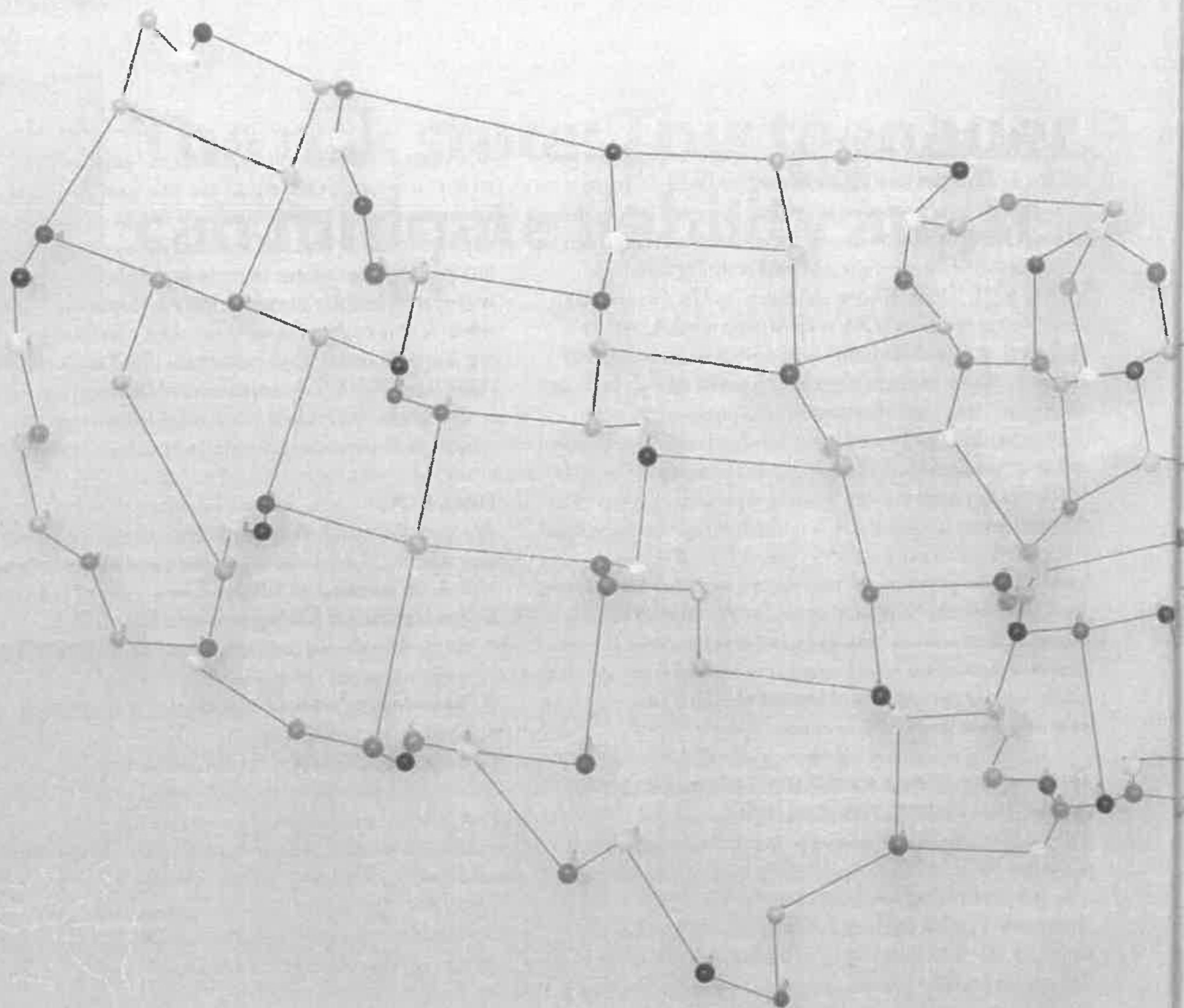

TAX

Sales tax compliance post-*Wayfair*

Here's how to help clients comply with the new sales tax collection requirements.

