YOU CAN'T IGNORE THE BIG FOUR

HOW CALIFORNIA, FLORIDA, NEW YORK, AND TEXAS ARE CHANGING THE SALES TAX GAME

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Sales and use tax compliance have never been more complicated. Determining where, when and how to collect sales tax and for which products and services is impossibly onerous.

California, Florida, New York, and Texas (hereafter the "Big Four") are four of the most populous states and have the highest sales tax revenue collections in the U.S. As a result, they are a good indicator of how other states might handle remote seller obligations in the future.

> The way each of these states handles the most complex compliance issues is the subject of this conversation.

What is going on with nexus and remote sellers?

The connection between a company and a state that triggers a sales tax collection obligation is called "nexus." If you're a company with a physical location in the state you typically collect sales tax from customers. It gets tricky when you don't have a physical location within the state but still need to collect sales tax due to that particular state's rules. In states into which your company sells, but for which you do not collect sales tax, consumers are required to remit use tax to the state—even though few actually do.

When customers began purchasing online, the concept of nexus began to shift from significant physical presence to encompass other activities such as affiliate relationships and click-through nexus.

Internet retailers such as Amazon would prefer not to collect sales tax from customers, while states (ever desperate for more revenue) try to capture any sources of uncollected revenue. Statutory efforts attempt to solve the problem of imposing sales tax collection obligations on remote or out-of-state sellers.

> All companies that sell outside their state will one day be impacted by sales tax legislation.

THE BOTTOM LINE: Broadening the definition of nexus is often an effective means for states to increase revenue without raising taxes.

How are the Big Four states expanding definitions of remote seller nexus?

States like California, Florida, New York and Texas have typically led the way in widening statutory definitions of nexus to increase the net and capture more sales tax revenue from remote sellers. Click-through and affiliate nexus describe two methods states are using to collect more sales tax revenue from remote sellers.

Click-through Nexus—You must collect and remit tax if you generate a certain amount of revenue via online referrals.

Do the Big Four have click-through nexus?

New York—Yes

New York was the first state to establish click-through nexus. In this case, the definition of nexus was expanded to include activity by in-state website owners for the benefit of out-of-state retailers.

California—Yes

Click-through nexus in California is similar to New York's. If you advertise on a website through an affiliate type program and that website is hosted in California, you have nexus in California. Keep in mind this doesn't address the taxability of what you sell, but rather the state's requirement that you collect sales tax.

Florida—No

Texas—Yes

Affiliate Nexus—You must collect and remit tax if you maintain certain affiliate relations in the state

Do the Big Four have affiliate nexus?

New York—Yes

A state court recently upheld an earlier statute that required certain remote sellers to collect and remit sales tax if their affiliate relationship created nexus.

California—Yes

California has beefed up their affiliate nexus laws. Any entity that's related to your company in any way, any sort of ownership relationship, who conducts any activities whatsoever on your behalf, for your benefit, or using a similar patent or trademark. Even if the related business operations are utterly separated from the retail operation in another state, this might be considered nexus in California.

Florida—No

Florida does currently enforce the collection of sales/use taxes on purchases made over the Internet or from other remote out-of-state vendors. However, if some Florida lawmakers have their way during the 2013 legislative session, Florida will join states like Arizona, where Amazon now collects sales tax, and Connecticut, where it will begin sales tax collection in November.

Texas—Yes

The Texas statute includes specific language regarding the treatment of distribution centers. In Texas, a nexus obligation is triggered if a remote seller such as Amazon runs a distribution within Texas. There's quite a history between Texas and Amazon, which is interesting if you're into that stuff; they've gone back and forth for several years.

THE BOTTOM LINE: As states broaden definitions of nexus to include out-of-state affiliations with in-state businesses, more remote sellers will have sales tax collection obligations.

How do the Big Four states tax digital goods?

Digital goods are an area of great growth and an area of great concern to sales tax authorities. It's also an area of great confusion, as states treat and tax digital goods quite differently.

There is little consensus when it comes to definitions of digital goods, even amongst the big four states. Some states lump them together with software. Some states create a legal fallacy and call them tangible products. Some states, especially Streamlined Sales Tax (SST) states, have adopted specific language to describe digital goods.

Sales tax compliance challenges like these giving you a headache?

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Do the Big Four tax digital goods?

California—Yes
California is very generous when it comes to digital products. California exempts all sales of digital items, unless (and here's the big but) a digital item is transferred to any sort of physical storage device. In such cases, the sale immediately becomes taxable. That may sound elementary, but it's not.

New York—No
Digital goods are not taxable in New York. Exceptions to this include digital information such as electronic news services, which are taxable in New York if they meet certain pricing criteria. New York legislation may seem really obvious and straightforward, but through regulatory rule making, it becomes more complex. Digital goods may not be taxable in New York most of the time, but watch out for exceptions.

Florida—No
Digital goods are not currently taxed in Florida. There is however, a document offering "informational guidance" released by Florida FOR that states that Florida typically does not tax products that lack physicality.

Texas—Yes
Any item sold in electronic form that could also be sold in a physical form is considered taxable. FOR that states that Florida typically does not tax products that lack physicality. Texas does not provide a lot of specific guidance, taking an interesting but indirect route.

