Morgan Lewis

STATE AND LOCAL TAX FOR TECH

Adam P. Beckerink
Matthew S. Mock
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Key State Tax Considerations in the Digital Economy

AGENDA

SECTION 01

STATE IMPACT OF FEDERAL TAX REFORM

Connection Between Federal and State Taxes

- Why does federal tax reform affect state corporate income taxes?
  - Almost all states start the computation of state corporate taxable income with federal taxable income.
    - Generally, either Line 28 or Line 30, subject to state-specific modifications.
      - Common corporate decoupling modifications include bonus depreciation, IRC Section 199 deduction.
- Thus, federal changes that affect computation of federal taxable income will affect state taxes if the state adopts the change.

State Conformity to the IRC

- States generally conform to the IRC in one of two ways:
  - "Moving" or "rolling" conformity states adopt the IRC as currently in effect for the tax year in question.
    - All federal changes will be automatically incorporated into the state's law unless a specific decoupling modification is enacted or the state changes its conformity to fixed.
- "Fixed-date" or "static" conformity states conform to the IRC as of a certain date.
  - For example, if a state conforms to the IRC as of January 1, 2015, the state does not adopt any federal tax changes that occurred after that date that would go into the computation of "federal taxable income".
  - The fixed-date states typically update each year.
- There are other states that update only periodically (e.g. CA) and/or adopt only certain sections of the Code (e.g., AR, CA, HI).

Mandatory Repatriation

What is it?

- Under TCJA, previously deferred foreign-source income must be considered to have been repatriated to the U.S. shareholder in 2017 (for a calendar year taxpayer).

How is this accomplished?

- Under section 965(a), deferred E&P (less certain E&P deficits) of each deferred income corporation will be allocated to each U.S. shareholder (with generally greater than 10% ownership) on a pro rata basis based on relative ownership.
- Deferred amounts to be included in each shareholder's income will be subject to a deduction under IRC Section 965(c) so that the effective federal tax rate on the deferred income will be lower.
- Repatriated amounts recognized as income under IRC Section 965(a) will be added to subpart F income under IRC Section 951(a)(1)(A), but they are not subpart F income as determined under or defined in IRC Section 952.

Mandatory Repatriation

What are the state issues?

- Does the state conform to the mandatory repatriation?
- Is any of the repatriated income included in the state tax base?
  - Does the state have an exclusion for Subpart F income?
  - Does the state (statutorily or by administrative guidance or practice) extend its foreign DRD to Subpart F income?
  - Is there any other means of excluding the income?
    - Foreign source income exclusion
    - State does not adopt Subpart F
    - Foreign Commerce Clause

Mandatory Repatriation

What are the state issues (cont'd)?

- How does the deduction to get the repatriated amounts to the lower rate affect state tax liability?
  - The amount of repatriated income to be included in a taxpayer's federal taxable income will reflect the DRD or participation exemption in IRC Section 965(c).
- What if all mandatory repatriation is excluded – will taxpayer get participation exemption deduction anyway (i.e., get a double benefit)?
  - If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?
  - If the income is included, will the state provide factor relief?

Foreign Commerce Clause Concerns

- ***Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992)**
  - Iowa included dividends paid by certain foreign subsidiaries in the state tax base, but excluded dividends paid by domestic subsidiaries; Iowa was a separate entity state.
  - Kraft alleged that the disparate treatment of foreign and domestic dividends violated the foreign commerce clause by favoring domestic business over foreign.
  - Supreme Court held for Kraft, saying that the disparate treatment of the dividends facially discriminated against foreign commerce.
    - Court found that the appropriate approach was not to compare the foreign dividend to a dividend paid by a domestic subsidiary doing business in Iowa (in which case the income would still have been taxed in the hands of the subsidiary), but to a dividend paid by a domestic subsidiary not doing business in Iowa (in which case the income would not have been taxed in the hands of the subsidiary).
    - The fact that Iowa conformed to federal treatment out of administrative convenience did not overcome the discrimination.

Foreign Commerce Clause Concerns

- ***In Re Tax Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).**
  - Taxpayer challenged Kansas' inclusion of dividends paid from unitary foreign subsidiaries in the apportionable income base of the domestic parent, arguing it violated the holding in *Kraft*.
  - Taxpayer conceded that all of its domestic and foreign subsidiaries operated as a single unitary business.
  - Kansas Supreme Court found that since Morton Thiokol (and all of its domestic and foreign subsidiaries) was a single unitary business, there were no domestic subsidiaries that were not doing business in Kansas and were not included in the Kansas return, as the analysis went in *Kraft*.
  - "In a combined filing state, such as Kansas, the hypothetical parent's tax base includes the combined federal taxable income of its combined domestic subsidiaries as well as dividends from foreign subsidiaries. We conclude there is no showing that this method is discriminatory under the holding in *Kraft*."

