

COST Southeast Regional State Tax Seminar

Digital Age SALT Issues - *Applying Old Rules to New Technology*

November 30, 2010

**Presented By: Loren Chumley
Carolynn S. Iafrate**

Agenda

- ▶ **Overview**
- ▶ **Characterization**
- ▶ **Sourcing of Digital Products**
- ▶ **Planning**



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 have eclipsed outdated sales and use tax laws, resulting in significant uncertainty on how to tax such products.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?

- ▶ **Items traditionally considered to be tangible personal property (and taxed as such as it was delivered on a tangible medium):**
 - Books
 - Magazines
 - Newspapers
 - Software
 - Music
 - Mailing lists
 - Databases
 - Commercials / Sales Videos / Training Programs

Does a Square Peg Fit in a Round Hole

- ▶ **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.

Does a Square Peg Fit in a Round Hole

► 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.

Does a Square Peg Fit in a Round Hole

► 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



Characterization

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

► Taxable as Tangible Personal Property (TPP)?

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

► 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

► Taxable as Something Else?

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

What are Digital Products?

SST Definition of Digital Products:

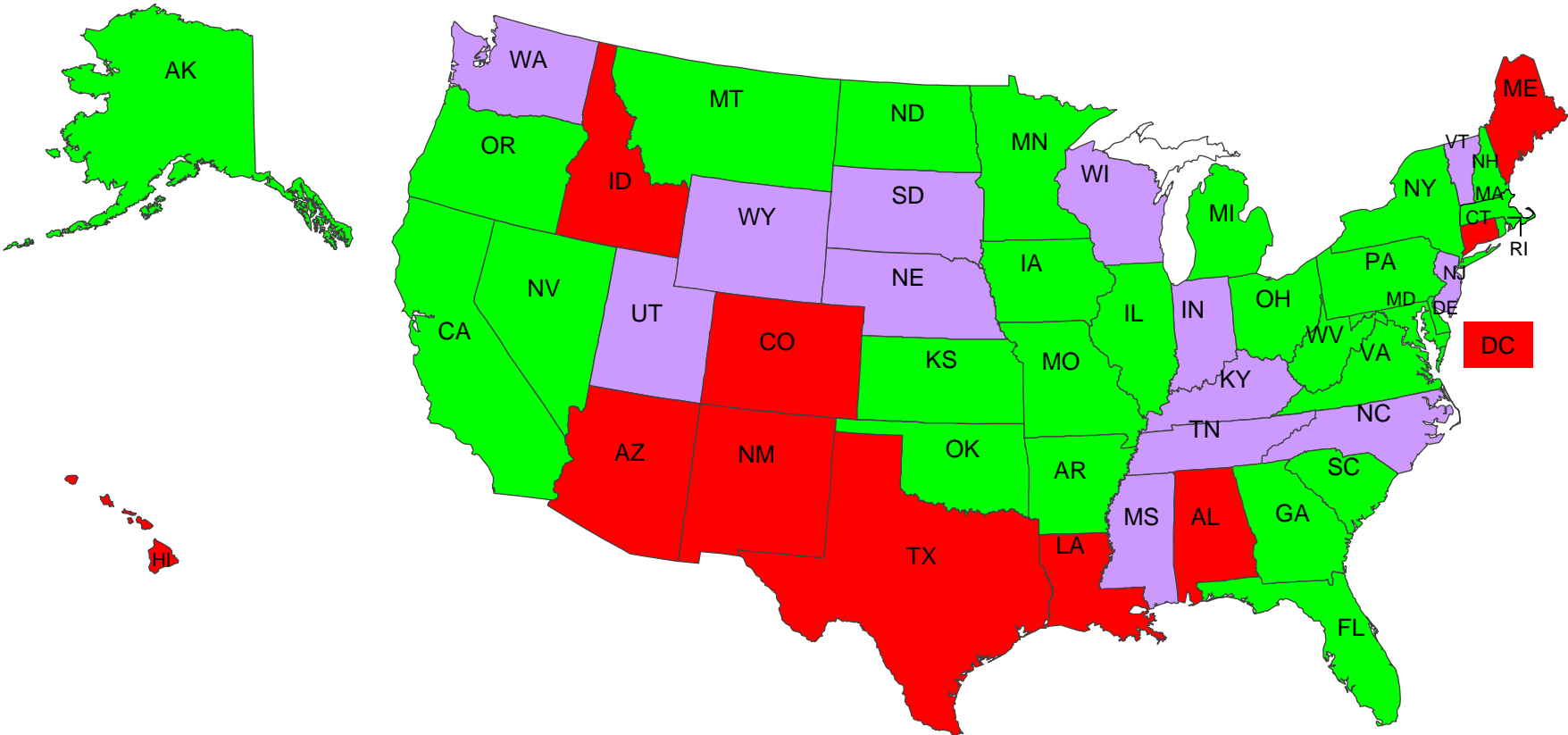
“Specified digital products” means electronically transferred:

