



State of confusion: Sales and use tax in an electronic world

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***Is your company
involved in transactions
using the Internet?***

- > **Nexus**
- > **Cloud computing**
- > **Digital products and SSUTA**
- > **Amazon.com update**
- > **Agency/Affiliate nexus**
- > **U.S. Value Added Tax and E-commerce**
- > **Questions and comments**

Nexus

Where the trouble begins

The legal, economic, or physical connection between a business and a state that allows a state to impose sales, income, franchise, or other taxes on a business enterprise

(Translated: Register, file a return, and pay tax!)

- > Nexus has many facets, with the rules varying by:
 - > Type of tax
 - > Industry
 - > State
- > Disagreement on the scope of state taxing powers

- > Does an entity have sufficient contact with a state to generate nexus?
- > Should a return be filed?
- > Are there limitations on state/local power to impose tax?
- > States have become more aggressive in asserting nexus for out-of-state (non-domiciliary) businesses

- > Direct taxes on business, e.g., net income and net worth generally have a different nexus standard than sales and use tax
- > Standards for sales and use tax
- > *Quill Corp. v. North Dakota* - 1992 landmark U.S. Supreme Court sales tax case
 - > Could North Dakota assert its taxing power over an out-of-state retailer that conducts all transactions remotely?

Physical presence test



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- > North Dakota argued that Quill had “economic presence”
- > Court ruled Quill must have “physical presence” to meet substantial nexus test of the Commerce Clause of the U.S. Constitution
- > Examples of substantial nexus - Property in the state, visits by sales persons, activities of third-party representatives

- > Federal action to repeal *Quill*
- > “Click-through” or *Amazon.com* nexus
- > Affiliate nexus
- > Agency nexus
- > Other - Colorado’s “big brother” sales tax reporting rules

Why care about nexus?



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- > Unlimited statute of limitations for non-filers
- > Delinquent interest
- > Failure to file and negligence penalties
- > Financial impairment (FAS 5) and potential “due diligence” problems

Cloud Computing

*Software as a Service (SaaS),
ASP software, and related
IT services*

What the heck is the cloud? - *Larry Ellison, Oracle CEO*

- > Companies with fewer than 100 employees expected to spend \$2.4 billion on cloud computing services in 2010
- > 80% of large business enterprises investigating or implementing a cloud computer application
- > How should “cloud” be treated in multistate sales and use tax environment?

Examples



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- > Google apps and docs
- > Salesforce.com - CRM software
- > Dropbox - File storage
- > Amazon Elastic Computer Cloud - Synchronization, back-up, and utility computing
- > Box.net - Workspace for file sharing and collaboration

- > Hosted software application(s) delivered over the Internet
- > Application available on demand
- > Managed by software provider, e.g., security, upgrades, and file storage
- > User typically needs only computer and Internet connection
- > Priced via a licensing agreement or user fees, e.g., by minute, hour, or application

“Host” of issues



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- > Nexus standards - Quill, agency/affiliate, economic?
- > Defining the tax base - Tangible personal property (TPP), digital product, service, or intangible?
- > Taxable situs of the transaction
- > Local taxes

Cloud computing applications

- > Few states have ruled on their nature
- > Do not neatly fit in the Sales & Use Tax Agreement (SSUTA) framework as a “digital product”
- > SaaS application is TPP (according to New York)
- > Not part of the sales and use tax base (in states where services not taxed)
- > Bundled services and software?

Sourcing - A nightmare?



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Server location

Seller location

Customer location

Customer billing address

New York - SaaS

Constructive possession



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- > Taxable even without delivery of the system
 - > Deemed to be constructively received in New York
- > *On Demand ASP Software* ((TSB-A-08(62)S), November 24, 2008)
 - > Allows a customer to upload an image onto the petitioner's servers and manipulate the image to show various colors and views
 - > Resides on servers located outside New York
 - > Held: Taxable license to use software

New York - SaaS

Constructive possession



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- > Use of out-of-state payroll processing service
 - > Taxable without delivery of software
 - > Deemed to be constructively received in New York
- > *National Football League* ((TSB-A-09(37)S), August 25, 2009)
 - > Related to a software product allowing a customer to upload payroll data to a server in Michigan
 - > Held: Taxable - The location of the code is irrelevant because the software can be used without a download
 - > Service component nontaxable

Tower Innovative Learning Solutions (TSB-A-06(5)S (February 2, 2006)) - Online educational services

