

Sales Tax Issues for Products and Service Transactions: Taxable and Nontaxable Components, Audit Defense, and Documentation

THURSDAY, MAY 12, 2022, 1:00-2:50 pm Eastern

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Sales Tax Issues for Products and Services Transactions: Taxable and Nontaxable Components, Audit Defense, Documentation

Thursday, May 12, 2022, 10:00 – 11:30 a.m., Pacific Time

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Today's Outline

- I. How to apply sales tax law to bundled transactions that include a mix of taxable and non-taxable products and services.
- II. Descriptions of transactions creating sales tax problems with both taxable and nontaxable components.
- III. Discussion of recent state sales tax legislation and real client examples addressing the issue.
- IV. Offer best practices for tax professionals and multistate businesses to compute the tax due on bundled sales of products and services

Determining the application of sales tax to products and services

Sales Tax Foundation

- General Rules
 - Sales tax applies to the purchase of tangible personal property
 - Sales tax generally does not apply to services
 - Sales tax is not due on the sale of most intangibles
 - Sales tax does apply to legislatively identified services
 - There are always exceptions to the General Rules and exemptions and exclusions from sales tax law
 - Answers aren't always black and white

- Sources to Determine the Correct Application of Law
 - Statutes passed by state legislators.
 - Regulations issued by state tax administrative agencies.
 - Case law decided by federal and state courts and in a state's tax appeal process.
 - Private letter rulings and annotations, and other guidance issued by state and local tax agencies.

Sales Tax Foundation (cont'd.)

- Truths Complicating an Understandable Application of Law
 - Innovations in products sold – What is it?
 - Advances in technology allowing for the combination of services with products purchased
 - State administrators have difficulty understanding innovative new products to determine how to tax.
 - Passing new laws cannot be accomplished quick enough to keep up with new products sold and new procedures to sell products.
 - Lack of uniformity of laws between states and local jurisdictions.
 - Politics make it virtually impossible for the proper development of sound tax policy.
 - Evolution from a manufacturing economy to a services economy reduces sales tax revenues if services aren't taxed to replace revenues lost by reduced sales of manufactured items.

Sales Tax Foundation (cont'd.)

- Product categories when combined in a sale create unclear applications of sales tax law
 - Tangible personal property
 - Services
 - Intangibles
 - Digital goods
 - NFTs

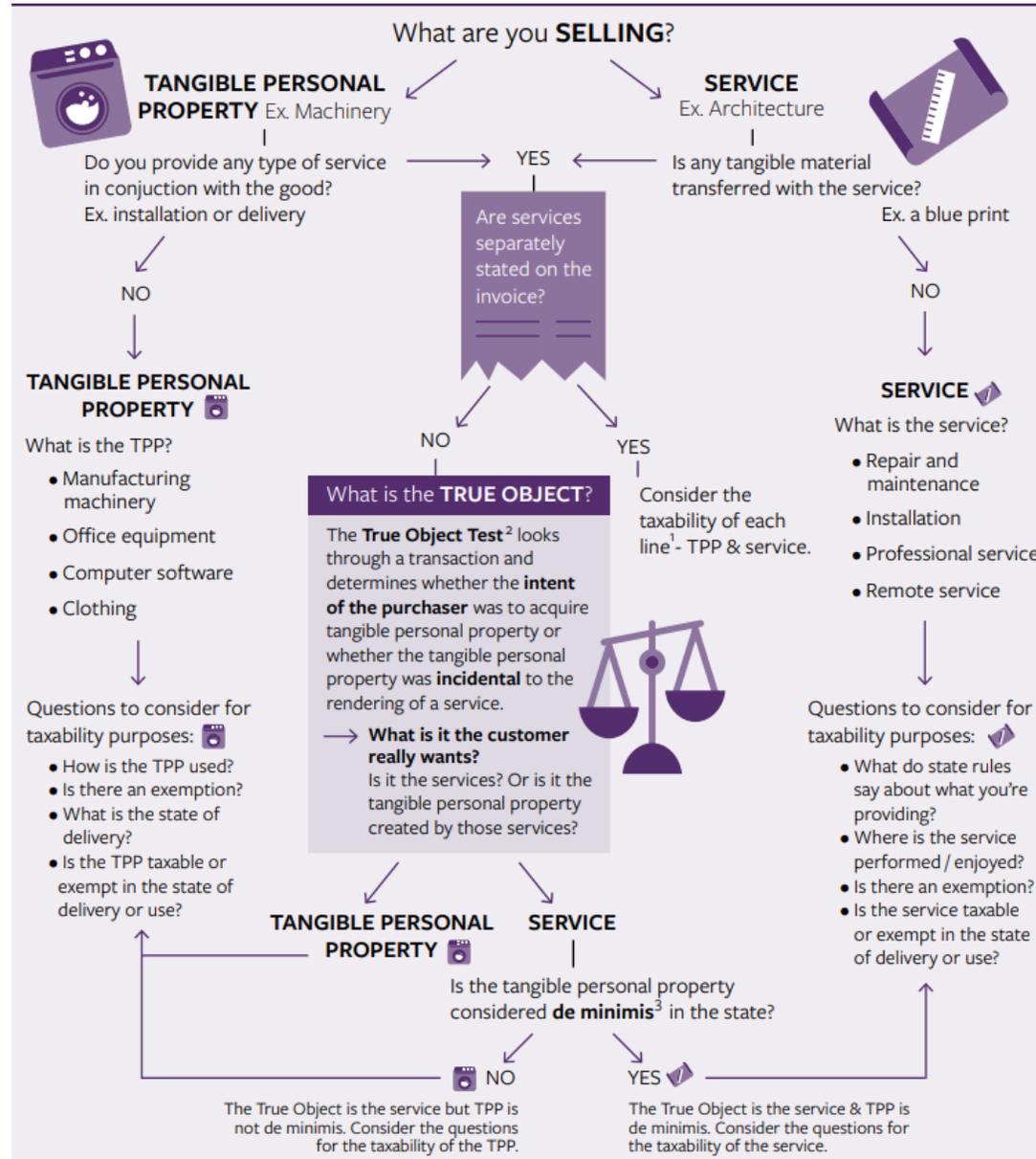
Sales Tax Foundation (cont'd.)

