

Arizona State Legislature
**Ad Hoc Joint Committee on the Tax
Treatment of Digital Goods and Services**

Wednesday, November 15, 2017

Stephen P. Kranz

Partner, McDermott Will & Emery LLP

Washington, DC

(202) 756-8180

skranz@mwe.com

www.mwe.com

1. Introduction

- a. Overview of Digital Goods and Services
 - i. 50-state Taxability Maps
- b. National Observations and Trends

2. Current Arizona Law and Policy

- a. Uncertainty and Associated Administrative Challenges

3. Implementing a Legislative Solution

- a. Follow NCSL Cloud Based Services Principles
 - i. Determine What to Tax (and Not Tax)
 - ii. Clear Definitions and Sourcing Rules

INTRODUCTION

■ **Prewritten software delivered electronically.**

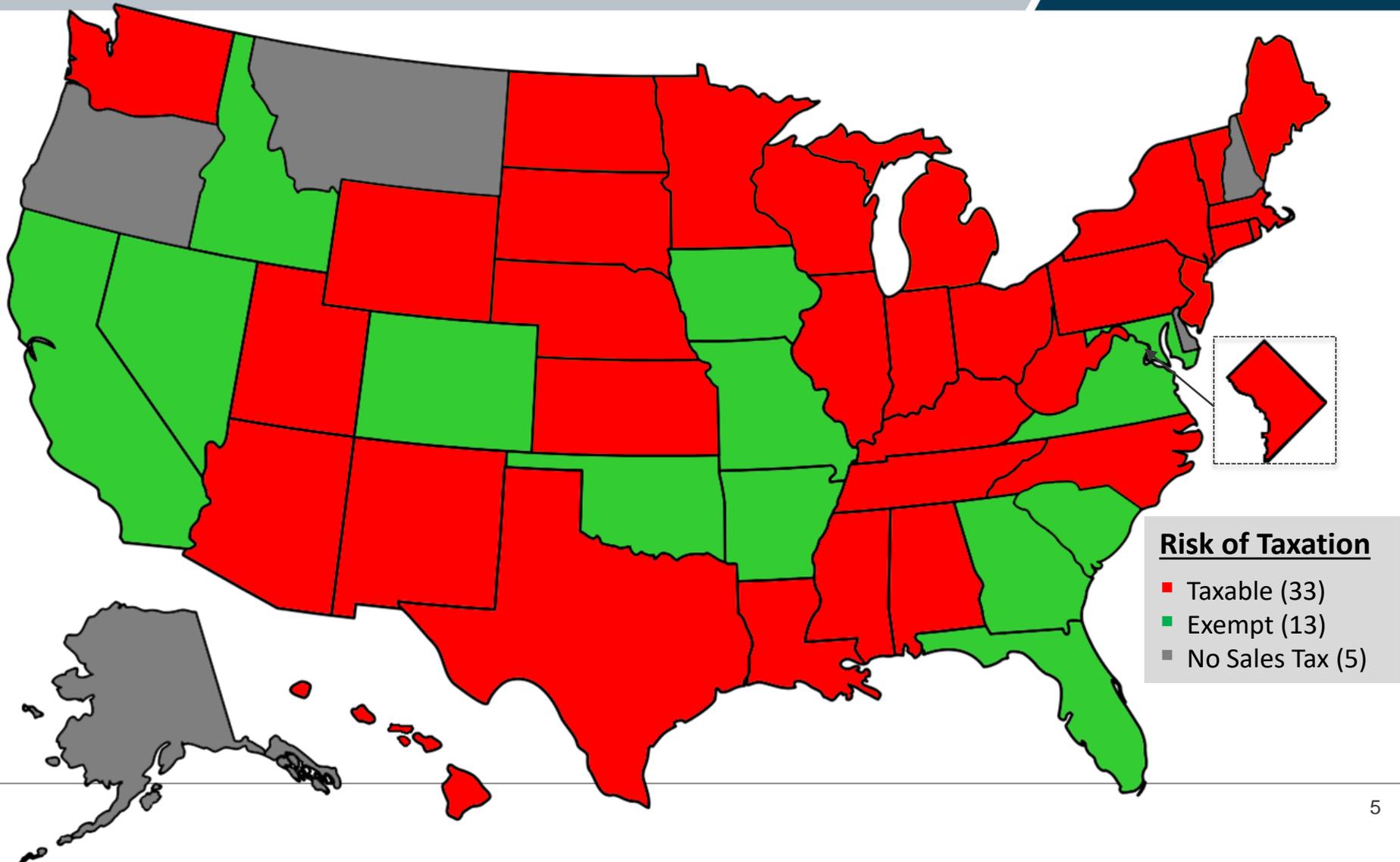
- Canned (non-custom) software delivered to the purchaser by means *other than* tangible storage media (e.g., disk, flash drive, etc.).
 - Examples include:
 - Downloaded Apps;
 - Downloaded computer software; and
 - Downloaded video games.
- A complete copy of the software is physically sent to the purchaser's device (cell phone, tablet, laptop, desktop, video game console, etc.).
- Accessibility can be for a specified period of time or indefinitely.