Global intangible low-taxed income - GILTI

What is it?

- Under the GILTI regime, earnings of certain CFCs that are considered "non-routine" are included on a current basis in the income of the U.S. shareholder of the subsidiary and taxed at a reduced rate, regardless of whether the amounts are actually paid to the U.S. shareholder.
  - GILTI will be treated "as if" it were subpart F for purposes of certain code sections, but it does not constitute subpart F income.

How is it accomplished?

- GILTI provisions found in new section 951A (which is in Subpart F).
- U.S. corporate shareholders are only eligible for a deduction under new IRC Section 250 in determining amount of GILTI subject to tax.
  - Deduction equals 50% for the tax years beginning after December 31, 2017 and ending before January 1, 2026.
  - Deduction reduced to 37.5% of GILTI for tax years beginning after December 31, 2025.

GILTI

What are the state issues?

- Does the state conform to new IRC Section 951A?
  - There are a few states that don't adopt Subpart F.

Is any GILTI included in the state tax base?

- Keep in mind that an exclusion for Subpart F income likely won't apply to GILTI and a state practice of extending the DRD to Subpart F likely won't operate to exclude GILTI.
- Is there any other means of excluding GILTI?
  - Foreign source income exclusion, or an exclusion for income included under IRC Sections 951 to 964.
- Foreign Commerce Clause
  - GILTI received from a foreign subsidiary cannot be treated less favorably than the state would treat similar income from a similarly-situated domestic subsidiary.

GILTI

What are the state issues (cont'd)?

- How does the GILTI deduction work for state purposes?
  - The amount of GILTI included in a U.S. shareholder's gross income under new IRC Section 951A will be subject to a deduction of a portion of GILTI under new IRC Section 250 (in the "Special Deductions" section of the IRC).
  - It is not yet clear, but it may be that the total GILTI will reflected on line 28 and the GILTI special deduction taken on line 29.
  - If there is an exclusion for GILTI, will the taxpayer still get the IRC Section 250 deduction?
- The same issue will present itself with the deduction being allowed under IRC Section 250 to reduce the tax rate on Foreign Derived Intangible Income (FDII).

100 percent bonus depreciation

What is it?

- Current bonus depreciation percentage under IRC Section 168(k) is increased from 50 percent to 100 percent for property acquired and placed in service after September 27, 2017, and before December 31, 2022.
  - The 100 percent expensing is phased down by 20 percentage points per calendar year beginning in 2023.

How is it accomplished?

- IRC Section 168(k), which is the current bonus depreciation statute, has been amended to allow for 100 percent immediate expensing.

100 percent bonus depreciation

What are the state issues?

- Does the state conform to IRC Section 168(k)?
  - A number of rolling conformity states have already decoupled from bonus depreciation.
- If the state doesn't conform to current bonus, how do they handle bonus and will this treatment apply to new 100 percent expensing?
  - *See e.g.*, Pennsylvania Corporate Tax Bulletin 2017-02, providing that the Commonwealth will not allow 100 percent bonus depreciation under IRC Section 168(k) for assets placed in service after September 27, 2017.

Limits on net interest deduction

What is it?

- TCJA disallows the deduction of net interest expense (excluding floor plan financing interest) to the extent it exceeds 30% of a taxpayer's adjusted taxable income (ATI).
  - There is an exception for taxpayers with an average of $25 million or less in gross receipts over the three prior years, certain real property businesses, farming businesses, regulated public utilities, and electric cooperatives.
  - Special rules for partnerships; indefinite carryover of disallowed interest.
  - Definition of ATI becomes narrower for tax years beginning on or after January 1, 2022, meaning a greater proportion of interest expense is likely to be disallowed.

How is it accomplished?

- IRC Section 163(j) has been amended to reflect the new interest limitations.

Limits on net interest deduction

What are the state issues?

- **Does the state conform to revised section 163(j)?**
  - How is the limitation computed for state purposes when the state and federal filing methodologies differ?
    - Prior IRC Section 163(j) included a statement that "all members of the same affiliated group (within the meaning of IRC Section 1504(a)) shall be treated as 1 taxpayer."
    - There is no such language in revised IRC Section 163(j).
- **Will state allow indefinite carryforward?**
  - How will the federal limits interact with state related party interest expense disallowance statutes?
    - The federal limits generally apply to all interest.
    - Not clear whether the character of the interest that deducted at the federal level is "related party" interest for state purposes.

State conformity to the IRC

State conformity is not always simple or clear and in 2018, states will likely not update as usual

- Idaho House Bill 355 (signed Feb. 9, 2018)
  - Updates the IRC to mean for taxable years beginning on or after the first day of January 2017, the IRC as in effect and amended on the twenty-first day of December 2017, except that IRC Sections 965 and 213 are applied as in effect on December 31, 2017.
  - Addback required for amounts deducted under IRC Section 965 and "other special deductions".
  - Two additional pending bills (House Bill 463 and House Bill 558) would address 2018
- South Dakota House Bill 1049 (signed Feb. 5, 2018)
  - For bank tax purposes, updates the state's conformity to the IRC as of January 1, 2018.