- Taxable base
 - Items exempt by law
 - Seller does not have to show exemption certificate
 - Description of the items sold must be clear
 - Items exempt based on the use of the purchased item
 - Purchaser must provide a valid exemption certificate
 - Items exempt because of who the purchaser is
 - Purchaser must provide a valid exemption certificate
- **Note:** Most states provide general exemption certificates for businesses to download and complete. A few states require businesses to accept state issued exemption certificates. Example: Florida, Tennessee

Transactions of taxable and nontaxable components

True Object Test Decision Diagram - Source: Sales Tax Institute

<https://www.salestaxinstitute.com/resources/true-object-test-decision-diagram>



Bundled Transactions Defined:

- The computation of sales tax due becomes complicated when tangible personal property or taxable intangibles (i.e. SaaS) are sold in a single transaction including a service or tangible personal property exempt from sales tax. If the sales price is not itemized for each item, vendors are reluctant to charge sales tax on 100% of the sales price when they know some of the items bundled as one are not subject to sales tax
- At the core of the complication for sellers is what amount of the purchase price is taxable and what amount is exempt?
- If the sales invoice does not itemize the purchase price, the seller may be forced to collect sales tax on 100% of the invoiced purchase price despite the inclusion of non-taxable services or items exempt from tax.

Bundled Transactions (cont'd.):

- The Streamlined Sales Tax Project for its member states defines a *Bundled Transaction* in Rule 330.1 as:
- A “bundled transaction” is the retail sale of two or more products (including services, digital property, and other products that tax is imposed upon), except real property and services to real property, where:
 1. The products are otherwise distinct and identifiable, and
 2. The products are sold for one non-itemized price.
- A “bundled transaction” does not include the sale of any products in which the “sales price” varies, or is negotiable, based on the selection by the purchaser of the products included in the transaction.

Bundled Transactions (cont'd.)

- A transaction that otherwise meets the definition of a “bundled transaction” is NOT a “bundled transaction” under the following scenarios:

A. *The True Object Test*

1. The “retail sale” of tangible personal property and a service where the tangible personal property is essential to the use of the service, and is provided exclusively in connection with the service, and the *true object* of the transaction is the service; or
2. The “retail sale” of services where one service is provided that is essential to the use or receipt of a second service and the first service is provided exclusively in connection with the second service and the *true object* of the transaction is the second service;
3. In these transactions the *True Object Test* is used to determine taxability of the non-itemized price.

Bundled Transactions (cont'd.)

