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US sales and use tax: A survival guide for international business

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Foreign companies are oftentimes caught off guard by the differences between U.S. sales and use tax and international value added taxes. As different states have different rules, figuring out which taxes are due to whom can seem quite overwhelming. In this article, Robyn Staros and Stephanie Gilfeather discuss approaches and tools that businesses can use to proactively understand and take command of their U.S. sales and use tax obligations.

U.S. Sales and Use Tax: A Survival Guide for International Business

By Robyn Staros and Stephanie Gilfeather

Introduction

Companies based outside the U.S. are sometimes surprised by the differences between U.S. sales and use tax and international value added taxes. Both are indirect taxes with the similar purpose of taxing consumption, and both require attention and planning on the part of the seller, but there the resemblance ends. The task of identifying states in which sales and use tax compliance is required and how to apply each state's tax may seem daunting, but it's not impossible. In this article, we will discuss approaches and tools that businesses can use to proactively understand and take command of their U.S. sales and use tax obligations.

Background

- Sales and use taxes are imposed on the sale of tangible personal property and certain enumerated services in 45 states and the District of Columbia.
- Generally, the place where possession or title passes to the customer determines which jurisdiction has the right to tax a sale of tangible personal property, while the place where the customer ''receives the benefit'' of a service determines which jurisdiction has the right to tax a service.
- When a sale made by a retailer is subject to sales tax, the retailer is generally required to collect the tax

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from the purchaser and report and remit that tax to the taxing authority.

- When an out-of-state retailer has not collected tax, a purchaser is generally required to report and remit applicable use tax directly to the taxing authority.
- When an out-of-state retailer makes sales to customers in a state where the seller has no actual place of business but otherwise has sufficient connection (''nexus'') with that state, the retailer is generally required to collect use tax from its customers and remit that tax to the state taxing authority.

Nexus: The Requirement for Sellers to Comply With Sales and Use Tax. Unlike U.S. income tax, sales and use taxes are not covered by international tax treaties. Accordingly, any international business with customers and/or activities in the U.S. should consider whether it has sales and use tax responsibilities in one or more U.S. states. Currently, a business is required to comply with sales and use tax laws in only those states where they have the requisite connection or ''nexus.''

Traditional Nexus. In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court held that before an out-of-state company can be obligated to register and collect state use tax, it must have ''substantial nexus'' in the taxing state. This substantial nexus standard derives from the commerce clause of the U.S. Constitution and requires some level of physical presence. In *Scripto v. Carson*, 362 U.S. 207 (1960), the U.S. Supreme Court sanctioned the agency theory of nexus, finding that an out-of-state seller who used independent contractors to solicit business could be required to collect the state's use tax. In *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987), the U.S. Supreme Court ruled that having representatives that perform activities on behalf of a seller while physically present in a state may create sales tax nexus for a seller if such activities are significantly associated with the seller's ability to establish and maintain a marketplace in the state for its sales.

Taken together, these decisions preclude a state from asserting the duty to collect sales or use tax upon an out-of-state seller absent proof that the out-of-state seller itself, or through an agent or representative soliciting on the out-of-state seller's behalf, is physically present in the state. In recent years, states have enacted nexus provisions that look to an agent's or representative's activities as they pertain specifically to internet sales solicitation and also through the shared activities of intercompany and/or affiliate entities.

'Click-through' and 'Affiliate' Nexus. New York became the first state in 2008 to enact what is sometimes called a ''click-through'' nexus statute. ''Click-through'' nexus statutes create a presumption of nexus for out-of-state sellers who compensate an in-state person based upon a commission arrangement for the placement of a hyperlink to the out-of-seller's website through the in-state company's website. The out-of-state seller may rebut the presumption provided it can document that the in-state person is not actively soliciting sales within the state on the out-of-state seller's behalf.

Additionally, some states have enacted ''affiliate nexus'' statutes that confer nexus on an out-of-state seller who is under common ownership with an in-state affiliate, when the affiliates share common logos and trademarks, or the in-state affiliate otherwise engages in activities that are deemed to expand the marketplace on behalf of the out-of-state affiliate.

States are not uniform in their enactment of these nexus provisions. Approximately 14 states have enacted click-through nexus laws, approximately 19 states have enacted affiliate nexus laws and one state administers both provisions via a policy statement. Accordingly, to determine its sales tax obligations, a seller should identify states in which it has traditional nexus via payroll and/or property, states in which the seller's representatives have a ''regular and systematic'' presence and states where click-through or affiliate nexus may apply.

