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Wayfair – The Impact on Manufacturers

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Welcome

Georgia Association of Manufacturers!

Presenters

Peter Giroux, SALT Partner
Dixon Hughes Goodman LLP – Atlanta
peter.giroux@dhg.com
404.575.8924

Tommy Varnell, SALT Sr. Manager
Dixon Hughes Goodman LLP – Atlanta
tommy.varnell@dhg.com
404.575.8859

Matt Tolan, SALT Sr. Associate
Dixon Hughes Goodman LLP – Atlanta
matt.tolan@dhg.com
404.575.8973

Agenda

- Nexus Background
- Examining the *Wayfair* Holding
- State Reactions to the *Wayfair* Decision and Other Nexus Standards
- Thinking About the Implication of Economic Nexus on Manufactures

Nexus Background

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)

Polling Question

Which of the following was NOT one of the four prongs established in Complete Auto Transit?:

a) Tax is fairly apportioned
b) Tax does not discriminate against interstate activity
c) Tax applies to an activity with substantial nexus to the taxing state
d) There can only be one tax rate per state

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)*

Challenges to Physical Presence

From a vendor standpoint, physical presence has become less representative of the activity taking place in each state.

Why?

- *Emergence of e-commerce*
  - + *Customers buy online from vendor instead of brick and mortar store*
    - *In many cases, vendor is out-of-state and not registered to collect sales tax.*
- *Shift to service-based / intangible economy*
  - + *Rather than buying software on a disk, customers download or remotely access software*

The changes in our economy have led to several challenges to the physical presence nexus standard over the last 20 years. However, until Wayfair, Quill continued to be the law of the land.

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Examining the *Wayfair* Holding

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

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?

Who is a Remote Seller?

While Wayfair itself is an e-commerce company, the *Wayfair* decision could impact other remote sellers, including:

- Sellers protected by P.L. 86-272 for income tax purposes
- Cloud computing service providers
- Software licensers
- Drop shipments

Polling Question

Which of the following was NOT a landmark nexus case:

a) Wayfair
b) National Bellas Hess
c) Kramer vs. Kramer
d) Quill

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State Reactions to the *Wayfair* Decision and Other Nexus Standards

How Will States Conform/Respond?

What are their laws regarding nexus standards?

- Streamline states
- Economic sales tax 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?

What is an SSTP state?

- State level administration
  - Unlike CO, AL and LA

- Uniform definition of products and services
  - A state may tax products and services differently, but definitions must be consistent.

- Simplified rate structure
  - Can’t have multiple rates based on industry / use.
  - Caused many states to convert specialized sales tax rates to excise taxes
    - *Ex. Local excise tax on utilities in GA for manufacturers*

- Provides sellers access to sales tax software paid for by the state

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's simplified sellers use tax rule?
- More conformity to streamline?

Other States Adopting Economic Nexus

To date, more than 30 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.

Wayfair Adoption – Summary by State *

State	Effective Date
Alabama	8/1/18
Colorado	12/1/18
Connecticut	12/1/18
Georgia	1/1/19
Hawaii	7/1/18
Illinois	10/1/18
Indiana	10/1/18
Iowa	1/1/19
Kentucky	10/1/18
Louisiana	1/1/19
Maine	7/1/18
Maryland	10/1/18
Michigan	10/1/18
Minnesota	10/1/18
Mississippi	9/1/18
Nebraska	1/1/19

State	Effective Date
Nevada	11/1/18
New Jersey	11/1/18
North Carolina	11/1/18
North Dakota	10/1/18
Oklahoma	9/1/18
Pennsylvania	4/1/18
Rhode Island	8/17/17
South Carolina	7/8/18
South Dakota	11/1/18
Tennessee	1/1/17
Utah	1/1/19
Vermont	7/1/18
Washington	10/1/18
West Virginia	1/1/19
Wisconsin	10/1/18
Wyoming	7/1/17

***Refer to notices issued by each state for specific guidance authorizing enforcement and economic thresholds.**

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 notice to the in-state customers that they may owe use tax and report 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

Georgia enacted notice and reporting requirements earlier this year, effective January 2019.

Polling Question

The objective of notice and reporting requirements is to ease the compliance burden for remote sellers.

- True
- False

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 (they also include economic thresholds with SW presence)

Polling Question

Cookie nexus refers to an attempt by states to increase sales tax compliance in the baking industry.

