Sales and Excise Tax:
Defense of Digital and ‘Cloud’ Products from State Taxation

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Introduction

- Overview of Digital and Cloud Products and Services
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Overview of Digital and Cloud Products and Services
What is the Product?

• Digital Products (Single Purchases and/or Subscriptions for Access)
  • Streaming Video / Audio (Netflix, Hulu, Pandora)
  • Games
  • Books
  • Apps

• Information Service (Lexis, Westlaw, Checkpoint)

• Software
  • Canned / Prewritten
  • Custom
  • Software as a Service / Remotely Accessed Software
What is the Product?

• Definitions from the Streamlined Sales and Use Tax Agreement:
  • **Prewritten Computer Software** (Appendix C, Part II)
    • “Computer software,’ including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser.”
    • “Prewritten software’ includes software that was designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the specific purchaser.”
    • “A member state may exempt ‘prewritten computer software’ ‘delivered electronically’ or by ‘load and leave.’”
  • **Specified Digital Products** (Appendix C, Part II)
    • “Electronically transferred” digital audio-visual works, digital audio works, and digital books.
What is the Product?

- **Information Services** (Lexis, Westlaw, Checkpoint)
  - Monthly subscription.
  - Access via the internet using a password.

- **Software as a Service**: An online service that enables a subscriber to access business application software hosted in the cloud (internet) via an internet browser.
  - Provider owns and operates the software application.
  - Provider owns and maintains the server(s) that store the software.
  - Provider makes software application available to subscribers via the internet.
  - Software is not downloaded or actually transferred to subscriber.
Nexus Developments
The Digital Goods and Services Tax Fairness Act of 2015

- Introduced in March 2015
- Prohibits imposition of multiple or discriminatory taxes on sales of digital goods or digital services delivered or transferred electronically.
- Restricts taxation to the state/locality of the customer’s address.
- Responsibility imposed on the seller to obtain the customer’s address.
- “Digital good” defined as “any software or other good that is delivered or transferred electronically . . . where such good is the true object of the transaction.”
- “Digital service” is defined as “any service that is provided electronically” but does not include “a service that is predominantly attributable to the direct, contemporaneous expenditure of live human effort, skill, or expertise, a telecommunications service, an ancillary service, Internet access service, audio or video programming service, or a hotel intermediary service.”

• The United States Supreme Court held that the Tax Injunction Act does not bar DMA from bringing a suit in federal court to challenge Colorado’s sales and use tax notice and reporting statute.

• The Tenth Circuit raised the TIA *sua sponte*.

• The Court “express[ed] no view of the merits” and took “no position” on whether the suit might be barred under the “comity doctrine.”

• The Tenth Circuit has directed the parties to provide full briefing on whether the case should be dismissed under the comity doctrine, as well as briefing on the Commerce Clause claims.

• DMA has a state court action pending on the same issue. The state court granted DMA a preliminary injunction on February 18, 2014.

• Concurrence by Justice Kennedy questions the continued validity of *Quill*. 

• The Comptroller found that electronically downloaded software licensed by a company to Texas customers constituted physical presence in Texas sufficient to establish nexus for sales and use tax purposes.
• *Travelocity.com v. Wyoming Dep’t of Revenue*, 329 P.3d 131 (Wyo. 2014). The Wyoming Supreme Court held that online travel companies (OTCs) had sales tax nexus in Wyoming despite maintaining no property or employees in the State.

• The court determined that the OTCs had nexus based on their contractual relationships with in-state hotels, which was sufficient to constitute nexus because these relationships were key for the OTCs’ ability to establish a market in Wyoming and the OTCs made use of affiliates and partners in the State that were paid commissions based on their facilitation of online bookings.

• The court found that there was “a sufficient nexus because ‘through these types of affiliation agreements, a vendor is deemed to have established an in-state sales force.’”
Taxation of the Cloud: State Assertions of Tax
State Assertions of Tax

- Digital Products
- Pre-written Computer Software
- Taxable Service
  - Telecommunication Service
  - Data Processing / Information Service
State Assertions of Tax

Digital Products
Digital Products: Downloaded v. Accessed

- No tax on downloads of digital products.
  - **SSUTA States**: Arkansas, Georgia, Indiana, Iowa, Kansas, Michigan, Nevada, North Dakota, Oklahoma, Rhode Island, West Virginia, Wyoming.
  - **Massachusetts**: Digital products transferred electronically are not taxable. LR No. 11-3 (Mar. 24, 2011); *see also* TIR 05-8 (July 14, 2005).
  - **New York**: Charges for electronic transfers of digital products, whether per download or by subscription, are not taxable. TSB-A-07(16)S (June 22, 2007).

