

**NATIONAL ASSOCIATION OF STATE BAR TAX SECTIONS  
32nd ANNUAL MEETING – OCTOBER 28-29, 2011**

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# **Cloud Computing: Sales Tax and Income Tax Issues**

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# Agenda

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- **Sales and Use Tax Issues**
  - Nexus
  - Taxability of various transactions
  - Sourcing of sales/licenses
- **Business Activity Tax Issues**
  - Nexus
  - P.L. 86-272
  - Apportionment

# Sales and Use Tax

## Nexus

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- Physical Presence
    - Direct
      - Employees, Tangible Property, Real Property
    - Attributional
      - Includes “affiliate” and “click-through” nexus
    - Agency

**Sales and  
Use Tax**

**Nexus**

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- **Physical Presence**
    - **Employees, Tangible Property, Real Property**
    - **What about intangible property that is deemed tangible property?**

# Sales and Use Tax

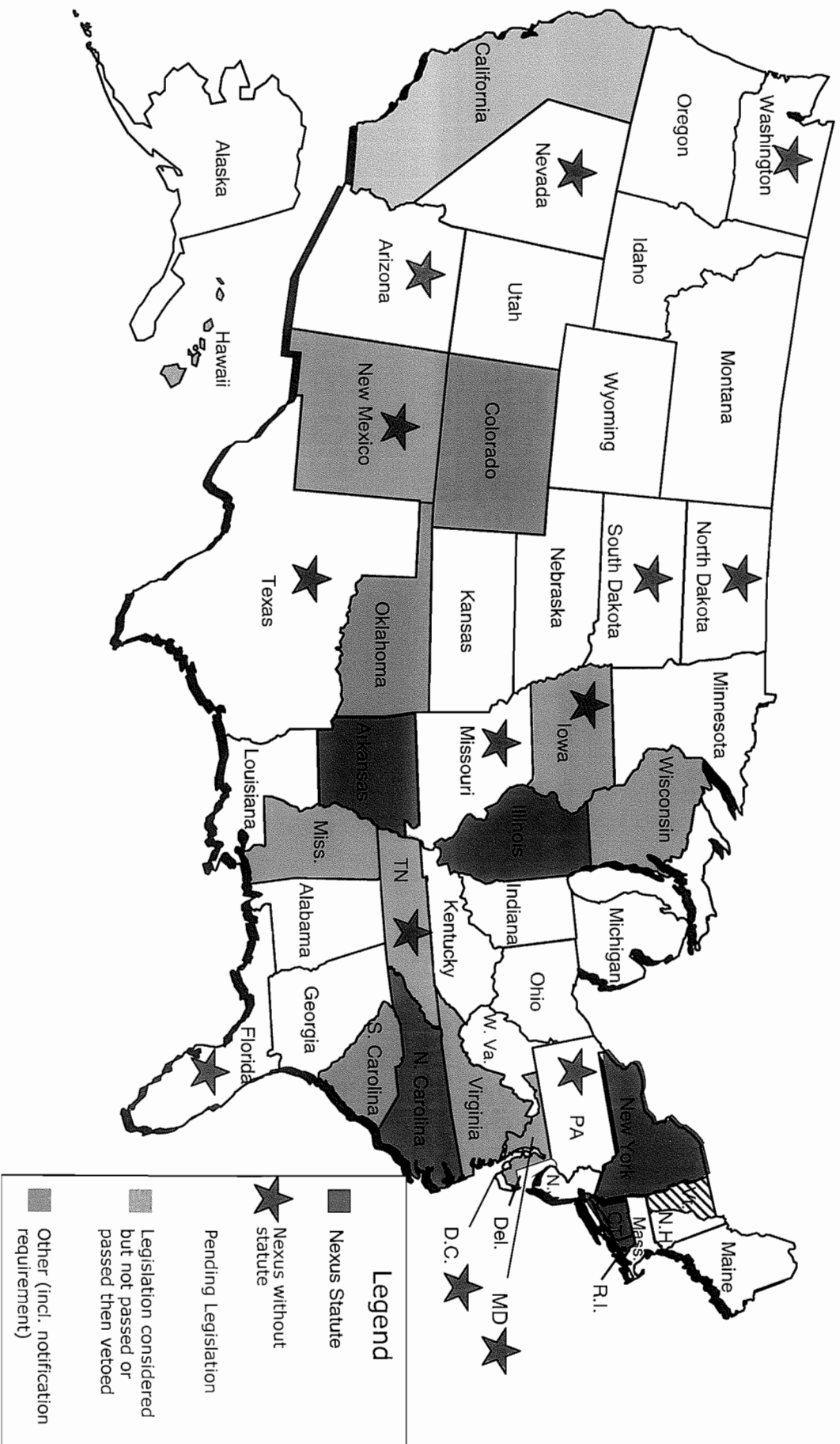
## Nexus

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- Physical Presence -- Attributional
    - *Tyler Pipe Industries v. Washington State Dept. Rev.*, 483 U.S. 232 (1987); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)

“significantly associated with the taxpayer’s ability to establish and maintain a market in [the] state for the sales.”

# Click-Through (“Amazon”) Nexus or Similar Nexus Position

(\*\*NOTE THIS IS A CONSISTENTLY CHANGING AREA – MAP MAY REFLECT A TIME LAG\*\*)



# Sales and

## Use Tax

## Click-through Nexus – Amazon Laws

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- **Legislation**
  - Legislation provides that a remote seller has to register as a vendor and collect sales and use tax if the remote seller contracts with residents who link to the remote seller's webpage and are paid a commission and thereby generate over a threshold number of sales for the remote seller (usually \$10,000, sometimes lower).
  - Some states treat in-state affiliates as creating a rebuttable presumption of doing business; other states treat the presumption as irrebuttable
- **Litigation**
  - New York
  - North Carolina
  - Colorado

# Sales and Use Tax

## Nexus

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- **Physical Presence: Agency**
    - Brick and mortar store and online retailer, for example:
      - *Barnesandnoble.com v. State Bd. of Eq.*, No. CGC-06-456465, (Sup. Ct., San Francisco Cnty., Sept. 7, 2007)
      - *St. Tammany Parish Tax Collector v. BarnesandNoble.com*, Dkt. No. 05-5695 (E.D. La. 2007)



