Tech Startups Should Resolve SALT Issues to Avoid Valuation Impacts in Due Diligence

Technology startups present a recipe for difficulties in the world of state and local taxes (SALT): novel services and business models, broad national or worldwide markets, and limited resources for compliance. While other businesses in that situation perhaps can make up for these difficulties by not knowing or complying with all of their SALT obligations, a startup seeking an exit or late-stage funding may find itself facing scrutiny—and downward pressure on valuations—for SALT exposure. As the due diligence process lends itself to worst-case thinking, a startup is generally better served by identifying and resolving material SALT issues before the due diligence begins. This article provides practical ideas and insight for addressing SALT exposure in startups or other fast-growing, small and mid-sized private companies.

Due diligence is an opportunity for buyers to push down valuations based on SALT exposure. Small and mid-size private companies, and especially startups, generally do not prioritize compliance with myriad state and local tax obligations. With limited resources and a need to do more with less, SALT compliance easily fails to keep up with rapid growth. Often the company has a general in-house finance manager or outside CPA who can handle financial accounting and federal income tax but who is not well versed in multistate SALT.

For most closely held companies, this is not a problem: they file income tax returns in the state of the main office and perhaps a few other locations. Perhaps sales tax is also collected in those states. Other SALT issues fly under the radar and are dealt with on an ad hoc basis if they come up. From a practical perspective, states' abilities to identify and tax out-of-state companies are limited. Such an ad hoc approach can be successfully maintained for a surprisingly long time.

For a late-stage startup looking at an exit or a major new round of funding, however, a much more effective SALT enforcement mechanism is at hand: The accounting firm providing due diligence review. The reviewers likely have a good working knowledge of state and local tax issues. Also, they have extensive access to company information and records. As a result, they can generate a scenario that errs toward worst-case projections: widespread nexus, more taxable products and services, long lookback periods, and maximum penalties and interest. Such a maximal exposure calculation will tend to push down the valuation and give the buyer or investor a better price.

Clearly, an advisor on the startup's side can and should push back on those positions and argue for some common sense. However, making headway with arguments based on pragmatism, and perhaps some nuance about taxability, is an uphill battle.

A better approach is for the startup already to have evaluated and established SALT compliance positions that it can defend. If the company has already considered and implemented reasonable positions, then the due diligence review will be less likely to seize on SALT issues—and, even if it does so, the startup will have a robust position from which to push back.

Evaluating SALT exposure. Evaluating SALT exposure for a startup is no different in principle from doing so for other businesses, although novel products or business models may present more questions: first identify the jurisdictions that have nexus—enough of a connection with the company to require tax compliance—and then identify the relevant tax obligations.

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Common nexus pitfalls for startups. A small, dynamic company can establish a surprisingly large nexus footprint as it tries to maximize growth. Common examples of physical presence being established include remote employees, traveling representatives, and business partnerships. In addition, for income or business activity taxes, economic nexus based on sales volume alone should be considered.

Perhaps the most common nexus pitfall for a startup is remote employees. There is no question that having a full-time employee in a state creates nexus, even if that employee is only working from

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home.[1] A startup that is attracting great talent and letting them work from anywhere will soon find itself with nexus in a number of states.[2]

Regular visits by company representatives to solicit sales or provide services create nexus.[3] This is the case whether the representatives are employees or independent contractors. So, for example, a sales representative periodically visiting assigned territories or customers will generally be enough to create nexus.

Moreover, there is the risk of nexus from third-party business partners or fulfillment providers. Several years ago, a wave of states enacted "click-through nexus" laws to target e-commerce providers for sales tax collection based on the presence of in-state referral-based marketers. These laws can be addressed with paperwork: contractual restrictions on solicitation and annual certifications of compliance thereof. However, in the absence of such paperwork there is a strong presumption that in-state referral marketers are creating nexus by soliciting on the company's behalf. A startup that has not taken the appropriate precautions is in a difficult position.

