

Taxation of Bits & Bytes

Latest Trends in the Taxation of Software & Related Services

October 26, 2010
1:30 PM – 3:10 PM






Presenters

- Carolynn Iafate
 - COO of Industry Sales Tax Solutions
 - Managing Member of Iafate & Associates
 - Based in Washington, DC
- Scott Steinbring
 - Director at Grant Thornton
 - Based in Houston, Texas




Objectives

- Upon completion of this session, you will be able to:
 - Identify the key concepts governing the taxation of software & related services
 - Understand key terminology used in the high tech arena
 - Identify audit saving and sales tax savings related to your company's high tech spend

Agenda

Topic	Time
Overview	10 minutes
Purchases of Software & Ancillary Services	20 minutes
Taxation of Digital Property	20 minutes
Sourcing	20 minutes
Developments & Planning	20 minutes
Questions and Answers	10 minutes



Overview



Overview

- **Uncertainty of Tax Application**
 - The advent of the Internet and the availability of electronic items (e.g., downloadable software, music, movies, magazines, books, etc.) and the availability of electronic services (e.g., payroll processing, etc.) have eclipsed outdated sales and use tax laws, resulting in significant uncertainty on how to tax such products.
 - Over the last few years, states have eyed the burgeoning digital products market as a potentially lucrative source of revenue or as an increasing erosion of the tax base.



Tangible Personal Property or Something Else?

- Items traditionally considered to be tangible personal property:
 - Books
 - Magazines
 - Newspapers
 - Software
 - Music
 - Mailing lists
 - Databases
 - Commercials / Sales Videos / Training Programs



Purchasing & Implementing Software & Ancillary Services



Software Purchases

- Software
 - Factors which impact the taxability of software include:
 - Whether the software is canned or custom
 - Many states distinguish between canned and custom, while others do not (i.e., Alabama, Nebraska, South Dakota, etc.)
 - The manner in which the software is delivered
 - Electronic Delivery – Software is delivered via electronic means (i.e., downloaded via the internet)
 - Load and Leave – The software is loaded by the vendor, who then takes the tangible media upon which the software was stored
 - Load and Return – The software is loaded by the customer, who then returns the software to the vendor



Software Purchases

- Software License Renewals
 - Taxability may be dependant upon the original software license
- Application Service Providers (“ASP’s”)
 - Treatment for sales tax purposes varies by state:
 - Electronically delivered software
 - Communications service
 - Data processing / information service



Impact of SSTP on Software Purchases

- The Agreement requires Member States to adopt the following definitions:
 - Tangible Personal Property**
 - Computer Software
 - Load and Leave
 - Bundled Transactions
 - Retail Sales Price
 - Delivered Electronically
 - Prewritten Computer Software
- Member states must denote a tax decision (taxable or exempt) for “prewritten computer software” software “delivered electronically” or delivered via “load and leave”
- Member states must also denote a tax decision for items impacting these transaction when adopting the definition of retail sale, such as installation and freight charges

** In some states, the inclusion of software in the definition of tangible personal property may provide an opportunity for a purchaser to avail itself of certain statutory exemptions applicable to tangible personal property, such as a manufacturing exemption



Purchasing Ancillary Services

- Services Related to Software Selection
 - The taxability of services related to the design and or selection of software (i.e., feasibility study) may be dependant upon whether the services are performed by the same vendor who sells the underlying software



Software Maintenance Contracts

- Software Maintenance Contracts
 - Factors which impact the taxability of a maintenance contract include:
 - Whether the contract is a mandatory or optional
 - Whether the contract is for services only (i.e., telephone support), updates / bug fixes only; or both
 - If it includes both services and updates, one must look to:
 - How is the contract invoiced
 - How the updates are delivered (tangible, electronic, etc.)
 - How the underlying software was delivered
 - Where a maintenance contract includes both services and updates, some states will tax only a percentage of the contract (i.e., CA and MN)



Impact of SSTP on Ancillary Services

- Software Maintenance Agreements
 - The Streamlined Sales Tax Project has adopted definitions related to the sale of software maintenance contracts:
 - The following have been defined:
 - Computer software maintenance agreement
 - Mandatory computer software maintenance agreement
 - Optional computer software maintenance agreement
 - It also provides for taxability toggles as follows:
 - A state can tax an optional software maintenance agreement based on a proportion of the invoice cost



State Approaches

- Illinois
 - Illinois has a five part test for determining whether the sale of software is subject to Retailers Occupation Tax ("ROT"). If the transaction meets the five part test, it is exempt from ROT:
 - It is evidenced by a written agreement signed by the licensor and the customer***;
 - It restricts the customer's duplication and use of the software;
 - It prohibits the customer from licensing, sublicensing or transferring the software to a third party (except a related party) without the permission and continued control of the licensor;
 - The licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make an archival copy and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and
 - The customer must destroy or return all copies of the software to the licensor at the end of the license period.



