State and Local Tax ADVISORY

June 12, 2012

“Outwit, Outplay, *Outsourced*”: A Sales and Use Tax *Survivor* Guide

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This article was originally published on May 7, 2012, in *State Tax Notes*, as part of Alston & Bird’s regular column “Audit & Beyond.” *See* 64 State Tax Notes 379 (May 7, 2012).

When people hear or read about U.S. companies engaging in outsourcing transactions, their immediate reaction is negative because they envision those U.S. companies moving jobs overseas, most notably to India.[1] Indeed, in 2004, during his presidential campaign, U.S. Sen. John Kerry, D-Mass., referred to companies that outsource as “Benedict Arnold” companies. Technically, Kerry is concerned about companies that engage in offshoring, but not all outsourcing involves offshoring. However, the public and media often — and incorrectly — use the terms “outsourcing” and “offshoring” interchangeably. Regardless of the effect on U.S. jobs, there can be no debate about the explosive growth in outsourcing, particularly information technology (IT) outsourcing, both offshore and onshore. This growth, coupled with the expansion by states of their sales and use tax bases, particularly in the area of computer and related technology services, has created significant complexity surrounding the sales and use tax consequences of IT outsourcing transactions. As practitioners (whether in law firms, accounting firms, or in-house), we must understand the intricacies of these transactions as well as the multistate sales and use tax issues in order to help our client or company (that is, the outsourcing customer) survive the sales and use tax minefield typically associated with these transactions. This article serves as a primer on the sales and use tax questions most often encountered in IT outsourcing transactions[2] from the perspective of the customer (the vendor is generally more familiar with the tax questions because it has engaged in these transactions repeatedly). The first section provides an introduction to outsourcing and explains why we care about sales and use tax questions. The second section examines several of the more common sales and use tax questions that arise from IT outsourcing transactions. Finally, the third section provides some practical guidance, particularly regarding sales and use tax questions in the main outsourcing agreement, typically called the master services agreement (MSA).

What Is Outsourcing and Why Should One Care About Sales and Use Taxes?

Although many may view outsourcing as some sophisticated, 21st century phenomenon because it has been in the news for the last several years and often involves new technology-related transactions, the truth is that companies have been engaged in outsourcing transactions for decades. At a basic level, outsourcing is simply the act of contracting the performance of a business function (in whole or in part) to a third party (rather than

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[1] Note on the title: For those who do not watch the CBS hit reality show *Survivor*, the show’s motto is “Outwit, Outplay, Outlast.”

[2] This article focuses on IT outsourcing transactions because they are one of the more popular types and because these transactions typically raise the most complex state and local tax issues.

performing it in-house). In this sense, outsourcing is the opposite of vertical integration. When viewed from this perspective, companies frequently engage in outsourcing, whether it's hiring a payroll processor, contracting with a law firm for legal services, hiring an accounting firm to prepare tax returns, or engaging a marketing firm to market and advertise the company's products or services. Any time that a company pays a third party to perform a service instead of hiring its own employees to perform that service in-house, the company is outsourcing. Companies outsource some business functions for a variety of reasons. First and most notably, is cost savings. For example, the price to pay a payroll processor for payroll services is cheaper than the cost of hiring employees and acquiring the infrastructure, equipment, and other overhead to perform that function in-house. Second, outsourcing allows companies to focus on their core businesses by freeing up capital that would have otherwise been spent on the out-sourced function. Finally, outsourcing provides companies with the ability to tap expertise in some areas, like IT and engineering, when it may be too costly or difficult to develop that expertise in-house.

