



BDO KNOWLEDGE

Webinar Series

CLOUD COMPUTING

April 26, 2016

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BDO KNOWLEDGE Webinar Series – Cloud Computing

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WITH YOU TODAY

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INTRODUCTORY COMMENTS

INTRODUCTORY COMMENTS

- Businesses use cloud computing for a variety reasons, including
 - Delivery of technology/software to employees/customers,
 - Data backup, and data/file storage,
 - Create a mobile work or virtual office environment, and
 - Information sharing.
- Cloud computing has become a highly demanded service due to:
 - Reduced IT costs,
 - Scalability to fit business needs, and
 - Technology accessibility leading to flexibility of work practices, and more efficient workplace collaboration.
- It allows companies to:
 - Avoid upfront infrastructure costs,
 - Focus on projects that differentiate their businesses instead of on infrastructure,
 - Get software applications up-and-running faster, with improved manageability and less maintenance, and
 - Rapidly adjust IT resources to meet fluctuating business demand.

INTRODUCTORY COMMENTS (CONT'D)

- It's here to stay - the proof is in the numbers:
 - More than 60% of businesses utilize cloud for performing IT-related operations.
 - During the period 2014-2020, the percentage of U.S. small businesses using cloud computing is expected to more than double from 37% to nearly 80%.
 - It is predicted that the global market for cloud equipment will reach \$79.1 billion by 2018.
 - 82% of companies reportedly saved money by moving to the cloud.
 - 14% of companies downsized their IT after cloud adoption.
- This webinar will not only help you better understand what cloud computing is, but also better understand the sales/use tax impact on your or your client's business as the sale/use of cloud computing services and related technology increase.

SOURCES

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- Cloud Computing for Business: Why Cloud?*, The Open Group, at http://www.opengroup.org/cloud/cloud/cloud_for_business/why.htm (last visited Apr. 12, 2016).
- Franklin Morris, *Infographic: SMB Cloud Adoption Trends in 2014*, PC World (Oct. 7, 2014), at <http://www.pcworld.com/article/2685792/infographic-smb-cloud-adoption-trends-in-2014.html> (last visited Apr. 12, 2016).
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- Rick Delgado, *The Past and Future of Cloud Computing*, Virtual-Strategy Magazine (May 27, 2015), at <http://www.virtual-strategy.com/2015/05/27/past-and-future-cloud-computing#axzz45bo3NP8r> (last visited Apr. 12, 2016).

AGENDA

AGENDA

- Sales Tax Nexus
- Sales Tax in the Cloud
- Digital Goods and Services
- Sales Tax Remediation
- FAS 5 / ASC 540-20 Considerations

SALES TAX NEXUS

SALES TAX NEXUS

Nexus Types

| | |
|--------------------------------|---|
| Nexus | • Nexus = connection or presence in a state sufficient to subject to state taxes. Requires a minimum connection, between the state and the person, property, or transaction. |
| Physical presence nexus | • Property or employees physically present in the state. Could include sporadic or temporary presence - seminars, trade shows; some states have safe harbors. <i>Quill v. N.D.</i> , 504 U.S. 298 (1992). |
| Agency nexus | • Seller engages in-state third-party contractors or representatives to perform certain activities (e.g., sales solicitation or warranty repairs) on behalf of the seller. <i>Tyler Pipe v. WA</i> , 483 U.S. 232 (1987). |
| Affiliate nexus | • State asserts that nexus exists based on the existence of common ownership between an in-state taxpayer and an out-of-state corporation |
| Economic nexus | • Parameters subject to debate. Solicitation of and receipts from sales to a state's residents may be sufficient. Some states have a minimum threshold for sales activity (i.e. "factor presence" nexus). |

SALES TAX NEXUS

Click-Thru Nexus

- Originated via New York law enacted on April 23, 2008, that creates a sales tax collection presumption with respect to an out-of-state seller that enters into an agreement with a NY resident for website referrals where the seller pays a commission based on sales generated therefrom, and NY sales resulting from referrals arising from all such arrangements exceed \$10,000. See N.Y. Tax Law § 1101(b)(8)(vi).
 - Presumption - A seller that makes taxable sales of TPP or services in a state has nexus when a state resident's website clicks through potential customers to the seller.
 - Rationale - Seller has a physical presence in the state through an agent (i.e., the NY resident).
- New York Court of Appeals held that NY's click-thru nexus law is not unconstitutional because the in-state physical presence may be satisfied via economic activities performed in New York by the seller's employees or on its behalf. *Overstock.com, Inc. v. N.Y. Dept. of Tax & Fin.*, Opinion Nos. 33 and 34 (N.Y. March 28, 2013).

