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Sales Tax on Software, Digital Products and Information Services

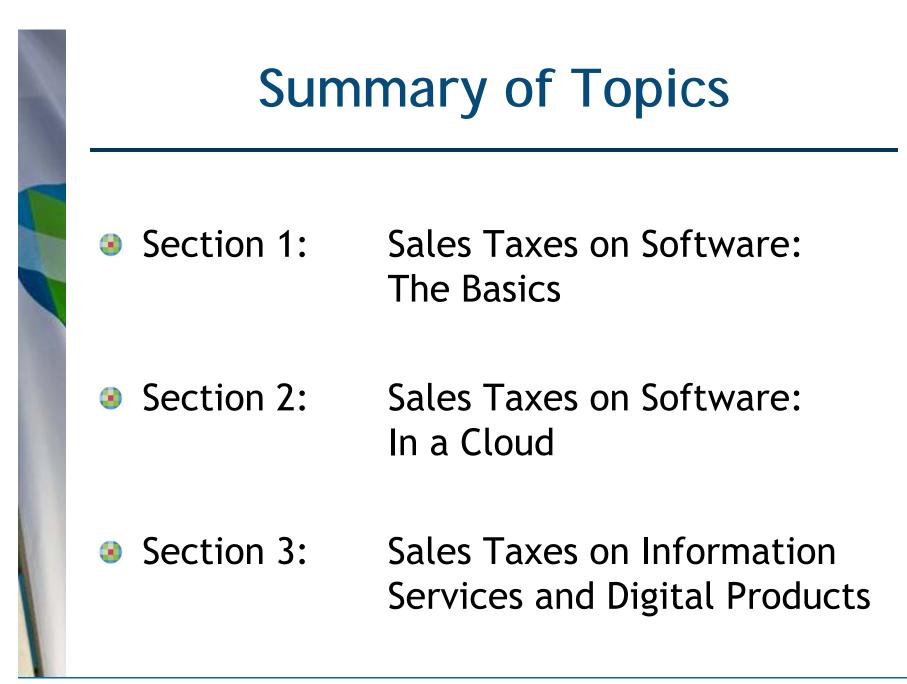*Presented by*

Timothy P. Noonan, Esq.

Today's Discussion Topics

- Jurisdictional Issues & Sales Tax Nexus

- How sales tax is applied to the sale of software products and services

- Treatment of "electronic" delivery, cloud computing, and out-of-state users

- Taxation of Digital Products

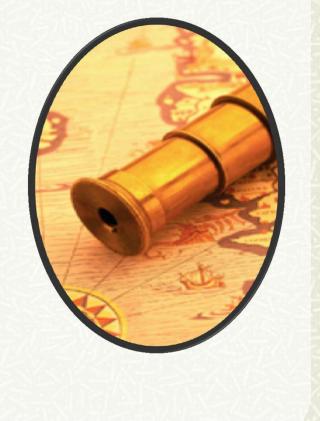- How sales tax is applied to the sale of information services

Summary of Topics
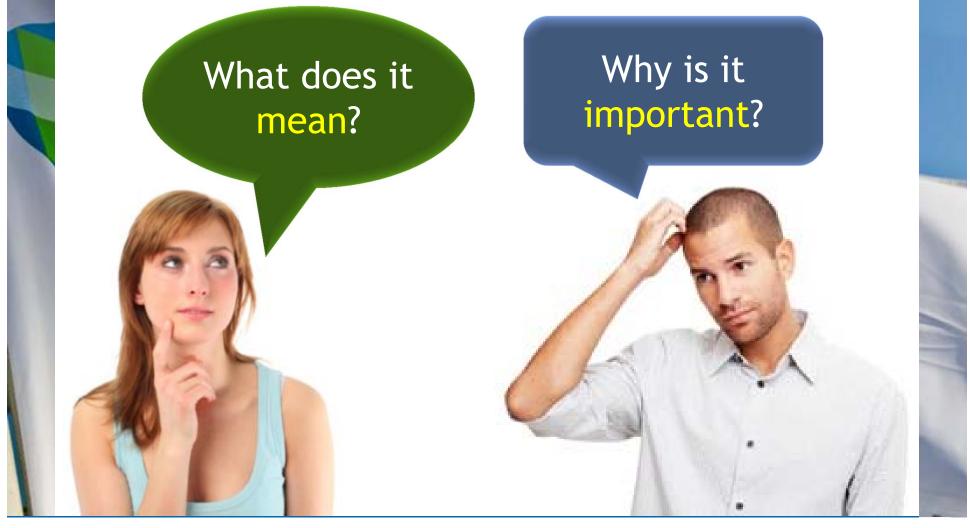
- Section 1:   Sales Taxes on Software:
  The Basics