So why should one care about sales and use taxes on outsourcing transactions? When services are provided by an employee to his employer, they are not subject to sales tax.[3] Thus, if an employee develops a custom computer program for the employer to use in its business, the employer is not subject to sales or use tax based on the compensation paid to the employee. However, if instead of having the employee develop that software, the employer hires a third party (that is, outsources the custom software development), any fee that the employer pays the third party would be subject to sales tax if the state with jurisdiction to tax the transaction treated the sale of custom computer software as a taxable service. In other words, services performed in-house are generally not subject to sales and use taxes, whereas those same services performed by a third party may be taxable depending on the state sales tax laws. If a company is engaging in an outsourcing transaction primarily to reduce expenses, it is important at the outset to understand the sales and use tax issues associated with the outsourcing arrangement because any sales and use tax cost will reduce the tax savings. For example, if a company maintained its own IT department at a cost of $10 million per year (employee wages and benefits, infrastructure, other overhead costs, and so on), but then decides instead to outsource its entire IT function to a third party for $9 million per year, the company can realize savings of $1 million per year. However, to use an extreme example, if a state taxed all the services provided by the third party at a rate of 7 percent, the customer would be required to pay $630,000 per year in sales taxes, reducing the savings to $370,000 per year, significantly less than anticipated. Although the savings may still make the transaction worthwhile, this example illustrates the need for practitioners to provide the client a detailed analysis of the sales and use tax issues associated with these transactions at the outset because any taxes will cut directly into the marginal savings anticipated by the client (which most likely will not have figured potential taxes into the cost-savings calculation). In some cases the cost savings, after taking account of the sales and use tax liability, may be too small to justify the transaction or may eliminate the savings. What is most important, however, is that the client be aware of the tax issues *before* entering into the transaction, because afterward it will be too late.

Common Sales and Use Tax Issues

In order to determine the sales and use tax effect on the cost of outsourcing transactions, we must first understand how states tax the various products and services that are provided in those outsourcing transactions. Because new technology is constantly being developed, the taxation of outsourcing transactions is always

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[3] For example, South Dakota, which, unlike most states, generally taxes services, defines the term "service" to exclude "services rendered by an employee for his employer." S.D. Cod. Laws section 10-45-4.1.

in a state of flux. Without limiting the scope of potential products or services that an IT outsourcing vendor may provide, generally those transactions involve products and services that states may classify as of one or more of the following:

- computer hardware and software;
- maintenance of the hardware and software;
- cloud computing services;
- information technology services; and
- data processing services.

One of the difficult aspects of analyzing the sales and use tax effect of IT outsourcing transactions is trying to determine whether a particular product or service fits into one of those classifications. This section of the article is intended to provide a high-level overview of the sales tax treatment of these classifications; state laws differ and each state must be reviewed to make a final determination. Because of the constantly changing technological landscape, states struggle to keep their tax codes and guidance up to date; however, there is guidance from many states on one or more of these classifications.

In addition to the issues mentioned above, this section will review the sales and use tax issues associated with sourcing (that is, which states' laws apply to the transaction) and bundling (that is, what happens when one or more products or services are provided). These issues are equally important and can have a significant effect on the resulting sales and use tax analysis.

For those who do not focus on sales and use tax issues, states generally impose sales and use tax on retail sales of tangible personal property and on services if those services are enumerated in the statute as taxable.[4] Therefore, a review of the sales and use tax consequences of an outsourcing transaction begins with a review of the definition of tangible personal property, which is defined by many states as "personal property which may be seen, weighted, measured, felt or touched, or which is in any manner perceptible to the senses."[5] However, that definition has been applied to new technology differently in different states, as we discuss in more detail below.

Computer Hardware and Software

Outsourcing transactions frequently require the vendor to provide computer hardware and software to the customer. Many states consider computer hardware to fall within the definition of tangible personal property stated above and therefore treat computer hardware as tangible personal property, which is generally taxable under state sales and use tax laws. Furthermore, some states include embedded software in the definition of computer hardware.[6] However, there are some instances in which computer hardware is exempt from

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[4] *See e.g.*, Ga. Code Ann. section 48-8-30(a). ("There is levied and imposed a tax on the retail purchase, retail sale, rental, storage, use, or consumption of tangible personal property and on the services described in this article.")

[5] *See e.g.*, Calif. Revenue and Taxation Code section 6016; Code of Ala. 1975, section 40-12-220(8).