SALES TAX NEXUS

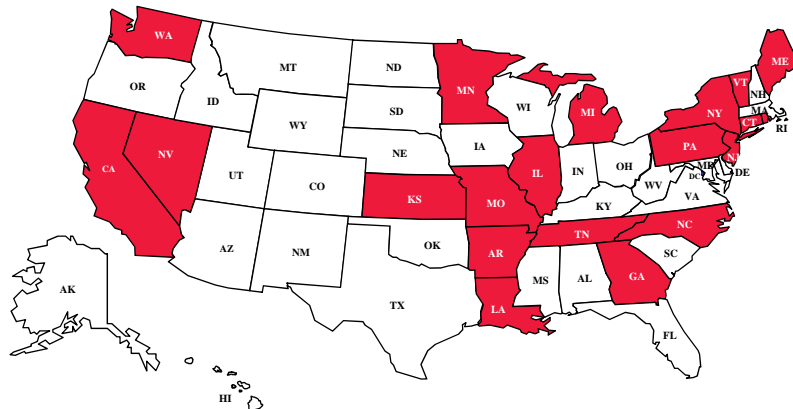
Click-Thru Nexus (cont'd)

| State | Effective Date | Annual Threshold | Statute |
|----------------|----------------|--|---|
| Arkansas | Oct. 24, 2011 | More than \$10,000 | Ark. Code § 26-52-117(d) |
| California | Sept. 15, 2012 | More than \$10,000 through affiliates and more than \$1 million in annual in-state sales | Cal. Rev. & Tax Code § 6203(c) |
| Connecticut | July 1, 2011 | More than \$2,000 | Conn. Gen. Stat. § 12-407(a)(12) |
| Georgia | Oct. 1, 2012 | More than \$50,000 | Ga. Code § 48-8-2(8)(M) |
| Illinois | Jan. 1, 2015 | More than \$10,000 | 35 ILCS 105/2 |
| Kansas | Jul. 1, 2013 | More than \$10,000 | Kan. Stat. § 79-3702(h)(2)(C) |
| Louisiana | Mar. 14, 2016 | More than \$50,000 | H.B. 30, 2016 1st Extra. Sess. (La. 2016) |
| Maine | Oct. 9, 2013 | More than \$10,000 | Me. Rev. Stat. tit. 36, 1754-B(1-A)(C) |
| Michigan | Oct. 1, 2015 | More than \$10,000 through affiliates and more than \$50,000 in annual in-state sales | Mich. Comp. Laws § 205.52b |
| Minnesota | Jul. 1, 2013 | More than \$10,000 | Minn. Stat. § 297A.66(4a) |
| Missouri | Aug. 28, 2013 | More than \$10,000 | Mo. Rev. Stat. § 144.605(2)(e) |
| Nevada | Oct. 1, 2015 | More than \$10,000 | A.B. 380, 78th Legis. Sess. (Nev. 2015) |
| New Jersey | Jul. 1, 2014 | More than \$10,000 | N.J.R.S. § 54:32B-2((1)(C) |
| New York | Jun. 1, 2008 | More than \$10,000 | N.Y. Tax Law § 1101(b)(8)(vi) |
| North Carolina | Aug. 7, 2009 | More than \$10,000 | N.C. Gen Stat. § 105-164.8(b)(3) |
| Pennsylvania | Sept. 1, 2012 | None specified | Pa. Bul. No. SUT 2011-01 (Dec. 1, 2011) |
| Rhode Island | Jul. 1, 2009 | More than \$5,000 | R. I. Gen. Laws § 44-18-15 |
| Tennessee | July 1, 2015 | More than \$10,000 | Tenn. Code § 67-6-520 |
| Vermont | Dec. 1, 2015 | More than \$10,000 | Vt. Stat. tit. 32, § 9701(9)(I) |
| Washington | Sept. 1, 2015 | More than \$10,000 | Wash. Rev. Code § 82.08.052(1) |

SALES TAX NEXUS

Click-Thru Nexus (cont'd)

Click-Thru Nexus States



SALES TAX NEXUS

Affiliate Nexus

- In Colorado, a person is presumed to be doing business if the person is part of a controlled group of corporations that has a component member that has a physical presence in the state and the component member:
 - Sells under the same or a similar business name TPP or taxable services;
 - Maintains an office, distribution facility, salesroom, warehouse, storage place, or other similar place of business in the state;
 - Uses trademarks, service marks, or trade names in the state that are the same or substantially similar;
 - Delivers, installs, or assembles TPP in the state, or performs maintenance or repair services on TPP in this state, which is sold to in-state customers by the person; or
 - Facilitates the delivery of TPP to in-state customers of the person by allowing such customers to pick up TPP sold by such person at an office, distribution facility, salesroom, warehouse, storage place, or other similar place of business maintained in the state. See Colo. Rev. Stat. § 39-26-102(3)(d). Rationale - Seller has a physical presence in the state through an agent (i.e., the NY resident).

SALES TAX NEXUS

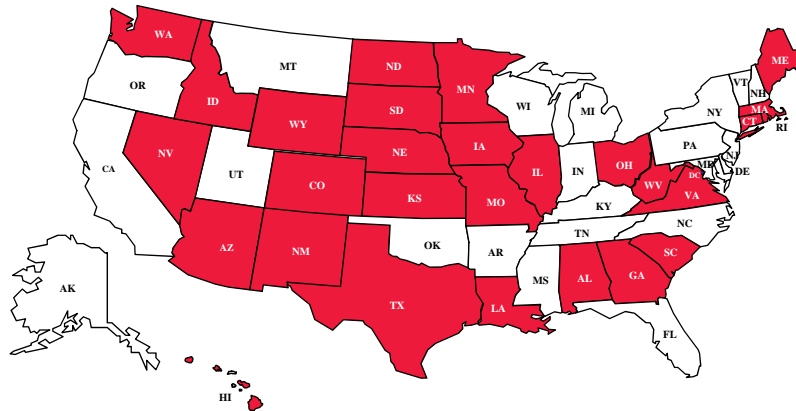
Affiliate Nexus (cont'd)

