CHAPTER 2

State Tax Issues Associated with Digitally-Delivered Goods and Services

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§ 2.01 INTRODUCTION

Technological advances and the development of new applications for existing technology are occurring at a rapid pace in the 21st Century. Not surprisingly, state taxing authorities are struggling to catch up with these changes in technology. One type of transaction epitomizing this challenge involves the taxation of electronic commerce, both via the creation of a new class of "digital goods" for tax purposes and the attempt to tax online services primarily provided through application service

provider and software as a service platforms.

A number of states have recently defined "digital products" for the sole purpose of imposing a sales tax specifically on such defined transactions. While this may seem aggressive to some, it is welcomed by others because of the attempt to bring more certainty into an uncertain area. In most states, however, there is not a solid construct in place to provide guidance as to how electronic commerce transactions will be treated for state sales tax purposes. This is particularly troubling because it is reasonable and analytically sound to believe that online services should not be subject to sales/use taxation. However, without definitive guidance, one must always be aware of the possibility that a state will attempt to tax the transaction. Many states do have low level case law or rulings addressing these issues. Accordingly, it is necessary to digest and analyze the guidance that does exist in order to determine the possible tax implications.

Income taxation of businesses engaged in electronic commerce raises issues of its own, including whether any software within the transaction is tangible or intangible, nexus determinations and the application of PL-86-272, and also sourcing for purposes of apportionment.

Thus, knowledge of the state tax constructs is a necessity in order to properly analyze any transaction involving digital goods, online services or other electronic commerce transactions. This paper discusses the current state of the law, complex and curious as it is, and addresses some of the more aggressive positions being taken by state taxing authorities.

§ 2.02 DIGITAL GOODS

With the proliferation of remote sellers (companies with no physical presence in a state that make sales via the Internet), states became increasingly concerned that they would lose sales tax revenues as more transactions took place over the Internet. To address this concern, the Streamlined Sales and Use Tax Project was born in the fall of 1999, with a goal of simplifying sales and use tax collection so that states may ultimately require remote sellers to collect use tax on a state's behalf.

A uniform Streamlined Sales and Use Tax Agreement (the "Agreement") encompasses the core principles of the Streamlined Sales and Use Tax related to sales tax simplification. These principles are: uniform tax definitions, uniform and simpler exemption administration; rate simplification; state-level administration of all sales taxes, uniform sourcing for transactions; and state funding of the administrative cost.

On September 20, 2007, the Agreement was amended to include a definition of "digital products." The amendment became effective on January 1, 2008. The states' objective was to be better able to impose sales tax upon certain digital goods and also to have the ability to "toggle" between digital goods that each desired to subject to tax or treat as exempt. A definition was drafted for "specified digital products," which included separate definitions for "digital audio-visual works," "digital audio works," and "digital books." The definitions for purposes of the Agreement are contained in Appendix C, Part II, as follows:

"**Specified digital products**" means electronically transferred:

"**Digital Audio-Visual Works**" which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any,

"**Digital Audio Works**" which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones, and 18

"**Digital Books**" which means works that are generally recognized in the ordinary and usual sense as "books".

For purposes of the definition of "digital audio works", "ringtones" means digitized sound files that are downloaded onto a device and that may be used to alert the customer with respect to a communication.

For purposes of the definitions of "specified digital products", "transferred electronically" means obtained by the purchaser by means other than tangible storage media.

Many states have now enacted legislation to specifically incorporate the taxation of digital products into their statutes. These states include Indiana, Kentucky, Mississippi, Nebraska, New Jersey, North Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin and Wyoming. Many of these states admit that the taxation of digital products is an expansion of the sales tax base.

Of the states enacting a tax on digital products, all are members of SST with the exception of Mississippi. Given the uniform starting point, one might assume that these statutes would be uniform among the states as well. However, this is far from the case, as the statutes differ considerably with respect to the type of digital goods specifically taxable and the scope of the tax imposition itself.

A review of these statutes reveals that while each state provision on digital goods generally addresses five elements, there is substantial variance among the states within these. The five elements are: (1) the type of property subject to taxation; (2) the classification of the purchaser; (3) user rights; (4) the type of payment; and (5) the trigger word.

The first element addresses the type of property that will be subject to taxation. Some states, for example Indiana, Utah and Vermont, incorporate a definition similar to the SST Agreement definition, limiting the taxable digital property to specific digital products. Others, such as Kentucky, extend the list of taxable property to include other specific items such as greeting cards, video games and artwork. South Dakota simply applies the tax to products transferred electronically if it would generally be taxed as tangible personal property. Washington has the broadest tax base for this purpose, encompassing digital goods, digital code and digital automated services. The other states are about evenly split as to whether they also subject digital code to tax, while very few have the extensive tax on automated services.

The second element addresses whether a sale of a digital product has to be to an end user in order to be taxable. Some states specify that it does, while others are silent and still others state that the digital goods are taxable regardless of whether they are sold to the end user. These differing standards could allow for the possibility of double

taxation in states that have strict sale for resale exemption requirements, as well as in the context of interstate transactions.

Third, the statutes address the rights that the purchaser must have in order for a sale of digital goods to be taxable. The three main categories are: (i) the purchaser receives a permanent right to use the digital product; (ii) a less than permanent right; or (iii) the user's right terminates upon a certain condition. For example, Indiana taxes a sale of digital goods only when the purchaser has a right of permanent use that is not conditioned upon continued payment, while Tennessee will subject a transaction to tax whether the use is permanent or terminates upon a condition. And contrast both of those standards to Utah's statute, which applies in all three of the above circumstances.

