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7 Steps Online Companies Can Take to Manage Sales Tax Exposure

Marvin Kirsner | 6/3/16

States have been fighting to collect sales taxes from online retailers since the dawn of the e-commerce age. But today, online companies that sell services rather than merchandise also need to be concerned about state sales taxes. Even though most services are usually not subject to sales tax, some states are now asserting that certain online services are taxable either as software, data processing, or information services, even if the type of service would not be taxable if delivered the old fashioned way – by people – rather than computing platforms.

Online service companies need to be aware of these potential tax traps so they are not surprised when a state tax agency comes knocking on their door. There are numerous steps that smart companies can take to avoid unpleasant surprises.

For example, medical services are generally not subject to sales tax. However, the New York Department of Taxation recently said that an online healthcare service company must collect sales tax from its customers. The company receives biometric readings from patients, like blood pressure or glucose levels, and these readings are transmitted to the company via its Web platform. If the algorithm detects a problem with the results, it sends a text message to the patient's caregiver. New York said that the company is providing taxable cloud computing services. If the same service was provided by a traveling nurse, it would not be subject to New York sales tax.

A 2013 New Jersey tax notice says that several types of services that are delivered using a computing platform are subject to tax as an information service. The taxable services include businesses that generate sales leads for automobile dealers, where prospective purchasers input the type of vehicle they are interested in buying and their location, and the service matches them to inventory in the auto dealer's lot. If the auto dealer paid for traditional advertising in a newspaper it would not be taxable, but using a Web platform to make the same match between an auto dealer and an auto purchaser transforms this into a taxable service in the eyes of the New Jersey Division of Taxation.

The Texas Comptroller's Office took the position that a company that provides a Web-based bill paying service platform to banks – so that the banks can allow its customers to pay their bills online – was a taxable data processing service. The company had to fight this in the courts, and was ultimately successful, but this cost the company a great deal in legal fees. More troubling to other online service companies is that the judge's rationale for ruling in favor of the online bill payment company was that it utilized over three thousand employees to provide this service, demonstrating that it was a nontaxable professional service rather than a taxable data processing service. Companies that provide services that do not employ large numbers of workers might face a less favorable result.

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There are seven steps that a company can take to manage these state tax risks:

1. An analysis should be performed to determine whether its service might be classified as (a) software as a service, (b) platform as a service, (c) a data processing service, or (d) an information service. This analysis will require discussions between the technology team and the company's tax advisors, reviewing each step of the service delivery process.

2. An initial survey should be performed to determine which states might take the position that the service fits into one of these taxable services. This state by state review should be prioritized based on which states generate the highest sales. It might not make sense to spend money to review the rules of a state that says the service might be taxable if the company has only minimal sales there.

3. Once the potentially problematic states are identified, a

“nexus” study should be performed to determine whether the company has the adequate presence in the state to require it to collect the state’s tax. A 1992 Supreme Court case said that a company needs to have a physical presence or “nexus” in the state before it can require the company to collect tax. So if the company does not have nexus, it is not required to collect sales tax from its customers. Nexus can be triggered by having workers in the state – even if they are working from home or just visit customers in the state. In many states, nexus can be triggered if the company pays commissions to a referral source there through a click-through arrangement. Nexus can also be triggered just by attending trade shows in a state. These rules vary from state to state, so the tax advisors need to review each state separately.

4. Once it is determined that there is sales tax exposure in a particular state, it may be possible to tweak the contract with the customer to limit exposure. This can be done by providing language classifying that the intent of the contract is to provide services, not cloud services, data processing, or information services. In addition, the contract should make clear that if the service is subject to sales tax, the customer agrees to pay the tax, even if the tax bill does not come until after the company is audited.

5. Policies should be adopted to ensure that the company will not inadvertently trigger nexus with any problematic states – such as prohibiting sales representatives from traveling there on business.

6. Invoices to customers in the problematic states can be structured to separately itemize the various components of the service, so that sales tax would be applied only to the potentially taxable portion of the services.

7. The company should consider filing a voluntary disclosure with problematic states in order to limit its tax exposure for prior sales.

It is a brave new world for online service providers who sell services that heretofore were not subject to sales tax. These companies should proactively determine whether they have any potential tax exposure. Companies that simply bury their heads in the sand might get buried by large state tax obligations.

This article is presented for informational purposes only and is not intended to be construed or used as general legal advice, nor as a solicitation of any type.

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