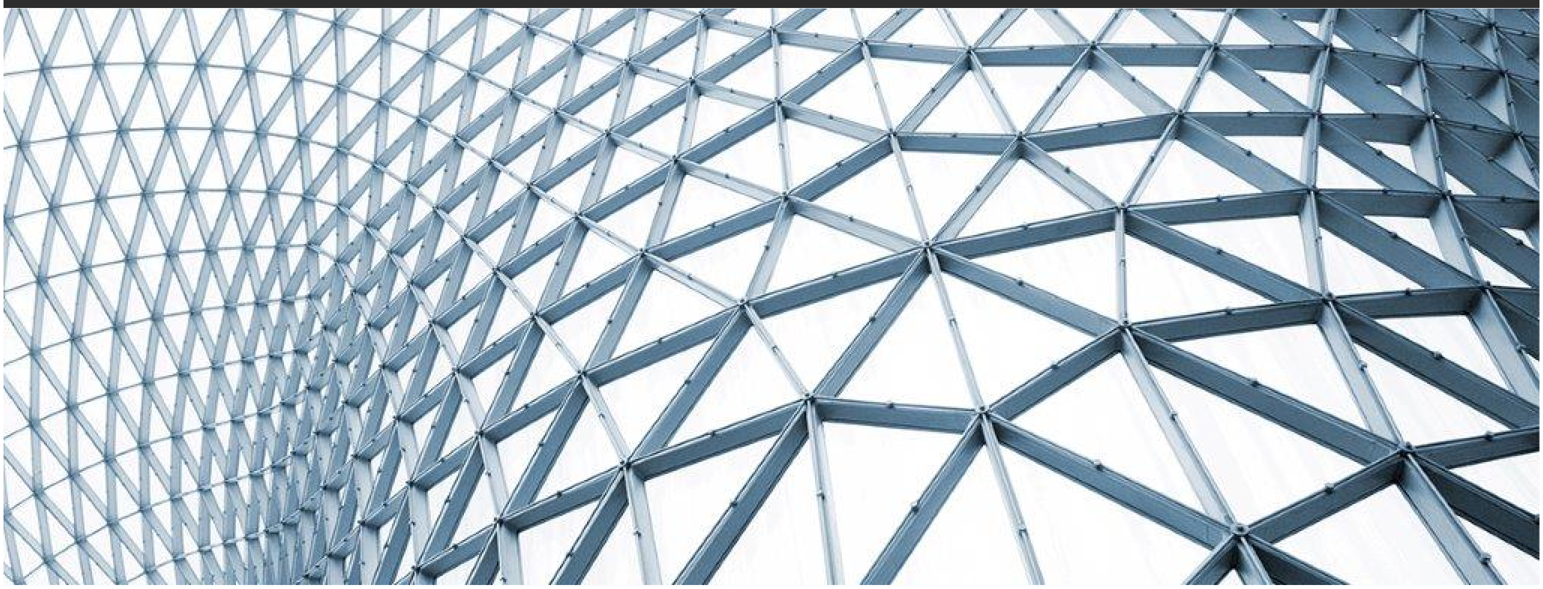
What CFOs Need to Know about the State Sales Tax Ruling



Tax attorney Marvin Kirsner discusses the recent Supreme Court ruling on state sales tax and its implications on private equity, including valuation of portfolio companies.

By Marvin Kirsner | July 13, 2018 | Private Funds Management

The recent Supreme Court ruling allowing states to tax online sales could result in a disruption in the operations of portfolio companies owned by private equity firms. With little time to act, chief financial officers need to know how to deal with the consequences of this decision that has significantly changed the tax landscape.

Prior to the June 21 high court decision in South Dakota v Wayfair, a company needed to have a physical presence in a state before it was required to collect sales tax. But the court's ruling upended a 26-year precedent for remote sellers and held that a physical presence is not necessary. CFOs at funds need to make sure that the CFOs at their portfolio companies know what immediate steps to take in dealing with this new sales tax world.

Here are actions that should be taken:

Does this ruling impact your business?

First, an assessment must be made as to whether this decision will impact the company. This ruling will directly affect portfolio companies selling merchandise over the internet, but it will also impact businesses selling digital products, downloaded software, cloud computing services (software as a service), telecommunication services, information services, data processing services and security services (including remote monitoring and cybersecurity), which are subject to sales tax in many states. Some companies might be surprised to learn that their remote services might be taxable under a tax agency's broad reading of the law. For example, New York says that a remote blood pressure monitoring service is taxable as a data processing service. Even if a company does not sell any goods or services subject to sales tax, it is still at risk for state income taxes, as discussed below, so no one is really off the hook.

