Bloomberg Exchange

https://news.bloombergtax.com/tax-insights-and-commentary/software-licensers-must-address-sales-tax-before-its-too-late?context=search&index=1

Tax Insights & Commentary

Software Licensers Must Address Sales Tax Before It's Too Late

July 6, 2022, 4:45 AM

Companies that provide software as a service should understand the state sales tax exposure to their businesses so they don't open themselves up to unnecessary risk by not paying taxes, says Marcum LLP's John Bonk.

Many software as a Service, or saaS, companies overlook an area of tremendous potential tax exposure that can be life-threatening for their businesses. Many don't recognize that even minimal contact with a state is enough to force compliance with sales tax rules. Further, while companies are generally aware that physical products are subject to sales tax, they may not understand that digital products and services can also be taxable.

Sales Tax Nexus

Nexus is a state's ability to impose tax on a taxpayer. The rules related to nexus vary state by state and are constantly changing. The basics of nexus seem deceptively simple but are quite complicated.

The existence of property or payroll will create nexus in every state. Property can include a home office, and payroll can include remote employees as well as temporary work performance of even one day. Out-of state companies with significant in-state sales are particularly vulnerable to nexus and the resulting tax exposure.

Remote workers create nexus for sales tax purposes, and with the dramatic growth of remote working arrangements during the Covid-19 pandemic, unexpected sales tax exposure became more common.

The activities of remote employees do not need to be related to the generation of the revenue in the state for nexus to exist. When a company has a remote worker, it is likely registered for payroll-related taxes in that state and therefore already known to the state. It is only a matter of time before the state reaches out to the company about their nexus status—this limits the taxpayer's options to address its tax exposure.

In 2018, the US Supreme Court decision in *South Dakota v. Wayfair* opened the door for states to adjust their nexus rules, and many states took the opportunity to establish more aggressive sales and transactions thresholds for nexus. The most common, and the lowest, threshold is $100,000 in sales or 200 transactions; the specifics of what comprises a sale vary by state.

Exceeding these thresholds is enough to create nexus—physical presence is not required. As a result, many more companies that historically had to worry about sales tax in only a handful of states are now required to register, collect, and remit sales tax in many more.

Understanding nexus is complicated, and the necessity of being vigilant is too often disregarded. Many businesses are served by competent federal tax professionals with limited state tax experience, and important details can be missed.

Every company should ask itself: Do we have any connection to a state where we do not currently file state tax returns? If the answer is yes, you should have an informed opinion as to why you are not filing a return there.

Understanding Exposure

Sales tax is a tax on consumers that is collected and remitted by retailers; sales taxes are a liability to retailers if uncollected. They apply not only to most tangible personal property but also to certain services.

Technology and software companies are the most common to have significant exposure; more than half of all states tax SaaS products. The taxability of a SaaS

product can vary state by state, depending on the specifics of the underlying SaaS—for example, a cloud-hosted canned software vs. an information/data service.

Non-collection of sales tax amounts to an unwritten discount on sales to customers. Since the nexus resides with the retailer, who has the requirement to collect tax from consumers, failure to collect results in the retailer assuming the liability of the customer.

Many companies fail to recognize this liability, falsely assuming that failure to collect tax will result in the tax being applied to the customer by state revenue departments. While the customer is legally responsible for the tax, and the retailer has the right in most cases to request it from the customer, the retailer is most commonly held responsible for its failure to collect. After all, it is easier for a state to audit a retailer that may have hundreds of customers than to audit the hundreds of customers. Furthermore, companies trying to collect past due sales tax from customers will run into issues of feasibility and customer relations.

State tax issues generally arise during an audit or during a due diligence examination. During an internal audit by an accounting firm, exposures may require an adjustment and/or disclosure by the company. Companies subject to state audit will find that no statute of limitation exists for non-filing, and the resulting exposure can be significant. There have been cases where states have required 25 years’ worth of returns.

During due diligence examinations, state tax exposures are common and can lead to escrow and/or a decrease in purchase price. An escrow is used to hold back funds from a transaction until an exposure is addressed by the seller, while a decrease in purchase price just reduces the total amount by the exposure or some portion of it.

SaaS Exposure

SaaS companies face a unique challenge when it comes to understanding their exposure. While it is easy for a company selling tangible property to understand where its items are shipped, the use of SaaS is much more difficult to track. A SaaS company may have a contract with a headquarters company using the SaaS across offices in multiple states.

The way a SaaS company addresses this issue is unique to the facts of each company. Sometimes they are able to identify the locations of use, while at other times, the only information they have is the billing address of their customer.

Some states allow the use of a multiple points of use exemption, which shifts the burden to the consumer. In these instances, the consumer would remit use tax, based on its use of the product or service in each state and based on a reasonable allocation. SaaS companies cannot assume that consumers will take on this burden and must have a multiple points of use certificate from their customers for their records.

Addressing Exposure

The first step in addressing a possible tax issue is calculating the potential amount of exposure. Once the exposure amounts are known, companies can make decisions as to how to address them. Depending on facts and circumstances, the company may file back returns or file a voluntary disclosure agreement. They allow a taxpayer to enter into an arrangement with a state to limit the look-back period for filings, waive penalties, and sometimes even waive interest.

After the voluntary disclosure process is completed, the company has a clean slate and will continue to file the returns on a go-forward basis. The main requirement for a taxpayer to be able to enter into a voluntary disclosure is that they cannot have been contacted by the state about their sales tax exposure. The company must take the initiative.

Conclusion

At a minimum, a taxpayer should understand the state sales tax exposure to the business. While a business decision to refrain from filing tax returns can be made, this step should never be taken without first obtaining a clear understanding of the potential tax exposure associated with nexus. After all, there is no reason to put your business at risk when the issues can be easily addressed.

This article does not necessarily reflect the opinion of The Bureau of National Affairs, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.

Author Information

John Bonk is the national state and local tax (SALT) practice leader at Marcum LLP.