

# Taxation of Digital Products and Cloud Computing and Online Nexus Developments

Can 20<sup>th</sup> Century Tax Systems Deal with 21<sup>st</sup> Century Technology? Or are will they just be “Chasing Clouds”?

New Mexico Tax Research Institute Tax Policy Conf.  
Santa Fe, New Mexico  
May 12, 2011

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# Agenda

- Introduction
- Digital Product Developments
- Software As a Service (SAAS)/ Cloud Computing and Application Service Provider (ASP) tax developments
- Online/ Click Through Nexus Developments
- Planning and Operational issues to consider

# Computing Timeline – How Did We Get Here?

- 1965 – Professor John McCarthy first posits that computing power may someday be provided as a utility.
- 1965 – Moore’s Law first published – Computing complexity will double every two years.
- 1969 – ARPANET started. Originally for military use, opened to universities in the 1970’s.
- 1983 – TCP/IP becomes the official protocol of ARPANET. TCP/IP is the protocol that computers still use to communicate with each other over the internet.
- 1985 – First release of Microsoft Windows.
- 1989 – The World Wide Web is invented by Tim Berners-Lee (The web is the use of the internet to access hypertext documents)

# Computing Timeline – How Did We Get Here?

- Early 1990's – Commercial providers are first allowed to sell internet connections to individuals.
- ~1993 – The mp3 file format is created.
- 1994 – Netscape released.
- 1995 – Windows 95/Internet Explorer released.
- Late 1990's – Telecommunications companies begin offering Virtual Private Network access, to provide access to private networks over the internet, instead of building point to point data connections.
- 1997 – The term 'Cloud Computing' is first used in academic circles.
- 1998 – ITFA Passes

# Computing Timeline – How Did We Get Here?

- 2001 – iTunes released.
- 2001 – The term SaaS (Software as a Service) first appears in an industry trade paper.
- 2002 – Microsoft launches Xbox live.
- 2006 – Amazon Web Services begins offering its Elastic Compute Cloud Product. (Infrastructure as a Service)
- 2007 – Google, IBM, and universities announce partnership to research cloud computing.
- 2007 – Streamlined Sales Tax Gov Board adopts definitions of “specified digital goods”
- 2011 – Federal Digital Goods and Services Tax Fairness Act Introduced ???

# Introduction:

- Over the last few years, states have eyed the burgeoning digital products market as a potentially lucrative source of revenue or as an increasing erosion of the tax base
- Significant developments in taxation of software –
  - Is it prewritten or custom?
  - Is it electronically delivered?
  - Are there services sold with software?
- Emerging Issues in taxability of Software as a Service and Application Service Providers involving access to and use of software hosted on the server of vendor. State statutes are unclear and states take differing positions. Cloud Computing model creates even more tax issues and complexities.

# Introduction

- Generally, many states impose sales tax on all retail sales of “tangible personal property” and specifically enumerated services
- Because “Digital Product” does not fit within most states’ existing definitions of tangible personal property and many states do not statutorily define Digital Products, states do not uniformly tax (or exempt) Digital Products
- This non-uniform treatment often leads to sales tax compliance problems for sellers and purchasers of Digital Products
- Issues with taxability (what are you buying?) and sourcing (where is the transfer for tax purposes?)

# Digital Goods - Example

- Customer buys a DVD of Rolling Stones Concert (subject to sales tax in WA and CA)
- Customer buys an electronic download of same DVD (subject to sales tax in WA but not CA)
- Customer buys a subscription to access a digital library of 20 concerts (taxable in WA but not CA)
- Customer pays a fee to view a live streaming web cast (taxable in WA but not in CA)
- Customer buys a ticket to a Rolling Stones Concert (not subject to sales tax in WA or CA)

# Digital Goods – Streamlined Sales Tax Project

- SSUTA Definition – Effective 1/1/09
- “Specified digital products” means “transferred electronically”:
  - “Digital Audio-Visual Works” which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any;
  - “Digital Audio Works” which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones; and
  - “Digital Books” which means works that are generally recognized in the ordinary and usual sense as “books”.
- “Transferred electronically” means obtained by the purchaser by means other than tangible storage media and includes electronic transfers to and electronic access by the purchaser.