State conformity to the IRC

- Michigan House Bill 5420 (passed House Jan. 25, 2018)
  - Changes the definition of "internal revenue code" and defines it as the United States internal revenue code of 1986 in effect on January 1, 2018 or at the option of the taxpayer, in effect for the tax year.
- Oregon Senate Bill 1529 (signed Apr. 10, 2018)
  - Updates conformity to the IRC from December 31, 2016 to December 31, 2017.
  - Requires the addback of the IRC Section 965 deduction.
  - Creates a tax credit based on taxes paid from the tax haven legislation and applied against the Oregon tax from repatriated income.
  - Repeals the tax haven law for tax years 2017 and after.

State conformity to the IRC

- Virginia House Bill 154/Senate Bill 230 (enacted Feb. 23 & 22, respectively)
  - Adopts the IRC as amended on December 31, 2017.
  - No part of the Tax Jobs and Cuts Act applies, except for changes affecting the federal taxable income of individuals and corporations for tax years beginning after December 31, 2016 and before January 1, 2018.
- West Virginia House Bill 4135 (signed Feb. 21, 2018)
  - All amendments made to the laws of the United States after December 31, 2016, but prior to January 1, 2018, shall be given effect.
  - The amendments to this section enacted in the year 2018 are retroactive to the extent allowable under federal income tax law.

State conformity to the IRC

Other conformity bills

- Arizona House Bill 2647
  - Updates to the Code as of January 1, 2018.
- Florida SB 530
  - Updates to reflect the Code as of January 1, 2018.
- Georgia House Bill 821
  - Updates the IRC for tax years beginning on or after January 1, 2017 to mean the IRC as of January 1, 2018 except for certain enumerated sections.
  - Adopts 80 percent NOL limitation.
  - Provides that IRC Section 118 applies pre-tax reform.
  - No deductions will be allowed under IRC Section 965 if the income is subtracted.
  - Provides that the IRC Section 250 deduction shall be applied if the related income is included in Georgia taxable income.
- Georgia House Bill 918
  - Similar to House Bill 821, but clarifies that IRC Section 163(j) applies pre-tax reform.

State conformity to the IRC

- Maine Senate Paper 612
  - Would update the Code to refer to the IRC as amended through December 31, 2017 retroactively to January 1, 2017.
- Vermont House Bill 839
  - Updates Vermont's conformity to the statutes of the United States relating to the federal income tax, as in effect for taxable year 2017.

SECTION 02

NEXUS DEVELOPMENTS

Nexus
Constitutional Limitations on State Taxation

- **Nexus**: Nexus is a sufficient connection between a state and a taxpayer which allows the state to impose its taxing jurisdiction on that taxpayer.
  - Due Process Clause
  - Commerce Clause
- A state is not permitted to tax an entity unless the entity has a "substantial nexus" with the taxing state.
- The substantial nexus standard for sales and use tax purposes requires some type of physical presence in the taxing state. *See Quill Corp. v. N. Dakota*, 504 U.S. 298 (1992).
  - There is an ongoing debate as to whether physical presence is required for other tax types (e.g., net income, gross receipts, etc.).

Nexus
Constitutional Limitations on State Taxation

- **Due Process Clause**
  - Generally concerned with the fundamental fairness of the tax imposition.
  - Requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).
- **Commerce Clause**
  - Generally concerned "about the effects of state regulation on the national economy." *Quill Corp. v. N. Dakota*, 504 U.S. 298 (1992).
  - Four Part Test (*Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)).
    1) ***Substantial nexus with the taxing state;***
    2) Fairly apportioned;
    3) Does not discriminate against interstate commerce; and
    4) Fairly related to the services provided by the state.

Nexus
Physical Presence

- ***Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).**
  - Facts: Quill was a mail order retailer that delivered merchandise to North Dakota customers by mail or common carrier from outside North Dakota. Quill had no physical presence in the state (other than a few floppy disks).
  - The U.S. Supreme Court affirmed the bright-line "physical presence" standard it had previously established for Commerce Clause purposes with respect to a state's sales/use tax collection obligations.
    - An out-of-state seller must have a physical presence in the taxing state that is more than *de minimis* before the state may impose its sales and use tax collection obligation.
  - The U.S. Supreme Court expressly stated that physical presence is not required to satisfy the Due Process Clause.

Nexus

Physical Presence via In-state Software

- The in-state licensing of electronically-delivered software may, by itself, be considered physical presence sufficient to create sales and use tax nexus.
- **Texas Comptroller's Decision 106632 (Sept. 14, 2014).**
  - The Texas Comptroller of Public Accounts determined that electronically-downloaded software licensed by a Utah corporation to Texas customers constituted physical presence in Texas sufficient to establish sales and use tax nexus.
  - Nexus was established because the software was characterized as tangible personal property and the Utah corporation retained all property rights in the software, which was physically present and generating revenue in Texas.

