NATIONAL SALES AND USE TAX UPDATE: KEEPING PACE IN THE 21ST CENTURY

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I. INTRODUCTION

This paper addresses two of the more prominent sales and use tax issues in 2010 and 2011: the emergence of click-through nexus laws and the taxation of digital goods, cloud computing, and software. The rapidly increasing importance of these issues reflects the prevalence of the Internet in all aspects of the modern economy.

II. CLICK-THROUGH NEXUS LAWS

A. Overview

In 2008, New York became the first state to enact a click-through nexus law which was aimed at requiring online retailers operating affiliate programs to begin collecting and remitting use tax on purchases made to New York customers.[1] Essentially, New York's law provided that an online retailer would be presumed to have nexus with New York (and thus would be obligated to collect use tax) if sales generated by all of the retailer's New York affiliates exceeded $10,000 in a 12-month period.

Since then, despite New York's law being challenged as unconstitutional by Amazon.com and Overstock.com in court, eight states have enacted their own versions of a click-through nexus law—Arkansas, Colorado, Connecticut, Illinois, North Carolina, Oklahoma, Rhode Island, and South Dakota. Even more states have introduced click-through nexus legislation, several of which are currently pending in their state's 2011 legislative session. Although many of these laws and bills have been modeled after New York's law, more recently states have been exploring the use of alternative out-of-state retailer use tax requirements that fall short of the imposition of an actual collection obligation. Such legislation generally requires retailers to disclose to in-state customers their obligation to pay use tax to the state. Further, a few states are also attempting to require retailers to report their in-state sales to the revenue department.

The remainder of this section of the paper will explain sales and use tax nexus, generally, discuss these click-through nexus law developments, analyze differences in the types of legislation, and identify recent challenges that have arisen to the laws upon their enactment.

B. Sales and Use Tax Nexus, Generally

In the 1992 *Quill Corp. v. North Dakota* decision, the U.S. Supreme Court affirmed its 1967 holding in *National Bellas Hess, Inc. v. Ill. Dep't of Revenue* that a taxpayer must have

[1] Affiliate programs involve retailers entering agreements with website operators ("affiliates") by which such affiliates place links on their websites to specific products sold by the retailer. The affiliate receives a percentage of all sales generated by customers' clicking the link on the affiliate's website.

physical presence within a jurisdiction in order to be subject to its sales and use tax laws under the Commerce Clause.[2] The burgeoning mail-order retail industry provided the context for the *Quill* decision; e-commerce had not yet achieved national prominence. Over the past decade alone, however, retail e-commerce sales have increased approximately 24 times faster than non-e-commerce retail sales.[3] In 2010, uncollected states and local sales tax from e-commerce totaled approximately $8.6 billion, and uncollected Internet sales taxes could cost state and local governments more than $11 billion a year by 2012.[4] Further, states are experiencing unprecedented revenue shortfalls and budget woes.

As a result, the continuing vitality of *Quill* has been increasingly called into question. In particular, states have questioned and criticized the Court's reasoning in *Quill* that requiring out-of-state retailers to collect sales or use taxes would be unduly burdensome, as the means of keeping up with multistate sales and use tax obligations have improved drastically since 1992.[5] Yet, the Supreme Court has not again addressed the physical presence requirement, and thus it remains as the constitutional standard for nexus under the Commerce Clause.

Additionally, state revenue departments and legislatures have developed the theory of "attributional nexus," which allows a state to impose its sales/use tax on an out-of-state taxpayer that does not itself have physical presence within the state, based on the physical presence of another entity. The U.S. Supreme Court has upheld attributional nexus.[6] Two factors have been held to be sufficient in finding attributional nexus: (i) the in-state entity is acting on behalf of the out-of-state taxpayer; and (ii) the in-state entity is performing activities in support of the marketing or sales activities of the out-of-state taxpayer.

In light of the drastically increasing prevalence of e-commerce, as well as the development of attributional nexus theories and the questioning of the physical presence standard, states have begun to introduce and enact click-through nexus provisions. The remainder of this section will discuss the four common models of click-through nexus legislation: affiliate nexus provisions, disclosure and reporting provisions, controlled group provisions, and other click-through nexus provisions.

C. Affiliate Nexus Model

The most common type of click-through law is the affiliate nexus model, which imposes use tax collection requirements on out-of-state retailers by creating a presumption that such retailers have nexus with the state as a result of their affiliate programs. New York's law (discussed above) is a common example of this model. Since New York passed its law in 2008, Arkansas, Connecticut, Illinois, North Carolina, and Rhode Island have enacted affiliate nexus provisions. A detailed look at each of these laws is as follows.

1. Arkansas

[2] 504 U.S. 298 (1992).
[3] Rob Atkinson & Daniel Castro, Information Technology and Innovation Foundation, *Closing the E-Commerce Sales Tax Loophole* (2010).
[4] Donald Bruce, William F. Fox, & LeAnn Luna, "State and Local Sales Tax Revenue Losses From E-Commerce," State Tax Notes, May 18, 2009.
[5] *See, e.g.*, Edward A. Zelinsky, "The Siren Song of 'Amazon' Laws: The Colorado Example," State Tax Notes, Mar. 7, 2011.
[6] *See* Scripto, Inc. v. Carson, 362 U.S. 207 (1960).

Arkansas's law—which was enacted in the 2011 legislative session—provides that an out-of-state seller "is presumed to be engaged in the business of selling tangible personal property or taxable services for use" in Arkansas, if "the seller enters into an agreement with one…or more residents of the state under which the residents, for a commission or other consideration, directly or indirectly refer potential customers, whether by a link on an Internet website or otherwise, to the seller."[7] This presumption applies "only if the cumulative gross receipts from sales by the seller to purchasers in the state who are referred to the seller by all residents…exceed [$10,000] during the preceding" 12-month period.[8]

An out-of-state seller may rebut this presumption "by submitting proof that the residents with whom the seller has an agreement did not engage in any activity within the state that was significantly associated with the seller's ability to establish or maintain the seller's market in the state during the preceding" 12-month period.[9] Such proof "may consist of written statements from all of the residents with whom the seller has an agreement stating that they did not engage in any solicitation in the state on behalf of the seller during the preceding year if the statements were provided and obtained in good faith."[10]

2. Connecticut

Connecticut enacted its affiliate nexus provision as part of the state's budget bill during the 2011 legislative session. It provides that "retailer" is defined to include:

> [E]very person making sales of tangible personal property or services through an independent contractor or other representative who is a resident of this state, if the retailer enters into an agreement with the resident, under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet web site or otherwise, to the retailer.[11]

Such a person will be presumed to be a retailer if "the cumulative gross receipts from sales by the retailer to customers in the state who are referred to the retailer by all residents with this type of an agreement with the retailer, is in excess of two thousand dollars during the preceding four quarterly periods ending on the last day of March, June, September and December."[12] This presumption "may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of the retailer that would satisfy the nexus requirement of the United States Constitution during such four quarterly periods."[13]

3. Illinois

Illinois also enacted its affiliate nexus provision during the 2011 session. It amends the definition of "retailer maintaining a place of business in this state" to include:

[7] S.B. 738, 88th Gen. Assem., Reg. Sess. (Ark. 2011).
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] S.B. 1239, 2011 Sess. (Conn. 2011).
[12] *Id.*
[13] *Id.*

> [A] retailer having a contract with a person located in this State under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link on the person's Internet website. The provisions of this paragraph…shall apply only if the cumulative gross receipts from sales of tangible personal property by the retailer to customers who are referred to the retailer by all persons in this State under such contracts exceed $10,000 during the preceding quarterly periods ending on the last day of March, June, September, and December.[14]

Unlike the Arkansas bill, the Illinois provision does not contain a minimum dollar threshold, and it is not couched in the form of a presumption.

4. New York

As discussed above, New York enacted its affiliate nexus statute in 2008. It clarifies who will be considered a "vendor" for N.Y. sales and use tax purposes. Specifically:

> A person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state [i.e., an in-state affiliate] under which the 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 seller.[15]

Like in Arkansas and Connecticut, there is a minimum dollar threshold under the New York law in order for the presumption to apply. A seller must have "cumulative gross receipts from sales…to customers in the state who are referred to the seller by all [in-state affiliates] in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November."[16] The presumption may be rebutted by proof that the in-state affiliate "did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States Constitution during the four quarterly periods in question."[17]

New York has provided additional guidance regarding the proof necessary to rebut the presumption. A seller may "establish that the only activity of its [in-state affiliates] in New York State on behalf of the seller is placing a link on the [affiliates'] Web sites to the seller's Web site."[18] Additionally, the seller can show that there is a contract between the parties that prohibits the in-state affiliate from "engaging in any solicitation activities in New York State that refer potential customers to the seller."[19] In order to take advantage of this method of proof, the seller must obtain, "on an annual basis, a signed certification stating that the [in-state affiliate] has not

[14] H.B. 3659, 96th Gen. Assem. (Ill. 2011).
[15] N.Y. Tax Law § 1101(b)(8)(vi).
[16] *Id.*
[17] *Id.*
[18] N.Y. Dep't of Taxation & Fin., TSB-M-08(3)S (5/8/2008).
[19] N.Y. Dep't of Taxation & Fin., TSB-M-08(3.1)S (6/3/2008).

engaged in any prohibited solicitation activities in New York State…at any time during the previous year."[20]

5. North Carolina

North Carolina's affiliate nexus law was enacted in 2009. The North Carolina statute provides that an out-of-state retailer has nexus with the state—and thus has a use tax collection obligation—if it "solicits or transacts business in this State by employees, independent contractors, agents, or other representatives, whether the remote sales thus subject to taxation by this State result from or are related in any other way to the solicitation or transaction of business."[21] An out-of-state retailer is:

> [P]resumed to be soliciting or transacting business by an independent contractor, agent, or other representative if the retailer enters into an agreement with a resident of this State under which the resident [i.e., the in-state affiliate], for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet Web site or otherwise, to the retailer.[22]

As in Arkansas, Connecticut, and New York, the presumption only applies if "the cumulative gross receipts from sales by the retailer to purchasers in this State who are referred to the retailer by all [in-state affiliates] is in excess of [$10,000] during the preceding four quarterly periods."[23] Additionally, the presumption of nexus may be rebutted by proof that the in-state affiliate "did not engage in any solicitation in the State on behalf of the seller that would satisfy the nexus requirement of the United States Constitution during the four quarterly periods in question."[24]

6. Rhode Island

Rhode Island enacted its affiliate nexus law in 2009. Rhode Island's statute provides that a "retailer" includes:

> Every person making sales of tangible personal property through an independent contractor or other representative, if the retailer enters into an agreement with a resident of this state [i.e., in-state affiliate], under which the 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….[25]

Like in Arkansas, Connecticut, New York, and North Carolina, there is a dollar threshold in place. Rhode Island requires that the "cumulative gross receipts from sales by the retailer to customers in the state who are referred to the retailer" by all in-state affiliates exceed $5,000

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[20] *Id.*
[21] N.C. Gen. Stat. § 205-164.8(b)(3).
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] R.I. Gen. Laws § 44-18-15(a)(2).

