TAX MANAGEMENT

MULTISTATE TAX REPORT

BNA Employee-Owned Since 1947

VOL. 18, NO. 4 APRIL 23, 2010

Services

As states continue to struggle with severe budget shortfalls, more and more states are turning to services as a potential source of revenue. But sales and use taxation of services presents complexities not found in the taxation of tangible personal property. In this article, authors Jordan Goodman, of Horwood, Marcus & Berk Chartered, and Carolynn S. Iafrate, of Industry Sales Tax Solutions, discuss the complications that have arisen in taxation of services and in taxpayers' attempts to apportion their sales and use tax base.

Is Taxing Services Too Taxing? A Primer on Complexity Created by States' Efforts to Expand Their Sales Tax Bases

BY JORDAN GOODMAN AND CAROLYNN S. IAFRATE

Forty-seven states, the District of Columbia, and Puerto Rico impose some type of tax on the sale or use of tangible personal property.[1] A majority of these states also impose a tax on certain types of services, but only a handful have extended their sales and use tax statutes to include broad taxation of services, other than ''utility'' services.

States have hesitated to impose a blanket sales tax on services, and past attempts were met with strong resistance and ultimately failed (Florida in 1987, Massachusetts in 1991, and more recently, Michigan in 2007 and Maryland in 2008). This resistance is due in part to the inherent problems associated with the taxation of a service versus tangible personal property—in particular, the problem of how to source services. Services traditionally taxed by states were commonly associated with property (*i.e.*, installation, repairs and maintenance, etc.), and as such, were relatively easy to source under traditional business models. However, with increased technology, sourcing even the more traditional services, such as repairs and maintenance of computers, has become more difficult given that in many instances, the repair can be handled remotely from any location with the use of the internet.

As states face mounting budget deficits, they will attempt to broaden the tax base, rather than impose higher tax rates.

Now, as the states face mounting budget deficits and seek additional revenue, it is likely they will attempt to broaden the tax base to impose tax on additional services, rather than impose higher tax rates. Recent proposals and efforts to expand policy positions further

[1] Delaware imposes a gross receipts tax on sellers; while certain localities in Alaska also impose sales and use taxes on specific items.

Jordan Goodman is a partner with Horwood Marcus & Berk Chartered, in Chicago. Carolynn S. Iafrate is chief operating officer with Industry Sales Tax Solutions in Washington, D.C., and managing member of Iafrate Associates. Mr. Goodman can be reached at jgoodman@hmblaw.com. Ms. Iafrate can be reached at csiafrate@industrysalestax.com.

 ISSN 1078-845X

validate this observation.[2] With new categories of services being taxed, taxpayers will continue to see different interpretations by states of what a particular service is. Further, taxpayers will face the burden of how to situs these services from a sales and use tax perspective, given that the benefit of these services occurs in many jurisdictions.

This article explores the complexities associated with taxing services and examines the issue of whether a taxpayer may apportion its sales and use tax base.

THE COMPLEXITIES OF TAXING SERVICES

What Is a Service?

In the past, distinguishing between the sale of tangible personal property and a service was relatively straightforward. However, with the advent of information technology, new technologies are constantly emerging and the distinction is no longer readily discernible. Take into consideration the following examples:

- books can be downloaded in audio version, downloaded in electronic form for handheld devices and computers, or purchased in tangible form;
- magazine and newspaper subscriptions can be purchased for internet delivery, delivery in tangible form or both; and
- computer software can be delivered in tangible form, downloaded electronically, installed via a ''load and leave'' or ''load and return'' transaction, or accessed via the use of an application service provider (ASP).[3]

In addition, music, movies, mailing lists, and databases all pose similar issues.

What Are Taxable Services?