Closely related to the rights of the user is the element that addresses the payment made for the digital good. The standards for this element typically include whether a purchaser makes a one time payment or continuous payments or whether both are sufficient for purposes of taxation. For example, Kentucky's statute does not distinguish between whether a one time payment is made for a good or whether the use of the digital good or goods is dependent upon continuous payments. However, Indiana does not tax transactions that are conditioned upon continued payment by the user. So a music download, with a one time payment, would be subject to tax in most states because it is an unconditioned right of permanent use for a single payment. However, movies that are available for download only when monthly payments are made would not be taxable in states that require the permanent use and do not tax transactions conditioned on continuous payments.

The final element deals with the "trigger" for taxation—meaning what are the words that are used to impose the tax upon the transaction. Most states use either the words "transferred" electronically or "delivered electronically," while North Carolina uses the words "delivered or accessed." There is clearly a significance between the term delivered and accessed. Query whether there is any significance between the terms delivered and transferred electronically?

As you can see from this brief outline of the statutes that impose sales tax on transactions involving digital goods, there is little uniformity and there could be many instances where the same transaction is treated differently for sales tax purposes in different states. Given that these statutes imposing sales tax on digital goods are not consistent among the states, it is vital that any business that possibly includes the provision or purchase of digital products review and analyze the statute specific to the states in which it conducts operations. In addition, the tax matrices for the SST states can provide some useful information related to the manner in which the state intends to interpret its statute. For example, many states are not explicit as to whether the tax applies only on a transaction to the end user; however, the state is forced to answer this question in its taxability matrix.

While 13 states have specifically adopted statutes imposing tax on digital products modeled roughly after the definition contained in the Agreement, other states have issued rulings holding that transfers of digital goods are taxable or have some variant of the uniformly derived statutory authority. For example, Louisiana includes "on demand audio and video downloads" in its definition of tangible personal property. In

addition, a recent ruling held that a transaction for "downloaded content," such as software, data, media, and information materials, is one for tangible personal property, and it will be subject to sales/use tax in the "customer's place of primary use." La. Rev. Ruling No. 10-001, 3/23/2010. Vermont has just issued a bulletin advising that sales tax will apply on the download of "specified digital products." Vt. Technical Bulletin TB-54. A Maine bulletin advises that tax applies to the sales of photographs, portraits, and videotapes, "including the sale of a digital product delivered electronically." Maine Instructional Bulletin No. 3, 7./28/2008. And the Texas statute clarifies that "the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status." Tex. Tax Code Ann. § 151.010.

On the other hand, some states have explicitly held that digital products are not taxable. For example, Minnesota has expressly stated in a newsletter that products that are taxable when delivered in tangible form are not taxable when delivered electronically. (It should be noted, however, that Minnesota does subject ring tones delivered electronically to sales tax.) Minn. Sales tax Newsletter No. 69, 2/01/2010. Illinois has held that downloaded videos are not subject to tax. Ill. Dep't of Rev. Gen. Info. Letter No. ST06-0071-GIL, 4/19/2006. And a Missouri letter ruling holds that downloaded photographs are not taxable when no tangible property is exchanged. MO. Private Letter Ruling No. LR 5058, 08/29/2008.

The remaining states are silent on the issue. The last major attempt by the states to respond to technological advances in the sales tax area was with respect to electronically delivered software. Certain states determined that canned software would be subject to tax only if it was transferred on a tangible medium, while many others determined that it would be taxable regardless of the method of delivery. There are currently 29 states that subject canned software to tax regardless of how it is delivered. It is not a particularly far leap to the explicit taxation of specifically defined digital products. Interestingly, North Carolina is the only state that has adopted a statute imposing a tax on digital goods that does not also tax the electronic delivery of canned software.

§ 2.03 ONLINE SERVICES OR CANNED SOFTWARE?

The 29 states that have decided to tax canned software even when it is delivered electronically have done so by including canned software within their definition of tangible personal property, with the qualifier that the tax applies regardless of the method of delivery. In addition, 14 states impose their sales/use tax on computer data processing and/or information services. Only a handful of states impose their sales tax on services generally.

In a startling development, states are now attempting to impose tax on services provided online. However, they are not enacting a new tax statute that would impose the tax (as states have previously done in order to tax data processing or information services or even "digital products"). Rather, in order to do so, states are effectively recasting the nature of the online service transaction as a sale of software.

One might ask how a state is able to make this argument with a straight face and in many cases prevail. The main basis for this argument is that in most states, the

definition of sale typically includes a lease or license to use the property. So in states that subject electronically delivered software to tax, a software license would also be taxable.

However, in application service provider ("ASPs") or software as a service ("SaaS") platforms, the purpose of the transaction is not the software that may be licensed in a limited capacity (usually to allow the access), but rather the online services that are provided. And such services would otherwise be generally exempt from tax. For example, the purchase of an educational course is not taxable if provided by a live speaker, but the same course may be considered subject to tax if the course is provided online and the purchaser must accept the terms of a software license to access the programming. Thus, the states are effectively equating the purchase of online services with the purchase of a shrink-wrapped version of Microsoft Word at a local Staples store.

Because no tangible medium for a software license is provided in the ASP and SaaS models, the states that are most likely to take this position are those that impose sales tax on software regardless of the method of delivery. If the state takes the position that a license is the basis for taxation, (which, as described below, is an aggressive position) it would be necessary to determine what the state's position is regarding bundled transactions—in other words, will the state attempt to impose the tax on the proceeds attributable to the software license alone or tax the entire transaction because it includes a license of software that is not separately stated. For example, Nebraska has taken the position that if software is licensed in the provision of online information services, the transaction is subject to tax. Moreover, the entire transaction is taxable if the portion of the proceeds related to the software license is not separately stated. Neb. Rev. Ruling No. 1-96-1, 5/14/96. Of course, if a taxpayer reasonably believes they are selling online services as opposed to software, it's highly unlikely that the invoice for the transaction would be separately stated between the service and the license.

