Multi-State Sellers Beware: The Supreme Court's Wayfair Decision

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LEARNING OBJECTIVES

- Understand the Supreme Court's *Wayfair* Decision
- Understand the Impact of the Decision on Businesses With Multi-State Sales

Outline

I. How The Supreme Court's *Wayfair* Decision Radically Altered Sales Tax Law

II. How Businesses With Multi-State Sales Should Handles Sales Tax

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Why do we refer to the result of this decision being a "Tsunami"?

- A **Tsunami** unleashes sudden, radical change in the ocean's level via huge destructive waves
- Likewise, the **Wayfair** case has unleashed sudden radical change in sales tax law that has the potential to wreak destruction on businesses who may have no idea of the danger that they are in if they do not come into compliance with the new sales tax law.

Why do we refer to the result of this decision being a "Tsunami"?

- States now can impose their sales tax laws on vendors who have no physical presence in their state
- This effect of this change extends far beyond large e-commerce sellers – impacting traditional brick-and-mortar sellers like distributors or manufacturers as well as myriads of smaller e-commerce sellers

Example of the result this sales tax "Tsunami" has had on a business:

- CLIENT is a manufacturer
  - sold goods (mostly for resale) to customers in all states, with annual sales of over $100,000 in many states
  - physical presence caused by salespersons in multiple states
  - were only been collecting tax in their home state
- As a result of *Wayfair*, CLIENT:
  - registered in and began to collect and remit tax in 70 jurisdictions over three divisions
  - set up software to bill and report the tax
  - collected exemption certificates
  - filed voluntary disclosures and remitted substantial back taxes

Example of the result this sales tax "Tsunami" can have on a business:

- CLIENT'S Costs:
  - Client first heard and understood risk January 2019 and shared with his foreign HQ about this exposure
  - By the time Client management approved action earlier in 2021, actual sales tax exposure was in the multi $100Ks
  - Professional service costs for registrations and voluntary disclosures and remittance of tax was in the multi $10Ks
  - Purchases sales tax software – estimated cost $20K
  - Professional services cost setting up sales tax software in the multi $10Ks
  - Internal personnel cost to compile information and seek exemption certificates

I) The Supreme Court's *Wayfair* Decision - A Radical Change to Sales Tax Law

1. Nexus – The Concept & Basis
2. Nexus – The Old Standard
3. Nexus – The New Standard

1) Nexus – Concept & Basis

- "Nexus" means that sufficient connection exists between an entity and a taxing authority for that jurisdiction to impose their tax law on that entity
- Nexus is regulated by provisions in the U.S. Constitution that limit the power of states to impose taxes on interstate sales
- The two provisions that limit states' powers to tax are the:
  - Due Process Clause
  - Commerce Clause

1) Nexus – Concept and Basis

- **Due Process Clause**
  - Amendment XIV §1, to the Constitution:
    - …"[n]o State shall…deprive any person of life, liberty, or property, without due process of law."
  - <u>Requires **minimum** contacts and exploitation of the market</u>
    - Notion of fairness
    - "Some definite link, some minimum connection."

1) Nexus – Concept and Basis

- **Commerce Clause**
  - Art. I, §8, Cl. 3, of the Constitution of the United States provides that "[T]he Congress shall have the power…[t]o regulate commerce with foreign nations, and among the several States and with the Indian Tribes."
  - The purpose of the Commerce Clause is to prevent states from imposing laws that unduly restrict the flow of commerce between the states.

1) Nexus – Concept and Basis

- **Commerce Clause**
  - Overly burdensome taxes definitely restrict the flow of commerce between states.
  - Has been interpreted to require "**substantial** nexus with the taxing state" for a state to impose sales or income taxes on a taxpayer

2) Nexus – The Old Standard

- Pre-Wayfair:
  - "substantial nexus" was equated with a sufficient level of physical presence in a state
- The Supreme Court twice ruled on this subject:
  - *National Bellas Hess, Inc. v. Ill. Department of Rev.* (1967)
  - *Quill v. North Dakota* (1992)

2) Nexus – The Old Standard

- The Court expressed concern about the cost of extending sales tax collection requirements to small businesses. They specifically noted:
  - Cost of complying with overly complex sales tax laws by 45 states plus DC and Puerto Rico and hundreds of locally administered
  - Over 12,000 sales tax jurisdictions exist
  - Annually hundreds of those units have rate changes or are affected by annexations