"during the preceding [four] quarterly periods ending on the last day of March, June, September and December."[26]

Out-of-state retailers that meet the statutory criteria and minimum dollar threshold "shall be presumed to be soliciting business through" in-state affiliates.[27] This presumption "may be rebutted by proof that the [in-state affiliate] did not engage in any solicitation in the state on behalf of the retailer that would satisfy the nexus requirement of the United States Constitution during such [four]quarterly periods."[28]

D. <u>Disclosure Model</u>

More recently, a handful of states have developed a second type of click-through nexus law, which does not require such retailers to actually collect the applicable use tax from their customers. Rather, under the disclosure model, retailers are obligated to disclose certain information to in-state customers upon (or sometimes after) a purchase has been made. In addition, a few laws under this model also require (or have proposed to require) that out-of-state retailers must report customers' use tax obligations to the state revenue department.

1. <u>Colorado</u>

Colorado was the first state to enact a disclosure click-through nexus provision, which it did in 2010. Colorado's statute requires both disclosing the use tax obligation to in-state customers (at the time of the sale and at the end of each year), as well as annually reporting customers' purchases to the Colorado Department of Revenue.

More specifically, the Colorado law provides that:

> Each retailer that does not collect Colorado sales tax shall notify Colorado purchasers that sales or use tax is due on certain purchases made from the retailer and that the state of Colorado requires the purchaser to file a sales or use tax return.
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> …
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> Failure to provide [this] notice...shall subject the retailer to a penalty of five dollars for each such failure, unless the retailer shows reasonable cause for such failure.[29]

Second, the law provides that:

> Each retailer that does not collect Colorado sales tax shall send notification to all Colorado purchasers by January 31 of each year showing such information as the Colorado Department of Revenue shall require by rule and the total amount paid by the purchaser for Colorado purchases made from the retailer in the previous calendar year. Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, if known by the retailer, whether the purchase is exempt or not exempt from taxation. The notification shall state that the state of Colorado requires a

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[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] Colo. Rev. Stat. § 39-21-112(3.5)(c).

> sales or use tax return to be filed and sales or use tax paid on certain Colorado purchases made by the purchaser from the retailer.[30]

Such notification must "be sent separately to all Colorado purchasers by first-class mail and shall not be included with any other shipments."[31] Further, the notification must "include the words 'Important Tax Document Enclosed' on the exterior of the mailing" and "include the name of the retailer."[32] Failure to provide this notice results in a penalty of ten dollars per failure, unless the taxpayer can show reasonable cause.[33]

Third, the law provides that:

> Each retailer that does not collect Colorado sales tax shall file an annual statement for each purchaser to the Department of Revenue on such forms as are provided or approved by the department showing the total amount paid for Colorado purchases of such purchasers during the preceding calendar year or any portion thereof, and such annual statement shall be filed on or before March 1 of each year.
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> …
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> The executive director of the Department of Revenue may require any retailer that does not collect Colorado sales tax that makes total Colorado sales of more than one hundred thousand dollars in a year to file the annual statement…by magnetic media or another machine-readable form for that year.[34]

A taxpayer's failure to provide this notice results in a penalty of ten dollars for each purchaser that the taxpayer should have included in it.[35]

2. <u>Oklahoma</u>

Oklahoma followed in Colorado's footsteps by enacting its own disclosure law later in 2010. In contrast to the Colorado law, Oklahoma's statute only requires than an out-of-state retailer provide notice to in-state customers at the time of the purchase; there is no accompanying reporting requirement. Specifically, the statute provides:

> Each retailer or vendor making sales of tangible personal property from a place of business outside this state for use in this state that is not required to collect use tax, shall provide notification on its retail Internet website or retail catalog and invoices provided to its customers that use tax is imposed and must be paid by the purchaser, unless otherwise exempt, on the storage, use, or other consumption of the tangible personal property in this state. The notification shall be readily visible. It is further provided that no retailer shall advertise on its retail Internet website or retail catalog that there is no tax due on purchases made from the retailer for use in this state.[36]

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[30] *Id.* § 39-21-112(3.5)(d)(I).
[31] *Id.*
[32] *Id.*
[33] *Id.* § 39-21-112(3.5)(d)(III).
[34] *Id.* § 39-21-112(3.5)(d)(II).
[35] *Id.* § 39-21-112(3.5)(d)(III).
[36] Okla. Stat. tit. 68, § 1406.1(A).

The statute also authorizes the state Tax Commission to promulgate a rule setting a minimum sales threshold for compliance. There is no specified penalty for violating this requirement, unlike under Colorado's law.

3. South Dakota

South Dakota enacted its disclosure law during the 2011 legislative session. Like Oklahoma, South Dakota's statute does not require the out-of-state retailer to report or disclose information to the state revenue department. Rather, the retailer is only required to give notice regarding certain information to South Dakota customers at the time of a purchase. In particular, retailers are required to give notice "that South Dakota use tax is due on nonexempt purchases of tangible personal property, services, or products transferred electronically and shall be paid by the South Dakota purchaser."[37]

Further, such notice must be "readily visible," and it must contain the following information:

> (1) The noncollecting retailer is not required, and does not collect South Dakota sales or use tax;
> (2) The purchase is subject to state use tax unless it is specifically exempt from taxation;
> (3) The purchase is not exempt merely because the purchase is made over the Internet, by catalog, or by other remote means;
> (4) The state requires each South Dakota purchaser to report any purchase that was not taxed and pay tax on the purchase. The tax may be reported and paid on the South Dakota use tax form; and
> (5) The use tax form and corresponding instructions are available on the South Dakota Department of Revenue and Regulation website.[38]

Like Oklahoma, there is no penalty specified in the bill for a violation of this notice provision. In fact, the bill instead provides that "[n]o criminal penalty or civil liability may be applied or assessed for failure to comply with the provisions of this Act."[39]

E. Controlled Group Model

A third click-through nexus model that has emerged imposes sales and use tax collection requirements on an out-of-state retailer that is a member of a controlled group of corporations. As of 2011, four states have enacted a controlled group provision: Arkansas, Colorado, Oklahoma, and South Dakota. Notably, each of these states also has another type of click-through nexus law in place.

1. Arkansas

Enacted in the same bill as its affiliate nexus provision, Arkansas's controlled group click-through nexus model provides that a seller is presumed to be engaged in the business of selling tangible personal property or taxable services in Arkansas "if an affiliated person is subject to the sales and use tax jurisdiction of the state," and the:

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[37] S.B. 146, 86th Sess. (S.D. 2011).
[38] *Id.*
[39] *Id.*

> (1) Seller sells a similar line of products as the affiliated person and sells the products under the same business name or a similar business name;
> (2) Affiliated person uses its in-state employees or in-state facilities to advertise, promote, or facilitate sales by the seller to consumers;
> (3) Affiliated person maintains an office, distribution facility, warehouse or storage place, or similar place of business to facilitate the delivery of property or services sold by the seller to the seller's business;
> (4) Affiliated person uses trademarks, service marks, or trade names in the state that are the same or substantially similar to those used by the seller; or
> (5) Affiliated person delivers, installs, assembles, or performs maintenance services for the seller's purchasers within the state.[40]

This presumption may be rebutted "by demonstrating that the affiliated person's activities in the state are not significantly associated with the seller's ability to establish or maintain a market in the state for the seller's sales."[41]

"Affiliated person" is defined to include a "person that is a member of the same controlled group of corporations of the seller," or "[a]nother entity that, notwithstanding its form of organization, bears the same ownership relationship to the seller as a corporation that is a member of the same controlled group of corporations."[42]

2. Colorado

Colorado's controlled group provision was also enacted as part of its disclosure law in 2010. It provides that:

> [I]f a retailer that does not collect Colorado sales tax is part of a controlled group of corporations, and that controlled group has a component member that is a retailer with physical presence in this state, the retailer that does not collect Colorado sales tax is presumed to be doing business in this state.[43]

A taxpayer may rebut such presumption "by proof that during the calendar year in question, the component member that is a retailer with physical presence in this state did not engage in any constitutionally sufficient solicitation in this state on behalf of the retailer that does not collect Colorado sales tax."[44]

3. Oklahoma

Like Colorado, Oklahoma enacted its controlled group nexus provision in 2010, along with its disclosure provision. Oklahoma provides that a retailer that is part of a "controlled group of corporations" having a "component member" that is a retailer engaged in business in Oklahoma will be presumed to be a retailer engaged in business in Oklahoma.[45] This presumption of nexus may be rebutted by proof that during the calendar year at issue, the

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[40] S.B. 738, 88th Gen. Assem., Reg. Sess. (Ark. 2011).
[41] *Id.*
[42] *Id.*
[43] Colo. Rev. Stat. § 39-26-102(3)(b)(II).
[44] *Id.*
[45] Okla. Stat. tit. 68, § 1401(9)(d).

component member that is a retailer engaged in business in Oklahoma did not engage in those activities on behalf of the retailer.[46]

4. South Dakota

South Dakota enacted its controlled group click-through nexus provision in 2011, along with its disclosure provision. South Dakota's controlled group provision is almost identical to Oklahoma's, providing that a retailer that is part of a "controlled group of corporations" having a "component member" that is a retailer engaged in business in South Dakota will be presumed to be a retailer engaged in business in South Dakota.[47] Further, such presumption may be rebutted by proof that during the calendar year at issue the component member that is a retailer engaged in business in South Dakota did not engage in those activities on behalf of the retailer.[48]

F. Other Click-Through Nexus Laws

Other states have taken different approaches to click-through nexus. A pending Texas bill would enact a click-through provision similar to ones enacted by Oklahoma in 2010 and South Dakota in 2011. Additionally, California is considering a unique approach not yet adopted in other states.

