

# NCSL Executive Committee Task Force on State and Local Taxation

## *Taxation of Digital Goods*

November 20, 2015

**Stephen P. Kranz**

Partner

McDermott Will & Emery LLP

(202) 756-8180

skranz@mwe.com

LinkedIn Group: State Tax Policy Exchange

Blog: [www.insidesalt.com](http://www.insidesalt.com)

[www.mwe.com](http://www.mwe.com)

Boston Brussels Chicago Dallas Düsseldorf Frankfurt Houston London Los Angeles Miami Milan Munich New York Orange County Paris Rome Seoul Silicon Valley Washington, D.C.  
Strategic alliance with MWE China Law Offices (Shanghai)

© 2015 McDermott Will & Emery. The following legal entities are collectively referred to as "McDermott Will & Emery," "McDermott" or "the Firm": McDermott Will & Emery LLP, McDermott Will & Emery AARPI, McDermott Will & Emery Belgium LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. These entities coordinate their activities through service agreements. This communication may be considered attorney advertising. Previous results are not a guarantee of future outcome.

## 1. Recent Developments

- Cloud Computing
- Digital Goods
- Streaming

## 2. Current state: state tax inconsistency

- Cloud Computing
- Digital Goods

## 3. Federal Legislation

- Digital Goods and Services Tax Fairness Act of 2015

# RECENT DEVELOPMENTS

- Overview of Legislative Activity:
  - 2013—12 states
  - 2014—8 states
  - 2015—7 states (YTD)

## ■ Cloud Computing Exemptions

### ■ Passed

#### ■ Vermont: S. 138

- “Charges for the right to access remotely prewritten software shall not be considered charges for tangible personal property.”

### ■ Proposed

#### ■ Michigan: H.B. 4018/4019 and S.B. 82/83

- Would provide an exemption from sales and use tax for granting the right to use prewritten software installed on another person's server.

## ■ Cloud Computing Impositions

### ■ Passed

#### ■ Tennessee: H.B. 644

- Imposes sales and use tax on the access and use of remotely hosted software that remains in the possession of a dealer or a third party on behalf of such dealer.

### ■ Proposed

#### ■ Pennsylvania: S.B. 117

- Gov. Wolf's budget proposal included language that would have expanded the definition of tangible personal property to include software, "whether electronically or digitally delivered or accessed, or whether purchased sing[ular]ly, by subscription or in any other manner."
- Unanimously rejected by House in June.
- Budget framework recently reached between Governor and Legislature.
- Discussions are ongoing with respect to the expansion of the sales and use tax base (See S.B. 76)

#### ■ Georgia: H.B. 445

- Proposes the imposition of sales and use tax on "prewritten computer software transferred electronically, which includes a charge to consumers for the right to access and use prewritten software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis."
- No movement in 2015, will be discussed in 2016.

## ■ Digital Good Exemptions

### ■ Passed

#### ■ Idaho: H. 0209

- Exempts certain digital products offered with a less than “permanent right to use” from the definition of tangible personal property.
- The bill clarifies that any “right to use . . . . conditioned upon continued payment from the purchaser it is not a permanent right of use.”

### ■ Proposed

#### ■ Minnesota: H.F. 848

- Would have repealed the tax on digital products.
- Did not pass.

## ■ Digital Good Impositions

- Passed
  - Tennessee: H.B. 644
    - Imposed sales and use tax on “video game digital products.”
- Proposed
  - Pennsylvania: S.B. 117
    - Gov. Wolf’s budget proposal also included language that would have expanded the definition of tangible personal property to include digital goods and services, including video, photographs, books, magazines, newspapers, apps, games, music and any other audio “whether electronically or digitally delivered or accessed, or whether purchased sing[ular]ly, by subscription or in any other manner.”
    - Discussions are ongoing with respect to the expansion of the sales and use tax base (See S.B. 76)
  - Georgia: H.B. 445
    - Would impose tax on specified digital products transferred electronically.
    - No movement in 2015, will be discussed in 2016.

- **Michigan** – Multiple Cases on Use Taxation of Software as a Service
- *Auto-Owners Ins. Co. v. Dep't of Treasury*, No. 12-000082-MT (Mich. Ct. Claims Mar. 20, 2014)
  - Issue: Whether a taxpayer's purchase of various cloud-computing services were subject to Michigan use tax;
    - The taxpayer contracted with certain third-party service providers to gain remote access to their computer networks, servers, data storage, and software applications, which the taxpayer used to service clients and independent agents; and
  - Decision: The Court of Claims concluded that the taxpayer did not take "delivery" of any prewritten software because remote access to a third-party provider's technology infrastructure does not fit into the term "delivery by any means."
- *Thomson Reuters v. Dep't of Treasury*, No. 313825 (Mich. Ct. App. May 13, 2014)
  - Issue: whether Thomson's sale of subscriptions to Checkpoint – a web-based legal and accounting research tool – were subject to Michigan use tax; and
  - Decision: The Court of Appeals, applying the "incidental to service test," concluded that any transfer of tangible personal property (some computer code was sent from Checkpoint's servers to subscriber computers) was incidental to the information service offering.
  - Petition for review to Michigan Supreme Court pending.

