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NAVIGATING SALES AND USE TAX: 5 CONSIDERATIONS TECHNOLOGY COMPANIES CANNOT IGNORE

Technology is evolving at a breakneck pace, and the associated finance and taxation frameworks follow hard on the heels. The evolution of new-age technology businesses, the rise of digital platforms and marketplaces, and the explosion of cloud-based business models have nudged the US regulators to tighten the noose on Sales and Use Tax implications across different states.

Technology businesses, especially ones providing only services, have a general notion of being exempt from the applicability of sales and use tax due to the absence of a tangible product. However, the state tax laws have evolved with time to include a variety of products and services that technology businesses deal with in the ambit of sales and use tax rules. Not being cognizant of these developments results in the erosion of business' profits quicker than what it takes to earn those dollars.

Evolving sales and use tax rules call for proactive understanding and compliance by businesses. Below are a few considerations to help technology companies get their understanding right –

1. Zooming into the nexus

A nexus is a link (in the absence of an actual place of business) between a business and a state that triggers the collection of sales taxes in the said state. An out-of-state seller is required to register, collect, and remit sales tax with the state tax authority either due to economic (value-based or transaction-based) or physical presence (by virtue of employees, property, etc.), as mandated by most states. However, the challenge lies in ascertaining each state's individual sales and use tax laws with respect to the applicability of the same to technology and software businesses. The shift to economic nexus standard by almost all the states post the Wayfair decision in June 2018 compounded the complexity of nexus determination for most businesses.

Looking closely at the nexus in every state will help businesses tick the compliance checkbox without a fault.

Way forward: Technology businesses need to identify the states in which it has nexus to determine the tax obligations.

2. Monitoring the ever-evolving taxability of services

Taxation of technology and software products & services is top of mind for the US government, policymakers, regulators, businesses, and citizens. The ever-evolving technology triggers evolution in its taxation. Over time, how technology-based services are packaged and delivered has changed the dynamics of taxation. For example – From selling software through CDs, flash drives, or similar tangible devices to installing software on clients' servers to cloud-based subscription models (SaaS) involving no tangible form, there has been a sea-change in the way software services are delivered, though the end benefit or utility of the software might remain the same. Each state has viewed this transition differently, therefore, the resultant taxability for SaaS models may vary from state to state.

States are leaving no stone unturned to appropriately characterize the taxability of technology services to plug tax leakages. For instance, there can be a fine line between what one generally classifies as IT services vis-à-vis staff augmentation services (where the employees of taxpayer work under the direction, control, and supervision of the client) and taxability thereof will be different.

Way forward: Technology businesses must not consider themselves off the hook if their services are characterized as non-taxable in a particular state based on the historical analysis. Businesses need to diligently track any new development concerning state sales/ use tax laws on a contemporaneous basis or should ideally revisit taxability for its products/ services at least annually.

3. Identifying the source and delivery of the services

As a practice, the finance department of a business keeps a meticulous record of service transactions and delivery details. However, to ensure alignment with state tax laws, it is critical to ensure the same information is visible and mapped to the sales tax engine, which calculates tax on each sale. How technology services are sold and delivered has prompted a shift from non-taxable to taxable transactions in several states. Sometimes it may not be feasible to determine the actual state of delivery, prompting the need to identify the next best option, which, in most cases, will be the billing address. For example- A taxpayer selling SaaS licenses issues licenses for ten users, wherein the end-users may be able to access the software from any state. The scenario makes it practically impossible for taxpayers to ascertain in which state(s) the license will be used, which could result in the taxability being determined based on the billing state.

Way forward: Technology businesses need to ensure alignment of source and delivery of services with individual state sales and use tax mandates.

4. IPaying use tax on products purchased

A buyer of products or services that are taxable in the state in which they are purchased or consumed is required to pay use tax if the seller has not charged the appropriate tax on the invoice. The issue of non-tracking and non-payment of use tax on the purchase of supplies/ consumables is common irrespective of the industry. The adjustments pertaining to use tax of the said nature have been observed in the case of state audits.

Way forward: Technology businesses need to identify ways to appropriately track the purchase invoices on which tax has not been levied, determine taxability for such products, and duly make the use tax payments with state tax authorities.

5. Optimizing bundled transactions

While bundling taxable and non-taxable products or services on an invoice for a single non-itemized price can save time and work for a business, it can hamper appropriate sales/use tax classification of the listed products and services. It could adversely result in the imposition of tax on the entire sales price. True object of the bundle transactions needs to be taken into considered while determining the taxability of the transactions.

Way forward: It is recommended that the technology businesses disclose taxable products and services separately on the invoice, so that tax may be imposed only to that extent. Alternatively, if that is not feasible, it is crucial to document that taxable products or services do not constitute material value (which is generally less than 10% of the total invoice value of a bundled transaction) to avoid sales tax implications on the total price.

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