50-state Taxability Map

Prewritten Software Delivered Electronically

Updated through July 2017

McDermott
Will & Emery



■ **Cloud Computing and Remote Access Services.**

- According to the U.S. Dep't of Commerce National Institute of Standards and Technology (NIST), “cloud computing” is defined as:
 - “a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.”
- According to NIST, the five essential characteristics are:
 1. On-demand self-service;
 2. Broad network access;
 3. Resource pooling;
 4. Rapid elasticity; and
 5. Measured service.

■ **Cloud Computing and Remote Access Services.**

– NIST Service Models (and Definitions):

1. Software as a Service (SaaS).

- i. The capability provided to the consumer is to use the provider's applications running on a cloud infrastructure. The applications are accessible from various client devices through either a thin client interface, such as a web browser (e.g., web-based email), or a program interface. The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, storage, or even individual application capabilities, with the possible exception of limited user-specific application configuration settings.

■ **Cloud Computing and Remote Access Services.**

– NIST Service Models (and Definitions):

2. Platform as a Service (PaaS).

- i. The capability provided to the consumer is to deploy onto the cloud infrastructure consumer-created or acquired applications created using programming languages, libraries, services, and tools supported by the provider. The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, or storage, but has control over the deployed applications and possibly configuration settings for the application-hosting environment.

■ **Cloud Computing and Remote Access Services.**

– NIST Service Models (and Definitions):

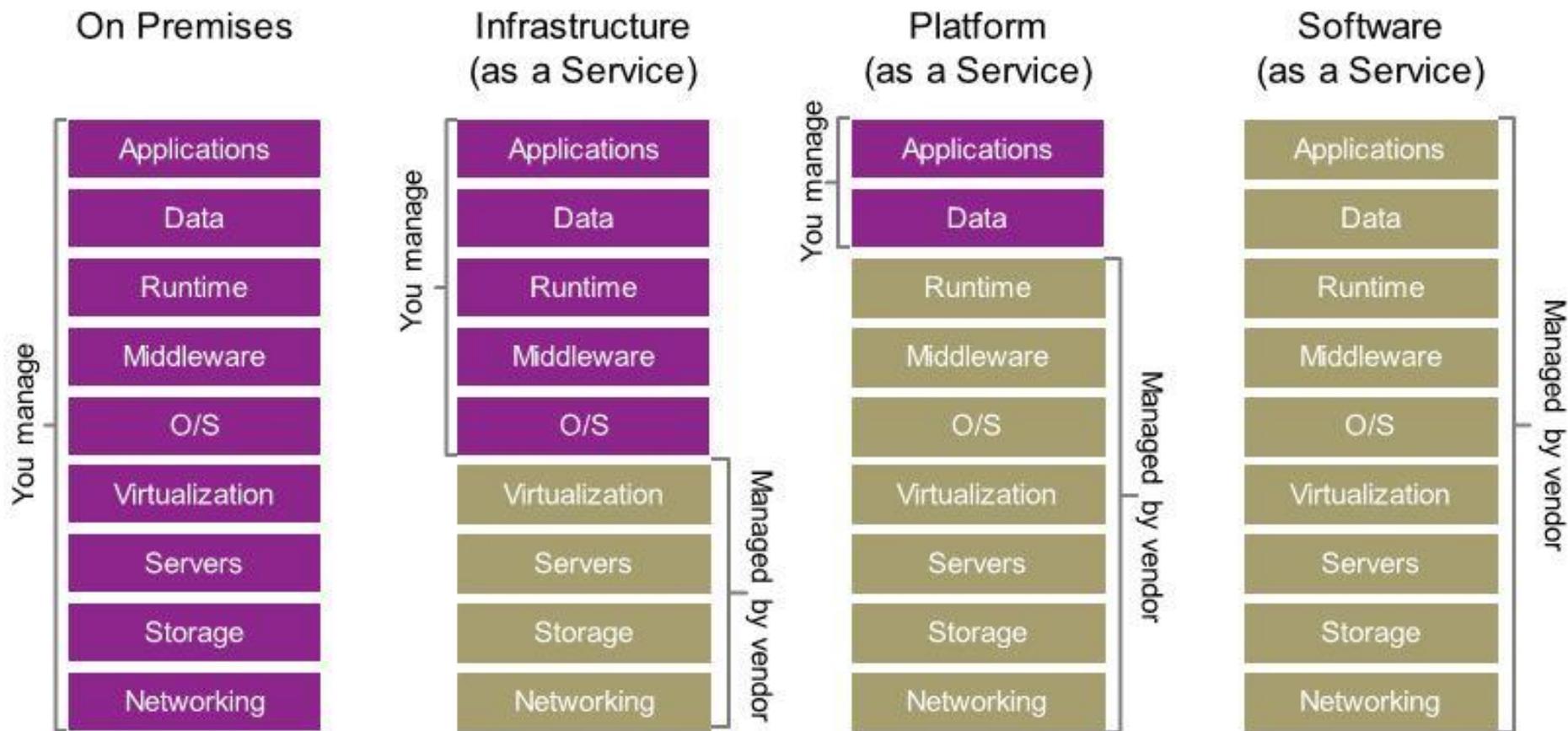
3. Infrastructure as a Service (IaaS).

