

31st ANNUAL

PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

Sales and Use Tax: What's the Latest and Where Are We Headed?

Zack Atkins, Pillsbury Winthrop Shaw Pittman

Jackie Orea, Andersen Tax

Patrick Reynolds, Council On State Taxation

October 28, 2024

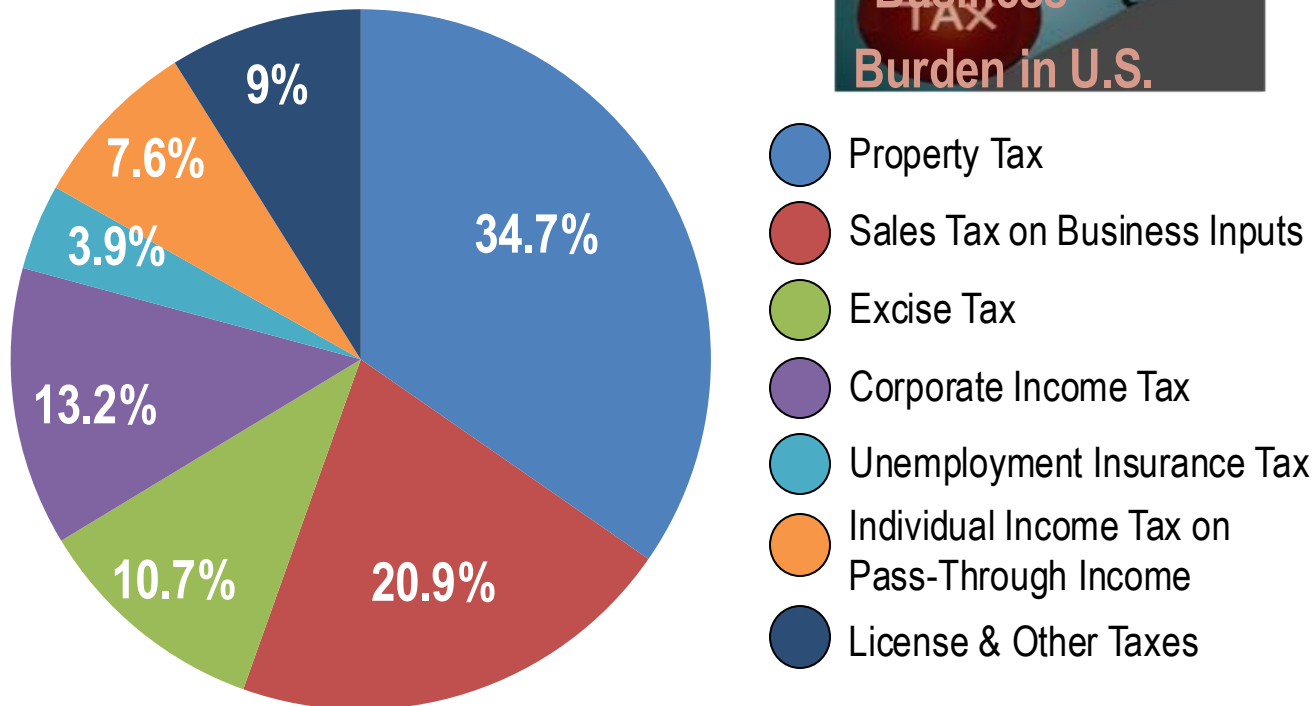
AGENDA

1. The Continued Importance of Sales and Use Taxes to the Fisc
2. (Unsound) Taxation of Business Inputs
3. Increased Focus on Bundled Transactions and Integrated Services
4. Persistent Sourcing and Apportionment Issues
5. Qui Tam and Class Action Lawsuits Continue

The Continued Importance of Sales and Use Taxes to the Fisc

COST/STRI FY 2022 State and Local Business Tax Burden Study

Composition of State and Local Business Taxes by Type, FY22



How Much Do Businesses Pay?