# Digital Goods – Examples of Recent Laws

State	Audio	A-V	Books	Other
Indiana	Yes	Yes	Yes	
Kentucky	Yes	No	Yes	Finished artwork, photographs, periodicals, newspapers, greeting cards and video games
Mississippi	Yes	Yes	Yes	
Nebraska	Yes	Yes	Yes	
North Carolina	Yes	Yes	Yes	Magazines, newspapers, newsletters, reports, other pus, photos, and greeting cards if taxed in tangible medium
South Dakota	Yes	Yes	Yes	All sales, leases and rentals of any product transferred electronically
Tennessee	Yes	Yes	Yes	Non-exempt electronically delivered advertising materials
Utah	Yes	Yes	Yes	
Vermont	Yes	Yes	Yes	All products transferred electronically if taxable when “transferred ... other than electronically”
Washington St.	Yes	Yes	Yes	See Next Slide
Wisconsin	Yes	Yes	Yes	Finished artwork, photographs, periodicals, greeting cards and electronic games

# Digital Goods – Washington State

- Digital goods – Digital audio works, a-v works and books and “all other sounds, images, data, facts or information transferred electronically”
  - Personal work transferred electronically, public records and certain business purchases and newspapers exempt
- Digital automated services – Service transferred electronically using one or more software programs
  - Includes photo sharing, car history reports, information services, paid search engines
  - Cash machines, payment processing, accredited education, online classified ads and travel agent services are exempt
- **Remote access software**
  - **Prewritten software residing on owner or third party server**

# Digital Goods – Sourcing Under SSUTA

- Sourcing under SSUTA Section 310 applies regardless of the characterization of a product as tangible personal property, a digital good, or a service. (Section 309 A)
- Section 310 A.5. provides,
  - When none of the previous rules of subsections (A)(1), (A)(2), (A)(3), or (A)(4) apply, including the circumstance in which the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped, from which the digital good or the computer software delivered electronically was first available for transmission by the seller, or from which the service was provided (disregarding for these purposes any location that merely provided the digital transfer of the product sold).

# Software As a Service (SAAS)

- State positions range from:
  - Not an enumerated taxable service
  - Not a sale of software (TPP) because no transfer
  - Not taxable because server is not in-state
  - Taxable information, communication or data processing service
  - Taxable sale of software (TPP) despite no transfer
- Inconsistently even within a given states administrative guidance.

# Characterization - SAAS

- Prewritten Computer Software general taxable as “tangible personal property”  
general taxable unless specifically exempt.
- Services are generally exempt unless specifically enumerated in tax law (daunting with technological change)
- New classification “digital goods and digital services” In between tangible person property and services.

# Characterization – Cloud Computing

- Cloud Computing:
  - Captures SAS and data center outsourcing services. Cloud computing really describes a wide variety of other services which are performed utilizing the internet. There is no “one” definition of cloud computing – it is a manner of performing a service. Billed based on usage vs. license fee.
- Be aware of potential issues with “server location”
- Be aware of “bundling issues” as prewritten software or even hardware may be part of “cloud computing” arrangements
- Very little tax guidance and business model is changing rapidly

# Sourcing Methods - Software

- **Destination:** Where tangible personal property is shipped
- **User Location:** The location at which the user of the software is located
- **Use:** The location where use of the software occurs
- **Performance:** The location where performance of the service occurs.

