



**CERINI
& ASSOCIATES** LLP
CERTIFIED PUBLIC ACCOUNTANTS

BUSINESS INSIGHTS: TECHNOLOGY INDUSTRY

2ND EDITION

A BEST PRACTICE RESOURCE FOR TECHNOLOGY EXECUTIVES

INTRODUCTION

We are thrilled to present to you our comprehensive guide tailored specifically for technology companies, addressing some of the most critical accounting and tax challenges in the industry. At Cerini & Associates, we recognize that technology companies operate in a rapidly evolving landscape where financial regulations and tax laws are constantly changing and difficult to understand. Our guide is designed to provide all tech companies from pre-revenue startups to established firms with actionable insights and expert guidance to help you navigate these complexities with confidence.

THIS GUIDE COVERS THE FOLLOWING ESSENTIAL TOPICS:

1. CAPITALIZATION OF SOFTWARE DEVELOPMENT COSTS FOR SAAS PROVIDERS

Best practices for capitalizing software development costs to ensure compliance with accounting standards and optimize financial reporting.

2. RESEARCH AND DEVELOPMENT TAX CREDITS

Strategies to maximize your eligibility for R&D tax credits, an invaluable resource for reducing tax liabilities and driving innovation.

3. ACCOUNTING FOR STOCK COMPENSATION AND SIMILAR EXPENSES

Guidance on navigating the complexities of stock compensation accounting to ensure accurate financial reporting and compliance.

4. EQUITY-BASED COMPENSATION – TAX PERSPECTIVES

An overview of the tax implications of equity-based compensation from both the employee and employer perspectives, helping you manage these benefits effectively.

5. DEMYSTIFYING DEFERRED TAXES

Insights into how deferred taxes impact your financial statements and how to manage them effectively.

6. IMPACT OF ASC 606 ON TECHNOLOGY COMPANIES

A deep dive into how ASC 606 affects revenue recognition, particularly for SaaS providers, and what it means for your business.

7. REVENUE RECOGNITION – TAX IMPLICATIONS

An analysis of the tax challenges associated with revenue recognition for tax reporting purposes, with practical solutions to ensure compliance.

8. ASC 340-40 – CONTRACTS WITH CUSTOMERS

Guidance on accounting for other assets and deferred costs related to customer contracts, in line with ASC 340-40.

9. SALES TAX COMPLIANCE FOR TECHNOLOGY COMPANIES

Strategies to navigate the complexities of sales tax compliance, particularly for tech companies operating across multiple jurisdictions.

We believe this guide will serve as an invaluable resource, equipping your financial and accounting teams with the knowledge they need to manage the unique challenges of the tech industry. At Cerini & Associates, we are committed to partnering with you to ensure that your business not only remains compliant but also thrives in today's competitive environment. Our team of experts is here to provide ongoing support and to help you implement the strategies outlined in this guide. Please do not hesitate to reach out if you have any questions or would like to discuss any of the topics in more detail.



*Matthew Burke, CPA
Partner*

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UNDERSTANDING CAPITALIZATION OF SOFTWARE DEVELOPMENT COSTS FOR SAAS PROVIDERS



In today's fast-paced tech industry, especially for (but not limited to) **Software-as-a-Service (SaaS)** providers marketing their solutions to external customers, the treatment of software development costs is pivotal for financial reporting and strategic decision-making. This is an important area of **generally accepted accounting principles (GAAP)** that is frequently overlooked by SaaS and other software startups. Just know, in a simple sense, that any expenditures made for software development may be required to be carried as an asset to be expensed over time, and not entirely upfront when costs are incurred. Read on to explore how SaaS providers navigate the complexities of capitalizing software development costs, including the impact of different methodologies used.

WHAT IS SOFTWARE CAPITALIZATION?

Software capitalization involves recognizing certain development costs as assets rather than immediately expensing them. For SaaS providers, this practice is critical as it affects how costs are amortized over time, impacting financial statements and taxable income, and influencing investor perceptions of profitability and long-term value.

ELIGIBILITY AND GUIDELINES

For SaaS providers marketing their software to external customers (*or for companies just developing their own internal-use software*), GAAP stipulates that software development costs be capitalized once "*technological feasibility*" is achieved. Technological feasibility occurs when the software is ready for its intended use and completion is probable. This guideline applies whether the software is developed internally or acquired externally for further development.

KEY CONCEPTS IN SOFTWARE CAPITALIZATION

- ▶ **Capital vs. Expense:** SaaS providers must distinguish between capital expenditures that enhance long-term value (*such as software development costs*) and expenses that are deducted immediately from earnings (*such as marketing or administrative costs*).
- ▶ **Assets:** Software developed for external sale is considered an intangible asset, reflecting its economic value to the company.
- ▶ **Amortization:** Capitalized software costs are amortized over their estimated useful life, typically on a straight-line basis, aligning with revenue recognition as customers use the software. Of course useful lives are estimates that are subject to interpretation and later adjustment. Typically we see three-to-five years used though.

STAGES OF CAPITALIZATION

The stages of software development have been ascribed certain labels in GAAP, which are subject interpretation despite the many examples and clarifications that have been made over the years. Remember that software has been around for decades. So too have the applicable accounting standards. With the current pace of change in the software and application development fields, GAAP has struggled to keep pace and adjust its sometimes-antiquated language and approaches to what is happening in real-time. For this reason, the **Financial Accounting Standards Board (FASB)** has added software development costs to its Technical Agenda. This means that the FASB has identified this area of accounting regulation as needing further review and likely adjustment. Don't hold your breath though. Change is slow at the FASB and with GAAP, and even when changes do come, they usually miss the mark. We'll be here to apprise you of any relevant changes. For now, and for the foreseeable future, here are descriptions of these stages and some examples of how to identify them (*and how to apply accounting to them*):

1. PRELIMINARY STAGE:

Costs incurred during the preliminary stage, such as initial concept development and market research specific to external customer needs, are generally expensed as they are incurred.

- ▶ *Conducting market analysis and feasibility studies to understand market demand and competitive landscape.*
- ▶ *Developing initial prototypes or **Minimum Viable Products (MVPs)** to validate customer requirements and product-market fit.*

2.

APPLICATION DEVELOPMENT STAGE:

Eligible costs during this stage include coding, testing, and customization required to meet external customer specifications. Costs can be capitalized during the application development stage under certain conditions, particularly for SaaS providers developing software for external sale or use.

- ▶ *Writing and testing source code to ensure functionality meets external customer requirements.*
- ▶ *Customizing features or integrating third-party services to enhance the software's value proposition in the market.*

3.

POST-IMPLEMENTATION STAGE:

Costs related to customer onboarding, support, and ongoing enhancements after software deployment are expensed as incurred.

- ▶ *Providing customer training and support to ensure successful adoption and usage of the SaaS platform.*
- ▶ *Iteratively improving the software based on customer feedback and market trends to maintain competitiveness.*

AMORTIZATION METHODOLOGY

Amortization of capitalized software costs for SaaS providers is based on the software's expected revenue-generating life. Factors influencing useful life include technological obsolescence, customer retention rates, and market demand shifts impacting the software's utility and value. This is an estimate that just needs to be reasonable and based on something realistic and appropriate.

