2012 Media Industry Tax Conference

State Taxation of Digital Goods and Electronic Commerce
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Recent Nexus Developments
Sales Tax Nexus Overview

Jurisdiction to Tax

- Physical Presence Nexus
- Attributional Nexus

- Affiliate Nexus
- Click-Through Nexus
In-State Affiliate Maintains Market on Behalf of Out-of-State Co.

In-State Affiliate Creates Presumption of Nexus

In-State Affiliate and Out-of-State Co. Have Common Trade names, Products or Business Plans

Mere Existence Of an Affiliate

Legislation Pending

Combination Market/Common Trade names

1 But see SFA Folio Collections, Inc. v. Tracy, 73 Ohio St. 3d 119 (1995) (limiting the scope of the statute).
Click-Through Nexus Legislation

As of Jan. 10, 2012

* Vermont only in effect if 15 other states enact

** California’s was stayed until 2012, subject to passage of a federal bill.

1 BNA, Survey of State Tax Departments (2010).
**Performance Marketing Assoc. v. Hamer**

- Bench decision by Cook County Circuit Court that held Illinois’s “Amazon” law violated the Commerce Clause and the Internet Tax Freedom Act (“ITFA”)
- In 2011, Illinois passed an “Amazon” law that defined an in-state “retailer” to include any retailer that has a contract with publishers located in Illinois where the publisher displays an advertisement on its website that links the Internet user to the retailer’s website in return for compensation
- Judge held that this law violated the Commerce Clause on its face
- Provided the Performance Marketing Association with declaratory relief and attorney’s fees for violating the Commerce Clause
- Also held that this violated the ITFA as a “discriminatory tax”
- Waiting for the written opinion to be published
Matter of Barnesandnoble.com

- The New Mexico Court of Appeals reversed a hearing officer's decision that Barnesandnoble.com LLC did not have a substantial presence in the state for gross receipts tax purposes.
- The appeals court ruled that Barnesandnoble.com LLC's in-state use of the Barnes and Noble trademarks (which it did not own), coupled with the presence of in-state physical stores operated by an affiliate, was sufficient to establish nexus.
- The in-state use of the trademarks at the physical stores, along with certain cross-marketing activities, resulted in the "vicarious accrual of goodwill to [the online company]," thereby benefiting the online company and helping it to establish a market in the state.
- Matter of Barnesandnoble.com v. N.M. Taxation and Revenue Dep't, Docket No. 31,231 (N.M. Ct. of Appeals April 18, 2012)
The court ruled that by themselves, the following activities were not sufficient to create nexus for the online affiliate:

1. Providing a store finder service on the website,
2. A return policy allowing online purchases to be returned to the physical stores,
3. The ability of customers to buy and use gift cards either online or in physical stores, and
4. The customer loyalty program (Readers' Advantage) that provided customers with discounts to both the online and physical stores.
Colorado law provided that vendors are required to provide additional information to the state concerning in-state purchases, including information regarding the purchasers, when they are not collecting sales/use tax on such purchases

- Vendors must provide additional information to such consumers concerning (1) the fact that state tax applies to their purchases and (2) the annual amount of such purchases.

U.S. District Court granted the Direct Marketing Association’s (DMA) motion for a preliminary injunction preventing the state of Colorado from enforcing its sales tax notice and reporting regime.

- Impact of the regime felt only by out-of-state retailers, because in-state retailers are already required under other laws to collect and remit taxes.
- Other non-discriminatory methods to achieve the legislature’s goal of collecting tax on sales by out-of-state retailers, specifically, the alternative method of having taxpayers remit use tax on personal income tax returns.
- “[B]urdens imposed by the Act and the Regulations are inextricably related in kind and purpose to the burdens condemned in *Quill*.”

