

ABA/IPT ADVANCED SALES/USE TAX SEMINAR

Sales & Use Tax Sourcing: Applying Old Rules to New Business Models

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Agenda

- ▶ **Importance of Characterization**
- ▶ **Sourcing**
- ▶ **Questions**

Characterization

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Characterization

► What are you buying?

- Tangible personal property
- Service
- Something else

► What does the Agreement state you are buying?

- Auditors and courts heavily rely on the contractual language in characterizing the item being purchased. If a software license agreement is executed, it will be difficult to argue that you are not licensing software.

► Why does characterization matter....

- Determining taxability
 - Most states tax sales of tangible personal property and enumerated services. Emerging trend to tax “digital goods”.
- What use based exemption may be applicable
 - Resale, Manufacturing, R&D, etc.

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Characterization

► Taxable as Tangible Personal Property (TPP)?

- States impose tax on TPP, unless specifically exempt.
 - How does the state define TPP?
 - SST has defined TPP as:
 - “personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. “Tangible personal property” includes electricity, water, gas, steam, and prewritten computer software.”
- Many states currently include “prewritten computer software in their definition of tangible personal property, thus subjecting it to sales tax.

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Characterization

► Taxable as Service?

- The majority of states that impose a sales and use tax still only tax those services specifically enumerated as taxable. Determining if the sale is taxable can be a daunting task.
 - Laws and interpretive guidelines are often outdated.
 - There is often a lack of clear guidance.
 - Categorization can have significant impact:
 - Reduced rates
 - Temporary imposition
 - Reduced tax bases
- The Streamlined Sales Tax Project has, with some exceptions, avoided addressing service transactions. Some clarity developed for:
 - Prewritten Computer Software (defined as TPP)
 - Digital Goods (addressed on following slides)
 - Bundled Transactions

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Characterization

► Taxable as Something Else?

- More and more states are moving towards expressly taxing “digital goods.”
 - The State of New Jersey was one of the first in line. Effective October 15, 2006, the New Jersey sales tax base was increased to include digital property and information services.
 - The SST Governing Board approved a definition of digital products in September, 2007.
- In the last year, bills have been passed in the following states, addressing the taxability of digital items, as defined under SST:
 - Kentucky, Mississippi, North Carolina, Vermont, Washington State, Wisconsin and Wyoming.

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New Business Models

► With new technology models evolving, states are making every attempt to tax these new models under existing provisions. Consider the following:

- Application Service Providers (“ASP”)
 - An entity that retains custody over (or “hosts”) software for use by third parties. Users of the software hosted by the ASP typically will access the software via the Internet. The ASP may or may not own or license the software, but generally will own and maintain the hardware and networking equipment required for the user to access the software. The ASP may charge the user a license fee for the software (in instances where the ASP owns the software) and / or a fee for maintaining the software / hardware used by its customer.

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New Business Models

► And the following:

- Software as a Service (“SaaS”)
 - This term is often used interchangeably with ASP – one could draw the distinction between the two in that under the SaaS model a services agreement is almost always executed, whereas in the ASP model, the customer may execute a software license agreement or a services agreement.

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New Business Models

► And the following:

- Cloud Computing
 - Captures all of the above and a variety of other services which are performed utilizing the internet. There is no “one” definition of cloud computing – it is a manner of performing a service.
 - Need to focus on the object of the transaction:
 - Data Processing
 - Information Service
 - Digital Goods
 - Software
 - Disaster Recovery

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Sourcing

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The Where

Sourcing is dependant upon characterization. For interstate sales, if taxable as:

- ▶ **Tangible Personal Property**
 - Generally destination
 - Consider subsequent use
 - Consider concurrent use (prewritten computer software)
- ▶ **Services**
 - Varies by state. May be:
 - Benefit
 - Performance
 - Consider multi-state benefit
- ▶ **Digital Goods**
 - Not clearly defined. May be:
 - Destination
 - Benefit
 - Consider multi-state use

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The Where

► What are the Problems?

- From a sales tax perspective, the concepts of destination and benefit are not easily applied to services and digital items. The Seller may have no idea where the receipt of the items takes place, or where the item is used.
- From a purchaser perspective, location of use may not always be known – or may be from multiple locations.
- Is “Use” at server location or user location? States vary, by way of example:
 - Alabama – Server Location
 - New York – User Location
 - Trend towards user location, but be careful of states that include software or digital products in their definition of tangible personal property – these states may take a more traditional view of where these items should be sourced – one location.

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The Where

Multiple Points of Use (“MPU”)

- The MPU provisions were repealed from the SST Agreement. Member states must repeal by January 1, 2008.
- The Multiple Points of Use (“MPU”) Exemption permitted a business purchaser of computer software, digital goods and services, which are concurrently used, to apportion, self assess, and remit use tax in all jurisdictions in which it will be used.
- Generally, purchasers are allowed to use an apportionment method so long as its reasonable, consistent, uniform, and can be supported by their books and records.

