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Industry Sales Tax Solutions

SUTHERLAND

COST NORTHWEST REGIONAL TAX SEMINAR

Digital Age SALT Issues – Applying Old Rules to New Technology

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Agenda

- ▶ Overview
- ▶ Sourcing of Digital Products
- ▶ Hot Topics & Audit Issues
- ▶ Planning

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Overview

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Classifying Digital Products for Tax Purposes

► What are you selling / buying?

- Tangible personal property
- Service
- Something else

► What does the Agreement state you are selling / buying?

- Auditors and courts heavily rely on the contractual language in characterizing the item being purchased.

► Why does characterization matter....

- Determining taxability
 - Most states tax sales of tangible personal property and enumerated services. Emerging trend to tax "digital goods".
- Impacts applicability of use based exemption
 - Resale, Manufacturing, R&D, etc.
- Determines applicability of:
 - Reduced rates
 - Temporary imposition
 - Reduced tax bases
- Impacts sourcing of transaction

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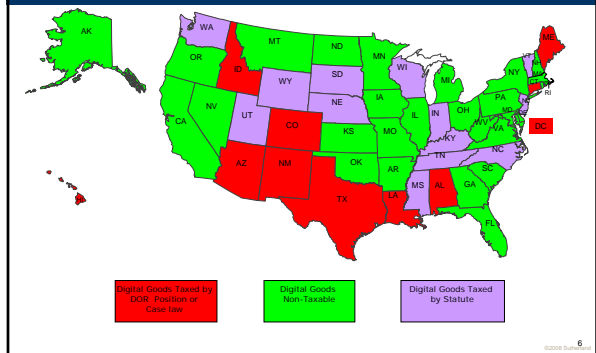
Characterization of Products

► 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, Wisconsin, and Wyoming

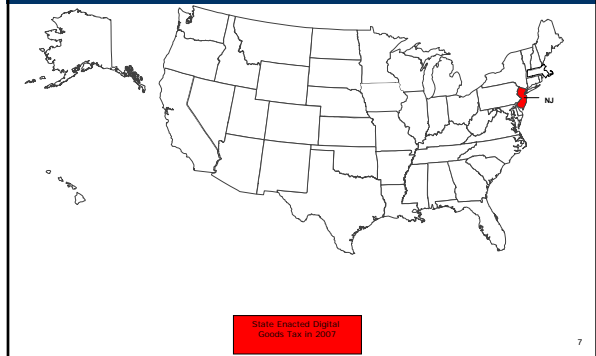
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States of Confusion – Digital Goods Taxability

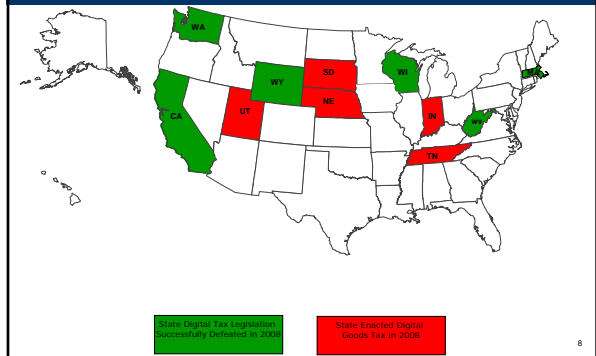


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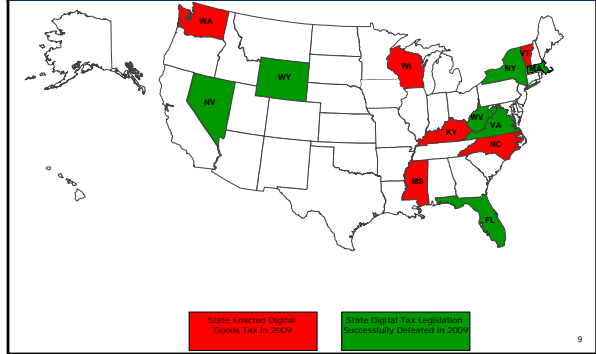
Digital Goods Legislative Activity - 2007



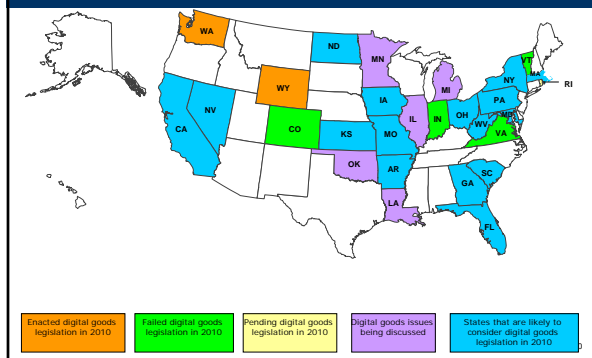
Digital Goods Legislative Activity - 2008



Digital Goods Legislative Activity - 2009



Summary of Digital Goods Legislative Activity – 2010



Sourcing of Digital Products

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Sourcing of Digital Products

The sourcing of a digital item is dependant upon its 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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Sourcing of Digital Products

► What are the Problems?