Department filed an appeal on April 27, 2012 → Stay Tuned.
Sourcing Overview

- The sourcing of a digital item is dependent upon its characterization. For interstate sales, if taxable as:
  - Tangible Personal Property
    - Generally destination
    - Consider subsequent use
    - Consider concurrent use (prewritten computer software)
  - Services
    - Varies by state. May be:
      - Benefit
      - Cost of Performance
      - Special industry or service type rule
    - Consider multistate benefit
  - Digital Goods
    - Not clearly defined. May be:
      - Destination
      - Benefit
    - Consider whether digital goods are treated as tangible, intangible or a service
The Problem

Step 1: A Customer at Dulles Airport uses her Wi-Fi to access the Apple store. The Apple store server is located in TX.

Step 2: She downloads three movies which are charged to her Apple account – her billing address is in CO.

Which state has the right to tax?
Sourcing Issues

• What are the problems?
  - From a sales tax perspective, the concepts of destination and benefit are not easily applied to digital items. The Seller may have no idea where the receipt of the items takes place, or where the item is used.
  - From a purchaser perspective, location of use may not always be known – or may be from multiple locations.
    - Is “Use” at server location or user location? States vary, by way of example:
      - Alabama – Server location
      - New York – User location
    - Trend towards user location, but be careful of states that include software or digital products in their definition of tangible personal property – these states may take a more traditional view of where these items should be sourced – one location.
Florida Communications Services Tax

- Florida broadened its definition of services subject to the Florida Communications Services Tax
- Legislature replaced "cable service" with "video service" in the definition of taxpayers subject to the tax
- Modified the term “Internet access” to be defined through reference to the federal statute
- Revised the definition of “sales price” to allow additional nontaxable items to be billed together in a single line item on a customer's invoice without the entire amount of the line item being taxable.
- Bill makes these revised definitions and liability provisions retroactive and remedial.
- Effective 07/01/2012
Equifax, Inc. v. Miss. Dept. of Revenue

- Equifax apportioned receipts using standard costs of performance methodology
  - Filed Mississippi income tax returns but paid no tax because all sales sourced outside of Mississippi
- Mississippi Court of Appeals reversed lower court finding to hold that Equifax was correct in using costs of performance
- Mississippi Dept. of Revenue argued that Equifax should be using an alternate apportionment formula - market sourcing
  - Won in Mississippi Commission Board of Review and Hinds County Chancery Court
- Court reversed based on standard of review
  - Reviewed the case de novo
    - Puts burden on Department of Revenue to prove standard apportionment does not accurately reflect the taxpayer’s activities
    - Trial court reviewed based upon a presumption of correctness to the Department of Revenue’s determination
- Equifax, Inc. v. Miss. Dept. of Revenue, 2012 WL 1506006 (Miss. Ct. of Appeals, May 1, 2012)
Digital Goods – SST Sourcing

• Digital Products Sourcing
  - SLAC formed Digital Products Sourcing Workgroup in October 2011 to address sourcing regime for digital goods under the Agreement
  - Definition of “receipt,” recordkeeping, and MPU
Taxability
Digital Goods Taxes – A Patchwork of Laws

Digital Goods Taxed by DOR Position or Case law

Digital Goods Non-Taxable

Digital Goods Taxed by Statute

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Digital Goods

• What is the character of the product being sold?
  ▪ Data Processing
  ▪ Information Services
  ▪ Telecommunications
  ▪ Digital Goods
  ▪ Software and Related Services
    ▪ Prewritten v. Custom
    ▪ Cloud Computing

• How is the product delivered?
Louisiana Sales/Use Tax on VOD/PPV

• Video-on-demand ("VOD") and Pay-per-view ("PPV") services historically not subject to Louisiana sales/use tax.

• Rationale:
  ▪ VOD/PPV are nontaxable services rather than TPP.
  ▪ Unlike downloaded software because customer receives limited viewing rights and no recording or download occurs.
  ▪ Even if taxable, VOD/PPV would qualify for exemption applicable to “necessary fees . . . collected from the subscriber for regular [cable] service.” La. R.S. § 47:305.16.
Louisiana Sales/Use Tax on VOD/PPV (cont’d)

• In 2010, Department of Revenue asserted that VOD and PPV are TPP subject to sales tax.
  ▪ See RIB 10-015 (6/25/2010).

• Department withdrew its position in 2011.