- i. The capability provided to the consumer is to provision processing, storage, networks, and other fundamental computing resources where the consumer is able to deploy and run arbitrary software, which can include operating systems and applications. The consumer does not manage or control the underlying cloud infrastructure but has control over operating systems, storage, and deployed applications; and possibly limited control of select networking components (e.g., host firewalls).

Introduction

Overview of Digital Goods and Services

■ Cloud Computing and Remote Access Services.

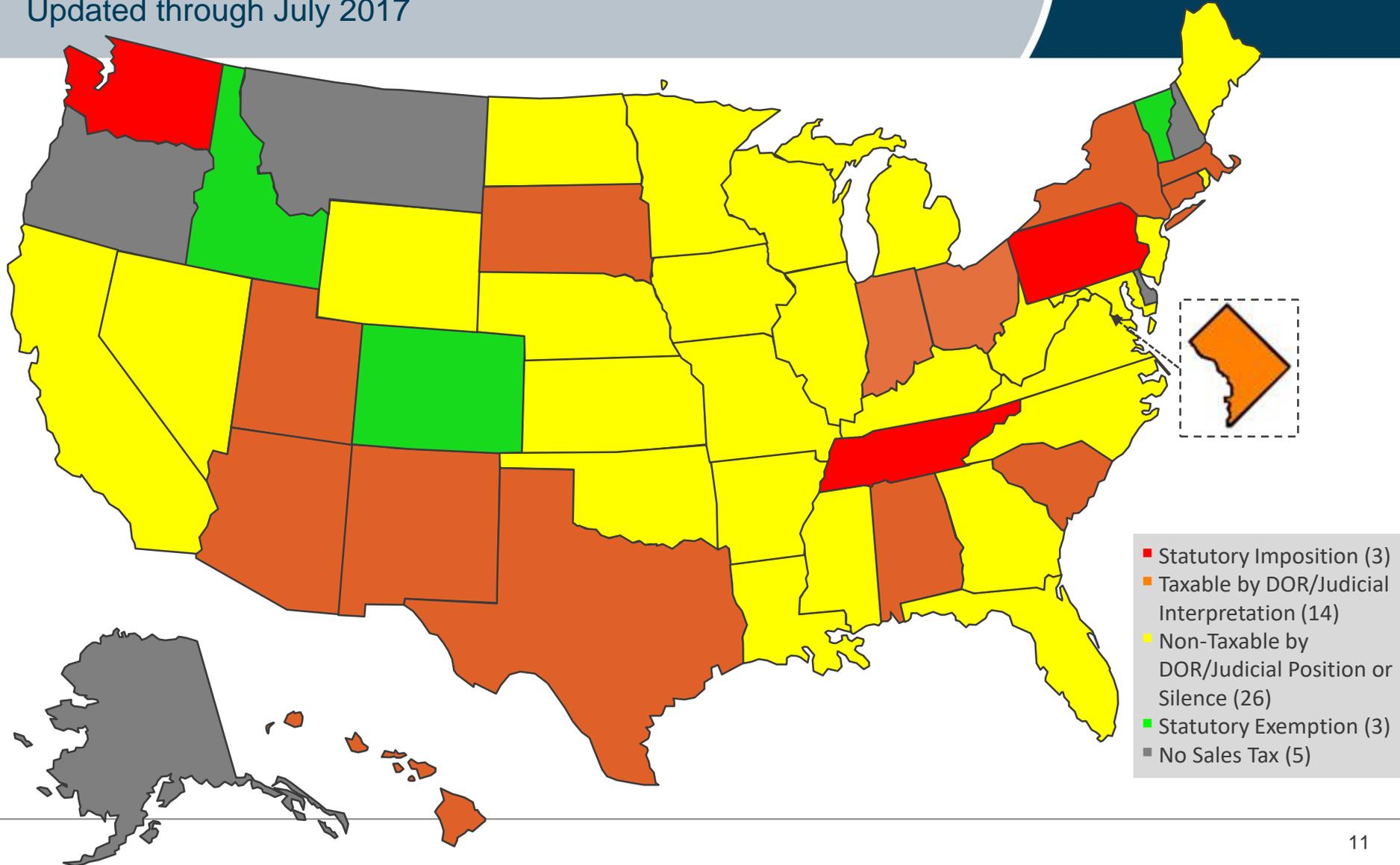


50-state Taxability Map

Software as a Service (SaaS)

Updated through July 2017

McDermott
Will & Emery



■ Digital Goods (aka Digital Products).