- > Taxpayer provided software to customers for professional development skills upon completion of the Internet course
- > Awarded a certificate of completion from a learning subsidiary of Cornell University
- > Academic support (hosting online discussions) offered as a service
- > Held: Nontaxable - Rationale was that the students' *primary objective* was to attend a course of study, not purchase software

MindLeaders, Inc. (TSB-A-09(2)S (January 21, 2009))

- > Company provided “real-time, interactive, Web-based training and educational services”
- > Customers received a certification; separate charges for the online course and for live, online mentoring.
- > Held: Taxable - The charge to participate in the course was taxable because the transaction constituted the sale of prewritten computer software

Licensed software to in-state user creates compliance requirement

- > Minnesota software licensor had no physical presence in Texas
- > Nexus arises from licensor's in-state presence of software (TPP) hosted on a server in Texas, even where license fees are generated outside of Texas

Washington

Remote access software



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- > 2009 ESHB - Clarified application of Washington sales and use tax to digital products
- > Remote access software (RAS) included as taxable
- > RAS defined as prewritten software provided remotely
 - > Buyer pays for the right to access and use the software that resides on the seller's or a third party's server
 - > Example: ASP software vendor
- > SSUTA sourcing rules apply

- > Missouri - Ruled that a sale of software hosted on out-of-state servers is not subject to sales or use tax when accessed from an in-state location (*Missouri Dept. of Rev., Letter Ruling No. LR5753, July 16, 2009*)
- > Utah - Hosted software is taxable based on the location of the server; SaaS is taxable if accessed by a resident from a Utah server (*Utah State Tax Comm., PLR Opinion No. 09-003, April 7, 2009*)

- > Monitor and control nexus footprint - Physical presence is still the overriding rule
- > Examine the software/service contract carefully - License or service agreement?
- > Situs - Can transaction be sourced in a nontaxable jurisdiction, e.g., Oregon?
- > Unbundle mixed transactions by separately invoicing taxable and nontaxable portions

- > Does the customer receive a copy or have access to the software?
- > Who is using the software? (i.e., seller provides service or seller licenses software to purchaser)
- > Pay attention to language in sales contract
- > Be careful how the product/service is marketed
- > Selling software or expertise? (i.e., primary purpose of transaction)

Digital products and SSUTA

- > Growing state attempts to tax remote sellers
- > Purchases of electronic goods, e.g., music and video downloads, pictures, books, ringtones, and computer applications
- > Estimated state and local sales tax lost to remote sellers: \$12 billion per year by 2012 (digital and other goods and services)
- > Intertwined with questions about hosted software - Nexus, tax base, and sourcing

- > Most state sales and use tax regimes designed to tax TPP
- > Digital goods do not meet definition of TPP - Intangible property, service, other?
- > Streamlined SSUTA - Dodged statutory problems by coming up with a special class of property termed “digital products”

- > Mode of delivery comes into play
 - > Hard copy - Taxable
 - > Via Internet or telephone - Exempt in some (California) but not all states
- > Differing tax treatment among types of digital products, e.g., software v. music
- > “Bundling”
 - > How transaction is invoiced can affect tax treatment
 - > If mixed transaction but billed as lump sum, likely all will be treated as taxable

Sourcing - A challenge



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- > If downloaded, tax situs is generally at location where digital product is received
- > If site where received cannot be determined, alternate conventions apply, e.g., customer billing address, where seller transmits the digital product, etc.

- > 27 states have adopted SSUTA in some form (Please visit the [Streamlined Sales Tax Governing Board, Inc. Web site](#) to see the latest listing of states.)
- > Pioneered the taxation of digital property
- > Provides expansive definition of “digital products”
- > Formulated a common set of tax base definitions, sourcing rules, documentation standards, and compliance methods
- > Goal is uniformity among states
 - > Governing board resolves definitional questions
 - > Many issues have yet to be addressed

- > Software is handled separately with prewritten software treated as taxable; separately stated software modifications are exempt in some states
- > Sourcing for digital products generally where buyer receives them
- > Mode of delivery does not impact taxability

- > SSUTA Governing Board continues to pursue federal legislation overturning *Quill* decision
- > HR 3396: Sales Tax Fairness and Simplification Act - Would confer authority on states to assert sales tax nexus based on “economic” presence
- > States seeking power to impose sales tax on remote sellers
- > Congressional view - Expansion of state taxing powers contingent on SSUTA goals of membership, simplification, and uniformity

- > 2009 Act 2 imposed sales and use tax on digital goods
- > Established conformity with SSUTA
- > Effective October 1, 2009
- > Includes “versions of products that have historically been produced and transferred as articles of tangible personal property that are now produced and transferred electronically as digital files”