[6] *See* New York TSB-M-98(5)(S) (June 8, 1998).

sales and use tax. One example is computer system hardware used or consumed directly and predominantly in designing and developing computer software for sale or in providing service for sale, or designing and developing Internet websites.[7]

There is also considerable guidance on the sales and use taxation of computer software. Canned software, or pre-written software that is not designed and developed by the author or other creator to the specifications of a specific purchaser, is generally treated as tangible personal property subject to sales and use tax.[8] However, taxpayers must look carefully at the definition of canned software to determine how aggressive a state may be regarding taxable software. For example, New York defines canned software as:

> the combining of two or more pre-written computer software programs or pre-written portions thereof does not cause the combination to be other than pre-written computer software. Pre-written software also includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser. Where a person modifies or enhances computer software of which such person is not the author or creator, such person shall be deemed to be the author or creator only of such person's modifications or enhancements. Pre-written software or a pre-written portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains pre-written software; provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute pre-written computer software.[9]

Contrast the broad and detailed New York definition with the somewhat vague inclusion of computer software in Texas's definition of tangible personal property.[10]

Many states exempt custom software from sales and use tax. "Custom software" is generally defined as software that was originally designed and developed to the specifications of a specific purchaser.[11] However, states also reclassify canned software as custom software in some instances. For example, in New York, custom software "loses its identity as such and becomes prewritten software, subject to tax, if and when it is sold to someone other than the person for whom it was specifically designed and developed."[12] California law states that "custom computer program" excluded from sales tax does not include a program that "was initially developed on a custom basis or for in-house use" if that program is later "held or existing for general

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7 *See* N.Y. Tax Law section 1115(a)(35).

8 *See Iowa Code section* 423.1(54); Ill. Admin. Code 130.2105; Minnesota Stat. section 297A.01.

9 N.Y. Tax Law section 1101(b)(16).

10 *See* Texas Tax Code section 151.009.

11 *See* Calif. Revenue and Taxation Code section 6010.9(d).

12 TSB-M-93(3)S. *But see* N.Y. Tax Law section 1115(a)(28), allowing an exemption for computer software designed and developed by the author or creator to the specifications of a specific purchaser, and later sold or transferred to (a) a corporation that is a member of an affiliated group of corporations that includes the purchaser, or (b) a partnership in which the purchaser and other members of the affiliated group have at least a 50 percent capital or profits interest. For corporations, the term affiliated group is defined under IRC section 1504, except that references to "at least 80 percent' in IRC section 1504 must be read as "more than 50 percent' for New York State tax purposes.

or repeated sale or lease."[13]

A second consideration in determining the taxation of computer software is whether the type of delivery of the software affects the taxation of the transaction. In most states, the manner of software delivery is irrelevant to the taxation of a sale of canned software. For example, New York's definition of taxable tangible personal property includes "pre-written computer software, whether sold as part of a package, as a separate component, or otherwise, and *regardless of the medium* by means of which such software is conveyed to a purchaser."[14] Kentucky has a similar provision:

> prewritten software and other tangible personal property such as books and movies, that are downloaded electronically to Kentucky customers are taxable on the same basis as comparable products delivered by mail or purchased over the counter. Prewritten software delivered via load and leave is also taxable.[15]

However, many states do not consider software that is delivered electronically to be a taxable sale of tangible personal property. Beginning July 1, 2012, Colorado will tax computer software if it meets all the following criteria: the software is prepackaged for repeated sale or license; the use of the software is governed by a tear-open non-negotiable license agreement; and *the software is delivered to the customer in a tangible medium*. Software is not delivered to the customer in a tangible medium if it is provided through an application service provider, delivered by electronic software delivery, or transferred by load and leave software delivery.[16] In California the sale or lease of a pre-written program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a pre-written program is not a taxable transaction if the program is installed by the seller on the customer's computer, except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.[17]

Computer Maintenance and Other Computer-Related Services

Outsourcing transactions that require use of specific computers and computer programs may offer computer maintenance and other computer-related services as part of the outsourcing agreement. Many states do not impose sales and use tax on services, and those that do impose tax only do so on services that are enumerated in the statute as taxable. Therefore, in some states, maintenance agreements are exempt from sales tax because they are nontaxable services and are not tangible personal property.

