



Indirect Tax Challenges in the Digital Economy

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Learning objectives

1

Recognize major digital sales/use taxation developments during 2021/2022

2

Analyze issues faced by providers of SaaS, digital video, cryptocurrencies & NFTs, and digital advertising

3

Define technical and practical state compliance requirements for digital goods/services

Agenda

1 Software-as-a-Service

2 Digital Goods and Digital Video

3 Digital Payments

4 Digital Advertising

Introduction

- Over 7,000 state and local tax rates in US.
- Generally monthly sales/use tax filing obligations (can be monthly/quarterly), some states even ask for accelerated/prepayments
- Accrual basis, not cash basis
- Indirect taxes (sales/use, VAT, property taxes) account for about 70% of a Company's tax expense; income tax is about 30%.
 - BUT, most company resources are focused on income taxes
 - Indirect taxes are based on "transactions" (sales/purchases)
- Indirect tax compliance should be a focus for US/Global businesses
 - Complexities in multistate sales/use tax rules lead to potential liabilities
 - A miss on sales/use tax side can cost you upwards of 9% x by your purchase or sales price, for VAT it could be 20% (and as high as 27% in the EU). Penalties can double this figure.

State & Local Tax Nexus

- Generally, substantial nexus is required for a state to impose a tax
- Historically, substantial nexus meant some form of physical presence
 - Includes office locations, remote employees, and employee travel
- In 2018, the U.S. Supreme Court held in *South Dakota v. Wayfair, Inc.* that the substantial nexus requirement could be met by surpassing locality-set thresholds of economic activity
 - States after Wayfair generally adopt South Dakota's greater than \$100,000 in sales or at least 200 separate transactions approach
 - Some states have higher thresholds (i.e. California and New York - \$500,000)
 - By the end of 2020, nearly all states imposing a sales tax had adopted remote seller and also marketplace facilitator legislation in response to Wayfair

General Taxability Rules

- Sales of tangible personal property/hardware are generally taxable in 46 states, including Washington, D.C.
- Sales made through distributors/retailers/partners rather than to end users likely considered sales for resale
 - Company should collect resale certificates in nexus states (which allows it to not charge tax)
- Software-as-a-service and information services are taxable in about 30 states; digital products are taxable in 34 states (including Chicago and FL Communication Services Tax)
- Sourcing is based on ship to address/where the end user is located
- ***NEXUS, TAXABILITY, SOURCING, COLLECTION. It's easy right.....***

Current Law v. Current Technology

“**Keypunching**” means recording information in cards, paper tapes, or magnetic tapes, disc, or drum by punching holes or otherwise entering information in the cards, tapes, discs, or drums, or recording data on any media to represent letters, digits, and special characters.

Wis. Admin. Code Tax 11.71 Computer industry

“**Storage media**” includes hard disks, compact disks, floppy disks, diskettes, diskpacks, magnetic tape, cards, or other media used for nonvolatile storage of information readable by a computer.

Iowa Admin. Code 701--18.34 (422, 423) Automatic data processing.

SaaS – Notable Holdouts & Updates

Mississippi

- Strike: “software maintained on a server located outside the state and accessible for use only via the Internet is not taxable.”
- Add: The gross income received from computer program or software sales and services is taxable at the regular retail rate of sales tax. Computer program software license fees (one-time or annual) and/or maintenance contract income are taxable regardless of how billed. *Taxable services also include ... certain services, delivered through SaaS, PaaS, IaaS and other cloud computing models. Proposed changes rule 35.IV.5.06*



SaaS – Notable Holdouts & Updates

Alabama – Conflicting authority:

- Automotive services guide: “Using a web-based service where the software is not transferred or downloaded to the dealer’s computer is not taxable”
- Revocation of 2010 ruling: Providing business and financial information through a database accessed through the internet is exempt – then the ruling was revoked.

