INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

BREAKING DOWN SALES AND USE TAX COMPLIANCE FOR SaaS COMPANIES

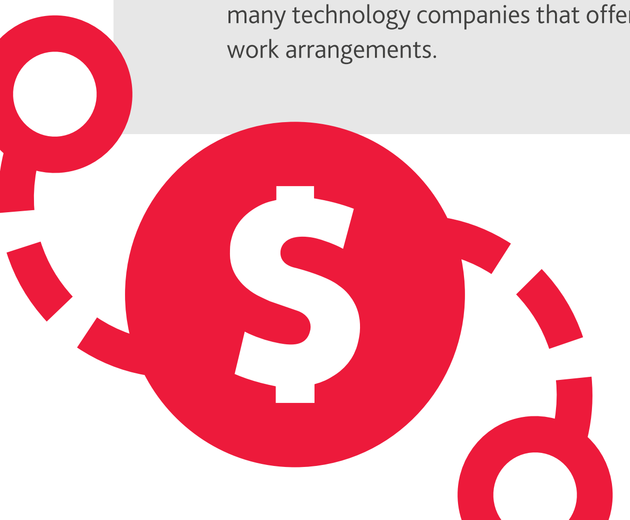
For many software-as-a-service (SaaS) providers, sales tax compliance remains a challenge. Approximately 20 states currently subject SaaS to tax, and taxability varies from state to state, which impacts many SaaS companies that scale rapidly and unknowingly expand their nexus footprint into these states.

In *South Dakota v. Wayfair, Inc.*, the Supreme Court held that states may assert nexus on an out-of-state business that exceeds a reasonable economic threshold, whether or not the business has physical presence in the state. The 2018 ruling is particularly impactful to SaaS companies because:

- Cloud-based offerings are delivered electronically without the need for in-state presence.
- Following the decision, all states have enacted some form of legislation that adopts an economic nexus threshold (typically, this threshold is $100,000 in sales or 200 transactions).
- With Wayfair standards now in place for over three years, historical noncompliance is becoming more material, and states are expected to increase enforcement.

The issue of sales tax compliance has become more pressing now for two key reasons:

- **First**, liabilities and exposures are cumulative, and material exposures may continue to mount for companies that are noncompliant.
  - This is especially relevant for companies that have failed to adhere to the Wayfair nexus standards.
  - In addition, the increasing presence of remote employees will expand the nexus footprints of many technology companies that offer flexible work arrangements.
- **Second**, while tech M&A activity is expected to slow for the remainder of 2022, some SaaS firms may still be looking to sell or raise capital. Sales tax exposure will remain a priority consideration during the due diligence process for any strategic deals taking place.
  - Due to the short lifecycle of most technology companies, tax due diligence is key in preparing for an exit or capital raise.



THE IMPACT OF EVOLVING TAX POLICY

An increasing number of states are amending the statutory definition of taxable services to include SaaS or are categorizing SaaS as taxable "tangible personal property." For example, Maryland recently enacted legislation that imposes sales tax on certain digital products, including SaaS.

Adding to the complexity, states often construe certain technology-based services as taxable SaaS. For example, state administrative guidance and case law may interpret online advertising and data analytics services as taxable SaaS if software is the predominant component of the offering. as noted previously, the state-by-state treatment varies widely. For instance, New York aggressively subjects cloud-based offerings to sales tax, whereas California does not subject SaaS or electronically downloaded offerings to sales tax.

A NEW ERA OF REMOTE WORK

The recent adoption of remote-work models further complicates the determination of nexus and sales tax obligations as companies hire employees in states where they have not previously had a physical presence. The vast majority (84%) of all technology businesses surveyed in BDO's 2022 Technology CFO Outlook Survey expect to see some impact on their total tax liability as a result of onboarding out-of-state remote workers.

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The presence of in-state employees is a nexus-creating activity irrespective of whether the company's sales exceed economic nexus thresholds. Therefore, if a SaaS company has employees working in a different state than its headquarters, it is critical to track employee start dates by state and consider the potential sales tax obligations.

UNDERSTANDING YOUR RISK EXPOSURE

In an exit scenario, CFOs don't want surprises, and buyers don't want to absorb liabilities. SaaS companies must carefully analyze their sales and use tax posture in the deal context to understand risks and proactively address any shortcomings. Failure to adopt appropriate tax compliance procedures at the onset of nexus-creating activities can lead to a material exposure.

Given the complex nature of SaaS sales tax, technology companies must address compliance in a step-by-step phased approach:

- **Nexus Study**: An initial nexus study consists of an examination of a company's state-specific activities to determine whether it has a filing obligation in various states. This includes an analysis of both physical presence (e.g., property, payroll, in-state services, etc.) and state-by-state economic nexus standards.
- **Taxability Analysis**: Once the company's nexus profile is established, a comprehensive taxability analysis is required to determine whether the states identified in the nexus study subject SaaS and other ancillary services to sales tax. Depending on the nature of the company's offerings, this may involve in-depth research on a state-by-state basis. For instance, if the company is providing a technology-based service that is potentially classified as a nontaxable service rather than SaaS, research in the material states is required to develop a supportable position. In addition, the taxability process will include an assessment of potential mitigating factors, such as tax-exempt customers, sale-for-resale exemptions and use tax remittance, on a customer-by-customer basis.
- **Potential Exposure Quantification/Remediation**: If the company has nexus in states that subject its offerings to tax, the exposure should be quantified to determine the magnitude of exposure in those states. This will help to determine whether to proactively remediate the exposure through participation in state voluntary disclosure programs. Voluntary disclosure participation allows a company that is historically noncompliant to pay the applicable back taxes in exchange for a limited lookback period (typically three to four years) with the waiver of penalties.
- **Sales Tax Compliance Automation**: Once the company has addressed its potential exposure in the applicable states, it will have a subsequent filing obligation. Depending on the complexity, an automated sales-tax solution is often recommended to assist with the nexus, taxability and filing compliance going forward. An automated solution often increases efficiencies, saves time and helps mitigate tax compliance risk.

Developing a plan to address sales tax prior to undergoing a diligence process is key to better understanding and controlling the compliance process. Failure to do so may lead to material escrow or purchase price allocation to remediate a sales tax issue that could have otherwise been prevented.

LEARN MORE ABOUT THE IMPACT OF *WAYFAIR* ▶

WAY FORWARD

Understanding state and local taxes (SALT) can make a big difference for technology companies, especially SaaS businesses. Non-compliance with tax standards could lead to financial risks and even affect customer relationships.

There is ample M&A opportunity to consider in 2022, with valuations leveling off and cash reserves ready to be spent. Nearly two-thirds of tech firms (65%) plan to buy, sell or partner this year, according to BDO data. Tech companies should prepare for dealmaking by being proactive about sales and tax compliance. Not doing so can block deals in the pipeline, as buyers and investors are keenly aware of tax compliance obligations.

Consulting a third party on SALT compliance, especially regarding economic nexus standards and taxability, may help SaaS firms receive the full value of their companies, mitigate exposure and liability, and empower company leaders to feel prepared when it comes time to sell.

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