TAXPAYERS' FEDERATION OF ILLINOIS

Knowing Your Digital Footprint & Business Licensing that is More of a Tax

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Agenda

1. **Knowing Your Digital Footprint: Income Tax and PL 86-272**
2. **Knowing Your Digital Footprint: Sales and Use Taxes**
3. **Digital Service Tax Litigation**
4. **Local Tax Nexus In the Digital Era**
5. **Illinois Franchise Tax Chaos**

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1. KNOWING YOUR DIGITAL FOOTPRINT: INCOME TAX AND PL 86-272

MTC Proposed Regulations

- MTC 2021 revised policy statement takes the position that activities conducted via the internet cause PL 86-272 protection to be lost.
- Example: text chatting over website with in-state users causes PL 86-272 protection to be lost.
- Several states adopted the revised policy statement as regulations or via informal guidance.
- American Catalog Mailers Association (“ACMA”) filed a challenge to New York regulations mirroring the MTC’s revised policy statement.

P.L 86.272 Under Assault

American Catalog Mailers Ass'n., v. FTB:

- The Superior Court granted American Catalog Mailers Association's ("ACMA") Motion for Summary Judgment holding the Technical Advice Memorandum No. 2022-01 ("TAM") and FTB Publication 1050 ("Publication 1050") invalid as underground regulations because the Franchise Tax Board failed to comply with the California Administrative Procedure Act, Gov. Code §§ 11340-11361 ("APA").
- The FTB issued guidance conforming to the Multistate Tax Commission's advisory statement on P.L. 86-272. The guidance expanded the scope of activities that would not be protected by P.L. 86-272.
- The Superior Court denied FTB's Motion to Vacate and Modify Judgement.
- In a separate February 13, 2024, order, the Court affirmed that ACMA is the prevailing party and the FTB is obligated to pay ACMA's attorney's fees.

P.L 86.272 Under Assault

ASAP Cruises, Inc. v. WI Dept of Rev.:

- A travel software company attempted to convince the Wisconsin Court of Appeals that software qualified as tangible personal property for P.L. 86-272 purposes.
  - The Court did not rule on whether only sellers of TPP were protected; it merely stated that the question was best resolved outside of summary judgment hearings.
- The Department argued that it was constitutional to attribute activities of independent contractors back to ASAP because it is well established that sales by these entities are sufficient to establish taxable nexus.
  - Further argued that P.L. 86-272 does not protect SaaS sales because it does not meet any traditional definition of property or tangibility.
- ASAP argued that it had no in-state physical presence akin to soliciting sales.
  - Independent contractors used their platform to book travel for their own separate customers and sell travel services on their own behalf.

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2. KNOWING YOUR DIGITAL FOOTPRINT: SALES AND USE TAXES

Digital Products/Services, SaaS, and NFTs

- Most states have addressed digital products and services
  - Area of focus and expansion for those states that have not yet addressed digital products

- SaaS
  - Currently approximately 50% of states tax SaaS
    - Indiana approach versus Kentucky approach
    - Vermont proposed a tax on "vendor-hosted prewritten computer software" effectively taxing SaaS
- NFTs
  - Very few states currently have specific guidance for NFTs (IL, MI, MN, WA, WI)
  - Are NFTs digital products? Intangibles? Apply the look-through rule.
  - Real life examples

Nationwide Proposed Taxes On Digital Advertising Services and Data

- Several proposals across states to establish new regimes imposing taxes on “Big Tech”; more to come in 2025 and beyond?
- Three categories of tax proposals:

1. **Digital Advertising Services**
    - Tax on apportioned gross revenue from digital advertising services
    - California, Connecticut, Louisiana, Maryland, Massachusetts, Montana, New York, Texas, Washington, West Virginia
2. **Social Media Advertising**
    - Tax imposed on social media companies’ gross revenue advertising services or number of users.
    - Arkansas, Connecticut, Indiana
3. **“Data Mining” Services / “Data Extraction”**
    - Tax on companies selling personal information or data, akin to a severance tax.
    - California, DC, Massachusetts, New York, Oregon, Washington, West Virginia

Taxation of Services and Digital Goods

- Where are services and digital goods taxed?
  - As stated above, services and digital goods are generally taxed where they are delivered to the ultimate consumer or the consumer's agent.
    - But where exactly is that?
  - Obviously, when the services and digital goods provider is in the same state as the ultimate consumer and the services and digital goods are not provided outside of that state, the services and digital goods are delivered in that state.
  - What happens when the services and digital goods provider and the customer are in different states or the services and digital goods are provided in more than one state?
    - For example: An architect/engineer based in New York visits Illinois to oversee a project and to make modifications to the blueprints.
    - A consulting firm has staff in five states working on a project at multiple locations.

