STATE & LOCAL TAXES

A cautionary tale: Challenges for firms in *Wayfair* compliance

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Lessons can be learned from an accounting malpractice lawsuit alleging failure to advise a client about *Wayfair*.

Law firms periodically receive requests for advice from CPAs regarding a client's need to come into compliance with the relatively new and sometimes confusing "economic nexus" or "*Wayfair*" rules for selling goods or providing services to customers in another state. Often, the client realized only recently they had a sales tax collection problem and are now hinting (or more) that their CPA firm should have either warned them or voluntarily stepped in to handle the new compliance issue. The most common responses heard from CPAs to these client complaints are, "You never asked us to look into the issue, and that's beyond the scope of our engagement," or "We thought *you* were … or someone *else* was … handling that for you."

How far can or should a CPA firm stray outside the scope of its engagement to please a client? Is educating clients on topics that fall outside the scope of the CPA firm's engagement really the firm's responsibility? An Asheville, N.C., CPA firm is facing similar questions after a client, an online retailer, filed a tax malpractice suit against the firm in North Carolina Business Court.[1]

Lawsuit overview

Vista Horticultural Inc., doing business as Eden Brothers, is headquartered in North Carolina and sells seeds and flower bulbs nationwide. It recently filed suit against its (now former) CPA firm, Johnson Price Sprinkle, PA (JPS) and the successor firm for allegedly failing to advise the business of new sales tax obligations created by the U.S. Supreme Court's landmark decision in *South Dakota v. Wayfair, Inc.* (discussed below) and allegedly violating North Carolina law, the rules of the North Carolina State Board of Certified Public Accountant Examiners, and the North Carolina Administrative Code, which has formally adopted the AICPA Code of Professional Conduct.[2] Summarized below are the plaintiff's allegations in its amended complaint and, in JPS's answer to the complaint, the firm's responses to date. As of this writing, the parties are engaged in the discovery process.

Eden Brothers hired JPS in 2017, allegedly to provide "regular business consulting services, monthly accounting and bookkeeping services, federal and state tax return preparation, and periodic sales tax assistance." Eden Brothers and JPS also allegedly held regular meetings

1. A specialized forum of the state's Superior Court Division.

2. *Vista Horticultural Inc. v. Johnson Price Sprinkle PA*, No. 23CV01594 (N.C. Sup. Ct. (Bus.) 4/25/23) (complaint filed).

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"to raise and discuss accounting and tax issues that needed to be addressed."

Soon after being hired, JPS informed Eden Brothers that its North Carolina sales tax process was not correct and helped Eden Brothers set up a proper system for collecting and remitting sales tax to that state. JPS helped implement only a North Carolina sales tax system — at the time, online retailers were required to collect/pay sales or seller's use tax only for the state (or states) where they had physical presence.

Although Eden Brothers claims "JPS was well aware that Eden Brothers had no internal financial or accounting staff and ... would be relying entirely on JPS in those areas," the engagement letters paint a different picture. The 2018, 2019, and 2020 engagement letters between JPS and Eden Brothers state that JPS "will only be responsible for the preparation of the [income] tax returns and forms listed above ... [but] tax returns may be required in other states and jurisdictions."

In June 2018, the Supreme Court handed down its watershed decision in *South Dakota v. Wayfair*.[3] The previous physical-presence nexus rule was overhauled, and online retailers like Eden Brothers generally are now subject to state (and sometimes local) sales or seller's use taxes based on their volume of taxable sales of goods or services to customers in a particular state.[4]

Eden Brothers claims it was not given notice of the ruling by JPS; however, JPS's answer states that "Eden Brothers was so advised" and received "urgent alerts" from the firm as to its expanded sales tax obligations after the *Wayfair* decision. JPS also stated that the new tax collection obligations "were well-known in the industry following the *Wayfair* decision," but that Eden Brothers failed to act upon its own awareness.

In 2021, Eden Brothers received notice from the state of Arizona regarding its new law requiring certain remote sellers to collect/pay state sales taxes. Eden Brothers allegedly forwarded the notice to JPS and specifically asked, "Do you know anything about other states asking for sales tax now? . . . We are currently not charging any tax to any other state customers. Let me know if we need to change any of that!" The engagement letters between Eden Brothers and JPS include that "[u]pon request [JPS] will assist you in evaluating any additional return or form filing requirements." A JPS company representative "indicated the need to do some additional research" in response to Eden Brothers' question, but Eden Brothers claims it did not receive the requested advice.

Eden Brothers hired a CFO; during his initial review process, the new CFO allegedly "discovered" that the retailer had not been collecting sales tax in any state except North Carolina for the three years since *Wayfair* was decided. JPS was consulted, which referred the CFO to another accounting firm, apparently one with more expertise in multistate sales tax compliance. Eden Brothers says it implemented procedures for collecting/paying sales tax in addition to applying for voluntary disclosure agreements (VDAs) in each state where it had delinquent sales tax obligations.

Fortunately for Eden Brothers, its VDA proposals evidently were granted — the company avoided substantial penalties for failing to collect/pay sales or seller's use tax in multiple states. Nevertheless, Eden Brothers' sales tax obligations (including interest) for the three years of missed tax payments exceeded $2 million. It sued JPS for more than $1 million plus punitive damages, attorneys' fees, etc.

