July 2013

SUTHERLAND

SALT SHAKER

Shaking things up in state and local tax.

Arizona: Software Licenses Determined to Be Personal Property Rentals

By Kathryn Pittman and Andrew Appleby

The Arizona Department of Revenue determined that a taxpayer providing online backup and restoration services was subject to Arizona's transaction privilege tax (TPT) after concluding that the receipts from such services were taxable as rentals of prewritten software. The taxpayer provided services that automatically backed up and restored files. As a conduit for the backup service, the taxpayer provided a software "agent" that customers installed on their computers to facilitate backups. The service agreement included a software license for the "agent." Based on the foregoing facts, the Department determined that the taxpayer's services included receipts for software. Software is considered tangible personal property for purposes of the TPT, and thus receipts therefrom are subject to the TPT. The Department further determined that the transactions fell within the personal property rental classification, as opposed to the retail classification, because customers had limited duration of access to the software. The Department did not undertake a "true object" analysis to examine whether or not the software conduit was de minimis compared to the overall backup service. Ariz. Priv. Ltr. Rul. No. LR 13-002 (Mar. 25, 2013).

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Rent-a-Cloud: Arizona's Transaction Privilege Tax Applies to Receipts from the Temporary Use of Online Software

By Mary Alexander and Prentiss Willson

The Arizona Department of Revenue determined in a private letter ruling that gross receipts from "renting" prewritten software available online are subject to Arizona's transaction privilege tax (TPT). The definition of tangible personal property for purposes of the TPT includes the electronic delivery of software. Thus, according to the Department, a business is subject to the TPT if the customer has "the defined and exclusive *right of use* of the software for a *specified period*…." The Department concluded that the requesting company's customers had "the requisite amount of use and possession" to constitute a rental, because they could use the company's employment application software to "add, delete, and modify job descriptions" and had the "ability to search and sort information in the reports produced by [the company]." Further, the Department noted that a customer's access to the company's software terminated when its contract expired. Thus, the Department determined the company's gross receipts from customers using the software at locations in Arizona were subject to the TPT under the personal property rental classification. Ariz. Priv. Ltr. Rul. LR13-005 (Apr. 29, 2013).

Handle with Care: "Shipping and Handling" Fees Subject to Arizona Transaction Privilege Tax

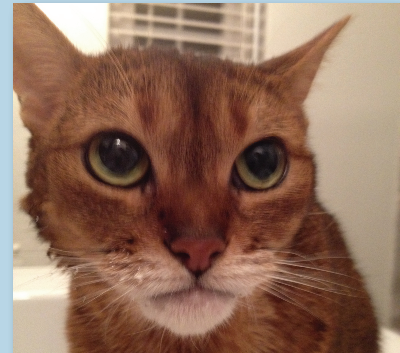
By Suzanne Palms and Andrew Appleby

The Arizona Department of Revenue determined that shipping and handling fees were subject to Arizona's transaction privilege tax (TPT). The company sold tangible personal property via the Internet. The company's affiliates fulfilled the orders, which included activities such as labeling, packaging and shipping the items via common carrier. The company billed its customers a separately stated shipping and handling fee (S&H fee), which included: (1) selecting, packaging and fulfilling the order, and (2) shipping the order to the customer via common carrier. The Department explained that delivery charges are typically deductible for purposes of the TPT as a "[s]ervice rendered in addition to selling tangible personal property at retail." The term "delivery" is not defined by statute, but the Department interpreted it to mean a retailer's actual costs to ship or deliver merchandise to a customer. The Department reasoned that since the S&H fee included a handling component for selecting, packaging and fulfilling a customer's order, a portion of the S&H fee was attributable to activities that occurred before the merchandise was shipped. Because the S&H fee included both components, the Department concluded that the entire S&H fee was subject to the TPT. Ariz. Priv. Ltr. Rul. LR13-003 (May 13, 2013).

SALT PET(S) OF THE MONTH

Juan Carlos and Felipe

Meet Juan Carlos and Felipe, the furry royalty of Sutherland Tax Partner Robb Chase and his wife, Allie. Juan and Felipe are Abyssinians, which the breeder described as a "regal" breed, so the brothers were named after the king and prince of Spain.



Juan is not a people person and lets his dislike be known if anyone other than Robb comes too close for comfort. Despite his tough demeanor, one of Juan's favorite pastimes is eating flowers, particularly when he wants to alert Robb that it is time to be fed. Although he is not allowed, Juan prefers to drink water from the faucet, and if a glass of water is left unattended, he will quickly claim it.

