

E-Commerce Income Tax and Sales Tax Issues

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Introduction

- Advances in a number of related technologies, including sensors, analytics, network, cloud, security, and M2M management platforms, are allowing companies across industries to illuminate their “dark” assets
- These companies can collect, analyze, share and act on the data to drive operational efficiencies or new growth models in new ways

Technology Innovation

- Smart Devices
 - Examples: Smart home devices, wearable tech
 - Devices are becoming miniaturized and more affordable
 - The trend is away from “all-in-one” devices to those that meet specific needs
 - The focus is now on more “personal” applications

Mobility

- More devices are enabled with both portability and connectivity
- The mobile device is finding application as the controller of other devices
- With “Bring-Your-Own-Device” (“BYOD”) trends, the focus is on device management to app management

Cloud Computing

- Over 50% of IT spending over next 2 years is on cloud
- Cloud is being used to help drive business agility and speed to market
- Cloud provides a common innovation platform for Mobile, Social, and Big Data
- Cloud enables the analysis/dissemination of data for IOT

Analytics

- Data visualization and dashboards are making analytics more accessible and driving adoption
- Data from smart devices is now being collected and monetized
- Predictive analytics is helping businesses be more proactive in driving decision-making

Data Security

- Security investments are dramatically increasing, driven by increased regulation and increased focus on privacy/controls
- Security as a Service is being driven by more users accessing cloud services from mobile
- Hybrid cloud model is helping meet more stringent SLAs

Cloud Metrics

- \$77 billion: Revenue expected to be generated by mobile apps by 2017
- 1.34 billion: Digital music tracks sold online in 2013
- 82 billion: Digital apps downloaded worldwide in 2013, expected to exceed 200 billion by 2017
- 1 million+: Number of e-books available from Amazon's online store

Defining the Transaction: License of Software, Service, or Something Else?

- How do we Characterize the Transaction?
 - Customer's "true object", "primary purpose?"
 - Which of the various elements of the service was "predominant?"
 - What ownership rights (to what is being purchased) are transferred?
 - What does the purchase agreement say?
 - What do the marketing materials say?
 - Is there a software license agreement?

Animal, Vegetable, or Mineral?

- States struggle to characterize transactions in the cloud:
 - Is it taxable software?
 - All internet-based platforms necessarily utilize software
 - But that doesn't mean software is the "true object" of the transaction

Is it a taxable information service?

- Internet-based services may draw upon a database of information.
- But that doesn't mean the "true object" of the transaction is the information.

Is it a taxable communications service?

- When, if ever, does a cloud based service that “routes” messages or information constitute a communications service itself?
- Who supplies the telecommunications transport?

Example

- Vendor = Platform where businesses can compare, match analytics
 - Is it information?
 - “Trading” personal information
 - Is it telecommunications?
 - Does “route” to correct recipient, but each customer uses outside telecommunications to get to the platform
 - Is it software?
 - Not really providing functionality, just access

Nexus Issues

- Emerging digital products and services can create sales tax liability for those who never had it before

Example

- Financial Services in New York
 - Investment research/reports
 - “Soft dollar” arrangements
 - For further discussion, see Timothy P. Noonan and Elizabeth Pascal, *State of Confusion: Sourcing Financial Services Receipts*
(http://www.hodgsonruss.com/media/publication/512_Sourcing%20Financial%20Services%20Receipts.pdf)

Income Tax

- Economic Nexus

Streamlined Sales and Use Tax Agreement

- “Prewritten computer software”
 - Tangible personal property, but states can choose to exempt it altogether or based on how it is delivered

“Specified Digital Products” and Products “Transferred Electronically”

- Separately defined from computer software, ancillary services, telecommunication services and tangible personal property
- Sources the sale/purchase of such products to where the products are “received” by the purchaser

“Receipt/Receive”

- Taking possession of tangible personal property, making first use of services or taking possession or making first use of digital goods, whichever comes first

Internet Tax Freedom From Discrimination

- Internet Tax Freedom Act (ITFA)
 - Bans state and local taxation of internet access
 - Forbids multiple or discriminatory taxes on electronic commerce (does not ban taxation of sales made over the internet)
 - Became permanent on February 24, 2016

What is a discriminatory tax?

- If the “brick and mortar” version of goods or services isn’t taxable, then the same goods delivered or services performed via the internet cannot be taxed
- Taxing the internet-based commerce at a different rate
- Imposing a tax collection or payment obligation on a different party than in the case of “brick and mortar” transactions

E-Commerce Discrimination

- *Performance Marketing Ass'n v. Hamer*, Ill. S.Ct. No. 114496 (10/18/13)
 - The Illinois Supreme Court applied the ITFA to strike down a discriminatory tax burden imposed on e-commerce
 - Illinois “click through” nexus statute required out-of-state vendors to collect Illinois use tax based on using in-state internet-based marketers
 - Collection obligation triggered if more than \$10,000 in sales were made through the link

- Illinois Supreme Court noted that performance marketing by out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, did not trigger an Illinois use tax collection obligation
- Court struck the Illinois statute for violating ITFA's bar against imposing a discriminatory tax on electronic commerce

How closely must the “brick & mortar” good/service parallel the cloud-based good/service for there to be discrimination?

Brick & Mortar	Cloud
Hardcover or paperback book	E-Books
Career consulting service operated “in-person” out of an office	On-line career consulting service with access to a database of jobs
Tax preparation performed “in-person” out of an office	On-line access to tax preparation software

Example

- “On-line” Personal Training Services
 - “Brick and mortar” gym training not taxable
 - What about on-line training?
 - Any interaction with “human” trainer?
 - Or do you just put in your personal information and a training program is developed for you?
 - Or is it something in between?

Apportioning Income

- Sourcing Issues
 - How the product/service is delivered to the customer does matter in determining taxability and sourcing of the sale

- Does the purchase agreement specify what is being sold?
 - Auditors and courts rely heavily on the contractual language in characterizing the item being purchased
 - If a software license agreement is executed, it will be difficult to argue that you are not licensing software
 - Invoice and marketing materials may also be relied on

- Services: Place of benefit, use, performance?
- Does the state have “digital goods” rules?
- Does server location matter? See, e.g., Alabama’s server location

States are moving toward market sourcing.

- Market based sourcing is used in 23, in addition to North Carolina's legislature directing the Department to draft rules to implement market sourcing
- Washington and Ohio do not impose an income-based tax, but have market-based sourcing rules for their business tax

“Delivery” v. “Where the benefit of the services are received”

- Defining the “market” under the “benefit of the services are received” test may be difficult.
 - States using “benefit of the services received”:
 - CA, GA, IA, NY, OH, RI, UT, WA, WI
 - See, e.g., NY Art. 9-A Sec. 210-A(10)(b), <http://law.justia.com/codes/new-york/2014/tax/article-9-a/210-a>.

States using “market”:

- AL, CT, LA, MA, PA, TN
 - See, e.g., CT S.B. 502, 2016 § 203 (Conn. 2016), <https://www.cga.ct.gov/2016/TOB/s/pdf/2016SB-00502-R00-SB.pdf>.

Best Practices

- Require electronic delivery.
 - Contract terms must address:
 - Delivery;
 - Characterization;
 - Sourcing; and
 - Responsibility for tax.
 - Consider incentives.
 - Get exemption/resale certificates.