INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

ONE YEAR LATER, EFFECTS OF *WAYFAIR* ON TECHNOLOGY COMPANIES STILL UNRAVELING

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The impact of the U.S. Supreme Court's decision in ***South Dakota v. Wayfair***, now over a year since it was handed down, continues to reverberate throughout the business world. As the year wears on, it's clear the decision carries implications for industries beyond retail and, indeed, for the very basic functions of any business with multi-state operations, which clearly includes technology companies. Not understanding these implications can have significant financial consequences for technology companies—for example failure to collect sales taxes on remote sales can result in significant tax assessments for the seller beside other income tax related ramifications.

Management, with their tax advisor's guidance, should be assessing potential sales and use tax exposures in light of *Wayfair*. Management should also consider how the *Wayfair* decision affects some less-obvious areas of their organizations. Managing the fallout from *Wayfair* requires a holistic view of how your business' areas of operation intersect with sales taxes, as well as other state taxes, such as income taxes. In other words, it requires leaders at technology companies to develop a comprehensive understanding of their total tax exposure.

The technology industry continues to pull at the thread of the *Wayfair* decision, unraveling its implications from income tax obligations and mergers and acquisitions (M&A) repercussions, to financial reporting changes and new marketplace facilitator tax laws. As with most matters concerning taxes, these issues seem straight-forward but can be very complex.

WAYFAIR SHEDS LIGHT ON HISTORICAL NONCOMPLIANCE

In its June 21, 2018, decision, the U.S. Supreme Court replaced the physical presence nexus standard in favor of an economic one, thereby removing constitutional barriers to states' lawful ability to collect sales and use taxes from out-of-state sellers. The *Wayfair* decision had a domino effect: States began adding or revising statutory language for remote sales/use tax collection, and several states introduced laws that automatically went into effect following the decision. As of the publication of this article, all but two states (Florida and Missouri) have enacted an economic nexus rule, which makes collecting and remitting sales taxes a likely necessity: If you aren't collecting sales tax, or aren't collecting the proper amounts, you may be taking on significant financial risks.

In light of the *Wayfair* decision, it is appropriate for every management team to reassess its organization's nexus, or connection, with each state where it ships or delivers sales. For many, this assessment may reveal a business already had state tax nexus, even before the *Wayfair* decision was issued, because they had an in-state physical presence. For example, software providers often offer onsite installation and training to accompany their product sales. If this is the case, the software seller most likely already had an in-state physical nexus because of the onsite installation service performed in the state. It is prudent for such sellers to quantify their historical exposures and consider mitigating historical liabilities through voluntary disclosure agreements (VDAs) before registering for sales taxes.

STATE INCOME TAX OBLIGATIONS TRIGGERED

The tax implications of *Wayfair* extend beyond sales and use taxes. The Supreme Court held that an activity is subject to a state's power to tax when "the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction." As such, *Wayfair* lifts the constitutional barriers to states imposing state income tax filing obligations on remote sellers, too.

Many businesses have been anticipating states will pass laws that codify not only their entitlement to sales taxes, but state income taxes, too. However, from the state income tax perspective, this generally has not happened. Most states already have a general nexus provision in their statutes that allows them to levy income taxes to the fullest extent allowed under the U.S. Constitution.

As a next step, states will likely clarify and/or enforce their preexisting laws. Massachusetts, for example, issued a proposed regulation indicating that if a remote seller's sales volume exceeds the state's sales tax safe harbor threshold, barring Public Law 86-272 immunity, the company will have an income tax filing obligation, too. Public Law 86-272 is discussed below, but as an overview: If you are selling tangible property such as hardware, then you may still be protected under this 1959 federal statute, which prevents states from levying an income tax on out-of-state companies if their activities within the state are limited to soliciting orders for the sale of tangible personal property and if the orders are approved and filled from outside the state.

Rather than proactively preparing to address any income tax exposure, many companies are delaying action until they receive a notification from state taxing authorities that says they need to file income tax returns. For obvious reasons, this isn't the best way to manage potential tax exposure. To determine whether you may be required to pay state income taxes, first look at the composition of your sales. Are you selling tangible property or a service? For technology companies, it could be either, as many companies offer solutions that may include installation, training,

Wayfair Case Study

If you are in the business of making retail sales of tangible property or taxable services, it is more likely than not that you will need to charge, collect and remit sales taxes. For businesses that have not been collecting sales/use taxes on their out-of-state transactions, their financial statements should reflect this liability and, if audited by state tax authorities, there may be a significant cash outlay.

CASE STUDY: ECONOMIC NEXUS OF A SOFTWARE AS A SERVICE (SAAS) COMPANY

A SaaS company was collecting sales and use taxes only for sales made to in-state customers, even though it had customers located nationwide. When the organization's owners decided to sell the entire business, the buyers discovered the company's failure to collect taxes on remote sales during their due diligence process and determined that there would be a significant successor liability related to these uncollected taxes. Once the sales tax liability was discovered, the buyers sought a considerable purchase price reduction for the acquisition of the company, which meant the seller had to sustain an economic loss they had not anticipated. Ultimately, the parties agreed on a plan to remediate the exposure in non-filing states through participation in state Voluntary Disclosure Programs, including an escrow that would allow the buyer to resolve the unpaid sales tax issue occurring under the seller's watch. The buyer then spent the next year working with its outside sales tax professionals to negotiate and finalize the terms of VDAs.

maintenance and hosting services in addition to hardware/ software products.

However, if you are selling SaaS solutions or tangible property that is installed by a company employee or contractor, these sales, by definition, contain a service element, which precludes Public 86-272's applicability, unless the unprotected activities are *de minimus*.