- In Texas, a retailer is engaged in business in the state if it holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who maintains a location in the state and the retailer:
 - Sells the same or a substantially similar line of products as the person with the location in this state; and
 - Sells those products under a business name that is the same as or substantially similar to the business name of the person with the location in this state. See Tex. Tax Code 151.107(a)(7)(A).
- States that have recently enacted affiliate nexus laws, include:
 - Louisiana, H.B. 30, 1st Extra. Sess. (La. 2016).
 - Michigan, Rev. Admin. Bul. 2015-22 (Nov. 3, 2015).
 - Nevada, A.B. 380, 78th Legis. Sess. (Nev. 2015).

SALES TAX NEXUS

Affiliate Nexus (cont'd)

Affiliate Nexus States



SALES TAX NEXUS

Economic Nexus

Alabama, Ala. Reg. 810-6-2-.90-03 (effective Jan. 1, 2016).

- A remote seller is required to collect and remit sales tax if:
 - Its Alabama sales exceed \$250,00; and
 - Distributes advertising matter in the state, or solicits sales by mail or pursuant to a contract with a cable television operator, broadcaster or publisher located in the state.

South Dakota, S.B. 106 (S.D. 2016) (effective May 1, 2016).

- A remote seller is required to collect and remit sales tax if:
 - The seller's South Dakota gross revenue from the sale of TPP, any product transferred electronically, or services delivered into South Dakota exceed \$100,000; or
 - The seller sold TPP, any product transferred electronically, or services for delivery into South Dakota in 200 or more separate transactions.

Justice Kennedy noted in his concurring opinion in *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124 (2015) that it may be time reconsider the Quill physical presence standard.

SALES TAX NEXUS

Marketplace Fairness Act

What is the Marketplace Fairness Act?

- The Marketplace Fairness Act is proposed legislation pending in the United States Congress that would enable state governments to collect sales/use tax from remote retailers with no physical presence in their state.

Legislative history

- 113th Legislative Session (Marketplace Fairness Act of 2013)
 - Introduced in the Senate as S.B. 743 on April 16, 2013, the Senate passed the bill on May 6, 2013, but it died in the House.
 - Was introduced in the Senate again on July 15, 2014 as S.B. 2609 (Marketplace and Internet Tax Fairness Act), but was not passed by the Senate.
- 114th Legislative Session
 - S.B. 698 (Marketplace Fairness Act of 2015) - Read twice and referred to the Committee on Finance on March 10, 2015.

Small Seller Exemption

- The exemption threshold in order to avoid the burden of collecting out-of-state sales/use tax is set at only \$1 million of gross sales.

SALES TAX NEXUS

Marketplace Fairness Act (cont'd)

Remote Transactions Parity Act of 2015 (RTPA)

- The RTPA (H.R. 2775) addresses the Internet sales tax issue using the structure of the Marketplace Fairness Act (MFA), which passed the Senate in 2013 and was re-introduced earlier this year. Although the RTPA retains many of the features of the MFA, it adds protections for remote sellers and certified software providers.
- Referred to the Subcommittee on Regulatory Reform, Commercial And Antitrust Law on July 1, 2015.
- Would adopt a 3 year phase-in of the small seller exemption as in the MFA.

SALES TAX NEXUS

Colorado Use Tax Reporting Law

- Colorado law requires a non-collecting retailer to:
 - Send a notice to Colorado customers that their purchases may be subject to use tax;
 - Send customers an annual purchaser summary if their aggregate purchases exceed \$500; and
 - Provide a customer information report to the Department of Revenue. See Colo. Rev. Stat. § 39-21-112(3.5)(d).
- In *Direct Marketing Ass'n v. Brohl*, No. 12-1175 (filed Feb. 22, 2016), the United States Circuit Court of Appeals for the Tenth Circuit upheld Colorado's use tax reporting law because the Quill physical presence requirement is limited to sales and use tax collection.

SALES TAX IN THE CLOUD

SALES TAX IN THE CLOUD

Overview

- Generally, sales tax is imposed on all sales of tangible personal property (TPP) and specifically enumerated services.
- Services – Taxation of services varies by state (e.g. compare IL, CA, TX).

Traditional Taxable Services

- Cable television services
- Repair and maintenance of TPP
- Printing services
- Personal services
- Landscaping services
- Dry cleaning services
- Amusement services

Recent Trends

- Data processing services
- Information services
- Telecommunication / communication services (expanding interpretation)
- Computer Services (ASP/SaaS/Cloud Computing)
- Digital Goods

Digital Goods – What is it?

- Tangible Personal Property
- Data Processing
- Information Services
- Telecommunications / Ancillary
- Services
- Software

SALES TAX IN THE CLOUD

Electronically Downloaded Software

7-Eleven Inc. v. Combs, 311 S.W.3d 676 (Tex. App. 2010).

Dechert LLP v. Commonwealth of Pennsylvania, 998 A.2d 757 (Pa. 2010).