- From a sales tax perspective, the concepts of destination and benefit are not easily applied to 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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Sourcing of Digital Products

► 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.
- Most auditors will look for a sensible approach that reflects a system of assigning sales to locations where the service is being “received.”
- 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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Sourcing of Digital Products

Multiple Points of Use (“MPU”)

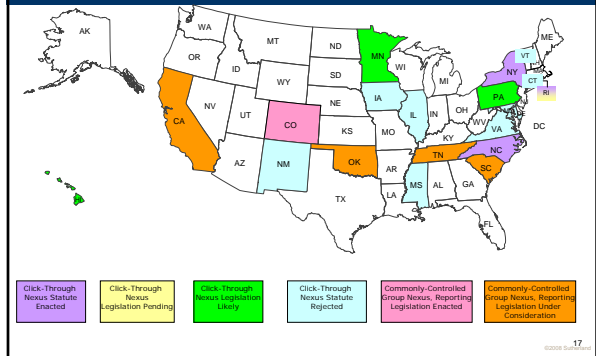
- The MPU provisions were repealed from the SST Agreement. Member states must repeal by January 1, 2008.
- The Multiple Points of Use (“MPU”) Exemption permits a business purchaser of computer software, digital goods and services, which are concurrently used, to apportion, self assess, and remit use 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.
- MPU is still used in a number of states, including two non-SST states, Colorado and Massachusetts.

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Hot Topics & Audit Issues

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Remote Seller Nexus Legislation



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Click-Through Nexus

- ▶ **Amazon.com / Overstock.com, N.Y.S. 2d, 2009 WL 69336 (Jan. 12, 2009)**
- ▶ **New York was the first state to pass legislation creating a presumption that sales by out-of-state retailers were taxable as a result of participating in an affiliate program where:**
 - Remote seller enters into an agreement with a NY resident whereby the NY resident directly or indirectly refers NY customers to a remote seller by an Internet link in exchange for a commission; and
 - Remote seller's cumulative gross receipts to NY customers, from NY resident's referral, exceeds \$10K during preceding four quarters
- ▶ **Presumption is rebuttable:**
 - Remote seller establishes that only activity performed by NY resident is a link, and none of NY resident's representatives solicit sales for remote seller
 - Remote seller must establish both prohibition against such activities and compliance with the prohibition

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Click-Through Nexus (cont'd)

► Litigation

- Amazon.com and Overstock.com challenged the NY legislation on grounds that their activities in the state did not create nexus under the Dormant Commerce Clause and that the affiliate program was simply advertising
- Court dismissed taxpayer's complaint and granted NY's motion for summary judgment; matter on appeal – oral argument heard Nov. 2, 2009

► Other States' Reactions

- Similar legislation enacted in NC and RI in 2009
- Legislation vetoed in CA and HI in 2009
- Other states that have considered or are considering such legislation in 2010 include: CA, CO, CT, FL, IA, IL, MD, MN, MS, NM, OK, TN, TX, VA, VT, and WI
- CO legislation amended to remove click-through, but enacted onerous reporting requirements for out-of-state vendors and commonly-controlled group affiliate nexus
- CA and TN considering legislation modeled after CO commonly-controlled group affiliate nexus and reporting requirements
- RI proposal to repeal 2009 enactment

► Valid alternative to Streamlined??

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Overview of Colorado HB 1193

► STATUTORY REQUIREMENTS IMPOSED ON OUT-OF-STATE RETAILERS

- Provide purchaser with notice at time of sale about use tax reporting and payment obligations;
- File an annual report with the State for each Colorado purchaser disclosing each purchaser's total dollar amount during the previous calendar year; and
- Provide annual notification, in writing, to each Colorado purchaser stating that Colorado requires the purchaser to file a sales/use tax return and pay any tax due, and list for each purchase, the relevant dates, amounts, and category of the purchase.

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Overview of Colorado HB 1193

► PENALTIES FOR NONCOMPLIANCE

► If non-collecting retailer fails to meet reporting and notification requirements, retailer is subject to significant penalties:

- \$5 for each failure to provide required notification at time of purchase;
- \$10 for each failure to provide required annual purchaser notification and report; and
- \$10 for each failure to file individual annual purchaser report with State.

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HB 1193 Is Unconstitutional

▶ Violates Commerce Clause

- Notice and reporting requirements are tantamount to the use tax collection burden found unconstitutional in *Quill* absent physical presence of retailer;
- Overbroad notice and reporting requirements impose excessive burdens on interstate commerce in relation to the local benefits;
- Application only to out-of-state retailers facially discriminates against interstate commerce (and is not a compensatory tax);
- Legislative intent was protectionist.

▶ Violates First Amendment

- Compels retailers to engage in commercial speech.