While questions exist on what constitutes tangible personal property for sales and use tax purposes, even more questions remain as to what constitutes a taxable service. Most states have a general imposition clause imposing a tax on the transfer of tangible personal property for consideration, but few states have imposed a similar tax on the provision of services. Generally, all sales of tangible personal property are taxable, unless specifically exempt. In contrast, sales of services are generally excluded from the tax base unless specifically enumerated as taxable by statute. States have approached this issue by identifying specific types of services on which they impose sales and use tax (*e.g.*, utility, maintenance, data processing, computer services, etc.).

While some states, such as Hawaii,[4] New Mexico,[5] and South Dakota,[6] tax all or a majority of services; most states tax only those services that are specifically enumerated as taxable. As a result, sales and use tax laws often fail to keep up with newly emerging services and technologies that do not fit neatly into previously defined categories. By categorizing services subject to tax, states have created uncertainty about which services fall within a specific category.

For example, consider an information technology company that does not sell software, but performs software related services, some of which are strictly consulting in nature. This company has a customer in Connecticut who requests assistance with the design of a new enterprise resource planning (ERP) system. This company merely assists in the development of the architecture of the system, but performs no services on any software. Connecticut imposes sales and use tax on various services, including both computer services and business analysis, management and management consulting services.[7] While the state sales tax rate is 6 percent, there is a reduced tax on computer services of only 1 percent.[8] Thus, the determination of which category this service falls into may make a significant difference on the amount of tax due.

Exemptions

Determining whether a particular service qualifies for an exemption also creates significant complexity. Consider whether the provision of a service can be an ''occasional sale.'' For example, when your next door neighbor's child performs a one time clean-up of leaves in your yard, does this constitute a taxable service, or does it qualify as an occasional sale? Also, determining whether a service can be resold can be a complicated issue. In some states, the definition of resale includes only the resale of tangible personal property.[9]

Bundled Transactions

Even more questions arise when there is a mixed sale of tangible personal property and a service, commonly referred to as a bundled transaction. Should the sale be taxed as a sale of tangible personal property or as a service? If tangible personal property is transferred in a nontaxable service transaction, and the transfer of property is a consequential element of the transaction, some states declare the entire transaction as taxable, even if that state does not impose a tax on services. By contrast, where the transfer of property is an inconsequential element of the transaction, then the charge for

---

[2] By way of example, Minnesota, which began taxing installation Jan. 1, 2002, is taking a less traditional view of what is installation, thus expanding its base. Other states have used their definition of ''retail sales price,'' which generally include the language ''services necessary to complete the sale,'' to tax services incidental to the sale of tangible personal property.

[3] Also commonly referred to as software as a service (SaaS), or cloud computing.

[4] Haw. Rev. Stat. §237-13(6).

[5] N.M. Stat. Ann. 1978 §7-9-1, *et seq.*

[6] S.D. Codified Laws Ann. §10-45-4. *See also* S.D. Codified Laws Ann. §10-45.4.1 defining ''service'' to mean all activities engaged in for other persons for a fee, retainer, commission or other monetary charge, which activities involve predominantly the performance of a service as distinguished from selling property. In determining what is a service, the intended use, principal objective or ultimate objective of the contracting parties shall not be controlling.

[7] Conn. Gen. Stat. §12-407(a)(37)(A) & (J).

[8] Conn. Gen. Stat. §12-408(C).

[9] *See* Ariz. Regs. R15-5-101.

   ISSN 1078-845X

the service is exempt from tax. This is generally referred to as either the ''true object'' or ''objection of the transaction'' test.[10]

As an example, the sales of video cassettes of depositions by court reporters have been found to be exempt from tax under the theory that the ''true object'' of such a transaction is the reporting service rather than the videos themselves.[11] Similarly, alteration services offered at an additional charge to purchasers of women's apparel were found not taxable by the Colorado Supreme Court, which held that ''services performed in connection'' with the sale refers to all services that went into the creation or construction of the article—not separate, additional services.[12] In states that follow the true object test, the person rendering the service would generally be subject to a use tax on the purchase of the property transferred.