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.

States of Confusion – Digital Goods Taxability

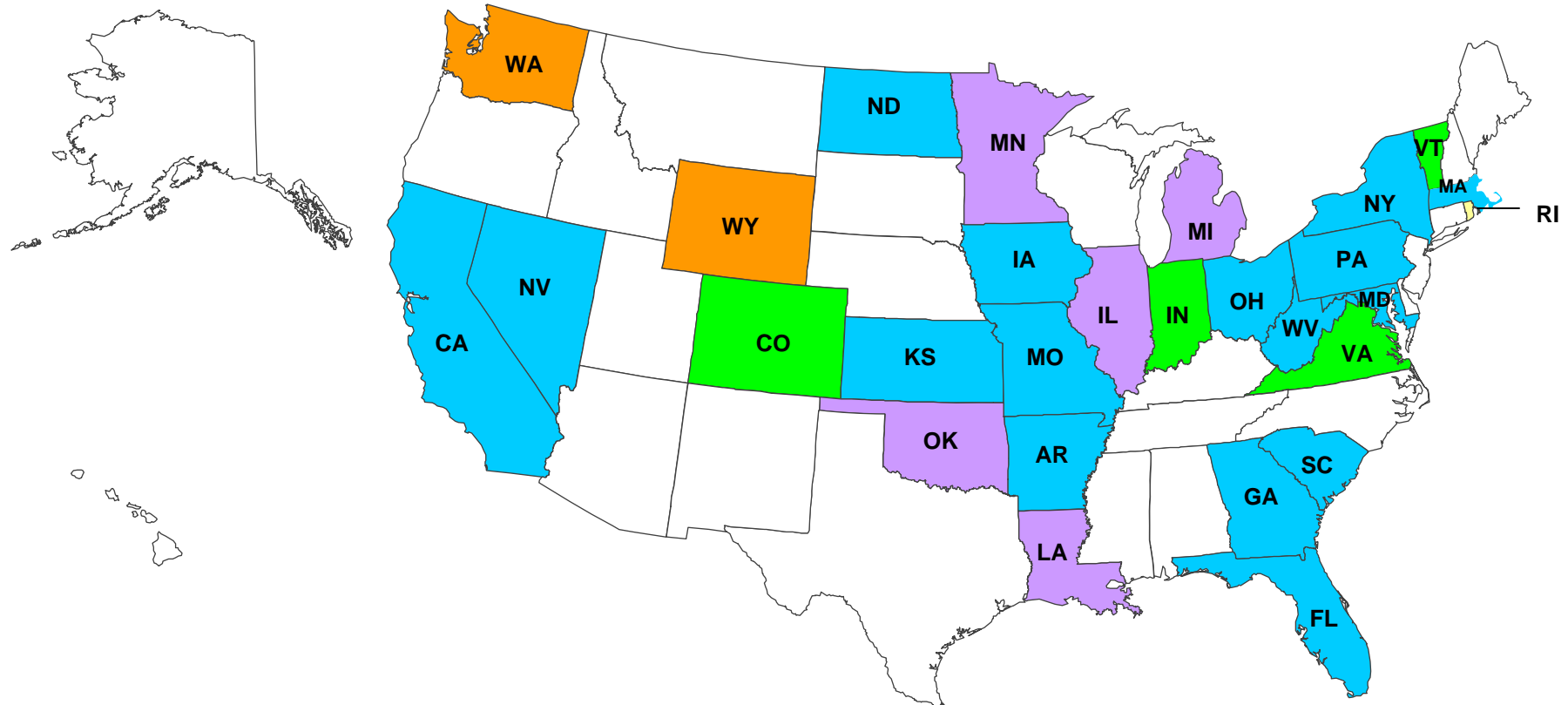


Digital Goods Taxed by
DOR Position or
Case law

Digital Goods
Non-Taxable

Digital Goods Taxed
by Statute

Summary of Digital Goods Legislative Activity – 2010



Enacted digital goods legislation in 2010

Failed digital goods legislation in 2010

Pending digital goods legislation in 2010

Digital goods issues being discussed

States that are likely to consider digital goods legislation in 2010

Impact on Planning and Compliance

- ▶ **Proactively assist in characterization of the sale**
 - Create tax categories according to intent of parties/language of contract
 - Consider bundling rules:
 - Unbundling – can components of the bundle be offered on a separate basis? Are books and records adequate?
 - If no books and records rule, is there a “true object”? Is one component subservient or *de minimis*?
 - Agree on uniform invoice language and create a tax practices document between the parties
- ▶ **Don't make characterization decisions in a vacuum; collaborate to the extent possible with other digital vendors**

Current Developments - Characterization

Colorado

- ▶ Effective March 1, 2010, sales of “standardized software” are taxable, regardless of method of delivery.
- ▶ ASPs continue to be exempt, even with the March 1, 2010 change to tax electronically delivered “standardized software.”

Illinois

- ▶ The Department holds that ASPs are the sale of canned software, and are therefore taxable (unless the five part test is met).

Indiana

- ▶ Letter of Findings No. 09-0746 (Ind. Dept. of Rev. May 27, 2010)
- ▶ The Department’s policy is that that ASPs are the sale of canned software, and are therefore taxable.

Kansas

- ▶ Opinion Letter No. O-2010-005 - ASPs are not the sale of prewritten computer software.

Recent Developments

New York

- ▶ TSB-A-10(28)S, TSB-A-10(4)C
- ▶ Voicemate

North Carolina

- ▶ Effective January 1, 2010, sales of prewritten computer software are taxable, regardless of method of delivery. Note that there is an exception for software that meets any of the following criteria
 - (a) it is designed to run on an enterprise server operating system;
 - (b) it is sold to a person who operates a datacenter and is used within the datacenter;