- Section 2:   Sales Taxes on Software:
  In a Cloud

- Section 3:   Sales Taxes on Information
  Services and Digital Products

Section 1

Sales Taxes on Software: *The Basics*

Nexus
The All-Important Term

What does it mean?

Why is it important?

Constitutional Nexus
The Commerce Clause

- *Quill v. North Dakota* (1992)

- Let's get physical

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New Rules on the Horizon?
Marketplace Fairness Act

- Grants states authority to compel online retailers to collect taxes

- Applies only to sellers with more than $1 million remote sales annually

New Rules on the Horizon?
Marketplace Fairness Act

- But only AFTER they have simplified their sales tax laws

  - Option #1

    - Join the Streamlined Sales Tax Project

  - Option #2

    - Follow simplification mandates, such as uniform sales tax base and software to manage sales tax compliance

Special Nexus Provisions
Software Context

- Location of Computer Servers = Nexus?

  - Texas Ruling No. 9601L1389604

    - Server = Nexus

    - But purchase of Internet "hosting service" from seller with in-state server ≠ nexus per 2011 law (Tex. Tax Code § 151.108)

  - Washington Rev. Code § 82.32.532(1)

    - Ownership of software located on someone else's server ≠ nexus

  - VA Ruling 12-36

    - Ownership of several servers "would appear to create nexus"

  - Mo. Letter Rul. 3819(2007)

    - Mere purchase of data storage or processing service ≠ nexus

Taxability Issues
Overview of State Sales Taxes

- Central Issues

  1. Custom vs. Canned

  2. Tangible vs. "Electronic"

  3. In-State vs. Out-of-State

  4. Maintenance vs. Upgrades

  5. Software vs. Service

Issue #1
Custom vs. Canned

- ⬢ **General Standard**

  - ▪ The New York Rule

- ⬢ **Other Standards**

  - ▪ The Illinois Rule

Issue #1
Custom vs. Canned

- Examples

  - Microsoft Word "customized"

  - The *Xerox/Amici* Case

  - Separately stating

Issue #2
Tangible vs. Electronic

- What's the Issue?

- State-by-State Chart
  (See SmartChart in Appendix)

- Planning Issues

Issue #3
In-State vs. Out-of-State

- Location of server— AZ and UT examples

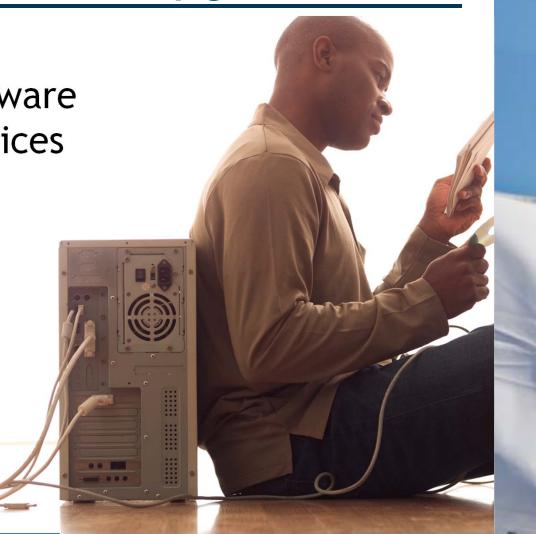- Location of users— New York and others

- Proof issues

Issue #4
Maintenance vs. Upgrades

- Taxability of Software Maintenance Services

- See SmartChart

- Watch out for upgrades!

Attendance Validation #1

Please locate your
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software

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Section 2

Sales Taxes on Software:
In a Cloud

What is Cloud Computing?