The good news is that a number of states have considered these transactions and have held that an ASP or SaaS platform transaction is not taxable even where there is a license of the software. In many cases, these decisions have relied upon the "true object" test, focusing on the purpose of the online service transactions. This is a much more reasoned and well-founded approach because the software license is not the user/purchaser's true object—what it really desires are the services it obtains through the ASP or SaaS platform and the software is merely an inconsequential element of the transaction. For example, a Massachusetts ruling holds that the provision of online access to prescription information was not taxable, even though customers received software to allow them to access and view the information—the license was an inconsequential element of the service transaction. Virginia has ruled similarly in the context of credit monitoring services.

While imposing sales tax on electronic commerce when a software license is an aspect of the transaction, is already an aggressive approach. It now appears, however, that some states are taxing online service transactions solely when users are granted access to software in order to facilitate the service whether through an ASP or SaaS platform or otherwise. This is quite frankly a shocking occurrence.

This phenomenon of taxation of online services generally discussed above and the progression to taxation of "access" is occurring in New York. The New York State Department of Taxation and Finance (the "Department") has painted with a broad brush to conclude, in a number of advisory opinions, that the following services or forms of entertainment are really sales of software over the Internet: (1) e-learning courses; (2) information technology courses; (3) mail-tracking services performed for airlines; (4) loan origination and processing services; (5) automobile insurance policy services; (6) payroll processing services; and (7) video games played on computers located at a business's facility.

Historically, the Department at least played homage to the fact that a software license was required in order to subject an online service transaction to taxation. As discussed above, that itself is an aggressive approach, considering both the "true object" of these transactions and the fact that there is no transfer of software to the purchaser.

For example, when someone purchases an online education course, the purchaser desires the education provided and not software. Moreover, the purchaser may not even be aware that software is involved in any way in the transaction, especially since the education course is hosted on the seller's server and the purchaser is not able to download the course.

This gives rise to a second reason evidencing the aggressive nature of this approach—no software has been transferred to this purchaser because the purchase has no ability to control the software. The purchaser has no ability to affect the seller's operating system or hardware, both of which are necessary for the software to be used, and cannot change the software, relicense it, alter its color scheme or affect how the software may be used by another purchaser.

While prior advisory opinions indicated that the Department attached significance to the presence of a software license in these transactions, the most recent rulings issued by the Department squarely state that an online service transaction will be subject to tax if the purchaser has the right to access the seller's host server, regardless of any software license. Indeed in one ruling, the Department stated that although the taxpayer characterized the transaction as a service, such characterization was not controlling. TSB-A-09(33)S, 8/13/2009. And—here's the kicker—the Department held that access to the host servers gave the purchasers "constructive possession" of the software sufficient to tax the transaction as a sale of software. Since when is a sales tax imposed on "constructive possession?"

The Department is taking these positions on audits and assessing sales tax for transactions as far back as 2005 despite the fact that its positions are highly aggressive and questionable interpretations of existing law. What is perhaps most disconcerting about New York's approach is that this is being done in the absence of any legislative mandate. In fact, the New York legislature previously considered, but then declined to enact, legislation that would have provided for sales taxation of "digital goods." Accordingly, the Department is ignoring the clear signals from the legislature related to electronic commerce, nonetheless attempting to tax electronic commerce on its terms.

§ 2.04 INCOME TAX ISSUES

As with sales and use tax, much of the income tax controversy centers on the characterization of digital products as "tangible personal property," (TPP) on the one hand, or "intangibles" or "services," on the other. As noted, the Streamlined Sales Tax Agreement (the "Agreement") resolves the issue in adopting states by forbidding the classification and consequent taxation of "specified digital products" as "tangible personal property" (or as "ancillary services," "computer software" or "telecommunications services"). SSUTA states wishing to tax such digital products must do so explicitly and using the definitions provided. In other jurisdictions, the classification issue generally remains subject to determination based on the interpretation of statutes pre-dating the technologies in question.

[1] TPP: Varying Meanings?

At the outset, it should be noted that the term "tangible personal property" will not necessarily have the same meaning for both sales and income tax purposes. It may have different meanings for those two taxes, and a third meaning may be utilized for ad valorem property tax purposes. A number of states define "tangible personal property" to include electricity, for example, e.g. see Fla. Stat. § 212.02(19), 72 P.S. § 7201(m) (Pennsylvania), and Wisconsin Stat. §77.51(20), but may not treat electricity as TPP for ad valorem tax purposes. By way of further illustration, Florida counties may impose ad valorem taxes against real property and tangible personal property, but only the State may tax intangible property. The 1997 Legislature defined "computer software" as intangible property for ad valorem purposes except as to the value of the blank disk or other medium, effectively putting software (other than embedded software, treated as part of the hardware) beyond the reach of local property tax. In *Gilreath v. General Electric Co.*, 751 So.2d 705 (Fla. 5th DCA 2000), the court held that custom flight simulation software used for training pilots was intangible property and that the statute which classified it as such did not offend the uniformity requirement of the Florida Constitution. More recently, a sister appellate court came to a similar conclusion about wireless services software used by Verizon to "provide their customers the ability to make a phone call with a cellular phone, as well as send text messages, operate a GPS navigator, and browse the Internet." *Nikolits v. Verizon Wireless Personal Communications, L.P.*, 9 So.3d 690 (Fla. 4th DCA 2009). The court there distinguished the "medium" (which constituted tangible personal property and was therefore taxable) from the software itself, which it considered "intellectual property" for ad valorem tax purposes.