WATERFALL VS. AGILE METHODOLOGIES

The choice of development methodology—whether waterfall or agile—affects how SaaS providers manage and capitalize software development costs.

- ▶ **Waterfall Methodology:** Traditionally used in software development, the waterfall approach follows a linear progression from requirements gathering through to deployment and maintenance. Costs incurred during each phase (e.g., design, coding, testing) can be categorized more straightforwardly as either capitalizable or expensable based on achieving specific milestones.
- ▶ **Agile Methodology:** Agile's iterative approach emphasizes flexibility and responsiveness to customer needs through short development cycles or sprints. Development costs under agile may be more challenging to capitalize, as costs are incurred incrementally based on ongoing improvements and customer feedback rather than completing distinct project phases.

EXAMPLES OF CAPITALIZED SOFTWARE COSTS FOR SAAS PROVIDERS

Examples include costs directly attributable to external-use software development and enhancement, which may qualify for capitalization:

- ▶ *Licensing fees for third-party software components integrated into the SaaS platform.*
- ▶ *Compensation for development teams involved in coding, testing, and customizing software features for external customer needs. These developers can be salaried or paid on a contract basis. For salaried employees, related payroll-related overhead should also be capitalized.*
- ▶ *Costs associated with securing intellectual property rights or patents related to proprietary software functionalities.*

BENEFITS AND CHALLENGES OF SOFTWARE CAPITALIZATION FOR SAAS PROVIDERS

BENEFITS:

- ▶ **Enhanced Financial Metrics:** Capitalizing software costs defers their impact on the income statement, potentially boosting reported profitability metrics over time.
- ▶ **Investor Appeal:** Reporting higher net income through capitalization may enhance investor confidence and valuation of the SaaS provider and the carrying value of the asset may indicate the technological prowess of the company on a very surface-level review.
- ▶ **Strategic Resource Allocation:** Deferred expenses can be reinvested in marketing, customer acquisition, or further product innovation to drive growth.

CHALLENGES:

- ▶ **Complexity in Amortization:** Determining the appropriate useful life and amortization method for SaaS software can be complex due to evolving customer preferences and technological advancements.
- ▶ **Compliance and Reporting:** Adhering to GAAP guidelines and accurately documenting capitalizable costs require meticulous record-keeping and internal controls.
- ▶ **Capitalization Thresholds:** The application development stages can be blurry, especially given how software is developed now as opposed to 40 years ago. Distinguishing between costs and efforts that meet the capitalization thresholds will be tricky, at best, if not seemingly impossible at times.

TO SUMMARIZE...

For SaaS providers, proper capitalization of software development costs is essential for financial transparency, investor confidence, and strategic decision-making. By navigating the complexities of software capitalization with clarity and adherence to regulatory guidelines, SaaS providers can optimize financial reporting, enhance market competitiveness, and sustain long-term growth in the dynamic tech industry landscape. None of this will be accomplished easily though. With nearly-obsolete accounting regulation definitions, an out of touch FASB, and so much data to review and assess before forming conclusions, this is an extremely challenging area of GAAP to apply. Turn to professionals like us who can help educate and advise you as you try to properly implement these accounting rules. We can help.

MATTHEW BURKE, CPA PARTNER



RESEARCH AND DEVELOPMENT TAX CREDITS: EMPOWERING INNOVATION



ONE OF THE BEST INCENTIVES AVAILABLE TO TECHNOLOGY COMPANIES COMES IN THE FORM OF THE CREDIT FOR INCREASING RESEARCH ACTIVITIES OR AS ITS MORE COMMONLY KNOWN THE **RESEARCH AND DEVELOPMENT (R&D) TAX CREDIT**. THESE CREDITS CAN HELP SERVE AS A CATALYST FOR INNOVATION AND GROWTH, OFFER THE BUSINESS CASE OPPORTUNITIES TO ADVANCE TECHNOLOGICAL FRONTIERS WHILE BENEFITING FROM SIGNIFICANT TAX INCENTIVES. ENACTED AS A PERMANENT FIXTURE UNDER THE **PROTECTING AMERICANS FROM TAX HIKES (PATH) ACT** IN 2015, THE R&D TAX CREDIT INCENTIVIZES RESEARCH AND DEVELOPMENT ACTIVITIES WITHIN THE UNITED STATES. ITS SCOPE EXTENDS BEYOND ESTABLISHED CORPORATIONS, EMBRACING STARTUP VENTURES AND NURTURING A CULTURE OF INNOVATION ACROSS INDUSTRIES.

QUALIFYING RESEARCH ACTIVITIES - FOUR PART TEST

For expenditures to be eligible for the R&D Credit they first must meet all parts of a four-part test.

- ▶ **New or Improved Business Component:** *The IRS considers a business component to be any product, process, computer software, technique, formula or invention to either be held for sale or used in the business of a taxpayer.*
- ▶ **Elimination of Uncertainty:** *Activities must intend to discover information that was unknown to the taxpayer as to the design, methodology or capability of the business component.*
- ▶ **Process of Experimentation:** *The taxpayer must perform an evaluation of alternatives, including testing, modeling or systematic trial and error to eliminate the uncertainty. The key here is that the expenses must represent research and development expenses in the experimental or laboratory sense, which are undertaken for the elimination of uncertainty.*
- ▶ **Technological in Nature:** *The expenses must rely on scientific principles or similar, such as engineering.*

For most early stage and technology companies, these activities will often revolve around their product offering, both in its initial development and then ongoing features.

ELIGIBLE EXPENDITURES FOR R&D CREDITS

Eligible expenses include qualified wages, supplies and contract research expenses.

- ▶ *Wages can be for both employees that are directly performing research and their related supervision; it does not however include any benefits or other costs. The calculation for employees is usually based on what percentage of their time is spent doing Research and Development activities; if 80% or more of their time is spent on these activities, then it is considered substantially all is spent in Research and Development and their time is allocated at 100%.*
- ▶ *Supplies are for items of tangible personal property (which can include software) used in the Research and Development process. However, specifically excluded from this category are capitalized items.*
- ▶ *Contract research expenses are for amounts paid to 3rd parties for research and can be included generally at 65% of the incurred amount.*

Crucially, one of the requirements of claiming these expenditures is that the activities must be performed in the United States.



CLAIM PROCESS:

To claim the R&D tax credit, businesses must file IRS Form 6765, “*Credit for Increasing Research Activities*,” with their timely tax return. Additionally, retroactive claims can be made by amending prior tax returns within the previous three years.

When claiming the credit, taxpayers have the option of either the Regular or Alternative Simplified Method. Additionally, the amount of the credit claimed would need to be taken as income in the year of the claim; however, in a post-Section 174 capitalization world most taxpayers will opt to take a reduced credit in exchange for the addback given its interaction with the capitalization.

After claiming on a tax return via Form 6765, technology companies can either use the credit to reduce current taxes, carry forward to future years or under certain circumstances, claim as a reduction of payroll taxes due. Many early-stage technology firms will choose to, assuming they qualify, take against payroll taxes, as this provides the fastest monetization of the credit.

