INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

POST-WAYFAIR SALES TAX PRIMER FOR TECH COMPANIES

By Steve Oldroyd and Ken Choi

The Supreme Court's recent decision in *South Dakota v. Wayfair* spurred many e-commerce companies to reevaluate their tax structures, while media reports explored the decision's impact on both large and small e-retailers.

Yet the Court's decision will also alter the tax processes of an industry equally dependent on online sales: technology. In this article, we unpack what this tax development means for the high-tech world in what is likely the Court's most significant state tax decision since 1992.

BACKGROUND

In 1992, the U.S. Supreme Court held in *Quill Corp. v. North Dakota* that a state may not impose a sales tax collection and remittance responsibility on a vendor unless it has a physical presence in the state, thus establishing the physical presence nexus standard. A physical presence may be established via an in-state physical presence either through employees, property, affiliates, or independent contractors acting on a vendor's behalf. At the same time, an internet link of a U.S. resident website can establish a "click-through" nexus.

In a direct challenge to the physical presence rule, South Dakota enacted an economic presence nexus statute for sales and use tax collection in March 2016. Under that statute, a remote seller is required to collect and remit sales tax IF: (1) the seller's South Dakota sales exceed $100,000; or (2) the seller has more than 200 separate sales transactions into South Dakota. At the time, Wayfair, Inc., and two other internet retailers, Overstock.com, Inc. and Newegg, Inc., had no physical presence in South Dakota and collectively challenged the statute in state court.

After years of hearings in lower state courts, on June 21, 2018, the Supreme Court issued its widely anticipated decision in *South Dakota v. Wayfair, et al*. No. 17-494. In a 5-4 decision, the Court held that the physical presence rule for state tax jurisdiction is incorrect and is not a requirement under the Commerce Clause of the U.S. Constitution. Instead, the Court ruled that the economic nexus standard establishes states' responsibility to collect sales and use tax from companies that make sales in its respective state borders, even if that company has no other presence, physical or otherwise, within that state's borders.

In the wake of the *Wayfair* decision, many e-commerce businesses have been assessing their state tax compliance requirements

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and, in some instances, initiating sales and use tax collection and remittance procedures in states where the business has had any business activities. Since the economic nexus standard established by *Wayfair* does not require the "physical presence," companies that conduct the majority of their business without physical storefronts, especially online retailers and those engaged in other forms of digital commerce, will experience the most change.

HOW WAYFAIR IMPACTS TECHNOLOGY COMPANIES

In addition to the online retail industry, companies that are expected to be most impacted are technology product companies, which include software, online services, software-as-a-service ("SaaS"), gaming, digital media and content (e.g., music, movies, literature), streaming, information, and data processing, just to name a few examples. However, these types of companies tend to lack the infrastructure to administer multi-state sales and use tax filings due to their traditional non-sales and use tax filing status outside of their state of commercial domicile. In addition, the sales and use tax rules and issues facing such companies are much more complicated than the traditional sellers of tangible personal property.

Post-*Wayfair* considerations for domestic and international tech companies include:

- **Knowing Where to File** – The first step in the state tax compliance journey is to identify the jurisdictions where a company needs to register for sales and use tax purposes. Unless the company's revenues are under each state's economic nexus thresholds, which can vary, a company needs to identify prospective filing jurisdictions based on its current business activities. However, in addition to any current and/or future filing obligations, a company should also assess whether it has had any latent historical filing obligations under the traditional physical presence nexus regime. Although retroactive application of the economic nexus standard is not likely to be enforceable, most states are not likely to forgive the historical liabilities of companies that should have been in compliance based on the physical presence nexus. As such, companies should assess their nexus footprint under both physical and economic standards, quantify potential historical liabilities, and consider liability mitigation strategies (e.g., voluntary disclosure agreements, settlement options, etc.) **before** registering with a taxing authority, since most jurisdictions disqualify registered businesses from participation in voluntary disclosure programs. BDO's **State Economic Nexus Standards** map can help companies identify states' relevant requirements.

- **Knowing When to File** – As of Aug. 6, 2018, 28 states have enacted economic nexus laws, several of which provide an option to remote sellers to either register and collect the sales tax **or** comply with certain use tax notice and reporting requirements, whereby the seller must provide the customer with a statement explaining they may owe use tax and that the sales transaction will be reported to the Department of Revenue. Since the effective dates for registration/collection requirements vary among states, companies should be aware of such dates to comply in a timely manner.