By contrast, Florida sales tax rules treat canned software as TPP and custom software as a non-taxable service transaction; the sale of electronically-downloaded software, canned and custom, is viewed as not entailing the transfer of any tangible personal property. FAC Rule 12A-1.032(4) and 12A-1.062(5).

The present concern is the meaning of these terms for state income purposes, and there are reasons for anticipating the possibility of different meanings than those which apply for property or sales taxation. First, state income taxes are not focused principally upon the taxation of items of property, but reach income derived from the sale, leasing or licensing of such items, as well as from the provision of services,

receipts from intangibles and other forms of income. Secondly, state income tax statutes are ordinarily concerned with the meaning of "tangible personal property" in different contexts. One is the protections against tax afforded those selling "tangible personal property" by P.L. 86-272. Another is the sourcing of sales in the sales factor for apportionment purposes, as well as the composition of the property factor. And the interpretation of state income tax statutes may be influenced by the Internal Revenue Code which most state income tax laws piggyback.

The typical sales tax definition of tangible personal property ("personal property that can be seen, weighed, measured, felt or touched or that is in any other manner perceptible to the senses") has no counterpart in UDITPA or most state income tax statutes. As for federal guidance, Section 179 of the Internal Revenue Code allows the expensing, rather than capitalization, of the cost of eligible property, defined as "tangible property (to which section 168 applies)" and certain computer software. Section 168 prescribes depreciation lives and rates for various classes of property. Section 197, treating the amortization of goodwill and certain other intangibles, excludes "computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified." IRC § 197(g)(3)1.A.(i). It defines "computer software" as "any program designed to cause a computer to perform a desired function," and generally excludes any data base. IRC § 197(g)(3)1.B. This section therefore appears to exclude pre-written or canned software from the definition of "intangible property," implying that it is tangible personal property for Code purposes. IRS Publication 946 confirms this characterization under Section 179:

> The treatment of property as tangible personal property for the section 179 deduction is not controlled by its treatment under local law. For example, property may not be tangible personal property for the deduction even if so treated under local law, and some property (such as fixtures) may be tangible personal property for the deduction even if treated as real property under local law . . . . Off-the-shelf computer software placed in service during the tax year is qualifying property for purposes of the section 179 deduction. This is computer software that is readily available for purpose by the general public, is subject to a nonexclusive license, and has not been substantially modified.

This provision does not address electronically-delivered software, and its restriction to "off-the-shelf computer software" implies that only software sold in that physical form qualifies. The United States Tax Court ruled in 1997 that software was tangible personal property for investment tax credit (IRC S. 38) purposes, but the software there in question was not electronically conveyed. *Norwest Corp. v. Commissioner*, 108 T.C. 358 (1997). At bottom, neither federal nor state sales tax definitions are particularly instructive in deciding how to treat digital goods and services for state income tax purposes. The remainder of this section examines the several areas in which state income tax questions over digital products have arisen.

[2] Nexus and P.L. 86-272

The well-known *Quill* decision established physical presence as the Commerce

Clause prerequisite to a state's jurisdiction to require an out-of-state business to collect use tax. If electronic downloads entail the transfer of a physical product to a user, and the property remains in the ownership of the transferor, that party would have a physical presence in the state which could be deemed to create sales tax nexus. In *South Central Bell Telephone Co. v. Barthelemy*, 643 So.2d 1240 (La. 1994), the court concluded that telephone switching system software (downloaded from magnetic tape) and data processing software (electronically downloaded) were tangible personal property for New Orleans sales tax purposes. It reasoned that in both cases, the software existed in the licensee's hands as a "physical recording," not merely as "incorporeal rights" (its view of intangible property):

> When stored on magnetic tape, disk, *or computer chip* [e.s.], this software, or set of instructions, is physically manifested in machine readable form by arranging electrons, by use of an electric current, to create either a magnetized or unmagnetized space. [citation omitted] The computer reads the pattern of magnetized and unmagnetized spaces with a read/write head as "on" and "off," or to put it another way, "0" and "1." [citations omitted] This machine readable language or code is the physical manifestation of the information in binary form.

As part of "the physical world," the software was thus deemed to be TPP subject to sales and use tax. The references to on/off or 0/1 "spaces" suggest the rejoinder that they are the software equivalent of words in a book. The book itself (whose counterpart here would be the computer chip on which the spaces "reside") might be deemed TPP, but few would say that the words themselves constitute "personal property," much less tangible personal property.

On July 20, 2010, the Pennsylvania Supreme Court ruled that canned software licenses purchased by a law firm were subject to state sales and use tax, both as to those transactions in which the software was delivered on a CD or disk and those in which it was electronically conveyed. *Dechert LLP v. Commonwealth of Pennsylvania*, 998 A.2d 575 (Pa. 2010). The court purported to rely on a policy statement issued by the Department of Revenue in the wake of 1997 legislation repealing the tax on computer programming services saying that canned software "remained" subject to tax as sales of tangible personal property. An application for reargument that was filed on August 3, 2010 pointed out, however, that the Department had historically treated *electronically-delivered* canned software as non-taxable.

If electronically-delivered products can be treated as TPP for income tax purposes, a nexus assertion could be made in some circumstances. Merely selling software, books, movies, music and the like, as tangible personal property, into a state via the Internet should not, by itself, establish a physical presence since those would be inventory items passing to the purchaser. But if such digital "goods" were electronically downloaded to a third-party server located in the state for re-distribution to purchasers from that point, the software developer could be treated for nexus purposes like a seller warehousing other kinds of TPP in the taxing jurisdiction. Moreover, if a court were to treat such digital goods as being leased or licensed (rather than sold), on the theory that the seller has retained ownership of the intellectual property content,

that owner would then have tangible personal property under lease or license in the taxing jurisdiction.

