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PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

Top 10 Sales and Use Tax Developments

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Learning Objectives

After attending this session, participates will be able to:

- Discuss recent sales/use tax cases, legislative developments, rulings and audit trends.
- Identify risks, opportunities and mitigation ideas to consider when encountering these developments.

Agenda

1. Nexus – Cookie Nexus
2. Nexus over the Transaction
3. Nexus – Consigned Inventory
4. Sales Price
5. Imposition of Tax
6. Characterization
7. ITFA Preemption
8. True Object
9. Situsing / Apportionment
10. Sales Tax Collection Scheme

Nexus

U.S. Auto Parts Network, Inc. v. Comm'r of Revenue, Dkt No. C339523 (Mass. Appellate Tax Board 12/7/2021)

- Issue: Whether pre-Wayfair, placement of cookies and applications on customers' computers and phones, and use of third-party "content delivery networks" ("CDNs") which expedited access to its website via the CDNs' servers, creates substantial nexus.

- Background: U.S. Auto Parts sold products to customers via the Internet. On September 22, 2017, the Massachusetts Department of Revenue promulgated a regulation stating that cookies and applications distributed or stored on computers or other devices inside the state established physical presence for sales tax purposes.

U.S. Auto Parts Network, Inc. v. Comm'r of Revenue, (cont'd)

- Holding: The Massachusetts Appellate Tax Board (ATB) ruled that the Commonwealth could not impose tax collection responsibilities on U.S. Auto Parts Network pre-Wayfair. Wayfair could not be applied retroactively, and that the physical presence standard applied to pre-Wayfair tax periods. The ATB also concluded that cookies and apps do not constitute physical presence.

- Status: The taxpayer requested a direct appeal to Massachusetts Supreme Judicial Court after the Department appealed to the Court of Appeals. The taxpayer's request has been accepted.

Quad Graphics Inc. v. North Carolina Department of Revenue, North Carolina Supreme Court No. 407A21-1, Tenth District (Oral argument August 30, 2022)

- The North Carolina Business Court held that Quad does not have the required nexus to impose sales and use tax on its book and catalog sales to North Carolina customers because title to the items transferred outside the state.
- Quad had a salesperson located in NC for the period in question. Under the contracts between Quad and its customers, title and possession to the sold products transferred outside NC.
- The Court agreed with Quad that the U.S. Supreme Court's 1944 holding in *McLeod v. J.E. Dilworth Co.* applied, meaning NC did not have sufficient transactional nexus — the nexus between a state and the activity being taxed — to the disputed sales under the U.S. Constitution's Commerce Clause.

Quad Graphics Inc. v. North Carolina Department of Revenue (cont'd)

- *Dilworth* precluded sales tax liability in cases where out-of-state goods were delivered by a common carrier into a state and title and possession to the goods transferred to the purchasers outside the taxing state.
- Court agreed with Quad that the holdings in *Dilworth* remain good law, saying that the Supreme Court's 2018 decision in *South Dakota v. Wayfair Inc.* did not overrule *Dilworth* formalism.
- MTC filed an amicus brief in support of NC arguing that *Dilworth* was overruled by *Complete Auto's* four-part test and its express rejection of the *Spector* case that rests on the same formalism as *Dilworth*.
- 21 states filed an amicus brief in support of NC.

Bed Bath & Beyond Inc. v. Dep't of Treasury, Michigan Court of Appeals No. 352088; No. 352667; LC No. 18-000220-MT (July 8, 2021)

- Bed Bath & Beyond (BBB) developed advertising materials outside Michigan and sent them to a third-party to distribute to retailer's mailing list by USPS.
- The Department argued that "tangible personal property is subject to use tax when a taxpayer exercises its rights of ownership over the property within the boundaries of Michigan," and that BBB exercised its ownership over the advertising materials because they required Michigan taxpayers to use them at specific stores in the state by a specific date.
- The Michigan Court of Appeals affirmed the Court of Claims decision which concluded that BBB did not "use" its postcards, circulars, coupons, and newspaper inserts (advertising materials) in Michigan because it "deferred all aspects of delivery" to a third-party direct mail vendor. The Court of Claims determined that there had not been "sufficient retention of control" of the advertising materials by BBB to constitute "use" in the State.
- The Michigan Supreme Court denied the Department's application for appeal in an order dated March 23, 2022.

