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PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

These Ain't Your Grandma's Digital Products Anymore...

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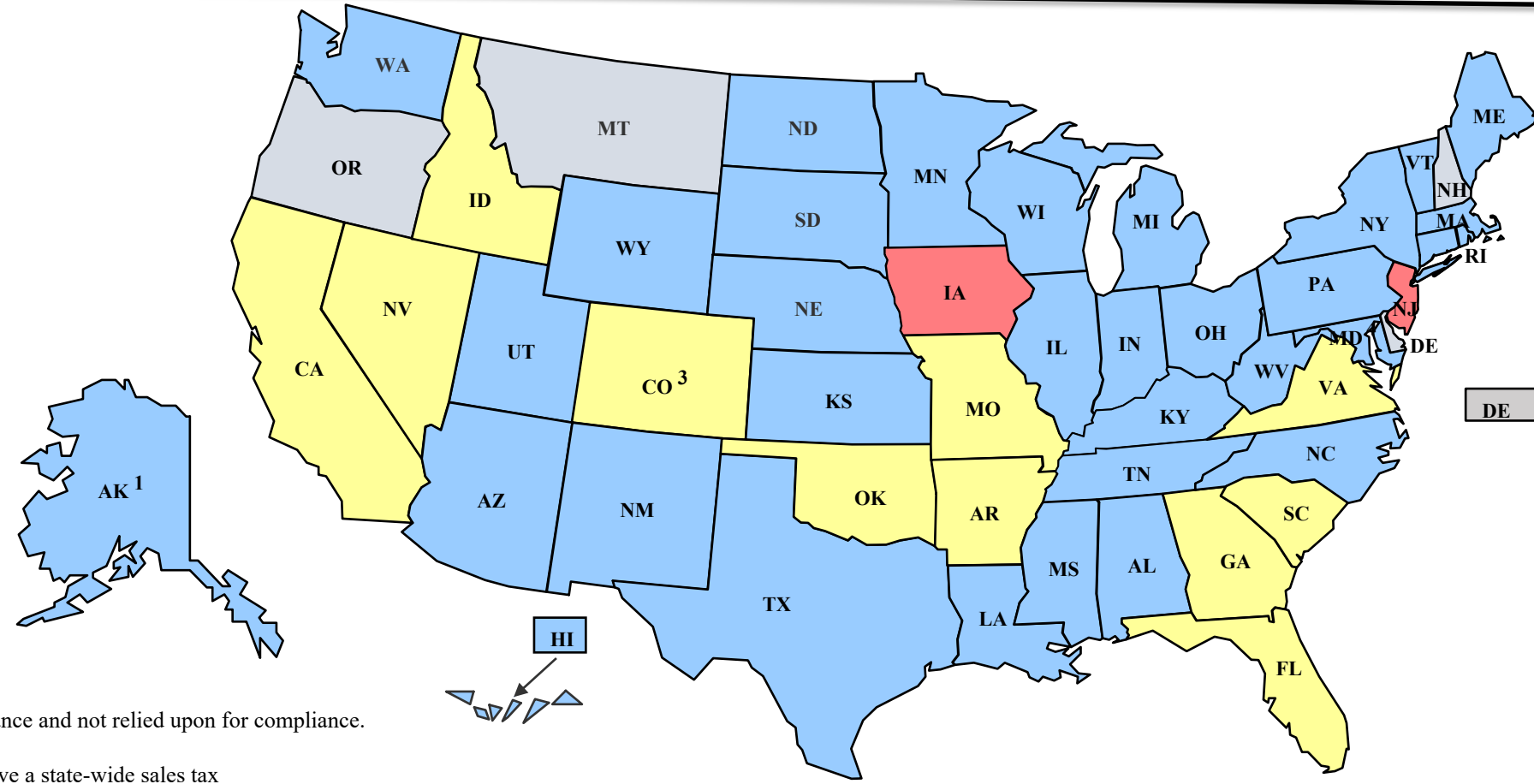
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Overview of Current State Taxation

Taxation of Prewritten Software

- Tax imposed both in tangible form and when delivered electronically
- Tax imposed in tangible form but not if delivered electronically
- No sales tax
- Tax is imposed but business purchases are exempt in Iowa and exempt for software delivered electronically in New Jersey



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation (COST)

¹Data is based on local municipalities since Alaska does not have a state-wide sales tax

