate,” he says. “They leave the onus 100 percent on the buyer to mail them an exemption certificate or to bring it into the store. If that happens, you have to hope that the right document was accurately and fully completed.

“You also have to hope that when they gave it to a part-time worker in your store, it actually got saved and faxed or mailed back to headquarters — to the people who will have to produce it three or four years later when they get audited.”

**A BETTER WAY**

Anyone who has ever been through even a personal income tax audit — or for that matter, had a look at the back office of a busy store — can appreciate the weaknesses inherent in such a system. “Overall compliance continues to grow,” Davenport says, “especially as the states get more and more stringent about their nexus. So I think it makes sense to use a third-party provider to help support you in that initiative. It allows your team members to focus on value-added work versus pen-and-paper activity.”

Northern Tool converted to an Avalara system for certification capture in 2012. “Now we collect everything electronically,” Davenport says. “We have a process in the back end that validates electronic exemption certificates. It’s a huge win for the company. We used to incur significant audit assessments, but now we rarely find any. In terms of money, the difference it makes is several hundred thousand dollars a year.”

The digital capability also provides a much better customer experience. “In the past, a customer would bring in an exempt certificate to make a purchase, and the next time they came in they had to remember to bring it,” he says. “Now, once they fill out the certificate one time, or bring in their existing one, it’s in the system. If you need to get in touch with a customer who’s not actually in the store, you can email them directly with a link to the Avalara portal and they can file the certificate from wherever they are.”

Beyond the improved customer experience, “At the end of the day, there’s a huge financial benefit,” Davenport says. “And there’s a significant time savings benefit for employees not having to dig through all that paper during an audit.”

Peter Johnston is a freelance writer and editor based in the New York City area.