

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

Mark Klein, Joe Endres
Taxstringer
February 1, 2019

Attorneys

Joseph Endres

Practices & Industries

State & Local Tax

Originally published on the *Taxstringer* website on February 1, 2019. Reprinted with permission.

This article is the second in a two-part series about **Practical Sales Tax Considerations for Vendors in the Wake of Wayfair**. To read the first part published in the January 2019 *TaxStringer*, please [click here](#).

Introduction

In last month's installment, we provided a brief review of the U.S. Supreme Court case *South Dakota v. Wayfair*, and included a state-by-state review of the new laws and rules governing sales tax administration that the case has engendered. News in this area is exploding on almost a daily basis. Case in point, since part one of this piece was published last month, New York State issued a Notice that states that out-of-state vendors have to collect and remit sales tax if their sales into the state exceed \$300,000 AND the number of transactions in the state exceeds 100 during the preceding four sales tax quarters. So the landscape is changing quickly. In order to make this article as useful and timely as possible, in this installment we've decided to pose a dozen practical questions to the following hypothetical situation in order to illustrate the issues that vendors should consider when analyzing their sales tax obligations.

Practical Advice Following Wayfair

Hypothetical Situation: a vendor, situated exclusively in New York, makes its goods available to customers anywhere in the world by allowing customers to purchase products (e.g., widgets) through its website. After the transaction is initiated through the website and payment is made, in most instances, the vendor contracts for and arranges shipment of the purchased material using a common carrier (UPS, FedEx or USPS). In these "typical" transactions, title and risk of loss transfer to the customer when the material is delivered to the customer at their delivery location. Customers, however, have the option of arranging their own delivery services and some occasionally arrange for a contract carrier (e.g., a private shipping company) to pick the goods up from the vendor in New York. On these rare occasions, title and risk of loss transfer to the customer in New York.

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

Question 1: Based on the facts above, is the “typical” transaction subject to sales tax in New York (where the vendor is located) or in the state where the customer is located?

Answer: Most state sales taxes are known as destination taxes. This means the jurisdiction where the customer takes possession of the property (i.e., the destination where the property changes hands) has the right to tax the transaction. In our facts, because the customer does not take possession of the property until it is delivered in the customer’s state, it is the customer’s state that can tax the transaction. However, it is important to note that on the rare occasions where the customer arranges shipping and has a contract carrier pick up the product in New York, this conclusion is reversed. If the customer arranges for a contract carrier to pick up the product in New York, then New York would take the position that its sales tax is due on the transaction. New York would argue that because the customer took possession of the product in New York (through its agent the contract carrier), the transaction is taxable in New York.

Question 2: If possession and title to the goods transfer at the customer’s location, does this mean that the vendor is potentially subject to sales tax in each state?

Answer: Now we get to the heart of the matter. Unfortunately, there’s no easy answer because this will require a state-by-state analysis. First, any sales to Alaska, Delaware, Montana, New Hampshire, and Oregon will not require a vendor to collect tax because those states don’t impose a general sales tax. But the real issue is whether a vendor has to collect in those states that have enacted economic nexus/*Wayfair* rules (see last month’s article for a detailed review of each state’s rules). If a vendor’s sales to customers in a given state do not exceed that state’s thresholds (in frequency or dollar amount), and the vendor has no other physical presence in that state, then it shouldn’t have any sales tax obligations in that state. But vendors should be warned that this analysis can be a bit counterintuitive. For example, some states, such as Ohio and Massachusetts, have enacted rules that say that something as incidental as having software cookies on computers in the state can create physical presence for nexus purposes if the vendor’s economic activity satisfies other thresholds. (Mass. Reg 830 CMR 64H.1.7: *Vendors Making Internet Sales* (\$500,000 sales and 100 transactions/yr. threshold eff. 10/1/17); Ohio Rev. Code § 5741.01(I)(2)(i) (\$500,000 sales threshold).