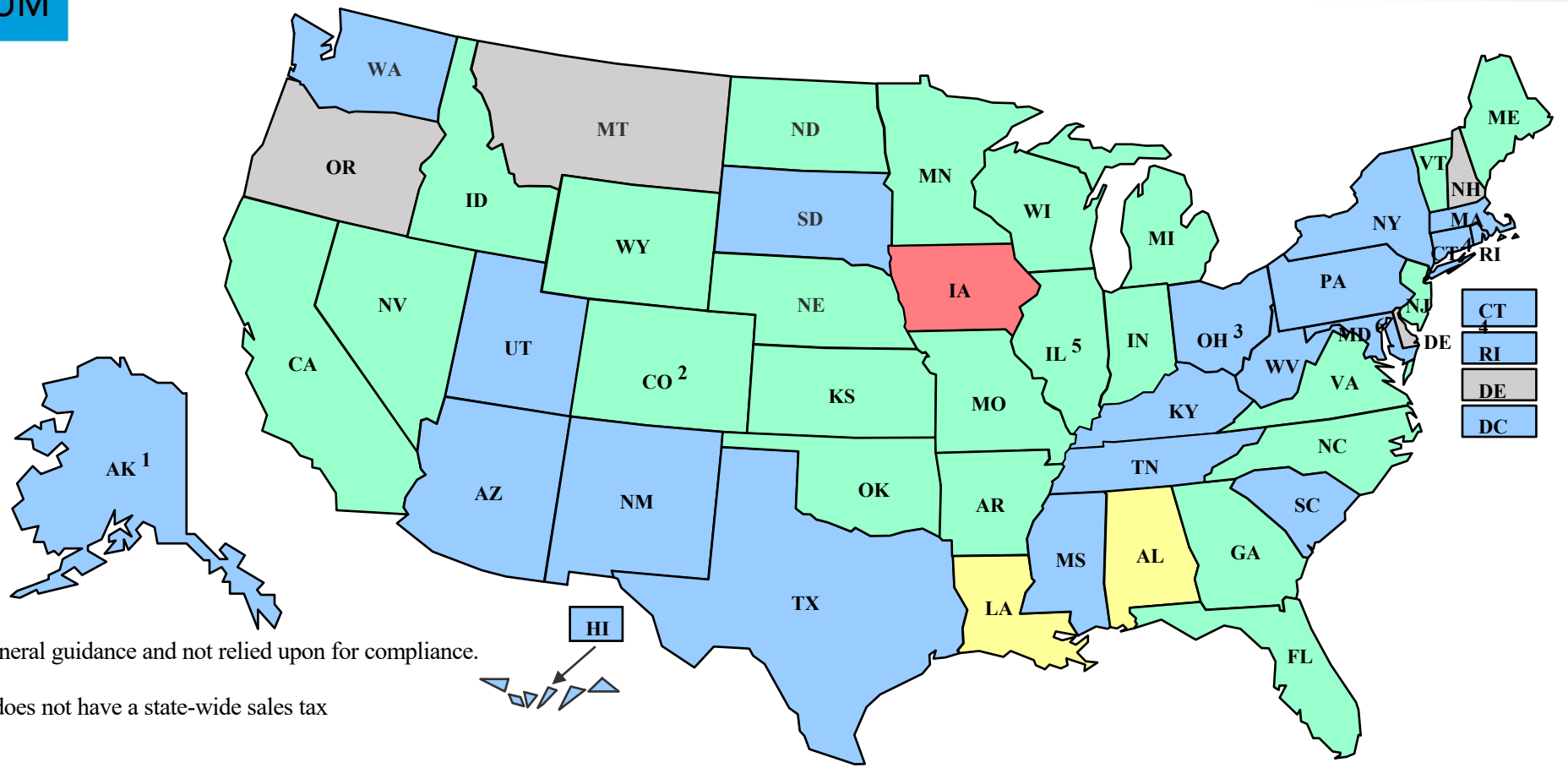
²Software delivered electronically is taxed at a 1% rate for businesses

³Tax may be imposed by some localities on electronic delivery

⁴Maryland has a limited exemption for enterprise software

Taxation of Remotely Accessed Software (SaaS)

- Tax imposed
- No tax imposed
- Tax is imposed but business purchases are exempt
- No sales tax
- Unclear if tax is imposed



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Source: Council On State Taxation (COST)

¹ Data is based on local municipalities since Alaska does not have a state-wide sales tax