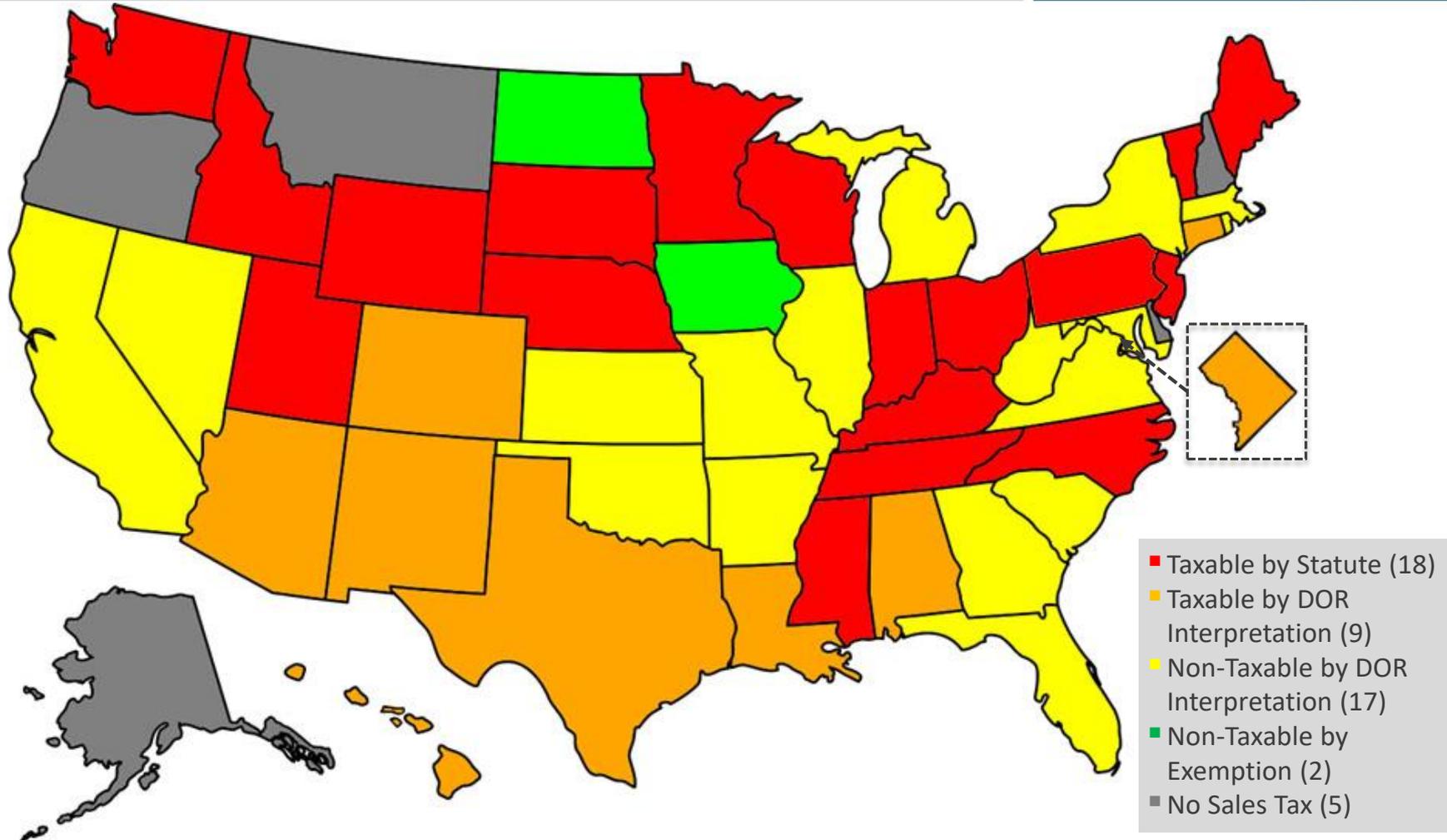
- Electronically transferred (*i.e.*, obtained by the purchaser by means other than tangible storage media):
 - **“Digital Audio-Visual Works”** which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any;
 - Examples – downloaded movies and TV shows.
 - **“Digital Audio Works”** which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones, and
 - Example – downloaded music or ringtones.
 - **“Digital Books”** which means works that are generally recognized in the ordinary and usual sense as “books”.
- A complete copy is physically sent to the purchaser’s device (cell phone, tablet, laptop, desktop, video game console, etc.), whether rights to the digital product are for a specified period of time or indefinitely.