- 7-Eleven argued its purchase of financial software qualified for a “sale for resale” exemption for software transferred to third-party franchisees outside of Texas.
- Transfer to corporate owned stores outside of Texas not resolved. Issue was remanded to determine whether there was use in Texas, what kind of software was purchased and whether that purchase could be properly allocated between company stores and franchise stores.
- Comptroller argued that the true purpose of the software was to automate 7-Eleven’s stores for its own benefit, and that 7-Eleven used the software to provide data processing services.
- Canned software constitutes tangible personal property.
- Purchases of licenses to use canned software are, therefore, subject to Pennsylvania sales and use tax.
- The delivery method for the software does not determine the taxability, according to the PA Supreme Court.
- UPDATE: Electronically accessing software is taxable because the user is exercising control over the software. Leg. Ltr. Rul. No. SUT-12-011, Pa. Dept. of Rev. (May 31, 2012).

SALES TAX IN THE CLOUD

Cloud Computing Platforms

- Hardware and software resources made available on the Internet and managed third party services.
- May be referred to as Application Service Provider (ASP), software as a Services (SaaS), or Cloud Computing.
 - Software housed and accessed remotely
 - No downloads or delivery
 - User may install temporary “applet” on computer/server
 - State may treat transaction as sale/license of electronically delivered software
 - Provision of computer services (e.g., data processing, information services)
 - Specific tax treatment of ASP/SaaS transaction (e.g., CO, NC, TX, WA)

SALES TAX IN THE CLOUD

Platform – Application Service Provider (“ASP”)

- Application service provider (“ASP”)
 - Provider retains custody over (or “hosts”) software for use by third parties. Users of the software hosted by an ASP typically will access the software via the Internet. The ASP may or may not own or license the software, but generally will own and maintain hardware and networking equipment required for the user to access the software. The ASP may charge the user a license fee for the software (in instances where the ASP owns the software) and/or a fee for maintaining the software/hardware used by its customer.
 - Typically the provider:
 - Fully owns and operates the software applications;
 - Owns, operates, and maintains the servers that support the software;
 - Makes information available to customers via the Internet or a “thin client”; and
 - Bills on a “per-use” basis or a monthly/annual fee.

SALES TAX IN THE CLOUD

Platform – Software as a Service (“SaaS”)

- Software as a service (“SaaS”)
 - “The capability provided to the consumer is to use the provider’s applications running on a cloud infrastructure. The applications are accessible from various client devices through a thin client interface such as a web browser (e.g., web-based email). The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, storage, or even individual application capabilities, with the possible exception of limited user-specific application configuration settings.”
 - Includes applications both general, such as word processing, email, spreadsheet, and specialized, such as customer relationship management (CRM), enterprise resource management (ERM), etc.

SALES TAX IN THE CLOUD

Understanding Cloud Services

- What is cloud computing?

Cloud computing is a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.

Worldwide market for public cloud services is forecast to reach \$203.9B in 2016, a more than 16% year-over-year increase – 24/7 Wall St.
- Benefits of cloud computing
 - Fully scalable
 - No major hardware or software upgrades required
 - Enables better use of IT budgets – No large fixed investments
 - Customer pays only for what it uses
 - Accessible from the Internet – Use software on terminal, but it resides on the server maintained by the cloud provider
 - Location of the server, to the extent relevant, may be difficult to determine, particularly in the case of large providers that have facilities in multiple locations.

Source: The NIST Definition of Cloud Computing

SALES TAX IN THE CLOUD

Understanding Cloud Services (cont'd)

- Five key elements
 1. On-demand self-service: Get it when you need it
 2. Measured service/usage-based billing: Pay for what you use (e.g. pay as you go)
 3. Rapid elasticity: Increase and decrease capacity quickly
 4. Broad network access: Access it from any Internet connection
 5. Resource pooling: Share fixed costs, which lowers individual costs (e.g., multi-tenancy)

Source: The NIST Definition of Cloud Computing

SALES TAX IN THE CLOUD

Understanding Cloud Services (cont'd)

Platforms

- Infrastructure as a Service (IaaS)
 - Raw computing power, storage and network bandwidth
- Platform as a Service (PaaS)
 - Database, development tools and other components required to support the delivery of custom applications

Deployment

- Private: Hosted
- Community: SaaS provider
- Public: Amazon, Rackspace
- Hybrid: Combinations of 1,2,3

Means of delivery include:

- The Internet (including downloading, web-browser access, streaming access)
- Wireless carrier
- Satellite

SALES TAX IN THE CLOUD

Examples

- Online learning and education
- Online health and medical advice
- Social Networking websites
- Transferring funds between banks
- Salesforce.com – CRM software
- Web-based email
- Google Wave – Collaboratively work on same doc's at same time
- Virtual IT – EC2 – Online servers
- Apple MobileMe – Online network storage
- Amazon Elastic Computer Cloud – Synchronization, back-up and utility computing

SALES TAX IN THE CLOUD

To which state should the transaction be sourced?

- No delivery, so no destination state?
- If sourced based on use, which is the state of use?
 - Location of customer/user
 - Location of the software/server
 - Conflict with sourcing between states that source SaaS sales based upon location of customer vs. location of server
- If sourced by use and location of customer
 - How do we determine where user is and use by customer occurs?
 - Factors:
 - Location of the server: What if multiple servers are involved?
 - Seller location: Where application is developed and maintained?
 - Customer billing address
 - User location: Allocation of contracts/licenses for users in multiple locations?