# Sales and Use Tax

## Taxability

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- Every day, more and more states impose sales tax on digital goods and/or services
  - By statute, for example:
    - Indiana ('08)
    - Kentucky ('09)
    - Louisiana ('09)
    - Mississippi ('09)
    - Nebraska ('08)
    - New Jersey ('11)
    - North Carolina ('09)
    - South Dakota ('08)
    - Tennessee ('08)
    - Utah ('08)
    - Vermont ('09)
    - Washington ('09)
    - Wisconsin ('09)
    - Wyoming ('10)
  - By administrative proclamation or caselaw, for example:
    - Alabama (digital images delivered electronically deemed TPP)
    - Missouri (drawings delivered electronically deemed TPP)
    - New York (online services are sale of pre-written software – TPP)

# Sales and Use Tax

## Taxability

Software, regardless of method of delivery

- Many states include “software” in the state’s definition of TPP so not considered a “digital good” or “digital product,” even if delivered electronically
- There is not much dispute as to the taxability of software in most states – statutes are clear
- But, are online services licenses of software?

# Sales and Use Tax

## Taxability

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- Digital goods / digital products
  - Streamlined Sales Tax definition of “specified digital products,” when transferred electronically:
    - **“Digital audio-visual works”** – movies, television shows, videoclips, etc.
      - A “series of related images...” so single frame artwork is not included
    - **“Digital audio works”** – songs, ringtones, soundclips, etc.
    - **“Digital books”**
  - Most states that tax digital goods use similar definitions
  - Like software, not a tremendous amount of dispute because statutes are relatively clear

# Sales and Use Tax

## Taxability

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- Digital services
  - Otherwise **taxable services performed electronically**
    - For example, “information services” and “data processing services” still taxable even if delivered electronically
  - Otherwise **non-taxable services performed electronically**, also known as “Software as a Services” (SaaS), Application Service Providers (ASPs), cloud computing

# Sales and Use Tax

## Taxability

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- Software as a Services (SaaS)/Application Service Providers (ASPs) issues:
  - Is the service taxable under a traditionally enumerated category?
    - E.g., is it an information service or a data processing service?
  - Does the state tax SaaS/ASP services?
    - For example, Washington State has taxed them since July 2009
  - Is the seller actually licensing software (i.e., TPP)?
    - For example, New York's administrative position