Taxation of Inputs

Materials used in rendering services, as contrasted to the actual property transferred to the ultimate consumer as part of the service transaction, are generally subject to tax, even in those states that do not impose a tax on the particular service at issue. A Kentucky regulation clarified that while advertising services are not subject to sales and use tax, tangible personal property purchased for use in the performance of advertising services or sold by advertising agencies is subject to tax.[13] This includes the purchase or rental of stock photos and movie footage and materials becoming a component part of a master advertisement. When an advertising agency sells both tangible personal property and exempt services, the charges must be clearly separated on customer invoices, or the entire transaction is subject to tax.[14]

The inconsistencies among state tax codes create headaches for those taxpayers who engage in business in multiple states. For instance, consider the definition of ''retail sale'' in New Jersey and Idaho. The New Jersey statute defines ''retail sale'' as any sale, lease, or rental for any purpose, other than for resale, sublease or subrent.[15] However, the term ''retail sale'' does *not* include: ''professional, insurance, or personal service transactions which involve the transfer of personal property as an inconsequential element, for which no separate charges are made.''[16] Contrast this with the Idaho Code which provides that ''a retail sale'' is any transfer of title for consideration.[17] However, ''sales price'' in Idaho means ''the total amount for which tangible personal property, including services agreed to be part of the sale is sold, rented or leased. . . .''[18]

Without clear guidance about what constitutes a service and whether a certain ''service'' in state ''A'' is also a service in state ''B'', improper reporting is likely to become more of a norm than a peculiarity—particularly as more states expand their tax base to include services and apply common terms in different manners.

What Types of Services Are Subject to Tax?

The list of services that are taxed by states is constantly expanding. Services commonly enumerated as taxable include: fabrication services; cleaning services; painting; polishing and finishing tangible personal property; telephone and telegraph services; credit services; transportation services; printing services; maintenance and repair to tangible personal property; and photographic services including film processing and video taping. This constantly expanding list provides states an alternative to raising revenue without having to raise tax rates on consumers. But, with a constantly expanding list, taxpayers are likely to face more challenges, particularly when it comes to determining how to situs a service.

SOURCING OF SERVICES

One of the most complex issues taxpayers face in the sales and use tax arena is deciding where a service is provided and which state has the authority to tax it. The destination principle, which is generally followed throughout the country for interstate sales,[19] provides that the sales or use tax will apply at the destination of the taxable property or service, irrespective of where title transfers. The term ''destination'' generally means where the property or service is delivered to the ultimate consumer. In the case of tangible personal property, this has historically been an easy determination, but the same cannot be said about the sale of services.

Problems arise in determining the location of delivery when the service provider and the customer are in different states or where the service is either performed in multiple states, or the customer is using the service in multiple states. Take the scenario where an architect/engineer who is based in New York visits Illinois to oversee a project and modify blueprints. Are the architect/engineer's services delivered in New York, Illinois, or both? This is a difficult determination, particularly given that many states have not expressly addressed how to apportion the sales tax base, nor has it been clearly addressed by the courts.

However, the courts have reviewed this issue in the income tax context when determining what sales should be included in a state's numerator for sales ap-

---

[10] Other tests are also applied, including the ''incidental to services test,'' developed by the Michigan Supreme Court in *Catalina Marketing Sales Corp. v. Michigan Dept. of Treas.*, 678 N.W.2d 619 (2004). In *Catalina*, the court created the ''incidental to services'' test for purposes of analyzing Catalina's ''Checkout Coupon Program.'' As part of the checkout program, Catalina installed hardware (including thermal printers at grocery store cash registers), software, and paper for the purposes of generating coupons for the purchaser's customers' use. Catalina contended that it was, ''selling services, not goods,'' and that the delivery of the manufacturer-clients' coupons and advertising messages was only one part of the sophisticated targeted marketing distribution services they provided to their manufacturer-clients.

[11] Rhode Island Div. of Taxn., Administrative Decision 2000-22 (June 13, 2000).

[12] *A.D. Store Co. Inc. d/b/a Auer's v. Colorado Dept. of Rev.*, 19 P.3d 680 (2001).