- Tax on downloads of digital products, but no tax for accessing the product online.
  - **New Jersey**: Publication ANJ-27 (July 2011) (“Receipts from sales of a specified digital product that is accessed but not delivered electronically to the purchaser are exempt from tax.”)
• Tax on digital products regardless of whether they are downloaded or accessed online.

• Idaho:

  • L. 2014, H598 (c. 340) (eff. July 1, 2014): Clarified that tangible personal property (i) does not include software that is remotely access or delivered but (ii) does include digital music, books, videos, and games, regardless of the method by which the title or right to use such software is transferred to the user.

  • L. 2015, H.B. 290 (c. 202), effective April 1, 2015, revises the definition of “tangible personal property” to clarify that the purchaser of digital music, digital books, digital videos, or digital games must be granted a “permanent right to use” in order to be taxable.
Digital Products: Subscription Services

• Subscription Fees to Access Video and Audio **Taxable:**
  • **Minnesota:** Taxable after June 30, 2013 pursuant to an omnibus tax bill signed by the governor on May 23, 2013.
  • **Ohio:** Taxable after January 1, 2014 pursuant to legislation. See Ohio Rev. Code Ann. § 5739.01(B)(12).
  • **Tennessee:** Subscriptions for digital video and audio works have been taxable since January 1, 2009. Tenn. Code Ann. § 67–6–233(a), (b)(3).

• Subscription Fees to Access Video and Audio **Not Taxable:**
  • **California:** Publication 109 (SBE June 2012)
  • **Florida:** Technical Assistance Advisement, No. 11A-002 (Jan. 13, 2011)
State Assertions of Tax

Pre-written Computer Software
States are increasingly asserting that charges for remote access software and certain types of services that were traditionally considered to be nontaxable information services are taxable as sales of pre-written computer software.

**New York:** Sales of access to software are taxable because customers gain “constructive possession” of the software.

“When a purchaser remotely accesses software over the Internet, the seller has transferred possession of the software because the purchaser gains constructive possession of the software and the right to use or control the software.” New York State Department of Taxation and Finance Tax Bulletin, TB-ST-128 (Aug. 5, 2014).

A distinction is drawn between situations in which the vendor uses its software and inputs customer information, and situations in which the customer uses the vendor’s software and inputs its own information. See TSB-A-15(1)S (Jan. 15, 2015).
Taxable Software

• **Utah**: Sales of access to software are retail sales because they involve the transfer of the use of the software.

• PLR No. 13-003 (Dec. 4, 2013). The Commission applied an “object of the transaction” test to find that the taxpayer’s sales of cloud-based applications, which supported customers’ telecommunications equipment and which customers purchased to avoid having to purchase otherwise necessary hardware and software, were taxable as computer software because the sale involved transferring use of software for a purpose other than resale and the object of the transaction was the software.
**Taxable Software**

- **New Mexico**: Sales of licenses to remotely access software are taxable.

- Ruling No. 401-13-3 (July 19, 2013). The Department found that the gross receipts of an out-of-state company that provided remote access to computing resources through the use of open source operating system software or third-party operating system software were derived from a license to use such software and therefore, were taxable.
State Assertions of Tax

Taxable Service
Taxable Service: Telecommunication Service

- Many states impose sales tax or a separate excise tax on telecommunication services.

- Taxable “telecommunication services” defined as broadly as possible in an attempt to reach any future advances in technology.

- Taxable “telecommunication services” are commonly defined as:
  - The transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points, whatever the technology used including such transmission, conveyance, or routing in which computer processing applications are used to act on the form, code or protocol of the content for the purposes of transmission, conveyance or routing without regard to whether such services are referred to as voice over internet protocol (VoIP) services or are classified by the [FCC] as enhanced or value added . . . ”
Taxable Service: Telecommunication Service

Missouri

• PLR No. LR 7292 (Aug. 28, 2013, released Feb. 24, 2014). The Department determined that purchases of virtual private networks, high speed internet access, and managed hosting solutions provided through a private network were subject to sales tax as telecommunications services. The Department noted, however, that charges for accessing the internet may not be taxable if they are separately stated on the taxpayer’s bill or on the seller’s records.
Taxable Service: Telecommunication Service

- PLR No. LR 7248 (May 24, 2013). The Department found that sales of cloud-based applications and services that supported customers’ telecommunication equipment, including voice, video, messaging, audio, web conferencing, and mobile capabilities, were taxable, despite the fact that customers separately purchased the necessary hardware and internet connection and the company’s servers were located outside of Missouri.

