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Top Six Dos and Don’ts for Software and SaaS Manufacturers Related to Handling Tax Obligations

Software and software as a service (SaaS) manufacturers are faced with increasingly complex regulatory environments ranging from cutting-edge data privacy and security issues (see our blog post about the ever-changing landscape of consumer data privacy laws) to more traditional obligations related to taxation. Pay close attention to these words of advice.

1. Don’t Assume that Sales Taxes are Inapplicable.

Many software manufacturers incorrectly assume that sales tax does not apply to transactions. The rules can differ significantly depending on whether you are selling traditional software, SaaS, or a hybrid product; and more importantly, how the taxing jurisdiction at issue defines your product or service. Accordingly, the safest bet is to flip the common assumption on its head and assume that unless there is some exception, “Uncle Sam,” or more likely his smaller state relatives, will always want to tax the transaction.

Most states treat prewritten (“canned” or “off-the-shelf”) software as tangible personal property and subject to applicable sales and use taxes. This is generally true regardless of if: (a) the software is obtained via tangible media or downloaded; or (b) the transaction is labeled a sale or lease. In contrast some states, for example, California and North Carolina, only tax prewritten software that is received in tangible form or can be downloadable into a tangible form (e.g, customers can back up the program to their own equipment).

The state taxability of custom software generally is dependent on if the state taxes personal services. For example, Arizona, California, and Texas all generally exclude custom software from the tax base, but the District of Columbia, New Mexico, and

Tennessee do tax custom software. This tax treatment is generally the same in situations where prewritten software is customized for a client. Some states will even tax the entire transaction, not just the value of the customizations.

To make matters even more complicated, there are often different tax treatment for SaaS. While a state like Missouri currently exempts both custom software and SaaS from taxation, other states, like Kentucky, tax the SaaS but exempts custom software. Yet other states like Texas treat SaaS as data process services that are taxable at a special rate.

As you can see, understanding the taxation related to software products and SaaS services is incredibly complex.

2. Don't Ignore, or Rely on, "Boilerplate" Contract Provisions.

All too often business executives gloss over commercial contract provisions that they deem to be boilerplate or otherwise "standard" provisions. In reality, these provisions can have extensive consequences for both software manufacturers and customers alike. Three primary issues are triggered related to state taxation of software. First, for state tax purposes, the particular state's laws govern how the state will treat a transaction. Simply labeling a transaction as a lease or a SaaS will not override the state's laws or its ability to impose a tax. Second, regardless of where the contract is entered into or any choice of law provision, the terms of the contract will generally not affect where the taxing authority deems the transaction occurred. Simply put, a contract entered into in Minnesota between two Delaware entities for delivery of software to a customer's terminals in California, Texas, and Tennessee may be subject to sales taxes in any or all of those locations.

Finally, standard contract provisions are often unclear and/or incomplete regarding how to handle state taxation issues. The contract should make clear who is liable for not only the applicable taxes but who is liable for any associated penalties and interest. The language should also address: (a) potential tax clawbacks; (b) any relevant tax indemnification obligations; and (c) which party is responsible for litigation and other defense costs if a state audits or attempts to impose a tax at a later date.

3. Don't Assume There's Only a "Slap on the Wrist" for Non-Compliance.

Many companies operate with the flawed assumption that the penalties for non-compliance on payment of taxes related to software products and/or SaaS services are relatively minimal. However, in reality penalties can be quite stiff. While public data sometimes is scarce on sanctions imposed for non-compliance, we are provided with some glimpses about the significant nature that non-compliance can cause.

For starters, generally the liability for non-payment of sales tax is on the seller of the product or service. A recent U.S. Supreme Court case (*South Dakota v. Wayfair, Inc.*) also makes it clear that you may have tax liability even if you do not have a physical presence within the particular state. Many states have adopted economic nexus standards that impose liability if the seller has as little as $100,000 in revenue (on a previous or current calendar year or on a rolling 12-month basis) or 200 or more total transactions.

If tax is owed but not paid, penalty rates generally range from about 2% to 10%, which can certainly eat into and/or eclipse any of the profit the business may otherwise have expected to receive from the transaction. In California, the failure to pay can impose penalties as high as 25% of the total tax due. Additionally, mandatory interest charges will almost assuredly also apply, which may add approximately an additional 8% to the amount due. Even more harsh is the prospect that your business may be audited not just for the current tax year, but for four or more prior years, which could cause your tax liability to balloon into nearly unmanageable numbers that could jeopardize your entire business.

In addition to avoiding the pitfalls mentioned above, you should implement the following best practices to help avoid unforeseen tax liability.

4. Do Understand What Product is Being Sold and How the Customer is Using the Product.

The first level of analysis is to understand if you are selling software or SaaS. As previously noted, the focus here is not on your and the client's understanding but rather how the specific state treats your transaction. You may need to consult with a technology and tax attorney to assist with this analysis. Once you understand this issue, you will need to determine how and where your customer is using that product. Depending on how and where the customer is using the product may implicate additional taxes, including different taxing authorities (e.g. different states / countries). This process usually involves asking your client questions at the time of the contracting process.

The overwhelming majority of states have implemented destination-based sourcing for interstate transactions of tangible personal property. This means the sale of canned software, and possibly SaaS, will generally be taxed in the jurisdiction where the purchaser will use the software. However, this is a general statement and each transaction must be analyzed individually.

Care should also be used if the software or SaaS allows for users in more than one state and accordingly the location of each access point should be clearly defined in the contract. Even more complications arise if you will have foreign users of the software or SaaS.

5. Do Review Your Contract Carefully.

The sad fact is that the taxing authorities often will target software companies for unpaid sales tax. Accordingly, if you are not collecting the tax from your customers, you as the software manufacture are shouldering the risk. It is, therefore, vital that the contract with your customer appropriately address tax implications and the procedures and logistics for how applicable tax will be assessed, calculated, and paid. Having your contract periodically reviewed by a technology and a tax attorney are important aspects to help minimize the liability that could result for not being in compliance with the tax laws. Furthermore, if you have contract language that allows you to recoup all taxes owed from your customer, while that may assist you somewhat, you assuredly will have an angry customer when your customer ends up with a surprise bill for the payment of taxes in the distant future from when the initial contract was signed.

6. Do Train Your Sales and Accounting Teams.

If your sales team is responsible for creating your Statements of Work or Purchase Orders, it is essential that they understand the taxable implications of each sale. Your accounting team should also be well-versed on what taxes may apply and who they can contact as a resource for answering questions about tax implications. Given the nuances of tax issues, best practice is to have both an internal and external resource to utilize as may be needed.

Conclusion: Be Mindful of the Complex Tax Issues that Exist.

Overall, tax compliance is a very tricky thing that requires multiple team members to properly execute compliance. This team ranges from the sales team, to the accounting team, to the legal team, as well as external experts. If you are a software manufacturer and have not reviewed your policies, procedures, and contracts recently, it is highly recommended to have such a review performed promptly by reputable technology and tax attorneys.

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