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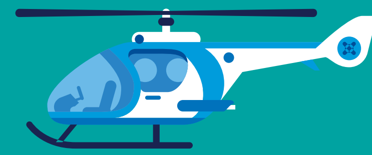

Defining Issues®

Supreme Court overturns ‘physical presence’ standard in Wayfair decision

July 12, 2018

KPMG reports on the financial reporting effect of states potentially requiring companies to collect sales and use taxes[1], even if they lack a physical presence in the state.

Applicability

Companies doing virtual business in states with an ‘economic nexus’ law.

Key facts and impacts

On June 21, 2018, the Supreme Court overturned its previous decision[2] that a state cannot require a business to collect sales and use taxes from customers in states where the business has no physical presence. While the Court did not say that the South Dakota law is permissible in every circumstance, it paves the way for states that have adopted an economic nexus law to begin requiring the collection of sales and use taxes if the law does not otherwise violate constitutional principles.

While the Court did not resolve all of the issues in its decision, it is clear that businesses that do not collect and remit sales and use taxes cannot continue to rely on not having a physical presence when doing business in states with economic nexus laws.

We believe that those companies will need to consider whether the Court’s decision means that they will need to recognize financial statement liabilities and provide additional disclosures.

Financial reporting implications

ASC 450[3] provides guidance on the accounting for contingencies, including contingencies associated with non-income-based taxes. However, because not all uncertainties create a contingency, we believe a company should first evaluate the technical merits of its current sales and use tax positions to see if an obligating event has occurred or an ASC 450 ‘contingency’ exists. When considering the technical merits, we believe a company should consider the effect of the Court’s decision assuming the relevant state taxing authorities have full knowledge of the positions. A company also may need to evaluate the accounting and reporting for its other non-income-based tax positions that could be affected.

Obligating event has occurred

We believe that if it is more likely than not (based on a technical analysis after the Court’s decision) that the state taxing authority will require the company to collect and remit sales and use taxes beginning June 21, 2018, then an obligating event has occurred. In that case, a company should

1 South Dakota v. Wayfair, Inc. No. 17-494 (S.Ct. June 21, 2018)

2 Quill Corp. v. North Dakota, 504 U.S. 298 (1992) and National Bellas Hess, Inc. v. Department of Revenue of Ill. 368 U.S. 753 (1967)

3 ASC 450, Contingencies

begin accounting for that obligation on that date (or as of the effective date of the particular state's tax law, if later).

We believe a company also should re-evaluate its exposures before June 21, but it may be considerably less likely that the state tax laws can be applied retroactively.

Contingency exists

If it is *not* more likely than not that the state taxing authority will require the company to collect and remit sales and use taxes, we believe the company should analyze and account for its exposure as a contingency under ASC 450.

A company recognizes a liability for a loss contingency only if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure is required if there is a reasonable possibility that a loss may have been incurred.

Income taxes

While the Court case was specific to whether a state can require companies that do not have a physical presence in the state to collect sales and use taxes, we encourage companies to also consider whether the decision affects their conclusions about state nexus for income tax purposes. We understand that some states may have applied by analogy the sales and use tax physical presence standard for asserting state nexus for income taxes. Affected companies may need to re-consider how the Court's decision affects the accounting for those positions. Income tax guidance[4] requires companies to reevaluate recognition and measurement of income tax positions in the period in which new information is available.

SEC reporting considerations

The Court's decision may affect a registrant's SEC disclosures. A registrant should consider whether it needs to provide additional or modified disclosures about the effects of the decision in its Risk Factors and Management's Discussion and Analysis (MD&A).[5] A registrant should also consider whether changes made to internal controls over financial reporting (ICFR) have disclosure and reporting implications.

Risk Factors include disclosure of the most significant factors related to a registrant's business. A registrant should consider, based on the states in which it operates, whether new or revised risk factors are necessary. While the disclosure requirements for Risk Factors are principles-based, Regulation S-K[6] requires an explanation about the risk's specific effects and registrants should avoid boilerplate language. For example, some registrants may decide to modify risk factors to highlight that evolving requirements to collect sales taxes may alter the competitive landscape.

MD&A provides information about the potential variability of a registrant's earnings and cash flows so that investors can evaluate the likelihood that past performance is indicative of future performance. If the Court decision may have a material effect on a registrant's future financial condition or operations, this should be disclosed.

Registrants are also required to disclose in MD&A contingencies that are reasonably likely to occur (or those for which a determination cannot be made) and could have a material effect on the financial condition or results of operations.

Internal controls

A company may need to make changes to its systems, processes and controls. For example, a registrant may implement more robust systems to comply with state requirements or controls to monitor compliance with evolving state tax laws. A registrant that makes changes to its internal controls[7] should disclose those changes if they materially affect (or are reasonably likely to materially affect) ICFR. The disclosure should include changes made to internal controls to address compliance with state laws after the Court's decision. These changes may also affect management's assessment of the effectiveness of internal controls.

Additional resources

KPMG SALT Alert! 2018-10 U.S. Supreme Court Overturns *Quill*

KPMG TaxWatch Webcast Reply – The Wait for Wayfair and Preparing for a Post-Quill World

[4] ASC 740, Income Taxes

[5] Regulation S-K, Item 303. Management's discussion and analysis of financial condition and results of operations

[6] Regulation S-K, Item 503, Prospectus summary, risk factors, and ratio of earnings to fixed charges

[7] Regulation S-K, Item 308, Internal control over financial reporting

Contributing authors

Timothy D Brown; Kayreen M Handley; Angela B Storm

KPMG's Financial Reporting View

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