However, states typically consider mandatory maintenance contracts connected with the purchase of computer hardware or canned computer software to be indivisible from the purchase of the underlying tangible personal

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[13] Calif. Revenue and Taxation Code section 6010.9(d).

[14] 14N.Y. Tax Law section 1101(b)(6) (emphasis added).

[15] 15Ky. Rev. Stat. Ann. section 139.010(22); *see also* Neb. Rev. Stat. section 77-2701.16; New Jersey Rev. Stat. Ann. Section 54:32B-2(g).

[16] Colorado FYI Tax Publication Sales 89, July 1, 2011.

[17] Cal. Code Regs. section 1501(f)(1)(D); *see also Iowa Code 423.3*; Ill. Admin. Code 130.2105.

property and therefore subject to sales and use tax.[18]

States differ in their taxation of optional maintenance contracts purchased as part of the same transaction as the purchase of hardware or canned software. For example, in California, there is a non-rebuttable presumption that the sale of an optional software maintenance contract as a single lump sum charge or price is subject to tax measured by 50 percent of the lump sum charge. The remaining 50 percent is presumed to be a charge for nontaxable repair services.[19] Idaho taxes contracts for computer software upgrades, but does not impose tax if the contract is for support services for the software such as telephone or on-site support.[20]

Cloud Computing

Cloud computing involves a purchaser's access to on-demand IT resources, software applications, and computer data maintained remotely by the provider of the service. The cloud is being used more and more frequently by service providers. A search of the term "cloud computing" identifies few pieces of guidance, in part because few states use this term in their guidance and in part because few states have directly addressed the taxation of cloud computing services. Those that have did so through administrative guidance with differing conclusions.[21] Examples include:

- Arizona Taxpayer Information Ruling LR10- 007 (Mar. 24, 2010) (a taxpayer who licenses software supported on servers in Arizona is deemed to be engaged in the licenses of tangible personal property and the gross receipts from those transactions are subject to the transaction privilege tax);
- Kansas Opinion Letter No. O-2010-005 (June 22, 2010) (separately stated fees such as recurring monthly charges, setup fees, support fees, training fees, and so on charged by ASPs to their customers for ASP services are not subject to sales tax); and
- Texas Policy Letter Ruling No. 201004665L (Apr. 29, 2010) (software as a service is a taxable data processing service).

As you can see from the rulings cited above, the cloud involves different types of transactions that states may tax differently. Therefore, the threshold question is: What is the cloud for state tax purposes? Is it software? Is it a service? Complicating matters is the fact that there are basically three variations of the cloud: software as a service (SaaS), through which software needed for a particular activity is accessed remotely; platform as a service (PaaS), which provides both the applications and hosting resources needed to support the building and delivering of Web applications and services; and infrastructure as a service (IaaS), which is the most basic and offers virtual computer services with an operating system and application software. Because of the

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18 *See State of Alabama Dep't of Rev. v. Storage Technology Corp*., S. 89-241 (6/17/1991); Ariz. Dep't of Rev. Director's Dec. No. 20080211-S (1/22/2010); Colorado FYI Tax Publication Sales 89, July 1, 2011; Ohio Admin. Code 5703-9-59; Wis. Stat. Ann. section 77.52(2).

19 Cal. Code Regs. section 1501(f)(1)(C).

20 *See* Idaho Tax Update Vol. 19, No. 2, Dec. 1, 2007.

21 *See* Kendall L. Houghton and Maryann H. Luongo, "No Improved Visibility for Cloud Computing Taxation," *State Tax Notes*, July 4, 2011, p. 69, *Doc 2011-14002,* or *2011 STT 128-1*.

complexity and newness of those services, taxpayers frequently have to make judgment calls in applying the limited guidance available to their fact pattern or making an analogy from their fact pattern to a product or service currently being taxed or exempt from tax in the state law and guidance.