- National Institute of Standards & Technology (NIST) Definition

    "Model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g. networks, servers, storage, applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction"

- Core Idea

    - Cloud computing allows users with remote access to software, storage capabilities, etc.

- See Noonan's Notes Article in Appendix

Polling Question

You just purchased and used the on-line version of TurboTax to prepare your own tax return. What did you buy?

❑ Software

❑ Tax return preparation service

❑ Malpractice in a box

❑ None of the above

Models of Cloud Computing?

- ⊞ Software as a Service (SaaS) Model

  - ▪ Allows a customer to access a provider's applications on a cloud infrastructure

  - ▪ Customer does not manage or control the underlying infrastructure

  - ▪ Examples

    - ➢ Turbo Tax, Google Docs, Quicken

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Models of Cloud Computing?

- Platform as a Service (PaaS) Model

  - Allows a customer to deploy its created or acquired applications on a cloud infrastructure

    - i.e., to build web applications

  - Customer does not manage/control underlying infrastructure, but does have control over its deployed applications

  - Examples

    - AppEngine from Google, WaveMaker

Starting Points for Discussion

- Hosted software/data storage ≠ cloud-computing, but for tax purposes treated the same

- Cloud-computing

  - Like pornography?

  - Definitions are imprecise

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Starting Points for Discussion

- What's NOT cloud-computing?

    - Electronic downloads of music, books and software

    - But states may follow similar framework

- Cloud computing and arcane sales tax laws

    - An unhealthy mix!

Cloud Computing
Taxability Issues

● Central Issues

1. Is there a taxable good or service?

2. Is there a sale or use

   ➢ i.e., does "possession" get transferred?

3. Where is the sale taxed?

Issue #1
Taxable Good or Service?

- State taxing authorities treat cloud-computing in one of two ways

As canned software, characterized as TPP (usually taxable)

As a service (usually not taxable)

Issue #1
Taxable Good or Service?

- Raises critical questions

  - Distinguishes between sales of TPP and sales of services

    - The age-old "true object" test

  - Treating cloud-computing as canned software

  - Treating cloud-computing as taxable or nontaxable service

Issue #1
Taxable Good or Service?

- Sale of TPP vs. Sale of Service

  - A test by many names

    - "true object"

    - "dominant purpose"

    - "essence of transaction"

    - "primary function"

  - NY example

    - Dating services case

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Issue #1
Taxable Good or Service?

- Examples in the Cloud
  - True Object = Service
  - Colorado
    - Hosted software solution provides service, not computer server or software
    - "Control" is key element
    - Common examples in other contexts
  - Massachusetts
    - Employee recruiting program also a service of database access, <u>not</u> sale of software

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Issue #1
Taxable Good or Service?

- 🔵 **Examples in the Cloud: Cloud Computing = Canned Software**

  - ■ New York

    - ➤ NFL's payroll-processing "service" actually was license of canned software (TSB-A-09(37)S)

    - ➤ Department relies on fact that customer has right to "use the software" to upload and manipulate its payroll information

    - ➤ Department has issued several similar rulings holding that SaaS models = canned software for various services:

      - – Web-based logistics (TSB-A-09(33)S);

      - – retail management (TSB-A-09(19)S);

      - – real estate ASP (TSB-A-09(44)S); loan processing program (TSB-A-09(15)S)

Issue #1
Taxable Good or Service?

- New York (continued)

  - ➢ New York formally announces its long-standing position that the provision of remote access to prewritten software is subject to sales tax (TB-ST-128 (Aug. 5, 2014))

  - ➢ "the purchaser gains constructive possession of the software and the right to use or control the software"

  - ➢ Compare with *Matter of SunGard* (below)

Issue #1
Taxable Good or Service?

- **Pennsylvania**

  - ➤ Subscription service allows taxpayer to access computer from remote locations

  - ➤ Taxable as access to canned software (PA Ruling SUT-12-001)

- **But see Missouri**

  - ➤ Hosted software = canned computer software BUT only tangible software is subject to tax

- **Iowa**

  - ➤ Same deal (Iowa Policy Letter, Cloud Computing, 1/11/12)

Issue #1
Taxable Good or Service?