Arkansas

- 2021 advisement indicating SaaS is exempt

Minnesota

- SaaS likely exempt - Minn. Fact Sheet 134



SaaS – Software-based Offerings

What about SaaS-like offerings?

Digital Automated Services (WA) – ... *any services transferred electronically that use one or more software applications...*

Computer Services (CT) ... *retrieving or providing access to information, designing, implementing or converting systems, providing consulting services...*

- 1% rate no longer applicable to SaaS for non-business use and digital goods

Automatic Data Processing (OH) – ... *providing access by any means to computer equipment for the purpose of processing data...*

Information Services (NY) – *Collecting, compiling or analyzing information of any kind or nature and furnishing reports*

States have challenged online advertisers by classifying their services into distinct taxable categories.

- Oftentimes, services provided by advertisers are considered non-taxable “professional services”, BUT
- Is the customer really buying reports/data (e.g. leads, market information)?
- Tools offered by digital advertisers for accessing an online portal to view advertising campaigns or manage them?

Digital Video

A ubiquitous offering; an enormous tax base:

- 85% of households subscribe to streaming video
- 4.7 services/household with streaming video

Taxability differentiators – Are these different offerings?

- Digital purchase v. digital rental
 - Illinois – Intangible – both not taxable
 - Chicago – Rentals subject to Amusement Tax
 - Florida – Rentals subject to CST
- Download v. streaming
 - West Virginia – Downloaded = product; Streamed = service
- More than half the states and dozens of cities now levy taxes or fees on digital streaming services such as Netflix, Hulu (and many others), aiming to recoup the revenue they lose when people cut the cable cord.
- If you have a Netflix subscription - Company is adding sales taxes to the monthly bill because gaming is being added to their entertainment package in certain states (e.g. NY)
 - BUT New York does not tax digital products?



Digital Video – Live Events

Digital Audio-visual works - common definition includes:

A series of related images which, when shown in succession, impart an impression of motion, ... that are transferred electronically ... includes live events.

Exponential increase in attendance for virtual live events such as:

- Streaming concerts
- Exercise classes
- Seminars/trainings

Range of state positions:

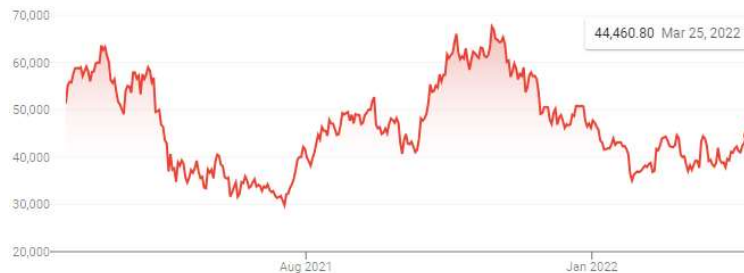
- Look to taxability of non-digital equivalent (WI)
- Potential for interaction with presenter (MN)
- Wait and see (OH) – *Examples of taxable digital products are Netflix, HULU, I-Tunes and e-books.*



Digital Currencies

What is the tax base: Currency value in constant and extreme flux

- Disregard the value of currency; use the FMV of the goods/services (KS)
- Value of currency at the time of the transaction (KY, NJ, WA)



BTC



EUR

Non-Fungible Tokens (NFT Primer)

Fungible (Fən-jə-bəl), *adj.* Commercially interchangeable with other property of the same kind <corn and wheat are fungible goods, whereas land is not>.

Token, *n.* A sign or mark; a tangible evidence of the existence of a fact.

Black's Law Dictionary, 3d ed.

- Ownership is memorialized on a blockchain (typically ETH); usually purchased with Cryptocurrency
- Minted, not mined
- Advantages: ownership verification; ease of transfer

Non-Fungible Tokens

Sales and use tax treatment by tax authorities – An entirely new species or as the underlying asset?

What can be an NFT?

