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A Multistate Perspective on Taxation of Digital Products

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In a previous post, we discussed how Illinois taxes software. In a General Information Letter published in 2017, Illinois addressed how its taxation of canned and custom software would apply to cloud computing. The state explained that software as a service ("SaaS") is not subject to the Retailers' Occupation Tax, and SaaS providers are instead subject to the Servicemen Occupation Tax.[1] Thus, providers of SaaS to Illinois customers will generally be subject to use tax on tangible personal property transferred as an incident to the sale of SaaS.[2] Of course, the Chicago Personal Property Lease Transaction Tax may still apply to a variety of software licenses.[3]

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Tax
All States

The Landscape of State Taxation of Canned and Custom Software

How does Illinois stack up to other states' taxation of digital products, specifically cloud computing? States generally conform to the "canned or custom" binary treatment of software. Custom software is generally characterized as software prepared specifically for one customer. "Canned" software, conversely, is pre-written software sold in the same form to many customers.

Most states treat custom software as a non-taxable service. However, a minority of states do tax custom software, including Hawaii, Louisiana, Mississippi, Nebraska, New Mexico, South Carolina, South Dakota, Tennessee, Texas, and West Virginia. Pre-written, or canned, software, delivered in tangible form is universally taxable except to the extent modifications have been made to the software. In that case, states diverge on whether modified canned software should be taxable. For instance, Massachusetts does not tax modified canned software.[4]

The taxability of software delivered electronically (such as that which is downloaded over the internet or via "load and leave") varies as well. Although all states tax canned software in tangible form, when that software is provided over the internet, it will not always be subject to tax. For instance, Arkansas, California, Colorado, Florida, Georgia, Iowa,[5] Idaho, Maryland, Missouri, Nevada, Oklahoma, South Carolina, and Virginia exempt from tax the sale of canned software that is delivered electronically.

State Taxation of Cloud Computing

Whether states tax SaaS, however, is a significantly more complicated question. Of the states that impose a sales tax, Alaska, Arkansas, Connecticut, Florida, Hawaii, Maryland, Maine, Minnesota, North Dakota, Nevada, Ohio, and South Dakota have not provided any guidance on SaaS or the taxation of cloud computing. A number of states, moreover, that do purport to tax some form of cloud computing do not explain what types of software services provided over the internet should be taxable and which types are not. However, Arizona, DC, Iowa,[6] Massachusetts, Mississippi, New Mexico, New York, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Washington, and West Virginia generally tax cloud computing products. Computing products like remote

storage,[7] information services,[8] or data processing,[9] however, may be exempt services in different states even if provided over some type of cloud interface.

While states' general rules regarding taxation of custom software or cloud computing software may often be clear, it is always crucial to understand the exact terms of any license or service agreement when selling or purchasing software. For instance, a buyer and seller may enter into a SaaS license agreement, but the license agreement is ultimately incidental to the sale of a service. In that situation, whether a state uses a "true object" test or a "bundled transaction" test will be crucial in determining the taxability of the sale. Some states, like Tennessee, have fairly strict bundled transaction rules, and will subject an entire sale to tax if any portion of the sale is taxable and the sales are not separately itemized.[10] Other states, like California, allow taxpayers to pay tax only on taxable sales of tangible personal property and to exempt sales of software provided in connection with the taxable sale.[11] Thus, in many instances, a state's rules on bundled transactions may govern the taxability of software licenses and sales.

Recent Rulings

Given the fast pace of technological change, state departments of revenue are often tasked with examining and monitoring how often-outdated tax rules should apply to new technologies. In *In the Matter of the Petition of Sungard Securities Finance LLC, NYS Div. of Tax Appeals, ALJ*, 824336 (2/6/2014), for instance, the taxpayer provided two distinct software services. One service, called "Smart Loan," provided consulting and data processing services to the financial industry by processing private financial information. The other service, called "Lending Pit," involved collecting and analyzing data retrieved from a database which it compiled into reports for customers. Because "Smart Loan" involved analyzing personal information, the ALJ held that the "Smart Loan" services were not taxable. However, because "Lending Pit" provided more general information, the software agreement was taxable as a taxable sale of an information service. Thus, two very similar software programs resulted in different taxability conclusions based on the nature of the information processed by the software.