- *Rehmann Robson & Co., P.C., v. Dep't of Treasury*, No. 12-000098-MT (Mich. Ct. Cl. Nov. 26, 2014)
  - Issue: Whether Michigan use tax was due on the subscription to an online legal research database as a taxable sale of prewritten computer software; and
  - Decision: The Court of Claims concluded that there was no “delivery” of the software, as the vendor never surrendered possession or control of the software to the taxpayer. The mere access to the software database by the taxpayer was not sufficient “use” (*i.e.*, not the “exercise of a right or power over tangible personal property incident to the ownership of that property”).
  - The Department appealed to the Court of Appeals.
- *GXS, Inc. v. Dep't of Treasury*, No. 13-000181-MT (Mich. Ct. Claims Mar. 4, 2015)
  - Issue: Whether a taxpayer owed use tax on web-based software accessed by the taxpayer’s Michigan customers and was not downloaded or transferred; and
  - Decision: The Court of Claims held that the software was not “delivered” to customers; it was not handed over, left, or transferred. Even if software was delivered, customers did not exercise any right or control “incident to ownership” over the software in a manner that would constitute a taxable use under Michigan law.
  - The Department appealed to the Court of Appeals.

- *Auto-Owners Ins. Co. v. Dep't of Treasury*, No. 321505 (Mich. Ct. App. Oct. 27, 2015)
  - Published (*i.e.*, precedential) Court of Appeals opinion affirming the 2014 Circuit Court decision holding that a variety of different cloud-based contracts were not subject to use tax under Michigan law.
  - “[T]he transactions at issue in this case were taxable under the [Use Tax Act] if plaintiff exercised control over a set of coded instructions that was conveyed or handed over by any means and was not designed and developed by the author or another creator to the specifications of a specific purchaser.”
  - “[T]he Court of Claims correctly determined that the mere transfer of information and data that was processed using the software of the third-party businesses does not constitute delivery by any means of prewritten computer software” noting that “[i]n that situation, only data resulting from the third-party use of software is delivered.”
  - In the handful of contracts where tangible property was controlled by/delivered to Auto-Owners, the property was “merely incidental to the services received.”
  - Treasury will not petition Michigan Supreme Court for review and intends to issue guidance in the near future.

## ■ Taxable

- **Chicago:** On June 9, 2015, the Chicago Department of Finance issued two rulings, one for the Amusement Tax and one for the Lease Transaction Tax, stating that services delivered over the Internet or electronically are subject to those taxes (including digital products, streaming services and software accessed through the cloud).
  - The Amusement Tax ruling's effective date was September 1, 2015 and a lawsuit is underway challenging the ruling.
  - The Lease Transaction Tax ruling's effective date was delayed to January 1, 2016.
  - The Mayor's revenue ordinance passed in October as part of the budget process provided an exemption for small businesses, reduce the rate, and adopted sourcing provisions for the Lease Transaction Tax.

# Recent Developments: Streaming Services

## ■ Alabama

- Proposed Regulations Issued Feb. 2015 that would have expanded the definition of tangible personal property for rental tax purposes to include “digital transmissions” (including streaming audio/video).
  - Opposed by the Legislative Council (a group of legislators responsible for overseeing regulatory changes) in July 2015.
  - The DOR ultimately withdrew the regulation, though the Commissioner indicated they would interpret the tax as applying to streaming products regardless of the regulation or statute.

## ■ Kentucky

- *Netflix, Inc. v. Finance and Administration Cabinet Dep’t of Revenue*, Order No. K-24900 (Bd. Tax App. Sept. 23, 2015) (Netflix’s streaming services provided did not meet the definition of “multichannel video programming services”).