Technology companies should also be aware of the possibility that while states may not seek to apply an economic nexus standard for sales and use taxes for periods prior to the June 2018 *Wayfair* decision, they may do so for other tax liabilities.

FINANCIAL STATEMENT OBLIGATIONS

Wayfair will also have an impact on financial accounting under GAAP, namely, Accounting Standards Codification (ASC) 450 for sales taxes and 740 for state income taxes.

ASC 450 outlines the accounting and disclosure requirements for loss contingencies. This GAAP rule provides that an estimated loss from a loss contingency must be accrued as a charge to income if both the amount of the loss can be reasonably estimated and if information indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

Under ASC 740, existing income tax positions must be reassessed at each balance sheet date to determine whether an income tax benefit should be recognized, or continue to be recognized and, if so, how much of the benefit should be recognized based on new information. Depending on a corporation's specific situation, an analysis should be performed to determine if state income tax exposure exists in non-filing states due to economic nexus or factor presence rules. Given that a company may have taken a historic position in reliance on constitutional arguments that a physical presence was required before a state may impose an income tax, this position will now need to be re-evaluated in light of *Wayfair*.

FULL IMPACTS ON M&A TO BE SEEN IN 2020

Because *Wayfair* was decided in June 2018, its impact on deal making won't be fully understood until after 2019 and beyond as potential buyers evaluate the consequences of *Wayfair* on financial metrics and potential contingencies.

For instance, deals involving foreign buyers may be delayed as these entities seek to understand how remote sales tax collection might affect their business. For foreign companies, *Wayfair* proves a bit of a paradox: On the one hand, they may see the benefit in striking a deal with a U.S.-based company that has a better grasp on the sales and use tax system, but on the other, the complexities around *Wayfair* and the amount of education required to understand the U.S. sales tax system may prove too intimidating for a prospect to tackle, even with a U.S. deal partner.

Of course, the nature of being a U.S. domestic company doesn't mean being automatically endowed with all the knowledge required to be in compliance with *Wayfair*. Given the potential complexity, even companies with knowledge of their sales and use tax requirements may not be able to easily comply with their obligations. In fact, our Technology Outlook survey found that more than two-thirds (68%) of tech CFOs harbor high or moderate concerns about tax changes in 2019, with changes required by the *Wayfair* ruling driving 10% of that worry. Meanwhile, 60% of tech CFOs expect to pursue M&A in 2019, and 53% intend to pursue it for an exit strategy. Valuations will require additional due diligence and scrutiny of tax liability for all parties involved.

Take, for example, a U.S. technology company being acquired by a private equity firm. Though the company had implemented a robust sales tax determination engine for the 35 states into which it made sales, it hadn't employed subject matter experts to verify whether its products were correctly mapped to the proper code for the purpose of determining whether sales were subject to tax in a given state. Incorrect mapping resulted in a material historical sales tax liability prior to the acquisition, necessitating pre-close clean-up and precious time spent before the deal was closed.

If you are considering a sale and believe you may have uncollected sales and use tax exposure in a state, there are paths to remediation. To avoid a liability and payment of interest and significant penalties for failure to file, technology companies should engage a professional service firm to anonymously reach out to states with material exposure amounts by participation in a VDA, whereby the company acquiesces to payment of the historical liability while having the benefit of a limited lookback period (often three years) and a penalty waiver.

Some companies have chosen to file on a prospective basis, thereby ignoring the historical nexus and related exposure. This has resulted in sales tax assessments for prior years, by preventing their ability to negotiate a limited lookback period, since most voluntary disclosure programs are not available for a current registered taxpayer. For technology companies that have been making sales for seven, eight, or more years, this means their liability (and interest and penalty payments) may double or triple what they would otherwise have been required to pay had they qualified to enter into a VDA with the ability to take advantage of a limited lookback period.

COMPOUNDING COMPLEXITY: MARKETPLACE FACILITATOR TAX LAWS

While *Wayfair* has obvious effects on the e-commerce sector, its impact also extends to the middlemen of retail software and hardware sales transactions. As the year continues to unfold, unforeseen exposure for both retailers and these middlemen has the potential to have great impact as companies begin to understand their collection and reporting responsibilities.

New sales tax laws are now requiring marketplace facilitators—third-party entities that facilitate sales such as Amazon—to collect and remit sales and use taxes on behalf of retailers. In the technology industry, an example is a consumer purchasing TurboTax software through Amazon. These laws help to substantially reduce the number of remote sellers that state tax authorities may seek to audit. We expect nearly all states will enact marketplace facilitator tax laws in the near future.

By nature, marketplace facilitators don't have intimate knowledge of the goods or services being sold as the retailers themselves. This lack of familiarity could result in a fair amount of under-collected sales tax if these sales are not properly accounted for or mapped to the correct taxability classification. Also, this under-collecting is compounded by the fact that there is lack of clarity around who should ultimately be responsible for the correct amount of sales taxes collected and reported to the taxing agencies, whether it's the retailer or the company facilitating the sale.

It is imperative that companies keep a record of how each sale is taxed and who has collected and/or reported the sales tax. This enables transparency into potential liabilities, which, by extension, allows companies to prepare for the payment of such liabilities.

The complexities and far-reaching effects of the *Wayfair* decision for technology companies cannot be understated. Sales and use tax exposure is just the tip of the iceberg. From state income tax to financial reporting, *Wayfair* has unleashed a formidable amount of change to the most basic tax operations of your business. If your company is in the business of making sales, you should be assessing how *Wayfair* compliance has altered your total tax liability.

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