² Tax may be imposed by some localities

³ Tax only applies to businesses

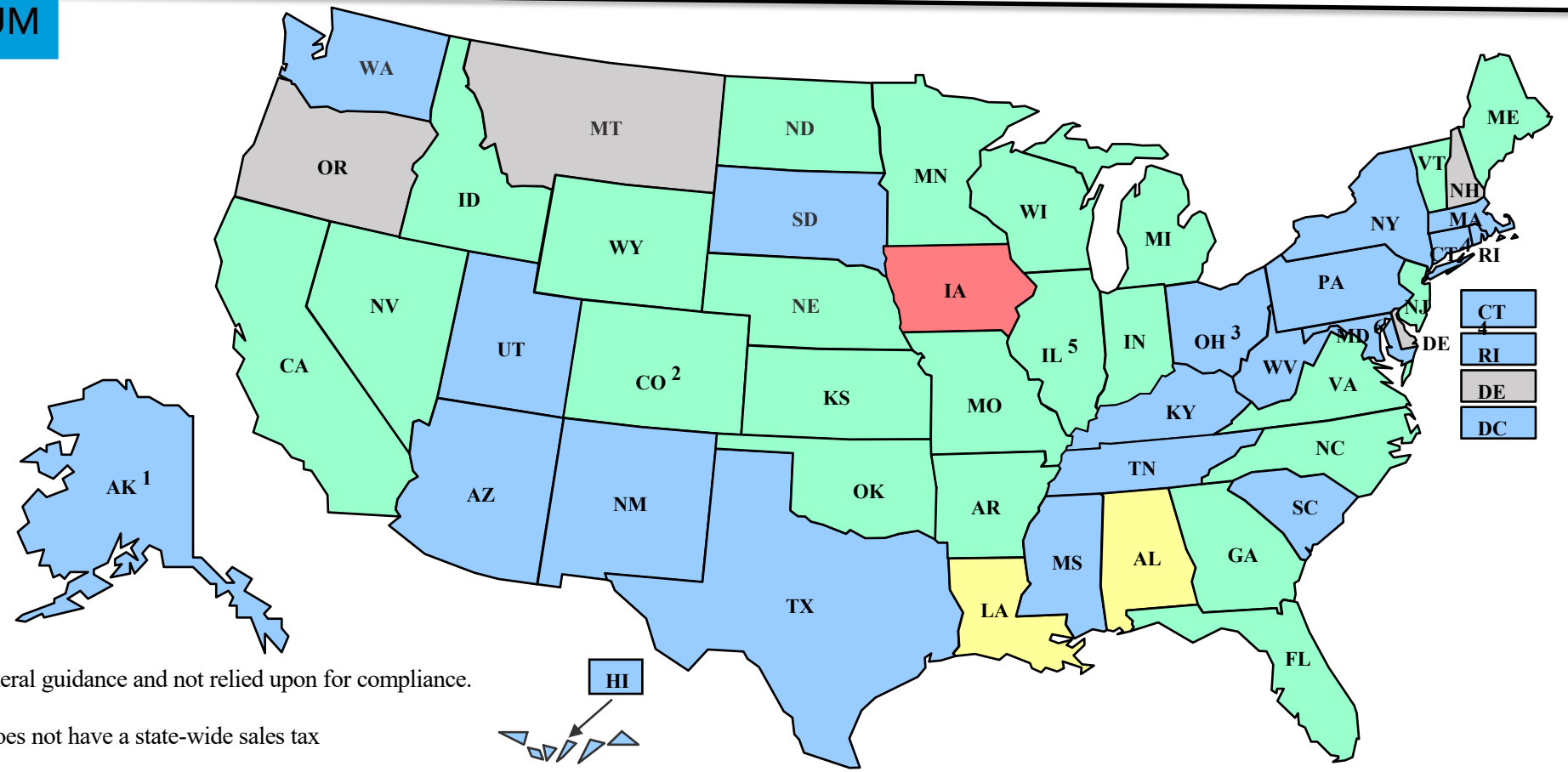
⁴ Electronically accessed software is taxed at a 1% rate for businesses

⁵ Taxed in Chicago

⁶ Maryland has a limited exemption for enterprise software

Taxation of Digital Information Services

- Tax imposed
- No tax imposed
- Tax is imposed but business purchases are exempt
- No sales tax



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Source: Council On State Taxation (COST)

¹ Data is based on local municipalities since Alaska does not have a state-wide sales tax