Online Merchants Guild v. Hassell (Pa. Cmwlth. Ct. Sept. 9, 2022)

- Merchants that sold through Amazon's "Fulfillment by Amazon" (FBA) program challenged the Pennsylvania Department of Revenue's efforts to require them to complete Business Activities Requests
- Issue was whether the FBA merchants could be held responsible for Pennsylvania sales tax (or personal income tax) because Amazon stored inventory in warehouses located in the Commonwealth
  - The FBA merchants, through the Guild, argued that they lacked meaningful contacts with Pennsylvania under the Due Process Clause
- The court concluded that the FBA merchants did not place their merchandise in the stream of commerce with the expectation that it would be purchased by a consumer in Pennsylvania
  - Further, the FBA merchants had not availed themselves of Pennsylvania's protections, opportunities, and services

Sales Price

Apple Inc. v. Tax Appeals Tribunal, 167 N.Y.S. 3d 564 2022 NY Slip Op 02459 (Supreme Court of New York, Appellate Division, 4/14/2022)

- The taxpayer had a promotion where qualified purchases received a $100 gift card. When a customer bought a qualified item, the taxpayer would reduce the sales tax base on that item by the amount of the gift card. A customer buys a $1,000 laptop and receives a $100 gift card. Apple considered that a $100 discount, and only collected and remitted tax on the $900 purportedly paid for the laptop.

- The court determined that these promotion giveaways were not in fact discounts and could not reduce the tax base on the sale. The taxpayer thus had under collected sales tax.

Imposition of Tax

Calcasieu Parish School Board Sales and Use Department, et al. v. Nelson Industrial Steam Company (La. Dec. 10, 2021)

- The issue before the court was whether a law limiting the sales and use tax further processing exclusion was invalidly enacted when it was not approved with a 2/3 vote in each house
  - Louisiana's Tax Limitation Clause requires that any legislation levying a new tax or increasing an existing tax receive a 2/3 approval of each house of the legislature
  - As amended, sales tax was imposed on purchases of limestone that were used in the taxpayer's business to produce energy, but also produced a saleable byproduct
- The test for whether a bill implicates the Tax Limitation Clause is whether its enactment caused something that was not taxable to be rendered taxable
- In the court's view, the law was invalidly enacted because it caused the taxpayer's purchases of limestone, which were not taxable before, to become taxable

*Books-A-Million, Inc. v. South Carolina Dep't of Rev. (*S.C. Sept. 14, 2022*)*

- Issue before the court was whether membership fees that entitled bookstore customers to merchandise discounts and free shipping were subject to sales tax
  - The Department asserted that the membership fees were taxable because they were part of the "gross proceeds of sales," which is defined as the value proceeding or accruing from the sale, lease, or rental of tangible personal property
  - The taxpayer argued that the membership fees were not taxable when the purchase of merchandise had not yet occurred
- The court agreed with the Department, holding that the value of the club memberships originated from the sale of taxable goods because the only benefit to buying the club membership was to get the discount on taxable transactions
- There were two dissents- one focused on the fact that the court did not fully address the taxpayer's argument that other retailers that charged membership fees were not paying tax on such fees

Characterization

Hegar v. Black, Mann, & Graham LLP, 2022 Tex. App. LEXIS 1311, 2022 WL 567853 (2/25/2022)

- Issue: Whether the services the taxpayer purchased were taxable data processing services or nontaxable legal services.

- Background: Black, Mann, & Graham (BMG) is a law firm specializing in residential mortgage services. BMG purchased loan packages from its vendors and resold those packages to lenders. The Comptroller assessed sales tax for 2014-2018, claiming the services were data-processing services. BMG claims the services were nontaxable legal services.

- Holding and result: Tex. Admin. Code § 3.330(a)(1) does not create a two-part test as alleged by BMG. The essence of the transaction was the provision of data processing services. The decision of the trial court was reversed, and the refund denied.

Enacomm, Inc. v. Hegar, Cause No. D-1-GN-20-001910, Travis County, Texas, 419th Judicial District (settled April 2022)

- Enacomm is a provider of Interactive Voice Response ("IVR") services, also known as call center services for customers like banks, utilities, and pharmacies. Enacomm uses servers, software applications, and internet and telecom networks to provide a platform for Enacomm's customers to interface with their clients, usually in the form of a digitized voice providing instructions according to pre-set preferences.
- Enacomm's position is that it serves the same function as a human customer service representative would. The only difference is that digitized voice messages are pre-recorded and delivered via software applications. However, no data from Enacomm's customers is stored or processed on Enacomm's servers. No data is processed.
- Enacomm characterizes its product as nontaxable automated call center services. Any data processing is incidental to the true service performed.
- Enacomm's payment after protest lawsuit includes constitutional due process and equal protection claims.

