Decoding the Tax Code after Wayfair: Key Considerations for Software Companies

While the Wayfair decision knocked many types of online and remote sellers for a loop, the software industry was, and remains, among those hardest hit. By eliminating the physical presence standard as a requirement, the ruling opened the door for states to define nexus as they choose.

They have been quick to do so, and, in the process, place sales tax obligations on a software sector that had long enjoyed the luxury of tax-free sales except in the company's home state. These businesses now face a daunting challenge to comply with myriad and ever-changing state tax laws. Here, then, are some of the key challenges for the software industry that arise from the Supreme Court's 2018 ruling in South Dakota v. Wayfair.

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Determining nexus status

Like all sellers, businesses that generate some or all of their income through software sales must closely scrutinize revenue in every state following Wayfair. Besides physical presence, companies must evaluate the number of transactions with customers in each state as well as the total revenue generated in a state.

State laws vary widely regarding the level of revenue, number of transactions, or combination of the two that suffice to establish economic nexus. Where nexus exists, not only must companies collect, report and remit sales tax, but they may face other tax obligations in the state as well.

Identifying taxable sales

Counting the revenue earned in a state is less straightforward than it sounds for software sellers. Is what the company sells a product or a service in the first place? The way individual states classify and tax digital products varies significantly, which makes determining the revenue that counts toward nexus thresholds even more challenging.

States often distinguish between electronically downloaded software, custom software, Software as a Service (SaaS), and software that is sold in a physical package, listing each category as taxable or nontaxable and setting applicable tax rates with no consistent standard to guide sellers. What is fully taxed in Georgia, for example, may be partially exempt in Alabama and not taxable at all in Tennessee and Florida. Unraveling this web of rules is a formidable task, and software companies must master it in every state their customers represent.

Establishing location for taxation

The issue of customer location is another tricky spot for the software industry. For SaaS and when delivery takes place via download, software sellers typically do not require a physical address from buyers (unless required for processing payment by credit card). What is more, the location of the download may or may not be the buyer's state of legal residence – or other licensed users'.

Software sellers may need to expand the information they obtain from customers and should definitely allot additional resources to sorting out sales by location. Inadequate attention to revenue sourcing questions creates a serious barrier to tax compliance for businesses in this sector.

Managing tax administration

Making sense of their new sales tax picture is hard enough for software-focused businesses, but even that may pale in comparison to the ongoing challenge of monitoring relevant information from myriad sources. States constantly change their policies regarding which types of products and services are taxable, along with their tax rates for different categories. These days they are also making rapid-fire changes to the definition of nexus in the state.

Tracking tax rates, taxability and nexus definitions for all jurisdictions; linking the appropriate rate to customers' bills based on location; monitoring changes; and keeping up with exemption certificates are all critical for compliance. Company leaders should expect to devote additional staff and time to these considerable burdens. In addition, most should also give serious thought to utilizing specialized software designed to help ease the onus of multi-state sales tax obligations or seeking third-party assistance from specialists in this area.

Conclusion

Adapting to Wayfair represents one of the most significant challenges the software industry has seen in its relatively brief history. The blow is highly unlikely to be fatal though, and what doesn't kill us often makes us stronger. If your software business is struggling with a post-Wayfair world, turn to the knowledgeable tax team at Mauldin & Jenkins. We'll help you overcome the hurdles and stay on the path of success.

Jeff Dorris
SALT Practice Leader
Mauldin & Jenkins
jdorris@mjcpa.com
770-955-8600
MJCPA.com