In *Accuzip, Inc. v. Director, Div. of Taxation*, 25 N.J. Tax 158 (2009), the New Jersey Division of Taxation took the position that two businesses selling pre-written computer programs were subject to the state's Corporation Business Tax (CBT). It argued first that Accuzip and Quark were licensing intangibles for use in the state and therefore had CBT nexus in accordance with *Lanco, Inc. v. Director, Div. Of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. den.* 127 S.Ct. 2974 (2007) (licensing of trademarks, trade names and service marks).

The court declined the *Lanco* contention. Accuzip marketed computer mailing programs on CD-ROMs. A co-plaintiff, Quark, Inc., licensed desktop publishing programs on disks. The court noted that the New Jersey sales tax statute treated such programs, including pre-written programs delivered electronically, as tangible personal property. N.J.S.A. 54:32B-2(g). It also cited Treas. Reg. 1.861-18(h) as treating such licensing agreements as a sale of tangible personal property, notwithstanding the parties' characterization of the transactions as a lease or license. It distinguished *Lanco* on the basis that Accuzip and Quark were selling TPP, not licensing intangibles into the state. The court further distinguished earlier sales tax cases that applied a true object test to conclude that the sale of mailing lists on magnetic tape was not the sale of TPP, but of intangibles (the data on such tapes). See e.g., *Spencer Gifts, Inc. v. Director, Div. of Taxation*, 440 A.2d 104 (N.J. Tax Ct. 1981). The court rejected the Director's contention that since the software was copyrighted, the companies were not selling it and therefore owned tangible personal property in the state subjecting them to CBT. It concluded that the copyright pertains to the underlying intellectual property and not the physical manifestation of that property, the CD-ROMs, noting that books were copyrighted but still treated as the sale of TPP to purchasers. With no agents, employees or offices in New Jersey and only *de minimis* sales, Accuzip was not "doing business" within the meaning of the CBT. Quark was subject to the minimum tax because it had a sales representative in the state, but was protected from any tax on its income by P.L. 86-272.

A number of courts have read the *Quill* physical presence dictate as applicable only to sales and use tax nexus. For state income tax purposes, they have found nexus on the basis of a seller's maintenance of a market in the state, so called "economic nexus." See, among others, *Geoffrey, Inc. v. South Carolina Tax Comm'n.*, 437 S.E.2d 13 (S.C. 1993), *cert. den.* 510 U.S. 992 (1993); *Lanco, supra*; *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. den.* 127 S.Ct. 2997 (2007); and *Capital One Bank v. Commissioner*, 899 N.E.2d 76 (Mass. 2009), *cert. den.* 129 S.Ct. 2827 (2009). *Lanco* and *Geoffrey* entailed the licensing of trade names and similar intellectual property for use in the taxing jurisdiction, but *Capital One* and *MBNA* dealt with the issuance of credit cards to residents of the taxing jurisdictions. The presence of the credit cards, as intangible personal property, was not really the basis for the finding of nexus in either of those decisions. The *MBNA* court focused on the "economic exploitation" of the state's market in concluding that the financial institution had a "substantial economic presence" satisfying the requirements of the

Commerce Clause. *Capital One* court relied on the institution's use of in-state banking and credit facilities and its generation of millions in income from Massachusetts customers.

If digitally-transmitted software, books, music and videos were characterized as the licensing of intangible personal property, with the focus on the intellectual property remaining in the ownership of the "seller," those states taking that position that the Commerce Clause substantial nexus requirement is satisfied by the use of the taxpayer's intangibles in the taxing jurisdiction could be expected to assert income tax nexus over such sellers. And even ignoring the licensing/use in-state issues, or treating the transactions as a sale of services, such a seller would be subject to income tax in jurisdictions applying a pure "economic presence" standard where the seller has a substantial customer base. In such jurisdictions, the characterization of digital products as TPP, intangibles or services would not matter for nexus purposes, but could be important for P.L. 86-272 purposes and for apportionment purposes, the matter to which we now turn.

[3] Apportionment—Sales Factor and Property Factor/Tangible Personal Property

As its name reveals, the Uniform Division of Income for Tax Purposes Act (UDITPA or the Act), adopted in 1957, was intended to establish general uniformity in a number of respects, including the classification of income as business income (apportionable among jurisdictions) or nonbusiness income (allocable entirely to a single jurisdiction), the formula for apportioning business income, and the rules for allocating nonbusiness income. Despite widespread adoption of all or portions of the Act over the years, nothing approaching national uniformity in the division of multistate income has resulted. And much of the variety has centered around the apportionment formula, in particular the sales factor.

Initially, it should be noted that while the Act employs the phrase "tangible personal property," and to a lesser extent "intangible property" and "services," for various purposes (e.g., S. 1, definition of "business income;" S. 4, dealing with rents and royalties; S. 5–6, allocation rules; and S. 10, defining "property factor"), it does not define those terms. Left for definition by individual jurisdictions, this is one of many Act features that have helped assure differing approaches even among adopting jurisdictions.

The UDITPA three-factor formula calls for apportionment based on the fraction of the taxpayer's property, payroll and sales present in the jurisdiction. S. 9. The property factor includes real and tangible personal property but not intangible property (S. 10), so it is clear that this factor would be affected by the characterization of given digital products as TPP on the one hand, or intangibles or services, on the other.