- Pictures; ringtones, tweets, baseball cards, houses.....
- 30 plus states (so far) impose sales tax on digital products, such as movies, music, ringtones, and e-book downloads.
 - Some of these tax statutes may be broad enough to encompass NFTs, if the NFT can be viewed (such as artwork or trading cards) or heard (such as a musical work).

Washington state plans to issue guidance specifying that non-fungible tokens, or NFTs, are subject to the state's sales and business taxes

- Washington will be the first state to express views on the relatively new digital asset
- *“While the tax advisory is being drafted taxpayers should treat NFT transactions as taxable”*

For the sale of a digital asset, the location of the sale is likely to be determined based on the state of residence of the transferee, or the state where the digital asset is stored, used or viewed.

- Companies will need to collect this information even though NFT transfers often occur without noting any information regarding the location of the transferee.

Digital Advertising

Possibly the largest untapped tax base for sales tax – 4/5 largest market cap companies are in this space

First Mover: Maryland (Md. Code Tax-Gen. § 7.5-102)

- First law – passed over Governor’s veto
- Effective 1/1/2022 – Quarterly estimates due Apr. 15, 2022 (which form?)
- “Small” company exemption: \$100m global/\$1m MD
- Legal challenges

Is it a sales tax?

- Imposed on annual gross revenues from MD digital advertising
- Statute prevents passing tax on to customer



Digital Advertising - Issues

Issue 1: Sourcing

- Revenues are determined using an apportionment factor that is based on the location of the on which the ads are viewed
- Location of the device is determined using both technical and nontechnical information in the taxpayer's possession or control:
 - IP address
 - Geolocation data
 - Device registration
 - Cookies
 - Other comparable information
- Throw out non-located devices from the apportionment calc



Digital Advertising - Issues

Issue 2: What is taxable?

[A]dvertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services

Likely Digital Advertising

- Banner ads/Roadblocks/Pop-ups
- Music/video ads
- Search engine results
- Preferential listings in shopping/app store

Comparable Advertising Services?

- Click-thru & affiliate relationships
- Product content (if you're not paying for the product...)
- Membership and matchmaking models
- Podcast sponsorships

Digital Advertising

Other states following suit (2021 proposals):

- New York (SB 1124) –
 - Tax similar to Maryland's on digital advertising
 - Also proposed expanding sales tax base to include digital advertising (SB 302)
- Massachusetts (HB 4179) –
 - Gross receipts tax that uses the sales tax rate: 6.25%
 - Smaller small business exception: Exempts first \$1m of digital advertising revenue
- Indiana (SB 372) –
 - Tax on social media providers; 7% + \$1 per account
 - 1m Indiana account holders and \$1m in digital advertising revenue from Indiana
- Several others

Practical Considerations & Takeaways

- Don't assume classification – Classification of digital offerings often depends on facts & circumstances
 - For example, with NFTs the taxability of the transaction could follow the underlying asset rather than the intangible token on the blockchain, BUT
 - With NFTs the underlying asset can take a variety of forms (e.g. digital images, videos, club memberships, video game characters) and more.
 - States have different approaches concerning what is included in their sales tax base, must carefully analyze what exactly is being sold in an NFT transaction.
- Be proactive – Better to determine taxability via ruling than via audit
 - Review marketplace facilitator rules. If you fall into the net of these rules, you own the tax compliance.
- Don't overlook sourcing – Just as critical as taxability for digital offerings, with shifting methods

Practical Considerations & Takeaways

- Data stewardship – Be audit/refund ready in advance; over-capture data points and learn to manage
- Coordinate – Make sure all aspects of the business are on the same page (i.e., keep an eye on marketing postures)
- Don't forget state sales/use tax exemptions on your purchases
 - Certain materials and equipment purchased or leased to create audio or video productions may qualify for sales tax exemptions.
 - This includes motion picture and video equipment, sound recording equipment and equipment used to create master copies.

Any final questions



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