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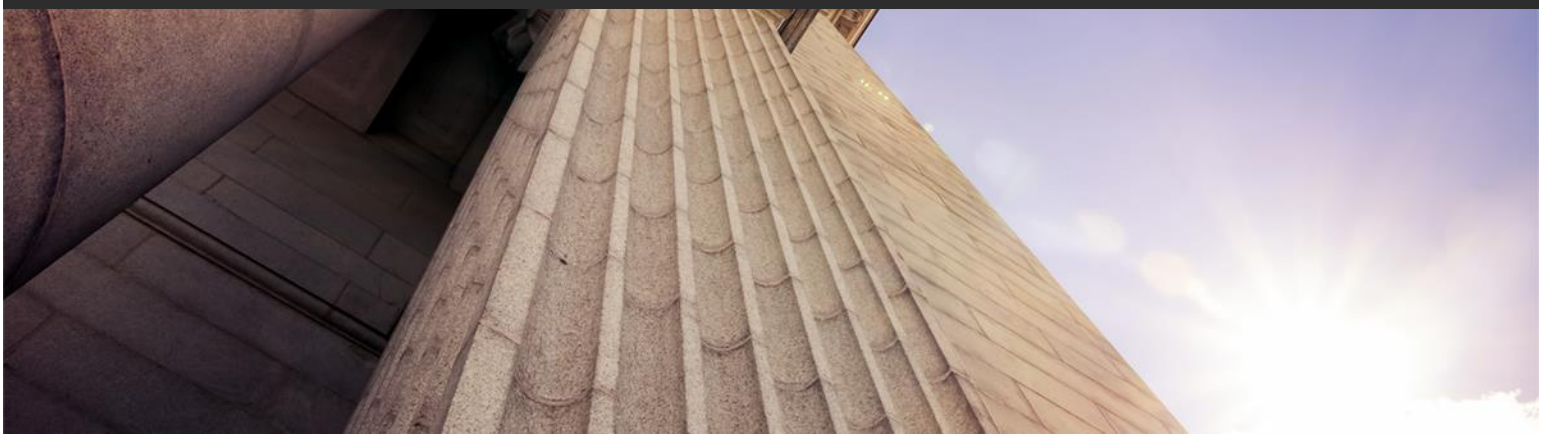

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Supreme Court's Online Tax Decision Will Impact Cloud Computing and Software Industries

On June 21, the U.S. Supreme Court decided *South Dakota v. Wayfair*, allowing states to tax online sales even if the retailer does not have a physical presence in the state. This decision, abandoning a 26 year-old precedent (based on a case heard 25 years before that) has shaken the retail industry. This case will create new challenges for online retailers, and is being welcomed by their brick and mortar competitors. The focus of this development has been on the online sale of goods, but it will also impact the software and cloud computing industries as well, forcing this sector of the economy to also face the changed online tax landscape.

The issue decided by the Supreme Court goes back to a 1992 decision which involved a traditional office products catalog business, *Quill Corp. v. North Dakota*. The *Quill* decision said that a remote retailer was not required to collect sales tax unless it had a physical presence in the state. At the time *Quill* was decided, there was no e-commerce industry, software was sold on floppy disks at brick and mortar stores, and cloud computing was only in the imaginations of science fiction writers and software visionaries. As these industries developed, they were shielded from having to deal with sales taxes so long as they did not have employees or property in the states where their customers are located. The ability to do business without having to commit resources to tax compliance functions of filing sales tax and defending audits in the 45 states and thousands of local jurisdictions where customers are located no doubt helped them to grow and flourish. But this has all changed with the *Wayfair* case, which says that *Quill* was wrongly decided – and now a company can be required to collect tax even without any physical presence in the state.

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This new change in the tax landscape might impact the software and cloud industries to even a greater extent than online merchandise retailers, because online retailers have long been the target of state tax agencies. State legislatures and tax agencies have been enacting rules which expand the concept of a physical presence for over many years. For example, New York passed the first "click-through nexus" tax law in 2008 which targeted e-commerce companies who paid compensation to an in-state business for referring sales, saying that the click-through arrangement created an in-state physical presence. Many other states have since followed New York's lead. Other states have been pursuing online retailers based on the fact that their inventory is located in third-party fulfillment centers in the state; several states passed laws requiring sellers to report sales of goods delivered into the state to facilitate use tax collection from their residents. On the other hand, software service businesses which do not require warehouses, inventories, deliveries, and returns have been able to fly under the radar of these rules geared toward merchandisers.

Currently, 32 states impose their sales tax on software downloads, and it appears that about 14 states tax Software as a Service (SaaS), either as the sale of software or as a data processing service (including several large states, like New York, Texas, Pennsylvania, Massachusetts and Arizona). Prior to the Supreme Court's *Wayfair* decision, these software and cloud businesses only had to worry about sales tax in these states if they had a physical presence there, either through property owned in the state, employees in the state, or agents or sales affiliates in the state. However, because the Supreme Court abandoned the requirement that a business must have some type of physical presence in the state to require tax collection, these states will now expect taxes to be paid by software and SaaS providers, who will need to prepare for this new reality. One issue to be considered as soon as possible is getting information from customers as to where the services are being used in order to allocate taxes among jurisdictions.

There is somewhat of a silver lining here. Because a software or SaaS company will need to collect tax in the states which tax these transactions, the company will now be free to hire employees in the state. For example, prior to the Supreme Court ruling, a California based SaaS company might have avoided hiring IT personnel working remotely from their homes in Boston, because if it did so, it would have had a physical presence in Massachusetts, triggering sales tax there since Massachusetts taxes SaaS. But now that the physical presence standard is no longer a factor, there would be no sales tax downside to hiring the workers in Boston. This same dynamic will also free companies to send employees to visit with their customers – under the prior law, if employees visited a customer, this might have triggered tax, but now without a physical presence requirement that is no longer an issue.

The bottom line is that all online businesses which sell products or services which a state will subject to sales tax will now have to face the Brave New World of sales tax compliance. The online industry has come a long way in the last two decades, and although this new landscape might pose some obstacles, it is not likely to be a devastating blow.

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