- Examples in the Cloud: Cloud Computing = Nontaxable Service

  - ▪ Wisconsin

    - ➤ Access to inventory management (web-based software ASP) is a nontaxable service (Wis. Ruling WI025002)

    - ➤ Relies on lack of download or "control" of underlying software

  - ▪ Massachusetts

    - ➤ Service that allows a doctor to prepare and submit a patient's prescription to pharmacy and that monitored delivery constituted nontaxable data processing service (Mass. Ruling 08-6)

Issue #1
Taxable Good or Service?

- **New York**

  - Smart Loan service that processes and maintains data from customers' securities lending and borrowing transactions constitutes a nontaxable information service (*Matter of SunGard Securities Finance LLC*, No. 824336 (N.Y. Div. of Tax App. 2014))

  - Licensing software vs. outsourcing services (Timothy P. Noonan & K. Craig Reilly, ''New York Ruling Raises Questions About The Taxation of Cloud Computing Services,'' State Tax Notes, Jun. 23, 2014, p. 691)

Issue #1
Taxable Good or Service?

- **Examples in the Cloud: Cloud Computing = Taxable Service**

  - **South Carolina**

    - SP that allowed communication on web-based platform between suppliers and vendors constituted taxable "communications" under SC law (SC Ruling 05-13)

Issue #1
Taxable Good or Service?

- **Texas**

  ➢ Cloud-computing = data processing, including

    – Voice recognition software that turns dictation into draft documents (Tex. Ruling 201004665L)

    – Access to web-design center that allows customer to design services (Tex. Ruling 200904664L)

    – A web-based reporting system that allows customers to enter data from remote locations and retrieve reports (Tex. Ruling 200801068L)

Issue #2
Transfer of Possession?

- Tax liability only arises if there is a "sale"

  - Issue turns on whether there is a transfer of "possession"

  - Getting technical

    - What is customer touching

Issue #2
Transfer of Possession?

- Transfer of Possession Assumed

  - New York

    - Customer gains "constructive possession" and the "right to use/control" (TSB-A-09(33)S)
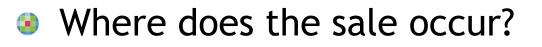
Issue #2
Transfer of Possession?

- ⬤ No Transfer of Possession

  - ▪ Tennessee

    - ➤ Remote access to software not taxable because no "transfer"

    - ➤ Title/possession of software remains with seller (Ten. Ruling 07-35)

  - ▪ Nebraska

    - ➤ If ASP retains title and "does not grant license with ownership rights to customer, there is no "sale" (Neb. Info. Guide 6-511-2011)

Issue #3
Location, Location, Location

- Where does the sale occur?

  - Most states follow fiction that a cloud-computing transaction is akin to sale of TPP

    - Therefore, user/customer location drives the tax liability

  - But sales tax = delivery/title passage

    - If customer has remote access to out-of-state server, why isn't "sale" located where server is?

    - Utah and Tennessee appear headed in this direction

Issue #3
Location, Location, Location

- **New York**

  - "The situs of the sale for purposes of determining the proper local tax rate and jurisdiction is the location from which the purchaser uses or directs the use of the software, not the location of the code embodying the software. Therefore, if a purchaser has employees who use the software located both in and outside of New York State, the seller of the software should collect tax based on the portion of the receipt attributable to the users located in New York." (TB-ST-128 (Aug. 5, 2014))

Multistate Survey

Cloud Computing Taxable (19): AZ, CT, DC, HI, ID, IN, MA(?), MI, NM, NY, OH, PA, SC, SD, TX, UT, VT, WA, WV

Cloud Computing Exempt (27): AL, AR, CA, CO, FL, GA, IA, IL, KS, KY, LA, MD, ME, MN, MO, MS, NC, ND, NE, NJ, NV, OK, RI, TN, VA, WI, WY

* See Smart Chart in Appendix *

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primary function test

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Section 3

Sales Taxes on Digital Products & Information Services

Taxation of Digital Goods & Services

- Current treatment of digital goods and services varies widely from state to state. See Smart Chart in Appendix.