ITFA Preemption

Landis+Gyr Midwest, Inc. v. Washington Dep't of Revenue, Washington Court of Appeals, Case No. 568772 (pending litigation)

- The Department assessed sales tax on L&G's automated meter reading services, which transmits data to Puget Sound Energy, contending that such services constituted taxable "digital automated services" (DAS).
- L&G argued that its services were excluded from tax as it meets the statutory definition "data processing services" i.e., primarily automated, provided to a business, the primary object of which is the performance of operations on data provided by the customer, and to convert the data to usable information.
- L&G paid the sales tax assessed by the Department and sought a refund in the Thurston County Superior Court. The Court granted the Department's motion for summary judgment and L&G appealed to the Washington Court of Appeals.
- On appeal, L&G also asserts ITFA preemption.

True Object

Cincinnati Federal Savings & Loan Co. v. McClain, slip op. No. 2022-Ohio-725 (Ohio Mar. 15, 2022)

- Issue: Whether the services the taxpayer purchased were taxable "automatic data processing" or "electronic information services" or nontaxable "personal or professional services" and whether the true object test applied.

- Background: Cincinnati Federal Savings & Loan purchased "computerized services" from a vendor. Cincinnati paid sales tax to its vendor and claimed a refund of the tax paid from 2013-2015, arguing the services were data processing services.

Cincinnati Federal Savings & Loan Co. v. McClain, (cont'd)

- Holding and Result: The transactions were mixed transactions because the vendor provided at least some customization of the product for Cincinnati Federal's needs. The true object test must be applied to a mixed transaction. The Court remanded for application of the true object test. The Court held that if there is not a mixed transaction at all, the true object test is not applied. In general, the Court stated that exempt services are those provided by a person, rather than by a computer.

- Status: Remanded for application of the true object test to the transactions involving customized software.

Policy Document 21-157 (Va. Tax. Comm. Dec. 28, 2021)

- The issue before the Department was whether an artist (the taxpayer) who painted a mural for a subway station was selling tangible personal property or providing a service
  - The mural at issue was painted on three separate canvasses before it was installed into the subframe of the subway station
- In a transaction involving both the sale of property and the provision of a service, the Commonwealth applies the true object test
- Under Virginia law, if the object of the transaction is to secure the property produced by the service, then the entire charge, including the charge for any services provided, is taxable
- In the Department's view, the "true object" of the transaction between the artist and the train station customer was to obtain the canvasses and that the mural work would be of no value to the customer without the transfer of the canvasses installed in the subframe
- Therefore, the entire charge for the mural, including the services rendered in creating the work, were subject to Virginia retail sales and use tax

Situsing/Apportionment

Oracle USA Inc. v. Commissioner of Revenue, 487 Mass 518, 168 N.E. 3d 349 (2021)

- Massachusetts Supreme Court held that the software vendors, Microsoft and Oracle had a statutory right to apportionment.
- The general abatement process was available to vendors, despite their having paid sales tax in excess of that properly apportioned to sales in the Commonwealth.
- Oracle and Microsoft collected and remitted MA sales tax on 100% of the sales price of software sold to Hologic's MA headquartered company.
- Software vendors filed abatement applications to report sales tax as apportioned based on Massachusetts use and sought a refund of the sales tax attributable to out-of-state users (17% of Hologic's employees using Oracle located in MA and 30% of Hologic's employees using Microsoft in MA).

Oracle USA Inc. v. Commissioner of Revenue (cont'd)

- Mass. Gen. L. 64H, §1 and its two critical provisions:
  1. Purchaser "knows at the time of its purchase of prewritten computer software that the software will be concurrently available for use in more than one jurisdiction, it may provide a Form ST-12 to the vendor no later than the time the transaction is reported for sales or taxes purposes."
  2. Sellers who know that the prewritten software will be used in more than one jurisdiction but have not provided an exempt use certificate to the purchaser "may work with the purchaser to produce the correct apportionment."
- Affirmed that the statute confers on taxpayers the right to apportion software sales. Court wrote that the Commissioner may make rules about how to apportion but had no discretion to decide whether sales tax from software sales may be apportioned.

Sales Tax Collection Scheme Challenged

Halstead Bead Inc. v. Richard (U.S. Dist. Ct. E. Dist. La., No. 2:21-cv-02106) (Pending litigation)

- Days after voters rejected a constitutional change that would have centralized tax collection in 2021, an out-of-state business sued Louisiana and several parishes to challenge the state's patchwork approach to collecting taxes.

- Halstead Bead, an Arizona-based business that sells jewelry-making supplies online, contends that Louisiana's parish-by-parish registration and reporting system violates the Federal Due Process and Commerce Clauses.

- May 23, 2022: Federal District Court agrees that the Tax Injunction Act applies, and that the matter should be heard in state court.

Questions?