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# What Exactly Did I Purchase? The True Object and Similar Test

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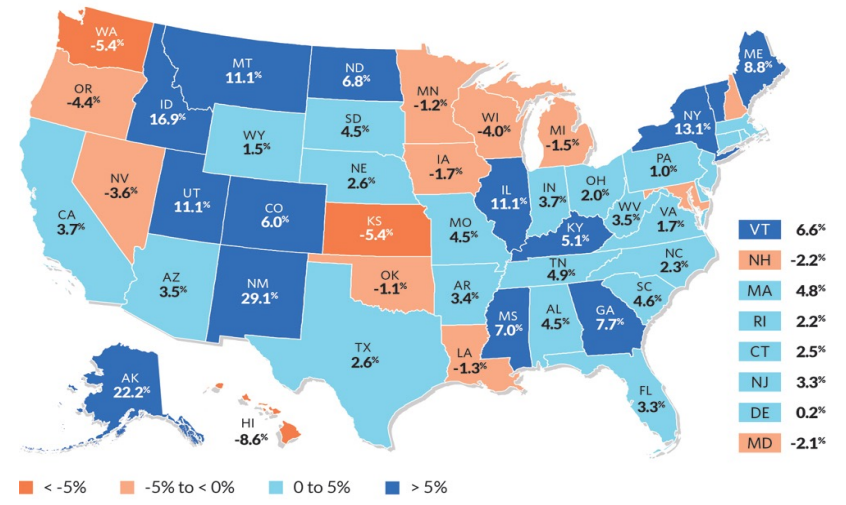
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# State Financial Outlook

# Post-COVID revenues by state

**Tax Revenue in Most States Outperformed Pre-Pandemic Trends**  
Collections relative to estimated totals based on pre-COVID growth trajectories, Q1 2020 to Q1 2023, inflation adjusted



Source: Pew analysis of data licensed by the Urban Institute, which adjusts the U.S. Census Bureau's quarterly summary of state and local tax revenue  
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# State fiscal summary

## **State revenues grew substantially in nearly all states in FY 2021 and 2022**

- State revenue growth offset COVID-induced declines and exceeded projected growth in nearly all states for FY 2021 and FY 2022; a range of factors, including inflation, drove the results
- Income tax collections (both corporate and individual) were exceedingly strong in most states as higher earning individuals remained employed, stock market gains drove revenues, and real wage gains and inflation raised incomes
- Sales tax revenues remained strong with shift to online buying, Wayfair, inflation, and various forms of COVID relief bolstering consumer spending
- Local revenues grew much more slowly, or in some cases declined, due to heavy reliance on real property taxes

## **State revenue growth has slowed considerably beginning in mid-FY 2022**

- In the 12 months ending March 2023, the rate of growth in state revenues declined by about 75 percent compared to the same period ending March 2022
- The decline was most pronounced in personal income taxes (down to nearly zero) as stock gains tapered off and new job growth moderated
- Sales taxes declined also by 75 percent with some lower inflation and shifts to service spending
- States continue to project slow growth through FY 2024 with nearly ½ projecting real declines and 34 states projecting a change between -5.0 to +5.0 percent
- Both rainy day funds and total ending balances reached all-time highs at the close of FY 2022 which should ease some degree of potential budget stress

# What to expect?

## Various yellow caution lights

- Near-term economic outlook is potentially placid, but still uncertain
- Several federal government challenges in the near- to mid-term
- ARPA/COVID funding is time-limited
- Can significant tax reductions enacted in 2021-2023 be sustained?
- Property taxes not increasing at nearly same pace; local governments generally more limited in fiscal tools
- All is not as rosy as FY 2021 and FY 2022
- Some caution, or at least vigilance, seems in order
- Accumulated balances will help cushion slowdown, presuming previously enacted tax cuts don't hit too hard

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# True Object, Predominant use, and More

## What is the true object test?

- When taxpayers report “mixed transactions” (e.g., transactions involving taxable and nontaxable components), would sales tax apply in whole, in part, or not at all?
- Some states use the “true object” test to make such a determination.



## What is the true object test? (cont.)

- The true object test is often subjective, and its application varies depending on the state.
- The true object test attempts to characterize the entire mixed transaction as either taxable or nontaxable by looking to the “true object,” “true essence,” or “intent of the purchaser” regarding the transaction.

# Facts to Consider

## How does the Seller View the Product?

- Internal memorandum
- Contracts
- Invoices
- NAICS Codes
- Annual Reports – Business, Competitors
- Other Tax Reporting
- Marketing materials
- Website

## How does the Buyer View the Product?

- Reviews
- Articles
- Competitors

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# Recent Case Law and Other Guidance

# Sales and use taxes – Imposition of tax

ADP, LLP v. ADOR and City of Phoenix (Az. Ct. App. Jan. 31, 2023)

- The Arizona Court of Appeals upheld a superior court’s order that a taxpayer was renting software subject to the state’s Transaction Privilege Tax (TPT) rental classification
    - The TPT applies to and sale, lease or rental of tangible personal property
  - The taxpayer, which provides HR and payroll solutions, argued:
    - That software was not tangible personal property;
    - That taxpayer was providing services, not renting out software; and
    - That imposing a tax on an internet-based product when no tax had been imposed for in-person services violated the Internet Tax Freedom Act (ITFA)
- The Arizona Court of Appeals upheld a superior court’s order that a taxpayer was renting software subject to the state’s Transaction Privilege Tax (TPT) rental classification
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# Sales and use taxes – True object test