² Localities may impose tax

³ Taxed at a reduced rate of 1%

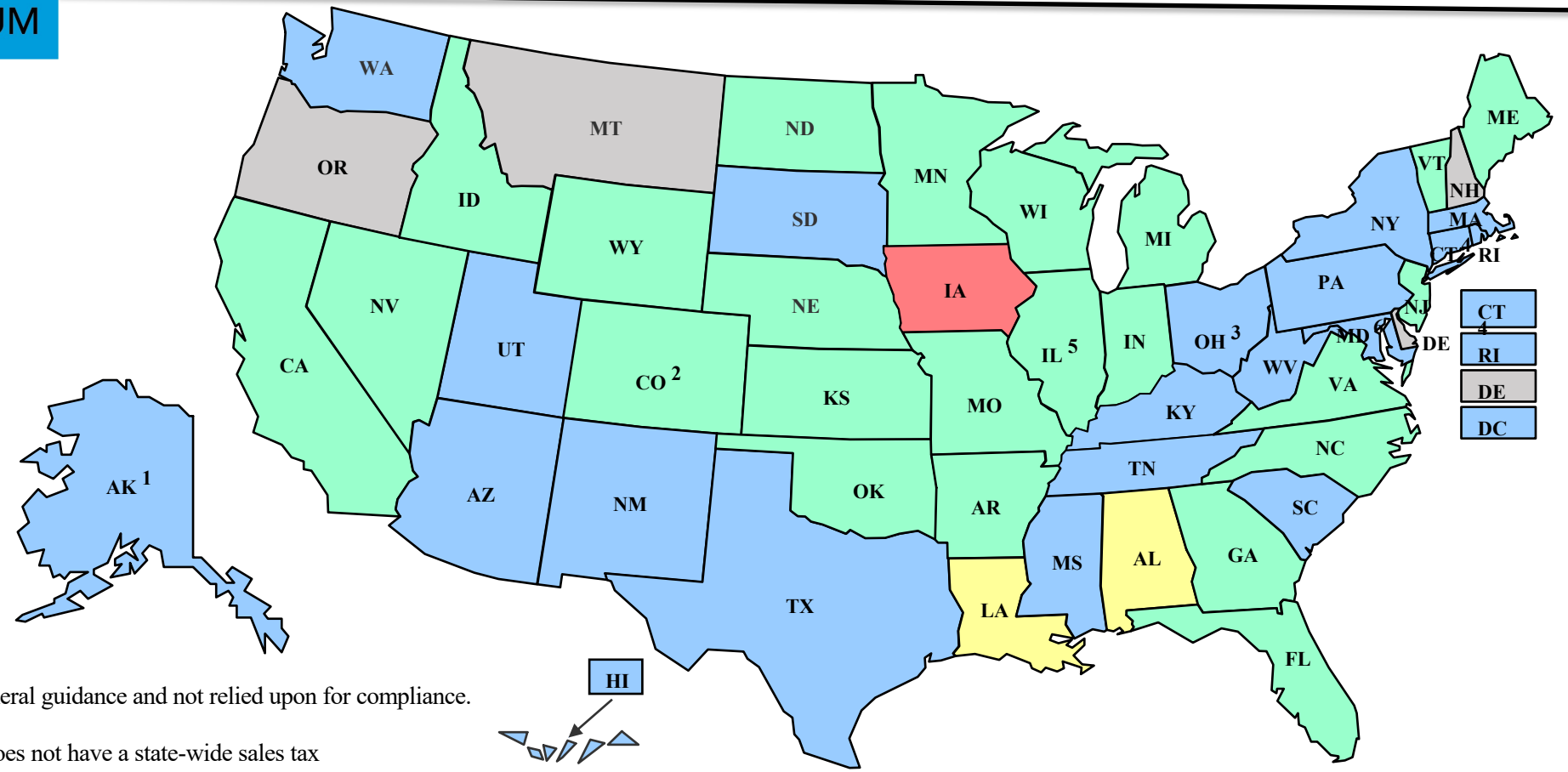
⁴ Tax imposed at 80% the standard rate

⁵ Taxed in Chicago

⁶ Maryland exempts some types of digital information services

Taxation of Specified Digital Products

- Tax imposed
- No tax imposed
- Tax is imposed but business purchases are exempt
- No sales tax



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation (COST)

¹ Data is based on local municipalities since Alaska does not have a state-wide sales tax

² Some products may be picked up by the tax on general services

³ Taxed under communications services tax

⁴ Tax not based on clear statutory authority

⁵ Taxed in Chicago

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Classifying Transactions

WHAT ARE YOU PURCHASING?

- Tangible Personal Property?
- Service?
- Software?
- Something Else?

“It’s not just the tax bases that differ; the entire characterization of single items can be wildly different based on statute writing from decades ago.”
Reformatted Remarks from June 1, 2023 MTC Sales Taxation of Digital Products Work Group Meeting

WHAT ARE YOU PURCHASING?

- **Primary Purpose / True Object Test**

- Many services and products are now provided electronically via the Internet using software platforms, oftentimes leading to questions regarding whether sales should be classified as sales of software, services, or something else.
- Primary purpose / true object test is used by many states to classify these transactions.
 - Facts and circumstances based.
 - Looks to determine the ultimate benefit / function sought.

Applying True Object / Primary Purpose

Tennessee Letter Ruling 23-01

- Tennessee Department of Revenue determined taxpayer's membership fees were subject to sales tax as transactions including taxable specified digital goods
- Taxpayer sold home exercise equipment and offered access to live and pre-recorded fitness classes
- Taxpayer's on-demand classes were included in membership cost sold for one non-itemized price, making entire transaction subject to tax
- Taxpayer inquired whether membership fees were exempt data processing or information services due to biometric tracking and leaderboard functions, but Department determined primary purpose was access to fitness classes

Applying True Object / Primary Purpose

Colorado Private Letter Ruling 22-005

- In a private letter ruling, the Colorado Department of Revenue addressed a streaming company's sales of platform credits and the subsequent redemptions by purchasers of the credits
- The company's online platform enables people to view streaming videos, including videos by third-parties
- In return for purchasing streaming platform credits, the viewer receives the ability to send the credits along with small images or graphics to a streamer in order to show support or be noticed by the streamer. The platform credits can also be used to purchase access to subscriber-only chats, or to purchase interactive enhancements to the streamers' videos or chats
- The streamer does not receive the credits or any dollar value associated with the credits at the time they are received, but later receives a monthly payout from the company based on the amount of credits received
- The Department analogized the streaming platform credits to gift cards
- Applied to the company's streaming platform credits, the Department found that they were not associated with the sale of tangible personal property, and therefore not subject to tax

Applying True Object / Primary Purpose

Matter of Yesware, Inc., New York Division of Tax Appeals (Sept. 29, 2022)