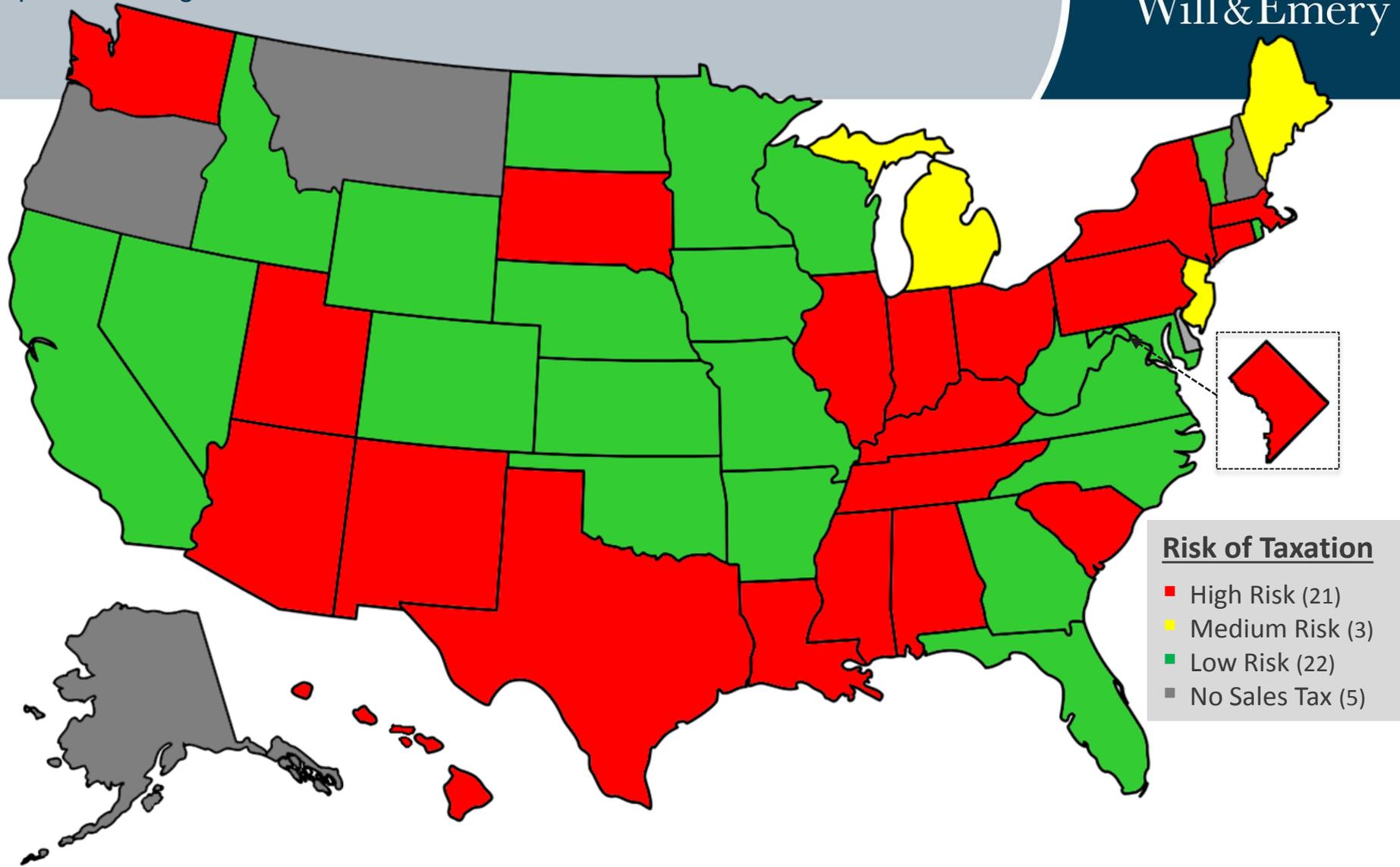
## ■ Connecticut

- Conn. Dep’t of Revenue Services Ruling No. 2015-5 (Nov. 3, 2015) (finding digital content streaming services to be subject to sales and use tax in Connecticut by characterizing them as taxable “computer and data processing services”).