Information Services

Many states also impose sales tax on information services. For example, New Jersey imposes a sales tax on information services, defining them as "the furnishing of information of any kind, which has been collected, compiled, or analyzed by the seller, and provided through any means or method, other than personal or individual information which is not incorporated into report furnished to other people."[22] However, the tax applies only to the sale of information services received by customers in New Jersey. Arkansas exempts from tax information services, while Florida subjects such services to tax.[23] Some states' statutes and regulations do not address information services, and regulations, and therefore taxpayers have taken the position that information services are not subject to sales tax.

Data Processing

States that tax data processing services include Connecticut, Ohio, and Texas, and the District of Columbia. Again, the definitions of data processing services vary across the states. Connecticut defines data processing as:

> including, but not limited to, time, programming, code writing, modification of existing programs, feasibility studies and installation and implementation of software programs and systems even where such services are rendered in connection with the development, creation or production of canned or custom software or the license of custom software, and exclusive of services rendered in connection with the creation, development hosting or maintenance of all or part of a web site which is part of the graphical, hypertext portion of the internet referred to as the World Wide Web.[24]

Texas, which taxes data processing services but exempts 20 percent of the value of the data processing service from tax, defines data processing to include "the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information." The term "data processing services" includes "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production, the performance of a totalisator service with the use of computational equipment required by the Texas Racing Act, and other computerized data and information storage or manipulation."[25] California has a detailed regulation that addresses the different types of data processing and the tax treatment of each.[26] There are also states such as Kansas and Washington that exclude data processing from imposition of sales and use tax.[27]

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[22] N.J.S.A. 54:32B-3(b)(12).

[23] *See* Ark. Regs. GR-10.1; Fla. Stat. section 212.08; Fla. Admin. Code Ann. 12A-1.062.

[24] Conn. Gen. Stat. section 12-407(a)(7).

[25] Texas Tax Code Ann. section 151.0035; Texas Admin. Code section 3.330(a)(1).

[26] *See* Cal. Code Regs. 1502.

[27] Kansas Information Guide No. EDU-71R, 07/23/2010; Wash. Rev. Code section 82.04.192(3)(b)(xiv), (xv).

Sourcing

An additional consideration in determining the sales and use taxation of the components of an outsourcing transaction is identifying which state's laws should be applied to a particular transaction — also called sourcing. It is easy to determine the sales taxation of transactions that occur in a store, because the parties to the transaction know where the sale takes place. However, services may occur in many different places and it may not be clear where the services were received. The Streamlined Sales and Use Tax Agreement section 310A provides for sourcing of a "product." That product can be a service or tangible personal property. Therefore, if the service is received by the purchaser at a location of the seller, the seller is to source the sale to that location. If the product is not received at a location of the seller, the seller is to source the sale to the location where the purchaser receives the service, so long as that location is known to the seller.[28] Section 311 of the SSUTA defines receipt and receive for purposes of sourcing services as the location where the purchaser can make first use of the service.[29] If neither of the above applies, the seller is to source to a location for the purchaser available from the seller's business records or to an address for the purchaser obtained during the consummation of the sale.[30] If none of the above apply to the transaction, the seller is to source to the location from which the service was provided.[31]

Bundling

As discussed above, sales of hardware, software, maintenance contracts, cloud computing, and other services often have differing tax treatment. However, providers often bundle taxable and nontaxable transactions into a single price, which can result in the entire transaction — both taxable and nontaxable components — being subject to tax.[32] However, some states provide specific guidance on dealing with bundled transactions. For example, in Texas the total charge for bundled transactions is presumed taxable when the taxable service represents more than 5 percent of the total charge. The presumption is overcome when the taxpayer establishes the portion of bundled charges related to taxable data processing services and nontaxable "unrelated services."[33] Illinois applies a primary purpose test to determine the tax consequences of a transaction. Under that test, if the primary purpose of the transaction is for the sale of tangible personal property, and the services connected with the sale are incidental, the entire sale is subject to sales tax.[34]

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28 *See* Streamlined Sales and Use Tax Agreement section 310A.

29 *See* Streamlined Sales and Use Tax Agreement section 311.

30 *See* Streamlined Sales and Use Tax Agreement section 310A.