Sales / Use Tax Sourcing Rules - Software

- State characterization of software matters: tangible personal property or service?
- Destination v. origin sourcing of software sales; most states have now moved to destination-based sourcing methods, though some still use origin-based, or mixed sourcing rules.
  - "benefit received" rule v. "place of performance" rule for services.
- Software with "multiple points of use" ("MPU").
  - Massachusetts purchasers may provide MPU Certificates to software sellers, which shift tax obligation from seller to purchaser.
  - No tax charged on invoice, but purchasers required to self-report tax based on location of actual use.
- Business-to-business transactions raise significant complications as software sellers are often unaware of where products are actually used by customers.
- SSUTA Rule 309 *et seq*. has attempted to bring some consistency in sourcing rules amongst SSUTA states.

Apportioned Taxes – Multiple Points of Use

- The Massachusetts Supreme Judicial Court ruled that software vendors may apportion sales tax to other states on software purchased by a Massachusetts company that accessed the software from other states. ***Oracle USA, Inc. et al v. Commissioner of Revenue*, Dkt. No. SJC-13013, May 2021.**
- The court held that the statute gave the purchaser the right of apportionment and it was not up to the DOR to decide whether apportionment was permitted
- Compare the Chicago Lease Transaction Tax (that applies to SAAS and cloud computing) and the opportunity to provide an affidavit confirming use outside the City
- Consider contractors who use equipment in multiple states – often for only a day or two at a time
  - See e.g. Ellingson Drainage, Inc v. South Dakota (USSC cert petition pending)

Sourcing Issues: Services and Digital Goods

- Multi-state sourcing: develop a sensible and uniform approach
- Many auditors will look for a sensible approach that reflects a system of assigning sales to locations where the service is being “received.”
    - Services are often delivered simultaneously to several jurisdictions, which requires allocation.
- Look for states that permit multiple points of use certificates (MPUs)
    - Does the MPU apply only to digital goods and software or to tangible goods and traditional services as well?

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3. DIGITAL SERVICE TAX LITIGATION

Recent Litigation – Digital Goods and Services

- **Maryland**: ***Peacock TV LLC v. Comptroller*, et al**, Case No. 23-DA-OO-0654 (pending). Peacock TV, Apple, Google, Meta (among others) argue Maryland's "digital advertising tax" violates the Internet Tax Freedom Act, the federal commerce and due process clauses, and the First Amendment. Maryland Tax Court's ruling on taxpayers' motions for summary judgment expected by December 31, 2024.

- **Texas**: ***Apple Inc. v. Hegar***, Case No. No. D-1-GN-20-004108 (pending). Do iCloud and iTunes Match services, allowing customers to access music, photos, videos, calendars and other digital files across multiple devices constitute a taxable data processing service?

Recent Litigation – Digital Goods and Services

- **New York**: ***Matter of Beeline.com***, DTA No. 829516 (May 2, 2024). A vendor management system assisted large businesses with gathering, organizing, assembling, and managing their workforce. This "service" was rendered taxable in full because: i) the VMS constitutes pre-written software because in most if not all cases no customization occurred; and ii) the true object test is not applicable here where the sale involved pre-written software and not non-taxable services. "The software that streamlines, automates and integrates the entire bundle of services petitioner is selling." Contract language provided that the software was transferred and used by customers. Compare with *Yesware*.

- **New York**: ***Matter of Yesware, Inc.***, Case No. 829638, 829639, 829640 (September 29, 2022). An email tracking service, where the taxpayer's proprietary software allowed its clients to track the clients' customers engagement with sales emails (e.g., which clients' emails received responses from the clients' customers and which email links were clicked by the clients' customers), was nontaxable because the "primary function" was neither the software, nor a taxable information service, rather it was a nontaxable "personal or individual" information service because specific client data / engagement information from their respective customers was not fungible and could not be sold to other clients. Compare with *Beeline.com.*

Recent Litigation – Digital Rewards Programs

- **Arizona**: ***Dove Mountain Hotelco, LLC v. Ariz. Dept. of Rev.***, Case No. CV-23-0176-PR (Jun. 7, 2024): Ritz-Carlton Dove Mountain filed refund claims for taxes paid on reimbursements it received through the Marriott Rewards Program. Hotel argued that it paid transaction privilege tax on the rooms when the reward points were earned, so it was taxed again when it paid $162,000 in tax on rewards program reimbursements between 2012 and 2016. Arizona Supreme Court disagreed and held the reimbursements are consideration for lodging space and, thus, subject to the TPT. Compare with *Marriott Int'l*.

- **New York**: ***Matter of the Petitions of Marriott International, Inc.***, Case No. 821078 (Jan. 10, 2010): Reimbursement from hotel chain marketing fund is not a taxable sale of a hotel room. Instead, Marriott Rewards Program was a marketing tool designed to increase stays at Marriott Hotels. Any payments between the program/fund and the hotels were designed as reimbursement for the cost of participating in the program; no taxable transaction involving the sale of a hotel room. Compare with *Dove Mountain*.