2) Nexus – The Old Standard

- In both cases, the Court stipulated that nexus required physical presence
- **In *Quill*,** the Court stated that **"substantial physical presence"** was required to establish nexus.
- Unfortunately, the Court did not define **"substantial physical presence"**
- Congress was invited to clarify this but never acted

2) Nexus – The Old Standard

After *Quill*, two factors undermined the physical presence test for nexus:

- First, e-commerce emerged and grew explosively
- Secondly, states passed laws that eroded the physical presence standard to the point that it was no longer a logical standard

This was possible because "substantial physical presence" was never clarified or enforced by Congress or the Supreme Court

2) Nexus – The Old Standard

- When the *Wayfair* decision was issued, 31 states had passed laws requiring tax collection by sellers who had very minimal physical presence in their states
- As a result of these laws, determination of whether nexus existed became UNSUSTAINABLY difficult

3. Nexus – The New Standard

- The Wayfair Case:
  - Resulted from a SD audit of Wayfair, Inc., an e-commerce seller with no presence in SD
  - SD law asserted nexus for sales tax based on either: (1) sales values totaling over $100,000 annually, or (2) 200 transactions annually.
  - The Court decided by a 5-4 count that the SD law did not violate the nexus standards based on the US Constitution

3) Nexus – The New Standard

ALL States Have Enacted Economic Nexus Laws But They are Inconsistent

Economic Nexus Imposition Enacted in

- All 45 states that have state sales taxes
- DC
- AK does not have a state sales tax, but the multiple local tax jurisdictions that are now centrally collected require compliance

3. Nexus – The New Standard

Inconsistences:

- Most states have established an annual sales threshold of $100,000
- Some states allow exclusion of services, resales, or exempt sales – others include all of these sales in their thresholds
- Measurement of a one-year period varies between states
- The ability of states which have locally administered taxing jurisdictions to require compliance is unsettled

3) Nexus – The New Standard

Inconsistences:

- Some states also have transaction count triggers
- Marketplace sales are excluded in some but not all states
- Marketplace sellers are required to collect in nearly every state
- Year period varies – calendar, rolling quarter, or even 12 consecutive months
- Once nexus is triggered, some states allow NO grace period to begin collecting

3) Nexus – The New Standard

Value Thresholds			
	$100,000	42	
	$250,000	2	AL, MS
	$500,000	3	CA, NY, TX
	TOTAL	47	
Transaction Thresholds			
	OR 200	23	
	AND 100	1	NY
	AND 200	1	CT
	N/A	22	AK, AL, AZ, CA, CO, FL, IA, ID, KS, ME, MS, MO, NM, ND, OH, OK, PA, SC, TN, TX, WA, WI
	TOTAL	47	
No Requirement		4	NH, OR, MT, DE

3) Nexus – The New Standard

<u>Marketplace Nexus:</u>

- Think FBA (Fulfillment by Amazon)
- If an online marketplace operates its business in a state and provides e-commerce infrastructure ("forum") as well as customer service, payment processing services and marketing, the marketplace facilitator is required to register and collect tax as the retailer rather than the individual sellers.

3) Nexus – The New Standard

- According to the OK statute, a **Forum** is defined as a place where sales at retail occur, whether physical or electronic. (68 O.S. Sec. 1391)
- Think Website – like Amazon or E-Bay
- Similar to a flea market or even an event like a convention where an organizer has many vendors participating under one roof

3) Nexus – The New Standard

Factors adding to the complexity of complying with sales tax laws on a multi-state basis include:

- Lack of uniformity in acceptance of sales tax exemption certificates
- Drop shipments not treated as sales for resale in some states
- Locally administered taxes
- Constantly changing tax laws

3) Nexus – The New Standard

- A PriceWaterhouseCoopers 2004 study pegged the national average cost of sales tax compliance at 3.09 percent of sales tax collected, with smaller vendors incurring costs exceeding 13 percent.