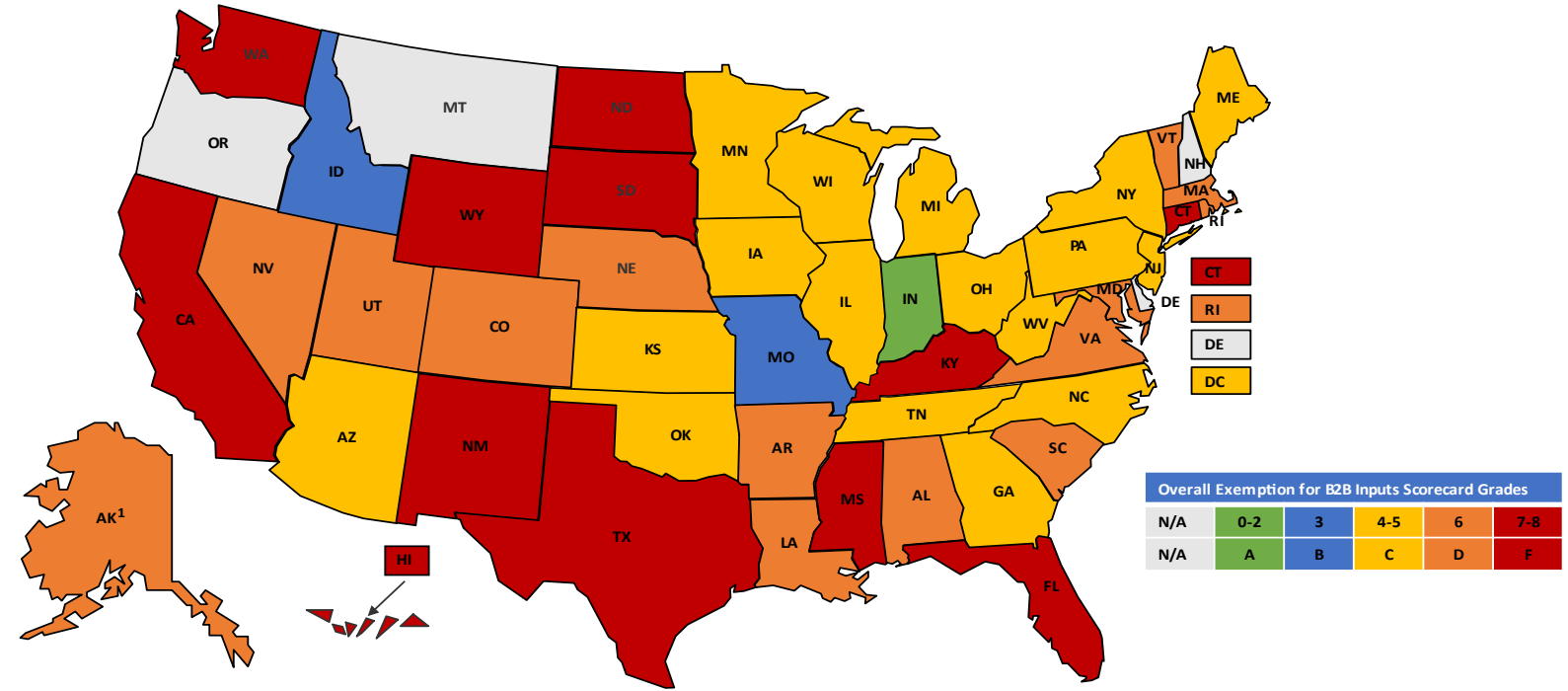
- Businesses paid more than \$1.07 trillion in U.S. state and local taxes in FY22, an increase of 13.7% from FY21
- State business taxes increased by 18% and local business taxes grew by 9%
- Corporate income tax revenue increased by 26.7% in FY22
- In FY22, business tax revenue accounted for 44.6% of all state and local tax revenue
- Remarkably, the business share of SALT nationally has been within approximately 1% of 44% since FY03

Source: *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2022*, study prepared by Ernst & Young LLP for the [State Tax Research Institute](#) and the Council On State Taxation (December 2023)

(Unsound) Taxation of Business Inputs

COST Scorecard - Business Inputs

Exemption for Business Inputs: Overall Grades



Disclaimer : This information should be used for general guidance and not relied upon for compliance.
Source: Council On State Taxation (COST)
¹AK - Data is based on local municipalities since Alaska does not have a state -wide sales tax

COST Scorecard - Business Inputs

- For the last four decades, the sales tax on business inputs contributed slightly over 40 percent of all state and local sales tax revenue.
- In fiscal 2020, the sales taxation of business inputs accounted for 42 percent of all sales tax revenue and over one-fifth of *all* state and local taxes paid by businesses.
- The business inputs share of sales tax revenue ranged from a low of 32 percent (Idaho and Indiana) to a high of 58 to 60 percent (South Dakota, Wyoming, and New Mexico).