SALES TAX IN THE CLOUD

Hosted Software

Washington

Wash. Rev. Code § 82.04.050(6)(c)

The term "retail sale" includes "the charge made to consumers for the right to access and use prewritten computer software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis."

Massachusetts

Ltr. Rul. No. 11-4, Mass. Dept. of Rev. (Apr. 12, 2011)

Sale, license and right to use software on a server hosted by the taxpayer or a third party are taxable.

When there is no charge for the use of the software and the object of the transaction is acquiring a good or service other than the use of the software, sales tax doesn't apply.

Taxpayer provided information services to its customers based on data from prospective employees and then provides this information to its customers in a report.

The object of the transaction was the database access, including reports prepared by the taxpayer, rather than use of the software; therefore the transaction was a nontaxable sale of services.

Kansas

Kansas Opinion Letter No. O-2010-005 (Jun. 22, 2010)

Fees charged by an ASP provider to its customers for ASP services are not subject to sales tax. Such fees include recurring monthly charges, set-up fees, support fees, training fees, data migration fees, and forms programming fees. However, the sale of canned software that can be used independent of the ASP service is subject to sales tax. See also Opinion Letter No. O-2012-001, Kan. Dept. of Rev. (Feb. 6, 2012).

Florida

TAA 10A-051, Fla. Dept. of Rev. (Dec. 6, 2010)

Sales of online authentication services to customers via the provision of a digital certificate (which allow an end user to recognize that he or she is indeed accessing the customers' website) are not taxable.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS

Minnesota

- Cloud computing not subject to sales tax regardless of server location – Considered an information service.
- Hosted on service provider's server.
- Customer only has remote access to software.
- Customer's use of the software is for processing only.
- Charges for maintenance and support are also not taxable.

New York

- TSB-A-11(17)S, N.Y. Comm'r of Tax. & Fin. (Jun. 1, 2011)
- Hosted marketing service provided to clients that use email, direct mail and other marketing channels to reach their customer is subject sales and use tax as the sale of prewritten software.
- Taxpayer licenses to clients the right to use the software housed on the taxpayer's servers for the purpose of marketing campaigns.
- Taxpayer's charges for optional training and consulting services not performed through software were not taxable.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Colorado

- PLR-11-007, Colo. Dept. of Rev. (Dec. 20, 2011) (Ruling on web-based IT solution)
- Fees related to web-based file transfer and tracking solution are not subject to sales or use tax
- Similar to Google email services
- Essence of the transaction: Not the license of software or use of hardware but obtaining a nontaxable service
- Rental of hardware: Customer did not have sufficient degree of control, e.g., seller retained custody of servers

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Iowa

- Policy Ltr. 12300002, Ia. Dept. of Rev. (Jan. 11, 2012) (Hosted software and training)
- Hosted software and training fees are not subject to Iowa sales or use tax
- Cited the National Institute for Standards and Technology's definition of cloud computing
- Noted that no software is downloaded or delivered to customers; title/possession to not transferred
- Fees meet definition of cloud computing services
- No statutory Iowa authority to tax such services

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

New York

- TSB-A-06(5)S, N.Y. Comm'r of Tax. & Fin. (Feb. 2, 2006) (Online educational services, bundled software/services)
- Primary objective: Service or software?
- Taxpayer, a learning subsidiary of Cornell University, provided software to customers for professional development skills. Upon completion of the Internet course, it awarded a certificate of completion.
- Academic support (hosting online discussions) offered as a service
- Held nontaxable. Rationale was that the students' primary objective is to attend a course of study. Students were not purchasing software.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

New York

- TSB-A-15(2)S, N.Y. Comm'r of Tax. & Fin. (Apr. 14, 2015) (Cloud computing product)
- Primary objective: Service or software?
- The taxpayer's cloud computing product provided business customers with Internet infrastructure, which could be used to run applications for internal use, or host a website (i.e., a virtual server that allows customers to access computing power).
- The taxpayer billed customers based on hourly rates, and made available software, data, and other content (collectively, operating system) necessary for use of the cloud computing product at no charge.
- Held nontaxable. The customer subscribes to the product to run its applications - not the operating software, taxpayer's advertising emphasizes right to use computing power, and the transfer of any software (if any) is an incidental part of the cloud computing product.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

New York

- TSB-A-15(28)S, N.Y. Comm'r of Tax. & Fin. (Jul. 9, 2015) (Online meetings and conferences, and remote access computer products)
- Primary objective: Service or software?
- Taxpayer provided products to customers, which enabled them to remotely: (i) host/participate in online meetings, (ii) organize/present online conferences/webinars, (iii) provide live technical support, and (iv) remotely access computers.
- Taxpayer did not provide software license, customers paid a monthly subscription fee, and each product was separately available for sale.
- Held all nontaxable. Rationale was that the Department has held that "bridging" services are not taxable telecommunication services, the customer only downloaded a Java applet, and the recording feature usable with respect to some of the products had limited functionality.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

