WebsterRogers LLP
Certified Public Accountants ♦ Consultants

Six Steps to Sales/Use Tax Compliance

More than two years after the infamous *Wayfair* decision, businesses continue to struggle with sales and use taxes. Particularly hard-hit are small-to-medium sized businesses that deliver their products, provide services, or license software to customers in multiple states. Prior to *Wayfair*, many of these businesses had sales tax collection responsibilities only in their home state. Now they are faced with the daunting task of complying with the myriad of multi-state sales and use tax requirements across the U.S.

WebsterRogers has helped many of our clients tackle these issues so that they can get back to the task of growing their business without the fear of sales tax "surprises" down the road.

In this article, we'll discuss the six steps to sales/use tax compliance that businesses can follow to protect themselves from costly sales tax exposure and achieve an efficient ongoing sales tax process.

Background

In *Wayfair v. South Dakota*, the US Supreme Court held that states can require businesses to collect and remit sales and use taxes even if the business has no in-state physical presence. States may now subject businesses to a sales/use tax collection and filing responsibility based solely on "economic" presence in the state. This "economic" presence can be as little as $100,000 of sales to in-state customers or 200 sale transactions with in-state customers.

For more information regarding the impact of Wayfair see our previous article Sales Tax Nexus. [The Wayfair Decisions – 2 Years Later.]()

Impact

Sales and use taxes tax can have a significant impact on a business' bottom-line.

Sales tax typically is a "pass-through" item. In other words, the business bills the tax to its customers on its sales invoices and then remits the collected tax to the state. The business isn't out-of-pocket for the tax but instead is merely a conduit. However, if you fail to charge the tax to your customer, you're still responsible for paying the tax to the state. So, failing to collect the tax in all states where you're required to do so can result in shifting the sales tax cost from the customer to your company. Further, these state and local tax obligations (including tax, interest and penalties) will grow over time. That can be a real hit to your business' bottom-line.

Sales and use taxes are among the most common exposure areas identified during the due diligence phase of a business acquisition. Private equity firms and others seeking to purchase an existing business have become sensitized to the significant potential impact of sales and use tax exposure in the wake of *Wayfair*. As a result, most business acquisition due diligence plans include an examination of state tax nexus and potential sales tax exposure, and there has been a significant increase in the number of hold-backs and escrows related to sales/use taxes as well as business purchase transactions that have been terminated as a result of sales/use tax exposure.

Solution

One of the most common questions we get from businesses who want to identify their sales tax filing obligations and come into compliance is *"where do I start?"* How do I identify where I need to collect tax and file returns? Are my products taxable in all states? Are additional charges (like services and shipping) taxable? What rates should I charge? What types of exemption certificates can I accept from my customers? How do I file sales tax returns?

WebsterRogers assists clients in tackling all of these questions (and more). We can help you follow these ***Six Steps to Sales/Use Tax Compliance*** to minimize exposure risk and implement the right processes to remain sales tax compliant.

STEP 1: *Identify Nexus*

44 of the 46 states that impose a sales/use tax now have *Wayfair*-type economic nexus provisions. For most of these states, as little as $100,000 in annual sales or 200 transactions results in economic nexus and a filing obligation.

Further, U.S. tax treaties apply at the federal level but not the state level. Therefore, foreign businesses selling into the U.S. also will be subject to states' economic nexus provisions and sales/use tax compliance requirements.

And don't forget good old fashioned ***physical nexus***. Many businesses are not aware of how little it takes to trigger physical nexus. *Wayfair* put sales tax nexus in the news headlines and made everyone aware of the issue. But don't fall into the trap of assuming your company didn't have nexus before *Wayfair*.

Even before *Wayfair*, sales tax nexus could be triggered by activities as minimal as sending a sales representative (whether an employee or a contractor) into a state to solicit sales. Having inventory stored at a third-party fulfillment center is another common way to trigger physical nexus. Even if you don't have control over the inventory's location, states still will deem in-state inventory to trigger nexus.

Finally, when evaluating state tax nexus, it is important to examine all tax types imposed by the states. A common mistake that businesses make is focusing on one tax type (like sales tax) and ignoring other tax types (like income and franchise taxes). Although sellers of tangible personal property (physical goods) enjoy a slightly higher level of nexus protection for net income tax purposes, this safe harbor doesn't apply to service and other types of businesses, and it doesn't apply to franchise, gross receipts or other taxes not based on net income.