 - (c) it is sold to a person who provides cable service, telecommunications service, or video programming and is used to provide ancillary service, cable service, internet access service, telecommunications service, or video programming.
- ▶ ASPs continue to be exempt, even with the January 1, 2010 change to tax electronically delivered software.
- ▶ Effective January 1, 2010, the sale of digital goods are subject to sales and use tax. These items include: an audio work; an audiovisual work; a book, a magazine, a newspaper, a newsletter, a report, or another publication; and a photograph or a greeting card.

Recent Developments

Missouri

- ▶ *Filenet Corporation v. Director of Revenue*, No. 07-0146 (8/20/2010)

Pennsylvania

- ▶ *Dechert LLP v. Pennsylvania*

Tennessee

- ▶ Tenn. Laws 2008, S.B. 4173, signed June 5, 2008 imposes tax on digital products effective 1/1/2009.

Vermont

- ▶ Technical Bulletin 43

Recent Developments

Washington

- ▶ HB 2620

Wisconsin

- ▶ PLR W1025002
- ▶ Wis. Laws 2009, S.B. 62, enacted Feb. 19, 2009 imposes tax on digital goods effective October 1, 2009.

Wyoming

- ▶ HB 29 imposes sales and use tax on specific digital products effective 7/1/2010.



Sourcing of Software & 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

Sourcing of Digital Products

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 of Digital Products

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 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.

Sourcing of Digital Products

▶ Local Tax Sourcing

- Watch for origin sourcing in several states (i.e., Texas, Ohio).
- Be careful of home rule cities – they have their own sets of rules and often aren't following nationwide trends.
- Mix of “destination” and “origination” rules could result in tax credit issues.

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.

Current Developments - 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)

Recent Developments

Sourcing – Examples of Inconsistencies

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.

New York

New York sources software based on “user location”. See TSB-A-10(32)S (among others).

Pennsylvania

Pennsylvania sources software based on “service location”.



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.

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.



Questions?

Contact Information

▶ Loren Chumley

- (615) 248-5565
- Ichumpley@kpmg.com

▶Carolynn S. Iafrate

- (610) 458-7227
- csiafrate@industrysalestax.com