1. The Texas, Oklahoma, and South Dakota provisions

Texas's HB 2403, which is currently pending in the 2011 legislative session, provides that a retailer is engaged in business in Texas if it "holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who maintains a location in this state from which business is conducted," and if:

> (A) the retailer sells the same or a substantially similar line of products as the person with the location in this state and sells those products under a business name that is the same as or substantially similar to the business name of the person with the location in this state; or
> (B) the facilities or employees of the person with the location in this state are used to: (i) advertise, promote, or facilitate sales by the retailer to consumers; or (ii) perform any other activity on behalf of the retailer that is intended to establish or maintain a marketplace for the retailer in this state, including receiving or exchanging returned merchandise.[49]

Further, a retailer is engaged in business in Texas if it "holds a substantial ownership interest in, or is owned in whole or substantial part by, a person that:

> (A) maintains a distribution center, warehouse, or similar location in this state; and
> (B) delivers property sold by the retailer to consumers."[50]

"Substantial ownership interest" is defined as at least a 50% ownership interest in a corporation or other business entity.[51]

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[46] *Id.*
[47] S.B. 146, 86th Sess. (S.D. 2011).
[48] *Id.*
[49] H.B. 2403, 82nd Sess. (Tex. 2011).
[50] *Id.*

Oklahoma's 2010 click-through nexus legislation contained a nearly identical provision, as did South Dakota's 2011 enacted bill, although both of those provisions require an ownership interest of only 10%.[52]

2. California SB 234

California's bill amends the definition of "retailer engaged in business in this state" to include "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."[53] According to an analysis of the bill by the California Senate, the purpose of the bill is to implement "so-called 'long arm' nexus, an approach which allows the BOE to assert nexus whenever warranted under the U.S. Constitution."[54] Thus, "[i]nstead of providing bright-line tests, this bill allows the BOE to examine the individual facts and circumstances of a particular firm, and impose the collection responsibility on the retailer if merited by the case law."[55]

G. Ensuing Controversy Over Click-Through Nexus Laws

New York, North Carolina, and Colorado are currently embroiled in litigation involving their click-through nexus laws.

1. *Amazon.com LLC/Overstock.com, LLC v. New York State Dep't of Taxation & Finance* (N.Y. Sup. Ct., App. Div.)

Following the enactment of New York's click-through nexus law in 2008, Amazon.com and Overstock.com brought separate declaratory judgment and injunctive relief actions against the state Department of Taxation & Finance, contending that the law was unconstitutional. The lawsuits were since consolidated.

In late 2010, the N.Y. Supreme Court, Appellate Division held that the click-through nexus law on its face comports with the dormant Commerce Clause physical presence nexus test articulated in *National Bellas Hess* and *Quill Corp. v. North Dakota*. Specifically, according to the court, the law:

> [I]mposes a tax collection obligation on an out-of-state vendor only where the vendor enters into a business-referral agreement with a New York State resident, and only when that resident receives a commission based on a sale in New York. The statute does not target the out-of-state vendor's sales through agents who are not New York residents. Thus, the nexus requirement is satisfied.[56]

The court also held that the law on its face complies with due process.

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[51] *Id.*
[52] Okla. Stat. tit. 68, § 1401(9)(b); S.B. 146, 86th Sess. (S.D. 2011).
[53] S.B. 234, 2011 Sess. (Cal. 2011).
[54] S.B. 234, Senate Rules Comm., Bills Analysis (Cal. 2011).
[55] *Id.*
[56] 2010 N.Y. App. Div. LEXIS 7943 (1st Dept. Nov. 4, 2010).

The court remanded, however, the as-applied Commerce Clause and Due Process Clause issues to the trial court. The court stated that it was "unable to conclude as a matter of law that plaintiffs' instate representatives are engaged in sufficiently meaningful activity so as to implicate the State's taxing powers," and also that it was "unable to determine on this record whether the in-state representatives are engaged in activities which are 'significantly associated' with the out-of-state retailer's ability to do business in the state," citing *Tyler Pipe*.[57]

2. Amazon.com LLC v. Lay (W.D. Wash. 2010)

North Carolina engaged in an audit of Amazon.com's North Carolina sales dating back to 2003. In conjunction with the audit, North Carolina demanded from Amazon the names and addresses of its customers associated with those sales. On April 19, 2010, Amazon filed a lawsuit in the U.S. District Court for the Western District of Washington, seeking an injunction against North Carolina's demand.

In its suit, Amazon contended that the North Carolina Department of Revenue did not need the specific customer information to audit it for sales and use tax compliance, and that the DOR has offered no rationale for the request. It further alleged that the First Amendment protects its customers' rights to purchase and receive expressive materials free from government scrutiny; therefore, the DOR's demand would chill its customers' free expression and limit Amazon's ability to sell expressive works to the public.

Subsequently, the American Civil Liberties Union ("ACLU") moved to intervene in the lawsuit on behalf of various Amazon customers. The ACLU similarly argued in its motion that "[i]f [the] DOR were to obtain information about which specific items [the customers] have purchased or received from Amazon, it would chill [the customers] from purchasing items on Amazon, especially controversial, personal and sensitive items."[58]

On October 25, 2010, the Western District of Washington ruled that the N.C. Department of Revenue could not force Amazon to disclose the identifying customer information that it sought, as such demand violates the First Amendment. The court granted Amazon's motion for summary judgment on this issue. The court also stated, however, that its ruling "only implicates [the] DOR's ability to determine whether an exemption applies to any particular transaction that would alleviate some tax burden on Amazon."[59] Further:

> While this may frustrate the DOR's desire to provide a proper calculation of the exact tax owed by Amazon, the DOR has admitted that any lack of names does not impede a tax assessment. The DOR has stated that it can and will impose a tax on Amazon, and that it will simply be up to Amazon to seek a lower tax rate.[60]

The ACLU and North Carolina settled in January 2011. According to an ACLU press release, "the North Carolina Department of Revenue…has agreed to stop asking for personally

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[57] *Id.*
[58] *Amazon.com, LLC v. Lay*, Dkt. No. 2:10-cv-00664-MJP (W.D. Wash. July 9, 2010) (motion to intervene), *available at* 2010 STT 123-31.
[59] *Amazon.com LLC v. Lay*, 2010 WL 4262266, at *6 (W.D. Wash. Oct. 25, 2010).
[60] *Id.*

identifiable customer information in combination with details about the titles of customers' purchases from Internet retailers."[61] Further, according to the settlement, the N.C. DOR:

> [W]ill include a statement on any "information document request" (IDR) issued to an Internet retailer that sells books, movies, music or other expressive items, which also includes a request for customer names, stating: "This IDR does not request the names, titles or other identifying information from which names and titles can be derived of the books, movies, music or other expressive items sold."[62]

3. *Direct Marketing Association v. Huber* (D. Colo. 2011)

On June 30, 2010, the Direct Marketing Association ("DMA") filed a lawsuit in the U.S. District Court, District of Colorado, to enjoin Colorado from enforcing its click-through nexus disclosure and reporting law, contending that it was unconstitutional.

Specifically, the DMA alleged that the Colorado law violated the Commerce Clause of the U.S. Constitution, because it "discriminate[d] against out-of-state retailers who do not collect Colorado sales tax," because it imposes "on those retailers notice and reporting obligations that are not imposed on Colorado retailers."[63] Additionally, the DMA contended that the law violated the Commerce Clause as an "improper and burdensome regulation of interstate commerce."[64]

Colorado petitioned the court to dismiss DMA's complaint, arguing that DMA did not have standing to sue, and that the law does not require disclosing information that violates a purchaser's privacy or free speech rights.

On January 26, 2011, the district court granted DMA's preliminary injunction against Colorado. The court ruled that DMA "has shown a substantial likelihood that it will succeed in showing that the act and the regulations are discriminatory because, in practical effect, they impose a burden on interstate commerce that is not imposed on in-state commerce."[65] According to the court:

> Regardless of the state's salutary local purposes, its enactment of a statutory scheme and concomitant regulations that produce, in effect, a geographic distinction between in-state and out-of-state retailers discriminates patently against interstate commerce, …which triggers the virtually per se rule of facial invalidity that has not been surmounted by a demonstration by the state of a legitimate local purpose that can not be served adequately by reasonable nondiscriminatory alternatives.[66]

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[61] Press Release, ACLU, CLU of North Carolina Celebrates Landmark Victory for Consumers' Privacy Rights (Feb. 9, 2011) (available at http://www.acluofnc.org/?q=aclu-nclf-celebrates-victory-consumers-privacy-rights).
[62] *Id.*
[63] *Direct Marketing Ass'n v. Huber*, 2011 WL 250556, at *3 (D. Colo. Jan. 26, 2011).
[64] *Id.* at *4.
[65] *Id.* at *4.
[66] *Id.*

The court suggested that Colorado, like other states, "might collect use tax from Colorado taxpayers via the Colorado income tax form."[67]

Regarding the undue burden claim, the court also agreed that the DMA had demonstrated a substantial likelihood of success. The court concluded that the Amazon law imposes its burdens "on out-of-state retailers who have no connection with Colorado customers other than by common carrier or the United States mail."[68] Accordingly, "[t]hose retailers likely are protected from such burdens on interstate commerce by the safe-harbor established in *Quill*."[69]

4. <u>Retailers' Responses</u>

In addition to litigation, large Internet retailers have responded to the enactments of click-through nexus laws by threatening to discontinue their affiliate programs in the particular state. At the same time, national brick-and-mortar retailers have thrown their support behind states. Thus, not only have click-through nexus laws changed the nature of sales and use tax nexus, but they have created highly unlikely political allies on both sides of the debate.