The Changing Landscape of U.S. Sales Tax: International Projects & Federal Legislation. Both the United States Congress and the Organization for Economic Co-Operation and Development (OECD) have recognized that traditional approaches to indirect taxation may not be effective in the modern business economy. OECD recently released a series of non-binding recommendations to change domestic tax laws, treaties, and other measures in an effort to ease government concerns related to tax base erosion and profit shifting. With change appearing to be at the forefront of the international conversation, some taxpayers have begun to consider the potential impact on their state tax postures as states begin to react to the international tax discussion. While many of the OECD's deliverables focused on income tax, *Action 1, Addressing the Tax Challenges of the Digital Economy*, discusses indirect taxes, including sales and use tax. OECD has identified challenges associated with the digital economy, such as: (1) taxable nexus created by the mobility of intangibles, users, and business functions; (2) attribution stemming from the collection and use of data; and (3) characterization of payments in certain digital economic business models.[1] OECD has not yet resolved the perceived policy challenges associated with the digital economy.

Proposals for expanding sales and use tax nexus can also be seen at the U.S. federal level. In the 113th Congress, the U.S. Senate passed the Marketplace Fairness Act (MFA), which if adopted into law would generally allow Streamlined Sales and Use Tax Agreement member states as well as states adopting ''minimum simplification requirements'' to impose laws that would require remote sellers (i.e., sellers that have no physical presence in a particular state) to collect and remit sales/use taxes on sales to in-state residents. Also, if adopted, the MFA would provide an exemption for sellers with annual gross receipts from U.S. remote sales of $1 million or less.

The 113th Congress expired on Jan. 3, 2015, having not passed the MFA. Thus, for the adoption of the MFA to remain a possibility, new legislation would have to be introduced and enacted by both the Senate and House of Representatives in a future Congress. Therefore, the form and timing of any potential Federal Legislation is unclear. It is noteworthy that in mid-November 2014, U.S. House Speaker, John Boehner, had expressed his concerns with the MFA and vowed his resistance to tak-

[1] See OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

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ing up the measure during the final months of the 113th congressional session.

While the specific details of OECD recommendations or final U.S. federal legislation are still unclear, both indicate that retaining a physical presence nexus standard for indirect taxes may not be practical in our modern digital economy. This is consistent with the states' adoption of click-through and affiliate nexus statutes that depart from the traditional physical presence model. At all levels, governments are recognizing that technological advances allow companies to carry out extensive economic activity in a jurisdiction without the need to be physically present in that jurisdiction. The ultimate goal of the taxing authorities is to ensure that revenue is taxed in the jurisdiction where the economic activities occur rather than in the jurisdiction where the seller chooses to locate its business.

A foreign-based multinational company that sells tangible personal property, software, or other digital products should be aware that, as a seller, it not only needs to identify the states in which it has payroll, property, or representatives with a ''regular and systematic'' presence, but also those states where it pays a commission to in-state companies for a referral to its website or has affiliates engaging in related business activities. These activities may result in a sales and use nexus determination pursuant to a state's nexus rules. Such a determination would then require the foreign-based multinational company to register with the state tax agency, file sales/use tax returns, pay sales/use tax, and collect sales/use tax from its customers and remit that tax to the taxing agency. These same foreign-based multinational companies should monitor OECD's recommendations, federal legislation, and state law changes for additional compliance requirements.

Structure and Administration of Sales and Use Taxes. Sales tax is collected by a seller from a customer when the transaction is subject to tax, unless the customer provides a customer-level or a transaction-level exemption certificate. Sellers are responsible for knowing what is taxable in the states in which they have nexus, collecting exemption certificates from customers to support a non-taxed sale, and remitting in a timely manner sales tax collected from customers on taxable sales. A transaction may be exempt because the customer making the purchase is exempt, because the type of transaction is exempt, or because the property or service being purchased or used is exempt.

A customer-level exemption is based upon the type of entity and whether it qualifies for an exemption. For example, a non-profit hospital or a school may be statutorily exempt from paying sales and use tax on its purchases. Some states may require such entities to apply and be approved for the exemption. The sale to certain statutorily exempt customers, such as the federal government, does not require an exemption certificate.

A transaction-level exemption is based upon the use of the product or service. For example, a sale to a customer who will resell a product without making any intervening use is generally considered an exempt sale for resale. Other common transaction-level exemptions are purchases used in an exempt activity such as manufacturing, research and development, or agriculture. The seller must collect an exemption certificate from the buyer to document the exempt nature of the transaction. The documentation requirements vary by state.

