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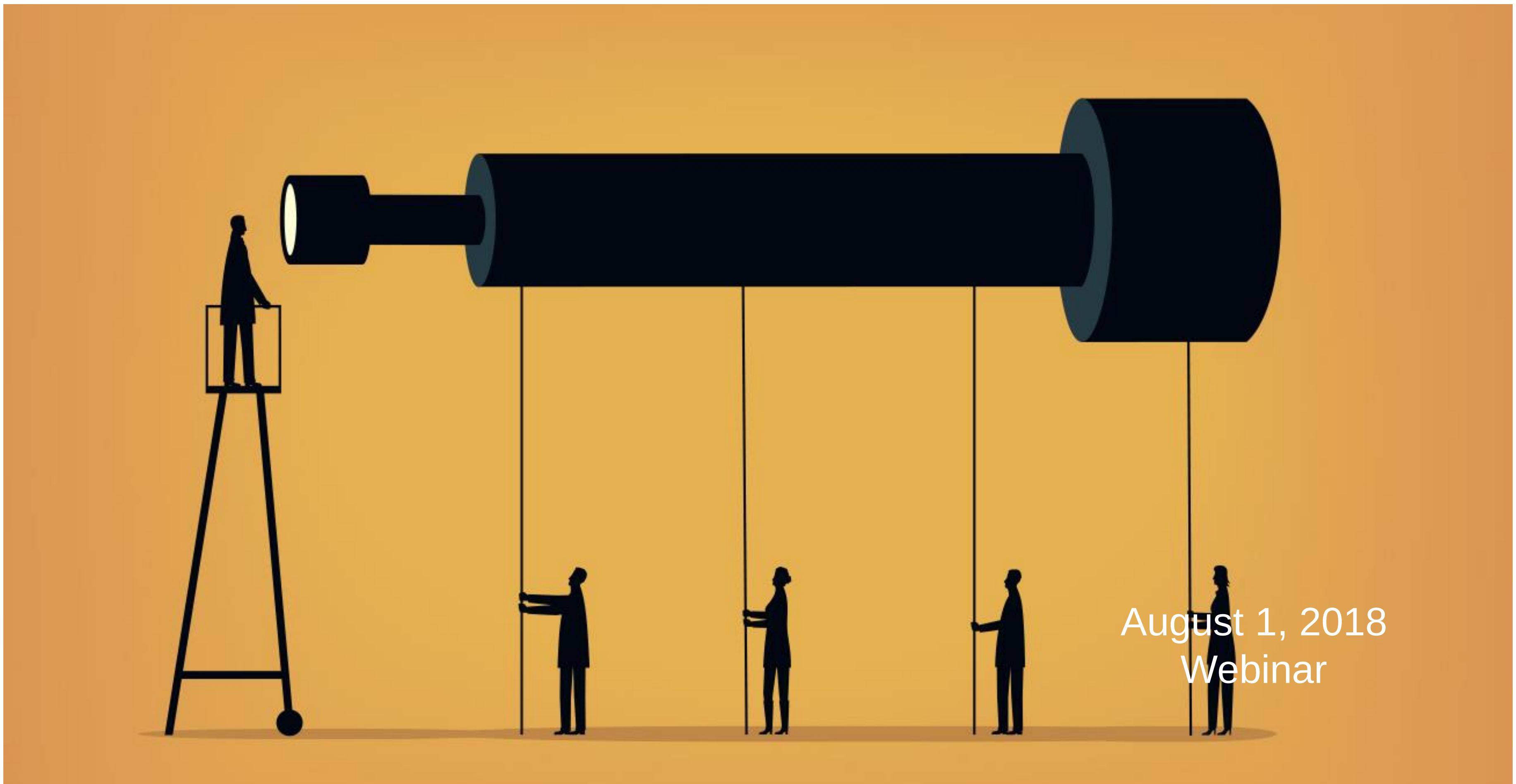
The Aftermath of Wayfair: What's Next?