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The Where

Multiple Points of Use (cont.)

► Colorado

- Colorado continues to source software based on multiple points of use, and has issued Emergency Reg. 39-26-102.13 addressing this topic.

► Massachusetts

- Massachusetts continues to source software based on multiple points of use – see Mass. TIR 05-15.

► Washington

- Washington permits a purchaser of a digital product, service or software to issue an exemption certificate and accrue use tax based on location of use.

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The Where – Washington Exemption Certificate

 **Digital Products and Remote Access Software Exemption Certificate**

This certificate allows the buyer to make tax exempt purchases using the exemptions checked below. This certificate cannot be used for purchases for personal use.

Exemptions claimed
Check all that apply (see page 2 for exemption descriptions):

- Purchased to be made available free of charge to the general public. (Only available for digital goods, digital automated services, digital codes, or remote access software).
- Digital goods purchased solely for a business purpose. (Only available for digital goods. Please see page 2 for more information).
- Purchased for concurrent use by the buyer in and out of Washington State. Buyer must report use tax for in-state use. (Only available for digital goods, digital automated services, digital codes, remote access software, or prewritten software).

Purchases for resale or Purchases of Components

- Purchased digital goods, digital automated services, digital codes, prewritten software or remote access software to be resold in the regular course of business without intervening use. For purchases made after December 31, 2009, you must enter your reseller permit number: _____
- Purchased for use as a component of a new product for sale. (Only available for digital goods, digital automated services, digital codes, or remote access software). For purchases made after December 31, 2009, you must enter your reseller permit number: _____

Seller's Information
Business Name: _____

Buyer's Information
Business Name: _____ Tax Registration Number: _____
Address: _____
City: _____ State: _____ Zip: _____
Telephone Number: _____ Email Address: _____
Type of Business: _____

I certify that the purchase(s) I am making qualify as indicated above. I understand that misuse of this certificate will result in taxes due, interest, possible penalties, and including, if applicable, the 50 percent penalty of the tax due for misuse of the reseller permit. Misuse may also result in the reseller permit being revoked.

Print name of person authorized by the buyer to sign the exemption certificate: _____
Signature of authorized buyer: _____ Date: _____

This certificate is valid for as long as the buyer and seller have at least one sales transaction within twelve consecutive months. RCW 82.08.050 (7) (c).

Reminder to Sellers: As of July 26, 2009, sellers of digital products or remote access software must file the state excise tax return electronically. Go to dot.wa.gov to file online.
Seller must keep a copy of this certificate. Please do not send to the Department of Revenue.

REV 27 06/06 (2/5/10)

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The Where

► Sourcing: Develop a Sensible and Uniform Approach

- State statutory and regulatory guidance often does not provide an answer/approach. Rather, a “range” of acceptable answers is the norm.
 - Washington
 - A business claiming this exemption must report and pay use tax on that portion of the digital products, digital code, prewritten software, or remote access software used in Washington. **The taxable amount is determined by the number of users in this state compared to users everywhere.** Generally, digital products and remote access software are used in Washington when the buyer first accesses, downloads, possesses, opens, stores, enjoys, or receives the benefit of the service in this state. A buyer may not claim a multiple points of use exemption for personal use.
- Most auditors will look for a sensible approach that reflects a system of assigning sales to locations where the service is being “received.”

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The Where

► Sourcing: Develop a Sensible and Uniform Approach

- Yes, it’s true: allocate, allocate, allocate!!
 - Services are often delivered simultaneously to several jurisdictions.
 - Consider
 - *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977);
 - *Goldberg v. Sweet*, 488 U.S. 252 (1989);
 - *Central Greyhound Lines, Inc. v. Mealy et al.*, 334 U.S. 653 (1948)
 - *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995)

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Tips on Allocating Sales & Use Tax Base

- ▶ **How does one source between States A, B, C & D?**
 - Based on expected usage?
 - Based on actual usage?
 - Based on a pro-rata split?
 - Based on “value” of the usage (management versus line employees)?
 - Others?

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Sales & Use Tax Sourcing Example

- ▶ **Sourcing Sales of E-mail and Similar Services**
 - A consumer’s computer may not be located in one jurisdiction.
 - Multiple servers supplying the same information.
- ▶ **500 Different “User” Locations in ten different states**
 - Where does “Use” occur?
 - Where does the transaction take place?
 - Server
 - Corporate headquarters
 - Customer's location
 - Customer's billing address
 - Other

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Questions?