DOCUMENTATION:

Like with most other tax matters, strong documentation is critical for the taxpayer claiming a Research and Development Credit. The documentation should include:

- ▶ *What business components were being worked on*
- ▶ *Who is working on them and what time was spent on these*
- ▶ *Research activities performed*
- ▶ *The information sought to discover*

In software development, the use of an Agile Fibonacci process is one of the most common approaches to keeping this documentation, including the story and process points which help document both the component and the activities performed, as well as time. The tax court has recently allowed estimates to be used for the time allocations as well, however, they are subject to more controversy.

SECTION 174 CAPITALIZATION:

In a sense counterintuitive to all of the above, starting in tax year 2022 as part of the Tax Cuts and Jobs Act businesses were required to capitalize and amortize research and development costs (*over 60 or 180 months*), rather than expense outright. The prior law which allowed expensing also intentionally used a broad definition of Research and Development costs under Section 174 as to allow these to be deducted easier and quicker. This change has now impacted firms in the complete opposite manner of the R&D Credit, by increasing tax bills in an artificial manner by delaying these deductions. While the R&D Credit and this capitalization are thought of in unison, they are in fact different tax code sections; said differently, even if a taxpayer does NOT claim an R&D Tax Credit, they still may be subject to this capitalization which will require much of the same analysis. This provision has proven to be wildly unpopular and features bipartisan support for repeal, but as of 2024 still has yet to be repealed.

JACOB LUTZ, CPA, MBA
MANAGER





NAVIGATING THE COMPLEXITIES OF ACCOUNTING FOR STOCK COMPENSATION

In today's dynamic business environment, attracting and retaining top talent is paramount for companies aiming to thrive. Stock-based compensation has emerged as a pivotal tool in achieving this goal, offering employees ownership in the company and aligning their interests with those of shareholders. However, the accounting for stock compensation expenses presents a labyrinth of complexities that require meticulous attention. In this piece, we will delve into some of the intricacies of accounting for stock compensation expenses, covering the fundamentals of stock-based compensation, valuing stock options, recognizing expenses, and addressing forfeitures. This is a very complicated area of accounting regulations, subject to interpretation at times, so please keep in mind that this is not an exhaustive guide and that you will almost certainly have further questions after reading this. That's why we're here – to educate and answer them.

WHAT IS STOCK-BASED COMPENSATION?

Stock-based compensation is a method through which companies incentivize their employees by granting awards in the form of stock, stock options, or **restricted stock units (RSUs)**. These awards often come with specific vesting timelines or conditions, enhancing total compensation beyond cash payments alone. By providing employees with a tangible stake in the company's success, stock-based compensation fosters alignment of interests and strengthens a sense of ownership among employees. Issuing stock-based compensation is common with early stage companies and those in various technology fields who are looking to preserve cash. These issuances provide additional contingent future compensation to employees, often times significant, in lieu of cash now.

WHY IS ACCOUNTING FOR STOCK-BASED COMPENSATION IMPORTANT?

Accounting for stock-based compensation is crucial due to its substantial potential impact on financial statements and the overall assessment of a company's financial health. This type of compensation directly affects the income statement, reducing net income as it is recognized as a non-cash expense. Furthermore, it influences metrics such as **earnings per share (EPS)**, with exercised stock options potentially diluting EPS. Auditors closely scrutinize stock-based compensation during audits, underscoring the necessity for precise accounting practices to ensure compliance with regulatory standards and facilitate a smooth audit process. Writing this as auditors, we can say from experience that this is an area of significant adjustment that early-stage companies frequently overlook and do not fully grasp. Don't fall into that category.

GUIDANCE ON STOCK-BASED COMPENSATION

Accounting Standards Codification (ASC) 718 provides comprehensive guidance on accounting for stock-based compensation, establishing key principles that must be adhered to:

RECOGNITION OF EXPENSES:

Stock-based compensation expenses should generally be recognized over the requisite service period, aligning with the duration over which employees provide their services. For awards subject to service-based vesting conditions, this involves spreading the expense over the vesting period rather than recognizing it upfront as a lump sum.

VALUATION OF AWARDS:

The fair value of stock-based compensation is determined as of the grant date, considering factors such as the stock price, exercise price, volatility, time to expiration, and risk-free interest rate. Public companies typically use the market price of the stock to determine fair value, while private companies rely on independent appraisers for 409A and other valuations. Such valuations are subject to interpretation and manipulation, so auditors tend to spend significant time assessing the reasonableness of such valuations.

ALIGNMENT WITH US GAAP AND IFRS:

Both **US Generally Accepted Accounting Principles (GAAP)** and **International Financial Reporting Standards (IFRS)** provide guidance on stock-based compensation, ensuring consistency and comparability in financial reporting practices globally.

GUIDANCE ON STOCK-BASED COMPENSATION FOR NON-EMPLOYEES:

The accounting standards for stock options granted to non-employees have been aligned with those for employees, simplifying accounting practices and reducing complexities associated with different treatment. ASU 2018-07, issued by the **Financial Accounting Standards Board (FASB)**, harmonizes accounting principles for both employee and non-employee stock options, streamlining compliance efforts for companies.

UNDERSTANDING THE COMPLEXITY

Accounting for stock-based compensation is inherently complex due to various factors:

DIVERSE GRANT TYPES:

Companies utilize a range of mechanisms for stock-based compensation, including restricted stock, stock options, RSUs, and **employee stock ownership plans (ESOPs)**, each requiring unique accounting treatments.

VESTING CONDITIONS:

Vesting conditions may be based on either time-based service requirements or performance metrics, adding complexity to expense recognition and necessitating careful estimation of the likelihood of conditions being met.

VALUATION CHALLENGES:

Valuing stock-based compensation involves navigating intricate valuation models like the Black-Scholes model, which can be particularly challenging for private companies without observable market prices for their stock and comparable companies to use as the basis for valuation.

MANAGING INPUTS:

Accurate accounting for stock-based compensation demands precise identification of key inputs, including the type of award, vesting conditions, grant date, and fair market value, to ensure precise expense recognition and presentation in financial statements.

VALUATION OF STOCK OPTIONS

As mentioned above, stock options granted to employees or others need to be valued to determine their fair value for accounting purposes. The fair value of stock options is primarily influenced by several key factors:

1. EXERCISE PRICE (STRIKE PRICE):

This is the price at which the option holder can buy the company's stock. A lower exercise price makes the option more valuable.

2. CURRENT STOCK PRICE:

The market price of the company's stock on the grant date is a critical factor in determining the value of the option. Typically, the higher the current stock price, the more valuable the option, assuming other factors remain constant.

3. VOLATILITY:

Volatility refers to the magnitude of fluctuations in the company's stock price. Higher volatility increases the probability that the stock price will move significantly, thereby increasing the value of the option.

4. TIME TO EXPIRATION:

The longer the time until the option expires, the greater the likelihood that the stock price will move favorably for the option holder, increasing the option's value.

5. RISK-FREE INTEREST RATE:

This rate reflects the cost of tying up capital without risk. A higher risk-free interest rate reduces the present value of the option's potential benefits.

PRACTICAL ACCOUNTING CONSIDERATIONS

To effectively manage stock-based compensation, companies should:

IMPLEMENT ROBUST PROCESSES:

Establish rigorous processes for tracking stock-based compensation awards, ensuring meticulous record-keeping and compliance with accounting standards.

UTILIZE TECHNOLOGY:

Leverage specialized software platforms such as Carta to streamline equity management and facilitate accurate accounting for stock-based compensation.