[4] Property Factor

In Arizona Corporate Tax Ruling 01-2, dated May 1, 2001, computer software that was treated as TPP following the determination that governs for federal income tax purposes was likewise treated as TPP for state corporate income tax purposes and included in the property factor. Interestingly, that ruling states that "computer software

is includible in the numerators of the states in which the software is actually used, not in the state in which the original program disk or tape is located." The statement is curious for a couple of reasons. First, it seems inconsistent to treat the software as TPP for property factor purposes and then ignore the location of that software in physical form. Secondly, in its reference to the "original" disk or tape, it appears to refer to digital or electronically-downloaded versions used in other states, and perhaps to copies of the original. In the breadth of that conclusion, it arguably expresses the curious conclusion the digital versions are TPP, but that the original disk or tape versions are not. It also poses the question at what cost the non-original digital or disk copies would be recorded to the property factor, since the cost of the original is presumably disregarded for such purposes.

Florida regulations treat canned software as TPP for property factor purposes. F.A.C. Rule 12C-1.0153(7)(g). For purposes of determining value, "software rentals will be capitalized as rents if they are determined to be tangible personal property." *Id.* The characterization of canned software as TPP appears to follow the sales tax treatment described above, so neither the cost of custom software (deemed a payment for services) nor of electronically-transmitted software or other digital "goods" (deemed not to entail the provision of any TPP) would be included in the calculation of the Florida property factor.

[5] Sales Factor

While UDITPA proposed an equally-weighted three factor formula, the clear trend among the states has been to increase the emphasis on the sales factor. Some states, like Florida, have long double-weighted the sales factor. Fla. Stat. § 220.15(1). In others the weighting has ratcheted up over time (see, e.g., Pa. Stat. Ann. §§ 7401(3)2(A)(9)(iii) and (iv) increasing the weighting to 90% for tax years beginning after 2009), and a number now require or allow apportionment based on sales alone. California, for example, will allow taxpayers to elect single sales-factor apportionment for tax years beginning after 2010. Cal. Rev. & Tax. Code § 25128.5(a). Since the sales factor is a fraction, the numerator of which is sales "in this state," the rules for determining which sales are assigned or sourced to the taxing jurisdiction in question are of paramount importance.

Those rules are set forth in Sections 16 and 17 of the Act. Under Section 16, sales of TPP are sourced to the state where the goods are delivered to the purchaser. In *American Business Information, Inc. v. Egr*, 650 N.W.2d 251 (Ne. 2002), the taxpayer contended, and the Nebraska Supreme Court agreed, that certain "business products" marketed by ABI were tangible personal property for sales factor purposes. The products included prospect lists on paper and on index cards, and business data delivered on computer diskettes, magnetic tapes and CD-ROMs. ABI also sold business data delivered to customers electronically. In the court's words:

> ABI also delivers online data from its database by computer communications over telephone lines. Customers purchasing online data use computer equipment capable of receiving, interpreting and storing an electronic signal transmitted by

ABI. Customers are able to conduct their own search query and download data directly from ABI's database.

The parties stipulated that two other ABI products, hard copy business directories and customized mailing labels, were tangible personal property for sales factor purposes. The Nebraska Department of Revenue audited ABI's tax returns for 1990 and 1991, decided that the sales of the disputed ABI products were sales of "other than tangible personal property" for factor purposes, and assessed deficiencies for those years. The relevant statute sourced TPP receipts on a destination basis and sales of services and intangibles on the UDITPA costs of performance rule. Neb. Rev. St. § 77-2734.14(2) and (3) (Reissue 1990). Those facts suggest that the greater proportion of ABI's costs of performing the underlying income-producing activities were in Nebraska and that many of its customers were outside the state.

The Department contended that costs of performance sourcing was required based on decisions from other states holding that similar "products" were not tangible personal property. It cited, for example, *Fingerhut Products Co. v. Comm'r*, 258 N.W.2d 606 (Minn. 1977) (typed mailing lists are "intangibles" not subject to sales and use tax), *Spencer Gifts, Inc. v. Dir., Div. of Taxation*, 440 A.2d 104 (N.J. Tax 1981) (rental of computer mailing lists on magnetic tape not a sale of TPP for sales tax purposes, but of intangibles, namely, the information reflected in such lists), and other sales tax cases.

The Nebraska Supreme Court did not find those authorities applicable, however, saying that the Nebraska legislature had specified that the phrase "tangible personal property" was to be interpreted consistently with its meaning for federal income tax purposes. The court cited a statute saying the term "shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes. . . ." Neb. Rev. St. § 77-2714 (Reissue 1996). The opinion then looked to the *Norwest* decision, *supra* interpreting the provisions of the Internal Revenue Code allowing an investment tax credit for certain expenditures. It is not clear how the meaning of "tangible personal property" for ITC purposes could be said to be cast in a "comparable context" to the use of that term in the Nebraska sales factor statute. The state statute is concerned with apportioning income among a number of state taxing jurisdictions, a matter entirely beyond the concern of the Internal Revenue Code. The court also thought it significant that customers did not have unrestricted right to the use of the intellectual property inherent in the ABI products—concluding that the customers thus did not secure IP rights and were therefore not purchasing intangible property.

As for the "online data," the court referred to its earlier decision in *May Broadcasting Co. v. Boehm*, 490 N.W.2d 203 (Neb. 1992) for the proposition that the transmission of electronic signals (there by satellites relaying syndicated television programming) was "the transmission of a tangible thing—electronic signals." The *May* court concluded that "the mere fact that the signals may be received and stored shows that a tangible thing is in issue" for Nebraska use tax purposes, and that the notion of storing intangibles was "beyond comprehension." The *ABI* opinion considered that

principle conclusive as to the electronic delivery of the taxpayer's business data for sales factor apportionment purposes.