• Working group currently studying taxation of digital goods and VOD and PPV.
New Jersey TAM-21

- New Jersey Division of Taxation issued TAM-21, relating to lead generation services, on November 5, 2011
- Taxpayer contracts with car dealerships to list dealers’ inventory on a website and match prospective car buyers with dealers
  - Taxpayer provides dealerships with sales lead information via email.
  - Information collected by Taxpayer is non-exclusive and is provided to all dealerships that have the same vehicles in their inventory
- New Jersey deemed sales leads a taxable information service
- Information was not “personal or individual” in nature because Taxpayer provided information to all dealerships with same vehicle in inventory
- If Taxpayer bundled lead services with website advertising, the true object was sales lead information
- Can use this logic to apply to all lead-generation services
Bundling – New York False Claims Act
New York False Claims Act

• New York defines a false claim to include when any person:
  ▪ “knowingly makes, uses, or causes to be made or used, a false
    record or statement material to a false or fraudulent claim”
• Knowingly – Means something more than actual knowledge
  ▪ It also means acting in deliberate ignorance or reckless disregard
    of the truth or falsity of information.
• Individuals may bring suit using a qui tam action
• 10 year statute of limitations
• Treble damages
• Additional statutory penalty of no less than $6,000 and no more
  than $12,000 for each “false” claim
• Taxpayers found liable are required to pay for the costs,
  including attorney’s fees, of bringing the action
New York False Claims Act

- At the federal level, there is a “tax bar” prohibiting FCA lawsuits in tax matters.
- **States with Tax Bars**
  - Include California, District of Columbia, Hawaii, Massachusetts, New Mexico, New York City, North Carolina, Tennessee, and Virginia
- **States without Tax Bars**
  - Include Delaware, Florida, Nevada, New Hampshire, New Jersey, and New York
  - New York is unique in that it is the only state to expressly authorize *qui tam* actions for tax claims
- **States with Partial Tax Bars**
  - Include Illinois, Indiana, and Rhode Island disallow *qui tam* actions in *income* tax matters
False Claims Cases

• No showing of an intent to defraud the government.
• This has led some opportunistic whistleblowers and plaintiffs’ firms
• *Qui tam* plaintiff claimed that a number of out-of-state retailers had fraudulently failed to collect use tax on internet sales made to Illinois customers. The plaintiff claimed that the defendants had “affiliate nexus” in Illinois because of their in-state “bricks and mortar” stores.
• Illinois recently intervened in a case against nearly 150 companies, claiming they fraudulently failed to charge sales tax on shipping charges
  - Some of the defendants are said to have been previously audited by the Illinois Department of Revenue and told their shipping charges were not subject to tax.
Sprint Complaint

• New York’s inaugural FCA case is against Sprint
  • $100 million claim, with treble damages and penalties for each “false claim”
    ▪ Total claim exceeds $300 million
  • New York impose sales tax on interstate calls, but not intrastate calls
  • Sprint sold a wireless plan that allowed customers to unlimited local and long distance calling for a set fee
  • Sprint separated its intrastate calls as a percentage of the purchase price of the plan
  • New York claims that this was fraudulent and illegal and filed the first FCA suit against Sprint
  • Primary reliance is on a TSB (non-binding guidance)
Federal Legislation
Federal Legislation

• Digital Goods and Services Tax Fairness Act of 2011 (HR 1860/S 971).
• A measure seeking to establish a national framework for the state and local taxation of digital goods and services (downloaded apps, cloud computing services, etc.).
Federal Legislation

• What the measure does
  ▪ Ensures digital goods are taxed only once, precluding multiple states from claiming the right to tax same transaction or multiple taxation in the course of production.
  ▪ Ensures only generally applicable taxes can be imposed (i.e., general sales taxes) and that it must be done legislatively.
  ▪ Precludes discriminatory telecom/utility taxes from applying to digital commerce solely because these goods and services are riding over broadband/communication networks.
  ▪ Ensures that digital commerce is subject to same rules as comparable tangible goods.
  ▪ Provides certainty in how segments of the new economy can be taxed for state and local tax purposes.
Credits for Production Companies
Tax Credits for Master Tapes