B. Taxable Product is De Minimis -

A transaction that includes taxable products and nontaxable products and the “purchase price” or “sales price” of the taxable products is de minimis.

1. De minimis means the seller’s “purchase price” or “sales price” of the taxable products is ten percent (10%) or less of the total “purchase price” or “sales price” of the bundled products.
2. Sellers shall use either the “purchase price” or the “sales price” of the products to determine if the taxable products are de minimis. Sellers may not use a combination of the “purchase price” and “sales price” of the products to determine if the taxable products are de minimis.
3. Sellers shall use the full term of a service contract to determine if the taxable products are de minimis;

Note: In these transactions, since the taxable products are de minimis, the sales price is not subject to sales tax.

Bundled Transactions (cont'd.)

C. *Transactions that Include Food, Drugs, Medical Equipment, etc. (50% Test)*

The “retail sale” of exempt tangible personal property and taxable tangible personal property where:

1. The transaction includes only tangible personal property, and at least one product that is: “food and food ingredients”, “drugs”, “durable medical equipment”, “mobility enhancing equipment”, “over-the-counter drugs”, “grooming and hygiene products”, “prosthetic devices” (all as defined in the law) or medical supplies; and
2. The seller's “purchase price” or “sales price” of the taxable tangible personal property is fifty percent (50%) or less of the total “purchase price” or “sales price” of the bundled tangible personal property. Sellers may not use a combination of the “purchase price” and “sales price” of the tangible personal property when making the fifty percent (50%) determination for a transaction.

Note: In these transactions, since more than 50% of the products are not taxable, the sales price is not subject to tax.

Bundled Transactions (cont'd.)

- Bundled transaction that includes: telecommunication service, ancillary service, internet access, or audio or video programming services (SSUTA Section 330)
 - If the price is attributable to products that are taxable and products that are nontaxable, the portion of the price attributable to the nontaxable products may be subject to tax unless the provider can identify by reasonable and verifiable standards such portion from its books and records that are kept in the regular course of business for other purposes, including, but not limited to, non-tax purposes.
 - If the price is attributable to products that are subject to tax at different tax rates, the total price may be treated as attributable to the products subject to tax at the highest tax rate unless the provider can identify by reasonable and verifiable standards the portion of the price attributable to the products subject to tax at the lower rate from its books and records that are kept in the regular course of business for other purposes, including, but not limited to, non-tax purposes.
 - The provisions of this section apply unless otherwise provided by federal law.

Recent state sales tax legislative and policy developments

Missouri Sales tax applies to Wine Club's digital membership fees.

MO LR 8181, January 28, 2022

- Monthly membership fees charged by a liquor retailer for its digital wine club are subject to state sales tax.
- Taxpayer is a retail seller of food, wine, and other liquor. It also offered various memberships, including digital club memberships.
- Taxpayer offered the club memberships to individuals on a monthly basis for a monthly fee
- The monthly fee charged included sales at retail and access to Taxpayer's digital material
- The charge included both taxable and non-taxable items without separating them
 - Because the sales are combined into one monthly fee and not listed separately, the sales tax applies to the fee in its entirety, the department said.

Ohio Supreme Court Clarifies ‘True-object test’

Cincinnati Fed S & L. Co. v. McClaim, Slip Opinion No. 2022-Ohio-725 (Ohio S.Ct. March 15, 2022).

- When different services are bundled in one transaction, the Supreme Court conditioned taxability of the whole transaction based upon its true object.
 - Taxpayer (a bank) entered into an “accounting processing services” agreement with a vendor
 - The services were automated and performed electronically, and included customization of software
 - Taxpayer argued that the purchase is nontaxable accounting services, or nontaxable custom software
 - Board of Tax Appeals said the whole transaction is taxable
 - The account processing service is taxable as data processing services
 - The customization of software is in the “middle” of the custom-prewritten spectrum and should be taxable

Ohio Supreme Court Clarifies 'True-object test' (cont'd.)

- Supreme court's argument:
 - **Account Processing Service.** Affirmed the Board's conclusion that this service is taxable.
 - Rejected the taxpayer's argument that the account processing services is a nontaxable professional service
 - There is no bundled transaction, and thus true-object test did not apply
 - **Customization of software.** Remanded the issue back to the Board to apply the true-object test to determine taxability
 - Is the customization of the software incidental to the account processing services, and thus taxable, or does it stand on its own as a true custom software?

Best Buy Minnesota Tax Court Case.