New York

- TSB-A-16(6)S, N.Y. Comm'r of Tax. & Fin. (Feb. 25, 2016) (Internet-based document transfer subscription plan)
- Primary objective: Service or software?
- The taxpayer provides a solution for sending, receiving and tracking large digital files via the Internet on a paid (monthly or annual subscriptions) and free basis, depending on data transfer/storage level.
- As part of the free and paid plans, the taxpayer makes available optional "plug-ins" and applications at no charge, which the customer can download by accepting a software license (less than 2% of customers download these applications).
- Depending on the plan level, the customer is able to use certain functions, such as setting file transfer expiration dates, file transfer/download notifications, send and receive track, custom branding of emails, etc.
- Held nontaxable. Rationale was the primary purpose of the product is to permit customers to send large files, and any additional functionality was ancillary.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Auto-Owners Ins. Co. v. Dept. of Treasury, No. 321505 (Mich. Ct. App. Oct. 27, 2015)

- Michigan-based insurance company accessed a variety of cloud-based software applications for its business including industry specific applications, customer support, marketing, communications, payment and processing, on-line research and other cloud-based software.
- On audit, Department of Treasury assessed use tax on access to the cloud-based software
- Court of Appeals held for taxpayer
 - No "delivery" of software (electronic or otherwise)
 - Taxpayer was required to download other software to enable access to the cloud, which the court held non-taxable under "incidental to service" test

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Chicago Lease Tax Ruling #12

- Applies the 9% Personal Property Lease Transaction Tax to a charge paid:
 - For cloud computing, cloud services, hosted environment, SaaS, PaaS, and IaaS; and
 - To obtain data that has been compiled, entered and stored on the provider's computer
- Provides rules related to sourcing and Exemption #11, which exempt a charge for access to information or data which is entirely passive without interactive use (e.g., streaming data), and materials that are primarily proprietary in nature (e.g., copyrighted newspapers, newsletters or magazines).
- Department has announced it will postpone the effective date of Ruling #12 until January 1, 2016.

Chicago 2016 Revenue Ordinance

- Applies a reduced 5.25% rate to "the lease of a computer primarily for the purpose of allowing the customer to use the provider's computer and software to input, modify or retrieve data or information that is supplied by the customer"
- Provides for a "small new business" exemption - license issued in the most recent full calendar year, under \$25 million in gross receipts (determined on a unitary business group basis), and has been in operation for fewer than 60 months.

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Chicago VDA Program

- The Department is offering a VDA program for taxpayers that have not addressed or underreported their Lease Tax obligations.
- The potential benefits of the VDA program include:
 - Limited look back period (depending on company's set of facts, the look back period is to January 1, 2015, January 1, 2016, or 4 years from the VDA filing date)
 - Abatement of penalties
 - Abatement of interest

SALES TAX IN THE CLOUD

Cloud Computing/ASP/SaaS (cont'd)

Tennessee

- 2015 Revenue Modernization Act added T.C.A. § 67-6-231(a)(2) to tax "use of computer software in the state," and to treat access to SaaS software by a user in TN as the electronic delivery of the software for use in TN (effective July 1, 2015).
- Purchase price consideration allocated among multiple points of use if customer accesses from locations in TN and outside TN.
- Exception from tax: Access to SaaS software is for a non-taxable service provided to the TN user/customer
- Department of Revenue has issued five Letter Rulings providing guidance on Department's interpretation of Section 67-6-231(a)(2) and taxable/non-taxable SaaS transactions - See Letter Rulings 15-07, 15-08, 15-09, 16-01 and 16-02.

Example (Letter Ruling 15-07): Access to SaaS software under basic "subscription package" for customer's use in performing its business processes was taxable use of software; access to same SaaS software under "business process outsourcing package" to enable vendor to perform the business process services for the customer was a non-taxable access.

- Essence of the transaction/"true object" test applies

DIGITAL GOODS AND SERVICES



DIGITAL GOODS AND SERVICES Data Processing Services

Texas

“The processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information.” 34 Tex. Admin. Code § 3.330(a)(1).

- Policy Letter Ruling No. 200805095L, Texas Comptroller of Public Accounts (May 28, 2008)
 - Taxpayer provided online business application where its customers entered their business information into the software via the internet.
 - Allowed the customer to conduct various activities including managing inventory, record sales, process payroll, etc.
 - Taxpayer position – It did not provide data processing; its customers performed any data processing activities
 - Comptroller held that taxpayer provided data processing; taxpayer’s computer processed the information entered by customers and made calculations to prepare a tax return (along with additional activities)
- Policy Letter Ruling No. 201004665L, Texas Comptroller of Public Accounts (Apr. 29, 2010)
 - Medical transcription services that used a “software as a service” or SaaS cloud platform to perform and deliver those services constitute taxable data processing services.



DIGITAL GOODS AND SERVICES

Information Services

New York

An information service includes "collecting, compiling or analyzing information of any kind or nature and the furnishing reports thereof to other persons[.]" N.Y. Tax Law § 1105(c)(1).

An information service excludes "the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons[.]" N.Y. Tax Law § 1105(c)(1).

- TSB-M-10(7)S, N.Y. Comm'r of Tax. & Fin. (Jul. 19, 2010)
 - Intended to "clarify" tax treatment of certain information services
 - Key factor is the "primary function" of the service
 - Lists a number of services that are considered "information services"
 - Revises previous positions on taxability of certain services
- *DZ Bank*, DTA No. 821251, N.Y. Div. Of Tax App. (May 11, 2009)
 - Web-based service that offered credit information of thousands of publicly held companies
 - Service determined to be a taxable information service, and not an electronic financial consulting service
- TSB-A-09(18)S, N.Y. Comm'r of Tax. & Fin. (April, 2009)
 - A web-based subscription service for online evaluation reports of broker-dealers is a taxable information service because a common database was used.