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SALES AND USE TAXATION
WHERE DOES THE SALE TAKE PLACE
Comprehensive Outline

I. WHERE ARE GOODS AND SERVICES TAXED?

A. The Destination Principle

1. The destination principle holds that the sales or use tax will apply at the destination of the taxable property or service irrespective of where title transfers.
2. Destination generally means where the property is delivered to the ultimate consumer. Delivery to the ultimate consumer may include delivery to a purchaser's agent.
3. This principle is generally followed throughout the country even though virtually every state's statute imposes tax on the transfer of title or possession.
4. Although there are some issues with respect to where delivery occurs and who is responsible to collect the tax (e.g. drop shipments), it is generally easier to pinpoint the state in which tangible personal property is delivered. The same cannot be said of services.

B. Where are services delivered?

1. As stated above, services are generally taxed where they are delivered to the ultimate consumer or the consumer's agent. However, unlike sales of tangible personal property, the location of the delivery of a service is a little harder to pinpoint.

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WHERE DOES THE SALE TAKE PLACE
Comprehensive Outline

2. Obviously, when the service provider is in the same state as the ultimate consumer and the service is not provided outside of that state, the service is delivered in that state. However, what happens when more the service provider and the customer are in different states or the service is provided in more than one state.
 - a) For example: An architect/engineer based in New York visits Illinois to oversee a project and to make modifications to the blueprints.
 - b) A consulting firm has staff in five states working on a project at multiple locations.

- C. Allocation or apportionment of services for sale/use tax purposes
 1. If a service is provided in more than one location, where should the service be subject to tax. The United States Supreme Court has looked specifically at this issue with respect to the telecommunications industry in Goldberg v. Sweet, 488 U.S. 252 (1989) and the transportation industry in Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995).

 2. Constitutional Limitations
 - a) Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)
 - (1) The tax must be applied to an activity with a substantial nexus with the taxing State;

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Comprehensive Outline

- (2) the tax must be fairly apportioned to activities carried on by the taxpayer in the taxing state;
- (3) the tax must not discriminate against interstate commerce; and
- (4) the tax must be fairly related to the services provided by the State.

b) Goldberg v. Sweet

- (1) Illinois imposed upon the “act or privilege” of “originating” or “receiving” interstate communications in Illinois so long as the call was charged to an in-state service address (i.e. to equipment in Illinois. The tax was imposed at a rate of five percent of the gross charge for the telecommunications.
- (2) The Appellants contended that the Illinois tax violated the apportionment prong of Complete Auto because the tax was levied upon the gross charge for each telephone call instead of the portion of the gross charge that reflected the ratio of in-state activity to total activity associated with the telecommunication.

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- (3) The Supreme Court, however, viewed the issue as to whether the tax was internally and externally consistent; meaning whether the tax was rationally related to the activity in the state and whether if all states imposed the same method of taxation there would be double taxation.
- (4) The Court recognized only a limited opportunity for multiple taxation since only two types of states had a sufficient nexus to impose a tax on telecommunications: (a) those like Illinois that keyed the imposition of the tax to the service address and (b) those like Arkansas that taxed calls either billed or paid within their boundaries.
- (5) The Court doubted that a state could tax a call merely because electronic signals passed through it, or that the termination of an interstate call, by itself, provided a substantial enough nexus for taxation.
- (6) Illinois avoided “actual multistate taxation” pitfalls by providing a credit for the amount of tax any taxpayer paid in another state on the same call that triggered the Illinois tax.

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- (7) In determining that the tax was fairly apportioned among the states, even though based on the gross charge for the call and not just the portion attributable to mileage traveled within Illinois, the Court likened the tax to a sales tax: it was assessed on individual consumers, collected by the retailer providing the service, and accompanied the retail purchase of an interstate telephone call.
- (8) The Court noted that if all states passed the same statute, only one state would tax each interstate telephone call. Even with different statutes, the credit provision in the Illinois statute avoided multiple taxation.
- (9) The Court further found that the tax was fairly related to benefits provided by the state to its taxpayers and, since it fell only on in-state consumers, did not discriminate unfairly against interstate commerce.
- c) Central Greyhound Lines, Inc. v. Mealey et al., 334 U.S. 653 (1948)
- (1) The State of New York sought to tax the total receipts of Greyhound Lines from transportation of

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which 43 percent of the mileage lay in New Jersey and Pennsylvania.

(2) The Court held that transactions that substantially took place in New Jersey and Pennsylvania could not be deemed legally to have taken place in New York.

(3) If New York were to have been allowed to impose a tax on the gross receipts for the entire mileage of a trip that had not taken place totally in New York, this would have subjected interstate commerce to an unfair burden of being taxed as to portions of its revenue by states that gave protection to those portions, as well as by a state that did not give such protections.

(4) Additionally, if neither Pennsylvania nor New Jersey had sought to tax their proportionate share of the revenue from this transportation, it would still not have justified the taxing by New York of the entire revenue.

d) Oklahoma Tax Commission v. Jefferson Lines, Inc.