COLLABORATE ACROSS FUNCTIONS:

Foster collaboration among finance, HR, legal, and other relevant departments to align stock-based compensation practices with organizational goals and regulatory requirements.

STAY INFORMED:

Stay abreast of regulatory updates and revisions in accounting standards affecting stock-based compensation to adjust accounting practices accordingly and mitigate compliance risks.

Accounting for stock compensation expenses is a multifaceted endeavor that requires a deep understanding of accounting principles, valuation methodologies, and regulatory requirements. By navigating the complexities of stock-based compensation with diligence and expertise, companies can ensure transparent financial reporting, promote employee engagement, and drive long-term shareholder value.

ACCOUNTING FOR STOCK WARRANTS

Stock warrants are similar to stock options but are typically issued by the company itself (*as opposed to options being granted to employees*). Accounting for stock warrants involves:

INITIAL RECOGNITION:

Stock warrants issued in exchange for cash or other assets are initially recorded at fair value on the issuance date.

SUBSEQUENT MEASUREMENT:

Depending on whether the warrants are classified as equity or liabilities, they are subsequently remeasured at fair value through profit or loss or at fair value through other comprehensive income.

ADJUSTMENTS:

Changes in the fair value of warrants are recognized in the company's financial statements until they are exercised or expire.

CLOSING REMARKS

Valuing stock options and accounting for stock warrants are intricate processes that require companies to apply rigorous valuation models and adhere to accounting standards such as ASC 718. By accurately valuing and accounting for these equity-based instruments, companies can provide transparent financial reporting, align compensation with performance, and effectively manage their overall financial health. There are many pitfalls in ASC 718 though, and you must be well-versed in its intricacies before ensuring proper compliance. Please contact us if you have stock-based compensation and don't know how to proceed. It seems like a daunting topic, but with proper support and guidance, it can be overcome.



EQUITY-BASED COMPENSATION – THE EMPLOYEE AND EMPLOYER TAX PERSPECTIVES



Equity-based compensation offers significant advantages for both employees and employers. For employees, it presents the opportunity for significant financial rewards, fosters a sense of ownership and alignment with company goals, and enhances overall compensation packages. Employers can leverage equity to attract and retain top talent, incentivize employees to contribute to long-term company success, and potentially reduce compensation costs. However, equity-based compensation also presents a complex landscape of tax implications for employers and employees.

UNDERSTANDING THE BASICS

Equity-based compensation is a versatile approach to rewarding employees with an ownership stake in the company. This compensation strategy typically employs a range of instruments, including incentive stock options, non-qualified stock options, employee stock purchase plans, restricted stock awards, and restricted stock units. The tax implications associated with each of these compensation structures can be complex and vary significantly. One common principle amongst all these compensation structures is that the value of the equity generally becomes taxable income when certain conditions are met, such as the exercise of options, the vesting of restrictions, or the sale of shares.

INCENTIVE STOCK OPTIONS (ISOS)

EMPLOYEE:

- ▶ No income tax is owed upon grant or exercise.
- ▶ If certain holding period requirements are met, any gain realized upon the sale of the stock is generally taxed at long-term capital gains rates.
- ▶ If holding period requirements are not met, the entire gain is taxed as ordinary income.
- ▶ Potential for alternative minimum tax (AMT) liability upon exercise.

EMPLOYER:

- ▶ No tax deduction is allowed when the options are granted or exercised.
- ▶ The potential for AMT implications could affect employer's tax planning strategies for highly compensated employees.

NON-QUALIFIED STOCK OPTIONS (NSOS)

EMPLOYEE:

- ▶ No income tax is owed upon grant.
- ▶ The difference between the exercise price and the fair market value of the stock at exercise is considered ordinary income.
- ▶ Any gain realized upon the sale of the stock is generally taxed at long-term capital gains rates if held for more than one year.

EMPLOYER:

- ▶ Deduction for the spread (difference between exercise price and fair market value) is generally allowed in the year the employee realized income.
- ▶ May be subject to payroll taxes on the spread when the options are exercised.

EMPLOYEE STOCK PURCHASE PLANS (ESPPS)

EMPLOYEE:

- ▶ The discount between the purchase price and the fair market value of the stock is generally taxed as ordinary income.
- ▶ Any gain realized upon the sale of the stock is generally taxed at long-term capital gains rates if certain holding period requirements are met.

EMPLOYER:

- ▶ No immediate tax deduction.
- ▶ Can be qualified plans under certain conditions, which may have limitations such as limitations on employer contributions and participant loans.

RESTRICTED STOCK AWARDS (RSAs)

EMPLOYEE:

- ▶ No income tax is owed upon grant.
- ▶ Income is recognized as ordinary income when the restrictions lapse (vesting).
- ▶ Any gain realized upon the sale of the stock is generally taxed at long-term capital gains rates if held for more than one year after vesting.
- ▶ Section 83(b) Election allows income recognition upon grant, potentially reducing future tax liability.

EMPLOYER:

- ▶ Deduction is generally allowed in the year the employee recognizes income.
- ▶ May be subject to payroll taxes on the fair market value of the restricted stock when it vests.

RESTRICTED STOCK UNITS (RSUs)

EMPLOYEE:

- ▶ No income tax is owed until the RSUs vest.
- ▶ The fair market value of the shares at vesting is considered ordinary income.
- ▶ Any gain realized upon the sale of the stock is generally taxed at long-term capital gains rates if held for more than one year after vesting.
- ▶ Section 83(b) Election allows income recognition upon grant, potentially reducing future tax liability.

EMPLOYER:

- ▶ Deduction of the fair market value is generally allowed in the year the employee recognizes income.
- ▶ May be subject to payroll taxes on the fair market value upon vesting.

PLANNING IS KEY

Equity-based compensation can be a powerful tool, but it's important to approach it with careful planning. Employers and employees should work with their tax professionals to ensure compliance while optimizing tax planning strategies.

EDWARD MCWILLIAMS, CPA
PARTNER



DEMYSTIFYING DEFERRED TAXES IN ACCOUNTING



ASC 740: INCOME TAXES - AN OVERVIEW

Accounting Standards Codification (ASC) 740 mandates the asset and liability method for accounting for income taxes. Under this method, companies recognize deferred tax assets and liabilities based on disparities between the carrying amounts of assets and liabilities on financial statements and their corresponding tax bases, which in turn gives rise to differences between taxable income and financial statement income. Deferred tax assets and liabilities are recognized on a company's balance sheet as non-current, to be reversed in future years as taxable income related to the temporary difference reverses in future years.

In the realm of financial reporting and accounting, deferred taxes wield considerable influence. Understanding its nuances is crucial for any business striving for accuracy and transparency in its financial statements. Among the myriad facets of accounting for deferred taxes are assets and liabilities, valuation reserves, allowances, and the intricate calculations involved. Let's delve into these elements and demystify the realm of deferred taxes, an area that is usually ignored by internal accountants and reserved for the likes of auditors and tax preparers. But we feel it's beneficial to educate the startup and technology sectors so they can best approach and deal with the intricacies of this subject.