[13] 103 Ky. Admin. Regs. §26:120 (effective Feb. 16, 2004).

[14] *Id.*

[15] N.J. Rev. Stat. §54:32B-2(e) (effective Jan. 1, 2009).

[16] N.J. Rev. Stat §54:32B-2(e)(4)(A) (effective Jan. 1, 2009).

[17] Idaho Code §63-3612(i).

[18] Idaho Code §63-3613(a).

[19] In many states, origin sourcing is used for purposes of determining the local tax rate to be applied for intrastate sales.

portionment purposes. For example, the Michigan Supreme Court addressed this issue in *Fluor Enterprises Inc. v. Michigan Dept. of Treas.*[20]

Fluor Enterprises

In *Fluor*, the court was asked how to allocate sales of intangible personal property to determine which sales could be sourced to Michigan. The plaintiff performed engineering and architectural services at out-of state facilities that were related to real estate improvement construction projects that were performed in Michigan. The plaintiff did not report the receipts for the engineering and architectural services in Michigan. Following an audit, Michigan issued three bills for taxes due, totaling $182,312. The tax commissioner reviewed the audit and issued a final assessment for total tax and interest of $343,340.96, which the plaintiff paid under protest.

The Michigan single business tax definition of ''business activity'' included the performance of services which were caused to be made or engaged in Michigan.[21] Thus, when business activity is performed partially in the state as well as out of state, the statute establishes a system of apportionment. In determining the numerator of the Michigan sales factor, the relevant statute provided:

> Sales, other than sales of tangible personal property, are in this state if:
>
> (a) The business activity is performed in this State; or
>
> (b) The business activity is performed both in and outside this state and, based on costs of performance, a greater proportion of the business activity is performed in this state than is performed outside this state.
>
> (c) Receipts derived from services performed for planning, design, or construction activities within this state shall be deemed Michigan receipts.[22]

The taxpayer claimed, and the lower court agreed, that section (c) deems receipts for services taxable as Michigan receipts only if the services are performed within this state. However, on review, the supreme court ruled that this was an incorrect reading of the statute.

The court found that the receipts for services performed in support of construction activities should be sourced to Michigan so long as the construction activities took place within Michigan. The court did not interpret the statute to require that the performance of the services be within the state, but rather, that the services performed be in conjunction with subsequent construction activities that had been or were to be performed within the state.

The court also found the statute to be constitutional as it met the four-pronged test articulated in *Complete Auto Transit Inc. v. Brady*.[23] Subject to its review were the issues of whether the activity had substantial nexus with the taxing state and whether the tax was fairly apportioned. With regard to the nexus issue, the court concluded ''the incidence of the tax as well as its measure are tied to the earnings which the State. . .has made possible.''[24]

In determining whether the tax was fairly apportioned, the court applied the internal consistency test, which provides that a statute is consistent if every state were to impose an identical application of the tax, and that no multiple taxation would result. Accordingly, under this test, had California (the state where engineering and architectural services were rendered) been subject to the identical statute, specifically section (c) stated above, the court ruled, California would not be able to tax the services. This is because the engineering and architectural services were performed in conjunction with a construction activity that was performed in Michigan.

The *Fluor* decision helps illustrates the sourcing problems and inconsistencies that are sure to arise when businesses render services to customers in multiple states or when businesses that have employees working in multiple states perform services for a single customer.

In the context of the telecommunication and transportation industry, the U.S. Supreme Court has looked at the issue of where the situs of the service lies when services are being provided in more than one location.[25] In *Goldberg v. Sweet* and *Oklahoma Tax Comn. v. Jefferson Lines Inc.*, the court applied the constitutional limitations established in *Complete Auto*[26] to businesses engaged in the telecommunications and transportation service industry.

Goldberg v. Sweet

In *Goldberg*, the Illinois Department of Revenue imposed a sales and use tax 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 5 percent of the gross charge for the telecommunications. The appellants, a class of Illinois citizens and telecommunication carriers, 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 telecommunications service.