- The Department ruled that the company was providing taxable telecommunications services because it interacted with the customer’s equipment to route voice and video transmissions and other information through its software applications and services, and that the customer would not be able to use its telecommunications equipment without the company’s software applications and hosting.
Taxable Service: Telecommunication Service

South Carolina

• Private Letter Ruling No. 14-4 (Nov. 4, 2014). The Department determined that a company’s cloud-based applications and related services that supported a customer’s telecommunication equipment, including the customer’s voice, video, messaging, presence, audio, web conferencing, and mobile capabilities, were taxable as sales of communications because they constituted “the ways or means for the transmission of the voice or messages.”
Taxable Service: Telecommunication Service

Tennessee

• Letter Ruling No. 14-05 (Aug. 25, 2014). The Department determined that sales of cloud-based applications and related services to supplement and support customers’ telecommunication equipment were taxable as sales of intrastate telecommunications and ancillary services.

• The Department explained that the sales were not taxable sales of tangible personal property because they did not involve the sale or use of tangible personal property in Tennessee, as the hardware was located out-of-state and the software was on out-of-state servers.

• However, because the services enhanced the functionality of the customer’s phone and other telecommunications equipment, the Department found that the services were subject to sales tax as telecommunications services.
Texas

- **SOAH Docket No. 304-14-2175.26** (Feb. 6, 2015). The Comptroller determined that sales of “plug-ins” created at the request of an advertiser were taxable as data processing or information services.

- The taxpayer derived its revenue from selling advertising on its website. Most of the taxpayer’s revenue was nontaxable advertising; however, the taxpayer also sold “plug-ins” that modified the taxpayer’s software to provide advertisers with additional functionality.

- Because the plug-ins were purchased after the advertiser had already purchased advertising, the Comptroller determined that the true object of the sale of the plug-ins were taxable data processing, because the nontaxable advertising purpose had already been fulfilled when the advertiser initially purchased advertising from the taxpayer.
Taxation of the Cloud: Taxpayer Defenses
Defenses

- Federal Preemption: The Internet Tax Freedom Act
- Nexus
- Nontaxable Service & The True Object Test
- Nontaxable Under Statutory Definitions
Federal Preemption: The Internet Tax Freedom Act ("ITFA")
Defenses: ITFA

- The ITFA prohibits states from imposing tax on internet access and “discriminatory taxes on electronic commerce.”
  - A “discriminatory tax,” is defined, in part, as “any tax imposed by a State or political subdivision thereof on electronic commerce that . . . imposes an obligation to collect or pay tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means.”

- Illinois: *Performance Marketing Association*

- United States Supreme Court: *CSX*

- California: *j2 Global, Inc.*
Defenses: ITFA


- The Illinois Supreme Court found that the State’s affiliate nexus provisions were expressly preempted by the ITFA.

- The court concluded that the statute imposed a discriminatory tax on electronic commerce under the ITFA because it imposed a use tax collection obligation on out-of-state sellers who contracted with persons in Illinois for online performance marketing services and that such obligation was not similarly imposed on out-of-state sellers who contracted with persons in Illinois to provide print or broadcast based (offline) performance marketing services.
Defenses: ITFA

• *Alabama Dep’t of Revenue v. CSX Transportation, Inc.*, No. 13-553 (U.S. Mar. 4, 2015).

• Under the Railroad Revitalization and Regulation Reform Act (“4-R Act”), states may not impose a tax that discriminates against rail carriers.
  - The Court explained that a tax discriminates under the 4-R Act when “it treats groups that are similarly situated differently without sufficient justification for the difference in treatment.”

• “Similarly Situated” / “Similar property, goods, services, or information”
  - The Supreme Court indicates that “similarly situated” varies depending on the context (e.g., most narrow in the context of equal protection).

• Impact on analysis under the ITFA?
Defenses: ITFA

• California: *j2 Global Communications, Inc. v. City of Los Angeles*

• In 2013, the California Court of Appeal upheld the trial court's grant of summary judgment and held that an e-mail fax service provider’s purchases of telecommunication services were not exempt from the City of Los Angeles‘ Communication Users Tax.

• *j2* argued that such purchases were exempt under the ITFA because the services purchased provided “internet access” as defined in the ITFA.

• The court found that the exemption in the ITFA only applied to providers of “traditional” internet access, and not to providers of e-mail services alone (even though e-mail was included in the broader definition of internet access under the 2007 amendments to the ITFA).
Defenses

Nexus
Defenses: Nexus

- Recent decisions by the United States Supreme Court limiting the exercise of jurisdiction by states under the Due Process Clause provide an additional defense for taxpayers.