STEP 2: *Determine Taxability of Products & Services*

Let's say you've determined that you have sales tax nexus in a state. What now? The next step is to determine whether the state taxes the products and services that you sell.

NEXUS + TAXABLE SALES = TAX REPORTING REQUIREMENT

If you have nexus with a state that taxes any of your products or services, you have a sales tax collection and filing requirement. If you have nexus but the state doesn't tax your products or services, there is no sales tax collection responsibility.

In general, states tax virtually all sales of tangible personal property (physical products) unless there is a specific statutory exemption. More on exemptions later…

Services are a bit more complicated. Most states tax only a few services that are specifically listed in their statutes. However, the list of taxable services continues to grow as states seek new revenue sources, and as technology shifts more products from physical to electronic versions (e.g., books, music, movies). A few states tax virtually all services (e.g., Hawaii, New Mexico, South Dakota, West Virginia).

Businesses licensing software, providing online services, or selling digital products face even more complicated rules. Even the task of defining the product in order to determine taxability can be a challenge, as these products often involve a mix of various different elements, and states' sales tax rules don't keep pace with advances in technology and business practices.

Then there is the issue of additional charges that often accompany the sale of a product or service, like shipping, handling, financing charges, discounts, coupons, rebates, installation, implementation, and training. Taxability for these charges also will differ by state.

It will take time, research and an intimate knowledge of your company's products and services to accurately determine taxability. But this effort is well worth it to avoid significant tax exposure or tax overpayments.

STEP 3: *Quantify Potential Tax Exposure*

Now that you've identified the states where you have nexus, and which of your products and services those states tax, the next step is to quantify the historical tax exposure.

When a business hasn't filed tax returns in a state, there is no statute of limitations to limit how far back the state can go to assess tax, interest and penalties. The state can go all the way back to the date nexus was first triggered.

It is important to quantify the potential exposure before determining how to move forward. For some companies, the state tax exposure amount may need to be recorded as a liability for financial statement purposes. The amount of historical exposure also may influence the plan you choose to implement in order to come into compliance with each state's filing requirements (as we'll discuss in Step 4).

To quantify historical tax exposure, you'll need to gather sales and income data and totals by state and by product for all states and periods where nexus exists. You'll want to quantify exposure for all tax types (sales/use, income, franchise) imposed by your nexus states. Companies often make the mistake of overlooking other taxes imposed by a state when attempting to clean up their sales tax exposure. This can lead to additional unexpected assessments.

STEP 4: *Mitigate Historical Tax Liabilities*

Once historical exposure has been quantified, you'll need to decide on the best approach to mitigate this exposure. Following are some of the steps you might take to mitigate historical exposure.

• **Obtain Exemption Certificates.** If you sell to customers who may be exempt (e.g., manufacturers, resellers, government, religious organizations, nonprofit organizations, etc.), the first and most successful exposure mitigation step may be outreach to your customers to obtain exemption certificates. An exemption certificate is required in order to substantiate exemptions claimed by your customers. It is a good practice to obtain an exemption certificate from customers who claim exemption before marking them as exempt in your billing system. However, since you are just now implementing a sales tax process, you'll need to go back and obtain the exemption certificates for prior sales during this exposure mitigation phase. Once a valid exemption certificate has been obtained from a customer, all historical sales covered by that exemption can be removed from your tax exposure estimate.

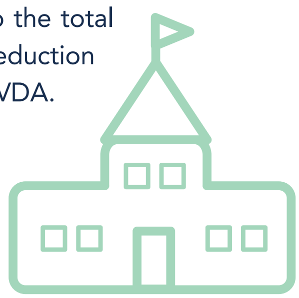
• **Ask About Use Tax Paid.** You also may reach out to customers to find out whether they have already paid use tax to the state on their purchases from your company. Purchasers generally have an obligation to pay use tax directly to the state if their vendor fails to collect the sales tax from them.[1] Some of your customers may be aware of this obligation, and others may have been audited and assessed the tax.