DIGITAL GOODS AND SERVICES

Digital Goods

What is a digital good?

- Tangible Personal Property
- Data Processing
- Information Services
- Telecommunications/Ancillary Services
- Software

Why does it matter?

- Need to know what it is before we can determine how it will be taxed
- States moving toward taxation of "digital goods" as new revenue source
- SSTP definitions and rules

DIGITAL GOODS AND SERVICES

Digital Goods (cont'd)

Florida

TAA No. 11A-002, Fla. Dept. of Rev. (Jan. 13, 2011)

- Sales transactions involving only digital transmissions via the Internet to a customer's computer, without any other evidence of the transfer of something tangible, are not sales of TPP for sales/use tax purposes.
- Such sales instead constitute services that are not subject to sales and use tax.
- On the other hand, files transferred via a hard drive, CD, flash drive, or DVD are TPP and thus subject to sales/use tax.

Indiana

Commissioner's Directive #41, Ind. Dept. of Rev. (Dec. 2014)

- Sales and use tax is imposed on "products transferred electronically" only if the products meet the definition of specified digital products, prewritten computer software, or telecommunication services.
- Previously, tax was based on whether products transferred electronically were taxable in their tangible forms.

DIGITAL GOODS AND SERVICES

Digital Goods (cont'd)

New York

TSB-A-11(20)S, N.Y. Comm'r of Tax. & Fin. (Jul. 8, 2011)

- Electronic books sold by California company not subject to sales tax
 - Ruled e-books do not meet definition of TPP
 - Do not meet definition of information services
 - Do not include any software

North Carolina

N.C. Stat. § 105-164.4(a)(6b)

- Imposes sales and use tax on digital property which includes:
 - Audio works
 - Audiovisual works
 - Books, magazines, newspapers, other publications
 - Photographs and greeting cards
 - Does not apply to information services

DIGITAL GOODS AND SERVICES

Digital Goods (cont'd)

Kentucky

Ky. Rev. Stat. §§ 139.010 and 139.200

- Imposes tax on the retail sale of "digital property," regardless of the user rights granted by the seller, or whether the buyer is obligated to make continued payments as a condition of the sale.
- "Digital property" means any of the following which is transferred electronically:
 1. Digital audio works
 2. Digital books
 3. Finished artwork
 4. Digital photographs
 5. Periodicals
 6. Newspapers
 7. Magazines
 8. Video greeting cards
 9. Audio greeting cards
 10. Video games
 11. Electronic games
 12. Any digital code related to this property

New Jersey

N.J. Rev. Stat. §§ 54:32B-2(zz) and 54:32B-3

- Effective May 1, 2011, "specified digital products" are taxable.
- Such products are defined as "an electronically transferred digital audio-visual work, digital audio work, or digital book," and includes digital code used to obtain a product.

DIGITAL GOODS AND SERVICES

Digital Goods (cont'd)

Will these provisions move to streaming services?

- *Netflix, Inc. v. Dept. of Revenue*, No. K-24900 (Ky. Bd. Tax Apps. Sept. 23, 2015) (Streaming services such as those provided by Netflix do not meet the definition of taxable "multichannel video programming services" for purposes of the Gross Revenues Tax, Excise Tax, or the Utility Gross Receipts License Tax for Schools)
- City of Chicago Amusement Tax Ruling #5 - Imposes the 9% tax on electronically delivered amusements such as television shows, movies, videos, music, and online games.

SALES TAX REMEDIATION



SALES TAX REMEDIATION Five Step Approach



SALES TAX REMEDIATION Five Step Approach (cont'd)

- Step 1 - Sales Tax Discussion
 - Determine where companies have nexus
 - We have a discussion more so than a nexus study
- State 2 - Taxability Based on Product Code
 - Taxability needs to mirror the client's product codes
 - The cost of the research varies on the number of product codes and the number of taxing jurisdictions
 - Product Code X Jurisdiction X Rate Per Hour = Research Cost
- Step 3 - Exposure Quantification
 - Spin historical data using taxability matrix
 - Contact customers to discuss liabilities
 - Determine actual amount of exposure

SALES TAX REMEDIATION Five Step Approach (cont'd)

- Step 4 - Voluntary Disclosure Agreements (VDA)
 - The exposure calculated under Step 4 may justify doing a VDA
 - A taxpayer cannot self-VDA in states where the VDA must be done on an anonymous basis
- Step 5 - Sales Tax Compliance (post-VDA)
 - Most clients need some type of rate software
 - Fees are typically based on the number of returns processed
 - BDO has a compliance center based in San Jose

FAS 5 / ASC 450-20 CONSIDERATIONS

FAS 5 / ASC 450-20 CONSIDERATIONS

- FAS 5 / ASC 450-20 provides that an estimated loss from a loss contingency must be accrued as a charge to income if *both* of the following conditions are met:
 - Information indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements; and
 - The amount of loss can be reasonably estimated
- Accrue the best estimate in a range or lowest amount in the range
- When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote.
 - *Probable* - The future event or events are likely to occur
 - *Reasonably Possible* - The chance of the future event or events occurring is more than remote but less than likely
 - *Remote* - The chance of the future event or events occurring is slight