50-state Taxability Map

Digital Products

Updated through July 2017

McDermott
Will & Emery



■ Streaming Services.

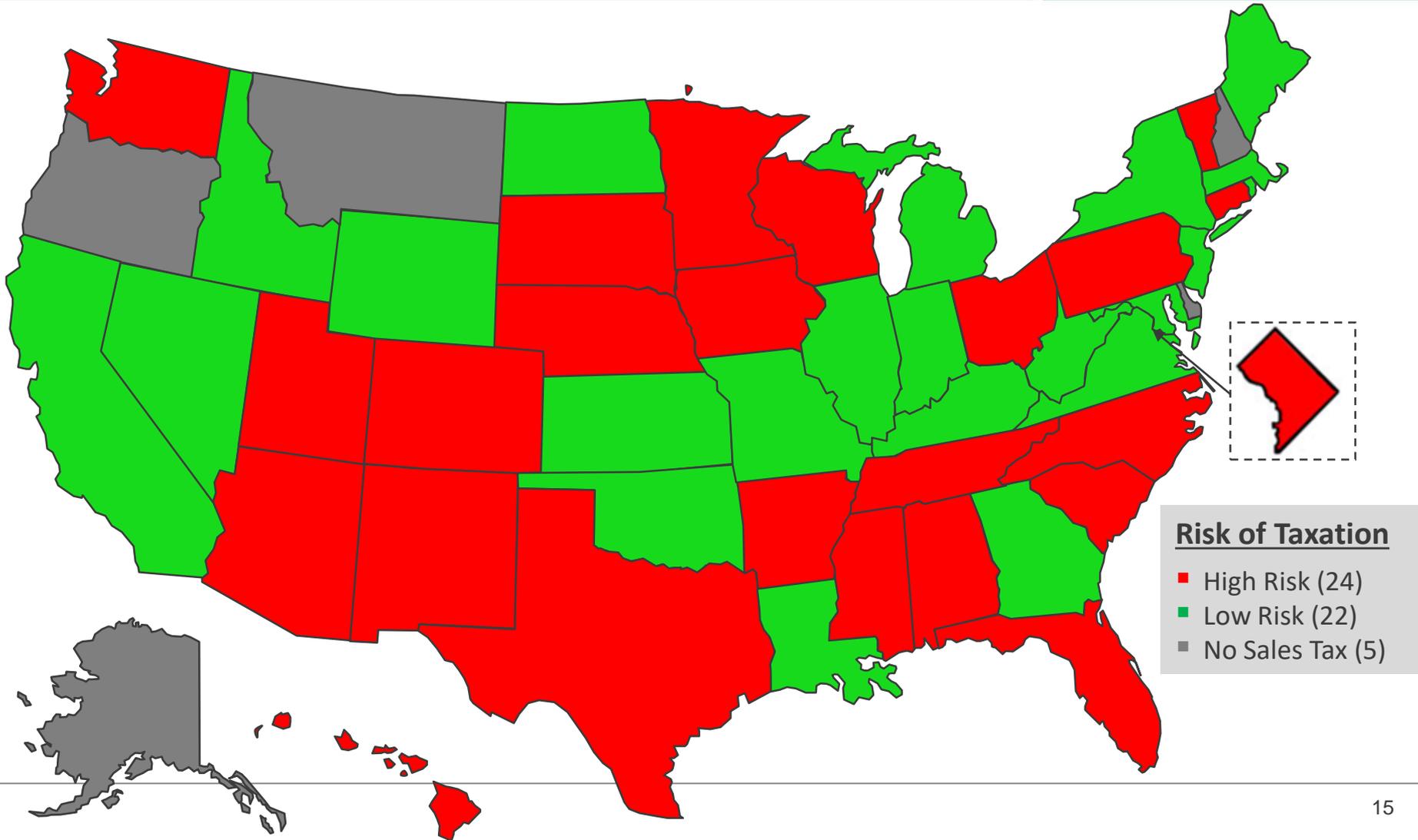
- Subscription-based access to a library of movies, TV shows, music, books, or other digital content via the Internet or LTE as a steady, continuous flow, allowing playback to proceed while subsequent data is being received. The end user does not obtain a complete copy (download) of any of the digital products they access from the library, and have no rights of permanent use.
 - Sometimes referred to as “over-the-top” (OTT) services.
 - Examples – Netflix, Amazon Prime Video, HBO Now, Spotify, Pandora, etc.
- Many service providers are now offering live broadcast television streaming services, which adds a layer of complexity as these services may be captured under the existing cable/satellite telecommunications tax regime (unlike non-broadcast offerings).
 - Examples - DirecTV Now, Sling TV, FuboTV, Hulu, PlayStation Vue, YouTube TV, etc.