III. DIGITAL GOODS, CLOUD COMPUTING, AND SOFTWARE

A. <u>Digital Goods</u>

Although only a handful of states have begun addressing the taxability of cloud computing services, states have almost universally recognized the necessity to tax (or exempt) digital goods, as transactions involving such goods have become a major part of the modern economy and society. Digital goods, which are otherwise known as tangible personal property transferred electronically, come in many shapes and sizes, and include products such as electronic music downloads, photographs transferred electronically, movies streamed over the Internet, e-books, and so on.

In light of the increasing prevalence of digital goods, states are beginning to expand their sales and use tax laws to apply the tax to sales of such products. These issues have been addressed within the Streamlined Sales & Use Tax Agreement ("SSUTA"). Under the SSUTA, "specified digital products" are defined to include the following three things:

- "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."[70]

Further, "transferred electronically" means "obtained by the purchaser by means other than storage media."[71]

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[67] *Id.*
[68] *Id.* at *5.
[69] *Id.*
[70] SSUTA, "Digital Products Definitions."

The SSUTA has established several rules regarding the taxation of these goods for member states. Under such rules, member states may not include any of the specified digital products within their general definition of tangible personal property, although they may impose a tax on "products transferred electronically" without using the terms "specified digital products."[72] Further, a statute imposing tax on digital goods shall be construed as only imposing the tax on a sale to an end user, unless specified otherwise.[73] Such statute shall also be construed as only imposing the tax on a sale with the right of permanent use granted by the seller, unless specified otherwise.[74] Further, a taxing statute must be construed as only imposing the tax on a sale that is not conditioned upon continued payment from the buyer, unless specified otherwise.[75] Member states may treat subscriptions to digital products differently, although the sale of digital code must be treated the same as the sale of a digital good.[76]

Since 2008, several states have newly imposed sales and use tax on digital goods, including: Indiana (2008), Kentucky (2009), Louisiana (2010), Mississippi (2009), Nebraska (2008), New Jersey (2009), North Carolina (2009), South Dakota (2008), Tennessee (2008), Vermont (2009), Washington (2009), Wisconsin (2009), and Wyoming (2010). States have taken numerous approaches to taxing digital goods. Such approaches can be grouped into three primary categories: (1) explicitly extending the sales and use tax statutes to apply to such goods; (2) expanding the definition of "tangible personal property" to include such goods; or (3) ruling administratively that certain digital goods are taxable.

1. <u>States that Have Explicitly Extended Sales/Use Tax Statute to Apply to Digital Goods</u>

a. Indiana

By statute, Indiana imposes its sales and use tax on "specified digital products," which are defined to be electronically transferred digital audio-visual works, digital audio works, and digital books.[77] Such digital products are subject to tax when a person electronically transfers them to an end user, and grants the right of permanent use of the specified products to the end user that is not conditioned upon continued payment by the purchaser. The transfer of a digital code to obtain a product transferred electronically is also taxed.

b. New Jersey

New Jersey specifies that "[d]igital property" is taxable, and it is defined as "electronically delivered music, ringtones, movies, books, audio and video works and similar products where the customer is granted a right or license to use, retain or make a copy of such item."[78]

c. North Carolina

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[71] *Id.*
[72] *Id.* § 332(A).
[73] *Id.* § 332(D)(1).
[74] *Id.* § 332(D)(2).
[75] *Id.* § 332(D)(3).
[76] *Id.* §§ 332(F), (G).
[77] Ind. Code §§ 6-2.5-4-16.4, 6-2.5-1-26.5.
[78] N.J. Rev. Stat. §§ 54:32B-3, 54:32B-29(vv).

Effective January 1, 2010, North Carolina provides that its sales and use tax applies to specified digital property that is delivered or accessed electronically, is not considered tangible personal property, and would otherwise be taxable if sold in a tangible medium. The tax applies regardless of whether the purchaser of the item has a right to use it permanently or to use it without making continued payments.[79]

d. Tennessee

Tax is imposed on sales of "specified digital products," which include electronically transferred digital audio-visual works, digital audio works, digital books, and digital code that allows a purchaser to obtain or access specified digital products.[80] Further, the sale or use of such digital products are subject to tax when the purchaser receives a permanent right of use, a right of use which terminates on some condition, or a right of use conditioned upon continued payments. Specified digital products are exempt from tax if the equivalent product in tangible form is exempt from tax.

e. Washington

By statute, Washington provides that tax applies to "digital products" sold to end users, meaning digital goods, digital codes, and digital automated services.[81] Digital goods subject to tax include digital audio works, digital audio-visual works, digital books, and all other "sounds, images, data, facts or information transferred electronically." Further, digital code is taxable. Washington tax applies regardless of the user rights granted by the seller, the method of obtaining the digital products, or whether the buyer is obligated to make continued payments as a condition of the sale.

2. <u>States that Have Expanded Definition of Tangible Personal Property to Include Digital Goods</u>

a. Louisiana

Louisiana has expanded its definition of "tangible personal property"—which is subject to sales and use tax—to include "'on demand' audio and video downloads."[82]

b. Texas

Texas provides that a "taxable item" is defined as "tangible personal property and taxable services."[83] Further, the statute makes clear that "the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status."[84]

3. <u>States that Have Ruled Administratively that Digital Goods are Not Taxable</u>

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[79] N.C. Gen. Stat. § 105-164.4(a)(6b).
[80] Tenn. Code Ann. §67-6-702(g).;
[81] Wash. Rev. Code §§ 82.04.050(8), 82.04.192).
[82] La. Admin. Code §61:I.4301(C).
[83] Tex. Tax Code Ann. § 151.010.
[84] *Id.*

a. Maine

Despite not being specified in a statute or regulation, Maine Revenue Services has established that tax applies to sales of photographs, portraits, and videotapes, "including the sale of a digital product delivered electronically."[85]

b. Minnesota

In a Sales Tax Newsletter, the Minnesota Department of Revenue has provided that "[p]rewritten computer software and ring tones are taxable when delivered or transmitted electronically."[86] However, "[o]ther products that are taxable when sold or delivered in tangible form (such as books, training/reference materials, business forms) are not taxable when delivered electronically."[87]

c. Texas

The Texas Comptroller has established that digital products, including photographs and music, are specifically considered to be tangible personal property and therefore subject to sale and use tax.[88]

d. Washington

The Washington Department of Revenue issued has reminded taxpayers that photographs delivered on media (paper, CD, USB drives, etc.) and photographs transmitted electronically (made available for access or download from a website, delivered via e-mail, etc.) are subject to retail sales tax.[89]

4. Several States Have Not Applied Sales/Use Tax to Digital Goods

In contrast, a number of states have explicitly held that their sales and use tax laws do not apply to the sale or use of digital goods (or at least, to certain types of digital goods). It is unclear how long these states will continue to adhere to this policy, given the increasing prevalence of digital goods in the economy as well as the significant budget deficits currently faced by many states.

a. Florida

Recently, the Florida Department of Revenue has made clear that sales transactions involving only digital transmissions via the Internet to a customer's computer, without any other evidence of the transfer of something tangible, are not sales of tangible personal property for Florida sales and use tax purposes.[90] Such sales instead constitute services that are not subject to sales and use tax. On the other hand, files transferred via a hard drive, CD, flash drive, or DVD are tangible personal property and are thus subject to sales and use tax.

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[85] Me. Revenue Servs., Sales, Fuel & Spec. Tax Div., Instr. Bulletin No. 3, 07/28/2008.
[86] Minn. Sales Tax Newsletter No. 69, 02/01/2010.
[87] *Id.*
[88] Tex. Pol'y Letter Ruling No. 200101966L, 01/03/01.
[89] Tax Topic – Sales of Photographs, Wash. State Dep't of Revenue, 02/11/2011.
[90] Fla. Tech. Assistance Advisement 11A-002, 01/13/2011.

b. Illinois

The Illinois Department of Revenue has held that that downloaded videos were not taxable.[91] In general, the downloading of digital media represents the transfer of an intangible and is thus not subject to Retailers' Occupation and Use Tax. Further, the DOR has established that:

> [T]he true object of the transaction when purchasing a digital code is the download of an intangible, specifically electronically downloaded music or video recording files. Illinois sales and use tax is applicable to sales of tangible personal property and certain enumerated services. The longstanding policy of the Illinois Department of Revenue treats digitized content delivered solely by electronic means as a transaction which does not involve the transfer of tangible personal property and is therefore not subject to Illinois sales and use tax.[92]

c. Minnesota

The Minnesota Department of Revenue has concluded that the transfer of a "final graphic design or photography" is not subject to sales tax if such transfer is accomplished electronically.[93] Additionally, "products that are taxable when sold or delivered in tangible form (such as books, training/reference materials, business forms) are not taxable when delivered electronically."[94]

d. Missouri

In a private letter ruling, the Missouri Department of Revenue has established that "sales of downloadable photographs over the Internet are not subject to sales tax if there is not a transfer of tangible personal property from [the taxpayer] to its member."[95] The taxpayer did not provide hard copies; rather, it provided only the digital downloads. The DOR thus concluded that such downloads were not subject to sales or use tax.

e. New York

The New York Department of Taxation and Finance has held that movies rented by movie theater operator and received via satellite transmission or electronically from the film studio were not subject to sales and use tax, because no tangible personal property has been exchanged.[96] Such rentals are considered to be sales of intangible property.

f. SSUTA Taxability Matrices

A final group of states have not explicitly passed legislation or issued administrative rulings addressing the taxability of digital goods. They have, however, updated their SSUTA taxability matrices to generally indicate that certain types of digital goods are not subject to sales or use tax. These states include Georgia, Iowa, Ohio, and Oklahoma.