UNDERSTANDING DEFERRED TAX ASSETS/LIABILITIES

A deferred tax asset arises when a company's current year taxable income is greater than its financial statement income due to temporary differences in taxability of certain items that will reverse in future tax years. In essence, the company is paying more tax in the current year than its financial statement net income would require but will pay less tax in future years when taxable income will be lower than its financial statement net income.

A deferred tax liability arises when a company's current year taxable income is less than its financial statement income, again, due to temporary differences in taxability of certain items that will reverse in future tax years. In essence, the company is paying less tax in the current year than its financial statement net income would require but will pay more tax in future years when taxable income will be higher than its financial statement net income.

EXAMPLES OF DEFERRED TAX ASSETS/LIABILITIES

One common scenario giving rise to deferred tax assets is the carryover of losses on a company's tax return, called **net operating loss carryforwards (NOLs)**, to offset taxable income in subsequent years. Disparities between accounting rules and tax rules for other accounting areas, such as bad debt expense and warranty expense also commonly contribute to the creation of deferred tax assets, as such costs are generally not immediately tax deductible when recognized for financial statement purposes.

Common scenarios giving rise to deferred tax liabilities include depreciation expense, which is commonly accelerated for tax purposes compared to the financial statements, and prepaid expenses, which are generally tax deductible when paid, but not recognized as an expense in the financial statements until incurred.

CALCULATING DEFERRED TAX ASSETS/LIABILITIES

Deferred tax assets and liabilities are computed based on expected future tax benefits arising from temporary differences between current period taxable income versus net income per the financial statements. These assets and liabilities are valued using enacted tax rates expected to apply when temporary differences reverse in future years.

DEFERRED TAX ASSET VALUATION ALLOWANCE

A valuation allowance is established when it's more likely than not that a portion or all of a deferred tax asset won't be realized. Factors indicating the need for valuation allowance include a history of operating losses, expiring tax loss or credit carryforwards, and limited future taxable income sources.

CALCULATING VALUATION ALLOWANCE

The valuation allowance is calculated based on the probability of realization of deferred tax assets. For instance, if management believes only 60% of a deferred tax asset will be realized, a valuation allowance is established for the remaining 40%. Journal entries are made to recognize the deferred tax asset and establish the valuation allowance as a contra account reducing the net value of the deferred tax asset recognized in the financial statements, accordingly. Subjectivity of course comes into play whenever estimates are being calculated, so you do have leeway in terms of setting the proper allowance rate. We often see that startups in cash burn mode without any clear path to (*or plans for*) profitability will fully reserve against any deferred tax assets in an effort to remain conservative.

SUBSEQUENT ADJUSTMENTS

Changes in the estimated realizability of deferred tax assets will require future adjustments to the valuation allowance. These adjustments impact income tax expense, with any increase or decrease in the valuation allowance recognized as an adjustment in the period of change.

SPECIAL CONSIDERATIONS

Deferred tax assets arising from net operating loss carryforwards beginning in 2018 can be carried forward indefinitely for most companies, though there are limitations on the amount of a net operating loss carryforward that may be applied to reduce taxable income in a future tax year. Changes in tax rates can also affect the value of deferred tax assets and liabilities, impacting the recognition of deferred income tax expense in the financial statements. Research and development credits and deductions (*which we have covered in a separate piece*) also play an important role for startups and technology-based companies in the calculation of deferred taxes.

DISCLOSURES

As with many areas of the ASC, voluminous disclosures are required in external financial statements (*that are normally audited or reviewed by a CPA firm*) relating to income taxes and deferred taxes. These income tax-related disclosures include entity types, filing status, years under tax authority investigation, components of income tax expenses in the financial statements, book-to-tax differences, credits, how valuation allowances are determined, and many others. Familiarity with these disclosures will help you best prepare your internal records for any financial statement audits you may need.

WRAPPING UP...

Accounting for deferred taxes involves navigating intricate rules and calculations. Understanding the interplay between deferred tax assets and liabilities, income tax expenses and benefits, valuation allowances, and required disclosures is essential for accurate financial reporting. By grasping these concepts, businesses can ensure transparency and compliance while optimizing their tax positions. Coordinating your tax and external financial statement accountants (*typically they are one and the same, and generally should be*) will help ensure that you're both maximizing tax advantages afforded to you and properly capturing and reporting any related information. These are concepts and issues that we've spent many grappling with. If you think we can help you with this challenging finance and accounting area, please contact us.

**LAUREN GRANDINETTI, CPA
MANAGER**



HOW ASC 606 IMPACTS TECHNOLOGY COMPANIES AND SAAS SOFTWARE PROVIDERS



In today's fast-paced technology-driven economy, adhering to stringent financial standards is crucial for sustaining growth and ensuring transparency. The adoption of **Accounting Standards Codification (ASC) 606** by the **Financial Accounting Standards Board (FASB)** has brought about significant changes in how revenue is recognized, presenting both challenges and strategic opportunities for businesses in the technology and **Software as a Service (SaaS)** sectors. Startups tend to struggle with implementing ASC 606 due to its complexity, convoluted nature, and nuances. Below we try to put some fences around an accounting standard that is difficult to wrangle.

UNDERSTANDING ASC 606

ASC 606, officially titled Revenue from Contracts with Customers, represents a comprehensive framework aimed at standardizing revenue recognition practices across industries. Its primary objective is to ensure revenue is recognized when goods or services are transferred to customers in amounts that reflect the consideration the entity expects to receive.

THE FIVE-STEP MODEL OF ASC 606

ASC 606 introduces a structured five-step approach to revenue recognition:

1. IDENTIFY THE CONTRACT:

The first step involves determining whether a contract exists between the company and the customer. This includes identifying the rights and obligations of each party, such as payment terms and performance commitments.

2. IDENTIFY PERFORMANCE OBLIGATIONS:

Once a contract is identified, the next critical step is to identify the distinct goods or services promised to the customer. A performance obligation is defined as a promise in a contract with a customer to transfer a good or service to the customer.

BUNDLED SERVICES:

Contracts often involve bundled services or multiple deliverables, such as software licenses, implementation services, training, and ongoing support. Each of these elements may represent separate performance obligations that need to be accounted for individually under ASC 606.

DISTINCTIVE ELEMENTS:

ASC 606 requires careful consideration of whether promised goods or services are distinct within the context of the contract. This assessment involves evaluating the customer's ability to benefit from each item independently and whether the items are interdependent or significantly integrated with other promised goods or services.

CUSTOMIZATION AND INTEGRATION:

Services that require significant customization or integration efforts may be considered as a single performance obligation if they are not separately identifiable from other promises in the contract.

3. DETERMINE THE TRANSACTION PRICE:

Once performance obligations are identified, the next step is to determine the transaction price. This involves estimating the amount of consideration the entity expects to receive in exchange for transferring the promised goods or services to the customer.

FIXED VS. VARIABLE CONSIDERATION:

The transaction price may include fixed amounts, variable amounts (such as discounts, rebates, or performance bonuses), or a combination of both. ASC 606 requires companies to estimate variable consideration using either the expected value method (probability-weighted average) or the most likely amount method (single most likely amount).

CONSTRAINTS ON VARIABLE CONSIDERATION:

Companies must assess whether there is a significant reversal of cumulative revenue recognized if there are significant uncertainties related to variable consideration. If so, they may need to recognize revenue only to the extent that it is highly probable that a significant reversal will not occur.