- True
- False

Thinking About the Implication of Economic Nexus on Your Business

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
- Tracking which states have or will be implementing similar nexus measures as SD
- Put in place procedures to ensure the collection of resale or exemption certificates
- Make tax determinations of products being sold into various states
- Registration requirements (even if non-taxable sales)
- Put in place revised risk and exposure analysis
- Other tax filings?
- Impact on M&A activity?
- Impact on purchases / use tax
- **Evaluate the Company's sales data as it pertains to sales tax reporting!**
    - **Invoice level detail, accurate street addresses, state-specific tax determinations of products/services sold**

Nexus Studies

Before *Wayfair*

- Analyze property, payroll, employee / contractor activity, delivery methods
- For some states, evaluate notice and reporting requirements

After *Wayfair*

- Analyze economic activity based on state thresholds:
  - Total Sales (NOT Taxable sales in most cases)
  - Number of Transactions (NOT Taxable transactions)
- Knowing which states have implemented new nexus standards and effective date / thresholds of those standards

Exemption Certificates

Before *Wayfair*

- Collect certificates for states with physical presence

After *Wayfair*

- Collect certificates everywhere
- Register based on economic thresholds

Tax Determinations

Before *Wayfair*

- Determine taxability based on physical presence / states where you are registered to collect tax

After *Wayfair*

- Determine taxability everywhere
- Even if under economic thresholds, knowing taxability in advance will be helpful if / when nexus switch is flipped

Registration Requirements

For economic nexus thresholds (typically $100K sales / 200 transactions), most states are not defining these in terms of taxable sales.

What does this mean?

- Wholesalers / distributors that only sell for resale may need to register, file zero returns and collect applicable certificates.
- Companies only making exempt sales into a state (ex. professional services) may need to register and file zero returns.

Revised Risk and Exposure Analysis

- 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**
  - **Make sure all major stakeholders are informed!**

- 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 could have an impact on EBITDA

As states continue to implement economic nexus, this will be a heavier focus in periods covered by post-implementation dates

Other Tax Filings

With the implementation of economic nexus for sales tax, will other taxes also be impacted?

- Registering for sales tax will increase state awareness of in-state activity and other potential taxes
- Already seeing similar nexus measures with other taxes (i.e. factor presence standard for income tax)
- **Double check P.L. 86-272 protection assertions!**

Purchase / Use Tax Impact

VERY CRUCIAL FOR MANUFACTURING

Use tax is the mechanism in place for remitting tax due to a state on purchases when a vendor did not charge sales tax.

Many manufacturers do not pay tax to their vendors for one of three reasons:

- Operating Under a Direct Pay Permit, thus purchasing everything exempt
- Extend manufacturing exemption certificate based on use of specific item
- Vendor does not have nexus in manufacturer's state, therefore tax would not be charged even without a certificate