Nexus

Physical Presence via In-state Software

- **Mass. Directive No. 17-1 (April 3, 2017).**
- Issued by the Massachusetts Department of Revenue to "explain the application of the general sales and use tax jurisdictional standard" to internet vendors. Asserts that:
  - Internet vendors are factually distinguishable from mail order vendors.
  - In-state software and "cookies" constitute in-state business activity & TPP.
  - Content Distribution Networks perform local activities "on behalf of" the internet vendor within the meaning of *Tyler Pipe*.
- A remote internet vendor is required to register, collect, and remit Massachusetts sales tax if, during the preceding calendar year:
  - It had more than $500,000 in Massachusetts sales; <u>and</u>
  - Made sales for delivery in Massachusetts in 100 or more transactions.
- **Effective July 1, 2017** (July 1, 2016–June 30, 2017 testing period).

Business Activity Taxes
Factor Presence Challenges

- ***Crutchfield, Inc. v. Testa, Slip Op. 2016-Ohio-7760 (Ohio Nov. 17, 2016);***
- ***Newegg, Inc. v. Testa, Slip Op. 2016-Ohio-7762 (Ohio Nov. 17, 2016);***
- ***Mason Co., Inc. v. Testa, Slip Op. 2016-Ohio-7768 (Ohio Nov. 17, 2016)***
  - CAT Factor Presence Nexus Standard:
    - $500,000 of annual gross receipts
  - Held:
    - "Quill's holding that physical presence is a necessary condition for imposing the tax obligation does not apply to a business-privilege tax such as the CAT."
    - The CAT's $500,000 nexus threshold is "an adequate quantitative standard that ensures the taxpayer's nexus with the state is substantial."

SECTION 03

INCOME TAX:
CLASSIFICATION & SOURCING

Income Tax - Classification

- Classification directly influences sourcing (also relevant for throwback).
- Tangible personal property vs. other than tangible personal property.
  - No clear definitions for income tax purposes.
- Lack of specific sourcing categories.
  - Few states address digital products/services (e.g., Nebraska and New York).
- Should guidance be sought in sales tax rules?
- What about federal income tax concepts?
  - IRC § 199 and others.
  - *Microsoft Corporation v. Franchise Tax Board*, 212 Cal. App. 4th 78 (Cal. 2012) (court looked to sales and use tax concepts and federal concepts under IRC § 936 to classify receipts from licenses to replicate and install software).

Income Tax – Sourcing

- Historically, sales of items other than tangible personal property were sourced to the state in which the greatest share of the costs of performance took place.
- Over the last several years, many states have transitioned, or are in the process of transitioning, to a market-based sourcing regime.
- Market-based sourcing regimes resemble destination-based sourcing regimes (generally applied to sales of tangible personal property).
- Current market-based sourcing regimes are widely divergent.
  - Location where benefit is received
  - Location of delivery
  - Location of primary use, etc.

Example

- Corporation A, with taxable nexus in all 50 states, provides cloud computing services (or "SaaS") to Corporation B for use in Corporation B's general business operations.
- Corporation B is headquartered in Illinois, where it has its only fixed place of business.
- Employees of Corporation B use A's cloud computing services in Illinois, New York and California. Corporation B has 300 employees in Illinois, 50 employees in New York (who work from home), and 50 employees in California (who work from home).
- A performs all of its services for B from Virginia (all of A's employees are located in Virginia).
- B entered into the contract in the ordinary course of business through its employees in Illinois.

How should A source its receipts from the provision of cloud computing services to B in California, Illinois, New York and Virginia?

Example – California

- Classification
  - California offers no guidance as to how SaaS is characterized for receipts factor purposes. It may be a service, a sale of intangible personal property, or a sale or lease of tangible personal property.
- Sourcing
  - California uses market-based sourcing for sales of services or intangibles
    - Receipts from services are California source to the extent that the purchaser receives the benefit of the services in California. [Cal. Rev. & Tax. Cd. § 25136(1)].
    - Receipts from sale of intangible property are generally California source to the extent that the intangibles are used in California. [Cal. Rev. & Tax. Cd. § 25136(2)].
  - Receipts from the sale, rental, or lease of tangible personal property are generally sourced to where the property is delivered. [Cal. Rev. & Tax. Cd. § 25135(a)].
  - If SaaS is characterized as a service or intangible, receipts are likely sourced to California to the extent of Corporation B's benefit or use in California. A reasonable way to measure benefit or use in California in this case may be to rely on employee data (50/400 employees or 12.5% of A's receipts from B should be sourced to California). See Cal. Code Regs. 25136-2(b)(1), Example (C); Cal. Code Regs. 25136-2(b)(2)(E).