# **CURRENT STATE OF INCONSISTENCY IN STATE TAXATION OF DIGITAL GOODS AND SERVICES**

# Taxability of SaaS\*

Updated through October 2015

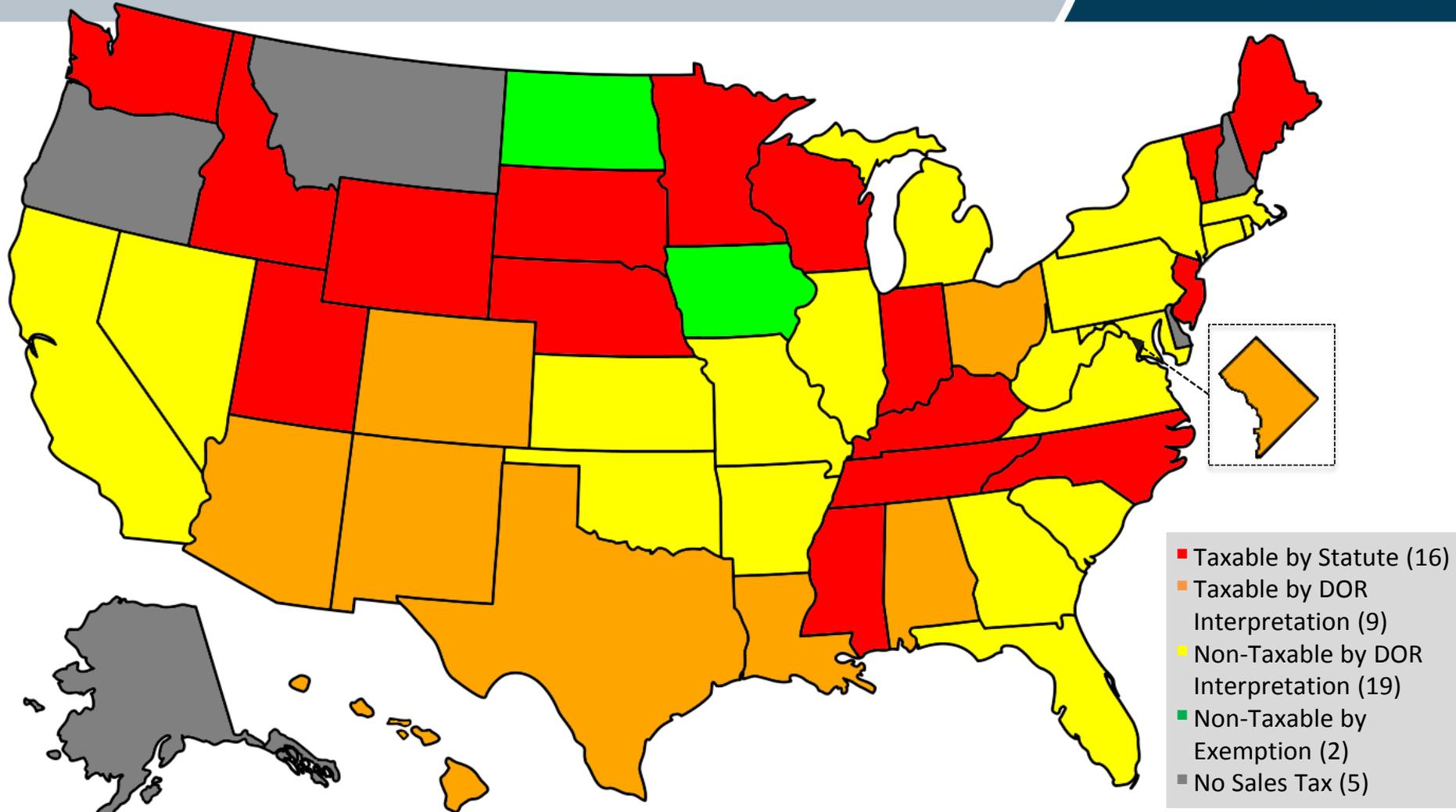


\*Note: Software as a Service is defined as a service that provides the customer with remote access to software applications. Consideration was given to the taxability of SaaS with and without a license agreement when analyzing risk. 15

# Taxability of Digital Goods\*

Updated through October 2015

McDermott  
Will & Emery



\*Note: Digital goods include digital audio, digital audio-visual, and digital books delivered electronically.

# FEDERAL LEGISLATION

# Digital Goods and Services Tax Fairness Act

- Originally introduced in both chambers by 113th Congress.
  - S. 1364, introduced July 25, 2013; H.R. 3724, introduced December 12, 2013.
  - Did not advance out of Committee.
- Subsequent Action by 114th Congress.
  - Re-introduced in House on March 26, 2015 by Rep. Lamar Smith. [H.R. 1643]
    - Passed out of House Judiciary Committee on June 17, 2015 after a hearing.
  - Re-introduced in Senate on March 24, 2015 by Senator John Thune. [S. 851]
    - Referred to Senate Committee on Finance.
- The act provides a sourcing regime based on a customer's "tax address"
- No state or local jurisdiction may impose a sales or use tax on digital goods or services unless it gives credit for comparable taxes paid to other states for the same transaction.
- Digital goods cannot be taxed at a higher rate than the rate for comparable tangible personal property or services that is not delivered electronically.

# Questions?

## **Stephen P. Kranz**

Partner

McDermott Will & Emery LLP

(202) 756-8180

skranz@mwe.com

LinkedIn Group: State Tax Policy Exchange

Blog: [www.insidesalt.com](http://www.insidesalt.com)