2023 U.S. Sales Tax Trends

What to know about indirect tax policy, nexus, digital taxation, and consequential court rulings

A laser-like focus on accuracy, a risk management mindset, and extensive technical proficiency in accounting, tax and audit permeate the certified public accountant (CPA) profession. So, it's worth considering what CPAs have to say about the top challenges facing tax groups and indirect tax teams in 2023. When that question was put to CPAs in a recent online survey, "keeping up with changing tax law" featured as the top response by a more than two-to-one margin over the second most common hurdle (finding, hiring and retaining tax talent).

Top Tax Challenges

What do you think is the biggest challenge facing tax professionals today?	
Poll Responses	**383 Total Votes**
Keeping up with changing tax law	56.40%
Managing a hybrid work environment	5.70%
Finding and retaining talent	25.80%
Technology adoption / digital transformation	12.00%

Source: *Online poll of CPAs conducted during December 2022 CPA.com webcast on sales tax trends*

Tax leaders would no doubt agree with their trusted advisors. After all, indirect tax policymaking has been walloped by a procession of fiscal disruptions in the past five years along with the U.S. Supreme Court's landmark 2018 *Wayfair* ruling and the many nexus challenges it triggered. Other drivers of tax turbulence cycle include:

- **A global pandemic;**
- **State, city and local fiscal shifts and gyrations;**
- **The highest inflation spike in decades;**
- **The most interest rate jumps in decades; and**
- **A long-term tax and accounting talent shortage.**

Those disturbances have made sales and use tax compliance even more challenging. New economic nexus requirements, as well as new interpretations of physical nexus standards, have sparked understandable confusion and misperceptions within tax groups of sellers and marketplaces. These misunderstandings can result in companies not registering to collect and remit sales tax in all jurisdictions that require them to do so. "There are still probably millions of businesses that are not registered everywhere they should be," notes Diane Yetter, President and Founder of YETTER Tax and the Sales Tax Institute.

Despite the magnitude of tax policy changes in recent years, tax leaders should anticipate an ongoing surge of rules and rate changes in 2023 and beyond. "Economic conditions tend to play a foundational role in driving fiscal policy shifts," notes Vertex Principal Economist & Tax Policy Advisor George L. Salis. "And changing fiscal policies drive tax policy changes." Regardless of when the next recession arrives, state, city and local tax authorities will eventually make adjustments in response.

This motley assortment of economic, policy and fiscal volatility makes it imperative for tax leaders to keep abreast of:

- **Indirect tax policy trends;**
- **Nexus updates;**
- **Digital taxes; and**
- **Litigation that may impact future policymaking.**

Tax Policy Trends: Mixed Messages

States implement sales tax rates and rules changes based on the overall health of their economies and budgets. While that fiscal health has been robust during the past 18 months, it appears likely to change this year amid a jumble of signals and noise. Indirect tax groups and tax advisors can zero in on the signals, Salis notes, by keeping a close eye on inflation rate changes, interest rates and the timing of the looming recession along with other regulatory factors, including the ongoing narrowing of the sales tax base throughout the U.S. It is foreseeable that some states may decrease tax rates while others may be widening the tax base by gravitating more toward digital goods and services, as the question of how to tax digital platforms and services, including digital advertising, lingers.

While that fiscal health has been robust during the past 18 months, it appears likely to change this year amid a jumble of signals and noise.

States "overly dependent on tourism and consumer spending will be most hard hit during a recession," according to Moody's Analytics.[1] Signs are emerging that the incipient economic downturn is being felt by some states. "Although states have been flush with cash, shortfalls are now being forecasted," says Salis, pointing research from the National Association of State Budget Officers and Pew Research showing that annual state tax revenue growth will decrease substantially in 2023 as temporary factors that previously bolstered recent growth fade. Since higher interest rates translate to higher debt-servicing costs, many state and sub-state jurisdictions will need to pull other levers – including sales tax rate increases -- to satisfy revenue needs amid higher prices and labor costs.

To get a read on possible 2023 tax policymaking actions, including sales tax rates and rules, tax leaders should monitor:

- **Inflation:** As of January, the U.S. inflation rate had decelerated 6.5%, a welcome drop from the previous 7.7% increase (and the staggering 9.1% increase in July 2022).[2] While the inflation rate is headed in the right direction, it remains high and unlikely to return to pre-2022 levels any time soon. Inflation has provided some benefits to states and substate governments (e.g., inflated prices translate to more sales tax revenues), but it also presents challenges (e.g., higher energy prices).

