

# Multistate Taxation of E-Commerce



*Presented by*

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# Today's Discussion Topics

- Jurisdictional Issues & Tax Nexus
- Special e-Commerce Nexus Issues
- Sales Taxes on Software & Cloud Computing
- Sales Taxes on Digital Goods
- Taxation of Information Services
- Select Income Tax Issues



# Part 1

## Nexus in the Digital Age

# Types of Taxes

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Income



Gross Receipts/Franchise



Sales



Others



# Nexus

## *The All-Important Term*

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What does  
it **mean**?



Why is it  
**important**?



# Constitutional Nexus

## *The Commerce Clause*

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- *Quill v. North Dakota* (1992): Applying the Commerce Clause
- Let's get physical



# *De Minimis Rule*

## *Is There Such a Thing?*

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- Is there such a thing as a “little bit of nexus?”
- Constitutional Basis: *Quill*’s “few floppy disks”
- NY’s *Orvis* Case: “More than a slight presence” test
  - 8-12 visits
  - Michigan and Illinois Follow Suit
- Most states say a couple visits is enough

# New York Ruling: Examining the Type of Visit?

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## TSB-A-13(6)C

- Taxpayer was clothing retailer and remote seller
- No NY stores; no real or tangible property; no sales visits
- BUT: employees did come to NY occasionally (10x/yr) to meet with merchandise vendors, for “inspirational” shopping trips and to attend (but not participate in) trade shows
- Due to limited purpose and duration = no nexus for corporate franchise tax
- “Close question”



# Economic Nexus?

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- Economic Nexus - An Income Tax Concept
- Geoffrey and South Carolina - It All Starts With The Giraffe
- Opening The Flood Gates
  - Other States Jump On The Bandwagon
  - NY's 2015 Shift To Economic Nexus: "Dr. Evil Rule"
- But physical presence still the standard for sales taxes...for now

# Sales Tax Nexus Attacks on Remote Sellers

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- Are online sales exempt from sales tax?
- How are states enforcing collection requirement?
  - Agency Nexus
  - Affiliate Nexus
  - “Amazon” Taxes

# Agency Nexus

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- The Basic Principle: Got a guy here?
- *Scripto v. Carson* Rule: In-state agent = nexus, even if independent contractor
- Examples:
  - In-state training/installation for software product
  - In-state visits by sales reps

# Affiliate Nexus

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- What's the Difference with Agency Nexus?
- Brother-Sister, Etc.
- The “dot-com” Affiliate: [hpshopping.com](http://hpshopping.com)
- Affiliate Nexus by Statute: TX & CA

# New York's Recent *Amazon* Decision

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## Quick History:

- In 2008, New York amended its Tax Law (§1101(b)(8)(vi)), expanding the definition of a “vendor” required to collect and remit sales tax on the vendor’s taxable sales in New York
  - The amendment accomplished this by creating a presumption of solicitation on certain out-of-state sellers who had agreements with New York affiliates.
- Shortly thereafter, two out-of-state sellers with no physical presence in New York (no offices, employees, or property), Amazon.com and Overstock.com, challenged the constitutionality of the amendment
- Nearly five years after the initial challenge, New York’s highest appellate court, the Court of Appeals, issued a decision on March 28, 2013. *See*, 20 N.Y.3d 586 and article in Appendix

# New York's 'Amazon' Tax Held Constitutional

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- N.Y. Tax Law § 1101(b)(8)(vi) did not violate the Commerce Clause's substantial nexus requirement
- Petitioners' Due Process arguments fail
  - (1) Presumption of solicitation not irrebuttable
  - (2) Presumption of solicitation has a rational basis

# States with Amazon Laws

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**Arkansas**

**California**

**Connecticut**

**Georgia**

**Illinois** (ruled unconstitutional by an IL lower court judge in 2012)

**Kansas**

**Maine**

**Minnesota**

**Missouri**

**North Carolina**

**Rhode Island**

**Vermont** (does not take effect until at least 15 other states have adopted a similar law)

**Pennsylvania**

# New Rules on the Horizon?

## *Marketplace Fairness Act*

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- Bill passed in Senate; stalled in House
- Grants states authority to compel online retailers to collect taxes
- Applies only to sellers with more than \$1 million remote sales annually



# New Rules on the Horizon?

## *Marketplace Fairness Act*

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- But only AFTER they have simplified their sales tax laws
  - Option #1
    - Join the Streamlined Sales Tax Project
  - Option #2
    - Follow simplification mandates, such as uniform sales tax base and software to manage sales tax compliance

# Final Nexus Points

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- PL 86-272 is a non-issue for this topic
  - Income tax protections only available to sellers of TPP
- E-commerce gives companies the ability to operate “virtually,” increasing chance of no nexus
  - But “we like to visit our money!”
- Location of people = nexus