In Tex. Priv. Letter Rul. No. 201801996L (1/4/2018), the taxpayer provided an internet-based platform where users could access real-time and on demand streaming videos, primarily for gaming, music, and other entertainment. The platform also contained chat functions and other indicia of social media. Users who broadcast on the platform could pay varying subscription fees to host their own "channels." The question was whether these subscription fees were subject to sales tax. In concluding that the subscriptions were taxable, the Comptroller concluded that the services constituted taxable amusements under Texas Rule 3.298(a)(1). Thus, the Comptroller did not even engage in a discussion regarding whether the subscriptions constituted taxable licenses or sales of software; instead, it merely concluded that the subscriptions should be treated similarly to cable television services and amusements.

Finally, in Tenn. Letter Rul. No. 17-15 (10/11/2017), the taxpayer provided cloud-based employee scheduling services that allowed customers to create an interface that allowed their employees to track their work schedules in accordance with company policies. The taxpayer employed a team of approximately 25 engineers who would spend an average of 40 to 50 hours populating the cloud-based interface with the customer's company rules. This would generally take between three to five months of engineers' time. The taxpayer's engineers would also train customers, often in person, on how to use the application. An additional 50 engineers, moreover, played a support role after the application was up and running. Despite the substantial amount of services provided by the taxpayer's engineers, the Tennessee Department of Revenue concluded that the "true object of purchasing the [taxpayer's product] is not the Taxpayer's services, but instead, remotely accessing and using the Taxpayer's software. The Interface is not merely incidental to the Taxpayer's services; it is a necessary component, without which the Taxpayer's services would be of no value to the Subscribers." As such, the entire subscription payment made by the taxpayer's customers was subject to tax.

Conclusion

While most states have addressed the taxability of canned and custom software, these two concepts already appear antiquated. Now, with electronically delivered and remotely accessible software, the guidance among states has begun to diverge substantially. Often, as is reflected in the New York, Texas, and Tennessee rulings, tax rules unrelated to the taxability of software may dictate the outcome of a particular situation. While guidance in this respect is not changing at the speed of technological change, it is nonetheless developing quickly, and taxpayers should remain aware of these changes on a nationwide basis. After all, after *Wayfair*, sellers of software are potentially subject to a sales tax collection obligation on their software services on a nationwide basis.

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[1] Ill. Dept. Of Rev. GIL ST 17-0006-GIL (3/2/2017).

[2] 86 Ill. Admin. Code 140.101.

[3] Personal property Lease Transaction Tax Ruling No. 12.

[4] Mass. Regs. Code 64H.1.3(6)(d).

[5] Iowa actually exempts prewritten software delivered electronically, but taxes software delivered via load and leave. Iowa Admin. Code 701-231.14(423).

[6] Effective January 1, 2019. Iowa Code 423.2.

[7] New Mexico Tax'n and Rev. Dept. Rul. No. 401-13-3 (7/19/2013).

[8] Miss. Admin. Code 35.IV.5.06(202).

[9] Mass. Regs. Code 64H.1.3(9).

[10] Tennessee Rev. Rul. 17-17 (10/31/2017) ("Additionally, whenever two or more items are sold for a single sales price and at least one of the items is subject to sales tax, the entire sale price is subject to sales tax as a bundled transaction. When a transaction involves taxable and nontaxable components and the transaction's true object or a 'crucial,' 'essential,' 'necessary,' 'consequential,' or 'integral' element of the transaction is subject to tax, the entire transaction is subject to sales tax."

[11] *Lucent Tech., Inc. v. Board of Equalization*, 241 Cal. App. 4th (2015)