# Sourcing Methods - Software

- **Server Location:** The location of the server upon which the software is residing
- **Benefit:** The location where the benefit of the service is derived. Typically this is where services are being utilized.
- **Destination/Bill to Address:** The location where the invoice is sent.
- **Multiple Points of Use:** Software and services are “apportioned” to multiple states

# What are the Problems with Chasing Clouds?

- **For Sellers/Vendors:** Destination and benefit rules are not easily applied to SAAS and Sellers may have no idea where use or receipt takes place, especially when invoice and tax are calculated. Tax audit risk and customer class action lawsuit risk. Difficult to get certainty.
- **For Purchasers:** Location of users and servers may be in multiple locations and may not be known at time of purchase when tax is calculated or may change over length of contract. Tax audit risk and disputes with vendors.

# What are the Problems with Chasing Clouds?

- US Sales tax system is not in synch with Value Added Tax (VAT) and Consumption regimes used by most foreign countries
- VAT taxes both tangible personal property and services. Digital Goods and SAAS are considered “electronically supplied services” (ESS).
- ESS applies to US sellers who sell to EU and Swiss “residents” (recently proposed by Norway)

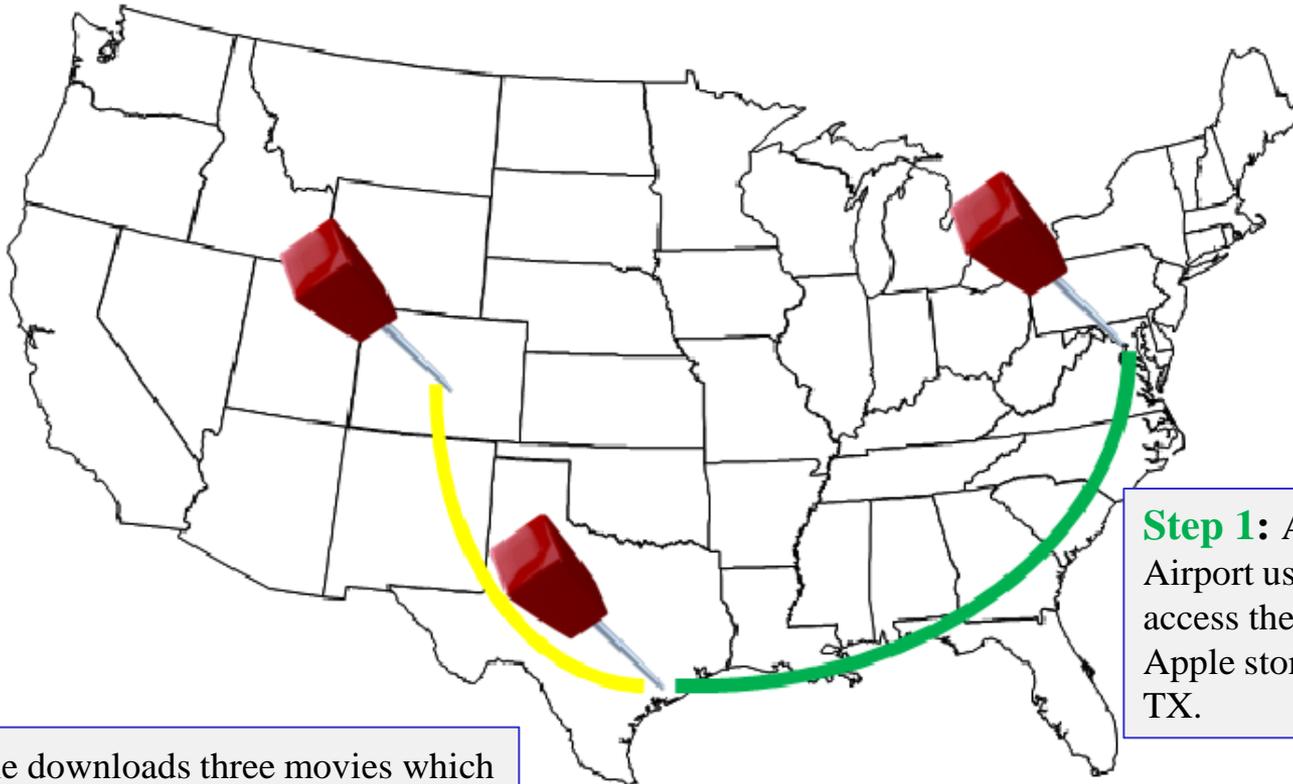
# What are the Problems with Chasing Clouds?