- **A recession:** The probability of a global recession occurring this this year remains "elevated," according to the National Association for Business Economics and its January 2023 Business Condition Survey. While most states currently are well-positioned to contend with a milder recession, several wildcards – including the recession's depth and duration – could negatively their impact their ability to do so.

- **State budgets:** New concerns about long-term costs are emerging in some states. Salis points to California Governor Gavin Newsom's September 2022 veto of a bill that would have replaced a partial manufacturing sales tax exemption in that state with a full exemption. While noting that the full exemption would have resulted in "substantial revenue loss to local governments, which impacts essential health, safety, welfare, and transportation services," Newsom estimated that local agencies would have lost more than $500 million a year.[3] Kentucky enacted a broad sales tax expansion last year to help fund a reduction in the state's individual income tax rate. The expansion extends sales and use tax to website design, development, and hosting services; marketing services; prewritten computer software access (SaaS), and numerous other services; it took effect Jan. 1.[4]

The shrinking sales tax base poses a longer-term challenge to state and local governments. A research report from the Tax Foundation indicates that sales tax breadth declined from a mean of 98% in 2000 to 29.52% in 2022. "State sales tax bases are narrowing," the report notes, forcing states to either raise rates or shift to other sources of tax revenue in response to this continuous erosion."[5] More states are considering reducing or eliminating income taxes with a broad sales tax, or gross receipt tax. While some of these legislative attempts have failed, more are certainly on the way. Should they succeed, it would make sales tax an even more important source of revenue.

Nexus Updates

Nexus challenges have intensified since *Wayfair*'s establishment of economic nexus in 2018. So much so that the federal government is taking a closer look at post-*Wayfair* sales tax rules and nexus criteria affecting online sellers and marketplace facilitators of all sizes.

The Supreme Court's historic 2018 decision produced an onslaught of new economic nexus determination rules in states. It is imperative for tax groups and advisors to know how each state measures economic nexus -- via annual online sales thresholds and/or via thresholds based on the number of online transactions a company conducts with consumers in a state each year. On that count, Yetter stresses that The Sales Tax Institute's Economic Nexus State Guide is helpful for online sellers and marketplace facilitators, which now have sales tax collection and remittance responsibilities.[6]

It also remains as important as ever to understand physical nexus rules and interpretations of "substantial physical presence" that extend to inventory locations, trade show attendance and – a major issue following the pandemic – remote employees. "Physical presence is still relevant," Yetter emphasizes. "If you have physical presence in a state, you have nexus -- and the economic nexus thresholds are irrelevant."

Registration Risks

Do you think you or your clients are registered everywhere they should be?

Poll Responses	387 Total Votes
Yes	44.20%
No	46.30%
Absolutely not	9.60%

Source: *Online poll of CPAs conducted during December 2022 CPA.com webcast on sales tax trends*

Interpretations and enforcement of physical and economic nexus continue to change, often in response to litigation and court rulings. Yetter reports that recent cases in at least four states may have significant repercussions:

- **Pennsylvania:** The Pennsylvania Department of Revenue (DOR) elected not to appeal a ruling that the DOR did not have sufficient evidence to prove that an out-of-state business selling merchandise through the Fulfillment by Amazon (FBA) program had enough contacts with the state to warrant those businesses to collect and remit sales tax based on the physical presence of the inventory in Amazon's Pennsylvania warehouse. A number of states – including Arizona, Arkansas, Illinois, Iowa, Kansas, Oklahoma and Texas – have taken similar stances regarding insufficient nexus related to third party fulfillment and warehousing. Most of these states adopted this position recently and in response to the enactment of marketplace facilitation legislation as well as economic nexus. Due to the litigation in Pennsylvania, this would apply retroactively. However, in most of the other states, the change is prospective from the administrative policy position. "This is great news in Pennsylvania, which had been aggressively going after sellers," Yetter notes. "It's a big win for taxpayers."

