

MOVEFORWARD

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Cloud Computing and Digital Goods: What Are They and How Do You Tax Them?

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Goods, Services and Software

What's the difference?

- In a letter dated November 2, 2021, the American Bar Association Section of Taxation submitted comments to the Multistate Tax Commission regarding sales and use taxes in the context of digital goods and services.
 - *“In some circumstances, existing taxes on tangible personal property (or software) have been expanded legislatively and administratively to incorporate new forms of Digital Products. But Digital Products often bear little resemblance to tangible personal property (or software) as traditionally understood.”*

AGENDA

- Cloud Computing
- Digital Products and Services
- Sourcing
- Compliance Insights

CLOUD COMPUTING

What is cloud computing?

- A model for enabling on-demand network access to a shared pool of configurable computer resources without active management by the user
 - From the U.S. National Institute of Standards and Technology (“NIST”)
- Computer resources can include networks, servers, storage, applications, and services

How are cloud transactions structured?

- Parties involved:
 - User
 - Provider
 - Host (may be the provider)
- Aspects of structure:
 - Provider contracts with user for the use of the software
 - Provider may contract with host to house and maintain the software
 - User interacts with provider to access software and applications

Cloud service models

- Application Service Provider (“ASP”)
 - No delivery: access only to remote services
 - Provider hosts software for use by third parties
 - Provider may or may not own or license software
 - Users typically access the software via the internet
 - Users pay a subscription fee

Cloud service models

- Software as a Service (“SaaS”)
 - Provider puts its software applications on a cloud infrastructure, which it manages
 - User executes a service agreement and pays a subscription fee
 - Access is only through remote services
- Examples
 - Web-based email
 - Word processing applications
 - Digital photo applications

Cloud service models

- Platform as a Service (“PaaS”)
 - Provider makes its platform accessible to the user
 - User uses the platform to run its own applications
 - Provider manages the platform
 - User has control over the deployed applications and, potentially, the hosting environment configurations

Cloud service models

- Infrastructure as a Service (“IaaS”)
 - Provider provides processing, storage, and networking capabilities to user
 - User runs software and also, potentially, operating systems and applications
 - Provider manages the infrastructure
 - User controls operating systems, storage, and deployed applications
 - User pays a subscription fee and usually enters a service agreement

Deployment models

- Private
 - Operated for a single organization
- Public
 - Available to general public or large industry group
 - Owned by an organization that sells cloud services
- Community
 - Supports a specific community

How is software traditionally sourced?

- Depends on how it is delivered
 - Generally, states only tax prewritten software when it is delivered in the form of tangible personal property
- Trend towards states characterizing software as tangible personal property regardless how it is delivered
 - For example, by electronic delivery or through load and leave

How is software traditionally sourced?

- General sourcing rules
 - Over the counter: location of sale
 - Remote sales: destination (where the tangible personal property is shipped)
 - Multiple points of use: variation
 - Could be: tax the entire transaction, if shipped and/or billed in state
 - Or could be: tax nothing, if not shipped and/or billed in state
 - Or could be: reasonable apportionment

The state of state taxation of SaaS

- Taxable in 18 states and D.C.
- Not taxable in 18 states
- Lack of guidance in the remaining 9 states

Common issues

- Characterizing what is being sold
 - Tangible personal property? Service?
 - If software is TPP, is the developer a manufacturer for tax purposes?
 - Understanding how a business really works and aligning its products with the definitions in statutes and regulations
 - Lack of clarity in law and regulations and dearth of administrative guidance
 - Auditors often look to contract language

Common issues

- Nexus
 - Does a cloud provider have nexus in the states where its users access its products?
- How is it being delivered?
 - Electronic: accessed, delivered, or streamed?
 - Sent in tangible form?
 - Load and leave, or load and return?
 - Especially with IaaS or PaaS, is the transaction a service agreement for remote access to hardware or for the leasing of hardware?

Common issues

- Planning opportunities
 - Receive software and updates in electronic form, whenever practical
 - Be proactive in characterizing the transaction in underlying agreements
- Use-based exemptions
 - Manufacturing: where software used in the manufacturing process
 - Research and development: could be part of manufacturing exemption
 - High tech exemption

DIGITAL PRODUCTS AND SERVICES



What is a digital product?