TIME VALUE OF MONEY:

If the contract includes a significant financing component (e.g., where payment terms exceed the normal payment cycle), the transaction price should be adjusted to reflect the time value of money.

4. ALLOCATE THE TRANSACTION PRICE:

If a contract includes multiple performance obligations, the transaction price must be allocated to each obligation based on its standalone selling price. This step ensures that revenue is recognized appropriately for each distinct element of the contract.

5. RECOGNIZE REVENUE AS PERFORMANCE OBLIGATIONS ARE SATISFIED:

Revenue is recognized when (or as) the company satisfies a performance obligation by transferring control of a promised good or service to the customer. This can occur over time (e.g., during ongoing service provision in SaaS models) or at a specific point in time (e.g., upon delivery of software licenses or physical goods).

QUIRKS AFFECTING TECHNOLOGY COMPANIES AND SAAS PROVIDERS

ASC 606 introduces several complexities specific to technology companies and SaaS providers:

SUBSCRIPTION-BASED REVENUE:

SaaS companies often provide services over time, necessitating careful assessment of when control of the service is transferred to the customer and how revenue should be recognized over the contract period.

VARIABLE CONSIDERATION:

Contracts in the tech industry frequently include variable elements such as usage-based fees or performance bonuses. ASC 606 requires companies to estimate and adjust revenue recognition based on these variables, impacting financial reporting accuracy.

CONTRACT MODIFICATIONS:

Changes in contract terms, such as upgrades or extensions, require reassessment under ASC 606 to determine if they represent separate performance obligations or modifications to existing obligations, influencing revenue recognition timing and amounts.

EXAMPLES OF ASC 606 APPLICATION IN TECHNOLOGY

1. SAAS COMPANIES:

Consider a SaaS provider offering a cloud-based project management software under an annual subscription. Under ASC 606, revenue is recognized ratably over the subscription period as the software service is provided. For example, if a customer signs a one-year contract for \$12,000, the provider would recognize \$1,000 of revenue each month over the 12-month term.

2. TECHNOLOGY SERVICE PROVIDERS:

A technology consulting firm engages in a project to implement customized software solutions for a client. The contract specifies milestone payments tied to project deliverables, such as completion of software modules. Revenue recognition under ASC 606 aligns with these milestones, ensuring revenue is recognized as services are performed and milestones are achieved.

3. HARDWARE SALES WITH EMBEDDED SOFTWARE:

A hardware manufacturer sells smart devices that include embedded software with ongoing updates and support services. ASC 606 requires the manufacturer to allocate revenue between the hardware and software components based on their standalone selling prices. Revenue from the hardware sale and software updates would be recognized separately as performance obligations are fulfilled.

CHALLENGES AND SOLUTIONS FOR TECHNOLOGY COMPANIES

Implementing ASC 606 poses several somewhat unique challenges for technology companies and SaaS providers:

COMPLEX CONTRACT STRUCTURES:

Technology contracts often involve multiple deliverables or bundled services, requiring careful identification and allocation of transaction prices to each distinct obligation.

DATA AND SYSTEMS INTEGRATION:

Compliance with ASC 606 demands robust systems capable of capturing and processing data related to contract terms, pricing, and performance metrics. Integration between financial systems and operational databases is crucial for accurate revenue reporting.

INTERDEPARTMENTAL COORDINATION:

Ensuring alignment between sales, operations, and finance teams is essential for interpreting contract terms correctly and applying revenue recognition policies consistently across the organization.

To address these challenges and ensure compliance with ASC 606, technology companies can adopt strategic solutions:

ADVANCED REVENUE RECOGNITION SOFTWARE:

Deploying specialized software solutions can automate revenue calculations, facilitate compliance audits, and enhance accuracy in revenue reporting.

ENHANCED CROSS-FUNCTIONAL COLLABORATION:

Foster regular communication and collaboration between departments involved in contract negotiation, service delivery, and financial reporting to ensure a unified approach to revenue recognition.

CONTINUOUS TRAINING AND EDUCATION:

Provide ongoing training sessions to employees on ASC 606 requirements, updates, and best practices to enhance their understanding and application of the standard.

EXTERNAL EXPERTISE AND AUDIT SUPPORT:

Engage external consultants or auditors with expertise in ASC 606 implementation to conduct periodic reviews, validate compliance efforts, and offer recommendations for improvement.

CONCLUSION

ASC 606 represents a pivotal shift in revenue recognition practices for technology companies and SaaS providers, demanding meticulous application and adherence to its principles. By embracing ASC 606, these industries can achieve greater transparency, accuracy, and consistency in financial reporting, thereby enhancing stakeholder trust and supporting sustainable growth in the competitive tech marketplace. Realistically though, ASC 606 will prove frustrating and difficult to implement without the proper support and resources. Effectively navigating ASC 606 requires a proactive approach, leveraging technology solutions, fostering cross-functional collaboration, and prioritizing ongoing education to meet the evolving demands of regulatory compliance and financial transparency. If your company hasn't adequately considered the impacts of ASC 606, we can help on your journey to reach compliance and a sufficient level of understanding.

MATTHEW BURKE, CPA PARTNER





REVENUE RECOGNITION FOR TECH COMPANIES: TAX IMPLICATIONS

Technology companies face unique challenges when it comes to revenue recognition for financial accounting or “book” purposes under ASC 606. The complex and nuanced nature of ASC 606 has been discussed elsewhere in this guide. For income tax purposes, ASC 606 has a cousin – **Internal Revenue Code (IRC) Section 451** “General rule for taxable year of inclusion.” While not nearly as well known or publicized, understanding IRC Section 451 and the differences between ASC 606 and IRC Section 451 is crucial ensure compliance and optimize their tax positions.

GENERAL PRINCIPLES OF IRC SECTION 451

IRC Section 451(a) has the general principle of when to include (*recognize*) revenue for tax purposes; it states that income should be included in the year received by a taxpayer unless its to be properly accounted for in a different period under the taxpayers accounting method – most commonly either cash basis or accrual basis.

For cash basis taxpayers the application of this rule is straightforward – **when the cash is received the taxpayer has income**. Corporate taxpayers can generally use the cash method if their average gross receipts are less than \$29 million (as of 2024) in the prior three years – this amount indexes for inflation annually. Under the cash basis method, accounts receivable and deferred revenue are not considered for revenue, only what was received. Many technology firms will opt to keep their books on the accrual basis but report for tax on a cash basis where possible, as the cash basis will typically result in both a deferral of tax (*as receivables and profit will grow faster than cash collected*) and better align cash flow with tax cash flow.

Accrual basis taxpayers will report for tax purposes **income when it is earned, rather than received – this rule will sound familiar as it’s the same standard for GAAP purposes**. However, when it is earned can be timed differently for tax purposes. The standard under IRC Section 451 is the “All Events Test.” Under this test, revenue is recognized for tax purposes when:

1. All events have occurred that fix the right to receive the income
2. The amount can be determined with reasonable accuracy

For tech companies using the accrual method of accounting, revenue is generally recognized under the all events test at the earliest of when the revenue is earned through performance or the product is delivered, the payment is due or the payment is made. This could at times, particularly in a post ASC 606 world, create substantial differences between book and tax income.