- **California:** In September 2020, the Online Merchants Guild alleged that the California Department of Tax and Fee Administration's (CDTFA's) assessment of back taxes for Amazon sellers with in-state inventory is unconstitutional. The Guild also alleged that the CDTFA discriminated against e-commerce in violation of the Internet Tax Freedom Act. When a U.S. District judge in California rejected the Guild's attempt to stop the state from pursuing back sales taxes from Amazon sellers with inventory in in-state Amazon fulfillment centers, he cited the Tax Injunction Act. That statute holds that claims regarding state tax assessment and collection matters should be settled in state court rather than federal court. The Guild appealed this ruling to the California Court of Appeal, Second Appellate District. The court upheld the prior decision in a ruling issued Jan. 9, 2023. In a loss for the taxpayer, the court stated that the CDTFA had the legal discretion to hold third party sellers responsible for the sales tax due on sales made through Amazon. In the decision, the appellate court sided with a trial court ruling which sustained arguments from both the CDTFA and Amazon and refused to grant leave for the plaintiff, Stanley Grosz, to amend his complaint. The court wrote in its decision that the California Sales and Use Tax Laws and their framework give the CDTFA the full authority to decide whether a party is a retailer for tax purposes, noting (importantly) that this decision is a determination the CDTFA is entitled to make (and not a mere ministerial task). As a result, Grosz lacked the legal standing required to sue the CDTFA to get the department to treat Amazon as the retailer.

- **Massachusetts:** A "cookie nexus" dispute was recently resolved "in favor of the taxpayer" (U.S. Auto Parts) according to the Supreme Judicial Court of Massachusetts. In a wonderful Christmas gift, the ruling confirmed an earlier ruling that "cookies" placed by U.S. Auto Parts on devices located in Massachusetts do not constitute physical presence and, therefore, the company does not need to collect and remit sales taxes in the state. The Massachusetts Appellate Tax Board (ATB) had granted U.S. Auto Parts an abatement from having to retroactively collect and remit sales tax due to its use of cookies and apps creating physical presence in Massachusetts under the state's cookie nexus regulation. Although the U.S. Supreme Court did not specifically include cookies and similar digital ties in the *Wayfair* ruling, the Massachusetts Supreme Judicial Court indicated that the Supreme Court ruling strongly suggested that cookies would not create the nexus.[7]

- **Louisiana:** Louisiana faces complaints from an Arizona-based jewelry wholesaler, Halstead Bead, that claims the state's sales tax system is unconstitutional due to its compliance burdens on out-of-state sellers. Most recently, Halstead Bead filed an opening brief to the U.S. Court of Appeals for the Fifth Circuit, urging it to reopen its case against the state of Louisiana, after it had been dismissed by a federal judge. Louisiana is a home rule state with 64 parishes, and each of those local tax jurisdictions administers different sales tax administration requirements.[8] Louisiana was also active on the legislative front last year. This is largely good news for taxpayers given that the three acts Louisiana's governor signed into law are designed to create greater uniformity among those 64 parishes' auditing programs and the way collectors' report sales taxes.

If this snarl of legislation, litigation, rates, and rules strikes you as complex, you're not alone. The federal government also expressed growing interest in post-*Wayfair* sales tax rules and compliance challenges last year. In June, the U.S. Senate Finance committee hosted a full committee hearing to examine the impact of the South Dakota v. *Wayfair* decision on small business and remote sellers.[9] Five expert witnesses, including Yetter, shared a range of insights in their testimonies.

"Complexity and confusion exist as physical presence is still used to determine if a business has nexus, even if the seller has minimal sales into a state," stated Yetter, who also weighed in on the challenges that economic nexus posed to small businesses and remote sellers. "The economic nexus rules enacted as a result of the *Wayfair* decision have made things harder for some businesses, particularly those with limited physical presence in multiple states and even more so on those businesses located in one of the four states without a general state sales tax (Delaware, Montana, New Hampshire, and Oregon)."[10]

In November, the U.S. General Accountability Office (GAO) issued a report raising concerns about the country's remote sales tax system. These misgivings include concerns about taxpayer equity; economic efficiency; and simplicity, transparency and administrability. The GAO encouraged Congress to work with states "to establish nationwide parameters for state taxation of remote sales. Such parameters should balance state interests with the need to address multistate complexities. The parameters should improve the overall system's alignment with the criteria for a good tax system and help address existing uncertainties regarding what remote sales taxation is legally permissible by states and localities."[11]