Giles Sutton and Tommy Varnell



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Webinar

Agenda

- Nexus Background
- Examining the Wayfair Holding
- Anticipating the Impact of Wayfair on Private Equity
- Thinking About Wayfair's Implications to Private Equity Diligence and Deal Structure

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Context: Sales Tax Nexus History

- Historic Constitutional limits on the state regulation or taxation of interstate commerce
  - Under the Commerce Clause of the Constitution state laws or regulations may not:
    - Discriminate against interstate commerce; or
    - Impose undue burdens on interstate commerce

Context: Sales Tax Nexus History

- Constitutional framework for state taxation of interstate commerce:
  - A state tax will be sustained so long as it:
    - **Applies to an activity with a substantial nexus to the taxing state**;
    - Is fairly apportioned;
    - Does not discriminate against interstate commerce; and
    - Is fairly related to the services the State provides
      - *Complete Auto Transit, Inc.* (1977)

Context: Sales Tax Nexus History

- What constitutes "substantial nexus"?

- Historically, for the imposition of sales tax, substantial nexus required physical presence
  - *National Bellas Hess, Inc.* (1967)
  - *Quill Corp., v. North Dakota* (1992)

Wayfair vs. South Dakota

The Decision…

- Court ruled 5-4 in favor of South Dakota
- Decision overturns physical presence requirement of National Bellas Hess and Quill
- Court focused on whether activity could establish "substantial nexus" (see *Complete Auto Transit*) without having physical presence

Wayfair's New Nexus Standard

- "In the absence of *Quill* and *Bellas Hess*, the first prong of *Complete Auto* test simply asks whether the tax applies to an activity with a substantial nexus with the taxing state"
- "Nexus is established when the taxpayer avails itself of the substantial privilege of carrying on business in that jurisdiction"
- "[N]exus is clearly sufficient based on both the economic and virtual contacts [taxpayers] have with the state…"

The Court's Rationale for the New Standard

- The reasons the Court has, in effect, changed the nexus standard
  - The physical presence rule undermines the necessary confidence in the tax system by giving some online retailers an arbitrary advantage over their competitors who collect sales taxes.
    - The Court cited the estimated amounts of state sales tax revenues being avoided by out-of-state remote sellers.
  - Nexus is sufficient based both the economic and virtual contacts taxpayers have with the state

What Statute Did Wayfair Uphold?

- The Supreme Court in *Wayfair* upheld a South Dakota statute

- In reviewing the South Dakota statute the Supreme Court observed, the statute:
  - Had a safe harbor for small business
    - Less than $100,000 in sales or 200 transactions annually
  - Was not retroactive
  - South Dakota conformed (is a member) of the streamline sales tax agreement
    - State level administration
    - Uniform definition of products and services
    - Simplified rate structure
    - Provides sellers access to sales tax software paid for by the state

What is Wayfair's New Nexus Standard?

- How do we interpret the new sales tax nexus standard based on the language of the Court's Wayfair decision?
  - A statute with reasonable safe harbor for small business?
    - $100,000 or 200 transactions annually
  - A state administered regime for remote sellers?
  - Streamline-type standardized definitions of products and services?
  - No retroactive application of the economic presence nexus standard?

New Definition of Physical Presence?

- Is physical presence now irrelevant?
- What might now constitute physical presence?
  - Access to a website within a state
  - Downloading a company's app onto phones and computers
  - Websites that leave cookies on a persons computer
  - Leasing data storage in a state

Who is a Remote Seller?

- Is the *Wayfair* case only aimed at e-commerce? What about:
  - Sellers protected by P.L. 86-272 for income tax purposes?
  - What about "flash title transactions" where by means of contract terms –absent physical presence title transfers to property within a state?
  - Cloud computing service providers?
  - Software licensers?

How Will States Conform/Respond?

- What are their laws regarding nexus standards?
  - Streamline states
  - Economic sales tax states
  - Constitutional permissibility states
  - Others

Streamline States

- A key observation in the Wayfair case was South Dakota’s membership in Streamline Sales Tax Project.
- Will other states join SSTP?
- Will non-streamline states face challenges enforcing similar nexus standards as SD?

Current Streamline States

- **Full Members**
  - Arkansas
  - Georgia
  - Indiana
  - Iowa
  - Kansas
  - Kentucky
  - Michigan
  - Minnesota
  - Nebraska
  - Nevada
  - New Jersey
  - North Carolina
  - North Dakota
  - Ohio
  - Oklahoma
  - Rhode Island
  - South Dakota
  - Utah
  - Vermont
  - Washington
  - West Virginia
  - Wisconsin
  - Wyoming

- **Associate Member**
  - Tennessee

Economic Nexus States

- States assert nexus for remote sellers with no physical presence –
  – Must exceed sales threshold
    - Generally $100k to $250K but some states have enacted lower thresholds
  – Minimum number of transactions (e.g., 200 separate transactions)
    - Some states only have a sales threshold

Anticipated State Reactions to Wayfair

- Swift adoption of similar economic nexus laws
  - Already starting to see this!
- A reasonable period to register and start collecting
- Home rules states: AL, CO and LA
  - Will others adopt something similar to the Alabama rule?
- More conformity to streamline?