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- (1) Jefferson Lines, Inc. is a Minnesota corporation that provided bus services as a common carrier in Oklahoma.
- (2) Jefferson Lines, Inc. did not collect sales tax on tickets it had sold in Oklahoma for bus travel from Oklahoma to other states, although it did collect and remit taxes for all tickets it had sold in Oklahoma for travel that originated and terminated in that state.
- (3) Oklahoma imposes a tax on certain services including transportation for hire and assessed Jefferson Lines, Inc. tax on the tickets it sold in Oklahoma that originated Oklahoma, but terminated outside of Oklahoma.
- (4) Jefferson Lines, Inc. objected to the assessment and claimed that: (a) the tax imposes an undue burden on interstate commerce by permitting Oklahoma to collect a percentage of full purchase price of all tickets for interstate bus travel, even though some of the value derives from bus travel through other states, and (b) the danger of double taxation exists because any other state through which a bus travels

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while providing the services sold in Oklahoma will be able to impose a tax of their own upon Jefferson Lines, Inc. or its passengers.

- (5) Jefferson Lines, Inc. relied upon the Court's decision in Greyhound Lines for support.
- (6) The Court, however upheld the tax as being constitutional and distinguished Greyhound Lines.
- (7) The features that distinguished the New York tax from the Oklahoma tax were (a) the identity of the taxpayers and (b) the opportunities that existed for multiple taxation of the same taxpayer. The taxpayer in New York was the interstate carrier and the carrier was subject to possible taxation on its income in other states. The taxpayer in Oklahoma was the purchaser who was not subject to tax in other states.
- (8) In Oklahoma, the taxable event comprised an agreement, payment and delivery of some of the services. Because no other state could claim to be the site of such a combination, there was no threat of multiple taxation.

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(9) The Court reserved the question as to whether the Commerce Clause would sanction taxes for tickets sold in Oklahoma for travel wholly outside of the state for travel on routes originating in other states and terminating in Oklahoma.

e) Origination, termination and payment or billing appears to be the key to situsing the sale of service when the service takes place in more than one state. However, how will this formula work with e-business remains to be seen.

II. ELECTRONIC COMMERCE

- A. When trying to source sales of e-mail and similar services, situsing the sale is complicated by the fact that a consumer's computer may not be located in one jurisdiction but may instead be moving (e.g. laptop computers, cellular phones, pagers, personal communications networks).
- B. When a vendor of Internet access or on-line services is considered the consumer of purchased telecommunication services, not the reseller, should the call be sourced to where the vendor is headquartered, or to the locations of the ultimate consumers of the end product? Does it make a difference if the on-line vendor has centralized server or switching pin through which all calls are routed?
- C. A computer software company sells a multistate customer the right to utilize its software in 500 different "user" locations in ten different states.

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The computer software company then electronically transfers a single version of the software to a single server site from which the software is accessed by the 500 employees. Is the sale of the software taxable in just the single jurisdiction where the server is located? What if that jurisdiction considers such a transaction to be the sale of nontaxable intangible property? Would a use tax be due in some or all of the other nine states from which the purchaser's employees access the software?

III. IMPACT OF THE STREAMLINED SALES TAX PROJECT (“SSTP”)

1. While the SSTP has, with some exceptions (i.e., bundling, sourcing, etc.), avoided addressing services, SSTP has offered some clarity in participating states at least with respect to prewritten computer software and digital goods. These definitions have introduced a greater degree of predictability for both sellers and purchasers transacting business in these areas. It is unlikely, however, that the SSTP will venture too far into the broader enumerated services arena and the problem of state tax legislation failing to keep pace with rapidly changing technology and business models is likely to continue to be a challenge for businesses struggling to meet their state tax compliance responsibilities.

a) Prewritten Computer Software

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(1) The SSTP has defined tangible personal property to include prewritten computer software (regardless of form of delivery). However, the SSTP has also developed definitions for both “delivered electronically” and “load and leave.” States have the ability to carve out exemptions for prewritten computer software delivered via one of these alternative methods.

b) Digital Goods

(1) The SSTP has defined specified digital products. The definition is somewhat narrow in scope, including the terms digital audio visual works, digital audio works, and digital books. However, of significance is the fact that the digital products provisions expressly state that no state shall include specified digital products, among those items defined with specified digital products, in its definition of ancillary services, computer software, telecommunications services or tangible personal property.

c) Sourcing

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- (1) SST has developed sourcing rules for both sales of tangible personal property and services. While guidance is still being developed to further clarify the sourcing rules related to services, in general, specific sourcing rules have been developed addressing computer services and software maintenance agreements. See *Appendix* for the SST sourcing rules.