31 *See* Streamlined Sales and Use Tax Agreement section 310A; State and Local Advisory Council, "Sourcing of Services with Respect to Tangible Personal Property — Summary Paper"(Sept. 2011).

32 *See e.g.*, Ariz. Admin. Code R15-5-105. ("Gross receipts from services rendered in addition to selling tangible personal property at retail are subject to tax unless the charge for service is shown separately on the sales invoice and records.")

33 34 Texas Admin. Code 3.330(d)(2).

34 *See Village of Rosemont, Ill. v. Priceline.com Inc.*, Slip Copy, 2011 WL 4913262 (N.D. Ill., 2011).

Practical Guidance — Negotiating the MSA Tax Provisions

Because of the complexities associated with analyzing the full effect of sales and use taxes to outsourcing transactions, it is imperative that the MSA cover all potential issues, including those that may arise in the future. This section provides some practical guidance for the client or customer and the tax practitioner on drafting questions to consider when negotiating the tax provisions of the MSA. As a general rule, it is important to review the entire MSA and any statements of work associated with the transaction, and to work directly with the business development people, the outsourcing attorneys, and the consultants to best understand the deal terms and the services that are being provided. IT and related services can be highly technical and confusing to someone who is not expert in computers, software, the Internet, and cloud computing platforms.

Also, it is crucial to work with the vendor's tax personnel and its tax counsel as the deal progresses. Although it may seem that this is an adversarial process, and to some extent it is, be mindful that after the deal is signed, the client is now a customer of the vendor, and a good vendor will want to establish a trusting relationship. Therefore, work with the vendor to understand its view of the tax consequences of the deal, which services are taxable, which services are not taxable, and in which jurisdictions the vendor plans to collect tax. It is likely that the vendor is already engaged in the same process for other customers and has some substantive experience dealing with the tax issues. Working with the vendor early on will also give you time to analyze the vendor's tax positions, to discuss concerns about those positions, and to attempt to resolve those differences before the deal is signed.

Regarding specific provisions within the MSA dealing with taxes, since each deal is going to be different, below are suggestions of issues to consider in the drafting and negotiating process to best position the client or customer should tax issues arise during the term of the MSA.

Definition of Taxes

Generally, the parties are most concerned about the effect of sales and use taxes (referred to hereinafter as "Taxes"), that is, taxes that are imposed on the specific services provided by the vendor to the customer based on the fees paid by the customer to the vendor. Typically, each party will otherwise be responsible for its own property, franchise, income, and other business activity taxes, including taxes based on gross receipts. Because not all states refer to sales and use taxes as "sales and use taxes," consider a definition of Taxes that is based on the underlying characteristics of the tax, as opposed to just saying that Taxes means "all sales and use taxes." Furthermore, parties should consider whether it is necessary in the definition of Taxes to distinguish gross receipts taxes that function legally and economically like a sales tax from those that function more like a business activity tax (for example, Ohio's commercial activity tax). Presumably, the former should be within the scope of the definition, whereas the latter should not.

Financial Responsibility for Taxes (Including Penalties and Interest)

In a typical retail transaction, the customer pays for a product or service based on the posted price, and the vendor adds sales tax to the price and collects it from the customer. The vendor is likely to expect the same process under the MSA, so it will make the customer financially responsible for any Taxes that are required to be paid regarding the provision of services. Nonetheless, it is important to make clear that the vendor has a legal obligation to collect the appropriate tax when required and to remit that tax to the appropriate taxing authority.

Because the customer is bearing the economic burden of the tax and the vendor bears the legal (that is, collection and remittance) obligation, the responsibility for interest and penalties can become an issue in the MSA. Often, the party bearing responsibility for tax liability in a business agreement also bears the interest and penalties that may be added to that liability. However, in an outsourcing transaction (and other transactions involving sales and use tax liabilities), the customer is typically not in control of the collection and remittance of Taxes, and thus should be careful about accepting responsibility for interest and penalties, particularly if they are imposed because of the negligence of the vendor. For example, if the vendor properly and timely collected the Tax from the customer but then fails to timely file the Tax return and remit the tax, should any interest and penalties be the responsibility of the customer? What about the situation in which the vendor does not collect any Tax based on its legal analysis that the services at issue are not taxable in a particular state, but the state later assesses the vendor, claiming that its analysis was incorrect? Should any interest and penalties associated with vendor's failure to collect be the customer's responsibility? Questions such as these should be addressed in the MSA.