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4. LOCAL TAX NEXUS IN THE DIGITAL ERA

Local Taxes After Wayfair – Implications

- Compliance challenges?
  - Require collection of locally administered tax by reference to state sales threshold with no regard for level of activity in locality?
  - Is collection through a central portal a sufficiently big fig leaf when there are no or few other simplification steps?
  - Can differing tax bases and local filings seriously not be considered burdensome?
  - Costs/burdens of local administration of taxes
    - Separate registration
    - Differing laws, rates, deadlines
    - Aggressive audits (third-party firms)?

Chicago Taxes

- Chicago's Personal Property Lease Transaction Tax (Lease Tax)
  - Eff. 7/1/15 – City announced cloud computing services subject to if user of service located in Chicago – even if the provider has no presence in the City
  - Presently a 9% tax rate
  - Potential transactional nexus and due process concerns

- Chicago's Amusement Tax
  - City announced in June 2015 that tax applied to streaming services, ordinance amended in 2016 – presently has a 9% tax rate (5% for live performances)
  - *Labell v. City of Chicago* (9/30/2019) – appellate court held taxing streaming services was not discriminatory under ITFA
  - *Apple Inc. v. City of Chicago* – disparate settlements?

Chicago Taxes – Nexus Guidance

- In January 2021, Chicago released "Information Bulletin – Nexus and Safe Harbor" to address questions received by the city since the U.S. Supreme Court's 2018 decision in *South Dakota v. Wayfair.*

- The bulletin establishes a safe harbor for remote sellers with revenues under $100,000 from Chicago customers during the most recent consecutive four quarters effective July 1, 2021 and applies to an entity with no other significant contacts with Chicago.

- If the safe harbor does not apply, the city expects businesses with Chicago activity to comply with all relevant tax ordinances and the city will review several factors to determine if a seller has established nexus and the resulting tax collection responsibility.

- One factor is whether the seller meets Illinois' economic nexus threshold (*i.e.*, $100,000 or more in sales or 200 or more transactions), though the bulletin explains that the state threshold alone is not determinative of city nexus.

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5. ILLINOIS FRANCHISE TAX CHAOS

Illinois Franchise Tax Chaos

- What Is It? In Illinois, the franchise tax is considered a fee or license for the privilege and protections of "incorporation" while "doing business" in Illinois, and therefore only applies to "corporations" with sales and/or property in Illinois.

- The term "franchise tax" most commonly means a tax based on some measure of a company's net worth or capital value. In Illinois, the franchise tax is measured by "paid-in capital":

  > "[T]he sum of the cash and other consideration received, less expenses, including commissions, paid or incurred by the corporation, in connection with the issuance of shares, plus any cash and other consideration contributed to the corporation by or on behalf of its shareholders, plus amounts added or transferred to paid-in capital by action of the board of directors or shareholders pursuant to a share dividend, share split, or otherwise, minus reductions as provided elsewhere in this Act."
  >
  > 805 ILCS 5/1.80(j).

- ***Practically speaking, look to the federal 1120, Schedule L, Line 22 (value of capital stock, preferred and common) <u>plus</u> Line 23 (additional paid in capital).***

Illinois Franchise Tax Chaos

- Paid in capital is then apportioned using an “allocation factor” measured by “property” and “business transacted.” Again, look to Illinois and federal 1120s for numerator and denominator calculations.
- Paid-in capital increases must be reported on Form BCA 14.30. Mergers combine the paid-in capital of the merged entities on Form BCA 14.35.
- Seven-year statute of limitations; however, no limit on unreported mergers and contributions.
- Current exemption amount is $5,000 tax. Expanding exemption to $10,000 in the future?
- Aggressive enforcement has frustrated taxpayers for decades.
- Change in leadership at the IL SOS – a new way forward?

Illinois Franchise Tax Chaos

Global Mail Delivers Reality Check to the Illinois Secretary of State -- *Global Mail, Inc. v. White*, 2019 IL App (1st) 181778

- The Illinois Appellate Court ruled that the Office of the Secretary of State improperly assessed an Ohio corporation, Global Mail, Inc., double the amount of franchise tax actually due.
- During a 2004 internal restructuring, Global Mail (Delaware) merged with and into Global Mail (Ohio). No notification provided to the Secretary of State.
- Global Mail changed its state of incorporation from Delaware to Ohio on its 2013 Corporate Annual Report. The Secretary of State caught the change on the 2015 annual report.
- The Secretary of State attempted to assess both the non-existent Delaware corp. and the Ohio corp. for all past periods due (2005-2016) due to Global Mail failing to report the merger.
- The Illinois Appellate Court held: “Delaware law dictates corporate existence and, once the Delaware corporation no longer existed under Delaware law, it no longer existed for purposes of incurring franchise taxes.”

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