Startups using an intermediary-based business model also need to consider risks of nexus from their platform participants. Offering performance of local services through an online platform can cause the online business to have nexus in the state where the services are performed.[4] In addition, a new wave of legislation, so far in effect in only a handful of states, aims to require tax collection by marketplace providers and, thus far, it seems to be meeting with success.

Besides traditional physical presence nexus, the business also should consider whether any states have nexus based on significant sales into the state, regardless of physical presence. While sales and use tax collection nexus has been held to a strict physical presence standard for years, and that is still the law as of the writing of this article,[5] many states have been successful thus far in imposing "economic nexus" or "factor presence" nexus for income taxes and gross receipts/business activity taxes. These laws require payment of the tax if sales into the state exceed certain thresholds. Nexus for purposes of sales and use tax seller notification laws (requiring not tax collection but rather information reporting) also is based on economic thresholds and these laws have been upheld so far.

Evaluating state tax obligations. Once the relevant states with nexus are identified, then it is a question of evaluating each state's tax obligations and potential exposure. Clearly this depends on the specific business of the startup, especially for sales and use taxes. Retailers of tangible personal property or canned software are going to face tax in most states with sales taxes. Also, providers of services should be careful about the taxability of their services in various states.

Perhaps the most difficult situation for evaluating sales and use tax taxability involving startups is when they provide Internet-based service offerings, particularly software-as-a-service (SaaS), but also information services, infrastructure-as-a-service (IaaS), and Internet-based communications systems. Many states and a few localities have sought to tax cloud-based services with varying administrative and legislative approaches.

1 *See, e.g., Telebright Corp., Inc. v. Director, Division of Taxation*, 25 N.J. Tax 333 (2010).

2 Many businesses think that they are doing well by paying state withholding tax and unemployment tax on remote employees. This is an audit risk: states are getting better about leveraging their employment tax data for business tax nexus audit leads.

3 A sufficient number of employee visits for purposes unrelated to establishing and maintaining a market conceivably can create nexus as well, but generally such visits are less risky from a nexus perspective.

4 Witness that the online travel companies (OTCs) have generally been found to have nexus in disputes over hotel taxes.

5 The United States Supreme Court is considering a case that could allow sales and use tax nexus based on sales thresholds instead of physical presence, *South Dakota v. Wayfair, Inc.*, Docket no. 17-494, *cert. granted* Jan. 12, 2018. Federal legislation also could change the framework.

6 Ordinarily no statute of limitations runs on nexus liabilities because no return has been filed. VDAs are a way to cut off this back-tax liability and limit the lookback period.

There is almost no uniformity among states' approaches. For a startup offering cloud-based services, perhaps the easiest approach is to start collecting in jurisdictions that may tax your service and then see what your customers say and whether they can provide good reasons not to collect.

A startup may also consider exposure for use tax on its purchases: office equipment, supplies, software, etc. Startups are prone to buying online, and in many cases the suppliers on such remote sales do not collect tax. The purchasing business then generally owes use tax to the state where the product or service was received and used.

Materiality of the exposures should be kept in mind. A startup that is in a loss position has little to worry about from income tax exposure, although gross receipts taxes may still pose a problem. Also, exposure may be concentrated in the larger states or states with a concentration of major customers. There is no sense in addressing small exposures where the cost to fix the problem will be more than the tax itself.

Options to fix SALT issues. Once SALT exposures have been assessed, the next question is how to address them. A business can expand filings either through voluntary disclosures or by "turning on the tax" and beginning to pay prospectively. In addition, changes to business practices or contractual arrangements may make sense.

Voluntary disclosure agreements. Perhaps the most often recommended way for a business to address SALT exposure is to enter into voluntary disclosure agreements (VDAs) with the relevant states, where the business pays tax owed, often with interest, for a limited lookback period of three to four years. In exchange, the state agrees to waive penalties and not go back any further for back taxes.[6] VDAs are transacted separately with each state, and states' terms and requirements of their VDA programs vary.