Other States Adopting Economic Nexus

- To date, more than 20 states have enacted or announced some form of economic nexus.
  - Most have effective dates between October 2018 and January 2019.
  - In many cases, states are relying upon existing laws / regulations.

Economic Nexus – State Examples

- Alabama
  - Per DOR website - the existing "economic nexus" rule 810-6-2-.90.03, which took effect in January 2016, will be applied prospectively for sales made on or after October 1, 2018.
    - Original effective date was delayed pending outcome of the *Wayfair* decision.
  - Remote sellers with annual AL sales in excess of the rule's $250,000 small seller exception can register for the AL Simplified Sellers Use Tax Program (SSUT) and begin collecting no later than October 1, 2018. This allows for collection at one flat rate (8%) for all sales in Alabama, regardless of varying local rates.

Economic Nexus – State Examples (cont.)

- Maryland
  - Announced via state tax alert, which stated in part:

    Pursuant to Maryland law, the Comptroller's Office shall impose sales tax collection requirements as broadly as is permitted under the United States Constitution. If you sell or deliver tangible personal property or a taxable service for use in Maryland, you should review and analyze the United States Supreme Court's decision in South Dakota v. Wayfair, Inc. to identify how it affects you.

  - Expect further clarification from MD at some point

Economic Nexus – State Examples (cont.)

- Utah
  - S.B. 2001 (signed by Gov. Herbert on July 21, 2018) expands registration requirements of remote sellers, amending UT Code s. 59-12-107
  - Remote sellers are required to register, collect and remit sales tax if seller:
    - receives gross revenue from the sale of tangible personal property, any product transferred electronically, or services for storage, use, or consumption in the state of more than $100,000; or
    - sells tangible personal property, products transferred electronically, or services for storage, use, or consumption in the state in 200 or more separate transactions.
  - Effective January 1, 2019

Other Approaches Beyond Economic Nexus

Before and during Wayfair, states have been developing other approaches to increase remote seller compliance, including:

- Notice and Reporting
- Assertion of Nexus Based on Marketplace Provider Presence
- Cookie Nexus

State Notice and Reporting Requirements

- What are Notice and Reporting requirements?
  - Attempts made by a handful of states to require remote sellers with no nexus to give <u>notice</u> to the in-state customers that they may owe use tax and <u>report</u> customer information to the state.
  - Filing requirements vary by state, and may depend on dollar threshold and number of transactions.

- Key Objective - make reporting so onerous that remote sellers would opt to register and collect tax

Marketplace Provider/Facilitator

- Online retailer's presence in a state would create a collection responsibility for 3rd parties (remote sellers) selling through that online retailer's platform
- States are requiring Marketplace Facilitator to collect and remit tax on behalf of remote seller
- Aimed at large online marketplace platforms like Amazon, Walmart, Etsy, eBay
- WA, PA & SC are asserting there is a filing requirement under this approach and other states are jumping on the bandwagon

"Cookie" Nexus

- Physical presence is established when cookies or similar software are stored on computers or devices in the state
  - Company owns tangible personal property in the form of browser cookies placed on consumers' computers and mobile apps placed on customers' cell phones

- Under this theory, a company that sells over the Internet would have nexus anywhere its customer is located

- State Examples – MA and OH

What Should Taxpayers Do Now?

- In light of the Wayfair decision, companies should consider the following:
  - Conducting nexus studies in light of the new Wayfair standard
  - Put in place procedures to ensure the collection of resale or exemption certificates
  - Make tax determinations of products being sold into various states
  - What now states conform to Wayfair
  - Put in place revised risk and exposure analysis
  - Income/Franchise tax filings?