The U.S. Supreme Court, however, viewed the issue as whether the tax was internally and externally consistent, meaning whether the tax was rationally related to the activity in the state and, in the event that all states imposed the same method of taxation, whether there

[20] 730 N.W.2d 722, 477 Mich. 170 (2007).

[21] Mich. Comp. Laws §208.1, *et seq.*

[22] Mich. Comp. Laws §208.53.

[23] In *Complete Auto Transit*, 430 U.S. 274 (1977), the U.S. Supreme Court held that the U.S. Commerce Clause requires that taxes: (1) be applied to an activity that has a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against intestate commerce; and (4) be fairly related to the services provided by the state. A tax will not be upheld if it fails even one prong of the foregoing test.

[24] *Quoting Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 446.

[25] *Goldberg v. Sweet*, 488 U.S. 252 (1989) (telecommunications industry); *Oklahoma Tax Comn. v. Jefferson Lines Inc.*, 514 U.S. 175 (1995) (transportation industry).

[26] 430 U.S. 274 (1977).

   ISSN 1078-845X

would exist double taxation.[27] The court recognized a limited opportunity for multiple taxation since only two types of states had a sufficient nexus to impose a tax on telecommunications:

- those, like Illinois, that keyed the imposition of the tax to the service address, and
- those, like Arkansas, that taxed calls either billed or paid within their boundaries.[28]

The court doubted that a state should be entitled to tax a call merely because intangible, electronic impulses pass through it, or that the termination of an interstate call, by itself, provided a substantial enough nexus for taxation.[29] 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.

In determining whether the tax was fairly apportioned among the states, the court likened it 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.[30] The court noted that if all states passed the same statute, only one state would have the ability to tax the interstate telephone call. Thus, the credit provision in the Illinois statute avoided multiple taxation. 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, it did not discriminate unfairly against interstate commerce.[31] In rendering its decision, the court noted that in the case of a telecommunications service, if the call originated or terminated in a given state, and the service address for that customer was located in that same state, then that state could constitutionally impose a tax on that call.

Central Greyhound And *Jefferson Lines*

In a gross receipts tax case involving a transportation carrier, *Central Greyhound Lines Inc. v. Mealey*,[32] New York sought to tax the total receipts of Greyhound Lines from transportation, of which 43 percent of the mileage lay in New Jersey and Pennsylvania. There, the court held that because a substantial amount of the activity took place in New Jersey and Pennsylvania, the transaction could not be deemed to have legally taken place in New York. The court found that if New York were permitted to impose a tax on the gross receipts for the entire mileage of a trip that had not taken place entirely in New York, it would have subjected interstate commerce to an unfair burden as states that had provided benefits and protections to the taxpayer would not have received any revenue.

In *Oklahoma Tax Comn. v. Jefferson Lines Inc.*,[33] Jefferson Lines was a Minnesota corporation that provided bus services as a common carrier in Oklahoma. Jefferson Lines did not collect sales tax on tickets it 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. However, Oklahoma imposed a tax on certain services, including transportation for hire, and assessed Jefferson Lines tax on the tickets it sold in Oklahoma that originated in Oklahoma, but terminated outside of Oklahoma. Jefferson Lines objected to the assessment, claiming that the tax imposed an undue burden on interstate commerce by permitting Oklahoma to collect a percentage of the full purchase price of all tickets for interstate bus travel, despite the fact that some of the value was derived from bus travel through other states. Jefferson Lines also argued that to impose a tax on these tickets would raise the danger of double taxation because any other state in which the bus travels would subject Jefferson Lines to tax.

In distinguishing *Greyhound Lines*, the court ruled that the Oklahoma tax was constitutional. The court noted that the taxpayer in *Greyhound Lines* was an interstate carrier that was subject to possible taxation on its income in other states. In contrast, the taxpayer in *Jefferson Lines* was the purchaser, who was not subject to tax in other states. In *Jefferson Lines*, the taxable event comprised an agreement, payment, and delivery of some of the services.[34] Because there was no other state which could claim to be the site of such a combination, there was no threat of multiple taxation.