COST Scorecard - Business Inputs

- This structural flaw of state sales tax systems — the widespread taxation of business purchases (excluding resale) — is of long-standing origin.
- The shortcomings of this deviation from the norms of a well-designed consumption tax are well documented.
- The pyramiding of sales tax at multiple stages of the supply chain creates a number of distortions because it affects business choices of input purchases, location of jobs and investments, and organization of business structures.
- A well-designed broad-based consumption tax on household goods and services can provide an efficient way to raise revenue for government with a minimal impact on economic growth.
- However, the cascading of taxes on business inputs can undermine this advantage and penalize both domestic business investment and the competitiveness of U.S. exports.

COST Whitepaper on Sales Taxation of Digital Business Inputs

- In 2022, COST published the “Down the Rabbit Hole: Sales Taxation of Digital Business Inputs” whitepaper.
- Per the whitepaper, only 3 states (Iowa, New Jersey, Washington) allow any kind of exemption for business purchases of software or digital products.
- One state (Connecticut) imposes a reduced rate for business purchases.
- Iowa is the only state with an exemption that covers most taxable digital commerce.
- Study is available on COST’s website.

COST 2nd Study on States Taxing Digital Product Inputs

- In January 2024 COST published its 2nd study on states taxation of digital products inputs with a focus on the states' history of exemptions for manufacturing and resale – study available on COST's website.
- Digital products are often a hybrid with features that are like tangible personal property and some features that are more similar to services
- States often expand their base to include digital products but fail to address exemptions for the creation, development, and combination of digital inputs before such products are sold to end-user consumers
- The Study notes the importance of states addressing these exemptions before or during an expansion of the tax base to minimize the concerns with revenue losses.
- States benefit by providing an improved environment for business to conduct their operations and reduce tax pyramiding.

Increased Focus on Bundled Transactions and Integrated Services

True Object/Primary Function Issues

- Identifying the true object/primary function of a product is a fact-intensive exercise, and few states have established objective rules or guidelines.
- In *Matter of FacilitySource, LLC*, Nos. 829500 & 829501 (N.Y. Div. Tax Apps. May 9, 2024), an administrative law judge determined that sales of facilities management services, which entailed intaking, managing, and resolving facilities work orders at national retail chains, were taxable sales of prewritten software or, alternatively, taxable sales of information services.
- The determination casted doubt as to whether the taxability of all mixed transactions is determined on the basis of primary function.

True Object/Primary Function Issues

- Some states take the approach that the true object test applies to each component of a transaction rather than the transaction as a whole.
- In *CheckFree Services Corp. v. Harris*, No. 2019-43 (Ohio Bd. Tax Apps. Oct. 10, 2024), which concerned debit authorization and disbursement authorization services, the Board held that when components of an integrated service are separately stated on invoices, the true object of each component must be analyzed—not the true object of the contract as a whole.
- The Board also held that “data authorization services” do not constitute taxable automatic data processing, electronic information, or computer services.

Bundling

- Texas Comptroller Proposed Data Processing Regulation (Rule 3.330)
- Purportedly based on prior guidance and long-standing policies, the Draft Rule provides definitions, examples, and – perhaps most importantly – that the “essence of the transaction” rule does not apply to data processing transactions.
- In determining whether data processing is ancillary to a nontaxable service, the Comptroller will focus on what seller is doing, not what taxpayer wants.
- “The buyer will never want the manipulation of data for its own sake.”
- Comments were due by October 13.

Continuing Transaction Characterization Issues

The “*ADP*” Problem

- Statutes and regulations are not keeping up with advancements in technology and changes in how products and services are being purchased, forcing taxpayers and taxing authorities to apply antiquated authority to new products.
- In *ADP, LLC v. Ariz. Dep’t of Revenue*, 524 P.3d 278 (Ariz. Ct. App. 2023), the court held that an HR service provider’s software licensing receipts were taxable receipts from the rental of tangible personal property, despite the fact that all customers accessed the same servers and none had exclusive use of the software.

Mixed Transaction Issues

- Identifying the true object/primary function of a mixed transaction is a fact-intensive exercise, and few jurisdictions have established objective rules or guidelines.
- In *Matter of FacilitySource, LLC*, Nos. 829500 & 829501 (N.Y. Div. Tax Apps. May 9, 2024), an administrative law judge determined that sales of facilities management services, which entailed intaking, managing, and resolving facilities work orders at national retail chains, were taxable sales of prewritten software or, alternatively, taxable sales of information services.
- The determination casted doubt as to whether the taxability of all mixed transactions is determined on the basis of primary function.