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[91] Ill. Dep't of Revenue Gen. Info. Letter No. ST 06-0071-GIL, 04/19/2006.
[92] Ill. Dep't of Revenue Gen. Info. Letter No. ST 07-0066-GIL, 06/18/2007.
[93] Minn. Sales Tax Fact Sheet No. 133, 07/01/2009.
[94] Minn. Sales Tax Newsletter No. 69, 02/01/2010.
[95] Mo. Private Letter Ruling No. LR 5058, 08/29/2008.
[96] N.Y. Advisory Opinion No. TSB-A-10(27)S, 06/29/2010.

5. Federal Legislation

On May 12, 2011, federal lawmakers introduced legislation that would prevent state and local governments from imposing "multiple and discriminatory" taxes on digital goods and services.[97] The act, which is titled the "Digital Goods and Services Fairness Act," prevents states and localities from taxing digital products differently than their tangible counterparts.

Specifically, the Act provides that: "No State or local jurisdiction shall impose multiple or discriminatory taxes on or with respect to the sale or use of digital goods or digital services."[98] A discriminatory tax is defined as one that is:

> (i) on at a higher rate than is generally imposed on or with respect to the sale or use of tangible personal property or of similar services that are not provided electronically;
> (ii) on any seller of digital goods or digital services at a higher rate or by incorporating a broader tax base than is generally imposed on or with respect to sellers in transactions involving tangible personal property or involving similar services that are not provided electronically;
> (iii) that is required to be collected with respect to the sale or use of digital goods or digital services by different sellers or under other terms that are disadvantageous to those applied in taxing the sale or use of tangible personal property or of similar services that are not provided electronically; or
> (iv) on or with respect to any separately stated amount that is charged by the seller of a specific digital good or digital service, and is directly related to electronically delivering or transferring that good or service, at a higher rate than is generally imposed on or with respect to delivery charges, or shipping and handling charges, on tangible personal property.[99]

"Multiple tax" is defined as "any tax that is imposed on or with respect to the sale or use of a digital good or a digital service by a State or local jurisdiction, for which such State or local jurisdiction gives no credit with respect to a tax that was previously paid on or with respect to the sale or use of such digital good or digital service to another State or local jurisdiction, unless the territorial limits of the jurisdiction imposing the earlier tax and the jurisdiction imposing the later tax both encompass the same tax address of the customer."[100]

Further, the Act limits taxes on the sale of digital goods and services to being imposed only on customers and collected only from customers or sellers; allows taxes to be imposed "only by the State and local jurisdictions whose territorial limits encompass the customer's tax address; prevents a tax on tangible personal property, telecommunications service, Internet access service, or audio or video programming service from being construed by a state as being imposed on the sale or use of a digital good or a digital service; and requires the tax treatment of the sale of a digital code to be the same as the tax treatment of the sale of the digital good or digital service to which the digital code relates.[101]

B. Cloud Computing

[97] S. 971, H.R. 1860, 112th Cong. (2011).
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*

1. <u>Overview</u>

An increasingly common business model in the modern economy is the provision of online services, a phenomenon that is typically referred to as "cloud computing." Cloud computing is defined as "a model for enabling 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."[102]

There are two primary platforms for providing cloud computing: (1) software as a service ("SaaS"), and (2) application service provider ("ASP"). SaaS is defined to mean:

> 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 a thin client interface such as a web browser (e.g., web-based email). 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.[103]

Further, "[m]ost SaaS solutions are deployed over the Internet and are priced as a subscription service."[104] The advantages of utilizing an SaaS are "reduced upfront costs compared with traditional user-installed software," and that the "provider, rather than the customer, makes the investment in technology, hardware, and support."[105]

By comparison, an ASP: "is an entity that retains custody over software for use by third parties and generally will own and maintain hardware and networking equipment required for the user to access the software. Thus, the ASP provider typically owns and operates the software application and allows customers to access it for a periodic fee."[106] The Kansas Department of Revenue has noted that the common features of ASPs include: (1) they fully own and operate the software applications; (2) they own, operate, and maintain the servers that support the software; (3) they make information available to customers via the Internet or a "thin client"; and (4) they bill on a "per-use" basis or on a monthly/annual fee.[107]

States have taken various (and often inconsistent) positions regarding the taxability of cloud computing services. Some states have held that such services are not taxable, because no sales tax is imposed on electronically delivered software. Some states have held that they are not taxable because there is no sale of tangible personal property (i.e., no transfer occurs). Other states assert that cloud computing is not taxable, because the server is not located in the state. Some states have held that it is not taxable, because the true object of the transaction is a service and SaaS/ASP is not a taxable service. The states that have taxed cloud computing, on the other

[102] *National Institute of Standards and Technology*, NIST.gov
[103] *Id.*
[104] Cara Griffith, "Navigating the Changing Conditions of Operating in the Cloud," State Tax Notes, Nov. 22, 2010.
[105] *Id.*
[106] Kendall L. Houghton et al., "Partly Cloudy Forecast for State Taxes on Cloud Computing," State Tax Notes, Sept. 20, 2010.
[107] Kan. Opinion Letter No. O-2010-005, 06/22/2010.

hand, maintain that such services are taxable as an information, communication, or data processing service (or are not taxable because they qualify for an exemption from such services, e.g.).[108] Finally, yet another approach is that cloud computing services are taxable as a sale of prewritten software.

Numerous issues arise in the context of states taxing cloud computing, including: whether such transactions involve a sale or license or prewritten software; whether they are characterized as a service, and if so, which type; and whether the "true object of the transaction" test come into play, as would be the case in mixed service and tangible personal property transactions.

As states' needs for revenues have grown more prevalent, a handful of states have decided to extend their sales and use taxes to apply to cloud computing. A few states, however, have explicitly determined that such services are not taxable. The remainder of this section of the paper will examine these recent developments.

2. States Finding that Certain Cloud Computing Services are Taxable

a. New York

New York has been at the forefront of cloud computing sales and use tax developments. Over a series of advisory opinions, the N.Y. Department of Taxation and Finance has established a fairly clear set of guidelines for analyzing the taxability of a particular cloud computing transaction. As evidenced below, many of New York's determinations hinge on the fact that information services are taxable. Also instructive is that prewritten software is taxable. The combination of these two principles generally dictates that most examples of cloud computing are taxable, unless the "personal purposes" exemption to information services is satisfied.

In Advisory Opinion No. TSB-A-09(33)S, 08/13/2009, the New York Department of Taxation and Finance held that the sale of software where customers had access to servers that allowed the customers to manage certain transportation functions was taxable. Customers had the ability to enter data. The department stated that:

> The accessing of Petitioner's software by Petitioner's customers constitutes a transfer of possession of the software, because the customers gain constructive possession of the software, and gain the 'right to use, or control or direct the use' of the software. Although Petitioner characterizes its product as a 'service,' and contends that it does not sell software to its customers, this characterization is not controlling.

In Advisory Opinion No. TSB-A-09(8)S, 02/02/2009, the department held that the sale of a software-based service that allowed financial institutions to edit terms of loans was taxable when the customer could directly enter and edit information, but was a nontaxable service when the taxpayer alone input the information.

The department held in Advisory Opinion No. TSB-A-10(28)S, 07/02/2010, that sales of prewritten computer software accessed by a purchaser's employees were subject to sales and use

[108] The following states have found that information services and/or data processing services are taxable: Connecticut (both), DC (both), Florida (IS), Hawaii (both), Massachusetts (IS), Minnesota (DP), Mississippi (DP), New Jersey (IS), New Mexico (both), New York (IS), North Dakota (DP), Ohio (both), Oklahoma (IS), Rhode Island (DP), South Dakota (both), Texas (both), and West Virginia (IS).

tax, even if the purchaser never receives the code on a tangible medium or by download. According to the department, the taxpayer should collect the tax based on where the software is used. If the taxpayer's employees who are using the software are located both in and out of New York, the taxpayer should collect the tax based on the portion of the receipt attributable to the employees using it in New York.

In Advisory Opinion No. TSB-A-10(32)S, 07/23/2010, the department concluded that sales of financial data feeds and financial reports accessed online and downloaded by customers were subject to sales tax as information services. Additionally, the department found that the licensing of optional application software that enables customers to find, filter, and organize information from the data feeds is subject to sales tax as tangible personal property/prewritten computer software, because it remains a distinct product even when sold in conjunction with access to the data feeds. Charges for technical and research support and for training are not subject to sales tax because they are optional and separately stated.

Further, in Advisory Opinion No. TSB-A-10(38)S, 08/20/2010, the department held that a company's web platform service, which allowed its clients to monitor, purchase, manage, and evaluate their online advertising across multiple third party ad networks, was not taxable as the sale of prewritten software, but rather was an information service. No software was licensed by company to clients or downloaded from company's website. As long as the information as to one client's activity was not sold, nor available for sale, nor substantially incorporated into reports furnished to other advertisers, and does not contain data from a common database, the department concluded that the information service would be considered personal and individual in nature and would therefore not be subject to sales/use tax.

The department established in Advisory Opinion No. TSB-A-10(44)S, 09/22/2010, that a license to use 3,000 copies of the seller's prewritten software was subject to sales and use tax. The situs of such sales is based on the location of the employees who use the software. Because employees who use the software are located in and outside of New York, the seller should collect tax based on the portion of the receipt attributable to the employee-users located in New York.