Policy Document 21-157 (Va. Dep't Tax. 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

# Sales and use taxes – True object test

Cincinnati Federal Savings & Loan Co. (Ohio March 15, 2022)

- The Ohio Supreme Court held that sales tax applies to transactions that involve automatic data processing (ADP), electronic information services (EIS), or computer services when the true object of the transaction is receiving such services
  - In the years at issue, the taxpayer –a bank– filed and was denied a refund claim on the purchase of computerized account-processing services that entailed collecting electronic data from the taxpayer and the taxpayer’s customers, processing and making the data available to the taxpayer, and maintaining the taxpayer’s general ledger
  - The BTA treated the matter as the taxpayer making a claim for a tax exemption based on the purchase of nontaxable accounting services, or alternatively, nontaxable customized software services, and found in favor of the Department because in “doubtful” cases, the exemption must be denied
- The Ohio Supreme Court noted at the outset that the BTA erred when it viewed the service of software customization as an exemption from the tax imposed on the services of ADP and EIS
- In the court’s view, ADP and EIS were distinct services that were separate and apart from personal and professional services, which were often performed by individuals, and furthermore, when nontaxable services and ADP or EIS were provided together in a single mixed transaction, the “true-object” test applied to determine whether the transaction was taxable
- The court therefore concluded the case should be remanded to the BTA to apply the true object test, but the court affirmed the BTA’s conclusion that the taxpayer was not purchasing personal or professional accounting services because the services at issue were solely performed by computer software and did not involve accounting-related services performed by individuals

# Sales and use taxes – Integrated Services

Matter of LendingTree, Inc., No. 829714 (N.Y. Div. Tax Apps. Dec. 9, 2021)

- LendingTree operates an online loan marketplace through which it connects prospective borrowers seeking loans and other credit-based offerings to lenders seeking qualified borrowers whom they can sell loans or other credit-based offerings.
  - LendingTree charges lenders “match fees” and “closed loan fees,” but charges prospective borrowers nothing.
  - The New York State Department of Taxation and Finance argued the services were taxable information services.
- The administrative law judge determined LendingTree’s services were not taxable information services because, while the transmission of information did take place, the primary function of the service was to facilitate the writing of loans by its network of lenders.

# Sales and use taxes – Imposition of tax

**In re Matter of Dynamic Logic, Inc. (N.Y. Div. Tax. App. Jan 14, 2021)**

- A taxpayer's service that examined the effectiveness of its clients' advertising was a taxable information service
  - The taxpayer granted its customers a limited right to its patented technology, which enabled the customer to send cookies to use the taxpayer's tracking and surveying technology for survey sampling and facilitating the collection of information from a viewer's computer
- New York law imposes sales tax on information services, but excludes from tax "the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to others"
- The ALJ held that the primary function of the taxpayer's service was a taxable information services
- The ALJ also determined that the taxpayer's service, while personal or individual in nature, could be substantially incorporated in reports furnished to others and therefore did not qualify for New York's exclusion
  - While the reports were unique to each client, the taxpayer retained the rights to copy, distribute, resell, modify, and otherwise use the data it collected



# Sales and use taxes – Imposition of tax

**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

# Sales and use taxes – Sales price

## Apple Inc. v. State Tax Assessor (Me. Feb. 18, 2021)

- The Maine Supreme Judicial Court addressed what constituted the taxable “sales price” as applied to cell phones purchased by customers who contracted for wireless services when they purchased a phone
  - The taxpayer, a phone manufacturer and retailer, sold phones at retail stores and offered discounted pricing on phones to those customers who elected to also purchase a wireless plan from a third-party wireless carrier
- Under Maine law, the term “sales price” excludes discounts allowed and taken on sales
  - Under the court’s prior ruling, if at the time of a sale, the retailer expects to be reimbursed for what may appear to be a discount, the amount of the expected reimbursement becomes part of the taxable sales price
- The taxpayer argued that these payments were “bounties” for finding new customers, and as such constituted true discounts that should not be counted toward the taxable sales price
- The court held that the payments made by the carriers should be included in the sales price because functioned as reimbursements to the taxpayer for the price reductions granted to customers
  - The taxpayer’s contracts with the carriers provided that the carrier “reimburse” the taxpayer with “subsidies” directly linked to the length of wireless plans that customers bought
  - The taxpayer did not offer discounted pricing to customers who did not also purchase wireless plans, thus the taxpayer expected at the time of sale to recover the full price for the phones from the carriers

# Sales and use taxes – Integrated Services

**Matter of 1Life Healthcare, Inc., No. 829434 (N.Y. Div. Tax Apps. Nov. 10, 2021)**

- 1 Life Healthcare Inc. (One Medical) provides non-medical, membership-based services to patients for a flat fee.
- The services were generally referred to as “care navigation services” and could be accessed through phone, email, in person as well as through mobile app and web portal.
- The New York State Department of Taxation and Finance argued 1Life was selling taxable prewritten software because it provided members with a mobile app and web portal, and thus the entire membership fee was taxable.
- The administrative law judge determined the membership fee was not taxable because the primary function was the provision of nontaxable care navigation services; the mobile app and web portal were simply means of providing the services.

## Other developing issues

- Advertising Platforms
- Security services
- Background checks
- Platform usage fees/marketplace facilitators
- NFTs
- Pennsylvania