

WAYFAIR AND THE MINEFIELD OF SALES TAX ECONOMIC NEXUS

By David Brennan

For better or worse, sales tax is changing. If your clients meet a certain sales or transaction threshold, they now have the obligation to collect sales tax in potentially multiple jurisdictions ... not just within Texas! You need to have an immediate discussion with your clients about economic nexus and its risks before a state has that talk with your client for you.

Economic Nexus Replaces Physical Presence

In the golden years of sales tax, the United States Supreme Court stated physical presence was required to compel a company to collect sales tax in the landmark case *Quill Corp. v. North Dakota*. If physical presence was not the baseline requirement, then every taxing jurisdiction in the nation could require sales tax to be collected. Companies could easily determine where they had to collect sales tax. Companies could also decide where they did not want to collect sales tax. Compliance was simple.

States noticed online sellers were not collecting sales tax, since the online seller was not physically present in the state and purchasers would not remit the required use tax. As a result, tax revenues were decreasing. In response, states came up with various ways to attempt to get sellers outside of the state to collect sales tax. One method was called economic nexus.

Economic nexus means an out-of-state company must collect sales tax if the business makes a certain dollar amount of sales or number of transactions into a state. One of the states instituting economic nexus was South Dakota. South Dakota stated if a company made more than \$100,000 of sales or at least 200 sales transactions into South Dakota, the company had to collect sales tax for the state.

This South Dakota law was immediately taken to court. The case became known as *South Dakota v. Wayfair* and eventually found its way to the United States



Supreme Court. The United States Supreme Court threw out the physical presence requirement. In other words, the Supreme Court said South Dakota's law was constitutional. Many of the ramifications of this decision remain unclear, including how low a state can go on its economic nexus thresholds and remain constitutional.

Economic Nexus Trending Nationwide

After the *Wayfair* decision, states began implementing thresholds similar to South Dakota with an effective date anywhere from a couple of weeks after the decision to several months later. Some states even chose to implement higher thresholds. It is highly likely this trend of economic nexus implementation will continue until almost all states have such a standard. As state legislatures have been having session since *Wayfair* was decided, these states have been adopting the "Wayfair" standard. However, the biggest implication of the decision is now every taxing jurisdiction nationwide can implement economic nexus – states, counties, municipalities or any other jurisdiction imposing a sales tax. For Texas CPAs, the burden of knowing a lot about everything has been taken to new heights with economic nexus.

The potential ramifications are astounding. Not only might a client have to become registered with a state for sales and use tax purposes, but also with a county and municipality. While some states do provide a consolidated application and administration, not all states do so, which effectively triples the number of taxing jurisdictions for clients (or you on behalf of your clients) to register in and file returns. Such a problem only becomes more frustrating for clients as they try to grapple with the new requirements thrust upon them.

Businesses now have the enjoyable exercise of determining the taxability of their sales in each taxing jurisdiction for which the business is required to collect sales tax. In addition to the taxability determination, research must be done for each jurisdiction as to what exemptions might apply and how to fully document the exemption.

We are particularly concerned about taxpayers being contacted directly by taxing jurisdictions. These jurisdictions are not waiting around on the chance to grab revenues from any source possible ... including your client. States are actively pursuing companies they believe meet the thresholds. A failure of the company to timely respond to the inquiry or the wrong answer to the inquiry can lead to potentially devastating results. In the eyes of the states, your client is guilty until proven innocent.

THERE ARE A FEW STEPS YOU CAN TAKE TO GET YOUR CLIENT THE IMMEDIATE HELP THEY NEED.

The Minefield of Economic Nexus

Economic nexus has created numerous pitfalls for the unwary. The slightest misstep could significantly exacerbate the issues your client faces, as clients can no longer be concerned solely with Texas. There are a few steps you can take to get your client the immediate help they need. The key is you should take the proactive step to act now before the issue worsens.

1. As an initial matter, you need to have a complete understanding of your client's business even if the business is only physically present in Texas. Know it inside and out. Besides what the client sells, you need to know how and where sales are made. Document your understanding.