- As defined by SSUTA, “Specified Digital Products” means electronically transferred:
 - Digital Audio-Visual Works
 - Digital Audio Works
 - Digital Books
- The term “transferred electronically” means obtained by the purchaser by means other than tangible storage media.
- Rights of Use / Conditions for Continued Payment
- Under SSUTA, tax treatment of a “digital code” shall be the same as the tax treatment of specified digital products. “Digital code” means a code, which provides a purchaser with a right to obtain a specified digital product or a product transferred electronically.
- Is Virtual Currency or Blockchain a Taxable Digital Product?

Characterization of sales

- Services
 - Digital automated services (Wash. Rev. Code 82.12.020)
 - Information services (NY Tax Law 1105(c))
 - Maintenance services (Connecticut Policy Statement 2006(8) (3/23/2007))
 - Data processing services (DC Code Ann. 47-2001)
- Under what circumstances will a sale be considered a sale of TPP?

Characterization of sales

- State Bar of Wisc. v. *Dep't of Rev.*, Dkt. 16-S-139 (Wisc. Tax. Comm'n 9/20/2019)
 - Although Wisconsin taxes digital audiovisual works, the Commission held that sales of digital CLE courses were not taxable because the true object was education, not a digital good.
- *J2 Cloud Services, Inc. v. Comm'r*, Docket No. C235426 (2/27/2019)
 - Cloud services and digital media company was taxable on its sales of eFax services as taxable telecommunications services.
- Texas Comptroller Dec. No. 114,952 (9/5/2019)
 - Taxpayer collected information for restaurant customers and produced customer reports. The Comptroller concluded this was a taxable data processing and information service.
 - See *also* Ind. Rev. Rul. No 2018-07ST (7/22/2019) (characterizing reports produced from information services as TPP)

Characterization of sales

- *Cincinnati Federal Savings & Loan Co. v. McClain*, slip op. No. 2022-Ohio-725 (Ohio Mar. 15, 2022)
 - The taxpayer, a bank, purchased computer services from a vendor. It claimed a refund on the sales tax it paid, contending that these constituted non-taxable professional services
 - The Tax Commissioner denied the refund, claiming that the services were taxable “automatic data processing and computer services,” and the Board of Tax Appeals agreed
- *Hegar v. Black, Mann, & Graham LLP*, No. 03-20-00391 (Tex. 2/25/2022)
 - The taxpayer, a law firm, purchased packages containing legal documents necessary to execute residential mortgage loans. It took the position that these purchases were nontaxable legal services
 - The court disagreed, finding that the purchases constituted data processing services, which are taxable

Characterization of sales

- New York NY-1 Life Healthcare ALJ #829434 (11/10/21)
 - Membership fees that granted access to web portal, mobile apps and digital content did not constitute taxable software.
- Rhode Island Ruling Request No. 2020-03 (12/29/2020)
 - The taxpayer hosted prewritten software that enabled customers to use the software to access real-time advertising data. The taxpayer argued that this constituted data processing and information services, which should not have been taxable. Because vendor-hosted prewritten computer software is taxable, the transactions were taxable notwithstanding how the software was used
- Ohio Tax Commissioner Opinion No. 20-0002 (July 1, 2020)
 - Provision of online panel and survey respondents for market research qualified as an electronic information service under R.C. 5739.01(Y)(1)(c).

Sourcing

How are sales of digital goods sourced?

- The SSUTA clarifies that a sale of a “digital good” is sourced in the same manner as a sale of TPP or service
- Under Section 310(A) of the SSUTA, the following hierarchy applies:
 1. If the product is received by the purchaser at a business location of the seller → business location;
 2. If the product is not received by the purchaser at a business location → location where receipt by the purchaser occurs (based on instructions for delivery);
 3. If (1) or (2) do not apply → location indicated by an address for the purchaser available from the seller’s business records;
 4. If (1), (2), (3) do not apply → location indicated by an address for the purchaser obtained during the consummation of the sale (including address for purchaser’s payment);
 5. If none apply → location is determined by the address from which the digital good delivered electronically was first available for transmission by the seller or from which the service was provided (disregarding any location that merely provided the digital transfer of the product sold)

How are leases of digital goods sourced?