By David L. Brennan Jr., Esq., LL.M. (tax)

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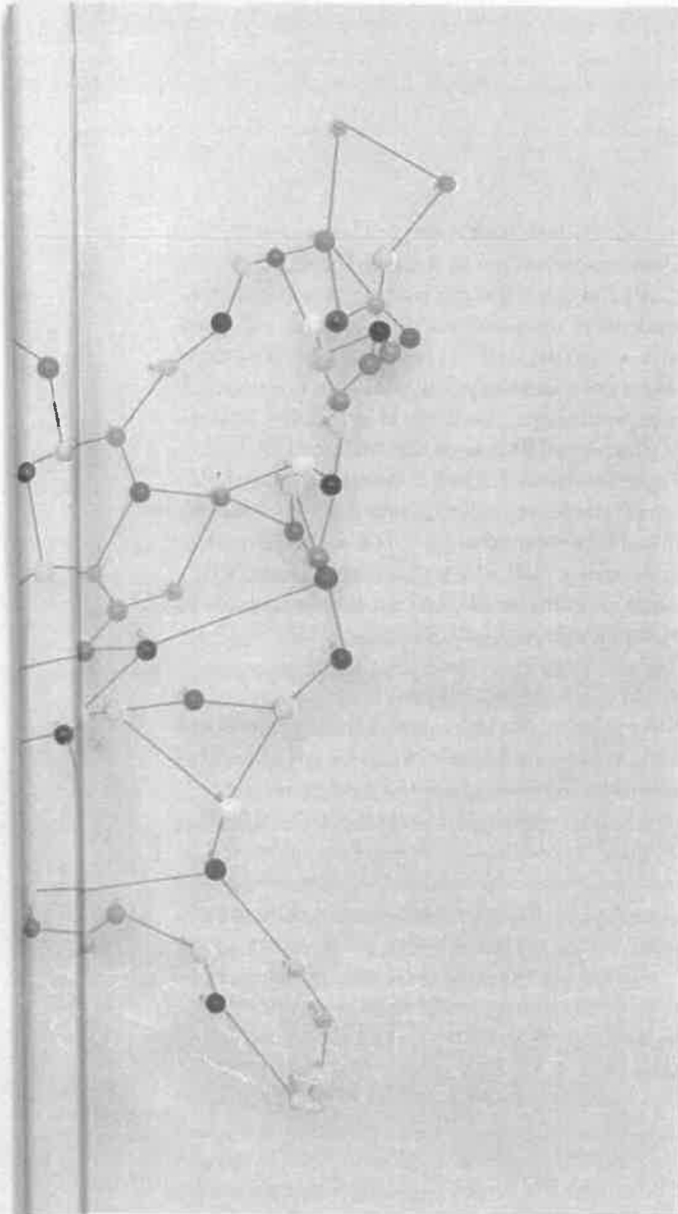

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Sales tax has turned into the Wild West not just for internet retailers, but also for brick-and-mortar stores, manufacturers, and wholesalers alike. With over 10,000 sales tax jurisdictions in the United States, almost any company selling across state lines needs to be analyzing its sales tax compliance. The question is: What are you and your clients doing about collecting sales tax for sales across state lines?

THE GLORY YEARS FOR OUT-OF-STATE SELLERS

In the 1980s and 1990s, states attempted to get companies to collect sales tax on transactions into the state. These companies were predominantly located out of state and were making sales via mail or telephone calls. The companies were not collecting sales tax on the transactions. The states were less than pleased. One state, North Dakota, passed a law requiring any company engaging in "regular or systematic" solicitation in the state to become registered for and collect sales tax. In 1992, the U.S. Supreme Court held a company needed to have a physical presence (employees, property, or offices) in a state before the state could require the company to collect sales tax. This landmark case was *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Quill made sales tax compliance easy for companies: If a company was physically present in a state, it had to collect sales tax for that state. If the company was not physically present in a state, it did not have to collect sales tax, although it was inevitable that there would be some controversy about when companies were "present."

The states were unhappy with this line of demarcation but saw no immediate way around it. That is until the internet arrived. Sales slowly began shifting from in person, in store (with mail-order catalog sales a lesser factor) to online. States began to see a dip in sales-and-use tax revenues because many internet sellers, such as Amazon, were physically located outside of most states and only made sales into these states. Since these internet sellers were not physically present in that state, they did not have to collect sales tax on sales into the state. Consumers noticed that sales tax was not due on these internet purchases, and most consumers failed to realize they were required to pay use tax on their internet purchases to their state of residence. And, of course, brick-and-mortar stores began to suffer as they lost sales to online retailers.

TIME TO KILL *QUILL*

Seeing revenues were on the decline, states began adjusting their tax laws or regulations. One-by-one, states devised new requirements to make companies collect sales tax. States enacted various laws or promulgated regulations to creatively find nexus, such as Massachusetts, which taxed sales based on an electronic "cookie" on a computer (830 Mass. Code Regs. 64H.1.7), and New York, which developed so-called click-through nexus, taxing internet sales that were derived from clicking through advertisements on websites (N.Y. Tax Law §1101(b)(8)(vi)).