Assess potential sales tax exemptions

Some products might not be subject to sales tax in every state. The rules vary state to state as to what goods and services are taxable, so the rules for each state should be reviewed to determine what is subject to tax. For example, some states do not tax clothing items under a certain price threshold, and many states exempt most, but not all food items. Also, if a company sells primarily to government, educational or charitable organizations, exemptions might apply, as would sales to a customer who will resell the products – but exemption certificates need to be collected.

Determine the deadline to comply

Many states have already passed laws which will require sales tax collection for online sales that are already effective and in some cases effective retroactively prior to the June 21 decision. These states will be expecting companies selling to customers in the state to begin collecting sales tax, and a company will have exposure if it fails to do so. Nine states already had laws on the books similar to the South Dakota law upheld by the Supreme Court that have an effective date prior to the date of the June 21 decision, meaning many companies may already be subject to back taxes. Hawaii has stepped back from its aggressive plan to seek taxes dating back to January 1, 2018. On July 12, the Department of Taxation revised Announcement 2018-10 to say that enforcement of tax collection by remote sellers with no physical presence in the state would commence for sales beginning July 1 and that this reason for this policy change was to avoid any constitutional concerns. Still, it is possible that some other states might seek to enforce tax collection retroactively.

Determine compliance thresholds

The Wayfair case specifically involved a South Dakota law which says that a company must collect tax if it has either $100,000 in sales into the state or 200 sale transactions in the state annually. The Supreme Court upheld this law with these minimum sale thresholds. As of the date of this article, 23 states have enacted or are in the process of enacting laws that will require tax collection. Many of these laws have the same $100,000 in sales or 200 transactions thresholds, but some have lower thresholds (most notably Pennsylvania with a $10,000 sale threshold). Even though it is not certain if a lower threshold would be upheld, the state will likely pursue companies that meet these lower thresholds. The first course of action would be to review the sales thresholds to determine which states would be of immediate concern.

Register with state tax agency

Once the states of immediate concern have been determined, it will be necessary to register with the state tax agency prior to actually collecting taxes from customers. This registration process can be a trap for companies if they have actually had a physical presence in the state but have been able to fly under the radar of the state tax agency. Most sales tax registration applications ask when the company began doing business in the state. In some cases, a company might be treated as having commenced doing business there due to employees or agents either visiting customers or suppliers there, allowing employees to work from their homes there, having affiliates operating in the state or from having click-through arrangements where commissions are paid to a business in the state that refers customers on their web page. In such a case, the company would need to answer that they commenced doing business in the state at an earlier date, and this might trigger an audit to determine the amount of back taxes owed. One possible solution would be to file a request for a voluntary disclosure agreement with the state prior to filing the sales tax registration. One advantage of a voluntary disclosure is that the state would typically agree to limit the look-back period to three or four years – without such an agreement, the look-back period might be unlimited because the statute of limitations does not begin to run since tax returns had not been filed.

Purchase sales tax software

The company would need to obtain sales tax software to calculate state and local taxes in the jurisdiction where the goods are to be delivered. The software should also be able to prepare the actual tax returns to be filed. The company's tax compliance group and information technology group will need to coordinate the integration of the sale tax software into the company's sales system, which should be rigorously tested prior to going online.

Assess potential state income tax exposure

In addition to assessing the company's sales tax exposure, the company needs to assess potential state income tax liabilities. Although the Wayfair case dealt with sales tax, many states have enacted laws which say that a company must file state income tax returns there if their sales exceed a certain threshold – typically in the range of $300,000 to $500,000, depending on the state, even if the company does not have a physical presence there. These laws have been on the books in many states for several years now with the states taking the position that the old physical presence requirement only applied to sales taxes, and the state courts have upheld these rules. The recent Supreme Court case seems to indicate that these state income tax rules are valid. Some of these states might apply these income tax filing obligations retroactively, since the laws have been on the books for many years in some instances, enhancing the potential exposure. As a result, a voluntary disclosure should be considered, which might limit the income tax look-back period to three or four years.

Assess impact on company value

Finally, the company will need to assess the impact of this new case on its value. The potential tax exposure (for both sales tax and income tax) might require adjustments to financials. In addition, there is the possibility that the requirement to charge sales tax could impact sales. Consumers have grown accustomed to purchasing goods without paying sales tax. The question now is whether the additional cost to the consumer will depress sales. The good news here is that due to this case, all but the very smallest of companies will be required to charge tax on sales, so charging tax should not result in a competitive disadvantage. On the other hand, for extremely price sensitive customers, it is possible that the additional cost of the sales tax might reduce demand, in which case, some companies might have to reduce costs to compensate for the additional tax cost. This new case ushers in a new era in electronic commerce, and private equity funds must take great care and consideration to address this new reality. It may not be the end of the world as we know it but it is a much bleaker one. The CFOs of many portfolio companies will be on the front lines of this new world.

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