Irwin Industrial Tool

A more recent case that explores the concept of apportionment or allocation of the sales and use tax base is *Irwin Industrial Tool Co. v. Illinois Dept. of Rev.*[35] In *Irwin*, the Illinois Department of Revenue sought to impose use tax on the purchase price of an airplane acquired by ATC Air Inc., a subsidiary of the plaintiff, which was hangared outside the state. The plaintiff was an international corporation that manufactured and distributed tools through its many subsidiaries. ATC provided air transportation services to Irwin and its affiliated companies. ATC maintained all of its air records at its Lincoln, Neb., office. Between the tax years at issue, 2000-2002, ATC had seven employees, all of whom lived and worked in Nebraska. The plane was at all times hangared in Nebraska. Between April 12, 2000, and April 30, 2002, from its hangar in Lincoln, the aircraft flew a total of 290 days. The flight log details that 734 flight segments took place, of which 269 either originated or terminated at an Illinois airport.

---

[27] *Goldberg*, 448 U.S. at 261.
[28] *Id.* at 263-64.
[29] *Id.* at 264-65.
[30] *Id.* at 265.
[31] *Id.* at 266-67.
[32] 334 U.S. 653 (1948).
[33] 514 U.S. 175 (1995).
[34] *Id.* at 190-91.
[35] Nos. 1-07-3331 and 08-0750, (Ill. App. Ct. Sept. 11, 2009); leave to file an appeal with the Illinois Supreme Court accepted February 2010.

These cases illustrate the difficulties in determining tax liability when a taxpayer uses tangible personal property or services in multiple states.

ATC was exempt from having to pay Nebraska use tax on the aircraft, as it was used in interstate commerce. ATC did not remit any use tax to Illinois for use of the aircraft within Illinois. The Illinois Department of Revenue conducted an audit and determined that a use tax was due on the transaction. As a result, Irwin paid the tax assessment on behalf of ATC, under protest.

ATC argued that Illinois' imposition of use tax violated the U.S. Constitution because there was no substantial nexus with the state of Illinois. Alternatively, ATC argued that even if there was a substantial nexus, the department's imposition violated the fair apportionment requirement of the Commerce Clause because it was based on the entire purchase price of the aircraft rather than the actual time that the aircraft was used by plaintiff in Illinois.

The Illinois Circuit Court did not agree with plaintiff's substantial nexus argument. However, it did side with plaintiff's argument that the department's assessment violated the apportionment requirement of the Commerce Clause because the aircraft only spent 3.65 percent of its time in Illinois. In addition, the aircraft spent only 25 nights in Illinois versus 509 nights in Nebraska. Thus, the Circuit Court determined that the use tax should not be based on the entire purchase price, but rather on the amount of time the aircraft spent in Illinois.

On appeal, the appellate court ruled against the Plaintiff on both arguments. The court found that one of the aircraft's main purposes was to pick up or drop off the taxpayer's corporate officers at its Illinois office. In addition, during the tax years at issue, the aircraft flight log revealed that it made 290 takeoffs and landings at Illinois airports. Additionally, one third of the total flight segments were logged on flights to and from Illinois. The aircraft stayed overnight at one of four Illinois locations on 25 separate occasions. Lastly, when originally purchased, both the registration and bill of sale listed an Illinois address for the aircraft. Taking these facts into consideration, the court found that the aircraft did have a substantial nexus with Illinois and, therefore, Illinois did not violate the U.S. Constitution by imposing the tax.

Additionally, the appellate court found that an imposition of use tax on the entire purchase price of the aircraft did not violate the Commerce Clause. The purpose of the fair apportionment clause is to prevent multiple taxation. Here, there was a provision in place which would prevent multiple taxation by affording a taxpayer a tax credit for sales and use tax already paid in another state. The appellate court also noted the impracticability and burdens associated with apportioning a sales and use tax and in determining the actual usage of the aircraft in Illinois. Accordingly, the appellate court reversed the circuit court and held that the use tax could be imposed on the entire purchase price of the aircraft.