Example – Illinois

- Classification
  - Illinois likely classifies SaaS as a service for receipts factor purposes. [Illinois Private Letter Ruling No. IT 14-0003-PLR, 04/04/2014].
- Sourcing
  - Illinois uses market-based sourcing for services.
  - Sales of services are Illinois-sourced if the service is "received" in Illinois.
  - However, gross receipts from services performed for a corporation may only be attributed to a state where that corporation has a fixed place of business.
  - If the state where the service is received is not readily determinable or is a state in which the corporate customer has no fixed place of business, then the service is deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's business. [ILCS § 5/304(a)(3)(C-5)(iv)].
  - Under this rule, because B has no fixed place of business in NY or CA, and it placed the order from its Illinois office in the regular course of business, 100% of the receipts from A's sales to B should be included in the numerator of A's Illinois sales factor.

Example – New York

- Classification
  - New York has a separate sourcing category for digital products, including SaaS. [N.Y. Tax Law, § 210-A(4)]
  - “Digital product means any property or service … delivered to the customer … through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media.… In addition, digital product includes computer software by whatever means delivered, including by physical media. The term ‘delivered to’ includes furnished or provided to or accessed by.” [Draft Reg. § 4-2.3(b)(9)].
- Sourcing
  - New York uses market-based sourcing for sales of digital products. [N.Y. Tax Law § 210-A(4)]
  - “A taxpayer must include a receipt in New York receipts when the digital product is primarily used by the taxpayer’s customer in New York. The primary use location is the location or locations where the customer derives the value from the digital product purchased from the taxpayer.” [Draft Reg. § 4-2.3(c)(1)].
  - “In the case where the taxpayer’s customer is a business, the primary use location is presumed to be in New York to the extent the taxpayer’s books and records kept in the normal course of business … indicate the customer’s use of the digital product is in New York.” [Draft Reg. § 4-2.3(c)(1)(ii)].
  - A’s receipts from B are likely sourced to New York to the extent of B’s use in New York. If A’s books and records are unclear, a reasonable way to measure use in this case may be to rely on employee data (50/400 employees or 12.5% of A’s receipts from B should be sourced to New York).

Example – Virginia

- Classification
  - Virginia may classify SaaS as from sales “other than sales of tangible personal property.”
- Sourcing
  - Sales other than sales of tangible personal property are Virginia sourced if (1) the income-producing activity is performed in Virginia, or (2) the income-producing activity is performed both in and outside Virginia and a greater proportion of the income-producing activity is performed in Virginia than in any other state. [Va. Admin. Code 10-120-230(A)]
  - Here, A incurs 100% of the costs of providing the services to B in Virginia. Thus, 100% of the sales should be included in A’s Virginia sales factor numerator.

Example – End Result

- Potential sourcing of A's receipts from B:
  - CA: 12.5%
  - IL: 100%
  - NY: 12.5%
  - VA: 100%
- Even among market-based sourcing states, results may be greater than 100%.
- Lack of guidance in sourcing context is both a pitfall and an opportunity.
- Consistency is not required on a jurisdiction by jurisdiction basis given the widely divergent approaches to sourcing

SECTION 04

SALES/USE TAX CLASSIFICATION & SOURCING

Sales and Use Tax - Classification

- Significance of Classification
  - Sales and use tax (SUT) is generally imposed on sales of tangible personal property (TPP), unless specifically exempt.
  - SUT is generally imposed only on specifically enumerated services.
- Trend: Numerous (yet generally unsuccessful) attempts by states to broaden the tax base to include more services.
- States are starting to issue guidance on whether mere access to computer hardware and remote access to software are subject to SUT.
- Although few states tax computer and data processing services, *per se*, some jurisdictions are attempting to classify online services involving remote access to software and/or hosting services as leases of TPP.

Sales and Use Tax - Sourcing

- Software as TPP
  - The traditional destination-based sourcing rules applicable to sales of tangible personal property can be difficult to apply in the digital goods/products context.
  - Where does delivery occur when software is accessed remotely?
- Trend: Source cloud/hosted software transactions based on user's location.
  - From a seller's perspective, user's location may be unknown.
- Issues arise with digital goods used concurrently in multiple jurisdictions ("MPU Transactions").
  - Should tax be paid to the state where the purchase is initially made?
  - Or, to the state (or states) where the software is eventually used?

Classification

Treatment of Cloud Related Items – Product or Service?

- Depending on the state, a cloud computing transaction may be deemed to fall into one of the following categories:
  - Software (canned v. custom);
  - Data processing or data storage service;
  - Information service (general v. proprietary);
  - Computer or other service;
  - Digital automated service – service transferred electronically that uses one or more software applications; or
  - Digital equivalent to traditional tangible personal property (i.e., digital goods).
- States generally look to the “true object” of the transaction.