Moreover, while it seems that the *Wayfair* thresholds should present a rather straightforward mathematical analysis, in practice it turns out to be a bit more complicated. This complexity stems from the fact that not all states calculate their thresholds in the same manner. For example, some states base their thresholds on a calendar year calculation, while other states choose a 12-month period beginning on a specific date, or use a rolling 12-month period. Additional complexity creeps in because some states calculate their thresholds based on the “prior” year, while other states calculate their thresholds based on the “current and immediately preceding years.” A vendor’s nexus status could hinge exclusively on the applicable state’s threshold calculation method/period, not just the threshold amount. This is especially true if the business does not make consistent and regular sales into a state, as is frequently the case in many industries.

Let’s take a look at the *Wayfair* rules in two states close to one another in proximity, but worlds apart in terms of sales tax nexus: Connecticut and New Jersey. According to Connecticut’s *Wayfair* law, effective December 1, 2018, an out-of-state vendor has nexus with the state if the vendor has:

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

at least two hundred fifty thousand dollars of gross receipts ... **and** two hundred or more retail sales from outside this state to destinations within this state ... during the twelve-month period ended on the September thirtieth immediately preceding the monthly or quarterly period for which liability for tax is determined.”

Two things stand out in the language above. First, an out-of-state vendor needs **both** \$250,000 in receipts from Connecticut customers and 200 or more separate transactions. This is an unusually high threshold (as discussed above, New York applies a similar test - \$300,000 in sales and 100 transactions). Second, the period for measuring whether these thresholds are met runs from a specified 12-month period beginning on a set date.

In New Jersey, the rules are quite different. Effective November 1, 2018, an out-of-state seller must collect and remit sales tax if its gross revenue from sales to New Jersey in the calendar year or the prior calendar year exceeds \$100,000 or if it conducted 200 or more separate transactions in New Jersey during the calendar year or the prior calendar year. This law's thresholds are lower and the time frame is more expansive.

Let's apply these laws to our hypothetical vendor. Assume the vendor makes occasional sales into other states, though the frequency can vary significantly. For example, there may be a dozen or so large transactions in a state in a given year but none into that state for another year or two. If we apply the laws above to these facts, we see very different results. First, in Connecticut, the occasional sale of material into the state (assuming it's delivered via common carrier and not by the vendor directly) will not create nexus under the state's new *Wayfair* threshold regardless of the dollar value because the vendor is unlikely to make anywhere near 200 sales into the state over a 12-month period.

In New Jersey, however, nexus is likely. First, the dollar amount is lower. Large sales of product can easily get above the dollar threshold of \$100,000. And since, unlike in Connecticut, the vendor does not need to have made the requisite number of sales (it's an "or" test, not an "and" test), the vendor could have nexus. Finally, because the time period for measuring the thresholds includes both the current and prior year, the timing of the sales likely won't matter. Consequently, we can see that under the new economic nexus rules, the vendor can still have nexus in one state but not in another. It is important to note, however, that more states follow New Jersey's approach. So it's likely our hypothetical vendor will have nexus in more states than not under these facts.

Question 3: If the vendor trips the thresholds in a given state, does it charge tax on sales for that state from that point on, or does it have to go back and charge tax on the previous sales that were below the threshold?

Answer: Because economic nexus does not begin until the out-of-state vendor exceeds the thresholds during the applicable time period, it should not have to go back and try to charge tax retroactively on the sales made before it exceeded the threshold. However, it is important to recognize that many of these laws have not become effective yet so the states haven't had an opportunity to enforce them. Thus, out-of-state vendors should proceed with caution. We can envision state auditors arguing that a vendor must collect and remit sales tax as of the date these laws became effective if their historical sales into the state exceed the applicable thresholds.

Question 4: What qualifies as a transaction for purposes of the *Wayfair* economic nexus threshold?

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

Answer: In our “typical” hypothetical posed above, each order of the widgets likely qualifies as a separate sale for purposes of the applicable nexus threshold. So, for example, an initial order of 100 widgets by a customer in a state likely qualifies as one transaction in that state despite the fact that 100 separate items are being purchased. The vendor’s next sale of 125 widgets to that customer qualifies as transaction number two. A third sale of 5 dozen widgets to another customer in the state qualifies as transaction number three, and so on.

That seems pretty straight forward. So now, let’s muddy the water a bit. What if I sell subscriptions to a biweekly magazine and give my customers the option to pay annually or monthly? If a customer signs up for a year, does this count as one sale of an annual subscription, or twelve separate sales based on the monthly invoice?