- **Knowing What to Tax** – Unlike tangible goods, digital products or services are generally difficult to categorize for sales and use tax purposes for various reasons. State laws are generally antiquated and do not clearly define or address the taxability of digital products. Gaps exist between taxing authorities' desire to broaden existing laws to include digital products and services and the actual statutory language. This lack of guidance provides ample opportunities, as well as drawbacks, to discern the proper sales and use tax treatment of a technology company's products and services.

  Even after a successful analysis and categorization of the main product, technology companies will need to also address the taxability of ancillary products and service offerings, including set up, maintenance, training, and other revenue streams. In addition, a company's billing practices (e.g., bundling charges vs. itemized listing) may also have tax implications, which need to be explored.

- **Knowing Where It Should Be Taxed** – Unlike tangible goods, digital products do not generally have a shipping address, and customer locations can be unknown, nomadic, or involve multiple locations. Consequently, technology companies will need to address revenue sourcing issues for sales and use tax purposes.

- **Infrastructure Requirements** – When faced with billing sales tax to customers in multiple states, businesses will need solutions for keeping track of sales tax rates of more than 10,000 different taxing jurisdictions within the U.S. that automatically tie to a company's billing system. Businesses without adequate personnel may want to consider implementing an automated process or outsourcing their sales tax compliance function to a third-party, since filing sales tax returns in a multistate environment can be a complex and time-consuming process. In addition, an exemption certificate management solution should also be considered for businesses that sell to exempt customers (e.g., reseller, government, or not-for-profit).

  Fortunately, there are a number of software solutions and outsourcing companies in the market for companies to consider. However, a careful evaluation of software solutions and outsourcing providers should be made, including the cost, implementation complexity, compatibility with the company's accounting system, scalability to grow with the company, and most importantly, availability of operational support, since most businesses will likely face questions from internal and

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external sources who are not used to seeing sales tax charged on their invoice.

- **Economic Nexus for Non-U.S.-Based Tech Companies –** Many businesses that sell digital products and services transcend borders and distances, with many foreign companies selling to U.S. consumers. To a U.S. consumer, downloading software from a U.S., or non-U.S. seller, is virtually indistinguishable. Similarly, since *Wayfair* instituted a new economic nexus standard, the obligation to collect and remit sales tax, should also be indistinguishable between a U.S. and non-U.S. seller. In general, U.S. treaties do not apply to the state's indirect taxes. Therefore, foreign sellers may be subject to U.S. sales/use taxes, franchise/net worth taxes, and gross receipts taxes.

WHAT'S NEXT

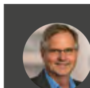
Wayfair is a watershed moment in state taxation. Although the *Wayfair* decision does not eliminate the physical presence standard set by Quill in 1992, the decision will have wide-ranging implications for all businesses, including remote, internet, and online sellers that have historically lacked any physical presence in a state. Overnight, *Wayfair* changes a remote seller's considerations from "do I have physical presence" to "how do I comply with all of the state and local jurisdictions where I deliver my products or services?"

Prior to *Wayfair*, almost half of the states that impose sales and use taxes had economic nexus statutes similar to South Dakota's. It is reasonable to expect that most, if not all, of the remaining states that impose sales and use taxes will now go this route. Companies should begin contemplating whether their online services or digital products are subject to tax and whether these products and services should be sourced to each taxing jurisdiction. They will also need to assess their current sales and use tax systems and controls to determine if they are robust enough to comply with all of the state and local taxing jurisdiction requirements.

Companies should also consult with their auditors and tax advisors to evaluate the potential financial statement implications under ASC 740 (formerly known as FAS 109: *Accounting for Income Taxes*), as the decision may indirectly impact the presumptive income tax nexus requirements applicable to services (including SaaS) in some states where explicit thresholds for economic nexus weren't already established by statute. Additionally, reserves and accruals for sales/use and indirect taxes under ASC 450 (formerly known as FAS 5: *Accounting for Contingencies*) would likely be impacted.

To learn more about *Wayfair's* impact on various industries, **visit BDO's Wayfair resource center**.

Listen to BDO's recent webinar "**How to Deal with the Impacts of Wayfair**" to hear how the decision may impact your company.



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