*** Illinois has issued various rulings providing that a customer that electronically accepts the terms by clicking "I accept" does not comply with this requirement.



State Approaches

- Texas
 - Texas imposes tax on software (canned and custom).
 - Software services such as maintenance, upgrades, or modifications are taxable if performed by the seller of the software. Services performed by someone other than the seller are not taxable.
 - Texas allows a multistate benefit exemption for services performed on custom software. Services performed for the benefit of both in-state and out-of-state locations are not taxable to the extent the services are for use outside of Texas.
 - A multi-state customer purchasing taxable services for the benefit of both in-state and out-of-state locations is responsible for issuing to the service provider an exemption certificate asserting a multi-state benefit.
 - The multi-state customer is responsible for reporting and paying the tax on that portion of the taxable service that will benefit the Texas location.
 - Texas has issued a number of letter rulings providing guidance regarding the taxability of software and software services.



State Approaches

- Reduced Rates
 - Connecticut taxes software delivered electronically and via load and leave as a taxable computer service. Computer services are taxed at a reduced rate of 1%.
- Reduced Tax Bases
 - California, Georgia, Idaho, Iowa, Massachusetts, Minnesota, and Virginia tax optional software maintenance agreements based on a percentage of the overall charge



Taxation of Digital Products



Classifying Digital Products for Tax Purposes

- 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
- 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.



8

Characterization of Digital Products

- 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



9

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 State and Wisconsin



10

What are Digital Products?

SST Definition of Digital Products:

"Specified digital products" means electronically transferred:

1. "Digital Audio-Visual Works" which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any,
2. "Digital Audio Works" which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones, and
3. "Digital Books" which means works that are generally recognized in the ordinary and usual sense as "books".

For purposes of the definition of "digital audio works", "ringtones" means digitized sound files that are downloaded onto a device and that may be used to alert the customer with respect to a communication.

For purposes of the definitions of specified digital products, "transferred electronically" means obtained by the purchaser by means other than tangible storage media.

VERTEX



Sourcing



Sourcing

The sourcing of software or 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

VERTEX



Sourcing

Sourcing under SST:

(A)(1) When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.

(A)(2) When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.

(A)(3) When subsections (A)(1) and (A)(2) do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith.

(A)(4) When subsections (A)(1), (A)(2), and (A)(3) do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available, when use of this address does not constitute bad faith.

(A)(5) When none of the previous rules of subsections (A)(1), (A)(2), (A)(3), or (A)(4) apply, including the circumstance in which the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped, from which the digital good or the computer software delivered electronically was first available for transmission by the seller, or from which the service was provided (disregarding for these purposes any location that merely provided the digital transfer of the product sold).

Sourcing

Sourcing Rules for Software, Software Maintenance Agreements & Computer Services

- The Multiple Points of Use ("MPU") Exemption was repealed at the December, 2006 Governing Board Meeting.
- Sourcing rules related to the sourcing of sales of prewritten computer software, software maintenance agreements and computer services were adopted at this same meeting. The sourcing rules essentially follow the hierarchy of Section 310:
 - The sourcing rules generally provides as follows:
 1. Over the counter sales are sourced to the business location of the seller where the sale occurs.
 2. If not over the counter sale, sale is sourced to location where receipt occurs (which can be multiple locations).
 3. When (1) and (2) do not apply, the sale is sourced to the location indicated by an address for the Purchaser that is available from the business records of the Seller that are maintained in the ordinary course of business when use of this address does not constitute bad faith.
 4. When (1), (2), and (3) do not apply, the sale is sourced to the location indicated by an address for the Purchaser obtained during the consummation of the sale, including the address of a Purchaser's payment instrument, if no other address is available, when this address does not constitute bad faith.
 5. When none of the previous rules apply, then the location is determined by the address from which the prewritten software was shipped or, if delivered electronically, was first available for transmission by the Seller.