CLOSING COMMENTS

CLOSING COMMENTS

- David and Steve provided you with:
 - The latest and greatest as it relates sales & use tax nexus, and taxation of cloud computing and digital goods.
 - A primer on sales & use tax remediation, and accounting for sales & use tax contingencies.
- This topic is becoming more and more significant to businesses as they increase purchases/sales of cloud computing and digital goods, and states become more aggressive in their approaches to nexus and the taxation of these items.
- You should now feel at least a little bit more comfortable with:
 - The ever-evolving sales & use tax nexus, cloud computing, and digital goods landscape, including whether a state has the jurisdiction to tax, what is or is not taxable, how to source the sale/use.
 - The possibility of remediating any pre-existing potential exposures, and how to account for them for financial accounting purposes.
- If you have questions or need assistance regarding sales tax issues or remediation, reach out to David or Scott, or any other BDO SALT resource.

QUESTIONS?



CONCLUSION

Thank you for your participation!

Certificate Availability - If you participated the entire time and responded to at least 75% of the polling questions, click the [Participation tab](#) to access the print certificate button.

Please exit the interface by clicking the red "X" in the upper right hand corner of your screen.



SPEAKER BIOGRAPHIES



BIOGRAPHY



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With 18 years of combined experience in state and local taxation, financial statement auditing, and operational auditing, Joe has worked with a broad range of the Firm's largest clients including manufacturing, retail, distribution, financial institutions, investment companies, and business services. He specializes in state and local tax issues with an emphasis on income/franchise taxation and unclaimed property compliance and consulting.

Joe leads BDO's National State and Local Tax Business Development and Marketing function. In this role, Joe touches many folks in the corporate community through dedicated BDO Knows Webinar Series on various topics, Alerts, pressing notices and other educational outreach efforts. Joe also maintains a standing column with State Tax Notes entitled "A View from the Windy City" where he along with his colleagues discuss various state and local topics important to the taxing community at large. Recent articles have included: (a) State and Local Tax Due Diligence Exposures and Procedures, (b) Extension of Delaware's Friendlier Voluntary Disclosure Program, (c) Chicago Taxes Cloud-Based Services and Amusements and (d) Unclaimed Property Concerns for the Healthcare Industry. Mr. Carr is a frequent speaker at firm and organizational events on unclaimed property and other state and local topics.

In addition, Joe manages the SALT practice for the Firm's Chicago office and heads-up the firm's National Unclaimed Property practice. He has had success in mitigating client escheat exposures in VDA and audit settlements before many state escheat divisions. Joe, in concert with his colleagues, works closely with clients to enhance their accounting practices, systems and ongoing efforts for operational efficiency through Accounting Assessment Reviews. This success is largely attributable to his deep understanding of accounting principles, transaction flow, and unclaimed property law. Having evaluated financial and operational corporate risks, Joe offers clients facing escheat issues valuable accounting experience and an unique perspective in dealing with unclaimed property matters.

Prior to joining the Chicago office of BDO USA, LLP, Joe worked with KPMG LLP and Deloitte & Touche LLP in state and local tax and audit divisions, respectively. In addition, Joe also managed the Internal Audit Division of a middle market food cooperative.



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Steve has more than 25 years of experience in state and local taxation and leads the Western Region's sales and use tax and property tax consulting practices.

Prior to joining BDO, Steve worked for the California State Board of Equalization for 10 years as a Senior Tax Auditor in Silicon Valley. During Steve's tenure with the Board, he was responsible for conducting sales and use tax audits on a wide variety of industries including but not limited to retailers, wholesalers, construction, life science and Fortune 500 manufacturers. Steve was also an instructor for the Board's audit staff sales tax continuing education training and update classes.

After leaving the Board, Steve worked several years in industry and public accounting, holding positions equivalent to Director of State and Local Taxes. Steve's management experience includes a large specialty retailer, a Fortune 100 computer manufacturer, and a Big Four accounting firm.

Steve has been involved with many M&A due diligence projects and has provided valuable consulting advice to his multi-state clients. He has also been able to identify, document, and secure millions of dollars worth of sales/use tax refunds through a variety of reverse audit techniques and has extensive experience in successfully defending multi-state sales and use tax audits. Steve has spoken before numerous industry, professional and taxpayer groups.

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David has more than 11 years of experience in state and local taxation and is a senior tax manager in BDO's Southwest Region sales and use tax practice.

David's primary focus has been in the area of providing multi-state sales and use tax audit defense, managed audit, overpayment review and general sales and use tax consulting services to clients in the manufacturing, exploration and production, oilfield service and oil and gas midstream industries operating in Louisiana and Texas. In addition, David has assisted clients within the banking, chemical manufacturing, construction, grocery retail and telecommunication industries throughout the Rocky, Southeast and Southwest regions.

David has extensive experience assisting clients with sales and use tax M&A due diligence, contract review, collection and review of exemption and export documentation, memo research and write-up and negotiating settlements or assisting clients through the audit redetermination process.

Prior to joining BDO, David worked at DuCharme, McMillen & Associates, Inc. and PricewaterhouseCoopers in Houston for a combined eight years where he was part of their state and local sales and use tax practices. David is a Certified Member of the Institute (CMI) for Professionals in Taxation.

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