- > Wisconsin Department of Revenue
 - > Stated that it is not necessary for a digital good to have a tangible counterpart to be considered a “digital good”
 - > Interpreted new law in Publication 240
- > Sourcing rules - Pub. 240, Sec. IV

- > Exemptions may apply to digital goods - Consumed in manufacturing, farming, newspapers and periodicals, nonprofits, etc.
- > Questions remain - SaaS?
- > Data storage, back-up, and other IT charges not covered by Act 2 changes and remain nontaxable

North Carolina - 2009 G. S. 105-164.4(a)(6b), effective January 1, 2010

- > Imposed sales and use tax on digital property. Defined to include:
 - > Audio works
 - > Audiovisual works
 - > Books, magazine, newspapers, other publications
 - > Photographs and greeting cards
- > Does not apply to information services

- > Colorado - HB 1192 as enacted defines standardized software as taxable TPP
- > Minnesota - Adopted SSUTA but does not tax all digital products, e.g., books, reference materials, and business forms
- > Washington - Broad taxation of digital goods
- > Vermont - Digital goods taxable under state telecommunication services definitions

Amazon.com update

If your company sells products or services over the Internet, does it have a commission arrangement with a Web site provider like Amazon.com?

- > Amazon.com - Click-through nexus
- > Concept originated by New York
- > Presumption - A seller that makes taxable sales of TPP or services in a state has nexus when a state resident's Web site clicks through potential customers to the seller
- > Rationale - Link on the Web site in New York creates a physical presence for the seller when the owner of the Web site is a resident of New York and acts as a sales agent for the seller

- > California
 - > Amazon.com legislation deleted from February 2010 budget repair package
 - > Created use tax reporting requirements
- > Colorado - Proposed but enacted something else
- > Hawaii - Similar bill vetoed by governor
- > North Carolina - S.B. 202 passed and signed into law
- > Rhode Island - H.B. 6164 passed and signed by governor
- > Introduced: Connecticut, Maryland, Minnesota, Tennessee, and Virginia

Colorado

Aggressive new rules



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- > Notification requirements - Every retailer that sells to Colorado customers without collecting Colorado sales tax (regardless of nexus)
- > Notification required on **each invoice**
- > Annual notices to purchasers (January 31)
- > Annual notices to Colorado Department of Revenue (March 1)
- > Penalties - \$5 **per invoice** violation
- > Penalties - \$10 **per annual notice** violation

Colorado

Aggressive new rules



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- > Took effect March 1, 2010
- > Grace period - March 1 to April 30, 2010
- > Waive interest and penalties ONLY if noncollecting retailer begins to provide notices by May 1, 2010
- > Exemption - Companies with less than \$100,000 in total gross receipts are exempt from notification requirements

California

New use tax requirements



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- > First report due April 15, 2010
- > Affects qualified purchasers
 - > At least \$100,000 in total gross receipts (within and outside of California)
 - > Not required to hold a seller's permit or certificate of registration for use tax
 - > Not a holder of a use tax direct payment permit
 - > Not otherwise registered with Board of Equalization to report use tax

California

New use tax requirements



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- > Mostly impacts service providers, i.e., law firms, medical offices, accounts, and other professionals operating in California
- > California automatically registered and sent “welcome letters” to approximately 180,000 individuals and businesses
- > **REMEMBER:** Use tax is NOT a new tax; the registration and reporting requirements are NEW

- > Amazon.com “laws” are viewed as a challenge to SSUTA. They achieve some of the same goals without adopting SSUTA-mandated uniformity
- > National Conference of State Legislatures task force
 - > Approved formal opposition to state efforts that force remote sellers to collect sales tax
 - > Concerned they will “undermine the streamlined sales tax push and efforts for a national bill”

Agency/Affiliate Nexus

***Does your company have
affiliates doing business in
other states?***

- > Agency nexus - Sales tax connection established by activities of another person acting on behalf of a retailer, i.e., an agent
- > Affiliate nexus - Retailer has sales tax filing responsibilities due to the presence or activities of a related company
- > Concepts are sometimes used interchangeably
- > Under both, nexus is asserted against a business without a direct physical presence within a state

New York trademark nexus created when:

- > A retailer with nexus in New York uses a trademark, service mark, or trade name in New York that is the same as that used in the state by a remote affiliate
- > A New York affiliate engages in activities in New York that benefit the remote affiliate in its development or maintenance of a market for its goods or services in New York