- Under Section 310(B) of the SSUTA, the lease or rental of a “digital good” is sourced :
 1. For a lease that requires recurring payments, the first payment is sourced the same as a retail sale. Subsequent payments are sourced to the primary property location for each period covered by the payment, which is indicated by an address for the property provided by the lessee that is available to the lessor from its records maintained in the ordinary course of business.
 2. For a lease that does not require recurring payments, the payment is sourced the same as a retail sale.

Multiple points of use?

- SSUTA MPU Sourcing Provisions (Repealed 12-2006)
 - Permitted a business purchaser of digital goods and services concurrently used in multiple jurisdictions to apportion, self-assess and remit use tax in all jurisdictions in which the goods and services would be used
 - Generally, purchasers were allowed to use an apportionment method as long as it was reasonable, consistent and uniform and could be supported by their books and records. (e.g., Chicago Transaction Tax)
- Certain states continue to have SSUTA-style MPU sourcing
 - Washington: WAC §§ 458-20-15502 and -15503
- What’s the problem if a state does not allow MPU sourcing?
- Oracle USA, Inc. v. Comm’r, SJC-13013 (5/21/2021)
 - Taxpayer was entitled to apportion its sales of software that were sold to customers in multiple states even when the purchasers did not submit a “multiple points of use” certificate at the time of purchase.

Sourcing of other digital services

- Amusement Services (TX)
 - Texas sources local taxes of an electronic game amusement service transaction to where the service occurred, not to the seller’s place of business, which applies to the state tax. 34 Tex. Admin. Code § 3.298(k); Tex. Comptroller’s Decision, Hearing No. 114,493.
- Data Processing Services/Information Services (TX)
 - If service used to support a “separate, identifiable segment of customer’s business” → presumed to be used at location where that part of business is conducted
 - If that part of business is conducted at locations both within and outside the state → service is not taxable to the extent used outside Texas
 - To the extent use of service cannot be assigned to an identifiable segment of a customer’s business → service is presumed taxable at customer’s principal place of business (place trade or business directed or managed)

Compliance Insights



Bundled transactions

- What is the true object?
 - State Bar of Wisconsin v. Dep't of Revenue; Docket No. 16-S-139.
 - “True objective” of on-demand seminars offered by the State Bar of WI are exempt educational services, not a taxable “digital audiovisual work.”
 - Washington Dept. of Rev., Det. No. 15-0328R (2017)
 - Non-itemized charge for information technology and software support services subject to tax as taxable bundled transaction
 - Texas Private Letter Ruling No. 2017010120
 - When nontaxable, separately stated service provided with taxable service, only treated as nontaxable if the two services are unrelated
- Clarifying Taxability
 - Unbundled billing
 - Review/revise product descriptions in invoices, agreements, and terms of agreement
 - PLR/GIL?

Sale for resale

- Exempt if incorporated into a different digital good?
 - The sale of digital goods is for resale if subsequently sold, licensed, leased, broadcast, transmitted, or distributed, in whole or in part, by the purchaser to an ultimate consumer as an integral, inseparable component part of a digital good or any of the following services:
 - Telecommunications services;
 - Community antenna television services;
 - Enumerated services;
 - Certified competitive video services.

Income tax implications

- Does P.L. 86-272 apply to “digital products”?
 - Several SSUTA advisory states define “digital goods” as TPP.
 - Ex: Conn. Gen. Stat. § 12-407(a)(13); Co. GIL 17-013 (2017).
 - VA Tax Commissioner previously determined that cloud computing was protected by P.L. 86-272 as TPP. Virginia Ruling of Commissioner P.D. 16-135 (June 24, 2016).
 - Violate ITFA to not apply P.L. 86-272 to digital goods?
- Sourcing of receipts?
 - Income from TPP, intangible or service?

Questions? Thank you!

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