In Advisory Opinion No. TSB-A-10(47)S, 09/29/2010, the department held that all of petitioner's information service products were nontaxable information services, except for optional access to prewritten software on the petitioner's website, which allowed a client to further analyze particular financial information. Because it was optional, the department held that "this software is not integral to the [petitioner's] information service, and thus its taxability must be separately determined."

The department held in Advisory Opinion No. TSB-A-10(60)S, 11/24/2010, that sales of petitioner's online e-discovery services were subject to sales/use tax as prewritten software (except for the fee paid by a customer merely for "Data Viewer" status, in which case petitioner is "merely providing the customer with access to the customer's data that has been converted into a different medium"). For the other statuses, customers are able to access petitioner's software to classify and organize documents and data for litigation purposes. The department found that the accessing of petitioner's software "constitutes a transfer of possession of the software, because the customers gain constructive possession of the software, and gain the 'right to use, or control or direct the use' of the software." According to the department, this is true despite the fact that no copy of the software is transferred to the customer.

Thus, as summarized, New York generally takes the position that online services are taxable as information services, which it explicitly subjects to sales and use tax.[109] There is an exception if a taxpayer is providing customers with data that is personal in nature. Alternatively, the provision of online services could be taxable as the sale of prewritten software, provided that the customer has some ability to input data into (or otherwise manipulate) the software. It is irrelevant whether the customer actually downloads or receives a license to use the software.

b. District of Columbia

By statute, the District of Columbia provides that "retail sale" includes the "sale of or charges for data processing and information services" for purposes of the district's sales and use tax.[110] Although this does not directly implicate cloud computing, it is possible that data processing or information services would be broad enough to include certain cloud computing services. The district has not yet provided guidance whether cloud computing is included within this statute.

c. South Carolina

In Revenue Ruling No. 05-13, 08/21/2005, the South Carolina Department of Revenue held that charges to access an ASP to use software was taxable as a communications service. The DOR based its determination on existing South Carolina provisions. Section 12-36-910(B)(3) of the S.C. Code imposes sales tax on "the gross proceeds accruing or proceeding from the charges for the ways or means for the transmission of the voice or of messages, including the charges for use of equipment furnished by the seller or supplier of the ways or means for the transmission of the voice or of messages."[111] However, section 12-36-910(C) exempts data processing services. It provides that:

> Notwithstanding any other provisions of this article or Article 13, Chapter 36 of this title, the sales or use tax imposed by those articles does not apply to the gross proceeds accruing or proceeding from charges for or use of data processing. As used in this subsection, "data processing" means the manipulation of information furnished by a customer through all or part of a series of operations involving an interaction of procedures, processes, methods, personnel, and computers. It also means the electronic transfer of or access to that information. Examples of the processing include, without limitation, summarizing, computing, extracting, storing, retrieving, sorting, sequencing, and the use of computers.

Nonetheless, the DOR concluded that charges by the ASP are similar to charges by database access services and are therefore subject to the sales and use tax under the provisions of Code Sections 12-36-910(B)(3) and 12-36-1310(B)(3). Additionally, "the [ASP] is not charging 'for…data processing' as defined in Code Section 12-36- 910(C)."[112]

Further, in Private Letter Ruling #10-2, 07/29/2010, the South Carolina DOR concluded that fees charged for certain online subscription services were subject to sales and use tax, since they are for access to and use of a communication system or service under code section 12-36-910(B) and -1310(B). The DOR also relied on a South Carolina regulation, which provides that

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[109] N.Y. Tax Law § 1105(c)(1).
[110] D.C. Code Ann. § 47-2001(n)(1)(N)
[111] *See also* S.C. Code Ann. § 12-36-1310(B)(3) (imposing a use tax on the same charges).
[112] S.C. Revenue Ruling 05-13, 08/21/2005.

"Database Access Transmission Services or On-Line Information Services, including, but not limited to, legal research services, credit reporting/research services, and charges to access an individual website (including Application Service Providers)" is an example of a communication service subject to tax.[113] The subscription services in question provided the infrastructure to allow subscribers to communicate, share information, and transact business with their suppliers, employees, and vendors, etc. in an electronic environment. Sales of the subscription services should be sourced to the business location where the end user who accesses or uses the subscription service is primarily located.

d. Texas

Texas has held that providing web-based business application software is a taxable data processing service, even where the customer (rather than the taxpayer) enters all of the information.[114] The software at issue "supports a customer's entire business operations, from customer relationship management…to enterprise resource planning."[115] The information provided by the taxpayer "serves as the basic platform for business operations, allowing the customers to manage inventory, record sales, fulfill orders, process payroll, execute accounting functions, manage employees and create financial statements."[116]

Section 151.0101(a)(12) of the Texas Tax Code subjects "data processing" services to tax, which are defined as "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production,…and other computerized data and information storage or manipulation," including "the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or computer time or by the purchaser or other beneficiary of the service."[117] The Texas Comptroller concluded that the taxpayer's service fit into this definition and was thus taxable.

e. Utah

In a private letter ruling, the Utah State Tax Commission held that the taxpayer's ASP platform was subject to state sales tax. The taxpayer in question provided a "software-supported service for automobile dealerships that helps automate the dealerships sales, parts, accounting and other functions," including "related support, forms programming, training, data, conversion and other services."[118] Its ASP was also "used to communicate with automobile manufacturers with respect to items such as sales, data, parts and inventory."[119] Relying on the "primary purpose of the transaction" test, the commission found that the transfer of the right to use the software was taxable, as the contract for the ASP was "essentially a personal property transaction."[120] The commission also concluded that that the hosting of the software and customer databases by [the taxpayer] is also taxable as a 'lease' or 'rental' of server space" based on the fact that the ASP servers were located in Utah.[121]

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[113] S.C. Reg. 117-329.4(k).
[114] Tex. Pol'y Letter Ruling No. 200805095L, 05/28/2008.
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] Utah Private Letter Ruling No. 08-002, 06/10/2009.
[119] *Id.*
[120] *Id.*
[121] *Id.*

f. Washington

Washington subjects digital goods to sales tax.[122] There is, however, a statutory "business purpose" exception.[123] The Washington Department of Revenue has held that "online searchable databases (OSD) are digital automated services (DAS)" and not digital goods.[124] As a result, OSDs do not qualify for the business purpose exemption, and therefore they "are subject to retail sales or use tax unless some other exemption applies."[125] A DAS is defined as "any service transferred electronically that uses one or more software applications," whereas digital goods are sounds, images, data, facts, or information transferred electronically.[126]

Additionally, in the recent *Qualcomm, Inc. v. Dep't of Revenue* case, the Washington Supreme Court held that "[w]hen a service involves both telecommunication and information processing, we adopt the primary purpose of the purchaser test to determine that applicable tax rate."[127] The court concluded that the service in question was an information service. The taxpayer sold systems to trucking companies consisting of hardware, software, and a service that collected, manipulated, and transmitted data from the trucks to the companies' dispatch centers.

In contrast, the following states have found that in certain circumstances, cloud computing services are not subject to sales and use tax.

3. States Finding that Certain Cloud Computing Services are Not Taxable

a. Florida

In a recent Technical Assistance Advisement, the Florida Department of Revenue concluded that sales of online authentication services to customers via the provision of a digital certificate (which allow an end user to recognize that he or she is indeed accessing the customers' website) were not taxable.[128] The DOR held that a "charge solely for electronically transmitted information is not subject to tax, pursuant to Chapter 212, F.S., as there has been no exchange of tangible personal property."[129] Thus, despite the somewhat limited nature of the facts, it seems probable that the DOR could extend this conclusion to other cloud computing scenarios that do not involve the provision of digital authentication certificates.

b. Illinois

In a similar factual scenario to the Florida advisement above, the Illinois Department of Revenue held that digital authentication certificates provided by the taxpayer did not constitute computer software.[130] In Illinois, software must provide a set of statements, data, or instructions that is used directly or indirectly in a computer in order to bring about a certain result.[131] The

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[122] Wash. Rev. Code. § 82.08.020(1)(b).
[123] *Id.* § 82.08.02087(1) ("The tax imposed by RCW 82.08.020 does not apply to the sale to a business of digital goods, and services rendered in respect to digital goods, where the digital goods and services rendered in respect to digital goods are purchased solely for business purposes.").
[124] Wash. Dep't of Revenue Special Notice (11/02/2010)).
[125] *Id.*
[126] *Id.*
[127] Dkt. No. 83673-6 (Wash. Mar. 10, 2011).
[128] Florida Technical Assistance Advisement 10A-051, 12/06/2010.
[129] *Id.*
[130] Ill. ST 11-0015-GIL, 03/29/2011.
[131] *Id.* (quoting 35 Ill. Comp. Stat. 105/3-25.

certificates provided by the taxpayer were flat files containing only information and not contain binary code; further, they did not dictate statements, data or instructions used directly or indirectly to bring about a certain result. Instead, the department concluded that:

> The digital certificates sold by the Taxpayer are akin to a digital product in that only data or information is being conveyed. In the case of the provision of digital certificates by the Taxpayer, nothing is downloaded to the user's computer. There is no transfer of tangible personal property and the entire transaction is conducted electronically via the Internet. Therefore the digital certificates would not be considered transfers of tangible personal property and are not subject to tax.