Colorado

New rules for affiliates



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- > Nexus presumption - Remote retailers that are part of a controlled group with a physical retail presence in Colorado
- > Nexus presumption - Creates requirement to collect sales tax as of March 1, 2010
- > Presumption can be rebutted; burden on taxpayer

Wisconsin Affiliate nexus statute



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- > Effective July 1, 2009
- > Expands definition of retailer engaged in business in the state to include any person with an affiliate in Wisconsin, if:
 - > Person is related to affiliate
 - > Affiliate uses facilities or employees in Wisconsin to advertise, promote, facilitate, and establish a market
 - > Provide services to related entity, e.g., accepting merchandise returns, resolving customer complaints, etc.
 - > Related means 50% or more ownership using IRC 318 stock attribution rules

Barnesandnobel.com LLC v. State Board of Equalization (CA 2007)

- > Out-of-state Internet retailer without physical presence in California found not to have nexus due to the activities of a sister corporation that operated stores in the state
- > Distribution by stores of a shopping bag with Internet seller's logo and coupons did not constitute an agency relationship
- > Commerce Clause requirement for substantial nexus was not met

South Carolina Online travel companies



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- > Facilitate hotel selection and reservation process for travelers through an Internet-based search and booking process
- > Do not book or resell rooms but negotiate a price (wholesale rate)
- > Collect the price of the rooms from buyers, including service fee and applicable sales and occupancy taxes
- > Pay the money to the hotel owner/operator net of fee; owner/operator remits taxes to proper revenue agencies

Travelscape, LLC, Petitioner v. South Carolina Department of Revenue, 08-ALJ-17-0076-CC

- > Commerce Clause requirement of substantial nexus was met and physical presence was established through connections with hotels
- > Administrative law court held that Expedia.com was liable for South Carolina sales tax on the full price of rooms charged to customers
- > Definition of gross receipts included Expedia's facilitation fee
- > Occupancy tax on 100% of customer room charge also sustained

U.S. Value Added Tax and E-commerce

Value added taxes - Why care?



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- > U.S. businesses increasingly sell goods and services into international markets
- > More than 130 countries impose some type of Value Added Tax (VAT)
- > Massive federal budget deficits projected suggest a U.S. VAT may be in store
- > VAT has been mentioned as a supplemental funding mechanism for Social Security, Medicare, and national health care

Value added taxes - Why care?



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- > Congressional Research Service estimated that a broad-based U.S. VAT would have generated \$8.8 trillion in 2008
- > 57% of senior business executives believe a U.S. VAT is likely to be adopted within 5 years (KPMG survey)
- > Identified VAT as an option to reform the U.S. tax system, October 2009 (AICPA Report on Tax Reform Alternatives for the 21st Century)

- > Focus on European Economic Community (EEC) for convenience
- > Average VAT rate - 19.8% in 2009
- > VAT registration - A function of having a business presence or being an importer of record
 - > Remote sellers must exceed floor of sales to a country, the distance threshold
- > Use of the Internet does not make a difference in how a transaction is taxed
- > VAT treatment of B2B and B2C sales not always the same

- > EEC VAT regime treats (broadly) anything not a supply of goods as a supply of services.
- > B2B - Point-of-sale and VAT is where customer is located with certain exceptions
- > VAT reverse charge - State use tax when an unregistered provider sells to a customer in the EEC

- > Point-of-sale and applicable VAT is based on supplier location
- > In 2015, digitized products sold B2C will be taxed at the customer location
- > EEC provider - VAT at local rate; applies to B2C digitized product sales
- > Non-EEC provider - VAT free; no reverse VAT charge

- > Web site supply or Web hosting services
- > Distance maintenance of programs and equipment
- > Supplies of software and updating
- > Supplies of images, text and information, and database access
- > Supply of music, films, and games, including games of chance and gambling games and of political, cultural, artistic, sporting, scientific, and entertainment broadcasts and events
- > Supply of computer based training and remote learning
- > Downloaded services
- > Web-based broadcasting only provided over the Internet or similar electronic network; not simultaneously broadcast over a traditional radio or television network

Special option (available only to non-EEC suppliers)

- > Register electronically in one country of choice
- > Quarterly electronic returns
- > Computing VAT due in each country of sale
- > Tax authority in country of choice then distributes VAT to each jurisdiction
- > Non-EEC businesses can register in a low VAT jurisdiction, e.g., Luxembourg
- > Provides tax savings of digital goods in B2C Sales (eliminated in 2015)

***Do you think the U.S. will
adopt a European-style
VAT to close the federal
budget deficit?***

Questions and comments

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