Understanding The Context of Sales Tax Pre and Post Wayfair

- Post tax reform asset sales
  - Key issue
    - Even on asset purchases (motivated by 100% bonus depreciation), buyers inherit successor liabilities for sales tax in states
- Responsible parties liability
  - States view sales tax liabilities like the IRS views trust fund (read FICA) liabilities
  - Therefore, principles in PE funds should have a heightened sensitivity to acquisitions in which there are latent sales tax liabilities; and
    - Should inform investors accordingly

How Does Wayfair Impact Due Diligence or Pre-Sale Due Diligence

- Wayfair will put more scrutiny into the sales tax portion of due diligence
- What are the practical implications?
  - Understanding the new state nexus standards and apply those standards to the targets sales footprint!
  - Measuring the tax, interest and penalty exposure accordingly!
  - <u>Making sure that purchase documents properly allocate responsibility between the parties</u>;
  - More focus on systems/process/compliance capabilities post transaction
  - Increased sensitivity to where taxes were collected but not remitted

How Does Wayfair Impact Settlement of Sales Tax Liabilities Between Buyers and Sellers?

- First, both parties must have a shared understanding of the issue
  - Agree what states have what nexus standards;
  - What products are taxable in what states based on:
    - Taxability of the product or service;
    - Taxability of the customer; or
    - The presence or absence of resale or exemption certificates
  - Agree on exposure measurement criteria
    - Including the use of statistical sampling

Agreed Upon Sales Tax Remediation

- In the post Wayfair world, buyers and sellers have to come to practical ways of identifying, measuring, and settling sales tax liabilities

- Suggested "best practices":
  - Agree to state specific nexus standards and effective dates;
  - Candid discussion of taxability of products or services of the target;
  - Understanding and documenting the existence of any exempt customers;
  - Full disclosure of where sales taxes may have been collected and not remitted;
  - Agreeing to a practical remediation strategy

Agreed Upon Sales Tax Remediation (Cont.)

- Many targets will have both pre-Wayfair type sales tax exposures, and post-Wayfair sales tax exposures

- How do parties deal with such exposures in an economically efficient manner?

Agreed Upon Sales Tax Remediation (Cont.)

- Agree to the amount and the nature of the exposure
  - – Nexus based exposure
  - – Interest and penalty based exposure
  - – Identify “collection but non-remittance” exposures
- Identify and agree to remediation options;
  - – VDAs:
  - – Registration and go-forward filings
  - – Resale and exemption certification gathering efforts;
  - – Informal settlements with states

Buyer/Seller Settlements – Best Practices

- Suggested framework:
  - Clearly delineate in the purchase documents
    - Pre-purchase and post-purchase responsibilities;
    - Who is responsible for professional fees to remediate post transaction;
    - Who has rights/responsibilities for assessments/refunds post closing;
    - Document retention including resale or exemption certificate retention

Post Transaction Compliance Realities

- No matter how exposure amounts are identified and settled – post-transaction compliance will need to be addressed:
  - Systems
  - Headcount
  - Process
  - Taxability determinations

What Does a Revised Risk Assessment Look Like?

- Companies will have to re-examine the following:
  - Look at the company’s activities in light of the Wayfair nexus standards
  - Look at sales by state in the context of the Wayfair decision
  - Understand state specific product or service taxability
  - Institutionalize resale and exemption certification collection and related document maintenance for al jurisdiction into which sales are made
  - Develop an understanding of the systems and personnel capacity to deal with expanded compliance responsibilities
  - Be prepared to register and file rapidly in a number of new states

What Does a Revised Risk Assessment Look Like?

- Exposure analysis and risk assessment
  - Keep a close eye on sales tax exposure in the post-Wayfair world
    - Including interest and penalties
  - Build a consensus on risk tolerance
  - Monitor sales tax exposure reserves
    - Be able to track and document assumptions and calculations

ASC 450 Concerns

- An estimated loss from a loss contingency is recognized only if the available information indicates that:
  - It is probable that an asset has been impaired or a liability has been incurred at the reporting date; and
  - The amount of the loss can be reasonably estimated.
    - Loss contingencies that do not meet both criteria for recognition still may need to be disclosed in the financial statements.
    - ASC 450 reserves will have an impact on EBITDA

Summary

- Wayfair has changed the nexus standard for sales tax
- Sales tax will become a more important element of tax due diligence
- Post transaction remediation will take on greater importance
- Expanded compliance requirements will demand more resources and perhaps greater outsourcing of compliance

DHG

DIXON HUGHES GOODMAN LLP

Questions?

DIXON HUGHES GOODMAN LLP

Giles Sutton

901 684-5654

giles.sutton@dhgllp.com

Tommy Varnell

404 575-8859

tommy.varnell@dhgllp.com