Audit and Enforcement: Nexus in the Spotlight

When it comes to audit trends, recent activities show that many states are taking more aggressive positions on what constitutes nexus, especially *economic* nexus. "We're really seeing a move toward increasing audits of taxpayers that registered for economic nexus late," Yetter reports. Economic nexus requirements came into force in the months and years following the June 2018 *Wayfair* ruling. "If your company didn't register until 2020, it may have a gap of anywhere from a couple of months to a year and a half," Yetter continues. "We're seeing many states taking a closer look at those gaps." In addition to enforcing economic nexus more aggressively, Yetter highlights four other audit trends:

1. **A growing overall focus on sales tax and increased tax revenue collections;**
2. **States challenging that economic nexus was a company's first nexus;**
3. **The ongoing use of virtual audits (even with many companies opening offices following pandemic restrictions); and**
4. **Some states – including California, Connecticut, Kansas, Ohio and Texas – moving to have taxpayers perform managed audits.**

Digital Domains: Does NFT = 'New Favorite Tax?"

As more states adjust their tax policies to address the increasingly digital nature of commerce, more compliance complexity – and uncertainty – also arises. "The entire world is reeling from the challenge of figuring out how to tax the digital economy," Salis says. "The European Union has a new digital services tax regime. In the U.S., there exists widespread misunderstanding about 'digital taxation,' which is often confused with the taxation of digital advertising, which is has proven constitutionally difficult here in the U.S.

Sales and use taxes have applied to digital goods – including digital books, music, and videos -- in the U.S. for years. The 24 member states of the Streamlined Sales Tax Governing Board have a standard definition for digital goods.[12] That said, digital advertising tax legislation and rules are sparking contentious legal battles. In addition to those forms of digital taxation, more states are taking hard looks at the taxability of cloud computing and non-fungible token (NFT), which offer new opportunities to enlarge existing sales tax bases.

Salis encourages indirect tax leaders and their advisors to watch 2023 developments related to the following digital domains:

- **Cloud computing:** Varying forms of cloud computing transactions are taxable in more than 15 states, including Texas, New York, Pennsylvania, and Ohio. "The use of cloud computing is vastly expanding," Salis explains. "In some states, these services are not taxable. A handful of states have yet to issue formal guidance. In some states, it's extremely taxable."

- **Digital services taxes (DST) and digital goods sales taxes:** While Maryland's lengthy attempt to enact (and then keep in force) a groundbreaking digital advertising tax currently appears headed for demise, other states have implemented various types of DSTs and digital products sales taxes, or are considering doing so (e.g., New Mexico). More states are now tax data mining, personal information usage and/or sales of personal data.

- **NFTs:** NFT refers to non-fungible tokens – or, as Salis, points out a "new favorite tax" for state revenue departments. More states are issuing guidance on their approach to taxing these cryptographic assets that are minted on a blockchain and comprised of unique identification codes and metadata (and therefore cannot be copied, substituted, or subdivided). Last July, Washington issued an "Interim statement regarding the taxability of non-fungible tokens (NFTs)" while stating that it plans to work with stakeholders to develop more comprehensive guidance. Washington's stance, so far, is that "NFTs are taxed based on the character of the underlying products (goods and services) included in the sale." Determining the taxability of a transaction involves three elements: 1) Whether the NFT is comprised of multiple components or is simply a digital code assigning ownership; 2) The taxability of each underlying component; and 3) The identities of the parties to the transaction (for example, whether the purchaser is a consumer or a reseller).[13]

- **Cryptocurrency:** States that have provided guidance on cryptocurrency taxation generally treat crypto as intangible property, with no sales tax due on cryptocurrency exchanges. Sales tax is due when cryptocurrency is used to purchase taxable property and services. That said, state guidance varies as to how to compute the tax base (e.g., basing it on the advertised selling price, crypto's value at the time of the transaction, or crypto's value at the time of payment).

> "The entire world is reeling from the challenge of figuring out how to tax the digital economy."
>
> *– George L. Salis, Vertex Principal Economist & Tax Policy Advisor*

Litigation Updates

The outcome of some tax litigation cases can have long-term effects on tax policymaking and subsequent compliance requirements. That will certainly be the case throughout 2023 as states and companies continue to square off over matters related to post-*Wayfair* economic nexus expansion (as noted earlier), marketplace taxation rules, retroactive tax levies and much more. "Four and a half years after the landmark case," Salis notes, "states continue to adjust or modify their regulations, in an attempt to bolster revenue collections. This often leads to more tax controversy."