1 The "use tax" is "complementary" to the sales tax. Which means that the use tax is due from the purchaser when the seller fails to collect the sales tax. In other words, the use tax acts as a sort of safety net to capture transactions that escape the sales tax.

STEP 4: Mitigate Historical Tax Liabilities, continued:

Obtaining documentation from customers proving that they have already paid the use tax (voluntarily or via audit assessment) is another way to reduce your historical sales tax exposure. Although this can reduce your historical sales tax exposure, it is important to note that this cannot be used as an option to avoid charging sales tax to customers on a go-forward basis.

• **Voluntary Disclosure.** Pursuing a voluntary disclosure agreement ("VDA") can significantly reduce historical exposure. Under a VDA, the state enters into a specific agreement with a taxpayer, limiting the number of prior years for which the state will assesses tax, as well as waiving penalty and in some cases interest. Because of the costs associated with obtaining a VDA and satisfying the related reporting requirements, this option typically is used when the potential exposure reduction is significant. When deciding whether to pursue this option, businesses typically do a cost-benefit analysis, comparing the cost of pursuing a VDA to the total tax, penalty and interest reduction to be achieved under the VDA.



• **Amnesty Programs.** Participating in a state's amnesty program (when available) also can significantly reduce historical exposure. Unfortunately, there are only a few states currently offering amnesty programs. If a state where you have historical exposure offers an amnesty program, be sure to carefully check the specific requirements of the program. Failing to strictly adhere to the amnesty program's requirements can cause you to lose the exposure mitigation sought, and could result in additional unforeseen exposure.

STEP 5: *Implement a Sales / Use Tax Compliance System*

Once you've identified your nexus states, determined which of your products and services are taxable in each state, and mitigated historical tax exposure, it's time to implement a sales/use tax compliance system to ensure that you are able to satisfy your ongoing tax collection and filing obligations.

With approximately 10,000 state and local taxing jurisdictions in the U.S., staying on top of sales tax rates can be a daunting task. If your sales are limited to a small volume of repeat customers at fixed locations, manually maintaining sales tax rates may be a manageable undertaking. However, if you sell to a large number of customers and/or locations, an automated sales tax solution likely is the best approach. An automated sales tax solution helps streamline sales tax compliance, increase accuracy, reduce compliance costs, and reduce risk.

Sales tax automation involves integration between a company's billing system or ecommerce system and third-party tax software that contains tax rates and tax calculation functionality. If you use a "shopping cart" software for your online sales, that software may already have built-in sales tax functionality or may interface with an external sales tax software tool.

If you sell online via a marketplace platform (e.g., Amazon, eBay, etc.), that provider may already be collecting sales tax on sales made via that marketplace. However, you will still be responsible for collecting and remitting sales tax on any taxable sales not made via that platform and any taxable sales for which the marketplace provider doesn't collect the tax. [2]

2 Marketplace facilitators are required to collect tax on behalf of their sellers in several states, but not in all states. It is important to confirm where (and on which sales) your marketplace provider is collecting and remitting tax on your behalf vs where they are not.

STEP 6: *Maintain Ongoing Sales / Use Tax Compliance*

After historical exposure has been addressed and a sales/use tax compliance system implemented, it's time to register, begin collecting sales tax, and begin filing returns in the states where your company has a filing obligation. Your process also should include continued monitoring of nexus, as well as maintaining and periodically updating processes and procedures based on changes in tax laws and business operations.

This can become a costly and labor-intensive process, especially as the business continues to grow and trigger nexus in additional states. Automation and ongoing process improvements may significantly decrease this burden. Management also may decide to outsource all or part of this ongoing process in order to minimize risks and enable the business to shift its manpower resources to other strategic initiatives.

Six Steps to Sales / Use Tax Compliance

WebsterRogers' team of State & Local Tax ("SALT") professionals has over 35 years of sales/use tax experience. We are ready and able to assist your company with any and all sales tax issues, including:

- Nexus Reviews
- Sales Tax Compliance
- Consulting
- Due Diligence for Business Acquisitions
- Transaction Analysis
- Taxability Reviews
- Voluntary Disclosures
- Tax Amnesty
- Sales Tax Systems Selection & Implementation
- Sales Tax Procedures Implementation & Review
- Sales Tax Risk Minimization

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