Most states changing the rules imposed the obligation to collect sales tax based on a new concept: "economic nexus." Broadly, these states claimed that if a seller who is not physically present in the state makes a certain dollar volume of sales or a minimum number of sales transactions to customers in the state, the seller has sufficient nexus with the ▶

About the author

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Steps to take with clients

- Understand the client's business backward and forward.
- Source the client's sales and number of transactions by state by year.
- Perform a full analysis of which products and services are taxable in what states and jurisdictions.
- Determine whether your client has a sales tax collection requirement in those states for each year because states or taxing jurisdictions have different economic nexus thresholds or implementation dates.
- Clients should decide when, where, and how to get compliant. Delays can result in clients' absorbing for months a liability for the taxes that otherwise could have been collected from customers.

state for the state to impose an obligation on the seller to collect the state's sales tax.

South Dakota was one state that enacted an economic nexus law (S.D. Codified Laws §10-64-2). The South Dakota law says if a seller makes $100,000 of sales into the state or has 200 or more sales transactions into the state in a calendar year, the seller must collect sales tax. The law did not impose sales taxes retroactively. South Dakota's law was designed to provoke litigation and for the issue it raised to reach the U.S. Supreme Court as quickly as possible. South Dakota pursued four large companies it knew would meet its threshold. Three of those companies sued: Newegg, Overstock.com, and Wayfair.

The case became known as *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018). After rocketing the case through state courts and losing, South Dakota took its arguments to the U.S. Supreme Court and won. Now, physical presence is no longer needed: If a company's activity has substantial nexus with a state, the state can require the company to collect sales tax on sales into the state. Likewise, counties and municipalities can impose the same requirements. What is unclear from the U.S. Supreme Court's decision is how low the threshold can be, as this was not addressed in the decision. All that is known for certain is that $100,000 of sales into a state or 200 sales transactions into a state meets a constitutional threshold for allowing states to require companies to collect sales tax.

WHAT IS HAPPENING NOW

Not just states, but also counties, municipalities, and other taxing jurisdictions are requiring retailers to register to collect sales tax. The number of taxing jurisdictions nationwide is approximately 10,000. While it is possible in some states to register at the state level for counties and municipalities, in other cases the law requires a separate registration in each state, county, and municipality.

On top of everything else, taxing jurisdictions do not all have the $100,000 in sales or 200 transactions threshold that South Dakota has (Washington and New Jersey are two states that do). In reality, the thresholds are all over the place. Some thresholds are $250,000 in sales, others are $250,000 in sales and 200 transactions (e.g., Connecticut), and others are $500,000 of sales (e.g., Ohio).

What makes things even more complicated is the effective date of the new thresholds. The effective dates could be any time. Then there is the

IN BRIEF

- For many years, the U.S. Supreme Court's *Quill* decision limited states' ability to tax sales made to customers in their states by out-of-state companies.
- As sales by internet-based companies grew exponentially, states tried various *Quill* workarounds, including cookie nexus and click-through nexus.
- A number of states, including South Dakota, enacted economic nexus statutes, which impose an obligation on out-of-state companies to collect sales tax once they exceed a set dollar amount or number of sales in the state.
- Several large internet retailers challenged South Dakota's economic nexus statute, but the Supreme Court upheld the statute in *Wayfair*.
- Following South Dakota's win in *Wayfair*, many states are enacting or promulgating economic nexus sales tax regimes, with different sales thresholds and effective dates.
- Because there are so many sales tax laws and jurisdictions, CPAs need to plan to help clients comply.

To comment on this article or to suggest an idea for another article, contact Sally P. Schreiber, a JofA senior editor, at Sally.Schreiber@aicpa-cima.com or 919-402-4828.

overwhelming number and wide variety of goods and services that are taxable in various jurisdictions, along with the question of whether exemptions apply. For example, many states tax sales of clothing while a few exempt them (e.g., Pennsylvania, which does tax formal clothing and sportswear), and some apply a cost threshold (e.g., New York taxes articles of clothing that cost $110 or more). Most states do not tax groceries, but a few do, and several tax groceries at a reduced rate. It truly does boil down to a complex jurisdiction-by-jurisdiction analysis.

To ensure registration, these taxing jurisdictions are getting information from whatever source they can find — information-sharing agreements with other taxing jurisdictions or third-party services, to name a couple. These jurisdictions send letters to companies saying the companies need to register based on their economic nexus threshold. These jurisdictions may ask companies to contact the jurisdictions if they believe they do not need to register and provide proof of that assertion. Proof can entail the dollar amount of sales or the number of transactions into the jurisdiction. If the company does not respond timely, the taxing jurisdiction may make certain assumptions and potentially hit the company with a daily penalty until registration is complete.