AFS INCLUSION RULE

As part of the 2017 tax reform known as the Tax Cuts and Jobs Act (TCJA) included an update to IRC Section 451 adding IRC Section 451(b), which states that a taxpayer must take into account income no later than in the year they do for financial accounting purposes (*also known as the “AFS Inclusion Rule”*). This was added heavily in response to the adoption of ASC 606 but also to eliminate controversies related to income inclusion and simplify the book/tax differences.

In order for this provision to apply, taxpayers must have an Applicable Financial Statement (AFS), which is:

1. 10-K or Annual Shareholder Statement
2. Audited Financial Statement
3. A financial statement filed with any federal agency other than for tax purposes.

Taxpayers were granted an automatic change for this in 2017/2018 which was expanded onward – for any accrual basis taxpayer this aligns the revenue for tax with the revenue for GAAP, with one notable exception.

ADVANCE PAYMENTS

Technology contracts often have payments in advance, sometimes for subscriptions or services covering multiple years. Under GAAP, these advance payments are treated as deferred revenue and not recognized until earned under GAAP rules. Under IRC Section 451 however has a significant departure from GAAP (*including the above AFS Inclusion*) that requires an advance payment to be included in gross income either:

1. In the year of receipt
2. For taxpayers with an AFS, the portion recognized in the AFS in the year of receipt and the remaining in the following taxable year.
3. For taxpayers without an AFS, a portion is recognized to the extent earned (on a statistical or straight line basis) in the year of receipt and the remaining in the following tax year.

Technology companies with long term contracts (*more than 2 years*) and payments received upfront need to be aware of this timing difference, as even with an AFS it can accelerate the recognition vs GAAP.

Revenue recognition for tax purposes remains a complex area for tech companies. While financial accounting standards have shifted with ASC 606, tax rules continue to focus on fixed rights to income and determinable amounts for taxpayers without an AFS; taxpayers with an AFS will be closely aligned with ASC 606. Tech companies must carefully navigate these differences to ensure compliance while optimizing their tax positions, particularly in regard to advance payments. As the tech industry continues to innovate, it’s crucial to stay informed about potential changes in tax regulations and seek expert advice when dealing with complex revenue recognition issues.

JACOB LUTZ, CPA, MBA
MANAGER



ASC 340-40, OTHER ASSETS AND DEFERRED COSTS - CONTRACTS WITH CUSTOMERS



BACKGROUND:

The somewhat new revenue recognition standards started by **Accounting Standards Update (ASU) 2014-09** added a subtopic to the **Accounting Standards Codification (ASC)**, ASC 340-40, which addresses accounting for incremental costs incurred as part of obtaining or fulfilling contracts with customers within the scope of ASC Topic 606 on revenue from contracts with customers. The purpose of this subtopic is to create a consistent framework to account for contract costs. This is an often-missed area of the ASC that many companies lack knowledge of. It's important to note and recognize that if your company adheres to ASC Topic 606 for its revenue recognition (*generally, the five-step recognition method for analyzing contracts with customers*), it may also be subject to ASC 340-40. Read on for more information about this accounting standard and how to apply it.

DEFINING INCREMENTAL COSTS:

Incremental costs are costs that are incurred to obtain a contract with a customer that would not have been incurred if the contract had not been obtained. Examples of incremental costs include commissions paid upon successful signing of a contract and bonuses paid based on quarterly sales targets. Other costs, such as legal fees for drafting contracts, travel expenses to pitch contracts, and salaries for salespeople working exclusively on obtaining new customers, are not considered incremental costs because they would have been incurred whether or not the contract was obtained.

ACCOUNTING TREATMENT:

Incremental costs to obtain a contract are capitalized and recorded as assets if they both **(1) relate directly to a contract greater than one year in length** and **(2) they are expected to be recovered**. Incremental costs to fulfill a contract are capitalized if they **(1) relate directly to a current or a specific anticipated contract, such as a contract renewal**, **(2) the cost generates or enhances a resource that is used to fulfill performance obligations**, and **(3) the cost is recoverable**.

Incremental costs incurred on contracts whose terms are one year or less are expensed when incurred.

Capitalized incremental costs are amortized on a straight-line basis over a period consistent with the length of the contract or the transfer of goods or services to which the asset relates. If the timing of the transfer of goods or services changes significantly at a point during the contract period, the entity should revise the amortization period to reflect such change on a prospective basis.

An impairment analysis should be performed at the end of the reporting period and when an event occurs that indicates that the capitalized contract costs may no longer be recoverable. If capitalized costs exceed the amount of consideration an entity expects to receive in future periods, the difference should be recognized as a loss in the entity's financial statements.

DISCLOSURES:

An entity is required to disclose judgments made in determining costs incurred to obtain or fulfill contracts with customers, the method used to determine the amortization period of capitalized costs, the amount of amortization, and any impairment losses recognized in the reporting period.

IN SUMMARY:

If your company incurs costs related to securing and fulfilling contracts whose terms are longer than one year, chances are ASC 340-40 applies to you. Make sure that you're following this and other standards to ensure full compliance with US GAAP, clean audits, and proper governance. There's also a certain financial benefit to adopting and implementing ASC 340-40, as expenditures that would otherwise be expensed in one period could potentially be deferred over time, which also better matches revenue under ASC 606 with underlying and related expenses. As always, if you have any questions about this subject (*or any others*), please connect with the Cerini & Associates Technology and Startup services group.

JACLYN HAHN, CPA, MBA
SUPERVISOR



UNRAVELING SALES TAX COMPLIANCE FOR TECHNOLOGY COMPANIES

For most technology companies sales tax compliance represents one of the biggest challenges and is often more burdensome and difficult than income tax or payroll tax compliance. Sales tax in particular is tough given the extreme amount of latitude given to each state in terms of the rate, what transactions are subject to sales tax and their legal right to impose sales tax collection on vendors. Much like technology itself, this is an often changing and evolving arena which can require special attention to avoid both firm level and personal level risk for directors or officers, as they can be held personally liable for unpaid sales tax in certain circumstances.

UNDERSTANDING SALES TAX NEXUS

In the realm of sales tax compliance, understanding sales tax nexus is paramount. As technology firms continue to expand their operations across state lines, navigating the complex landscape of sales tax nexus has become increasingly challenging. Recent developments highlight several key strategies and regulatory updates that are crucial for maintaining compliance in a multistate environment. Sales tax nexus, the connection between a business and a state that triggers tax obligations, has evolved significantly in recent years, particularly with the landmark Supreme Court decision in *South Dakota v. Wayfair, Inc.* This article delves into the intricacies of sales tax nexus, delineating between physical and economic nexus, exploring state policies, thresholds, and enforcement trends, and offering insights for businesses to navigate this complex landscape.