- An Administrative Law Judge (ALJ) for the New York Division of Tax Appeals concluded that a taxpayer providing email tracking services was providing nontaxable information services
- To provide these services, the taxpayer tracked data received from email recipients and provided individualized reports that summarized a customer's sales leads. After an audit, the Division of Taxation asserted that the taxpayer was selling prewritten computer software and issued an assessment
- The ALJ disagreed that the taxpayer was licensing prewritten computer software. In the ALJ's view, the taxpayer's service was a bundled service, and the primary function test must be applied to determine its taxability. The ALJ determined that the primary function of the taxpayer's services was to provide customers with reports regarding activity that occurred with the emails they sent to their prospective clients, including whether they read the emails, clicked links, downloaded attachments, or replied to the emails
- Because the reports provided to clients consisted solely of the customer's own data and the reports were not furnished to or incorporated in reports to others, the ALJ concluded that the taxpayer was providing a nontaxable information service

Applying True Object / Primary Purpose

Tennessee Letter Ruling 22-08

- The Tennessee Department of Revenue provided a ruling on a taxpayer's compliance monitoring services
- The taxpayer's services utilized the taxpayer's own proprietary data set, which the taxpayer constantly verified, enhanced, and updated. The scope and extent of each of the taxpayer's four service offerings varied slightly, but generally each service allowed customers to monitor certain information (e.g., information on a customer's employees or vendors) against the taxpayer's proprietary data set. The customers accessed the services either through the taxpayer's online portal or through an API
- Although the Department noted that the API could broadly be seen as taxable computer software, the Department applied the true object test and concluded that the use of the online portal or API was merely incidental to providing nontaxable information and data processing services. The Department's ruling noted that there was no additional charge for the API, and that the online portal and the API were being used only to gain access to the nontaxable services

Applying True Object / Primary Purpose

Massachusetts TIR 23-8

- The Massachusetts Department of Revenue recently issued guidance on the proper tax treatment of software developers
- In TIR 23-8, the Department concluded that the determination as to whether a corporation is selling services or standardized software will depend on the facts and circumstances of each case
- A corporation that develops and sells access to software is engaged in the manufacture and sale of tangible personal property if the software allows customers to input their information, manipulate the software, and run reports without interaction with the software provider or its employees
- Such corporations will be treated as manufacturing corporations for purposes of property and sales tax benefits and are required to use single sales factor apportionment for corporate excise tax purposes

WHAT ARE YOU PURCHASING?

- **Statutory Definitions**

A few states have adopted statutory definitions for digital products or other online services (*i.e., data processing*).

- Different statutory definitions can result in states classifying the same product entirely differently.

Applying Statutory Definitions

- *Landis+Gyr Midwest, Inc v. Department of Revenue*
 - Washington Court of Appeals found that the taxpayer's sale of remote meter reading service to an electric & natural gas utility was not subject to retail sales tax as a digital automated service (DAS).
 - WA imposes retail sales tax on the sale of a DAS, which includes any service transferred electronically that uses one or more software applications.
 - However, data processing services are expressly excluded from the definition of a DAS.
 - "Data processing service" means a primarily automated service provided to a business or other organization where the primary object of the service is the systematic performance of operations on data supplied in whole or in part by the customer to extract the required information in an appropriate form or to convert the data to usable information.

Applying Statutory Definitions

- *Landis+Gyr Midwest, Inc v. Department of Revenue, cont.*
 - Court found that the primary purpose of the taxpayer's remote meter reading service was the extraction of data from the meters and the conversion of that data into usable "good billing reads."
 - Therefore, the service was not subject to sales tax because it was excluded from the definition of a taxable DAS.

Applying Statutory Definitions

Florida TAA 22A19-002R

- The Florida Department of Revenue concluded that a taxpayer's online learning platform which offered streaming and downloadable videos was subject to the state's Communications Services Tax (CST)
- In a Technical Assistance Advisement, the Department rejected the taxpayer's position that the platform constituted an information service, and instead found that the platform was a video service because it provided the transmission of video, audio, or other programming service to purchasers, including digital video
- Since the statutory definition of a "video service" contains no test for the primary purpose of the transaction, the underlying purpose of the taxpayer's platform was irrelevant. Because the platform met the definition of a video service, it was subject to the CST

Applying Statutory Definitions

Texas Memo STAR Accession No. 202309029L

- The Texas Comptroller of Public Accounts issued a private letter ruling concerning the taxation of electronic games and associated content
- The prior ruling (STAR Accession No. 201405957L, May 18, 2014) had previously explained that the purchase of electronic games and associated content were subject to Texas sales and use tax as a taxable “amusement service”
- The new ruling provides additional description and examples of what constitutes an electronic game or an associated service. The changes expand several existing definitions by including “similar” items, with a particular focus on clarifying taxable methods of purchase by expressly describing the use of “virtual currency” and redeemable, physical cards that grant access to the game and/or associated content