If the customer is obligated to pay for the annual subscription even though it is billed monthly, we can see a good argument for treating this as one sale. But that seems to be contrary to some of the initial advice coming out of the states. The states, at least initially, seem to be focusing on invoicing, probably because that provides the most readily verifiable metric on audit. So each invoice that is generated by a vendor likely qualifies as a separate transaction for purposes of the nexus threshold. Thus, if a customer chooses to purchase the subscription and pay for it in one invoice on an annual basis, that would likely qualify as one transaction. However, for customers that choose to be billed monthly in separate invoices, several states have indicated that each invoice would be treated as a sale for economic nexus purposes. So be careful with your invoicing as it appears to be the triggering event.

Question 5: How long does economic nexus last?

Answer: Again, because these laws have not been enforced yet, our answer is largely speculation. But because nexus is now based on sales during a specific time period, a strong argument can be made that nexus ends as soon as sales fail to meet those thresholds. Consequently, it’s possible that vendors will find themselves having to comply with state sales tax laws intermittently. In other words, out-of-state vendors may have to collect tax in a state for a few years, and then not have to collect tax for a year or two, and then have to start collecting tax again. Because New York’s new law requires the thresholds to be satisfied during a rolling period (i.e., “immediately preceding four sales tax quarters”), it’s possible that vendors who are close to the nexus thresholds could jump in and out of nexus on a quarterly basis!

Since few customers pay the corresponding use tax when the vendor does not charge the applicable sales tax, this noncompliance can create a strategic advantage for the vendors who are not obligated to collect sales tax on their sales (this advantage fueled the growth of many Internet vendors). But now vendors will have to balance this strategic advantage against the cost of intermittently complying with state sales tax laws (i.e., having to closely track sales figures, register for sales tax, file final returns when the nexus thresholds are not met, reregister when they are met again, and so on...and on...and on). We think many vendors are likely to simply “turn on the tax” everywhere (i.e., collect and remit tax on all transactions) and not worry about tracking sales. The states certainly hope that’s the case. More on this later.

Question 6: Do these new economic nexus laws apply to wholesalers? And what if I sell both taxable and nontaxable products?

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

Answer: Again, the answer will be based on the specific language of the state rules at issue. Many states have been limiting these threshold rules to “retail sales,” which will not impact wholesalers and may exclude nontaxable transactions. In some states, however, the applicable language references “gross receipts” and “gross revenue.” These terms are broad enough to encompass wholesale transactions or nontaxable transactions. If the statutes don’t base the thresholds on “retail sales” or “taxable receipts,” nontaxable transactions can be included. You might be thinking, “Who cares?”—wholesale transactions aren’t taxable (material that will be resold is not taxable in most states). While that’s true, many vendors make both wholesale sales and retail sales. In other words, vendors sell to both end users and other resellers. If this is the case, both types of transactions may be included in the calculation of the thresholds. And if the vendor exceeds the threshold using these combined wholesale and retail figures, then the state might take the position that it must collect tax on its taxable retail transactions into the state even where the taxable retail transactions by themselves would not have exceeded the applicable threshold.

Finally, keep in mind that with wholesale transactions, a resale certificate is usually provided by the customer to the vendor to memorialize the fact that the purchased materials will be resold. Most of these state resale certificates require that the purchaser be registered for sales tax purposes in the state because the resale certificates typically require that the purchaser provide its sales tax registration number on the form. Depending on how the transactions are structured (i.e., where possession changes hands), this could cause some wholesalers to have to register in additional states when purchasing the raw material they will resell.

Question 7: Some pretty large states have not yet provided official guidance on how *Wayfair* impacts their sales tax laws and administration (Florida, Arizona, etc.)—am I still safe not charging tax in those states if I don’t have any physical presence?

Answer: Unfortunately, even here there isn’t a clear answer. The answer will depend on the amount of risk the vendor is willing to accept. You might think that since these states haven’t amended their rules yet, that the old nexus rule of physical presence still applies. There are potential weaknesses with this assumption.