The upside to VDAs is that they provide maximal assurance that the taxpayer has mitigated exposure for back taxes. In many instances, however, they do not provide great value for startups because the material part of the business's exposure is within the VDA lookback period. In such a situation, essentially all that the startup is getting is a penalty waiver. VDAs also involve out-of-pocket costs for the back taxes, as well as employee time or professional fees to deal with the associated administrative hassles.

Turning on the tax. An alternative to VDAs is to simply begin collecting (if applicable), filing, and paying the relevant taxes. This is straightforward administratively and the taxpayer has no immediate out-of-pocket cost. There is no closure for liability for prior periods, however, and that back-tax exposure continues to exist indefinitely.

A variant of just turning on the tax is to incorporate a new legal entity and shift the operating business to that entity, which then registers and begins filing prospectively with no prior history. In some instances, this may make sense, although it should be noted that most states have successor liability provisions such that the liability for back taxes would also follow to the new entity.

Turning on the tax may be an appealing option for startups if enough time can pass before the due diligence associated with the exit—say perhaps a year or more. That way the startup will have a track record of tax compliance that is unlikely to raise red flags to the reviewers.

Getting guidance from states. In some instances it may make sense for the startup to

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solicit letter rulings or other forms of guidance from one or more states, particularly for sales taxability questions on new products or business models. If this is the startup's home jurisdiction, it may particularly make sense to seek guidance as tax administrators are sometimes more favorably disposed toward hometown businesses.

Guidance or letter ruling efforts should be done with caution and using a knowledgeable professional who understands the relevant legal framework and tax administrator. It is generally a substantial undertaking to submit a thoughtful guidance request. Throwing up some basic information to the tax administrator and asking for open-ended guidance will tend to yield sub-optimal results.[7]

Changing business practices. While tax issues should not drive major business decisions, sometimes a small change in business practices can have dramatic tax impacts that justify the change. This is particularly the case for nexus risks. For example, commission-based online advertising could be changed to cost-per-click to reduce click-through nexus risks. Or a remote, back-office employee may be changed to an independent contractor or reassigned to a different legal entity to avoid having that remote employee establish nexus for a business.

Changing contracts. In addition, contractual changes—changes to the legal wording of terms, conditions, and agreements—may be an effective way of mitigating SALT risks. Practically speaking, sales tax on SaaS and other cloud-based services can be dramatically affected by the precise terminology in customer agreements or terms and conditions: Is what is being sold a software license, the provision of services, or something else? Often, careful drafting can optimize the position for tax purposes without materially affecting the business itself.

If click-through nexus is an issue for a startup, it also is critical to prohibit direct solicitation in contracts with advertising affiliates and to put in an annual certification process. This is paperwork that needs to be addressed but which rarely requires changes in fundamental business operations.

One contractual approach of only limited value is shifting the tax compliance obligations to customers. If there is nexus and taxability, the duty to collect sales and use tax is mandated by law and can only be avoided as provided by law (as in the case of exemption certificates or similar exemption documentation). Otherwise, the company has a non-delegable duty to collect the tax. A contractual agreement that the buyer will be responsible for all taxes cannot absolve the seller from responsibility; it only gives the seller a better claim to seek reimbursement from the buyer if tax is owed. A seller coming back to buyers for tax reimbursement years after the transactions occurred faces a hazardous venture given the vicissitudes of time, customer relationships, and recordkeeping.

Conclusion: addressing SALT issues proactively to maximize value. Startups are often well served by stepping back to evaluate SALT obligations and address or mitigate material issues. Such a process should begin well in advance of an exit (or a late round of funding) to provide enough time for corrective action. While no one should expect perfection in SALT compliance from a startup—or any business for that matter—cost-effective mitigation or prevention of SALT issues can help avoid serious downward valuation pressures in the due diligence process. ■

[7] In addition, a quick phone call to a contact at a tax administrator may provide helpful informal guidance. The taxing state will not be bound by oral guidance, however, and such guidance would be of limited use in providing comfort in the SALT due diligence process.

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