The department also held that all associated services—such as the due diligence procedures utilized by the taxpayer to identify the customers' identities—were also non-taxable, as there is no transfer of tangible personal property.[132]

c. Kansas

The Kansas Department of Revenue has recently held that fees charged by an ASP provider to its customers for ASP services were not subject to sales tax.[133] Such fees included recurring monthly charges, set-up fees, support fees, training fees, data migration fees, and forms programming fees. However, the DOR specified that the sale of canned software that can be used independent of the ASP service is subject to sales tax.

d. Massachusetts

In a series of administrative rulings, Massachusetts has declined to extend the state's sales and use tax to certain cloud computing services. Specifically, the Massachusetts Department of Revenue has held that the provision of online access to prescription information was not taxable, even though customers received software to allow them to access and view the information.[134] The DOR has also held that accessing the taxpayer's website to receive data was a non-taxable service rather than a taxable software license.[135] Further, the DOR has concluded that an e-commerce authentication service provider's digital certificate sales are not subject to sales tax because the certificates are transferred to customers electronically and do not constitute transfers of prewritten software.[136] Finally, the DOR has held that a technology company's online services assisting organizations in their employee application gathering and selection process are not subject to sales and use tax because the services do not involve the transfer of prewritten software or a license to use software.[137]

e. Pennsylvania

The Pennsylvania Department of Revenue has recently established that access to software solely through the Internet is not a taxable transfer of software, unless the server or data center

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[132] *Id.*
[133] Kan. Opinion Letter No. O-2010-005, 06/22/2010
[134] Mass. Letter Ruling No. 08-6, 03/26/2008.
[135] Mass. Letter Ruling No. 08-5, 03/24/2008.
[136] Mass. Letter Ruling No. 11-3, 03/24/2011.
[137] Mass. Letter Ruling No. 11-4, 04/12/2011.

resides in Pennsylvania.[138] The taxpayer in question provided "various web-based services…that enable subscribers to have remote computer access, attend and participate in meetings online, attend online webinars, and provide attended or unattended technical computer support to their internal and external customers," and it "utilizes its proprietary system to provide the [services] and charges for these web-based services on a per-user, subscription basis."[139]

4. Other Cloud Computing Issues

Aside from simply determining the taxability of certain types of cloud computing services—which as demonstrated above varies widely among states, like most other state tax issues—numerous other issues arise in the cloud computing context. One such issue is how and where to source receipts of sales of cloud computing services. Related sub-issues include:

- To which state should the transaction be sourced?
- Where does "use" of the service occur?
- How to deal with multiple users in multiple locations?
- How to deal with "roaming" users?
- How to deal with multiple jurisdictions claiming the same transaction?

In assessing these issues, we have offered some recommendations that sellers of cloud computing services may want to consider. For example, sellers may want to consider doing the following:

- Identify sourcing rule for each product SKU.
- Identify existing best available business information to apply for sales transaction sourcing.
- Develop improved sources of business information to apply for sales transaction sourcing.
- Establish policy and procedure for sourcing sales transactions.
- Implement changes to business applications.

The SSUTA provides some general sourcing guidelines. More specifically, section 310(A) lists the following in order of priority:

- Over-the-counter sale;
- Delivery location known to seller;
- Purchaser's address available from seller's business records;

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[138] Pa. Sales & Use Tax Ruling No. SUT-10-005, 11/08/2010
[139] *Id.*

- Purchaser's address obtained at time of sale; and

- Location from which TPP was shipped, digital goods or computer software delivered electronically was first available for transmission, or from which the service was provided.

Further, new section 310.1 permits election to use origin-based sourcing under certain conditions.

A second issue that this paper has not yet addressed is whether web-hosting itself constitutes a taxable cloud computing service. The primary question that arises with respect to this issue is whether hosting a website on a server situated in a state results in sales tax obligation for a taxpayer. A related question is whether server presence in a state alone is sufficient to trigger nexus with that state. California and Texas have taken different approaches. Texas has established that being "engaged in business" includes deriving "receipts from a rental or lease of tangible personal property that is located in this state" or owning or using "tangible personal property that is located in this state, *including a computer server or software*."[140] Recently, however, Texas has gone back on this position, asserting instead that only having a website on a server located in Texas is not sufficient to create nexus.[141]

On the other hand, California maintains that "[t]he use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California."[142]

C. Software

The taxation of software represents the final major area of digital sales and use tax developments. Unlike cloud computing and digital goods, software is not a new type of good or service; it has existed in some form or another throughout the last several decades. Software has historically been distributed to consumers on tangible media, such as compact or floppy discs. More recently, however, software has begun to be distributed to consumers in electronic forms involving no exchange of tangible personal property. Thus, issues arise regarding whether the mode of delivery affects the taxability of the software. Another issue is whether the type of rights being granted to the consumer impacts the sales and use tax treatment of the software. The threshold issue—and the first that we will address—is whether the software must be prewritten to be taxable, or instead whether the state subjects all types of software to tax, both prewritten and custom.

1. Prewritten vs. Custom

All of the states that subject software to sales and use tax apply the tax to prewritten software. Most of those same states, however, also exempt custom software from sales and use tax. Thus, whether software is considered prewritten or custom is an important part of the equation and the threshold inquiry in determining the sales and use tax implications associated with software transactions. However, not every state has established concrete guidelines for

[140] 34 Tex. Admin. Code § 3.286(a)(2)(E).
[141] Tex. Pol'y Letter Ruling 201103016L (3/24/2011).
[142] Cal. Code Regs. tit. 18 § 1684.

making this determination, and some states tax both prewritten and custom software. A state-by-state summary of the treatment of prewritten and custom software is as follows.

a. Colorado

Colorado subjects prewritten software to tax, but not custom software.[143] More specifically, Colorado provides that "standardized software," which is prewritten software, "does not include software that is designed or developed to the specifications of a specific purchaser."[144] Further, software that is "designed and developed to the specifications of a specific purchaser shall not be considered standardized software simply because it includes de minimis standardized software as part of its code."[145]

b. District of Columbia

The District of Columbia is among a handful of jurisdictions that impose sales and use tax on software notwithstanding whether it is custom or prewritten. By regulation, D.C. provides that tax applies to "[g]ross receipts from the sale, lease or rental, or maintenance of any computer software…regardless of whether the software is canned, prepackaged or customized."[146]

c. Georgia

Georgia has indicated on its SSUTA taxability matrix that prewritten computer software is taxable, while custom software is not.

d. Illinois

Illinois provides that tax applies to the sale or use of tangible personal property, which is specifically defined to include "computer software."[147] Further, canned software is tangible personal property "regardless of the form in which it is transferred or transmitted."[148] Thus, the "sale at retail, or transfer, of canned software intended for general or repeated use is taxable, including the transfer by a retailer of software which is subject to manufacturer licenses restricting the use or reproduction of the software."[149]

On the other hand, "custom computer programs," which are "prepared to the special order of the customer" are not taxable. According to Illinois, "[t]o be considered exempt software, the following elements must be present:

A) Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and

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143 Colo. Rev. Stat. § 39-26-102(15)(b) ('Tangible personal property' includes standardized software without regard to how such standardized software is acquired by the purchaser or downloaded to the purchaser's computer.")
144 Colo. Emergency Reg. 39-26-102.13.
145 *Id.*
146 D.C. Mun. Regs. 474.
147 35 Ill. Comp. Stat §§ 120/2, 105/3, 110/3.
148 86 Ill. Admin. Code 130.1935(a).
149 *Id.*

B) The program requires adaptation by the vendor to be used in a specific work environment, e.g., a particular make and model of a computer using a specified input or output device."[150]

e. Indiana

By statute, Indiana provides that tangible personal property includes "prewritten computer software."[151] Further, the Indiana Department of Revenue has ruled that patches and updates to prewritten computer software are also tangible personal property and thus subject to tax.[152]

f. Iowa

Iowa's SSUTA taxability matrix indicates that prewritten computer software is taxable, while custom software is not.

g. Kansas

Kansas has enacted and issued several authorities addressing the taxability of software. By statute, Kansas provides that tangible personal property includes "prewritten computer software."[153] In a revenue ruling, the Department of Revenue has held that sales tax applies to sales of prewritten computer software "regardless of how possession or the right to use the software is transferred," whether by CD-ROM, disc, or the Internet.[154] Further, the department has concluded that particular software that turns a customer's computer, printer, and scanner into a document transmission station on the Internet is taxable, whether delivered electronically by download or by CD, or both.[155] Such software would be considered prewritten because it is not designed to the specifications of a specific customer.

h. Kentucky

The Kentucky Department of Revenue has established that "receipts from the retail sale of prewritten computer software are subject to Kentucky sales and use tax regardless of the manner that the software is delivered."[156]

i. Louisiana

In a relatively old decision, the Supreme Court of Louisiana has held that that software was tangible property even if conveyed electronically.[157] Interestingly, the court based its reasoning on the fact that software is composed of electrons that have a physical existence and make physical things happen. Specifically, the court stated that:

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[150] *Id.* 130.1935(c).
[151] Ind. Code. § 6-2.5-1-27.
[152] Ind. Dep't of State Revenue Letter of Findings 10-0121.
[153] Kan. Stat. Ann. § 79-36029(pp).
[154] Kan. Revenue Ruling No. 19-2004-03, 07/01/2007.
[155] Kan. Private Letter Ruling No. P-2010-009, 11/16/2010.
[156] Ky. Tax Facts No. 09/01/2007.
[157] *South Cent. Bell Tele. Co. v. Barthelemy*, 643 So.2d 1240 (La. 1994).