Example 1: Sales/Use Tax Sourcing

- CubNation, Inc. is a company headquartered in Chicago, Illinois, where all of its product development and hosting is performed, with operations in Illinois, California and New York.
- CubNation provides hosted marketing services to clients that use email, direct mail and other marketing channels to reach their customers.
- CubNation's software platform and related services help clients evaluate their potential and existing customers.
- CubNation's software platform allows customers to take information that they accumulate on their customers and prospects and apply search criteria against that information to derive a list of targeted recipients for its email campaigns.
- **What are the sales/use tax implications of this transaction?**

Example 1: Sales/Use Tax - Response

- Illinois would not tax the sale of CubNation's software platform. Information or data that is electronically transferred or downloaded is not considered the transfer of tangible personal property in Illinois. See 86 Ill. Adm. Code 130.2105(a)(3).
  - Chicago would assess its lease transaction tax on the sale of CubNation's software platform. See Transaction Tax Ruling #12.
- California does not tax the sale of prewritten software if it is delivered electronically (i.e., no tangible property transferred).
- New York taxes the sale of prewritten software regardless of delivery method and the sale of information services, subject to an exception for individualized reports. Does the customer get access to use the software? Or just a report?

Example 2: Sales/Use Tax Sourcing

- Cheesehead, Inc. is a company headquartered in California with operations in California and Wisconsin.
- Cheesehead purchases prewritten software from CodeKing, Inc. for $100, and CodeKing delivers the software electronically to Cheesehead in California.
- Cheesehead uses the software in its facilities in California and Wisconsin, transmitting the software to Wisconsin electronically.
- Each facility in California and Wisconsin has the same number of employees using the software.
- **What are the sales/use tax implications of this transaction?**

Example 2: Sales/Use Tax - Response

- California does not tax the sale of prewritten software if it is delivered electronically (i.e., no tangible property transferred).
- Wisconsin would assess its use tax on this transaction on the *full sales price of the software ($100)*, even though Cheesehead used the software in both states equally.
  - No credit available because California sales tax was not imposed
- **Result: Taxed in Wisconsin (Use Tax)**

Example 2A: Sales/Use Tax Sourcing

- Same facts **EXCEPT** the software was delivered in California on a disk. **What is the sales/use tax result?**
  - Cheesehead, Inc. is a company headquartered in California with operations in California and Wisconsin.
  - Cheesehead purchases prewritten software from CodeKing, Inc. for $100, and CodeKing delivers the software to Cheesehead in California using a disk.
  - Cheesehead uses the software in its facilities in California and Wisconsin, transmitting the software to Wisconsin electronically.
  - Each facility in California and Wisconsin has the same number of employees using the software.

Example 2A: Sales/Use Tax Sourcing - Result

- California taxes the sale of prewritten software if it is delivered with tangible property (e.g., on a disk).
- Wisconsin would attempt to assess its use tax on this transaction on the *full sales price of the software ($100),* even though Cheesehead used the software in both states equally.
  - However, Cheesehead may claim a credit for California sales taxes paid.
- **Result: Taxed in California (9%); no use tax due to Wisconsin (5.5% rate).**

Example 2B: Sales/Use Tax Sourcing

- Same facts EXCEPT the software was delivered in California on a disk AND
  1. The software was copyrighted by CodeKing;
  2. In a written agreement, CodeKing granted Cheesehead the right to copy the software; and
  3. Cheesehead uploaded the software to its equipment in California and Wisconsin that relied on the software to produce precisely cut, cheese-related products.
- What is the sales/use tax result?

Example 2B: Sales/Use Tax Sourcing - Result

- Assuming that the arrangement is a Technology Transfer Agreement ("TTA"), then California would only impose sales tax on the value of the blank disk that was used to deliver the software.
  - Wisconsin would still likely assess use tax on the value of the software used in Wisconsin (less CA credit).
- A TTA is an agreement under which "a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." CRTC §§ 6011(c)(10)(D); 6012 (c)(10)(D).
  - In a TTA, sales tax is on the tangible property transferred, not the intangible property transferred.

SECTION 05

SALES TAXATION OF DIGITAL GOODS AND SERVICES

Overview – State and Local Governments Take the Lead

- Sales of Prewritten Software
  - 32 states and the District of Columbia tax electronic sales and deliveries of prewritten software, while 13 states exempt such sales.
- Sales of Software as a Service (SaaS)
  - States are inconsistent with respect to their treatment of sales of Saas.
  - In most states, the taxability of SaaS is either decided administratively or through judicial interpretation.

Overview – State and Local Governments Take the Lead

- Sales of Digital Products
  - 26 states tax sales of digital products.
  - 19 states exempt sales of digital products.
  - In 2015, Chicago became the first municipality to tax streaming content.
  - Several California localities have considered taxing streaming content.