Sales tax nexus refers to the minimum connection or link that a business has with a state or jurisdiction that requires it to collect and remit sales tax on sales made to customers in that state or jurisdiction. Traditionally, nexus was established through physical presence, such as if a business has a physical presence in a state—like an office, store, employee, or warehouse—it generally has nexus in that state and must collect sales tax. However, the *Wayfair* decision revolutionized this paradigm by introducing an economic nexus standard, holding that states can require out-of-state sellers to collect sales tax based on their economic and virtual connections to the state, rather than just a physical presence. The court reasoned that the previous physical presence rule was outdated due to the growth of e-commerce and that it was necessary to level the playing field between online and brick-and-mortar retailers. Many states have adopted economic nexus laws, which require businesses to collect sales tax based on economic activity rather than physical presence. This often includes criteria like a certain amount of sales revenue or number of transactions within the state. Each state has the right to make their own law – the law for California may not be the same as New York. Most states have used the threshold that South Dakota used in the *Wayfair* decision of \$100,000 in annual transaction volume (*in previous or current year*) or 200 transactions. Some states have economic floors as low as \$10,000 or don't have a transaction bright line number, but luckily most of the states use a somewhat similar test.

TAXABILITY OF TECHNOLOGY TRANSACTIONS

Beyond having nexus, it is also then important for technology companies to assess if their offering is subject to sales tax in the state itself. While state legislatures are continually updating their sales tax laws to address emerging trends in technology, e-commerce and remote sales, emerging technology will always be ahead of this, forcing companies to “*put a square peg in a round hole.*” It wasn't until the mid-2010s that some states released guidance or laws related to **Software-as-a-Service (SaaS)** transactions, and still many have not directly addressed Platform-as-a-Service or Infrastructure-as-a-Service. States have historically looked at what is the “*true object*” of a service to determine its taxability but increasing software integrations and components have made this more and more difficult and the line more blurred than ever. Further complicating matters is the ability of each state to determine what transactions are subject to tax – as an example most SaaS transactions are exempt in California but are subject to tax in New York. As more technology firms are audited by states and matters of controversy reach courts we get continued guidance on how each individual state is looking at matters, but often firms are in the dark applying analog standards to a digital world.

STATE POLICIES AND ENFORCEMENT:

Enforcement of economic nexus rules has become more rigorous, driven in part by states' efforts to address budget shortfalls exacerbated by the COVID-19 pandemic. States are leveraging technology and data analytics to identify non-compliant businesses, including issuing nexus questionnaires and monitoring online sales activities. State tax authorities are ramping up their audit activities, focusing on businesses with significant economic nexus but potentially underreporting their tax obligations. It's essential for businesses to maintain thorough records and be prepared for potential audits. Regular internal reviews and consultations with tax professionals can help identify and address any compliance gaps before they become issues.

MITIGATING RISK AND COMPLIANCE:

Given the complexity of managing sales tax across multiple jurisdictions, many businesses are turning to technology for assistance. Sales tax automation software can streamline the process of tracking nexus, calculating tax liabilities, and filing returns. Advanced systems integrate with ERP and e-commerce platforms to ensure accurate and timely compliance, reducing the risk of errors and penalties. In response to heightened enforcement efforts, businesses must proactively monitor their nexus footprint and assess their compliance obligations on a regular basis. Leveraging state-provided tools and resources can facilitate sales tax collection and filing processes, while participation in voluntary disclosure programs can mitigate penalties for non-compliance. Moreover, businesses should advocate for clearer nexus guidelines and engage in dialogue with policymakers to address systemic challenges.

The landscape of sales tax continues to evolve, driven by legislative changes, technological advancements, and increased enforcement. Technology companies operating in multiple states must stay informed about these developments and adopt robust compliance strategies to manage their tax obligations effectively. Leveraging technology, staying abreast of legislative changes, and consulting with tax professionals are key steps in ensuring ongoing compliance in a complex multistate environment.

**KIMBERLY MARTINEZ, CPA
DIRECTOR**





CERINI & ASSOCIATES LLP
CERTIFIED PUBLIC ACCOUNTANTS



OUR CONTRIBUTORS



Burke specializes in serving startup and mid-sized business clientele. With over 20 years of experience, he works closely with many types of complex accounting, auditing, compliance, and general business matters that impact both the nonprofit and entrepreneurial communities.

MATTHEW BURKE, CPA, CFE | PARTNER | MBURKE@CERINICPA.COM



McWilliams has worked with technology firms and other mid-size businesses for 15 years assisting with tax compliance, tax controversy and business advisory services with a specialization toward both international and state and local tax issues. His experience includes working with companies as early stage startups through successive fundraising rounds and exits.

EDWARD MCWILLIAMS, CPA | PARTNER | EMCWILLIAMS@CERINICPA.COM



Martinez has 15 years of experience in providing clients with tax compliance, tax planning, assurance and advisory services across a variety of industries, including software and technology companies. Her cross-functional experience between tax and assurance services allows her to employ analytical skills to tax clients to help advise them on improving operations and efficiency.

KIMBERLY MARTINEZ, CPA | DIRECTOR | KMARTINEZ@CERINICPA.COM



Grandinetti has been a member of Cerini & Associates' audit and consulting practice area since 2012 where she focuses on serving healthcare, small businesses, contractor, and software clients. She has experience performing assurance work, outsourced accounting work, and government filings. Grandinetti brings her expertise, diversified background, and helpful approach to all of her engagements.

LAUREN GRANDINETTI, CPA | MANAGER | LGRANDINETTI@CERINICPA.COM



Lutz is the firm's leader of the technology practice for tax clients having spent his whole career working with technology companies. A self-proclaimed "nerd", He brings the ability to understand the technical matters for software and technology providers and is able to pair that with his deep understanding and experience of tax law. He was the recent recipient of the Long Island Software & Technology Network (LISTnet) Technomic Award.

JACOB LUTZ, CPA, MBA | MANAGER | JLUTZ@CERINICPA.COM



Hahn is a member of Cerini & Associates' audit staff where she focuses on serving for profit and employee benefit plan clientele. She has extensive knowledge surrounding the operations, controls, and environment of the sectors she focuses on.

JACLYN HAHN, CPA, MBA | SUPERVISOR | JHAHN@CERINICPA.COM



Harvey is a member of Cerini & Associates' audit staff where she focuses on serving various for-profit and employee benefit plan clientele, including software providers. She has experience performing assurance work and outsourced accounting work, as well as preparing tax returns. Crystal has extensive knowledge surrounding the operations, controls, and environment of the sectors she focuses on. She brings her expertise, diversified background, and helpful approach to all of her engagements.

CRYSTAL HARVEY | SUPERVISOR | CHARVEY@CERINICPA.COM

WHAT OUR CLIENTS ARE SAYING...

As we have grown our technology company from a start-up idea into a thriving business, Cerini has been an indispensable partner for us, providing spot on accounting, impeccable advice and top-notch professionalism. I have peace of mind that my accounting needs are being addressed by the Cerini team.

*Drew Stern, Founder & Co-CEO
Esquify, Inc.*

Business Overview

Cerini & Associates, LLP is a full services accounting firm with a foundation built on value-added ideas and integrity. C&A is a leader in providing accounting services in the technology field, combining a deep understanding and experience with different technology platforms and models. C&A services include, but are not limited to:

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-  Operational & Internal Control Reviews
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C&A's staff takes pride in the quality of its work and operates with the technical ability of a much larger firm. C&A is also proud to have received an unqualified opinion during its last tri-annual peer review. The firm is affiliated with many professional organizations, including the: New York State Society of Certified Public Accountants, American Institute of Certified Public Accountants, and Association of Certified Fraud Examiners.

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3340 Veterans Memorial Hwy, Bohemia, NY 11716
(631) 582-1600
www.CeriniCPA.com





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