> When stored on magnetic tape, disc, or computer chip, this software, or set of instructions, is physically manifested in machine readable form by arranging electrons, by use of an electric current, to create either a magnetized or unmagnetized space.... The computer reads the pattern of magnetized and unmagnetized spaces with a read/write head as "on" and "off", or to put it another way, "0" and "1". This machine readable language or code is the physical manifestation of the information in binary form.[158]

By statute, Louisiana further provides that the term "tangible personal property" shall not include custom computer software.[159]

j. Massachusetts

By regulation, Massachusetts provides that "sales in Massachusetts of computer hardware, computer equipment, and prewritten computer software, regardless of the method of delivery" are generally subject to sales and use tax.[160]

k. Michigan

Michigan has enacted a statute providing that tangible personal property includes "prewritten computer software."[161]

l. New Jersey

New Jersey provides that its sales and use tax applies to "pre-written computer software," even if delivered electronically.[162] However in New Jersey's SSUTA taxability matrix, the Division of Taxation indicates that custom software is not taxable.

m. New York

In an advisory opinion, the New York Department of Taxation and Finance has held that sales of prewritten computer software accessed by a purchaser's employees were subject to sales and use tax, even if the purchaser never receives the code on a tangible medium or by download.[163] The department specified that the taxpayer should collect the tax based on where the software is used. If the taxpayer's employees who are using the software are located both in and out of New York, the taxpayer should collect the tax based on the portion of the receipt attributable to the employees using it in New York. Further, separate charges for custom modifications of software are not subject to tax if they are reasonable in relation to the total charge.

n. North Dakota

[158] *Id.*
[159] La. Rev. Stat. § 47:301(16)(h).
[160] Mass. Regs. Code 64H.1.3(3)(a).
[161] Mich. Comp. Laws Ann. § 205.92(k).

[162] N.J. Div. of Taxation Tech. Bulletin No. TB-51R, 03/13/2007.
[163] N.Y. Advisory Opinion No. TSB-A-10(28)S, 07/02/2010.

By statute, North Dakota provides that sales and use tax applies to "prewritten computer software."[164]

o. Oklahoma

Oklahoma specifies in its SSUTA taxability matrix that prewritten software is subject to sales and use tax. Custom software, on the other hand, is not taxable.

p. Pennsylvania

In a 2005 case, the Pennsylvania Commonwealth Court held that canned software is tangible personal property but custom software is not.[165] License fees paid for renewal of software licenses were subject to sales tax because the grant of a license to use tangible personal property for a fee is considered a "sale at retail."[166] The court also held, however, that custom computer software is not taxable.

q. Tennessee

By statute, Tennessee provides that sales and use tax applies to both custom and prewritten software, "regardless of whether the software is delivered electronically, delivered by use of tangible storage media, loaded or programmed into a computer, created on the premises of the consumer, or otherwise provided."[167] Thus, like D.C., Tennessee does not distinguish between prewritten and custom software with respect to taxability.

r. Vermont

Vermont indicated in its SSUTA taxability matrix that prewritten computer software is taxable. Further, the revenue department has specified that the purchase of prewritten software is taxable because prewritten software is included within the definition of tangible personal property.[168] Prewritten software includes "customized software that is compiled through the addition of separate stub programs, sub routines or modules, each prewritten and available to sale to other customers in other combinations." Additionally, prewritten software that is licensed for use and available from a remote server is also subject to sales tax.

The revenue department also stated that non-prewritten software—i.e., custom software—is not taxable.[169] Such software is designed and developed to meet the unique requirements of a specific purchaser and sold for that purchaser's exclusive use.

s. West Virginia

Similar to D.C. and Tennessee, West Virginia provides by statute that tangible personal property includes both prewritten and custom software.[170]

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[164] N.D. Cent. Code § 57-39.2-02.1(1)(h).
[165] Graham Packaging Co. v. Commonwealth, 882 A.2d 1076 (Pa. Commw. Ct. 2005).
[166] *Id. See also Dechert LLP v. Commonwealth*, 922 A.2d 87 (Pa. Commw. Ct. 2007).
[167] Tenn. Code Ann. § 67-6-231(a).
[168] Vt. Technical Bulletin No. TB-54 (rev. 11/19/2010).
[169] *Id.*
[170] W. Va. Code §§ 11-15-3(g), 11-15B-2(b)(57).

2. Distinguishing Between Prewritten and Custom Software

A related issue to whether a state taxes prewritten and/or custom software is how the state differentiates between the two types of software. By statute, Indiana and North Carolina provide specific guidelines. Specifically:

- The combining of 2 or more prewritten computer software programs or prewritten parts of the programs does not cause the combination to be other than prewritten computer software.

- Prewritten computer software includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser.

- If a person modifies or enhances computer software of which the person is not the author or creator, the person is considered to be the author or creator only of the person's modifications or enhancements.

- Prewritten computer software or a prewritten part of the software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software. However, where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such a modification or enhancement, the modification or enhancement is not prewritten computer software.[171]

In sum, both North Carolina and Indiana provide that prewritten software remains prewritten software for sales and use tax purposes despite modification or enhancement. Further, when custom software is re-sold by the developer to another purchaser, it is no longer considered custom software. Similarly, New Jersey provides that prewritten software includes "pre-written software that has been modified for the customer as well as software initially designed as "custom" software for a specific purchaser, which is subsequently sold as is to anyone other than the original purchaser.[172] Virginia also generally adheres to these principles.[173]

In contrast, a California regulation makes clear that modification can render prewritten software to be considered custom instead. According to the regulation, this occurs when: (1) the modification "is so significant that the new program qualifies as a custom program"; and (2) the price of the prewritten program (if marketed) was 50 percent or less of the price of the new program.[174] If the prewritten program was never marketed, the new program will be considered custom "if the charge made to the customer for custom programming services…is more than 50 percent of the contract price to the customer."[175]

3. Jurisdictions that Tax Both Custom and Prewritten Software

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[171] Ind. Code. Ann. § 6-2.5-1-24; N.J. Stat. Ann. § 54:32B-8.56

[172] N.J.S.A. 54:32B-8.56.

[173] Va. Code Ann. § 58.1-602 (providing that: "[c]ustom software" is limited to "a computer program which is specifically designed and developed only for one customer"; "[t]he combining of two or more prewritten programs does not constitute a custom computer program"; and "[a] prewritten program that is modified to any degree remains a prewritten program and does not become custom").

[174] Cal. Code Regs. tit. 18, § 1502(f)(2).

[175] *Id.*

Three jurisdictions, including the District of Columbia, Tennessee, and West Virginia, tax both prewritten and custom software.[176]

4. Electronic Delivery vs. Delivery in Tangible Medium

In addition to distinguishing between whether software is prewritten or customized, many states have established that the taxability of software depends on the method of delivery of the software to the customer.

Most states that tax software impose their tax regardless of how it is transferred. For example, by statute, Idaho provides that software is tangible personal property "regardless of the method by which the title, possession or right to use the software is transferred to the user."[177] Similarly, an Illinois regulation provides that canned software is tangible personal property "regardless of the form in which it is transferred or transmitted."[178] Kansas, too, has held that tax applies to sales of prewritten computer software "regardless of how possession or the right to use the software is transferred," whether by CD-ROM, disc, or the Internet.[179]

On the other hand, some states exempt software transferred electronically from taxation, including Florida, Georgia, Iowa, Missouri, Oklahoma, and Virginia. In a technical assistance advisement, Florida has held that purchases of licenses to use software are not subject to Florida sales tax when the software is downloaded by purchasers electronically.[180] This conclusion is true regardless of whether the software is customized or canned. Likewise, Missouri has recently held that a transaction in which software was transferred by load and leave was not subject to Missouri use tax, because (i) "there was no use of any physical medium" to transmit the software, and (ii) "there was no sale of tangible personal property."[181] Finally, Virginia has established that computer software transferred electronically is a nontaxable transaction because there is no transfer of tangible personal property involved.[182]

5. Full Ownership Rights vs. License to Use

A final distinction that some states draw regarding the taxability of software is the type of rights given in the software to customers upon their purchase. A few states take the position that if a customer receives merely a license to use the software—rather than an absolute ownership interest in the software—there has not been a taxable transaction. However, on the other hand, other states assert that the transaction is taxable regardless of the rights received by the customer.

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[176] D.C. Mun. Regs. 474 (stating that tax applies to "[g]ross receipts from the sale, lease or rental, or maintenance of any computer software…regardless of whether the software is canned, prepackaged or customized"); Tenn. Code Ann. § 67-6-23(a) (providing that effective July 1, 2009, tax applies to both custom and prewritten software, "regardless of whether the software is delivered electronically, delivered by use of tangible storage media, loaded or programmed into a computer, created on the premises of the consumer, or otherwise provided"); W. Va. Code §§ 11-15-3(g), 11-15B-2(b)(57) (providing that tangible personal property includes both prewritten and custom software).

[177] Idaho Code § 63-3616(b).

[178] Ill. Admin. Code 130.1935(a).

[179] Kan. Revenue Ruling No. 19-2004-03, 07/01/2007.

[180] Fla. Technical Assistance Advisement 10A-028, 06/21/2010.

[181] *Filenet Corp. v. Dir. of Revenue*, No. 07-0146 RS (Admin. Hearing Comm'n 2010).

[182] Va. Pub. Doc. Ruling No. 10-241, 10/04/2010.

Illinois, for example, has recently provided clear instructions regarding software licenses. The Department of Revenue has provided that a license of computer software are not taxable if it meets all of the following criteria: (1) it "is evidenced by a written agreement" (2) it "restricts the customer's duplication and use of the software"; (3) it prohibits the user from transferring the software to a third party without permission; (4) the "licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software" or permitting an archival copy; and (5) the software must be returned or destroyed at the end of the license period.[183] Similarly, the Pennsylvania Commonwealth Court has held that license fees paid for renewal of software licenses were subject to sales tax because the grant of a license to use tangible personal property for a fee is considered a "sale at retail."[184]

IV. CONCLUSION

Among the most important state sales and use tax developments from the last few years are those pertaining to transactions involving the Internet. This is perhaps to be expected given the electronic, interconnected nature of contemporary society and the economy. As business models shift more and more from the tangible to the digital, and as states seek new sources of revenue, taxpayers should expect states to increasingly subject digital transactions to sales and use tax and to assert nexus over businesses that may not have a traditional physical presence on the taxing state.

[183] Ill. Dep't of Revenue Gen. Info. Letter No. ST 10-0077-GIL, 08/23/2010.
[184] *Graham Packaging Co. v. Commonwealth*, 882 A.2d 1076 (Pa. Commw. Ct. 2005).