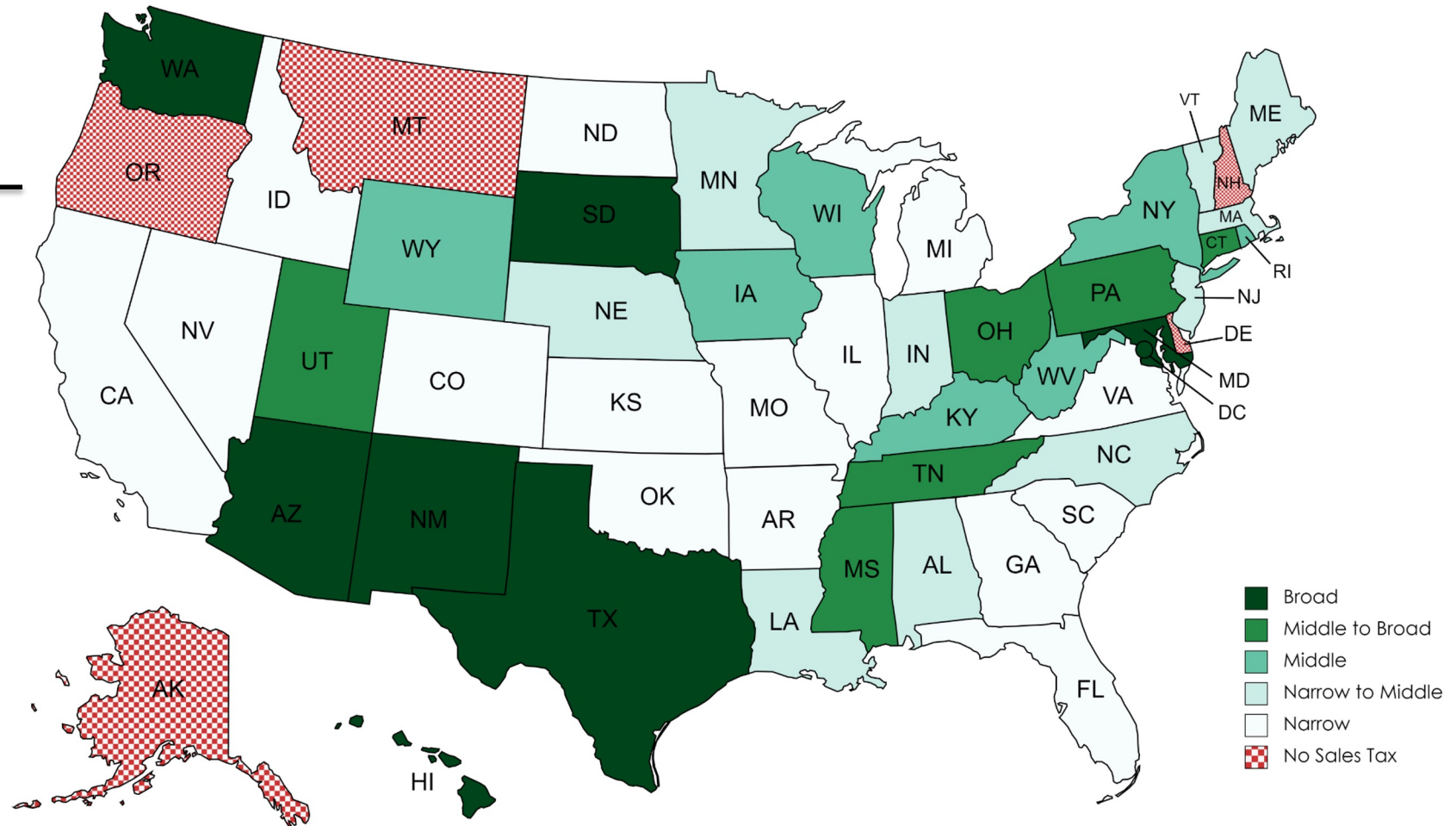
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Multistate Tax Commission Work Group on the Sales Taxation of Digital Products

Non-Uniformity

The MTC analyzed state approaches to taxation of digital products, and generally divided states into three categories of taxation approaches: broad, middle, and narrow



MTC Chart

Created with mapchart.net

MTC Workgroup

- In July 2021, the Uniformity Committee of the Multistate Tax Commission (MTC) formed a work group to draft a whitepaper on state sales taxation of digital products.
- A whitepaper was selected as a product (rather than a uniform law) because it is unlikely that the states will reach consensus on a single approach to taxing digital products. The goal is to provide states with analysis of different options and the pros & cons of each approach, so each state's policymakers can make informed choices that fit that state's unique needs while promoting consistency and uniformity among the states as much as possible.
- The Work Group has a [project page on the MTC website](#) that chronicles their work to date and includes links to many different background materials.
- Currently, the Work Group is reviewing a draft whitepaper in the form of a matrix that compares & contrasts three different approaches ("broad," "middle," and "narrow") to the taxation of digital products that states might consider.
- The next Work Group meeting is scheduled for November 2nd and will be followed by additional discussion at the upcoming MTC Fall Committee meetings November 13th–16th in Montclair, NJ.

