

State Tax Considerations in Light of the Constantly Evolving Use of Technology

Today, many states are trying to close large budget deficits and are looking for new ways to raise revenue. This is particularly true with respect to the sale or use of technology. Accordingly, many states have enacted rules expanding (1) the definition of "doing business" in their state and/or (2) services that are subject to sales tax. Two areas where we have seen significant legislative changes, and we expect there is more to come, are "Amazon"/remote seller nexus and "cloud computing."

"Amazon"/Remote Seller Nexus

Determining whether an entity was "doing business" within a state was once a simpler endeavor, but the significant increase in online sales has created a new and more complex world. So-called "Amazon tax"/remote seller laws have perhaps been the most significant sales/use tax development in recent years. As online/remote sales continue to grow, states are looking for ways to ensure that tax is paid on the sale of taxable products and services.

Amazon, one of the largest online retailers, has been at the center of this controversy, as many states have attempted to require that Amazon collect and remit sales tax on the retailer's sales in a specific state. In order for a state to require that a taxpayer collect and remit tax, however, the taxpayer must have a physical presence in the taxing state. These new "remote



seller" provisions have often used the remote seller's relationships with local online advertising affiliates to create this taxable presence. This has led to the remote seller's decision to terminate these relationships in many of the states adopting these "remote seller" rules which, according to the affiliates and their supporters, caused job loss and decreased business revenue.

Currently, 13 states have some form of remote seller nexus provision, each with their own effective date and many with state-specific nuances. These rules can apply to all remote sellers, not just those selling over the internet, a point that many taxpayers are not aware of. States with some form of "remote seller" rule include:

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| ■ Arkansas | ■ California |
| ■ Colorado | ■ Connecticut |
| ■ Illinois | ■ New York State |
| ■ North Carolina | ■ Oklahoma |
| ■ Pennsylvania | ■ Rhode Island |
| ■ South Dakota | ■ Texas |
| ■ Vermont | |

The potential tax at risk can be significant and it is understandable why states are trying to create a sales tax collection obligation for remote sellers. For example, Amazon was issued a \$269 million tax bill for sales tax reportedly owed from 2005 – 2009 relating to sales to Texas customers. Also, it is clearly much easier for the states to collect tax from a single vendor as opposed to their millions of customers.

If states are to have remote seller nexus rules, there must be understandable, equitable guidelines for determining when a taxpayer has a taxable presence in a jurisdiction. Many advocates of remote seller legislation state that requiring all remote sellers to collect tax will “level the playing field” for all retailers. Their position has some merit, but is not an accurate statement. For example, while large remote sellers may have the infrastructure to collect and remit tax in the thousands of tax jurisdictions in the United States, we have seen, for other smaller businesses, that the cost of setting up systems to determine taxability, compute the tax due, and remit the tax far outweigh the potential sales, let alone the potential tax. Forcing sellers to not compete in a business because the significant cost of compliance is not “leveling the playing field” for all retailers.

Today, there is a growing push for the passage of Federal legislation, with at least three potential bills introduced during 2011, which would allow the states to require remote sellers to collect and remit sales and use taxes. The enactment of disparate remote seller rules across the United States has a dampening effect on the U.S. economy at a time when we need to encourage, not stifle, business growth. The states and the Federal government must be careful not to so encumber small business with additional regulation that they discourage economic growth. Amazon is now behind this push for a uniform Federal rule, provided the threshold for exempting taxpayers from the collection requirement are kept very low. Significantly, taxpayers with low taxable sales are the ones needing protection.

Cloud Computing

Another component of our new complex world encompasses a special type of “outsourcing.” Today, many businesses

are looking to outsource various functions, including payroll processing, HR administration, and technology and many states are looking to expand their tax to include the outsourcing of certain information technology tasks

Today, there is a growing push for the passage of Federal legislation, with at least three potential bills introduced during 2011, which would allow the states to require remote sellers to collect and remit sales and use taxes.

(commonly referred to as “cloud computing”). Cloud computing involves the delivery of software, infrastructure, and storage over the internet, either as separate components or a complete platform, based on user demand and allowing individuals and businesses access to various programs using a web-based model, thus granting users greater access, mobility, memory, and efficiency. In essence, many taxpayers are reducing their hardware and software expenditures and are hiring third parties to perform many technology functions.

Accordingly, many states are attempting to revise their tax laws to include some form of cloud computing as a taxable item. This change typically involves the question of whether cloud computing is considered by the taxing jurisdiction to be a software or a service. Software, for example, has historically been taxed as tangible personal property (even though most would agree that software is intangible property), with taxability often depending on whether the software is delivered electronically or via a tangible medium and whether the software is considered to be “canned” or custom.

If a jurisdiction taxes “cloud computing,” taxpayers must then consider where to source the service (e.g., where is the tax due?). Some states that tax “cloud

computing” services source the service to the place from which it is accessed. New York, for example, taxes the sale of a license to use a taxpayer’s software to a subscriber in New York based on the location associated with the license.

If the subscriber’s employees using the software are located both in and out of New York State, the taxpayer should collect tax on the portion of the receipt attributable to the employee users in New York (New York Advisory Opinion No. TSB-A-09(33)s, 8/13/2009).

Taxpayers looking to use some type of “cloud computing” service must be sure they understand whether such services will be taxable in their state and, if so, how the tax is determined. Tax on these services can be significant and should be part of any “buy” or “build” analysis undertaken by a taxpayer looking to change its technology infrastructure. ■

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