Prosecuting Audits and Claiming Refunds

Problems with audits and refunds arise for the same reason that interest and penalties may be a question — the party bearing the legal obligation for the Tax (the vendor) is not the same party that bears the economic burden (the customer). Thus, if the vendor is not collecting Tax based on its legal analysis that the services are not taxable, but the state performs an audit and issues an assessment claiming that the services are taxable, how should that be handled under the MSA? Without any provision dealing with the audit prosecution or defense, the vendor has little incentive to spend its time and money defending a position for which it does not bear the economic burden. The vendor can just concede the issue, pay the Tax, and then seek indemnification from the customer because the customer is financially responsible for the Tax under the MSA (perhaps the vendor will have to pay the interest and penalties). In order to resolve this question, the MSA must provide a specific set of procedures that must be followed if the vendor receives an assessment for taxes from which it will ultimately seek reimbursement from the customer. Questions to be addressed include control of the audit, the right to settle, the costs associated with the audit, and timing of any notifications so that the customer is able to respond and prosecute the audit without missing any deadlines for filing any documents or appeals.

Claim for refunds should be addressed in a similar fashion. Ordinarily, without any mention in the MSA, a vendor has little incentive to file a claim for refund for any Tax it may have overcollected or collected erroneously, since any money returned would be on account of the customer. In some states, only the vendor has the legal right to file a refund claim, and in some states the vendor is permitted to assign its right to file a refund claim to the customer. The MSA should be explicit about what rights the customer has to require the vendor to claim a refund.

Invoicing

As discussed above in the section on bundling, there can be unfavorable tax results if a vendor issues an invoice that does not separately state taxable items and nontaxable items. The MSA should address the format for any invoice and allow the customer to control how the vendor presents information on the invoice.

Service Locations

One question that often goes unaddressed is changes in service location. What if the vendor, at the outset of a 10-year outsourcing transaction, provides services from its location in State A, where those services are not taxable, but in year three obtains a significant economic grant and tax credits from State B and moves its service location to State B, where those services are taxable? Without any provision in the MSA to address that situation, the customer will likely be in a situation in which the anticipated cost savings from the outsourcing deal in years three through 10 are reduced significantly, or even eliminated. The MSA should address whether, and under what conditions, the vendor is allowed to change the location from which it provides services. Does a change require the customer's consent? What about the burden for any new or additional taxes imposed as a result of the location change?

Potential Future Taxes

This question is similar to the question of a change in service location, with one major exception — the vendor did not initiate it. The term of an outsourcing agreement can be many years. What makes the sales and use tax analysis so difficult in these transactions is that not only are the existing rules complex, unclear, and not uniform from state to state, but as states look for ways to raise revenue, expansion of the sales tax base, particularly in the area of services, is highly likely. Therefore, a service that the vendor provides might not be taxable in year one, but may be taxable in year three based on a new statute, a change in the regulations, or perhaps a ruling from the state. Alternatively, and certainly less difficult, there may be a change in the applicable sales and use tax rate. Absent a provision in the MSA to address the tax consequences of these changes, the customer would likely bear the economic burden with similar reductions in cost savings as mentioned above.

Cooperation

Finally, and perhaps least controversial, there should be a provision in the MSA that requires the parties to cooperate with each other to minimize taxes to the extent allowed under law. For example, the MSA may provide that the customer can require the vendor to deliver any taxable software electronically (see discussion of software taxation above). Also, the provision should require the parties to provide any documents, forms, or information to the other as may be necessary to administer tax obligations.

Conclusion

As states continue to expand their sales and use tax bases by focusing on technology-related services, analyzing the potential effect on IT technology outsourcing transactions will remain a challenge. It is crucial that parties engaged in those transactions understand the sales and use tax risks, and that they address those risks through proper drafting of the tax provisions in the MSA.

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