The opinion did not address any factual differences which obtain between information assembled by the provider for delivery in digital form and information selectively downloaded by customers in the course of remotely accessing ABI databases. Such arrangements arguably reflect the provision of services. Query: if electronic signals were transmitted, but not stored (downloaded) to the customer's computer or server in such a browsing session, would there be a transfer of tangible personal property? Headed off in an entirely different direction in such circumstances, Florida's sales tax rules declare that electronically accessing such remote databases constitutes a rental of the equipment upon which such information resides, with the result that Florida sales tax is due if the database is found on a computer located in Florida, but exempt if the database exists on computer equipment in another jurisdiction. F.A.R. 12A-1.032(3). Although the *ABI* ruling accommodated the position sought by the taxpayer, its holding that the transmission of electronic signals reflects a sale of TPP to recipients for state apportionment purposes has large and obvious implications.

The notion that electronic "storage" establishes the presence of TPP did not fly in a recent matter before the Missouri Administrative Hearing Commission. On August 20, 2010, that body issued a decision holding that pre-written software delivered on a "load and leave" basis did not constitute a sale of tangible personal property for state sales and use tax purposes. *FileNet Co. v. Director of Revenue,* MAHC No. 07-0146 RS. The seller brought the software to the purchaser's facilities in Missouri using a USB hard drive, downloaded it, and left without giving the purchaser any disk, tape or other such tangible item. The Missouri Supreme Court had earlier affirmed the taxability of canned software delivered on tapes and disks left with the purchaser. *Bridge Data Corp. v. Director of Revenue*, 794 S.W.2d 204 (Mo. banc 1990). The MAHC had ruled in the *Bridge Data* case that software delivered "by telephone" was not subject to sales tax, but that portion of the ruling was not addressed by the Missouri Supreme Court. As for *FileNet*, if the sales factor treatment follows the sales tax treatment, one would not expect digital goods to be treated as TPP, despite the fact that something is stored in physical form as a result of the download.

[6] Sales of Services/Intangibles

Receipts from the sale of services and intangibles are sourced under different rules than those applicable to TPP transactions. The UDITPA sourcing rule for TPP is commonly referred to as destination or "market" based sourcing. Under current Section 17 of UDITPA, sales of "other than tangible personal property" are sourced to the state if "the income-producing activity is performed in this state, or the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." That set of rules requires that specific "income-producing activities" be identified, and, with respect to each such line of income activity, that the costs of producing that income be located geographically.

Note that the UDITPA rule also uses an all-or-nothing approach: receipts from such

transactions are sourced only to the state with the greatest percentage of the costs of performance for the income-producing activity. There are state variations on that all-or-nothing take on COP. Some states source receipts from the sale of services and intangibles using a "pro rata" approach—e.g., attributing 22% of such receipts to the numerator of the State A sales factor if 22% of the income-producing activities occur there based on costs of performance. See e.g., Ark. Code Ann. § 26-51-717(b) and S.C. Code Ann. § 12-6-2295(A)(5) (services sourced to South Carolina "to the extent the income-producing activity is performed in this State"). Virginia compares in-state to out-of-state COP, sourcing the receipts to Virginia only if the in-state costs are greater. Va. Tax Code § 58.1-416.

The MTC regulation, Reg. IV.17(2), interpreting the Act defines "income-producing activity" as follows:

> Income producing activity: defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.

MTC Reg. IV.17(3) defines "costs of performance":

> The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income producing activity which gives rise to the particular item of income. Included in the taxpayer's costs of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.

In *Midwest Bus Corp. v. Dep't of Treasury*, 488 Mich. 992, 791 N.W.2d 283 (Mich.Ct.App. 2010), a contract for the remanufacturing of buses was held to be predominantly a sale of services rather than TPP, so that receipts were sourced to Michigan for Single Business Tax purposes because the business activities producing the income were in that state. MCL 203.53. Under the TPP sourcing rule of MCL 208.52, the receipts would have been sourced to the out-of-state customer markets where the reconditioned buses were delivered.

In *Interface Group v. Comm'r of Revenue*, 918 N.E.2d 97 (Table) (Mass.Ct.App. 2009), the court considered the activities of a business which "bought airfare, hotel accommodations, and ground transportation in bulk [to secure discounted pricing, then] bundled these products into individual travel packages" that were sold by independent travel agents or broker/dealers. Interface contended that the governing statute established a "transactional" approach to identifying the location of costs of performance, i.e., that each sale of a travel package constituted a discrete "income-producing activity." The court accepted the Commissioner's reading of the statute as taking an "operational" approach instead–the "income-producing activities" for

purposes of constructing Interface's sales factor was the assembly and creation of the travel packages collectively. The decision had its roots in *General Mills, Inc. v. Comm'r of Revenue*, 795 N.E.2d 552, 570 (Mass. 2003) (income-producing activities were overall business operations (including billing and customer relations) and management of Talbots) and *Boston Professional Hockey Ass'n v. Comm'r of Revenue*, 820 N.E.2d 792 (Mass. 2005) (income-producing activity was operation of a NHL franchise, not the playing of individual games).

The identification of the relevant "income-producing activity" was again at issue in *Crystal Communications, Inc. v. Dep't of Revenue*, 2010 Ore. Tax LEXIS 207 (Or.Tax Regular Div. 2010). In dispute was gain from the sale of a FCC license covering areas within the state of Oregon. The taxpayer maintained that the income-producing activities should be viewed as only those of negotiating and consummating the sale of the FCC license. The court was of a different mind, saying that "those transactions and activity were the development, operation, and sale of the cellular network in the license area." It held that all activities whose *ultimate* goal was the realization of a profit should be treated as part of the income-producing activities yielding the gain in question, not simply "the last acts taken to realize gain."