MTC Digital Products Workgroup

- Created in July 2021 under Uniformity Committee
- Deliverable will be a whitepaper on state sales tax of digital products and alternative approaches to taxation
- Monthly workgroup calls with focus on different topics
- Challenging to come to recommendations
- Definitions and Bundling have been focus to date

Sticky Sourcing/ Apportionment Issues

Multiple Points of Use

- In *Oracle USA, Inc. v. Commissioner of Revenue*, 487 Mass. 518 (2021), the Massachusetts Supreme Judicial Court held there is a statutory right to apportion sales tax on prewritten computer software used in multiple jurisdictions.
- Other states, such as Minnesota, New York, Ohio, Pennsylvania, Tennessee, Texas, Utah and Washington, also expressly recognize MPUs, although some are stricter than others.
- To the extent the state recognizes MPUs, formally or informally, does it apply to digital goods or services only?

Unapportioned Use Tax

- In *Ellingson Drainage*, an out-of-state drain tile installer used movable construction equipment purchased outside South Dakota in connection with South Dakota projects, without paying South Dakota use tax.
- South Dakota Supreme Court sustained a use tax assessment based on the full fair market value of the equipment at the time of use against the taxpayer's as-applied Due Process Clause and Commerce Clause challenges. *Ellingson Drainage, Inc. v. S.D. Dep't of Revenue*, 3 N.W.3d 417 (S.D. 2024), *cert. denied*, ___ S. Ct. ___, No. 23-1202 (Oct. 7, 2024).
- Does the imposition of an unapportioned use tax violate external consistency?

Distribution Center Complexity

- In *VVF Intervest, LLC v. Harris*, No. 2019-1233 (Ohio Bd. Tax Apps. Sept. 13, 2023), the Board held receipts from products temporarily stored at an Ohio warehouse and ultimately delivered outside the state could not be situated to Ohio, confirming situsing is based on where property is received after all transportation is complete.
- In *Jones Apparel Group v. McClain*, Nos. 2020-53 & 2020-54 (Ohio Bd. Tax App. Sept. 13, 2023), the Board confirmed contemporaneous knowledge regarding the product's ultimate destination at the time of transportation is not required, but held that the taxpayer did not meet its burden of proof.
- The Ohio Supreme Court will hear both cases.

Continuing Qui Tam and Class Action Risk

False Claims Acts & Taxes

- A majority of states, and even some local governments, have laws which impose liability for submitting false claims; most have a tax bar but some, most notably New York and Illinois, do not.
- Some state false claims acts include qui tam provisions, which authorize private citizens to sue, on behalf of the government, persons alleged to have submitted false claims and recover a portion of the ultimate award.
- In general, penalties are imposed on a per-violation basis, and damages may be trebled.

Why This Is a Bad Idea – Exhibit A

- In *People v. Sprint Nextel Corporation*, 42 N.E.3d 655 (N.Y. 2015), a majority of the New York Court of Appeals held that a sales tax statute unambiguously imposes tax on interstate voice service sold by a mobile provider along with other services for a fixed monthly charge and that the Attorney General sufficiently pleaded a cause of action under New York’s false claims act.
- The dissent argued that both the taxpayer and Attorney General had advanced reasonable interpretations of the statute, making the statute inherently ambiguous and thus precluding any showing of actual falsity (a threshold requirement under the state false claims act).

Recent Developments

- The District of Columbia expanded its false claims act to include tax claims effective January 2021.
- In 2023, New York amended its false claims act to cover “tax law violations” where a person “knowingly and improperly avoided an obligation to pay taxes to the state or a local government,” i.e., non-filers.
- In *People v. Sears Brands, LLC*, Nos. 1-23-1163 & 1-23-1177 (Ill. App. Ct. Sept. 30, 2024), a qui tam action, the court held that a home improvement retailer violated the state’s false claims act when it paid use tax on certain installed appliance sales, instead of charging sales tax, because it was contrary to a nonbinding alert issued by the department of revenue.

Class Actions - The Other Side of the Coin

- Adopting a more conservative approach to minimize audit risk may potentially increase consumer class action risk.
- In Missouri, an individual filed a now-settled class action lawsuit against a beauty retailer for charging tax on online transactions at the higher sales tax rate instead of the lower vendor use tax rate.
- In Florida, an individual filed a now-dismissed putative class action lawsuit against an online food ordering and delivery platform for charging sales tax on separately stated delivery fees; but state law provides an affirmative defense when the retailer remits the tax collected to the taxing authority.

31st ANNUAL

PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

THANK YOU!