The Illinois Supreme Court has accepted the taxpayer's leave to appeal and oral argument is expected to take place in the Fall of 2010.

These cases illustrate the difficulties in determining tax liability when a taxpayer uses tangible personal property or services in multiple states. In *Greyhound Lines*, the high court allowed for apportionment of a New York gross receipts tax based on the amount that the interstate carrier traveled within the state of New York. However, the interstate carrier was not permitted to collect tax on the 43 percent of travel that occurred outside of New York. This line of reasoning is opposite to that of the recent *Irwin Industrial* case, where plaintiff alleged that the aircraft had only performed 4 percent of its flight time in Illinois. The Illinois Appellate Court relied on authority that has identified the difficulties in apportioning sales and use tax and allowed for the Department of Revenue to collect use tax on the entire purchase price of the aircraft, despite the fact that it spent a majority of its time outside the state of Illinois.

These inconsistencies can be explained in part by the different types of tax being imposed. However, intensive analysis is still required to sort out the nexus and apportionment issues. Ultimately these inconsistencies and uncertainties will lead to increased litigation, hopefully providing some clarity. In the meantime, what should a taxpayer do?

Practical/Current Day Solutions

With advanced technology, services are no longer performed in the traditional sense. Computer maintenance can be performed remotely by a person in another country via the use of the internet. Databases, e-mail, and networks can be accessed by employees traveling anywhere in the world. While states historically sitused sales of services to only one location, states have begun to adapt to these changing technologies, and as a result, many states will permit, and in many cases, require, a purchaser of services to apportion or allocate its use tax base. However, in this regard, most states do not have statutory or regulatory guidance in this regard, but have permitted this methodology via policy positions and decisions.[36]

As a result, taxpayers have the ability to apportion or allocate the tax base, but have no clear guidance on what is acceptable from a state tax perspective. Generally, states have permitted a taxpayer to use a ''reasonable method.'' There may be numerous reasonable methods for determining use: number of locations using the service; numbers of employees using the service; etc. Whether one method is more reasonable than another is usually in the eyes of the beholder and can vary greatly from state to state.

[36] The District of Columbia expressly requires apportionment of data processing services via D.C. Mun. Regs. §474.5. Similarly, Texas provides guidance related to the service benefit location of multistate customers in Tex. Admin. Code §3.330(f). Texas provides similar rules for other enumerated services.

   ISSN 1078-845X

Taxpayers have the ability to apportion or allocate the tax base, but have no clear guidance on what is acceptable from a state tax perspective.

From a practical perspective, taxpayers have been apportioning their sales and use tax base for years. For use tax purposes, taxpayers commonly apportion or allocate their promotional spend by multiplying their expenditures by the applicable sales factor in a given state. The rationale behind this methodology is that there is a direct correlation between marketing efforts and resulting sales. There is little or no published guidance on this methodology, but it is not only commonly applied, it is commonly accepted by state auditors. The burden is on the taxpayer to prove that this is a reasonable method.

The taxpayer should apply this method consistently in all states in which the same transaction is taking place. In other words, this same methodology is utilized to allocate the promotional spend to all states, not just a select few. States frown upon taxpayers using their sales apportionment factor in most states, but using a three-factor formula in their state because it yields a better result.

Finally, the taxpayer should adequately document this methodology in the event of a sales and use tax audit. Preparing a memorandum outlining the process used, and the rationale for it, will go a long way in universal acceptance by states conducting sales and use tax audits.