SAP Retail v. Commissioner of Revenue, 8345-R, (Minnesota Tax Court, 09/19/2013)

- A 2013 MN Tax Court Case. A little old, but a good one. MN Tax Court agreed that software license and consulting service are sold separately, and thus the consulting should not be taxable
 - SAP Retail provided enterprise resource planning (ERP) software to Best Buy
 - The software included modules for sales and distribution, materials management, and production planning, among others
 - The modules are accessed by codes of “transactions”.
 - For example: codes allow the software to perform creation of a sales order or sales invoice
 - The modules rely on a shared data set, and are integrated with one another
 - Because the modules are already integrated, the licensee does not have to do anything to assemble the modules so that they work together

Best Buy MN Case (cont'd.)

- The software is installed on a group of computer servers, known as “environment”
- Specific functionalities within each environment are called “client”
- The development system usually has four or more “clients” or “functionalities”
- These are the sandbox in which configuration settings are made and first tested
- The software has various “configuration” options built into it
 - Can be configured to the specifications of the particular user by selecting from the various options

Best Buy MN Case (cont'd.)

- *Installation vs Implementation*

- Installation of software

- Placing a software in a location from which it can be executed
 - Installation makes the software available for use
 - Setting the application and the software up on the hardware
 - SAP considers its software fully installed once **the user is able to log onto the software or a license key can be entered.**

- Implementation/Configuration

- Determines how the software will be used after it has been installed
 - The software is **configured** to perform the business functions that are necessary to carry out the customer's particular process and business activities
 - Implementation of the SAP software begins with project preparation, during which the scope of the project is defined or refined
 - Customer determines which business or activities the software will address

Best Buy MN Case (cont'd.)

- Implementation (cont'd.)
 - Various modules of the SAP software are configured at different stages (Development Environment, QA Environment, etc.)
 - After the software is tested as fully configured, preparations are made to receive customer data
 - The software as configured is again installed, this time in the Production environment, and begins process of actual data.
- **Sale of SAP software to Best Buy**
 - Non-exclusive, perpetual license to use SAP
 - Best Buy had the option to purchase the software without implementation services
 - SAP agreed to perform consulting and professional services including software installation and implementation.
 - However, SAP did not actually install the software, Accenture did.

Best Buy MN Case (cont'd.)

- At Issue: Whether SAP's configuration services related to the software subject to Minnesota sales tax.
- Department of Revenue argument:
 - ERP implementation is the process of combining different software applications into one cohesive software system.
 - The implementation of SAP's ERP systems includes elements of both installation and fabrication, both of which are taxable
 - Implementation labor consistent with taxable installation charges (M.S. §297A.61 Subd. 3)
 - Installation labor means labor to set an item into position or to connect, adjust or **program** it for use.
 - Arranging preprogrammed modules to form a complete program is taxable labor. MN Regs 8130.9910

Best Buy MN Case (cont'd.)

- Counter argument:
 - SAP's consulting services were **not necessary to complete the license of the software**
 - The professional services contract and the license agreement contracts were separate, and were never negotiated together
 - Implementation service is not enumerated as taxable services
- The court held that the implementation services performed by SAP were not subject to Minnesota tax.
 - Implementation/configuration is not part of installation.

Information Technology Support Services. Colorado PLR-20-008

- Taxpayer provided a “Backup Service”
- As part of the backup service, it delivered servers to the customer’s location.
- Does the placement of the servers constitute a taxable lease of tangible personal property?
- DOR concluded that the true-object of the Backup Service is the sale of the nontaxable computer software
 - The customers own neither the hardware nor the software
 - Only company staff have access to the content on the server
 - Company staff maintain and support the devices

Connecticut. Learning Plans are not Digital Goods.

Ruling No. 2022-2

- Taxpayer offered an online learning platform, and the courses offer streamlined video lessons.
- The learning plans offered access to a live tutor and practice quizzes
- The courses are not downloadable.
- Audio-visual works is an important component, but the true object for the students in taking the courses on the platform is the education or training, and not the sale of digital good.
- CT determined that learning plans are not subject to tax.