Taking just the opposite tack is *Ameritech Publ'g, Inc. v. Wis. Dep't of Revenue*, 327 Wis. 2d 798, 788 N.W.2d 383, 2010 WI App 100 (Wis.App. 2010). In that case the dispute centered on receipts from the sale of advertising in local telephone directories distributed in Wisconsin. The transactions were determined to constitute the sale of services, not tangible personal property for apportionment purposes. The taxpayer insisted that many of the applicable costs of performance (in creating and marketing the advertising) occurred outside Wisconsin, a matter not factually contested. The statute then in effect used a proportionate approach, attributing receipts from the sale of services to the state based on the COP within Wisconsin. While there was no dispute over the fact that marketing, graphics, layout, billing and other activities occurred outside Wisconsin, the court accepted the Department's contention that the only relevant activity was the last one—that of distribution of the directories. It did not matter in the court's view that another party, the printer of the directories, actually effected the distribution per the publisher's instructions. The statutes expressly excluded activities conducted on the taxpayer's behalf by independent contractors. The court rationalized its acceptance of the Commissioner's construct, saying that API's service was "at bottom, the provision of access to a Wisconsin audience."

Effective January 1, 2005, the statute was changed to provide that if the benefit of a service is received in Wisconsin, income from that service is fully allocable to Wisconsin. Wis.Stat. § 71.25(9). Following rules like those Florida used in its short-lived sales tax on services in 1987, the Wisconsin statute deems the benefit to be received in the state if the service

- relates to real property in Wisconsin
- relates to TPP that is in Wisconsin when the service is received
- relates to TPP delivered directly or indirectly to customers in Wisconsin

— is provided to a person physically present in Wisconsin when the service is received, or

— is provided to a person engaged in business in the state and relates to that business in Wisconsin.

Other states have adopted a place of delivery or benefits-received test (forms of market-based sourcing), as distinct from the current UDITPA costs of performance method. *See e.g.*, Ga. Code Ann. § 48-7-31(d)(2)(C)(I) and Ga. Comp. R. & Regs. 560-7-7-.03(5)(c)(6)(ii), Mich. Comp. Laws s. 208.1305(2)(a) and Iowa Admin. Code s. 701-54.6(a). A benefits-received test will be used for sourcing services in California commencing with tax years beginning on or after January 1, 2011. Cal. Rev. & Tax. Code § 25136.

The *Ameritech* analysis effectively disregards the costs of performance in favor of sourcing based on the market into which the services are provided; it transmutes the COP statute into the benefits-received rule for years preceding the legislative change. On virtually identical facts, a Tennessee appellate court allowed a "variance" from the UDITPA costs of performance rule in *BellSouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350 (Tenn.Ct.App. 2009). The variance it allowed simply applied a customer-location or benefits-received approach, based on the distribution of the directories in Tennessee. While the opinion described the situation as "unusual," an effort to accommodate the UDITPA drafters' view that relief from the regular apportionment formula would be granted only in extraordinary or unusual circumstances, it is evident that there are numerous instances in which the costs of performing a service would occur outside the jurisdiction in which the services benefit the purchaser.

[7] Pending MTC Proposal/Section 17

The Multistate Tax Commission has been urging the revision of the UDITPA Section 17 sourcing rules for services and intangibles for the last few years. It endeavored to have such changes made by the Uniform Law Commission, formerly the National Conference of Commissioners on Uniform State Laws (NCCUSL). See Huddleston & Sicilian, *The Project to Revise UDITPA*, from the proceedings of the NYU Institute on State and Local Taxation (2009). Although that effort failed, the MTC is pressing forward with its own proposals to abandon costs of performance sourcing in favor of a market-based approach. The July 2010 draft of Section 17 being considered by the MTC Uniformity Subcommittee reads as follows:

17 (a) Sales, other than sales described in Section 16 [sales of TPP], are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:

(1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;

(2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;

(3) In the case of sale of a service, if and to the extent the service is delivered

to a location in this state; provided, that if such location cannot be determined, it shall be reasonably approximated;

(4) In the case of sale, lease or license of intangible property, if and to the extent the intangible property is used by the payor in this state; provided, that if the location of such use cannot be determined, it shall be reasonably approximated.

(b) If the taxpayer is not taxable in a state to which a sale is assigned, or if the state of assignment cannot be determined under subsection (a), such sale shall be excluded from the denominator of the sales factor.

It is expected that the draft will be reviewed, and possibly revised, during Subcommittee discussions of it on October 19 and November 16, and brought to conclusion during a 4-hour review of the same during MTC meetings December 7–9, 2010 meeting in Atlanta.

How will a benefits-received test be used in the case of electronically-delivered services? Consider, for example, the digital provision of customized information resulting from research performed by a seller, or the provision of customized software treated as a services transaction. If the relevant statute uses benefit identification rules like those of Wisconsin described above, the determination would need to be made whether the service relates to real property in a given jurisdiction, TPP located there, or the operation of a business in the subject jurisdiction. If the new UDITPA proposal moves forward and is adopted in a given jurisdiction, the "delivery" location would control, failing which the taxing agency would presumably "approximate" such location—a process not defined or otherwise explained in the current draft. The use of a delivery point suggest planning opportunities—it would be easy enough to have digitally-delivered services conveyed to a low tax-rate location under the taxpayer's control, and re-transmitted to other points in higher-rate jurisdictions for actual use. Furthermore, it is unclear how simultaneous delivery to multiple locations (multiple points of use) would be handled under the pending MTC proposal. With little extant judicial authority, state budgets in poor condition, the probability that digital goods and services will be treated, for state apportionment purposes, either as intangibles or services, increased emphasis on the sales factor, and the steady march toward market-based sourcing of sales receipts, the only certainty is that exciting times lie before us.