3) Nexus – The New Standard

Affects on other types of taxes:

- Gross Receipts Taxes - OR and NV gross receipts taxes, OH CAT tax, DE gross receipts tax, and the WA B&O tax
- Income Taxes - HI passed a law flatly stating that their income tax applies if a sales $ threshold is passed
- Other states are generally being more aggressive based on this trend – AND – <u>when a taxpayer registers for sales tax, the company is more visible to states for income tax consideration</u>

II. How Businesses With Multi-State Sales Should Handles Sales Tax

1. Determine: Nexus & Taxability
2. Evaluate exposure; Collect exemption certificates
3. Register and use remedial procedures to clear exposure
4. Procure sales tax calculation & compliance software
5. Consider Other Effects of Multi-State Nexus

1. Examine the Nexus Footprint of Each Company

The Court's ruling does not do away with physical presence as a factor – it adds a new factor

- Companies now face TWO criteria for nexus:
  - physical presence
  - economic thresholds
- Traditional physical presence factors must still be considered when evaluating nexus exposure

Example of Traditional Nexus Troubles

- CLIENT began as a small manufacturer shipping goods from their facility in their home state. Later, they began to provide installation services for their goods using third-party contractors in many states.
- As a result of these installations, CLIENT has nexus in all of the states in which these were done. Their potential exposure was very significant and would prevent them from ever selling the business.

1) Examine the Nexus Footprint of Each Company

Companies having significant sales into multiple states should conduct an annual nexus review:

- Economic nexus: Check sales by ship-to state to check for thresholds
- Physical nexus: Check payroll, inventory, asset listings, sales calls, contracts with third party vendors to install or repair property, and delivery in company vehicles

2) Evaluate exposure and collect exemption certificates

- Compile physical and economic nexus information
- Determine taxability in key states
- For states with likely nexus, determine how many sales are sales for resale – collect exemption certificates
- Then calculate potential tax exposure based on estimated taxable sales during the period in which nexus existed

3) Register and use remedial procedures to clear exposure

- Voluntary Disclosures – cost v. benefits
- Problem with registrations: “Gotcha” Question
- What to do about previously uncollected tax?
- Possible back-billing of tax

4) Procure sales tax calculation & compliance software

- Calculation of tax without aid of software is impractical for most sellers
- Sales tax software is widely integratable with many invoicing programs with prebuilt connectors
- Implementation of sales tax software should be done by experienced personnel due to the complexity of sales tax

4) Procure sales tax calculation & compliance software

Complicating Factors for Setting up Sales Tax Compliance:

- Where to collect tax (states)
- Where to collect tax (locally administered jurisdictions)
- Upon which items being sold should tax be collected
- Handling credit memos and tax adjustments
- Managing exemption certificates
- Reporting taxes collected

4) Procure sales tax calculation & compliance software

Common errors in sales tax implementations:

- Collecting but not remitting tax
- Incorrectly dealing with locally administered jurisdictions
- Not differentiating between sales tax and sellers use taxes in states where different rates or rules apply to interstate versus intrastate sales

4) Procure sales tax calculation & compliance software

Common errors seen - continued:

- Incorrect taxing of added invoice charges like freight, installation, services, etc.
- Improper handling of credit memos and tax adjustments
- Poor management of exemption certificates
- Failure to reconcile tax sales payable accounts

4) Procure sales tax calculation & compliance software

Other considerations besides sales tax calculation software

- Exemption certificate management software is a huge help to sellers with many exempt customers
- Sellers need someone in house or on an outsourced basis to maintain these sales tax functions – including dealing with notices and audits
- Reporting and payment of tax is also a costly and complicated burden. Usage of a third-party filer is often the most economical solution.

5) Consider Wayfair's Effects in Addition to Sales Tax

- The effect that beginning sales tax compliance could have on state income & franchise taxes
- The requirement to Disclose Liability Exposure Issues with Audited Financial Statements under ASC 450 & ASC 740
- Issues Revealed in Due Diligence Processes With the Sale of Businesses

SUMMARY

Sales tax has a profound impact on sales made by multi-state sellers. Failure to comply properly with the burdens imposed by states with varying laws and procedures can be damaging or even devastating to businesses.

Dealing proactively that this burden is important as liability exposure increases in amount and complexity over time. Companies need to properly understand and take action to avoid what can be catastrophic results.

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It is Important for Public Accountants to Have an Awareness of Basic Sales Tax Issues

- Clients typically expect "their CPA" to make them aware of all tax issues – even if only engaged to handle income taxes
- This is a professional liability issue. Engagement documents should specify tax matters covered.
- You can be a valuable ally to your clients by pointing out potential exposures to be avoided or savings opportunities to be captured