HELPING CLIENTS

Businesses should have a game plan in place for what to do. If not, here are a few steps to take to navigate these challenges and get clients into compliance (see, also, the sidebar, "Steps to Take With Clients").

First, CPAs need to really understand their client's business backward and forward more than ever. CPAs need to know not only what their client sells, but how the sales are made, what post-sale services are provided (think warranty work), and where the inventory is kept. Does the client have employees in other states? CPAs may be surprised to find out how many of their clients had nexus with certain states long before *Wayfair*, which is a ticking time bomb if the client simply registers in those states without analyzing its exposure first. Knowing about these issues will help CPAs and clients tread carefully.

Second, CPAs need to get each client's sales and number of transactions sourced by state by year and figure the potential economic nexus exposure. This step will require a full analysis of which products and services are taxable in what states. Economic nexus thresholds are calculated on sales of goods and services *before* sales tax exemptions are taken into account. By way of example, if a wholesaler solely has exempt sales under a state's sale-for-resale exemption, it will determine whether it meets the sales threshold without considering whether the sales will ultimately be exempt.

Third, CPAs need to determine whether a client has a sales tax collection requirement in those states for each year. As noted above, while South Dakota's law is $100,000 of sales or 200 transactions into the state, not every state is the same. Knowing the thresholds for each state will allow practitioners to gauge the severity of the exposure for clients before moving to the next step. Furthermore, states have been implementing their new sales tax economic nexus standards with different effective dates. When the standard was implemented will directly determine client exposure. Practitioners should also drill down to the county and municipal levels to determine the threshold for collecting and when the collection requirement was implemented. Simply registering for sales tax everywhere can create more problems than it resolves. However, and despite any potential issues, some clients will want to register everywhere nevertheless.

Finally, clients will need to make the tough decision on when, where, and how to bite the bullet to get compliant. Sometimes it can be much more advantageous to register through a state's voluntary disclosure program to minimize past exposure. Clients may want to register in the states identified as having economic nexus all at once or over several months. However, delays can result in clients' absorbing for months the taxes that ▶

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Not just states, but also counties, municipalities, and other taxing jurisdictions are requiring retailers to register to collect sales tax.

otherwise could have been collected from customers. Whatever the chosen approach, a problem often arises of when the client had nexus and how best to request forgiveness for periods when the client was not registered.

There are ways to potentially get the penalties waived. It will be on a case-by-case basis depending on the client's facts. The real challenge is choosing the best path to minimize past exposure and collect tax from customers going forward.

An equally important consideration is how clients are going to manage sales tax compliance going forward. For some companies, this simply means purchasing software to plug into their sales software. For other companies with custom accounting systems, the software compliance side of things can be both difficult and expensive.

These decisions need to be made *before* registering. Companies will also need to determine whether they need to register for other state taxes, such as income tax or franchise tax.

Though intuitive, it bears mentioning: Every tax type in every taxing jurisdiction for which a client is registered is potentially another audit lurking in the future. Ensuring clients are registered only where needed and for the tax types necessary will help avoid headaches later. In about three to five years, clients will start being audited wherever they are registered. Instead of dealing with perhaps one or two audits in a year, imagine juggling five to seven audits simultaneously. Despite best efforts, multiple simultaneous state audits may become a reality for many clients.

It also bears mentioning that if the client is also an audit client of your firm, then there is a possible contingent liability growing daily that should be addressed. The level of exposure for past sales tax liability for clients and the firm probably warrants updating annual engagement letters to address these issues.

TALK TO YOUR CLIENTS AND DEVELOP A PLAN

Have a talk with clients about their potential nationwide exposure for sales tax. Clients will need help to determine where to register and for which taxes. Staying ahead of the curve will ensure the client's business has the best chance of staying viable over the next few years. ■

AICPA RESOURCES

Article

"Professional Liability Spotlight: Addressing Risks Related to the TCJA and *Wayfair*," *JofA*, Feb. 2019, tinyurl.com/y3l7rekd

CPE self-study

Multistate Income Tax (#732476, text)

Multistate Taxation — Tax Staff Essentials (#157645, online access)

Nexus Update: Latest Developments in State Income, Franchise, and Sales Taxes (#164253, online access)

For more information or to make a purchase, go to aicpastore.com or call the Institute at 888-777-7077.

Other resources

"*South Dakota v. Wayfair*: What It Means for Your Firm," tinyurl.com/yy68y3vn

Compliance & Advisory: Roadmap to Your Sales and Use Tax Practice Model, tinyurl.com/y5dowsjg

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