# Part 2

## E-commerce Sales Tax Issues

# General Rules Regarding Sales Tax Imposition

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- In virtually all the states, all sales of tangible personal property are considered taxable, unless an exemption applies
  - So, for example, sales of goods to governmental agencies, non-profit, charitable, religious, etc. would be non-taxable if a properly executed exemption certificate is received by the seller from the buyer
- However, in most states, the sale of services is only taxed when the service is specifically enumerated as taxable in the statute
  - So, for example, a statute might read that “the repair, painting or alteration of tangible personal property is taxable”

# Services Typically Subject to Sales Tax

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- Utilities (gas, electric and telecommunications)
- Lodging
- Meals
- Information Services
- Repair and Installation
- Cleaning and Maintenance Services
- Landscaping
- Personal Grooming (barbers, hair dressers, tanning salons and beauty care)
- SaaS?



# Models of Cloud Computing?

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- Software as a Service (SaaS) Model
  - Allows a customer to access a provider's applications on a cloud infrastructure
  - Customer does not manage or control the underlying infrastructure
  - Examples
    - CCH ProSystem FX, Google Docs, Quicken

# Models of Cloud Computing?

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## Platform as a Service (PaaS) Model

- Allows a customer to deploy its created or acquired applications on a cloud infrastructure
  - i.e., to build web applications
- Customer does not manage/control underlying infrastructure, but does have control over its deployed applications
- Examples
  - AppEngine from Google, WaveMaker



# Polling Question



You used CCH's cloud-based ProSystem FX Software to prepare a tax return. What did you buy?

- Software
- Tax return preparation service
- None of the above



# Starting Points for Discussion

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- What's **NOT** cloud-computing?
  - Electronic downloads of music, books and software
  - But states may follow similar framework
- Cloud computing and arcane sales tax laws
  - An unhealthy mix!

# Cloud Computing - Taxability Issues

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## Central Issues

- Is there a taxable good or service?
  - Some states treat as simple license of software
  - Others classify as nontaxable service
- Is there a sale or use
  - i.e., does “possession” get transferred?
- Where is the sale taxed?
- See Noonan’s Notes Article in Appendix

# Multistate Survey

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- **Cloud Computing Taxable (15):** AZ, CT, DC, HI, IN, NM, NY, OH, PA, SD, TX, UT, VT, WA, WV
- **Cloud Computing Exempt (31):** AL, AR, CA, CO, FL, GA, IA, ID, IL, KS, KY, LA, MA, MD, ME, MI, MN, MO, MS, NC, ND, NE, NJ, NV, OK, RI, SC, TN, VA, WI, WY
- And even within states, results all over the map (see attached NY chart in Appendix)

# Another Cloud Issue

## *Location, Location, Location*

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- Where does the sale occur?
  - Most states follow fiction that a cloud-computing transaction is akin to sale of TPP
    - Therefore, user/customer location drives the tax liability
  - But sales tax = delivery/title passage
    - If customer has remote access to out-of-state server, why isn't "sale" located where server is?
    - Utah and Tennessee appear headed in this direction

# Cloud Computing: Steps in the Analysis

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- Start Here: Will the State treat the transaction as a sale of TPP?
  - If the state imposes sales tax on downloaded software, you likely have a problem
- If treated as TPP, can you argue “no transfer of possession?”
  - Really what you are arguing here is that the transaction is a service, so ...
- If not TPP, will the state tax cloud-computing as a service?
  - In most states, the answer will be no
- Is the sale taxes based on user-location?
  - In most states, yes

# Taxation of Digital Goods & Services

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- Current treatment of digital goods and services varies widely from state to state. See Smart Chart in Appendix.
- Generally Taxable (25): AL, AZ, CO, CT, DC, HI, ID, IN, KY, LA, ME, MO, MS, NC, ND, NE, NJ, NM, SD, TN, TX, UT, VT, WA, WI
- Generally Nontaxable (21): AR, CA, FL, GA, IA, IL, KS, MA, MD, MI, MN, NV, NY, OH, OK, PA, RI, SC, VA, WV, WY (Exceptions: Taxable software/information services/cloud services)

# Taxation of Digital Goods & Services (con't)

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- Streamlined Sales and Use Tax Act (SSUTA): Specified digital products cannot be included within the definition of “ancillary services,” “computer software,” “telecommunications services” or “TPP” (See Sections 332 and 333)
  - “Specified digital products” = electronically transferred
    - “Transferred electronically” = obtained by the purchaser by means other than tangible storage media
  - “Digital Audit-Visual Works,” “Digital Audio Works,” and “Digital Books”
  - Sourcing
    - “Receive” or “Receipt” = taking possession or making first use of digital goods, whichever comes first

# Permanent Internet Tax Freedom Act of 2013

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- S. 31 - introduced on January 22, 2013 by Sen. Kelly Ayotte (R-NH); H.R. 434 - introduced on January 29, 2013 by Rep. Steve Chabot (R-OH).
- Would make permanent the existing ban on state or local taxes on internet access and on multiple or discriminatory taxes on e-commerce.
- New issues relative to 2007 expansion of ITFA to “email.”