OTHER CONSIDERATIONS

Electronic Commerce: A Unique and Growing Problem

Electronic commerce presents unique problems associated with situsing a sale that are generally not associated with the sale of tangible property. For example, situsing the sale is complicated by the fact that a consumer's computer may not be located in one jurisdiction, but instead may be portable, and thus located in multiple jurisdictions (think laptop computers, cellular phones, iPods, Kindles, etc.). Another issue may present itself when an internet service provider is considered the consumer of purchased telecommunication services and not the reseller. Should a call be sourced to where the vendor is located or should it be sourced to the locations of the ultimate consumers of the end product? Whether an online vendor utilizes a centralized server in a given location or whether it utilizes a switch pin to route calls will also complicate the issue of where to situs a sale.

The aforementioned issues are highlighted by the following hypothetical: An online information service provider sells to a multistate customer the right to access its database in hundreds of different ''user'' locations. The database is located in one state, but may be accessed by 500 employees in ten different states. The issue is whether the sale of the database should be sitused only to the jurisdiction where the server is located or whether it should be sitused to the jurisdiction of the end user. What if the jurisdiction of the server does not tax information services? Would a use tax be due in some or all of the other nine states from which the purchaser's employees access the database?

Without an implementation of a consistent tax code that is utilized by all jurisdictions, these issues, among the others outlined above, will undoubtedly occur. In order to ensure compliance, multistate taxpayers must be competent and well-versed in the tax codes of each state in which they do business. Furthermore, the manner in which a company chooses to do business in each state will continue to be affected as a result of inconsistent codes. This will likely lead to inefficiencies and decreased productivity by businesses as they are forced to adjust their business model to each state that they do business in and will also lead to further tax planning so that companies may legally minimize their sales and use tax liabilities by forum shopping.

With all these issues at the forefront as a result of states looking to balance budget deficits, there is hope that the Streamlined Sales Tax Project (SSTP) may be able to provide clarity and consistency to these problems. The SSTP has already provided some clarity with respect to prewritten computer software, software maintenance and digital goods in participating states. Its guidance has introduced a greater degree of predictability for both sellers and purchasers transacting business in these areas, assuming all states consistently apply these rules.

In order to ensure compliance, multistate taxpayers must be competent and well-versed in the tax codes of each state in which they do business.

However, it is unlikely that the SSTP will venture too much farther into the broader enumerated services arena given businesses wariness over defining specified services, and states unwillingness to introduce new legislation. Thus, state tax legislation will continue to fail to keep pace with rapidly changing technology and evolving business models. As such, businesses will continue to struggle to meet their state tax compliance responsibilities due to the inconsistency and uncertainty that exists amongst states' legislation.

THE BOTTOM LINE

Adding to the complexities and inconsistencies of already complex and inconsistent state laws, we are likely to see states increasing the types of services found to be taxable. State by state legislation is already in the works to expand the sales and use tax base. By way of example, Illinois proposed S.B. 750,[37] which includes a new sales tax on labor services for computers and soft-

[37] Referred to Assignments as of Aug. 15, 2009 http://www.ilga.gov/legislation/default.asp.

ware. If passed, this bill could create tax liabilities for employers who repair computers, develop software, program computers, design websites, or engage in other computer and software related services.

The road to consistency may only be achieved one of two ways:

- a blanket sales and use tax on all services—which would likely be met with strong opposition from taxpayers; or
- further assistance and guidance from the SSTP and an attempt to implement a unified sales and use tax base.

However, the most likely result will be more headaches and uncertainty for taxpayers while attempting to determine if their actions constitutes a service and if so, where the service should be sourced.

The bottom line is that while a taxpayer may apportion or allocate their tax base on the purchase of services, little guidance exists to provide taxpayers with assurance that their methods will withstand audit scrutiny. A taxpayer should use a reasonable method, which will be facts and circumstances specific, it should apply this method consistently in all states in which the same transaction is taking place, and it should adequately document this methodology in the event of a state sales and use tax audit.

This article was originally published in the BNA Tax Management Weekly State Tax Report *and BNA Tax Management* State Tax Library. *The article is reprinted with permission from Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., 1801 S. Bell St., Arlington, Va. 22202 (www.bnatax-.com).*

   ISSN 1078-845X