An exemption certificate is not normally required if the sale is statutorily exempt such as the sale of food for human consumption, prescription drugs, or certain medical devices, which are not taxable or are taxed at a lower rate in most states.

Sales and use tax is generally administered by each state's Department of Revenue, although some municipalities self-administer a municipal-level sales tax. The tax rates, return filing frequency, and filing requirements are specific to each jurisdiction. Enforcement of the rules is state-specific, with most having an audit division that routinely reviews in-state and out-of-state seller compliance. State tax auditors often pay particular attention to the exemption documentation in support of non-taxed sales.

Product Taxability. It is the responsibility of businesses to understand how a state interprets and classifies the product or service it buys or sells within the scope of the state's sales tax regime. To demonstrate the complexity in applying taxability rules among various states, the example below depicts the sales tax treatment of the same item in different states. Each of the listed states taxes canned software delivered via a hard copy under the premise that the canned software meets the definition of tangible personal property and is thus subject to tax.[2] The same canned software that is delivered electronically is not deemed tangible personal property in California and is thus not taxable. Further the concept of Software as a Service (SaaS) can be classified under multiple taxation rules as discussed below.

[2] Cal. Rev. & Tax Code §§6006(a), (b); Cal. Code Regs. tit. 18 §1502(b)(9), (f)(1); N.Y. Tax Law §1101(b)(5), (6), (14); N.Y. Tax Law §1105(c)(1); Tex. Tax Code Ann. §151.005; Tex. Tax Code Ann. §151.0101(a); 151.009; 34 Tax Admin. Code §§3.308(b)(1),(2); RCW §82.05.050(6)(a); RCW §82.12.020(1)(b); WAC §458-20-15502(3).

Product	California	New York	Texas	Washington
Canned Software- delivered via tangible media	Taxable [Cal. Rev. & Tax Code §§6006(a), (b); Cal. Code Regs. tit. 18 §1502(b)(9), (f)(1)]	Taxable [N.Y. Tax Law §1101(b)(5), (6), (14); N.Y. Tax Law §1105(c)(1)]	Taxable [Tex. Tax Code Ann. §151.005; Tex. Tax Code Ann. §151.0101(a); 151.009; 34 Tax Admin. Code §§3.308(b)(1),(2)]	Taxable [RCW §82.05.050(6)(a); RCW §82.12.020(1)(b); WAC §458-20-15502(3)]
Canned Software- delivered electronically	Not Taxable [Cal. Rev. & Tax Code §§6006(a), (b); Cal. Code Regs. tit. 18 §1502(b)(9), (f)(1)(D)]	Taxable [N.Y. Tax Law §1101(b)(5), (6), (14); N.Y. Tax Law §1105(c)(1)]	Taxable [Tex. Tax Code Ann. §151.005; Tex. Tax Code Ann. §151.0101(a); 151.009; 34 Tax Admin. Code §§3.308(b)(1), (2)]	Taxable [RCW §82.05.050(6)(a); RCW §82.12.020(1)(b); WAC §458-20-15502(3)]
SaaS	Not Taxable [Cal. Rev. & Tax Code §§6006(a), (b); Cal. Code Regs. tit. 18 §1502(b)(9), (f)(1)(D)]	Not Taxable [N.Y. Tax Law §1101(b)(5), (6), (14); N.Y. Tax Law §1105(c)(1); N.Y. Reg. §526.7(a)(2); TSB-A-99(31)S, New York Commissioner of Taxation and Finance (June 7, 1999); TSB-A-13(22)S, New York Commissioner of Taxation and Finance (July 25, 2013)]	Taxable - on 80% of the taxable base [34 Tax Admin. Code §3.330; Tex. Letter No. 200805095L (May 28, 2008)]	Taxable [RCW §82.05.050(6)(a); RCW §82.12.020(1)(b); WAC §458-20-15502(9)]

An interesting development involving software occurred recently in Texas where the Texas Comptroller of Public Accounts ruled that an out-of-state licensor's retained property rights in software licensed to Texas customers[3] created sufficient physical presence in Texas to constitute the substantial nexus necessary to subject the licensor to the obligation to charge, collect, and remit Texas use tax.[4]

Cloud–Based Services. Cloud computing services include products and services provided or furnished electronically such as SaaS, hosted software, cloud computing, web-enabled services, or other web-based items. While certain jurisdictions have directly addressed the taxability of cloud-based services, the seller is often left to fit its facts to statutes that were drafted to address the sale of traditional tangible personal property or at best, downloaded software.