- Serious risk of multiple jurisdictions applying tax to the same transaction
- Contracting complexities, particularly for global contracts which impacts both large and small companies
- Borderless nature of transactions presents enforcement challenges for tax authorities and pace of technological change. Server location has been an important factor in international taxation under OECD principles for sourcing transactions. Interplay with US state and local taxes.
- Is federal legislation required? (Federalism, potential need for transaction tax treaties)

# Digital Goods – Legislative Activity

## Digital Goods and Services Tax Fairness Act

- A measure seeking to establish a national framework for the state & local taxation of digital goods and services (downloaded apps, cloud computing services, etc.)



**Step 2:** She downloads three movies which are charged to her Apple account – her billing address is in CO.

**Step 1:** A Customer at Dulles Airport uses her Wi-Fi to access the Apple store. The Apple store server is located in TX.

**Which state has the right to tax?**

# Digital Goods – Legislative Activity

## Digital Goods and Services Tax Fairness Act

- **Why a national framework is needed -**
  - States and localities, desperate for new revenue sources, are already eyeing this expanding part of the economy as a source of new tax revenues, without first ensuring that digital goods and services will not be subject to multiple and discriminatory levels of taxation. Failure to establish a national framework will invariably lead to costly and wasteful litigation.
  - Congress has a clear role to act in tax matters impacting interstate and international commerce – digital commerce is sold over global networks crossing numerous state boundaries.

# Digital Goods – Legislative Activity

## Digital Goods and Services Tax Fairness Act

- **What the measure does –**
- Ensures these goods & services are taxed only once, precluding multiple states from claiming the right to tax the same transaction
- Ensures only generally applicable taxes can be imposed (i.e., general sales taxes) and that it must be done legislatively
- Precludes discriminatory telecom/utility taxes from applying to digital commerce solely because these goods and services are riding over broadband/communication networks
- Provides certainty in how segments of the new economy can be taxed for state & local tax purposes which benefits:
  - Our consumers,
  - Providers of digital goods and services (the tax collectors), and
  - State & local governments seeking stability in their revenue sources

# Online and Click –Through Nexus Developments

Overview of State Legislative Initiatives

# Overview -

- Brief Explanation of Click-Through Nexus
- States that have enacted Click-Through Nexus Laws
- Status of Amazon and Overstock litigation in New York challenging Click-Through Nexus laws.
- 2010 states that have proposed Click-Through Nexus laws
- 2010 Colorado Proposed Sales Reporting

# Elements of Click-Through Nexus Laws

- Retailer is “doing business” if the retailer enters into an agreement with a resident of the state under which resident for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise to the retailer, if cumulative gross receipts from sales who are referred exceeds a threshold (NY = \$10K, RI = \$5K) during preceding 4 quarterly periods.

# Elements of Click-Through Nexus Laws

- Rebuttable presumption
- In state residents are “presumed” to be engaging in physical solicitation activities in the state
- Presumption can be rebutted by retailer
- NY requires annual certification by each in state resident affiliate that they did not engage in physical solicitation

# Elements of Click-Through-Nexus

- Pomp/ Platner legal theory is based on Scripto and Scholastic and Troll books
- NY limited application to Google/ Yahoo key word search referrals via TSB
- Very difficult to rebut presumption
  - Who is a “resident” (e.g. corporations, single member LLC’s)
  - NY provides for yearly certification from affiliate marketers, but unclear what happens if less than 100% certifications are obtained

# Current States with Click-Through Nexus Laws

- New York - April 2008
- Rhode Island – July 2009
- North Carolina – August 2009
  - North Carolina is aggressively auditing companies who terminated relationships (Amazon 1<sup>st</sup> Amendment ruling in Fed Ct)
- Note: Amazon terminated it's relationships with Rhode Island and North Carolina Associates in July 2009

# New York Litigation brought by Amazon and Overstock

- In April 2008 both Amazon.com and Overstock challenged the New York statute as end run around Quill
- In January 2009 the New York Supreme Court (ill named, but really the lowest court in NY) ruled in favor of NY
- Amazon and Overstock appealed decision
- October 2009 oral arguments heard at NY Intermediate Appellate Court. No decision issued as of today.