- *Walden v. Fiore*, No. 12-574 (Feb. 25, 2014)
Defenses: Nexus

• **American Business USA Corp. v. Dep’t of Revenue**, No. 4D13-1472 (Fla. Dist. Ct. App. Nov. 12, 2014). The Florida District Court of Appeals held that an assessment of sales tax on a Florida-registered Internet company for sales of flowers that were never stored in or brought into Florida violated the Commerce Clause of the U.S. Constitution as the transactions in question did not have a substantial nexus with the State.

• The company collected Florida sales tax on sales to in-State customers, but not on sales to out-of-State customers.

• The court observed that the company’s only connection with Florida was that it was registered in the State, and the only interaction the out-of-state customer had with Florida was by shopping for flowers on a website operated by a company incorporated in Florida.

• The court found that “[m]erely registering in a state does not give the taxing state the right to assess sales tax on transactions without any other facts to constitute ‘substantial nexus.’”

• Compare to Texas Hearing No. 106,632.
Defenses

Nontaxable Service & The True Object Test
The true object test is an effective tool to determine the taxability of products involving both nontaxable services and the use of computer software.
Defenses: Nontaxable Service True Object Test

Colorado

- Private Letter Ruling No. PLR-15-001 (Feb. 4, 2015) and Private Letter Ruling No. PLR-15-003 (Feb. 4, 2015). The Department determined that a company’s electronic data interchange (EDI) value added network (VAN) services, which allows routine business documents to be exchanged electronically using industry-standard data formats, were not taxable because customers use the EDI VAN services to access the company’s software that formats the communications, and therefore, the true object of these services is the data conversion service not the data transmission service.
Defenses: Nontaxable Service
True Object Test

Massachusetts

• LR No. 14-4 (Mar. 29, 2014). The Department found that a company’s on-line training programs that provided customers with access to digital content in the company’s library of training modules, which involved audio, graphics and some minor user interaction, were not taxable because the object of the transaction was access to information and therefore, the company was providing nontaxable database access services.
Defenses: Nontaxable Service
True Object Test

New York

• **TSB-A-15(1)S** (Jan. 15, 2015). The Department determined that a company’s service of assisting its retailer and wholesaler clients in capturing, displaying, sharing and analyzing online customer feedback was not taxable. The company’s Core Offering collected customer feedback from across the Internet, screened it, and transmitted it back to the company’s retailer and wholesaler clients.

• Although the Department noted that certain components of the service would be taxable as sales of remote access software if sold on a stand-alone basis, because the service was sold for one price and the predominate benefit that clients received was the ability to educate their customers about their products and brands and thereby promote sales of those products and brands, the Department found that the service was a nontaxable advertising service.

• However, the Department found that the company’s optional software-as-a-service product, which enabled clients to run reports, was taxable as a sale of prewritten computer software.
Defenses: Nontaxable Service
True Object Test

Tennessee

• A line of case law has developed making it “clear” that “the issue of whether a service is taxable as a telecommunications service does not turn on whether or not a service provides the transmission of information, but whether communication between users of the service was the primary purpose of the service.” *IBM Corporation v. Farr.*

• *Prodigy Services Corp. v. Johnson*, 125 S.W.3d 413 (Tenn. Ct. of App. 2003).


Defenses: Nontaxable Service
True Object Test

Utah

• Appeal No. 12-2455 (June 5, 2014). A Utah Administrative Law Judge upheld a sales and use tax deficiency resulting from the taxpayer’s data restoration and recovery services.

• The ALJ indicated that the taxpayer should have argued that charges were not taxable because the object of the transaction was the nontaxable service of preserving and protecting the customers’ data, and that the software was merely incidental to that service.

• The ALJ noted that private letter rulings discuss various internet based service charges, including PLR 07-013, which the ALJ explained “dealt specifically with the provision of data protection or back up services and based on the facts in that case found them to not be subject to tax.”