At the federal level, Salis is monitoring the U.S. Supreme Court's upcoming decision in *National Pork Producers Council vs. Ross*, which could have wide implications for states' regulation of remote sellers, and indirectly for onerous inter- state taxation. The law forbids the sale of pork in the state unless it's produced in conditions that include a specific minimum square footage of space for breeding animals. But nearly all pork products sold in California are produced outside the state. If a pork producer in Iowa, say, wants to sell into California, it will need to meet California's standards for breeding pen sizes. And that, according to the plaintiffs, constitutes an impermissible extraterritorial effect that could damage the industry nationwide. "It's a fair assumption that rather than attempting to block sales of these products, California will pursue ways to tax them," Salis notes. "And it's by no means a given that the dormant commerce clause will be upheld, as the Court's 2018 *Wayfair* decision demonstrated by enabling states to require out-of-state online retailers to collect sales tax."

Salis also notes that circuit courts ruled on the challenges that 20-plus states brought against the American Rescue Plan Act's (ARPA's) tax mandate and the federal government's ability to recoup funds in courts. On Dec. 14, 2022, the appeal of the case *Missouri v. Yellen* was filed in the Supreme Court. Although several federal courts had sided with the petitioning states, on Jan. 17, 2023, the Supreme Court rejected the petition for review from the Eight Circuit Court of Appeals, re-affirming the ruling that Missouri lacked standing. The Court ruled that the state wasn't challenging the actual offset provision as written but rather the hypothetical broad interpretation of the provision and had not suffered an injury under either the broad or the narrow interpretation of the provision, Salis explains.

Some states have already passed legislation to reduce personal income tax rates and corporate income rates. If any of these reductions are determined to violate ARPA stipulations, the federal government could "claw back" ARPA funds, creating revenue gaps that many, if not most, affected states would consider closing via sales tax rules changes and/or rate increases.

> "Four and a half years after the landmark (*Wayfair*) case, states continue to adjust or modify their regulations, in an attempt to bolster revenue collections. This often leads to more tax controversy."
>
> – *George L. Salis, Vertex Principal Economist & Tax Policy Advisor*

Conclusion: Complexity Continues

As Salis emphasizes, ongoing litigation outcomes drive tax policy changes, which increase compliance complexity. The court proceedings described above, as well as audit and enforcement actions will undoubtedly influence tax policymaking over the short-term and sales tax related legislation over the medium term. All of these challenges will create new compliance hurdles inside tax groups that – along with their trusted CPA advisors – need to address.

Notes

1. https://www.moodysanalytics.com/about-us/press-releases/2022-09-29-moodys-analytics-most-states-well-prepared-to-weather-recession.
2. https://www.usinflationcalculator.com/inflation/current-inflation-rates/.
3. https://www.gov.ca.gov/wp-content/uploads/2022/09/AB-1951-VETO-message.pdf?emrc=2654fe.
4. https://www.pwc.com/us/en/services/tax/library/kentucky-enacts-major-sales-tax-base-expansion-tax-amnesty.html.
5. https://taxfoundation.org/state-sales-tax-base-reliance/.
6. https://www.salestaxinstitute.com/resources/economic-nexus-state-guide.
7. https://www.salestaxinstitute.com/resources/supreme-judicial-court-of-massachusetts-issues-ruling-on-cookie-nexus.
8. https://www.salestaxinstitute.com/resources/arizona-business-owner-complains-louisiana-sales-tax-is-unconstitutional-for-out-of-state-sellers.
9. https://www.finance.senate.gov/hearings/examining-the-impact-of-south-dakota-v-wayfair-on-small-businesses-and-remote-sales.
10. https://www.finance.senate.gov/hearings/examining-the-impact-of-south-dakota-v-wayfair-on-small-businesses-and-remote-sales.
11. https://www.gao.gov/products/gao-22-106016.
12. https://www.streamlinedsalestax.org/home.
13. https://dor.wa.gov/interim-statement-regarding-taxability-non-fungible-tokens-nfts.

About Vertex

Vertex Inc., is a leading global provider of indirect tax software and solutions. The company's mission is to deliver the most trusted tax technology enabling global businesses to transact, comply, and grow with confidence. Vertex provides solutions that can be tailored to specific industries for major lines of indirect tax, including sales and consumer use, value added, and payroll. Headquartered in North America, and with offices in South America and Europe, Vertex employs over 1,300 professionals and serves companies across the globe.

To learn more, visit VertexInc.com.

North America | Latin America | Europe | Asia Pacific