50-state Taxability Map

Video Streaming

Updated through July 2017

McDermott
Will & Emery



■ ***Other Digital Goods and Services.***

- Information services - collecting, compiling, or analyzing information and furnishing a report to a customer.
 - Examples - stock quotes, financial/legal research, property values, marketing trends, etc.
- Data processing services – collecting, compiling, or analyzing the customer's own data.
 - Examples – payroll or inventory control services.
- Remote storage - allows customers to store, retrieve, and maintain content, data, applications, and software on its servers.
- Digital periodicals (magazines and newspapers) and greeting cards.
- Digital codes – purchase of a code used to access a digital good/service.
- Custom software or information services - designed exclusively to the specifications of one customer.

NATIONAL OBSERVATIONS AND TRENDS

■ Tangible Personal Property v. Services.

- Most jurisdictions with a transaction tax impose the tax on tangible personal property (“TPP”) but do not broadly tax most services.
- When TPP and services are provided as part of the same transaction, separately stated charges are usually respected and analyzed independently.
 - When charges are not separately stated, most states will look to the “true object” or “predominant purpose” of the transaction.
 - Example 1 – Sale of prewritten computer software with a maintenance agreement (updates, bug fixes, etc.) is considered by most to be predominantly the sale of software, with the maintenance services secondary.
 - Example 2 – Cloud service/license agreements on the other hand are predominantly services, with any TPP merely incidental to the nontaxable service.

- **When Electronically Delivered Software is Taxed, it is Defined as TPP.**
 - Most jurisdictions that consider electronically delivered software to be “tangible personal property” have defined it as such in their statutes, ordinances and regulations.

- **But When Digital Products are Taxed, it is Outside Definition of TPP.**
 - Consistent with the Streamlined Sales and Use Tax Agreement (SSUTA), most states that tax digital goods/products do so outside the definition of “tangible personal property.”

■ States and Locals Ignoring *Quill*.

- In the midst of an effort by states to overturn the U.S. Supreme Court's physical presence requirement in *Quill Corp. v. North Dakota*.
- This has had an impact on many providers of digital goods and services that have no physical presence in a state or locality, but have customers located in the jurisdiction.
- Pending *South Dakota v. Wayfair* litigation creates some uncertainty going forward, but *Quill* remains binding precedent for now and state and local governments must abide by the physical presence test for the time being, or risk similar litigation.

■ States and Locals Overlooking ITFA.

- In 2015, Congress permanently extended the Internet Tax Freedom Act (“ITFA”). See Pub. L. 114-53.
- ITFA is a federal law that prohibits a state or locality from imposing a “discriminatory tax on electronic commerce.” Congress has provided that a tax discriminates against electronic commerce if it “is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means” or if it “imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means.” See Pub. L. 105-277, div. C, tit. XI, § 1104(2)(A).

■ States and Locals Overlooking ITFA (cont.).

- When enacting or implementing a law that taxes digital goods and services (*i.e.*, electronic commerce), states and localities must carefully evaluate whether doing so will violate ITFA.
 - *Question 1* – does the taxing jurisdiction impose and collect tax on the tangible/physical counterpart of the digital goods and services?
 - If not, the taxing jurisdiction is violating federal law and at risk for a lawsuit.
 - Arizona example – DOR has considered “remote storage” to be taxable under the TPT rental classification, but exempts physical self storage services.
 - *Question 2* – even if tax is imposed on the tangible/physical counterpart, is the obligation to collect or pay on a different person or entity?
 - If so, the taxing jurisdiction is violating federal law and at risk for a lawsuit.