Additionally, you must find out whether any services are provided after the sale and where inventory is kept. For instance, does your client use Amazon's FBA Services? If so, your client's inventory could be spread across the country, leading to nexus long before the change in the law. Worse, clients oftentimes have no idea their inventory has been moved or where the inventory is currently located. This Amazon FBA inventory problem is something we have already seen states aggressively pursuing.

2. Next, obtain from your client the sales and number of transactions broken out by state by year. An Excel spreadsheet of this information is best. The information may even need to be broken out by county/municipality. Sales might be made from the client's location in Texas, but most states will take the position the sale counts toward the threshold based on where the goods are delivered (destination based). Cross-reference this information from your client against the jurisdictions imposing economic nexus. You need to take this step to determine your client's exposure nationwide.
3. Now, the decisions are up to the client on what to do next and when. Based on the jurisdictions with economic nexus, the client can make an informed decision on which jurisdictions outside of Texas to register in to mitigate overall exposure. Some clients may want to register everywhere and some clients may decide to register nowhere. Still other clients may conclude to register on a rolling basis for business

reasons (e.g., to allow time to integrate tax software with websites, point-of-sales systems, etc.). The longer it takes for the client to reach a decision, the greater the client's liability becomes, as sales tax is not being collected from its customers. And again, you may want to document your discussion with the client and their decision.

Registration Pitfalls

For the jurisdictions your client wishes to register in, you must be careful when completing the registration applications. We have seen application questions that lead businesses to a particular response that permit the state to audit the business from the beginning of the business start date. While a question appears to be benign, it is not.

You must have a formulated position on when your client had nexus with the state, as placing any date could lead to the state instituting an audit for the prior period, and an assessment of tax, penalties and interest. Answering these registration questions in a careful, but accurate manner is precisely how we have advised clients and has been our objective.

In our experience, we generally suggest having a client with exposure in a state register through the voluntary disclosure program. The voluntary disclosure program allows your client to minimize penalties, reduce the state's look-back period and apply for forgiveness for taxes not collected from customers. However, if your client has already been contacted by the state, voluntary disclosure may be off the table.

Another pitfall hidden in the application is potentially admitting to a requirement for registering for other tax types, which is discussed in more detail below. With these other tax types, your client then has to build the additional cost of doing business in a given state into higher sales prices instead of simply passing the tax on to the customer as one would with a sales tax. Imagine the anxiety a client would have after receiving an audit assessment that could put them out of business. The sad part is the devastating assessment could have been avoided if certain actions had been taken earlier.

Finally, simply registering in all taxing jurisdictions is not always the right answer. There are two significant issues with blindly registering everywhere. First, by registering for sales tax everywhere, the possibility exists of the need to also register for other tax types. While states have similar tax types, there are certain states with unique taxes that will trap the unwary. Therefore, your client should be certain of registering in specific jurisdictions, due to other unknown tax types lurking in the shadows.

Wayfair Legislation in Texas

During the 2019 legislative session, HB 2153 was passed to allow the Texas comptroller to identify a single tax rate to apply to remote sellers with the intent to simplify online vendors' sales tax calculations. A related bill, HB 1525, also passed and requires "marketplaces" such as Etsy, Ebay and Amazon to collect sales tax on third-party, out-of-state sellers.

It is expected to yield more than half a billion dollars for the state. Both HB 2153 and HB 1525 became law and are effective effective on October 1. TXCPA will keep members informed about new Texas Comptroller regulations that conform to the new laws as they become available.

Every time a registration is made for a specific tax type, your client will most likely have an audit on the tax sometime in the future. While the number of audits for the tax may vary, imagine having a full company audit every two months. Even for the more sophisticated Texas businesses, such a frequency is unsustainable!

Being Proactive

In conclusion, you and your clients need a clear path to tackle the new burdens associated with economic nexus. Understanding the traps for the unwary can help ensure a smoother process.

It is important for taxpayers to take action swiftly to avoid the expense of battling with a state. In fact, the states are already sending out inquiry letters. Why wait until a letter is received to do something? Be proactive and help clients mitigate their exposure right away.

About the Author:

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