Unlike Juan, Felipe is prone to dropping on his side and rolling over so that you can scratch his belly. But, do not let these signs of affection fool you. Between Juan and Felipe, Felipe rules the roost and has been known to attack his (larger) brother without warning, to the point that Juan has a healthy respect for Felipe and typically keeps his distance.

Juan Carlos and Felipe say thank you for featuring them as Pets of the Month!

SALT Pet of the Month: It's Your Turn!!

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Katie O'Brien Schrack at katie.schrack@sutherland.com.

California Court Melts Ice Cream Maker's External Obsolescence Argument

By Zachary Atkins and Douglas Mo

A California appellate court held that an ice cream maker's property tax appeal involving an alleged failure to make an external obsolescence adjustment was subject to the "substantial evidence" standard of review. The taxpayer asserted that certain production equipment used in its novelty product lines was underutilized as a result of low market demand for those novelty products. The primary issue before the court was whether the failure to include an adjustment for external obsolescence was an error in the valuation method and thus a question of law to be reviewed *de novo*, or whether it was simply a matter of appraisal judgment and thus an issue of fact subject to the substantial evidence standard. The court concluded that the substantial evidence standard applied because the question was whether the assessment appeals board could conclude, based on the evidence presented, that the taxpayer failed to meet its burden of proving its entitlement to an external obsolescence adjustment based on underutilization. In affirming the judgment of the superior court upholding the assessment, the appellate court found that the taxpayer did not establish that it met the requirements for an underutilization adjustment because it did not show that the claimed underutilization was beyond the control of a prudent operator that was recognized in the market. *Dreyer's Grand Ice Cream, Inc. v. Cnty. of Kern*, Case No. F064154 (Cal. Ct. App. July 22, 2013) (unpublished).

Colorado High Court Rejects Public Utility's Request for Parity-Down

By Zachary Atkins and Prentiss Willson

The Colorado Supreme Court held that the Colorado Division of Property Taxation did not violate a public utility's equal protection and uniformity rights by valuing and taxing its property differently than cable companies' property. The public utility, Qwest Corporation, is a telecommunications service provider that competes with cable companies for telephone service customers in Colorado. Unlike Qwest, which is subject to central assessment, cable companies are not treated as public utilities and, therefore, are subject to local assessment. The key difference is that public utilities are not entitled to the intangible property exemption or cost cap valuation method afforded by statute to locally assessed taxpayers. Qwest argued that the Division's failure to apply the exemption and the valuation method to its property violated the federal Equal Protection Clause and its counterpart in the Colorado Constitution, as well as the Colorado Uniform Taxation Clause. Rather than seeking to invalidate the exemption and valuation method statutes, Qwest sought to have both applied to its property. The court affirmed the dismissal of Qwest's complaint, concluding that the differential tax treatment has a rational basis for equal protection purposes and is not the type of differential taxation that the Colorado Uniform Taxation Clause prohibits. *Qwest Corp. v. Col. Div. of Property Taxation*, Case No. 11SC669 (Col. June 24, 2013).

Ending the Storm Tax: Delaware Excludes Emergency-Related Work from Nexus Determination

By Shane Lord and Prentiss Willson

Under the Delaware Infrastructure Emergency Response Act, emergency work related to a declared state of emergency does not constitute legal presence, residency, or doing business in Delaware for purposes of state and local taxes, licensing, and regulatory requirements. This exclusion applies to out-of-state businesses and employees that conduct emergency work relating to "infrastructure" during a defined period of five days prior to and 60 days after a declared state of emergency (unless a longer period is authorized). The term "infrastructure" for the purposes of the exclusion is defined to include property and equipment owned or used directly in connection with the provision of services to multiple customers or citizens, and does not include office buildings or billing or administrative offices. Out-of-state businesses and employees that remain in the state after the emergency period are subject to the normal standards for establishing presence, residency, or doing business in the state. The Multistate Tax Commission has recommended that other states consider enacting comparable legislation. Delaware 147th Gen. Assemb., H.B. 145 (Approved July 16, 2013).

Two States, One Compact: Michigan Joins California in Reviewing the Multistate Tax Compact

By Todd Betor and Pilar Mata

On July 3, 2013, the Michigan Supreme Court granted International Business Machines Corporation's (IBM) motion for leave to appeal the Court of Appeals' November 20, 2012, judgment in favor of Michigan in *International Business Machines v. Department of Treasury*, Michigan Supreme Ct., Case No. 146440. Consequently, the highest courts in Michigan and California are now both poised to decide whether taxpayers in those states have the right to elect to apportion their business income using the Multistate Tax Compact's (Compact) apportionment formula. The California Supreme Court is reviewing the California Court of Appeal's decision in *Gillette Co. v. Franchise Tax Board*, Cal. Supreme Ct., Case No. S206587, with briefing already under way.