- Generally Taxable (25): AL, AZ, CO, CT, DC, HI, ID, IN, KY, LA, ME, MO, MS, NC, ND, NE, NJ, NM, SD, TN, TX, UT, VT, WA, WI

- Generally Nontaxable (21): AR, CA, FL, GA, IA, IL, KS, MA, MD, MI, MN, NV, NY, OH, OK, PA, RI, SC, VA, WV, WY (Exceptions: Taxable software/information services/cloud services)

Taxation of Digital Goods & Services (con't)

- Streamlined Sales and Use Tax Act (SSUTA): Specified digital products cannot be included within the definition of "ancillary services," "computer software," "telecommunications services" or "TPP" (See Sections 332 and 333)

  - "Specified digital products" = electronically transferred

    - "Transferred electronically" = obtained by the purchaser by means other than tangible storage media

  - "Digital Audit-Visual Works," "Digital Audio Works," and "Digital Books"

  - Sourcing

    - "Receive" or "Receipt" = taking possession or making first use of digital goods, whichever comes first
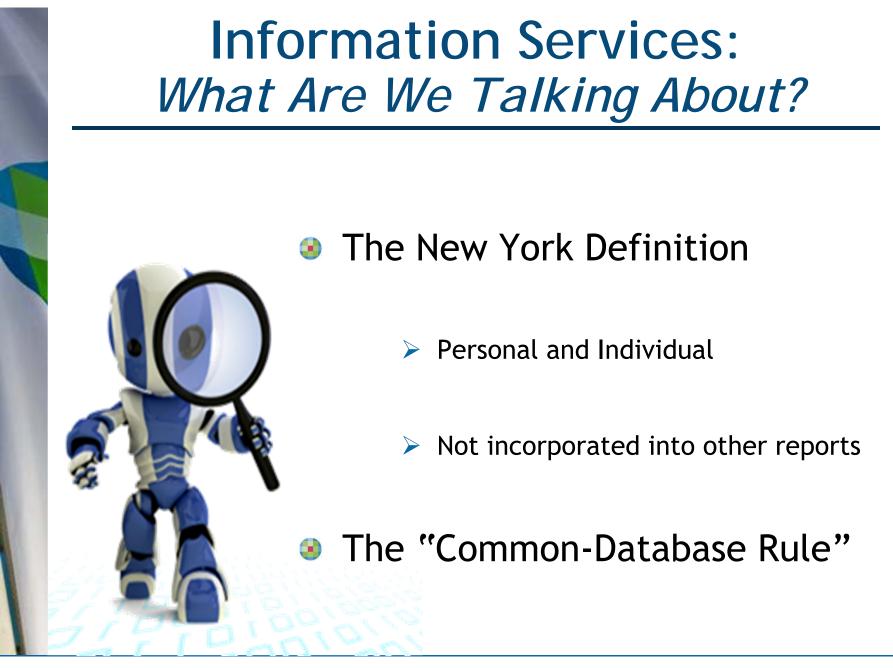
Digital Goods and Services Tax Fairness Act

- H.R. 1860/S. 971 in the prior Congress (not yet introduced in the 113th Congress).

- Prohibits multiple or discriminatory taxes on digital goods or digital services.

- Provides rules for digital goods and service taxation, including sourcing rules and rules for bundled transactions.

- Limits taxation of digital goods or services under expansive statutory interpretations.

- Encompasses software within digital definitions.

Permanent Internet Tax Freedom Act of 2013

- S. 31 – introduced on January 22, 2013 by Sen. Kelly Ayotte (R-NH); H.R. 434 – introduced on January 29, 2013 by Rep. Steve Chabot (R-OH).

- Would make permanent the existing ban on state or local taxes on internet access and on multiple or discriminatory taxes on e-commerce.

- New issues relative to 2007 expansion of ITFA to "email."

- The most recent extension of ITFA is scheduled to expire on November 1, 2014.

Information Services:
What Are We Talking About?

- ### The New York Definition

  - ➢ Personal and Individual

  - ➢ Not incorporated into other reports

- ### The "Common-Database Rule"

Sales Taxes on Information Services

- States that tax information services (See Appendix)

  - New York, Texas

  - California, Illinois, Connecticut (?)

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Sales Taxes on Information Services

🔳 **Turbulence in New York (See Appendix)**

➤ TSB-M-10(7)S

➤ Risk Management Reports

➤ Are you "on the list?"