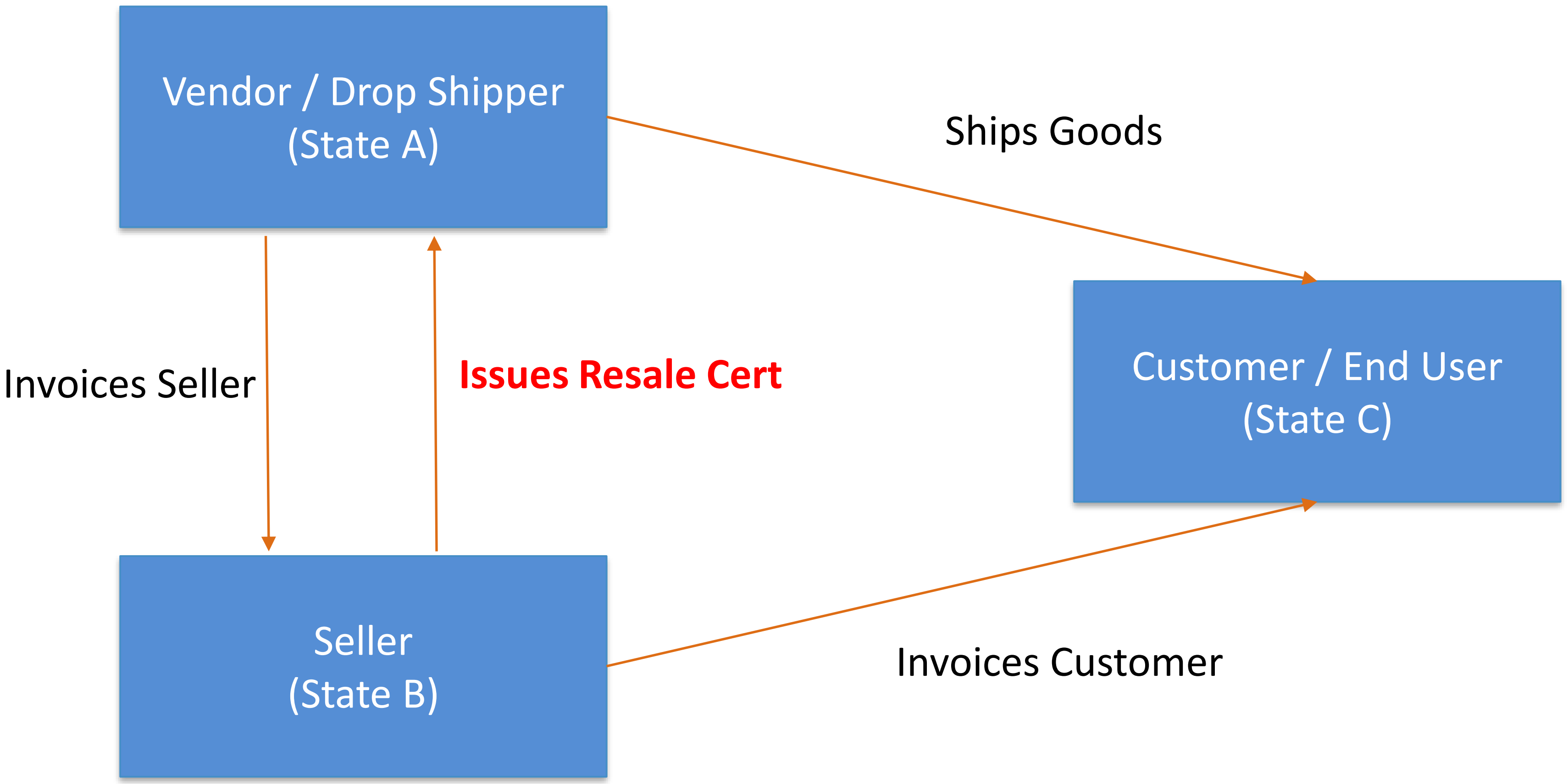
If vendors who were not charging sales tax due to lack of nexus suddenly flip the tax switch on:

- Ensure accruals are turned off to avoid double taxation
- If valid exemption applies, coordinate with vendor to ensure proper certificates are issued

Drop Shipment Tax Impact

What is a drop shipment?

+ One party sells product to an end-user, and a vendor (drop-shipper) of the seller ships the product to the end-user and bills the seller
+ The primary sales tax issue is the vendor and the seller may have different sales tax nexus and/or filing profiles.



Drop Shipment Tax Impact (cont.)

Before *Wayfair*

- When seller did not have nexus with customer’s state, most states would allow seller to issue their own state’s resale certificate to the drop shipper.
- The seller would not charge sales tax to customer, thus putting the tax responsibility on the customer

After *Wayfair*

- Seller may now have nexus with customer’s state based on economic activity.
- May remove ability to provide out of state certificate to drop shipper.
- Would then require seller to charge applicable sales tax to customer.

Impact on M&A Activity

- Sales tax is typically a focal point for M&A
  - Unlike most taxes, there are successor liability provisions in most states for sales tax. **Obligations can move to successor even in an asset sale.**
- Sales tax is THE MOST COMMON issue identified in tax due diligence!
- Expect a higher level of non-compliance for targets initially as companies navigate changes.
- For prior period activity, it is important to evaluate pre and post-*Wayfair* periods in estimating liabilities.
  - Look at traditional nexus triggering events, then layer in state economic nexus implementation dates.

Summary

Wayfair has changed the nexus standard for sales tax

- Several states have already announced prospective adoption of economic nexus standards
- Expect this to expand as we move forward

Expanded compliance requirements will demand more resources, potential need for more sophisticate sales tax systems and perhaps greater outsourcing of compliance

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Questions?