• Aside from film production credits, certain states offer incentives for taxpayers to invest their company in the state.
• New York has permitted a production company’s master tapes to qualify for the Investment Tax Credit ("ITC").
• TSB-A-06(5)C, In re American Broadcasting Companies, Inc. stated that master tapes qualified for New York’s ITC because it met all of the statutory requirements.
  ▪ Taxpayer produced and distributed live and taped television programs and operated the ABC Television Network.
  ▪ Produced master tapes and determined that the tapes qualified as tangible personal property.
New York ITC Requirements

- To qualify for the New York ITC, the following 6 requirements must be met by the qualifying property:
  1. Tangible personal property;
  2. Depreciable under Internal Revenue Code (“IRC”) § 167;
  3. Have a useful life greater than four years;
  4. Acquired by purchase as defined in IRC § 179(d);
  5. Principally used in the production of goods by processing; and
  6. Sitused in New York

- New York imposes clawback provisions if the requirements are not fully met or only met for a limited period of time

- ABC, Inc. TSB stated that the master tapes met all of the ITC requirements

- Broadcast companies may want to consider applying for the credit if their facts meet New York’s requirements
Property Tax on Intangibles
Oregon – Comcast Litigation

- Until 2009, Comcast was locally assessed
- In 2009, the DOR reinterpreted the statutory definition of “communication” in order to centrally assess cable television and internet access services providers like Comcast
  - “Communication” includes telephone communication, telegraph communication and data transmission services by whatever means provided. ORS 308.505(2) (2007).
The DOR asserted two arguments at trial:
- (1) Cable television and internet access services are “data transmission services”
- (2) The definition of “communication” is not exclusive, and the Department is authorized to broaden or narrow the scope as it sees fit

The tax court held:
- (1) Cable television is not a data transmission service
- (2) Internet access is a data transmission service

Comcast also proved that, by any measure, it is primarily a cable television company. Applying Oregon’s “primary purpose” statute, the tax court held that none of Comcast’s integrated property was subject to central assessment.

Appealed to the Oregon Supreme Court, and oral arguments expected in 2012.
- *Comcast Corporation v. Department of Revenue* (2011)
California – *Elk Hills* Litigation

- California Court of Appeals held that emission reduction credits ("ERCs") were "necessary" for the use of the tangible property and thus allowed the ERC values to be added to the cost pursuant to the cost approach.
- California Supreme Court granted certiorari.
- Elk Hills purchased ERCs for a power plant in California and the SBOE added the value of the ERCs under the cost approach.
  - Regional pollution districts award ERCs to underpolluters, which can then be sold to overpolluters.
- Section 110(e) states that you can assume the presence of intangibles necessary to put taxable property to beneficial or productive use.
California – *Elk Hills Litigation*

- Section 110(e) codifies the holding in *Michael Todd v County of Los Angeles*, 57 Cal. 2d 684 (1962)
  - Taxpayer argued film negative of “Around the World in Eighty Days” (Best Picture Oscar) was worth scrap
- Court in *Michael Todd* held that a film negative can not be valued at scrap because the copyright is a nontaxable intangible
  - Instead, the film negative can be valued by assuming the presence of the copyright
  - Assessor used cost approach to value film negative and did not add the value of the negative to the cost approach
- If intangibles that are “necessary” to put the property to beneficial or productive use of taxable property are themselves taxable, that opens the floodgates for assessors
  - Will call into question taxability of FCC licenses, customer relationships, and goodwill, to name a few
Recent Audit Developments
Microsoft Corp. Inc. v. Office of Tax and Revenue

- D.C. Administrative Law Judge ("ALJ") found that the controversial method used by several states, including D.C., for transfer pricing violations is invalid
- Chainbridge, a contingent fee auditor, uses a transfer pricing study that does not investigate the taxpayer’s books and records, but instead relied upon their tax returns and public information
- In Microsoft, ALJ held that Chainbridge improperly:
  1. Included both controlled and uncontrolled transactions in their analysis
  2. Aggregated Microsoft’s intercompany transactions without proving that they were functionally comparable
- Several additional states utilized Chainbridge in their contingent fee audits
Questions?

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