Nexus

Physical Presence via In-state Software

- The in-state licensing of electronically-delivered software may, by itself, be considered physical presence sufficient to create sales and use tax nexus.
- **Texas Comptroller's Decision 106632 (Sept. 14, 2014).**
  - The Texas Comptroller of Public Accounts determined that electronically-downloaded software licensed by a Utah corporation to Texas customers constituted physical presence in Texas sufficient to establish sales and use tax nexus.
  - Nexus was established because the software was characterized as tangible personal property and the Utah corporation retained all property rights in the software, which was physically present and generating revenue in Texas.

Nexus
Physical Presence via In-state Software

- **Mass. Directive No. 17-1 (April 3, 2017).**
- Issued by the Massachusetts Department of Revenue to "explain the application of the general sales and use tax jurisdictional standard" to internet vendors. Asserts that:
  - Internet vendors are factually distinguishable from mail order vendors.
  - In-state software and "cookies" constitute in-state business activity & TPP.
  - Content Distribution Networks perform local activities "on behalf of" the internet vendor within the meaning of *Tyler Pipe*.
- A remote internet vendor is required to register, collect, and remit Massachusetts sales tax if, during the preceding calendar year:
  - It had more than $500,000 in Massachusetts sales; <u>and</u>
  - Made sales for delivery in Massachusetts in 100 or more transactions.
- **Effective July 1, 2017** (July 1, 2016–June 30, 2017 testing period).

Classification

What is a Service/Software?

- Significance of Classification
  - Sales and use tax ("SUT") is generally imposed on sales of tangible personal property ("TPP"), unless specifically exempt.
  - SUT is generally imposed only on specifically enumerated services.
- Historically, very few states enacted broad-based SUTs applicable to most services.
- Recently, there have been numerous (yet generally unsuccessful) attempts by states to broaden the tax base to include more services.
- States are starting to issue guidance on whether mere access to computer hardware and remote access to software are subject to SUT.
- Although few states tax computer and data processing services, per se, some jurisdictions are attempting to classify online services involving remote access to software and/or hosting services as leases of TPP.

Classification

Treatment of Cloud Related Items – Product or Service?

- Depending on the state, a cloud computing transaction may be deemed to fall into one of the following categories:
  - Software (canned v. custom);
  - Data processing or data storage service;
  - Information service (general v. proprietary);
  - Computer or other service;
  - Digital automated service – service transferred electronically that uses one or more software applications; or
  - Digital equivalent to traditional tangible personal property (i.e., digital goods).
- States generally look to the "true object" of the transaction.

Taxability of Digital Goods & Services

- Prewritten Computer Software
  - Taxed as TPP virtually everywhere when delivered via tangible medium.
  - Taxed as TPP in many states when delivered electronically.
    - E.g., New York and New Jersey
- Modified Prewritten Computer Software
  - Some states treat the sale entirely as a sale of TPP or as a service.
  - Some states (e.g. New York) allow the transaction to be split between a taxable sale of TPP and a non-taxable service.

Taxability of Digital Goods & Services

- Software-as-a-Service (SaaS): service provider hosts prewritten software on servers that user does not control.
  - Some states explicitly tax SaaS.
  - Some states tax SaaS only when it falls within one of the enumerated categories of taxable services.
    - See, e.g., New Jersey (sales tax on information services includes legal research databases); N.J.S.A. 54:32-B-3; TB-72.
- Infrastructure-as-a-Service (IaaS): service provider owns, maintains, operates, and houses equipment used to support customer's operations.
- Platform-as-a-Service (PaaS): contains elements of SaaS and IaaS.

Taxability of Digital Goods & Services

- **Michigan Cases**: Michigan Courts held that the sale of SaaS did not constitute the sale of taxable prewritten computer software.
  - *Auto-Owners Ins. Co. v. Dep't of Treas.*, No. 321505 (Mich. Ct. App. 2015).
- The Michigan Department of Treasury issued a notice regarding Auto-Owners dated January 6, 2016.
  - Treasury will follow *Auto-Owners* for all open years as follows:
    - No tax if no delivery of the code that enables the program or system to operate.
    - Electronic delivery of a portion of a software program requires application of the "incidental to service" test to determine whether the transaction constitutes the rendition of a nontaxable service rather than the sale of tangible personal property.
    - If a software program is electronically downloaded in its entirely, it will be taxable.

Taxability of Digital Goods & Services

- **Chicago**
  - Chicago has taken the position that the Personal Property Lease Transaction Tax ("Transaction Tax") applies to non-possessory computer leases as well as to software transactions that qualified as exempt under Illinois law.
  - Transaction Tax Ruling #12 (7/1/2015, effective 1/1/2016) provides examples of taxable transactions.
    - Effective January 1, 2016
      - A reduced Transaction Tax rate of 5.25% (rather than 9%) will apply to cloud products such as PaaS, IaaS, and SaaS.
      - A qualifying "small new business" will be exempt from the Transaction Tax on its sales or purchases of nonpossessory computer leases.