The Michigan Supreme Court's order granting IBM's appeal provided that the parties shall brief whether:

1. IBM could elect to use the Compact's apportionment formula in calculating its 2008 tax liability to Michigan, or whether IBM was required to use the Michigan Business Tax (MBT) Act's single-sales factor apportionment formula;
2. The MBT repealed, by implication, the Compact's apportionment formula;
3. The Compact is a contract that cannot be unilaterally altered or amended by a member state; and
4. The MBT's modified gross receipts tax component constitutes an income tax under the Compact, thus subjecting it to the Compact's election and apportionment provisions.

New Jersey SaaS It IaaS Going to PaaS on Imposing Sales Tax on Cloud Computing

By David Pope and Prentiss Willson

The New Jersey Division of Taxation concluded in a technical bulletin that sales of cloud computing services are not subject to sales and use tax in New Jersey. Although this is not a change to the Division's position, the bulletin specifically identifies software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS) as non-taxable cloud computing services. The Division explained that SaaS retailers provide customers with access to software through remote means; PaaS retailers provide customers with computing platforms through remote means; and IaaS retailers provide customers with equipment and services necessary to support and manage the customer's content and dataflow through remote means. While New Jersey generally defines taxable tangible personal property to include prewritten software delivered electronically, the Division stated that SaaS, PaaS, and IaaS do not fit within New Jersey's definition of tangible personal property because the retailer does not transfer any software to its customers. The Division further stated that New Jersey does not enumerate SaaS, PaaS, or IaaS as taxable services. New Jersey Division of Taxation Technical Bulletin TB-72 (July 3, 2013).

New York: Disallowance of Mandatory Combined Reporting Position Sustained

By Nicole Boutros and Andrew Appleby

In a case of first impression interpreting when substantial intercorporate transactions are present for purposes of New York's mandatory combined reporting provisions, a New York State Division of Tax Appeals Administrative Law Judge (ALJ) concluded that the taxpayers could not file on a combined basis. In 2007, New York State amended Tax Law section 211[4] to provide that a combined report is required for corporations engaged in a unitary business if substantial corporate transactions exist between the corporations. Knowledge Learning Corporation (KLC) acquired KinderCare and moved all of KinderCare's employees to KLC. KLC and KinderCare, along with certain other affiliates, filed on a combined reporting basis for their 2007 tax year. Despite all employees being KLC employees and KLC paying all of KinderCare's expenses, the ALJ failed to find "substantial intercorporate transactions." The ALJ weighed "heavily" against the taxpayers because of the absence of written intercompany agreements memorializing the claimed intercorporate transactions and disregarded witness testimony specifically supporting the existence of such intercorporate transactions. The ALJ inexplicably declined to analyze the taxpayers' alternative argument that there was actual distortion even if there were not substantial intercorporate transactions, permitting "forced combination." Although the "forced combination" provision remains in New York Tax Law, the ALJ summarily concluded in a footnote that the 2007 amendment eliminated the need to entertain a distortion analysis. *Matter of Knowledge Learning Corp.*, DTA Nos. 823962 and 823963 (June 27, 2013).

New York Trial Court Trims the Fat but Keeps the Meat on False Claims Act Lawsuit

By Christopher Chang

A New York State trial court has denied a motion filed by Sprint Nextel Corporation and its subsidiaries (Sprint) to dismiss a claim brought under the New York False Claims Act (FCA) alleging the company knowingly filed false tax returns and underpaid New York State sales taxes on fixed-rate monthly wireless telephone plans sold to New York customers. The court rejected Sprint's argument that it reasonably interpreted the law when it determined that section 1105(b) of the New York Tax Law allowed it to exclude from sales tax the portion of its fixed monthly charges attributable to interstate voice services. Focusing solely on section 1105(b)(2) of the Tax Law, which imposes tax on sales of mobile telecommunication services, the court held that sections 1105(b)(1) and (3) of the Tax Law were not relevant to the analysis, even though those provisions specifically exempt interstate telecommunications from tax and despite statutory language suggesting that the provisions must be read together. The court also rejected Sprint's arguments under federal law and the U.S. Constitution. Specifically, the court held: (1) the federal Mobile Telecommunications Sourcing Act (MTSA) does not require that Sprint be allowed to unbundle its charges because the MTSA applies only to states that—unlike New York—do not subject aggregated telecommunications services to taxation; and (2) the Ex Post Facto Clause of the U.S. Constitution does not prohibit retroactive application of the FCA because the penalties imposed under the FCA are not intended as a punishment. Plaintiffs' causes of action brought under the Executive Law and Tax Law were partially dismissed as time-barred for periods prior to March 31, 2008. Plaintiffs' cause of action alleging that Sprint conspired to violate New York law was dismissed in its entirety. *People ex rel. Empire State Ventures, LLC, v. Sprint Nextel Corp., Sprint Spectrum L.P., Nextel of New York, Inc., and Nextel Partners of Upstate New York, Inc.,* Index No. 103917/2011 (N.Y. Sup. Ct., July 1, 2013).