Sourcing

SSTP Sourcing "Computer-Related Services"

- "Computer-Related Services" are undefined, and are sourced to where purchaser makes "first use."
- Contains a "delivery" concept:
 - "Over-the-counter" sales are sourced to seller's business location.
 - Services performed at purchaser's location are sourced to that location.
 - Presumption in favor of purchaser's location, not the seller's:
 - Purchaser, with a single location in State A, accesses, but does not license, software located on Seller's server located in State B, which is characterized in both States A and B as a computer-related service. The Seller knows that the Purchaser makes first use of this service at its location in State A. Seller sources the transaction to State A.
- Allocation is allowed when purchaser and seller agree on the allocation method.



Sourcing

- 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



Sourcing

- 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



Sourcing

- 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)



Developments

EXCHANGE
2010

Recent Developments

- Canned v. Custom
 - Wisconsin
 - *Wisconsin Dept. of Rev. v. Menasha Corp.*, No. 2004AP3239 (Wis. Sup. Ct. July 11, 2008)
 - Florida
 - TAA 08A-035 (12/16/2008)
 - TAA 09A-001 (1/08/2009)
 - TAA 10A-010 (2/16/2010)

vertex

Recent Developments

- Delivery Methods
 - Colorado
 - Effective March 1, 2010, sales of "standardized software" are taxable, regardless of method of delivery
 - Florida
 - Fla. TAA 10A-028 (6/21/2010)
 - Missouri
 - FileNet Corporation v. Director of Revenue (8/20/2010)
 - North Carolina
 - Effective January 1, 2010, sales of prewritten computer software are taxable, regardless of method of delivery

vertex

Recent Developments

- 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.



Recent Developments

- 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.



Recent Developments

- Application Service Providers ("ASP's")
 - New York
 - TSB-A-10(28)S, TSB-A-10(4)C
 - Voicemate
 - 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.
 - Vermont
 - Technical Bulletin 43



Recent Developments

- Digital Goods
 - North Carolina
 - Effective January 1, 2010, the sale of digital goods are subject to sales and use tax
 - Tennessee
 - Effective January 1, 2009, Tennessee subjects sales of digital products, to the sales/use tax. Tenn. Laws 2008, S.B. 4173, signed June 5, 2008.



Recent Developments

- Digital Goods
 - Wisconsin
 - Effective October 1, 2009, sales and use tax is imposed on the sales price from the sale, lease, license or rental of specified digital goods pursuant to Wis. Laws 2009, S.B. 62, enacted Feb. 19, 2009.



Recent Developments

- Ancillary Services
 - Florida
 - Fla. TAA 10A-035 (7/22/2010)
- Audit Positions
 - Minnesota
 - New Jersey
 - Virginia



Recent Developments

Software Maintenance Agreements

Indiana

- The Indiana Department of Revenue has issued Letter of Findings No. 08-0413 (1/29/09) which held that a taxpayer's purchase of certain software maintenance agreements were exempt from sales tax because they did not mandate the transfer of upgrades or updates. However, the taxpayer did not provide evidence that the remainder of the agreements lacked a guarantee of upgrades and, therefore, these were found to be taxable. Furthermore, the taxpayer's purchases of certain online database subscriptions remained taxable because they constituted the transfer of property packaged for sale to the general public.

Kansas

- The Kansas Department of Revenue has issued Revenue Ruling 19-2009-01 (6/2/2009) discussing the state sales taxability of computer software maintenance agreements. Optional computer software maintenance agreements sold with or sold separately from or after the canned or prewritten software sale, are characterized as 50% for taxable software in a bundled transaction in which the taxable and nontaxable products are not separately itemized on the invoice or billing document, but separately stated charges for technical support services are exempt. Whether separately stated or not, charges for upgrades and enhancements for canned or prewritten software and sales of copies of operating manual updates are taxable.



Recent Developments

Sourcing

Colorado

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

Ohio

- Beginning January 1, 2010, H.B. 429 requires all vendors use origin-based sourcing for all intrastate sales. New legislation is intended to conform Ohio's sales and use tax laws to SSTP.



Planning



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.
 - 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.



5

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.



6

Conclusion

- Law is constantly changing, however:
 - A clear understanding can result in:
 - Better audit defense
 - Legally minimized liabilities on a prospective basis



7

Questions and Answers



Contact Information

- Carolynn S. Iafrate
 - Industry Sales Tax Solutions
 - Phone: (610) 458-7227
 - Email: csiafrate@industriysalestax.com
- Scott Steinbring
 - Grant Thornton LLP
 - Phone: (832) 476-5070
 - E-mail: scott.steinbring@gt.com



Thank You!

- Please complete the session evaluation
- Let us know how we can serve you better