Sourcing of Digital Goods & Services

- Software as TPP
  - The traditional destination-based sourcing rules applicable to sales of tangible personal property can be difficult to apply in the digital goods/products context.
  - Where does delivery occur when software is accessed remotely?
- Trend: Source cloud/hosted software transactions based on user's location.
  - From a seller's perspective, user's location may be unknown.
- Issues arise with digital goods used concurrently in multiple jurisdictions ("MPU Transactions").
  - Should tax be paid to the state where the purchase is initially made?
  - Or, to the state (or states) where the software is eventually used?

Sourcing

Multiple Points of Use Transactions

- What states are doing about MPU transactions:
  - Many states not only permit allocation or apportionment of the sale/use tax base, but require it.
  - State statutes and regulations often do not provide a specific answer/approach, but instead provide for a "range" of acceptable answers.
  - Auditors may hopefully look for a sensible approach that assigns sales to locations where the service is being "received".
- Practice Tips
  - When allocating or apportioning the sales/use tax base, develop a sensible and uniform approach.
  - Uniform does not mean that all transactions are equal, but rather that a particular type of transaction should be allocated in the same manner to each state (unless a particular state has a different sourcing regime).

Sourcing

Multiple Points of Use Transactions (examples)

- **Washington (Wash. Admin. Code 458-20-15502(11))**
  - A business claiming an MPU exemption must report and pay use tax on that portion of the prewritten software used in Washington.
  - The taxable amount is determined based on the number of users in Washington compared to the number of users everywhere.
- **Minnesota (Miss. Stat. § 297A.668, Subd. 6a)**
  - A business purchaser that has not received a direct pay permit may use an exemption certificate indicating multiple points of use if:
    - The purchaser knows at the time of its purchase of a digital good, computer software delivered electronically, or a service that the good or service will be concurrently available for use in more than one taxing jurisdiction; and
    - The purchaser delivers to the seller the exemption certificate indicating multiple points of use at the time of purchase.

SECTION 06

ESCHEAT: WALLETS AND CRYPTOCURRENCY

Unclaimed Property Basics

- State law requires that companies report and pay unclaimed property after a certain amount of time, usually 3-5 years (a “dormancy” period)
- The US Supreme Court has explained the rules for deciding which state gets escheat of unclaimed property:
  - First priority rule: State of the owner’s last-known address
  - Second priority rule: If holder’s records do not disclose, property is subject to the laws of the holder’s domicile, e.g., state of incorporation

  See Texas v. New Jersey, 379 U.S. 674 (1965).
- Unclaimed property as a source of significant state revenues took off in the last 20 years with the rise of novel consumer programs like rebates and gift cards

Unclaimed Property and Payment Solutions

- Wallets and novel payment solutions present unclaimed property challenges
- Example: HipCo Inc pays independent sales associates with stored value cards
  - The stored value cards are issued by CardCo Inc, a 3rd party service provider
  - HipCo funds the cards and pays CardCo a service fee
  - Associates use the cards to activate a virtual “wallet” on CardCo’s website
  - Once activate, cash is made available to associates through an account with BestBank
- What property type is this, payroll, stored value cards, bank accounts?
- Who is the statutory “holder” of the funds, i.e., who is obligated to associates?
- How does this interact with money transfer rules?

Cryptocurrency and Escheat

- Cryptocurrencies present unique escheat challenges
- States should be expected to take the position that cryptocurrency is unclaimed property under state "catch-all" provisions as intangible property
- The 2016 Revised Uniform Unclaimed Property Act (RUUPA) expressly provides for the escheat of "Virtual Currency"
  - Illinois, Tennessee, Utah, and Kentucky have adopted this provision of RUUPA
- What type of property are cryptocurrencies, securities, commodities, accounts?
- It is unclear how a holder would remit cryptocurreny to the state
  - Liquidate cryptocurrency and transfer cash?
  - Send the cryptocurrency in its native format?
- An exchange or wallet provider may not have the right or ability to transfer

Cryptocurrency and Escheat

- On March 2, 2018, plaintiffs filed a class action lawsuit against cryptocurrency exchange Coinbase alleging violation of California's Unclaimed Property Law. *Faasse v. Coinbase Inc.*, 4:18-cv-01382, U.S. District Court, Northern District of California (Oakland)
  - Coinbase allows users to email cryptocurrency via a link and instructions for creating Coinbase accounts to access the cryptocurrency
  - Plaintiffs allege certain recipients did not create accounts and claim the cryptocurrency
  - The complaint further alleges Coinbase failed to escheat the cryptocurrency to California
  - Plaintiffs are asking that unclaimed cryptocurrency be awarded to the recipients, or escheated to California

THANK YOU