■ States and Locals Overlooking ITFA (cont.).

– Example – City of Chicago

- On June 5, the Entertainment Software Association (ESA) filed a complaint in Cook County Circuit Court challenging the City of Chicago's Amusement Tax Ruling # 5 (2015), which administratively expands the city's 9 percent Amusement Tax to providers of online amusements, including streaming gaming, movies, television and music that are located outside the city.
- Basis for lawsuit is violation of ITFA, and ESA is requesting a declaratory judgment and permanent injunction enjoining the city from enforcing Ruling # 5.
- Liberty Justice Center has a similar lawsuit pending on the same issue.

■ Increased Local Activity.

- Localities (most of which have more antiquated laws than the states) are ramping up their enforcement efforts and taking the position that various digital goods and services are subject to tax, usually with no basis other than the position that the digital goods and services are TPP.
 - Examples – Colorado, Louisiana, etc.
 - This has resulted in a noticeable increase in litigation and controversy.
- Last year, a coalition of California cities joined together in an effort to administratively interpret their local **utility user taxes** to apply to over-the-top streaming providers.
 - California Assembly Revenue and Taxation Committee introduced legislation in response to temporarily prohibit (through Jan. 1, 2023) local tax imposition on video streaming services.
 - Enforcement by locals has since ceased.

■ Aggressive Streaming Positions are Being Litigated.

– *Example* – Kentucky.

- In 2015, the Board of Tax Appeals (BTA) held that Netflix’s video streaming service is not comparable to taxable “multichannel video programming services” (defined to include cable, satellite and IP TV).
 - See *Netflix, Inc. v. Finance and Administration Cabinet Dep’t of Revenue*, Order No. K-24900 (Bd. Tax App. Sept. 23, 2015).
- In August 2016, a Kentucky Circuit Court affirmed the BTA order.
 - See No. 15-CI-01117 (Franklin Cty. Cir. Ct., Aug. 23, 2016).
- DOR filed notice of appeal on Sept. 20, 2016.
- Attempted to transfer the case to Kentucky Supreme Court, but ultimately withdrew the motion and the case was dismissed earlier this year.
- The Circuit Court decision holding that Netflix’s services are not within the scope of the cable/satellite imposition is now final.

– *Other Example* – Colorado localities.

CURRENT ARIZONA LAW AND POLICY

- Canned software, delivered electronically.
 - Taxable under retail classification; at server location.
- Custom software, delivered electronically.
 - Nontaxable service.
- Data processing services.
 - Nontaxable service.
- Canned information services, delivered electronically.
 - Taxable; at destination.
- Customer information services, delivered electronically.
 - Nontaxable service.

- Software as a Service.
 - Taxable under TPT rental classification; at user location.
- Remote Storage.
 - Nontaxable service, *unless* the customer has the option of choosing the operating system and computing capacity or is provided with software to be used as a conduit for the remote storage service.
- Digital Products.
 - Taxable under TPT rental classification; at user location.
- Digital Periodicals.
 - Taxable under TPT rental classification; at user location.

■ Sourcing

- **Retail** sales of tangible personal property are sourced: (1) to the seller's business location (origin) if the seller receives the order at a business location in-state; (2) to the purchaser's location in-state if the seller receives the order at a business location outside Arizona. A.R.S. § 42-5040(A).
 - An order is received when all of the information necessary to accept the order has been received by or on behalf of the seller, regardless of where the order is accepted or approved. A.R.S. § 42-5040(B).
- **Rental** or leases of tangible personal property are sourced:
 - 1. To the lessor's business location (the business address that appears on the lessor's TPT license) if the lessor has a business location in this state.
 - 2. To the lessee's address (the residential address of an individual lessee and the primary business address of any other lessee) if the lessor does not have a business location in this state. The gross receipts are taxable when the property is shipped, delivered or otherwise brought into this state for use in this state. A.R.S. § 42-5040(C)-(D). Remote access uncertain.

■ Administrative Challenges

- Municipalities determine own TPT tax base; rental classification in MCTC is broader than State TPT and inconsistent as to whether incidental services are included in the tax base.
- State “*tangible personal property*” definition broad, but outdated and does not expressly include software—creates uncertainty.
 - “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.” A.R.S. § 42-5001(17).
 - DOR software interpretation based on old case law and regulation. Taken to its extreme, the DOR could find everything to be “tangible” so long as it can be perceived by the senses in some form...
 - MCTC does not even define TPP!
- Rental classification requires the customer to have exclusive possession or control over the TPP. *State Tax Comm’n v. Peck*, 106 Ariz. 394 (1970).