To Be Taxed or Not to Be Taxed? Ancillary Telephone Charges Examined for Purposes of Pennsylvania's Gross Receipts Tax

By Shane Lord

The Commonwealth Court of Pennsylvania held that gross receipts received by Verizon in connection with nonrecurring service charges—including telephone line installation, moves of or changes to telephone lines and service, and repairs of telephone lines—were not taxable under the Commonwealth's gross receipts tax on telephone companies. The court distinguished these nonrecurring services from Verizon's provision of private telephone lines and directory assistance services, which the court held were taxable. Gross receipts from private telephone lines were held to be taxable because such services were provided for the sole purpose of transmitting telephone messages, while gross receipts from directory assistance services were held to be taxable because such services allowed Verizon to transmit telephone messages more effectively and satisfactorily and therefore were also services provided for the sole purpose of transmitting telephone messages. In contrast, the court determined that gross receipts from Verizon's nonrecurring services were not taxable because the services: (1) did not include a transmission of telephone messages; (2) were separately billed to customers; and (3) where inside wiring was required, the work did not have to be done by Verizon (i.e., it could be completed by the customer or through a third party). In holding for Verizon on the nonrecurring service charge issue, the court emphasized that, as a tax imposition statute, the law had to be strictly construed with any ambiguity resolved in favor of the taxpayer. *Verizon Pennsylvania, Inc. v. Commonwealth*, No. 266 F.R. 2008 (Pa. Commw. Ct. July 5, 2013).

Texas Reins In Its Comptroller: Specified Locations to Qualify as a Retailer's Place of Business for Sales Tax Remittance Purposes

By Saabir Kapoor and Timothy Gustafson

Texas has clarified the Comptroller's authority to disregard certain retail business locations in determining the situs of a sale for local sales tax purposes. Current law requires retailers to collect and remit local sales tax based on the ship-from location on all delivery sales of taxable items that are shipped from a "place of business" in Texas when the order is not placed in person by the purchaser or lessee. Texas Senate Bill (S.B.) 1533, which becomes effective on September 1, 2013, allows the Comptroller to disregard a business location only if the location functions or exists to "avoid the tax legally due" or "exists solely to rebate a portion of the tax imposed." S.B. 1533 also provides that an outlet, office, facility or location will not be disregarded if such location "provides significant business services, beyond processing invoices, to the contracting business, including logistics management, purchasing, inventory control, or other vital business services." The legislation specifies that the changes do not affect tax liability accruing before September 1, 2013, and that any accrued liability continues in effect as if S.B. 1533 had not been enacted. Tex. S.B. 1533; Tex. Tax Code § 321.002(a)(3), eff. Sept. 1, 2013.

Even the Refunds Are Bigger: Texas to Return Up to $50 Million in Sales and Use Taxes Paid by Cable, Internet and Telecom Service Providers

By Sahang-Hee Hahn and Andrew Appleby

Effective September 1, 2013, Texas will refund state sales and use taxes paid by providers of cable television, Internet access or telecommunications services on tangible personal property used in their businesses. On June 14, 2013, Governor Rick Perry signed H.B. 1133 into law, authorizing such refunds. Under the new legislation, a provider is entitled to a refund of sales and use taxes paid on the sale, lease, rental, storage or use of tangible personal property if it meets two requirements. First, the provider or one of its subsidiaries must sell, lease, rent, store, consume or otherwise use the tangible personal property on which taxes were paid. Second, the provider or one of its subsidiaries must directly use or consume such property in the provision of cable television, Internet access or telecommunications services. Purchases made for data processing or information services do not qualify for a refund. The legislation includes a $50 million limitation on the amount of the refund. If the total tax paid by all providers and subsidiaries eligible for a refund is not more than $50 million for a calendar year, then the refund amount will be the amount paid by the provider or the subsidiary. If this $50 million threshold is exceeded, then the refund amount will be a pro rata share of $50 million. Tex. Tax Code Ann. § 151.3186 (2013).