First, the existing sales tax laws in some states might be broad enough to justify imposing a *Wayfair*-like standard without an official legislative or administrative change. For example, New York’s law contains a catchall provision that requires vendors who regularly or systematically solicit business in the state to collect and remit sales tax if “such solicitation satisfies the nexus requirement of the United States constitution.” See N.Y. Tax Law § 1101(b)(8)(i)(E). The New York law defines regular and systematic solicitation to include receiving gross receipts from the state in excess of \$300,000 AND entering into more than 100 transactions. See N.Y. Tax Law § 1101(b)(8)(iv). Because these provisions of the law were in place well before the *Wayfair* decision, the **New York Tax Department** could argue that it has the legal justification to apply economic nexus to periods prior to the date it announced its policy (January 15, 2019). Indeed, the authors have informally heard from Tax Department sources that retroactive application is a possibility, at least in certain circumstances.

In the *Wayfair* case, the Supreme Court placed emphasis on the fact that South Dakota’s law was not retroactive. Most commentators think that a retroactive law might not pass judicial scrutiny. However, some other states have also indicated a willingness to press this issue. For example, the Florida attorney general recently asserted that state attorneys can apply the result in *Wayfair* retroactively to defend against refund claims or otherwise win litigation challenging taxes assessed in prior

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

years. Rhode Island has also indicated the possibility of retroactive application. And we expect that these remaining states that have not made any legislative or regulatory changes following *Wayfair* will do so in the near future. Proceed with caution.

Question 8: As a result of *Wayfair*, do I have to collect and remit the local sales taxes counties and municipalities might impose in addition to the state sales tax?

Answer: Likely, yes. If a business has nexus for the state sales tax, it will likely have nexus for all local sales taxes that might apply. In most states these local taxes are largely invisible because the state administers all tax matters and collects the local tax along with the state tax. Thus, in most states, vendors won't have to file separate registrations or returns, or make separate payments. But there are a few states that follow "home rule" with respect to local taxes and allow the localities to collect and administer their respective taxes separately (e.g., Louisiana and Colorado). So be careful, a vendor might have to make more than one filing in a few states. This bifurcated administration might create a problem for these states because the *Wayfair* Court was particularly concerned with the burden sales tax compliance imposes on out-of-state vendors. We could envision a court invalidating a *Wayfair*-like nexus law if the compliance was particularly onerous for out-of-state businesses. But that's not a position you want to have to take up. It's better to do it right in the first instance, so be aware that in a few states you might have to make filings to multiple jurisdictions.

Question 9: So far, this article has examined vendors selling goods or material (i.e., tangible personal property). But what about vendors who sell services—do the new *Wayfair* laws apply to them?

Answer: The short answer is "likely, yes." Once again, it will depend on the specific terms and language used in the applicable state rule. But thus far, broadly speaking, the new rules are broad enough to encompass both sales of tangible property and sales of services. In most states, services are subject to tax in the jurisdiction where they are performed.

Question 10: What if I fail to collect and remit sales tax in states where my sales exceed the applicable thresholds?

Answer: Vendors should be particularly cautious with sales tax compliance because sales tax is one of the few taxes that can create personal liability for those operating the business. Sales tax is known as a "trust fund" tax because in most states the tax is collected by the vendor from the customer and held "in trust" until the vendor remits it to the state with a timely filed sales tax return. If the vendor fails in this trust, it becomes liable for the tax that should have been remitted. Even worse, in most states, those responsible for running the business become personally liable for the sales tax assessment (including interest and penalties). And this personal liability for "trust fund" tax can apply even if the tax was never collected from the customer. Thus, states can look to the personal assets of those responsible for running the business to satisfy the business's sales tax debt.

Question 11: Do I now also have to pay income tax to these states, as well as sales tax?

Answer: Not necessarily. The federal government passed a law in the 1950s prohibiting the states from imposing their income taxes on out-of-state sellers in certain circumstances. Known as Public Law 86-272, this law protects out-of-state vendors of tangible property if their only activity in the state is "mere solicitation." The term "mere solicitation" has been thoroughly defined over the years, but basically covers any action related to asking for a sale. But in our hypothetical above,

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

where the vendor occasionally sells into a state over the internet through its website and then ships the product via common carrier to the customer, the vendor arguably doesn't have any activity in the state let alone solicitation activity. So Public Law 86-272 should apply to prevent the state from requiring the vendor to pay income tax on income earned from sales to customers in the state.