# Sales and Use Tax

## Taxability: SaaS / ASP -- New York Issues

- **The Law:**
  - A taxable license includes the transfer of possession (actual or constructive) of TPP
- **NY's position:**
  - Software is TPP, regardless of method of delivery
  - The user receives constructive possession of the software because s/he has control over the software
  - (Additionally, sale is sourced to where user sits)
- **The “right” answer:**
  - Constructive possession requires more than temporary possession
  - Constructive possession requires actual control
  - Primary purpose of the transaction should control taxability
  - (Additionally, if sale of TPP, should be sourced to where delivered – the server, which may be out of state)

# Sales and

## Use Tax

## Sourcing

- Sourcing: Which jurisdiction's tax rules apply to determine taxability and rate?
  - Where delivered / Multiple Point of Use (MPU)
  - Where digital good was first made available by seller
  - Buyer's billing address

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# Income Tax Issues



# Business Activity Tax Issues

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- Nexus
- P.L. 86-272
- Apportionment

## Income Tax Issues - Nexus

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Do my digital goods create a physical presence (i.e., **nexus**) in a state where the goods are licensed?

- Is software tangible personal property for **INCOME TAX** purposes?
  - If yes, licensing software into a state can create a physical presence in that state.
  - If no, licensing software into a state will not create a physical presence in that state. (However, some states may still assert economic nexus against the licensor because of in-state customers.)

## Income Tax Issues - Nexus

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Is software tangible personal property for INCOME TAX purposes?

- Federal tax treatment – software is intangible property for IRC 179 and 197 purposes
- State sales tax treatment – software is tangible property
- State non-sales tax decisions go both ways:
  - Dallas Central Appraisal District v. Tech Data Corp, 930 SW2d 119 (Tex. Ct. App. 1996): software intangible because binary pulses could not be seen, weighed, measured, felt
  - AccuZip, Inc. v. Director, Division of Taxation, N.J. Tax Ct. 5744-2003 (2009): software is tangible personal property for income tax purpose

## Income Tax Issues – P.L. 86-272

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If digital goods are tangible personal property for income tax purposes, does selling them constitute a protected activity under P.L. 86-272?

- P.L. 86-272 prevents a state from imposing income tax on an out-of-state seller whose only activity in the state is related to the solicitation of order of TPP, which are accepted outside the state and which are shipped from outside the state.
- If digital goods are TPP, then P.L. 86-272 should apply; if digital goods are not TPP, then P.L. 86-272 should not apply.
- AccuZip, Inc. v. Director, Division of Taxation, N.J. Tax Ct. 5744-2003 (2009): software is tangible personal property for income tax purpose. Therefore, P.L. 86-272 applies and in-state solicitation activities are protected.

## Income Tax Issues - Apportionment

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- **Sales Factor:** If TPP, most states use destination-based sourcing. What is the destination of an electronic transfer? If intangible property, cost of performance or market based. For market-based, where was the benefit of the digital good received?
- Appeal of Adobe Systems, Inc. (Cal. 1997) CA taxpayer licensed software to customers in MA. MA auditor treated as TPP. CA SBE treated as intangible.
- American Business Information Inc. v. Egr (Neb. 2002) Taxpayer sold database on physical media and electronically. Treated as TPP.
- IL PLR 90-0007-PLR. Canned software TPP, customer software IPP
- Microsoft Corp v. Franchise Tax Board Dkt. 08-471260 (2011)  
software is TPP, thus royalties sourced to ultimate customer's location
- What about throw-out and throw-back rules?

## Income Tax Issues - Apportionment

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- **Property Factor:** If TPP, include in property factor. If intangible property, generally not included in property factor.
- AZ Corporate Tax Ruling 01-2 (2001) – if treated as TPP and capitalized for federal tax purposes, then treat as TPP for property factor purposes
- FL Admin. Code Ann 12C-1.0153 – canned software is TPP for property factor
- California - Failure to take into account intangible property in the company's property factor did not distort its income apportioned to the state. *Microsoft Corp. v. California Franchise Tax Board*, California Superior Court Docket No. CGC08-471260 (Calif. Sup. Ct. Feb. 17, 2011)
- New York - Amounts paid pursuant to certain license agreements to broadcast television programs were intangible property that could not be included in the property factor and were not rentals of tangible personal property. *Matter of Meredith Corporation*, Tax Appeals Tribunal, DTA No. 822396 (Mar. 10, 2011)

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