Specific Industry Issues

- Market Research

  - The Common Database Issue

Specific Industry Issues
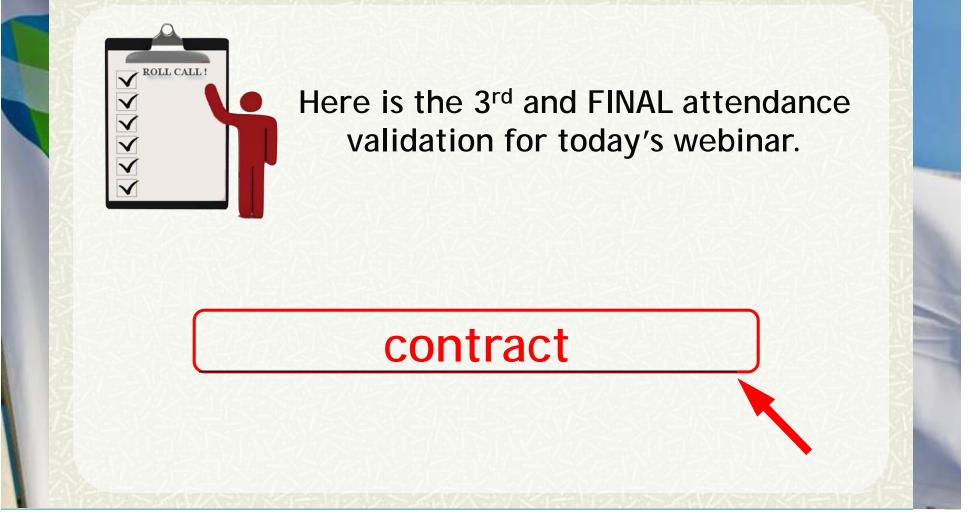
Investment Research
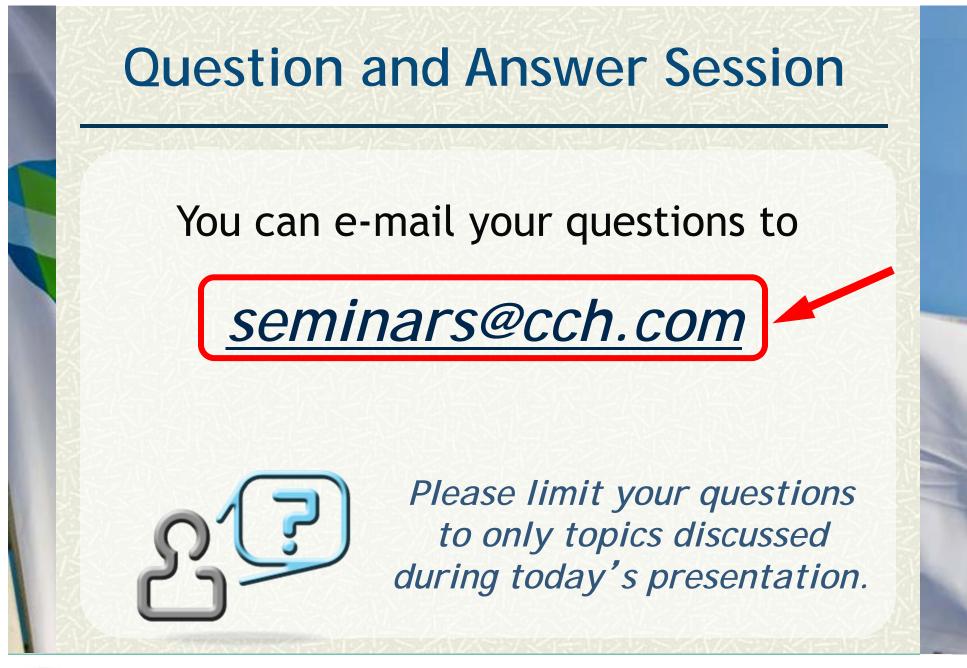
- Consulting vs. Information Service

- More Common Database Issues

- Bundling Problems

- Soft-Dollars

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contract

Question and Answer Session

You can e-mail your questions to

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Please limit your questions to only topics discussed during today's presentation.

CONCLUSION

Contact Information

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Thank you for attending today's program