



2011 HOTEL TAX EXECUTIVE COMMITTEE MEETING

Transaction Taxes on Use of Software or Intangibles

May 5, 2011

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Agenda

- Overview
- The How
- The Where
- Planning

Overview

Who

- **Every business should be focused on the latest developments impacting this area.**
 - Do you know what you're high tech spend is?
 - How many data centers does your company maintain or are these outsourced?
 - What's the cost of your company's disaster recovery services?

What

- **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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What

- **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.

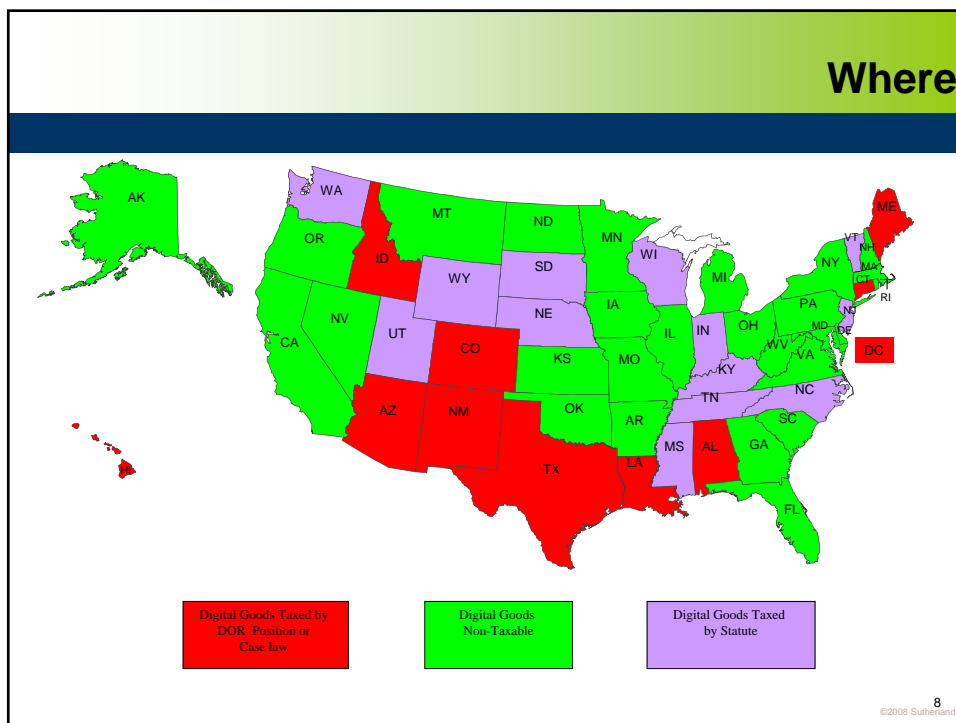
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What

- **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

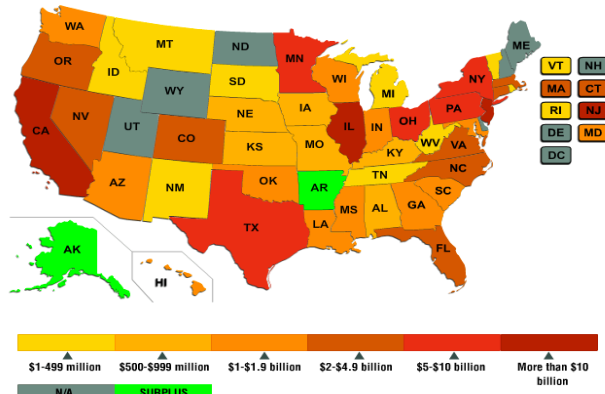
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Where



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Why - Projected FY 2012 Budget Shortfalls



Sources include: the Center on Budget and Policy Priorities article "States Continue to Feel Recession's Impact" from October 7, 2010, the Stateline article "As state revenues tick upward, budget gaps remain" from July 27, 2010, Governors' Budget documents and speeches, Minnesota 2020, as well as independent FOCUS research.

Source: Kimball Sherman And Ellis FOCUS at www.ksefocus.com

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The How

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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.
 - Sourcing

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ASP / SaaS

- **ASP / SaaS**
 - Software
 - NY - TSB-A-10(28)S, TSB-A-10(4)C, but consider *Voicemate* decision.
 - IN - Letter of Findings No. 09-0746 (Ind. Dept. of Rev. May 27, 2010)
 - Service
 - PA – Nontaxable service
 - TX - Taxable data processing service
 - SC – Taxable telecommunications service.
 - Kansas - Opinion Letter No. O-2010-005
 - Issues with Inconsistency
 - Consider impact on intercompany transactions.
 - Consider sourcing issues.

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Shared Service Centers / Corporate Procurement

- **Centralized purchasing results in intercompany charges for centralized purchases, including software, etc. This can create complexity from a sales and use tax perspective:**
 - Who is the purchaser and thus responsible for taxes?
 - How is the intercompany transaction described?
 - Is it invoiced?
 - Does it include a mark up?
 - Are there written agreements in place?

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Digital Goods

- **Digital Goods**
 - Most states tax sales of tangible personal property and enumerated services. Emerging trend to tax “digital goods”.
 - Tennessee legislation took effect in 2009.
 - Washington legislation took effect in 2010.
 - Proposed rules pending (public comments were taken on 2/17/2011).

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Other Cloud Computing Models

- **Other Cloud Computing Models**
 - Web Hosting
 - Vermont - Technical Bulletin 54
 - Consider Washington's tax on digital automated services.

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The Where

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The Where

The sourcing of a digital item is dependent 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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The Where

- **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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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

Department of Revenue

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 dor.wa.gov to file online.
Seller must keep a copy of this certificate. Please do not send to the Department of Revenue.

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The Where

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

- **No single answer, allocation must be “a reasonable and consistent method” (see SSTP Rule 309.3(2)(b)).**

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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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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.
 - Depending on the state, it may be more beneficial to receive in tangible form (due to application of exemptions).
 - 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.
- **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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