But, as the saying goes, the devil is in the details. There are some caveats you need to keep in mind when relying on Public Law 86-272. First, this law only applies to taxes imposed on a business's income. Thus, Public Law 86-272 does not apply to less traditional corporate taxes, such as Texas's Margin Tax, Ohio's Commercial Activities Tax, and Washington's Business and Occupations Tax (to name a few). Moreover, even if a vendor isn't subject to a state's income tax, some states impose alternative minimum taxes that might still apply. These minimum taxes, though small, can create sizable liabilities, including penalties and interest, if they go unaddressed for many years. Finally, though there are some credible arguments to the contrary, it is likely that most states will argue that Public Law 86-272 only protects sales of tangible property. Thus, sales of services may be outside its protection. So if you're going to rely on Public Law 86-272, be sure to consult your tax professional to ensure there are no additional issues to consider.

Question 12: What are my practical options for dealing with this changing sales tax landscape?

Answer: For a small company with limited resources, these new rules may seem daunting. Faced with the prospect of having to learn the rules in sundry jurisdictions and then closely monitor their sales into these jurisdictions, many vendors throw up their hands in frustration. As we see it, vendors have three options for sales tax compliance post-*Wayfair*:

1. Turn on the Tax Everywhere—some vendors are simply applying tax to all transactions so that they do not have to monitor sales thresholds or worry about a potential liability during subsequent audits. This has the benefit of simplifying compliance, but it comes at the cost of a potential competitive advantage (i.e., not charging the tax while other competitors will). And it would still require vendors to correctly apply the appropriate rate in each jurisdiction and file the applicable return. Thus, this has its own compliance burden.

2. Hire a Third-Party Administrator—there are several companies that will help take on the burden of sales tax compliance for a fee. These companies include Avalara, TaxJar, and TaxCloud. The services and fees range, but vendors who sell into many states are finding these services to be extremely helpful. The main downside: the cost. We've seen some vendors pay tens of thousands of dollars a year for this service. So, while you may decide these vendors are well worth the peace of mind they provide, it's important to recognize that your margins are going to get a bit narrower.

3. All Sales in One State—some vendors have considered making sales exclusively in one state. Here's how this scenario plays out. Let's say I'm a vendor who is located exclusively in New York. I sell over my website to customers around the world. However, as a condition of buying my product, I require the purchaser to arrange for a private shipping company to come to my place of business to collect the product for transportation to the customer. In other words, I sell my goods FOB seller's dock (free on board seller's location). Under these facts, there is an argument that the vendor would only have to worry about collecting New York tax because all transactions occur in New York (i.e., the customer takes possession and

PRACTICAL SALES TAX CONSIDERATIONS FOR VENDORS IN THE WAKE OF WAYFAIR (PART II)

title of the property, through their agents, the private shipping company, in New York).

While this sounds pretty simple, in practice, it can get complicated. First, the additional logistical burden placed on customers may create a barrier to completing the sale. Second, some customers may object to being charged New York sales tax, especially those who reside in states with a lower sales tax rate. And an exception to this approach would almost certainly have to be made for customers who live in the few states that do not impose a general sales tax (Alaska, Delaware, Montana, New Hampshire, and Oregon). Finally, not all states agree that “change of possession” determines the situs of the sale. While New York would be happy with this hypothetical scenario because it gets to tax all transactions, other states might have a problem with it. For example, we have seen California argue that its sales tax applies when the product is delivered to a California customer, regardless of the shipping details. While the underlying legality of this position is tenuous, it’s important to recognize that even under this simplified approach, you still might end up in a fight on audit. So this approach has its limitations as well. We find that it is a viable option only for certain, select industries (e.g., high-end jewelry).

Note that none of the answers above included a recommendation to “do nothing.” Vendors who sell into multiple states are going to have to address the new nexus landscape. Simply burying your head in the sand and carrying on as if nothing has changed is certainly the riskiest strategy of all (if you want to call it a strategy).

Conclusion

We’re in the midst of significant change in sales tax administration and compliance. As you can see, the nexus analysis is heavily dependent on the specific language of the applicable state law and the underlying facts of the situation. Thus, we strongly recommend that vendors consult their tax professionals when deciding on a new sales tax compliance strategy.