# 2010 Proposed Click-Through-Nexus Bills

- Mississippi SB 2927 - died in committee
- New Mexico HB 50 – tabled
- Virginia SB 660 – dropped
- Maryland SB 824 – dropped
- Vermont H. 661 – dropped
- California S. 8 – dropped
- Illinois SB 3353 – dropped
- Nevada – Proposed by Gov. Gibbons - dropped

## Colorado – HB 10-1193

- Started out as New York style click-through nexus bill
- Evolved during session after pressure from Colorado in state affiliate marketers
- Bill is awaiting Governor's signature (anticipated that Gov. will sign )
- Law would be effective March 1, 2010

# Colorado – HB 10-1193

- 3 Elements in Colorado bill
  - Presumes that any subsidiary in controlled group per IRC 1563(a) creates nexus for out of state retailers. Presumption may be rebutted by taxpayer
  - Gives Subpoena power to Executive Director of DOR or employee agent to request information from non nexus Colorado retailers making sales into Colorado

# Colorado HB 10-1193

- Requires out of state that do not collect Colorado sales tax must furnish notifications to all Colorado purchasers by January 31<sup>st</sup> showing total amount paid by purchaser for previous calendar year. Similar reporting to Colorado DOR
- Must be sent separate from shipments by first class mail. “Important Tax Document” on envelope
- \$5 penalty per occurrence for failure to notify customers
- Separate \$10 penalty per occurrence for failure to supply report to both CO DOR and Customers

# Planning and Operational Considerations

# Planning and Operational Considerations

- Up front involvement and planning are critical for either purchase or sales transactions involving software, SAS and digital goods
- Drafting of contract and manner of invoicing are very important elements of how tax authorities will ultimately characterize a transaction
- Understand your facts and what is happening from a technology perspective. Involve IT department early and often.

# Planning and Operational Considerations

- Understand the scope of the transaction
  - Local country versus global agreement
  - Involvement of multiple subsidiaries
- Tax Clauses - consider breadth (e.g. electronically supplied services in EU) and “future proofing” tax clause to cover potential future changes in law or tax rules and regulations
- Monitor Legislative and Policy Developments

# Planning and Operational Considerations

- Develop a corporate policy that takes into account the following:
  - Receive software in electronic form, whenever practical.
  - Document delivery method in contract, and purchase order, if applicable.
    - Incorporate “Certificate of Electronic Delivery” into contract (both parties execute)
  - Involve tax personnel for major purchases:
    - Consider services related to the purchase and how they may be taxed.
      - May want to consider using a 3<sup>rd</sup> party vendor for consulting / implementation work.

# Planning and Operational Considerations

- Proactively assist in characterization of the Sale
  - Create tax categories according to intent of parties/language of contract.
  - Consider bundling rules and consider:
    - De-bundling (are services offered on a “separate” basis?)
    - True Object (is there one? Is one service “subservient” to the other?)
    - Agree on “uniform” invoice language and create a “tax practices” document between the parties.
    - Don’t make characterization decisions in a vacuum, purchaser/seller should collaborate.

# View from Bricks and Clicks and Bricks & Mortar Retailers

- Want a level playing field
- Want Congress to Act
- Concerns about Vendor compensation
- Concerned about relative growth rates over past 3 years of economic downturn
- Rapid adoption of digital goods has been a concern (e.g. US DVD sales down 20% YOY in 2010)

# Questions ?????