Texas Apportionment: Think Outside the [Set-Top] Box

By Timothy Gustafson and Stephen Burroughs

The Texas Comptroller determined that receipts received for the delivery of satellite programming to Texas subscribers should be sourced to the site of the subscriber's set-top box for apportionment purposes. The taxpayer provides direct broadcast satellite television programming to subscribers in Texas and across the United States. For the years in dispute, the taxpayer did not include programming receipts in its Texas receipts factor numerator because the equipment used to receive, amplify and transmit programming signals was located outside of Texas, and therefore the taxpayer concluded the service was being performed outside of Texas. However, the Comptroller determined that "the act that produces the receipts at issue…is the act performed by the [set top box]" in Texas. The set-top box descrambled incoming satellite signals into viewable television programming and therefore, according to the Comptroller, provided the "end-product acts for which the customer contracts and pays to receive." Texas's place-of-performance sourcing statute resembles a market-based sourcing mechanism for satellite television providers. Tex. Comp. Dec. 104,224 (May 17, 2013).

Come See Us

August 1-2, 2013
Georgetown Law CLE Advanced State and Local Tax Institute
Georgetown University Law Center – Washington, DC
Todd Lard on The Presumptive Correctness of Tax Assessments

August 8-9, 2013
Manufacturers Education Council Annual Ohio Tax Conference
Cherry Valley Lodge – Columbus, OH
Jonathan Feldman on Multistate Tax Issues and Trends and on Nexus

August 25-28, 2013
Midwestern States Association of Tax Administrators Annual Meeting
Sheraton – Oklahoma City, OK
Todd Lard will present

October 4, 2013
National Business Institute Sales and Use Tax Seminar
Washington, DC
Charlie Kearns on Recent Developments; Identifying Tax Exemptions, Deductions, Credits and Incentives

October 17, 2013
National Business Institute Sales and Use Tax Seminar
Brooklyn, NY
Andrew Appleby on Resolving Sales and Use Tax Disputes

October 23-25, 2013
COST 44th Annual Meeting
Sheraton Wild Horse Pass – Phoenix, AZ
Jeff Friedman on How to Survive an MTC Audit and Live to Tell About It
Todd Lard on Top 10 Predictions of the Most Important State Tax Litigation and Legislative Issues Over the Next Few Years

October 27-30, 2013
TEI Annual Conference
Hyatt Regency – New Orleans, LA
Marc Simonetti on Because I Said So: Forced Combination, Alternative Apportionment, and Taxpayers' Concerns About State Transparency

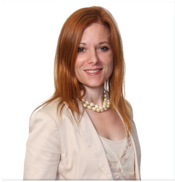
Recently Seen and Heard

July 28-31, 2013
Southeastern Association of Tax Administrators Annual Meeting
Marriott–Hilton Head, SC
Todd Lard on The Legal Realm, Recent Court Cases, Alternative Methods of Apportionment

July 22-25, 2013
Multistate Tax Commission Annual Conference
San Diego, CA
Jeff Friedman on State Tax Assessments and Controversies – The Lay of the Land

June 26-30, 2013
TEI Region VII Conference
Hilton Head, SC
Eric Tresh on State Tax Roundtable – Planning and Techniques

The Sutherland SALT Team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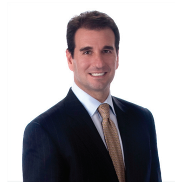
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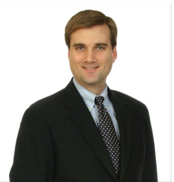
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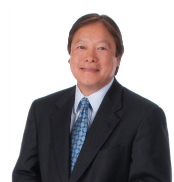
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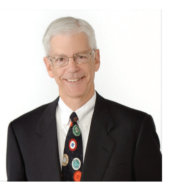
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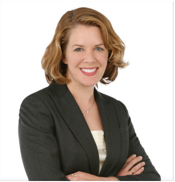
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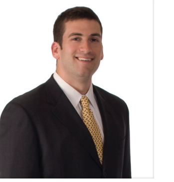
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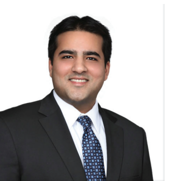
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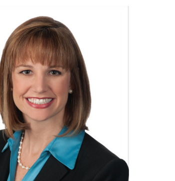
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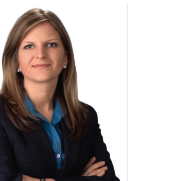
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