• The ALJ then provided an excerpt from an Initial Hearing Order, which provides citations and explanations of various private letter rulings involving the primary object test, so that “the Taxpayer is aware of Private Letter Rulings that were available.”
Defenses

Nontaxable Under Statutory Definitions of Pre-written Computer Software or Telecommunication Services
Defenses: Nontaxable Under Statutory Definitions

Michigan

  - In Michigan, tangible personal property includes “prewritten computer software,” which is defined as computer software that is delivered by any means.
  - The Department asserted that *Checkpoint*, an online tax and accounting research program that provides subscribers access to a wide collection of information, was taxable as prewritten computer software.
  - The Court of Appeals reversed the Court of Claims and held that sales of subscriptions to *Checkpoint* were not taxable as sales of tangible personal property.
  - The court applied the “incidental to service test” and found that, regardless of whether there was a transfer of tangible personal property, any such transfer was incidental to the service provided.
  - Application for leave to appeal pending at the Michigan Supreme Court.
Defenses: Nontaxable Under Statutory Definitions


  • The Michigan Court of Claims found that remote access software could not be taxed as “prewritten computer software” because there was no “delivery” of the software. Moreover, the court found that there was no “use” because Auto-Owners could only access the underlying software, it had no control over the software. Further, the court found that, even if it was prewritten computer software that was used by Auto-Owners, such use was incidental to the services provided by the third-party providers and therefore, would not be taxable.

  • Appeal pending at the Court of Appeals.
Defenses: Nontaxable Under Statutory Definitions

  - The Michigan Court of Claims held that an accounting firm’s subscription to an online tax and accounting research program (*Checkpoint*) was not taxable because (i) no software was “delivered” to the accounting firm, (ii) the accounting firm did not have sufficient control over the software for the use tax to be properly applied, and (iii) even if prewritten computer software was delivered and used by the accounting firm, such use was merely incidental to the services rendered through *Checkpoint* and would not subject the overall subscription charge to the use tax.
  - Appeal pending at the Court of Appeals.
Defenses: Nontaxable Under Statutory Definitions

  • Similar to the analysis in *Thomson*, *Auto-Owners*, and *Rehmann*, the Michigan Court of Claims found the services were not taxable because there was no “delivery” and no “use” of software.
  • The services provided were similar to those discussed in Colorado Private Letter Rulings Nos. PLR-15-001 and PLR-15-003.
  • The court noted that “[t]he Legislature is quite capable, as legislatures in other jurisdictions have done, of expressing a specific intent as to how web-hosted services and remotely accessed computer software and applications are taxed” and “[u]ntil then, the Court refuses to engage in the judicial extension of the scope of the [Use Tax Act].”
  • The court also held that the Department’s telecommunications service argument was without merit because the transactions “fit squarely within” the statutory exclusion for data processing and information services.
  • Appeal pending at the Court of Appeals.
Defenses: Nontaxable Under Statutory Definitions

- **Kansas**: Private Letter Ruling No. P-2015-001 (Mar. 25, 2015). The Department explained that retail sales of access codes, subscription cards, and point or dollar cards to remotely access software, virtual goods, and third party networks, from which digital content could be accessed or directly downloaded, were not taxable either on the initial sale or upon redemption because the sales were not for the delivery of prewritten computer software.
Defenses: Nontaxable Under Statutory Definitions

- New York: *Matter of Sungard Securities Finance LLC*, DTA No. 824336 (ALJ Feb. 6, 2014); (Tax. App. Trib. Mar. 16, 2015). The ALJ found that the taxpayer’s services were not sales of prewritten computer software because: (i) title and rights to the software remained exclusively with the taxpayer; (ii) the taxpayer did not transfer, sell or license its system to its customers in tangible or electronic form; (iii) customers did not have access to the software; (iv) customers could not modify the software in any manner; and (v) the services were only available during certain specific hours when the taxpayer’s employees were available.

- The ALJ noted that “[i]t would appear entirely inconsistent for one who purchases prewritten software, either outright or by license to use, to be limited in the hours during which it can access and use the same.”

- The Department also assessed tax on other services. Those portions of the assessment were upheld by the ALJ and the Tribunal. The Department did not appeal the ALJ’s determination regarding the taxability of its ASP services and therefore, the Tribunal did not address that issue.
Defenses: Nontaxable Under Statutory Definitions

- **Wyoming**: Computer Sales and Services (Jul. 1, 2014). The Department explains that:
  - Providing a platform where customers can access hosted software via an internet connection is not taxable provided the customer does not receive any tangible personal property or enumerated service embedded within the service;
  - Charges to access web hosted sites are not taxable because the site maintains control over the software and possession does not pass to the customer; therefore, a sale has not transpired since there is no transfer of possession or control of tangible personal property;
  - Online data storage fees are not taxable provided the host provider does not perform any data manipulation and does not have the ability to access individual computers in Wyoming for the purpose of alteration because, in order for a taxing event to occur, the sale, lease or service must transpire within Wyoming’s taxing jurisdiction and there must be an exchange of property or service for consideration.
Questions?

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