THE BOTTOM LINE: More states are attempting to require sellers to charge sales tax on digital goods. As a result, businesses need to look closely at what they're selling and how it's delivered.

How do Big Four states treat drop shippers and the companies they serve?

Drop shipping and what UPS likes to call logistics is becoming the dominant distribution and delivery mode for many businesses, particularly ecommerce companies in the U.S.

Drop shipping rules contain a lot of traps for remote sellers and other businesses. The confusion around drop shipping stems from the fact that it's not an obvious nexus-triggering situation.

In other words, functions traditionally performed by a business at a headquarters or at an office are now often performed by jobbers and affiliated entities– both in the U.S. and globally..

Do the Big Four states count contracts with drop shippers a nexus-creating activity?

New York—Yes

On the drop shipper side, New York is one of the more flexible states. New York allows for the inclusion of a resale certificate number from the company's home state. So that way, if a drop shipper is in New York, and you're in Washington, you can provide your Washington resale number to New York in many cases.

Florida—Yes

If a remote seller uses a drop shipper with nexus in Florida, sales made into Florida might be subject to sales tax. If a drop shipper in Florida is delivering goods on a remote seller's behalf, that drop shipper is obligated to collect sales tax.

The Florida drop shipper or wholesaler selling to a retail customer is required to charge tax on the retail price. If the dollar transaction is taking place between the wholesaler and the reseller, the wholesaler is required to charge a tax on the wholesale price on that transaction.

California—Yes

California, much like Florida, requires collection of sales tax by drop shippers who have nexus in California. California is one of most aggressive states about drop shipping. California wrote the book about drop shipping and the collection obligation. If the drop shipper is not privy to the retail price, they have to add ten percent to the wholesale price, which becomes the tax base.

California's treatment of drop shipping is just another reason to keep very good records of all sales tax related transactions.

Texas—Yes
Texas is a little more like New York when it comes to drop-shipper rules: fairly relaxed. Drop shippers are obligated to collect sales tax on sales made in Texas. In other words, the burden is on the retailer, not on the drop shipper. If the retailer has nexus, the retailer needs to collect. If the retailer doesn't have nexus, then the transaction is not taxed. And of course, wholesalers in Texas are required to collect resale certificates if they're not charging tax to their retailer.

THE BOTTOM LINE: More states are looking closely at the relationship between out-of state sellers and drop shippers. Should those relationships constitute nexus, sales tax collection obligations will follow.

State	Affiliate nexus?	Click-through nexus?	Tax digital goods?	Drop shippers create nexus?
California	✓	✓	✓	✓
Florida	✗	✗	✗	✓
New York	✓	✓	✗	✓
Texas	✓	✗	✓	✓

Why do sales tax issues like Use Tax and Resale Certificates matter?

Use Tax in California. New developments in use tax compliance in California are really pointed at accounting firms, law firms, and other professional services that historically have not registered for sales tax. The use tax rules apply to any vendor not on the sales tax registry.

In other words, folks that just don't believe they have a sales tax issue and maybe historically don't, and perhaps don't for taxability purposes, might have an issue over reporting purchases made absent payment of sales tax. However, California does not require businesses with gross receipts under $100,00 to report untaxed out-of-state purchases.

Mobile commerce is truly going to make our commercial lives mobile. The idea of physical locations and headquarters and offices are probably on their way out.

Resale Certificates. People mistakenly believe that if they have a resale certificate in hand, they are exempt from sales tax. Compliance with resale certificate terms, as well as storage and upkeep, is a huge area of focus for auditors. If sales tax is the most forgotten about element of tax compliance in most business finance offices, resale certificates are the least emphasized element of sales tax compliance.

Resale certificates are often conditioned on only certain types of sales or purchases for certain types of objectives of, say, a not-for-profit. Some states have not-for-profit laws where a certificate for exemption only applies to particular items that are used for the furtherance of that not-for-profit's goal or legally stated purpose.

What other changes are coming?

Mobile commerce. As smartphones become cash registers, via card swipe devices for mobile phones, taxability issues get complex quickly. There are several accounting applications for mobile devices currently for sale. Frankly, there are all sorts of apps that can turn a smart phone or device into a cash register, into a point of sale, into a place of business immediately.

Smart phones have implications for rates and boundaries. What rules apply, where a person is when a sale is made, where a person is when a thing is delivered, and whether that "thing" is taxable or not are all issues nowhere near being settled that raise interesting questions for the future.

Virtual games. Farmville and similar online games represent online commerce using virtual currency. We're talking about virtual games, virtual reality, online, where commerce happens either through virtual currency or through real currency that is translated into virtual currency. States are just beginning to look more closely at digital goods, and have yet to determine whether or not these transactions fall under the sales tax net.

About Avalara

A privately held company, Avalara was founded by a team of tax and software industry veterans to fulfill a vision of delivering an affordable, scalable sales tax solution. Thus making what was not economically feasible in the past for mid-sized business not only affordable, but more accurate as well —all with the latest and most innovative technology available. From Bainbridge Island, close to Seattle, Avalara's knowledgeable staff works tirelessly to help customers put the hassles of sales tax compliance out of mind. Avalara's mission is to transform the tax process for customers by creating cost-effective state-of-the-art solutions. The company does so through integrated on-demand, Web-based software services that provide transparent transactions, accurate tax compliance, painless administration and effortless reporting.