# Information Services: *What Are We Talking About?*

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## ● The New York Definition

- Personal and Individual
- Not incorporated into other reports

## ● The “Common-Database Rule”



# Sales Taxes on Information Services

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- States that tax information services  
(See Smart Chart in Appendix)



New York, Texas



California, Illinois,  
Connecticut (?)



# Part 3

# E-Commerce Income Tax Issues

# Apportionment Factors

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- Traditionally states used the UDITPA Formula which was an equally weighted three-factor formula including sales, property and payroll
- Many states have modified the traditional formula by adding weight to the sales factor
- Payroll and Sales factors are the most troublesome, especially in the services context

# UDITPA Three Factor Formula

$$\frac{\frac{\text{In-State Property}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3}$$

x

Apportionable  
(Business)  
Income

=

Income  
taxable by the  
State

# Property Factor

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- The property factor is generally a fraction with the numerator being value of real and tangible property in-state and denominator being of property everywhere

Instate Property  
Everywhere Property

- What about “property” like computer servers?

# Payroll Factor

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- The payroll factor is a fraction the numerator of which is the corporation's compensation in a particular state divided by the denominator which is the taxpayer's total compensation everywhere

Instate Payroll  
Everywhere Payroll

- How to handle “moving” payroll?

# Sales Factor

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- The sales factor is a fraction the numerator of which is the corporation's sales in a state divided by the denominator which is its total sales everywhere

Instate Sales  
Everywhere Sales

- Sales are usually sourced by destination for sales of goods, but it's tougher for services



# Sales Factor Issues

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## Cost of performance

- Source where income production activities takes place
  - Direct costs determined in a manner consistent with GAAP
    - Income Producing Activity (IPA) is determined from each transaction that goes into making a profit

 But, in the e-commerce context, is the sale a service? Or is it more like the sale of a good?

# Matter of Expedia

NYS Division of Tax Appeals, Feb. 2015

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- ALJ in NYS held 2005-07 online travel reservation services and advertising receipts sourced as “services” - not as “other business receipts”
  - “Services” → where performed
  - “Other business income” → where earned
- Found Tax Department’s position that services require human involvement at moment of sale was impermissible expansion of statute
  - Different result under new law

# Sales Factor

## *Market-Based Sourcing*

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- Most states use cost of performance, but trend towards market-based sourcing
- States which use market-based sourcing
  - Alabama, Arizona, California, Georgia, Illinois, Iowa, Maine, Maryland, Michigan, Minnesota, Nebraska, New York, Ohio, Oklahoma, Utah and Wisconsin



# Polling Question



Will market-based sourcing will change have a significant effect on your client base?

- Yes
- No
- Too early to really say

# Sales Factor

## *Market-Based Sourcing*

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- 🌐 Market-Based Sourcing: UDITPA Rule
  - Looks to “if and to what extent” the service is delivered to a location in a state
  - If delivery cannot be determined sourcing location should be “reasonably approximated”
  - Includes a “throw-out” provision when taxpayer is not taxable in state to which sale is assigned (or if state of assignment cannot be determined)
- 🌐 Practical Application?
  - How does a data-based information service allocate based on market sourcing?

# Sourcing Digital Products under NYS Proposed Regulations

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- Provide sourcing hierarchy for sales of digital products
- Must annually use “due diligence” and “good faith” to source receipts under hierarchy:
  - #1 - Customer’s primary use location
  - #2 - Where received by customer
  - #3 - Apportionment fraction for preceding taxable year
  - #4 - Apportionment fraction for current year

# NYS Draft Regulations for Sourcing Digital Products

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- Presumption of “Primary Use Location”
  - Individuals - customer’s billing address
  - Businesses - NYS if contemplated in contract; otherwise must ask customer
- Sourcing Commingled Receipts
  - *If digital product = digital property + service → considered 1 receipt*
  - *If digital product = digital property + TPP → source as 100% TPP unless TPP is incidental to digital product*
  - *If sale = digital product + service or “other business activity” commingled in 1 receipt → source under Tax Law § 210-A.10*

# Personal Income Tax Issues

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- Nonresident Owners
  - Partners, S corp shareholders, LLC members
- Tax Computation Methodologies
  - Three-factor apportionment
  - Direct accounting
  - Mixing and Matching in NY
    - Difference between LLCs and S Corp factor-based apportionment



# Conclusion

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