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Anticipated “Copycat” Legislation

▶ Other jurisdictions likely to enact a version of HB 1193:

- ▶ Oklahoma legislation (HB 2359) sent to Governor on May 28, expected to be signed by June 15
- ▶ Considered in Tennessee (SB 1741/HB 1947) and California (AB 2078)
- ▶ Approximately 284 local Colorado jurisdictions, with different use tax laws, could enact own version of State notice and reporting requirements

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Amazon v. North Carolina DOR

- ▶ Amazon.com LLC filed a federal lawsuit alleging the North Carolina Dep’t of Revenue’s attempts to obtain names, address, and purchases of customers violates the First Amendment of the US Constitution, Article I, §§ 4, 5 of the Washington State Constitution, and federal Video Privacy Protection Act, 18 USC § 2710
- ▶ Suit filed on April 19 in federal district court in the Western District of Washington
- ▶ Declaratory judgment sought to confirm above federal and state constitutional violations and federal statutory violation

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Taxability of Access to Software

- ▶ Certain states are taking the position that access to or the ability to use software is a taxable transaction, e.g., through application service providers/cloud computing and software as a service (SaaS) models
- ▶ Approximately 18 states impose tax on mere access to software, such as software hosted by an ASP (most notably New York State)
- ▶ Most states source the transaction to the location of the license to use, but some states (Utah) source the sale at the location of the server

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Taxability of Access to Software (cont'd)

Application Service Providers ("ASP's")

Colorado

ASP's continue to be exempt, even with the March 1, 2010 change to tax electronically delivered "standardized software."

Illinois

The Department holds that ASP's are the sale of canned software, and are therefore taxable (unless the five part test is met).

Indiana

The Department's policy is that that ASP's are the sale of canned software, and are therefore taxable. Note that Indiana is an SST member state (see KS and NC below).

Kansas

The Department's policy is that ASP's are not the sale of prewritten computer software. Note that Kansas is an SST member state.

North Carolina

ASP's continue to be exempt, even with the January 1, 2010 change to tax electronically delivered software. Note that North Carolina is also an SST member state.

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Services Related to Sale of Software

▶ Taxation of Services Related to the Sale of Software

- Many states have tried to include services related to the sale of software as part of the tax base under the theory that it was as "service necessary to complete the sale."
 - Known states include: Florida, Tennessee and Texas
- More states are attempting to try to expand their tax base by revising policy decisions in this area.
 - States to Watch out for include: New Jersey, Minnesota and Virginia.
 - Their theories stem from the fact that prewritten compute software is defined as tangible personal property and that the state taxes either services to tangible personal property and fabrication labor.

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Services Related to Sale of Software (cont'd)

► What are the Issues with this Approach?

- New Jersey does not tax electronically delivered software, but will try to tax the services as an enumerated service.
- Minnesota's position is based on the fact that it taxes fabrication labor.
 - "Fabrication labor makes or creates a product or alters an existing product into a new or changed product." See Minn. Sales Tax Fact Sheet 152.
 - "...if there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, the modification or enhancement does not constitute "prewritten computer software." See Minn. Stat. §297A.61.
- Virginia taxes services "in connection with the sale of software."
 - Rulings on point have used "contract date" as determining factor. Audits does not take same approach.

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Federal Streamlined Legislation

- **Main Street Fairness Act to be introduced in May**
- **Placeholders for controversial issues – vendors compensation and communications services tax simplification**
- **Are states' attempts to circumvent Quill through click-through nexus and reporting requirements undermining SST effort?**

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Planning

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Planning to Minimize Sales & Use Tax on Software Related Transactions

- ▶ **Develop a corporate policy that takes into account the following:**
 - Receive software in electronic form, whenever practical (including updates, bug fixes, manuals, etc.).
 - Document delivery method in contract, and purchase order, if applicable.
 - Incorporate "Certificate of Electronic Delivery" into contract (both parties execute)
 - Involve tax personnel for major purchases:
 - Consider services related to the purchase and how they may be taxed.
 - May want to consider using a 3rd party vendor for consulting / implementation work.
 - Work with vendor regarding breaking in out cost of updates and bug fixes from telephone support services.
- ▶ **Proactively assist in characterization of the Sale**
 - Create tax categories according to intent of parties/language of contract.
 - Consider bundling rules and consider:
 - De-bundling (are services offered on a "separate" basis?)
 - True Object (is there one? Is one service "subservient" to the other?)
 - Agree on "uniform" invoice language and create a "tax practices" document between the parties.
 - Don't make characterization decisions in a vacuum, purchaser/seller should collaborate.

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Audit Tips

Assessments on Software Purchases

- ▶ **Does the state distinguish between canned or custom?**
 - If so, review existing provisions and guidance to see if a position exists for you to claim it is custom (look closely at changes in the provisions for prior periods, i.e., New Jersey)
- ▶ **Does the state provide an exemption for electronically delivered software?**
 - If so, does your invoice or contract provide documentation of this fact. If not, contact your IT Department and the Vendor. If software was electronically delivered obtain documentation from the vendor attesting to this fact (be careful of states where documentation requirements are more stringent on audit, i.e., Virginia).
- ▶ **Were there services performed that are being assessed, such as customization, installation, training, etc.?**
 - If so, determine if the invoices or contracts break out the separate charges. If not, determine if the vendor has a break down that they can provide to you for audit documentation.

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Questions?

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