MTC Workgroup

ISSUE	BROAD APPROACH	MEDIUM APPROACH	NARROW APPROACH	NOTES/COMMENTS
GENERAL INFORMATION				
General description of the approach / tax base.	Typically a broad tax base. Imposition may be on gross income or may be on an expansive set of transactions. If the latter, the base will contain purpose-built modern definitions for modern products and reflect some consideration of drafting legislation and rules to future proof the tax.	Imposition limited to TPP and enumerated services but with a broader definition or interpretation of TPP and broader definitions of services than the narrow approach. Definition or interpretation of TPP will typically not require a physical component.	Typically a narrow tax base. Limited to TPP and a narrow set of enumerated services. TPP interpreted narrowly and services defined tightly. Definition or interpretation of TPP likely to require some physical component.	
General coverage of categories of digital products.	Custom and prewritten software likely taxed. Numerous services and cloud products taxed.	Software and limited cloud products taxed. Taxation of cloud products typically relies on prewritten software, but not always (Iowa).	Limited to software and "digital equivalent of tangible personal property" or the Streamlined suite of digital products.	
Representative jurisdictions and work group members.	DC (Olufemi Obikoyai), NM (Mark Chaiken), SD (Alison Jares), WA (Gil Brewer)	KY (Richard Dobson), WV (Emily Cramer), UT (Frank Hales, Shelley Robinson)	CO (Josh Pens, Esther Van Mourik), CA (no work group member, but Brad Heller regularly speaks), KS (Jordan Raye)	
Representative statutory language.	Washington Digital Product Definition	Utah Digital Product Definition	Standard Streamlined Language	
ISSUES UNIQUE TO DIGITAL PRODUCTS				
Does the approach adapt to changes in technology and new products in the marketplace in a way that provides clear results?	Yes. Broad definitions will allow more administrative flexibility to adapt to changes.	Likely more administrative flexibility to provide guidance than the narrow approach.	No. A narrow approach will not adapt to changes in technology and new products. A narrow approach will have little administrative flexibility and will require legislative changes.	Q: we know that some TPs and their reps believe tax agencies should have no or little leeway to issue interpretations without clear legislative guidance. Should we reflect that?
Since the taxation of digital advertising service has been a focus of recent discussion, is the approach generally amenable to including digital advertising if the state wants to?	Yes. It is easier to accommodate taxation of digital advertising in the broad approach because it reduces the need to distinguish it from other digital products.			

MTC Workgroup

ISSUES:

- General approach to imposition of tax – broad, middle or narrow
- Ability to accommodate changes in technology or business practices
- Need for statutory “maintenance” to maintain desired results
- Clarity and ease of administration generally, for both taxpayers and state revenue agencies
- Bundled transactions
- What exemptions might be desirable or necessary, (e.g., an exemption for business inputs)
- Sourcing issues, including SSUTA compliance and possible multiple points of use
- Conformity with existing state marketplace facilitator laws
- Possible complications with the federal Internet Tax Freedom Act (ITFA)
- Equitable treatment of different business practices and competing products
- Effect on possible qui tam, class action, or similar lawsuits

MTC Workgroup – Business Inputs

TAXATION OF BUSINESS INPUTS:

One issue that has raised particular attention in recent MTC Workgroup discussions is how states should be taxing (or not taxing) business purchases of taxable items

- Traditional state sales tax vs. value added tax (VAT)
- Traditional attempts to ease pyramiding within the sales tax structure
 - Manufacturing machinery & equipment exemption
 - Sale for resale exemption
- The closing “Window of Opportunity” for states to adopt a business inputs exemption for digital products

MTC Workgroup – Business Inputs

TAXATION OF BUSINESS INPUTS, continued:

Examples of current state business inputs exemptions for digital products

- **Washington -- RCW 82.08.0208(3)**

(3)(a) The tax imposed by RCW 82.08.020 does not apply to the sale to a business of digital goods if the digital goods are purchased solely for business purposes.

(b) For purposes of this subsection (3), the following definitions apply:

(i) "Business purposes" means any purpose relevant to the business needs of the taxpayer claiming an exemption under this subsection (3). Business purposes do not include any personal, family, or household purpose;

MTC Workgroup – Business Inputs

TAXATION OF BUSINESS INPUTS, continued:

- **New Jersey – NJSA Sec. 54:32B-8.56**

Receipts from sales of prewritten software delivered electronically and used directly and exclusively in the conduct of the purchaser's business, trade or occupation are exempt from the tax imposed under the "Sales and Use Tax Act", P.L.1966, c.30 (C.54:32B-1 et seq.). The exemption provided by this section shall not apply to receipts from sales of prewritten software delivered by a load and leave method

MTC Workgroup – Business Inputs

TAXATION OF BUSINESS INPUTS, continued:

- Iowa – Sec. 423.3(104) Code of Iowa

There is exempted from the provisions of this subchapter and from the computation of the amount of tax imposed by it the following:

104. a. The sales price of specified digital products and of prewritten computer software sold, and of enumerated services described in [...] furnished, to a commercial enterprise for use exclusively by the commercial enterprise. The use of prewritten computer software, a specified digital product, or service fails to qualify as a use exclusively by the commercial enterprise if its use for noncommercial purposes is more than de minimis.