■ Administrative Challenges (cont.)

- DOR policy making via PLR's has resulted in differential treatment for similarly situated companies.
 - Other companies cannot rely on PLR's or informal guidance, especially when it is constantly changing.
 - Policy decisions going forward need to ensure a level playing field for competitors, regardless of whether specific digital goods and services are subject to tax or not.
- TPT rental classification regime taxes companies based on gross receipts of TPP leases or rentals with no reduction for incidental nontaxable services (bundled transaction issues).
- Administratively considering digital products to be TPP under an old software regulation is not good enough. More authority needed for DOR to tax.

IMPLEMENTING A LEGISLATIVE SOLUTION

- National Conference of State Legislatures' Standing Committee on Communications, Financial Services & Interstate Commerce, *Policy Directive - The Internet and Electronic Commerce*.
 - State legislatures share the concern of many in Congress that **ill-conceived over-regulation and taxation of the Internet and electronic commerce services could harm our nation's ability to compete globally**.
 - Government policies should create a workable infrastructure in which electronic commerce can flourish. **Policy makers must resist any temptation to apply tax policy to the Internet in a discriminatory or multiple manner that hinders growth**. Government tax systems should treat transactions, including telecommunications and electronic commerce, in a competitively neutral and non-discriminatory manner. The federal government and America's industries should work with state legislatures in ensuring equal tax treatment of all forms of commerce and should **encourage state efforts to achieve simplification and uniformity through the streamlining of state and local sales and telecommunications tax systems**.

- National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation, *Cloud Based Services Principles*
 1. To ensure that taxation is equitable, states contemplating taxes on Cloud Based Services should:
 - A. Establish consistent sourcing regimes that recognize the special challenges that cloud computing presents so as to avoid the multiple taxation of individuals or businesses in multiple states; and
 - B. Not impose discriminatory taxes on Cloud Based services.

- National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation, *Cloud Based Services Principles* (cont.)
 2. States considering taxes on Cloud Based Services should base their decisions on the nature of the service and not on the nature or type of provider.

- National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation, *Cloud Based Services Principles* (cont.)
 3. To ensure that taxation is clear, efficient, and fair, states choosing to impose a tax on Cloud Based Services should:
 - A. Avoid imposing any tax on Cloud Based Services through administrative action and only consider imposing the tax through statutory imposition;
 - B. Carefully draft definitions to provide clarity to buyers and sellers of Cloud Based Services;
 - C. Recognize the broad range of services included in Cloud Based Services and address those differences within the statutory scheme;

- National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation, *Cloud Based Services Principles* (cont.)
 3. To ensure that taxation is clear, efficient, and fair, states choosing to impose a tax on Cloud Based Services should:
 - D. Design any tax impositions only on specific and clearly delineated services where state statutes provide for broad taxation of services, exclusions or exemptions, if any, for certain Cloud Based Services should be clearly delineated;
 - E. Encourage the involvement of providers of Cloud Based Services in any drafting efforts involving the taxation or sourcing of those services; and
 - F. Provide clear and consistent rules to govern bundled transactions involving Cloud Based Services.

- While Arizona is not a SSUTA state, the uniform definitions, sourcing hierarchy, and underlying principles should be utilized when crafting a legislative solution in the digital goods and services space.
- Following the NCSL principles, legislators should work with the DOR and key industry representatives to decide which digital goods and services should be subject to tax in Arizona and which should not.
- Clear definitions, sourcing regimes, and state-local uniformity are all important drivers for industry compliance.
- General rule of thumb – consider whether customer is *predominantly* receiving a tangible good or a service.

- Clarifications that statutorily impose tax should be prospective-only (no “new” retroactive tax).
- Clarifications that make it clear that tax is not due should not have a going-forward limitation.
 - Revenue “loss” claims by the DOR should not trump the taxpayer’s ability to claim a refund for funds remitted based on reliance on faulty DOR administrative positions.
- Ad Hoc Joint Committee should further evaluate the telecommunications classification and determine the interplay with digital goods and services to ensure tax parity for all providers.

Comments? Questions?

Stephen P. Kranz

Partner

McDermott Will & Emery LLP

Washington, DC

(202) 756-8180

skranz@mwe.com

LinkedIn Group: State Tax Policy Exchange

Blog: www.insidesalt.com