JPS lists several defenses in its answer to the Eden Brothers lawsuit. For example, although the online retailer claims it relied on JPS for updates on its tax obligations, JPS asserts that it neither controlled Eden Brothers' operations nor owed any fiduciary duty to the company, arguing that the former client was "fully responsible" for its own tax obligations. JPS claims it notified its former client of the *Wayfair* ruling but, in any event, the ruling was "well-known in the industry." However, JPS further claims, Eden Brothers either failed to obtain that information or failed to act upon its own awareness.

Reflecting a common frustration CPAs have with clients, JPS also argues that Eden Brothers failed "to read communications from [JPS] concerning [Eden Brothers'] obligations." Although the engagement letters contemplate additional requests for non–income tax services from Eden Brothers, JPS claims the former client failed "to provide [JPS] sufficient information to determine [Eden Brothers' obligations], despite specific advice from [JPS] and requests for such information."

Recommendations

It is often said that a detailed engagement letter, signed by the client and clearly limiting the scope of the engagement, goes a long way toward managing client expectations and mitigating the risk of lawsuits. A *Journal of Accountancy* article describes engagement letters as "one of the best defensive tools a CPA can possess."[5]

Another best practice is to periodically send questionnaires and alerts to clients to warn of new tax developments and offer to provide detailed advice *if*

3. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (U.S. 2018).
4. For a useful article on what has happened since the *Wayfair* ruling, see Jensen et al., "*South Dakota v. Wayfair* — Five Years Later," 54-6 *The Tax Adviser* 48 (June 2023).
5. Ference, "Frequently Asked Engagement Letter Questions," 232-3 *Journal of Accountancy* 8 (September 2021).

the client calls on the CPA firm to do so — and to document their issuance. Not only do these newsletters give clients the opportunity to request additional services, but they can also function as a subtle if not express reminder that the CPA firm is otherwise limited in the scope of its services to those listed in the engagement letter.

Additionally, simply speaking to your clients on a periodic basis can help you better understand their business needs and goals, create opportunities to identify additional services or opportunities (e.g., multistate nexus compliance), and manage risk. A phone call, a lunch, or an in-person meeting can be an incredibly effective way to demonstrate commitment to a client while helping to expand the relationship. Of course, it is critical to document these discussions and follow up as necessary. Managing risk does not have to be a zero-sum endeavor limited to perfect engagement letters, robust caveats, and detailed terms-and-conditions language. Routinely asking high-value questions can help expand your book and head off concerns before they materialize.

Alternatively (and although it could be painful), it might sometimes be wise to do as JPS did and refer your client to another professional services firm or to a sales tax consulting/software firm for specialized services that your CPA firm simply is not staffed to provide.

The states' (and occasionally local governments') aggressive post-*Wayfair* "economic nexus" rules potentially expose CPA firms to surprise malpractice claims. The North Carolina lawsuit is a cautionary tale for every CPA firm with clients that sell goods or services outside their home-state boundaries, whether online, via common carrier, or otherwise.

Other areas of potential concern

According to the AICPA, tax services were the source of 73% of malpractice claims filed against CPAs in 2021. "Failure to advise/improper advice" was the second leading reason for these tax services claims at 36%, trailing only "filing error." In prior years, the top reason for tax-related malpractice claims was incorrect advice or failure to advise.[6] In its 2022 written statement to a hearing of the Senate Finance Committee, the AICPA highlighted the complexities companies face from the lack of uniformity of economic nexus thresholds.[7]

We fear another source of potential malpractice claims will be the Corporate Transparency Act of 2021 (CTA), which is slated to go into effect Jan. 1, 2024.[8] The CTA generally requires beneficial ownership information (BOI) reports to be filed with Treasury's Financial Crimes Enforcement Network (FinCEN) regarding both newly formed and *existing* business entities that are not "exempt entities." These reports must identify owners that hold, directly or indirectly, at least a 25% ownership interest or that otherwise exercise "substantial control" over the entity. Failure-to-report violations can lead to significant penalties. Unfortunately, many small to medium-sized businesses will be subject to the reporting requirements of the CTA.

Like the significant change *Wayfair* wrought for online retailers — and their CPA firms — the new CTA requirements could lead to consequences for CPA firms. For example, if FinCEN comes calling or if a potential buyer's due diligence turns something up, they could be blamed for failing to warn the client of the new rules or for an unwitting failure to prepare and file the necessary reports in a timely and ongoing manner. The AICPA is on record as opposing the broad scope and potential unintended consequences of the law and is now urging Congress to delay the CTA's effective date.[9] So far, FinCEN has agreed only to give nonexempt companies formed in 2024 up to 90 days (versus 30) to file their first BOI report.[10] ■

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6. Ference, "Malpractice Claims in 2021 and Future Predictions," 234-2 *Journal of Accountancy* 4 (August 2022).
7. Senate Finance Committee, hearing on "Examining the Impact of *South Dakota v. Wayfair* on Small Businesses and Remote Sales" (June 14, 2022).
8. Corporate Transparency Act, P.L. 116-283. See Esser and Heroux, "Beneficial Ownership Information Reporting: Right Around the Corner," 54-10 *The Tax Adviser* 21 (October 2023).
9. See Waggoner, "AICPA Advocates for Delay in BOI Reporting Requirements," *Journal of Accountancy* (July 27, 2023).
10. Notice of Proposed Rulemaking (RIN 1506-AB62); see Waggoner, "FinCEN Proposes BOI Reports Deadline Extension for Certain Companies," *The Tax Adviser* (Sept. 28, 2023).