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Recent Developments With Digital Products and Services

Georgia

Georgia Senate Bill 56 (2023)

- Georgia will impose sales and use tax on "specified digital products" starting January 1, 2024
- The tax applies to retail purchase of specified digital products, other digital goods, or digital codes sold to an end user in Georgia
- "Specified digital products" include digital audio-visual works, digital audio works, or digital books transferred electronically to an end user
- "Other digital goods" include artwork, photographs, periodicals, newspapers, magazines, video or audio greeting cards, and video games or electronic entertainment
- The tax only applies if the end user receives or will receive the right of permanent use of products or codes and the transaction is not conditioned on continued payment by the end user

Mississippi

Department of Revenue v. EKB, Inc., 348 So.3d 968 (Oct. 6, 2022)

- The Mississippi Supreme Court held that a taxpayer's sales of wedding photography packages were not subject to sales and use tax
- The taxpayer offered photography packages of varying prices to couples for their weddings. Every package included a transfer of digital images via a DVD, flash drive, or a tablet. In almost all packages, the clients purchased the copyrights to the digital images. The more expensive packages included options such as engagement photo sessions, slideshows, linen prints, and coffee-table picture books
- The Department of Revenue argued that the taxpayer's sales were taxable because customers received their photos in tangible form through a flash drive or disk
- The court disagreed, however, finding that the flash drive and disk were incidental to the taxpayer's photography service. The court also recognized that the taxpayer paid sales tax on the drives, disks, and tablets used to transfer the digital photos, as well as on the photobooks given to certain customers. The court further noted that sales of still digital images are not taxable specified digital products, as the definition of the term only includes digital audio-visual works, digital audio works, and digital books

Michigan

Michigan Revenue Administrative Bulletin 2023-10

- The Michigan Department of Treasury recently issued updated guidance on the taxability of software and digital goods
- Generally, prewritten computer software is subject to Michigan sales or use tax as a sale or use of tangible personal property
- For products not easily identified as pre-written computer software, the Department will examine whether there is some delivery of software in Michigan and, if so, will apply the incidental-to-services test
- The Bulletin also addresses the taxation of digital goods, including NFTs, and micro-transactions. To the extent that an item or product constitutes a “digital good” that does not fall within the definition of “prewritten computer software,” it is not subject to sales tax or use tax regardless of whether it is downloaded, streamed, or accessed through a subscription service
- Products that appear to be “digital goods” but actually constitute taxable “prewritten computer software” will be taxable. Micro-transactions, commonly referred to as in-app or in-game purchases, are charges for prewritten computer software if the underlying app or game constitutes prewritten computer software

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Recent Developments with Software and Cloud Computing

Tennessee

- Tennessee Works Tax Act (House Bill 323)
 - Among other provisions, the bill imposes sales and use tax on certain repair and installation services, including computer software transactions
 - Beginning July 1, 2024, tax is imposed on the repair or installation of tangible personal property or computer software when such repair or installation occurs at a place of business outside the state and the serviced tangible personal property or computer software is delivered by the seller to the purchaser or the purchaser's designee within the state or to a carrier for delivery to a place within the state for use or consumption within the state

Alabama

Alabama Revenue Ruling 22-003

- The Alabama Department of Revenue determined that royalty payments for licensing medical billing codes were not subject to sales and use tax
- The taxpayer licensed a copyright owner's medical billing codes for use in its proprietary medical billing and medical use software. The taxpayer licensed its software to its customers but did not specifically charge customers for the royalty payments
- The Department held that the billing codes were not considered computer software but rather copyrighted content within the computer software. Further, the copyright owner was not transferring title to the billing codes to the taxpayer
- Thus, because the licensing agreement with the copyright owner did not constitute an actual or beneficial sale or exchange of the codes, the royalty payments were not subject to sales and use tax

Arizona

ADP, LLC v. Department of Revenue, 254 Ariz. 417 (Ct. App. Jan. 1, 2023)

- The Arizona Court of Appeals upheld a lower court's decision that a human resource services provider was selling software rentals subject to Transaction Privilege Tax
- The taxpayer's software product at issue allowed customers' employees to enter time and other employment data over the internet, which the taxpayer used to generate the employees' paychecks
- The court rejected the taxpayer's argument that its product was intangible property, holding that software was tangible personal property because it was perceptible to its users
- The court further held that a customer's use and control over the software established that it was renting the software from the taxpayer, not purchasing a service
- Finally, the court held that the tax did not violate the Internet Tax Freedom Act because the taxpayer had changed the nature of its product by automating tasks that were previously done by human effort, and the imposition of tax under these circumstances was not discriminatory

Mississippi

Mississippi Notice 72-23-12

- The Mississippi Department of Revenue announced new Computer Software Direct Pay Permits. The permit will allow the customer to remit the correct sales and use tax directly to the Department rather than paying it through the seller
- Earlier this year, Mississippi SB 2449 amended Mississippi's tax law to provide an exemption for purchases of remotely accessed software hosted on servers outside of Mississippi
- The Notice explains that customers charged for computer software and/or computer software services that include both taxable and nontaxable items may reasonably allocate the payment to each separately identifiable item or service if properly supported by the books and records of the seller, service provider, user, or consumer