States vary widely on the treatment of hosted products, defined generally as software that is installed and accessed from a remote server. Some states do not tax hosted products because no software has been deemed to have transferred, while other states consider hosted software to be a statutory sale of software regardless of the form delivered (i.e., electronically). Some states limit their tax base and do not tax other digitally based products while still others have extended their sales tax to a broad range of cloud technology. In addition, there may be other tax types to consider, such as telecommunication taxes, gross receipts taxes, or specific municipal taxes that could be applicable to these electronically delivered transactions.

In determining what product or service is being sold, the seller should examine customer contracts, the terms and conditions to which the customers agree, and the applicable marketing and promotional materials.

Sourcing Rules. Sellers must also determine which state's sales tax rules apply to a given sale. A sale of tangible personal property, where title transfers to the customer at a seller's location and is shipped by common carrier, is generally sourced to the state in which the property comes to rest or at the customer's physical location (i.e., the destination state). Other sourcing rules may apply if the customer takes title at the seller's place of business, if the transaction involves a sale of service, or if the item sold is available for use in more than one place at a time, such as hosted software.

The Streamlined Sales Tax Agreement, a uniform agreement of definitions adopted as law in 24 states,

[3] Delivery occurred either by digital download over the Internet or by common carrier.

[4] Texas Comptroller of Public Accounts, SOAH Docket No. 304-13-5657.26 (Sept. 19, 2014) at 18.

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contains cascading sourcing provisions to help enable the seller to make these determinations. For the 22 non-streamlined states, the sourcing rules vary. Still there may be separate rules that apply specifically where local taxes are involved.

Use Tax. A foreign-based multinational company may need to accrue use tax on purchases where its vendor did not collect sales tax. Use tax complements sales tax and is meant to provide equality among in-state and out-of-state sellers by imposing a use tax upon the customer in the event a seller did not charge the sales tax. Accordingly, a business needs to have a process in place to determine whether its *purchases* would be subject to use tax.

Action and Direction. The task of understanding the myriad of state rules, authorities, and requirements can be daunting. We recommend that businesses focus on the following important areas:

Structure: Review the legal entity structure to determine which entity is doing business in the U.S., including the relationship and shared activities between that entity and others within the organization and how the entity conducts or plans to conduct business in the U.S.

Nexus: Determine states in which the entities have nexus, including traditional physical presence or nexus under the more recent click-through and affiliate nexus standards.

Taxability: Identify products and determine product taxability, including a thorough review of how the product or service may be conveyed or delivered. Also, determine whether use tax should be accrued on purchases consumed in the business' activities.

Sourcing: Understand where and how products are conveyed and what states' rules apply to the products being sold, paying careful consideration to cloud-based services.

Compliance Readiness: Analyzing sales and use tax compliance readiness before the MFA, or some other broad U.S. federal law, is adopted may help identify gaps and improve processes and policies.

Automation: Understand and document the process flow from the general ledger to the source documents to ascertain whether sales and use tax compliance requirements are met within the current automated processes and to help identify compliance gaps. Determine whether third-party sales and use tax automation software could help to control and address the compliance reporting requirements.

Exemption Certificates: Review the current policy and processes for collection and retention of exemption documentation to assess the level of compliance. This analysis may involve gathering, updating, and tracking exemption certificates to support non-taxed sales, a key area for review in state sales and use tax audits and most often where errors are discovered.

While taxpayers and the tax community await the outcome of the OECD recommendations and possible U.S. federal legislation, sellers should analyze potential tax exposure and tax reduction opportunities, while also considering implementation of improved processes in preparation for a likely scenario—that remote sellers with customers in the 45 states (and the District of Columbia) that impose a sales and use tax may in the near future face sales and use tax collection responsibilities in all such jurisdictions. A successful sales tax function is one where the seller proactively invests the time and appropriate resources to thoroughly review, assess, and determine the obligations of the business and take the steps necessary to establish a process to enhance tax compliance. An international company expanding business in the U.S. is faced with many tax decisions. State sales tax rules are often the last item to be looked at and can be the most challenging to address. Implementing a process to review, understand, and comply with the state tax rules can make the difference in a business's ability to more fully capitalize on U.S. consumer spending as opposed to paying those profits to state taxing authorities in the form of tax, interest, and penalties.

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