New York Tax Appeals Tribunal. Tax Treatment of Gift Cards given with qualifying purchases

- Apple's promotion entitled customers to receive a free gift card with qualifying purchases
- Apple listed the gift card's value as a separate item on the invoice
- It did not charge tax on the gift card

Apple		
Qualifying purchase	\$ 1,000.00	T
Discount	\$ (100.00)	T
BTS Promotion Gift Card	\$ 100.00	NT
Total before tax	\$ 1,000.00	
Tax, @8.875%	\$ 79.88	
Total	\$ 1,079.88	

New York Tax Appeals Tribunal. Tax Treatment of Gift Cards given with qualifying purchases (cont'd.)

- NY said customers received the gift cards for free and therefore should pay sales tax on the full amount of purchase

NY Dept of Taxation & Finance		
Qualifying purchase	\$ 1,000.00	T
BTS Promotion Gift card	\$ 100.00	NT
BTS Promotion Gift card (free)	\$ (100.00)	NT
Total before tax	\$ 1,000.00	
Tax, @8.875%	\$ 88.75	
	\$ 1,088.75	

New York Tax Appeals Tribunal. Tax Treatment of Gift Cards given with qualifying purchases (cont'd.)

- *Apple's position:*
 - It did not owe sales tax on the gift card
 - If it did, the gift card would be taxed again when they were redeemed.
- *Appeals Court:* the language in the promotion's T&C reflects that the qualifying product was purchased, and the gift card was not.
- What appears to be two separate transactions tangled together because of a POS issue, resulted in the taxpayer defending a position that was unintended at the time of the transaction.

Real World Examples of Bundled Transactions

Washington State Appeal

- Taxpayer provided platform for the prevention of cybersecurity attacks.
- Platform facilitated discussions identifying potential cybersecurity attacks.
- Core of Taxpayers' business (the true-object of the sale) is bringing customers and experts together to identify security vulnerabilities.
- Taxpayer charges for platform access, and the charge is more than 10% of total sale.
 - Taxpayer argues their fee is for marketing/business reason. The true cost of the platform is significantly less than 10%.

Washington State Appeal (cont'd.)

- DOR believes the service is a taxable digital automated service, under WAC 458-20-15503 (203)
- Taxpayer argued that the service qualifies as a “**service that requires primarily human effort by the seller**,” under WAC 458-20-15503(303)(a)
- DOR requested that taxpayer provide cost breakdown to support this argument

CDTFA (California) Appeal

- Taxpayer designs and manufactures custom window treatments
- Taxpayer separately billed for the manufacture and design service
- Taxpayer argued design service is not taxable
- CDTFA said the engineering design is part of the manufacturing cost and should be taxable, as fabrication labor.

CDTFA (California) Appeal

- Taxpayer provides on-site equipment repair services.
- Traveling to customer locations is required to provide repair services.
- Taxpayer charged tax on repair parts but not on travel expenses.
- CDTFA assessed tax on a portion of the travel expense, based on the ratio of parts to total charge
 - If you are a retailer of materials furnished for a job, all or part of your related trip charge or service call charge is taxable. CDTFA Publication 62.

Multistate – Assembly Fees

- Taxpayer assembles appliances (such as BBQ grills) at retail store.
- Retail store pays taxpayer on a per unit basis.
- Retail store does not charge its customers for this service.
- Are the assembly services fee taxable?
 - California: Assembly of a customer's new barbecue or new bicycle that is sold unassembled is taxable.
 - Other states: a variety of applications depending on the state.

Best Practices for Bundled Transactions

Best Practices for Bundled Transactions

- Be sure that descriptions on Taxpayer's invoices and contracts are accurate and unambiguous.
- Keep good data that can be produced for audits that may take place more than three or four years after a sale.
- Be careful of what is published on Taxpayer's website and social media that might be contrary to taxpayers' audit positions .
- Do not overlook indemnification opportunities. States are not a party to a taxable sale, but Taxpayers may be able to recover the State's tax assessments from purchasers.

Best Practices for Bundled Transactions

- Unbundle sales of combined property and services, if/when practical.
- Keep cost breakdown on “human element” factor to support a non-taxable service argument.
- Be sure supporting documentation is consistent – invoices, contracts, sample service agreements posted online
- Communicate with customers for consistent descriptions of sales.
 - How does the customer describe the product/service/contract on its PO?

General Sales/Use Tax Risk Practices – Audit Defense

- Maintain and save contemporaneous documentation including, but not limited to:
 - Accurate facts of transactions and legal authorities for positions taken.
 - Correspondence/memos supporting facts of transactions
 - Tax returns as filed and amended.
 - Supporting workpaper documentation.
 - Contracts – documenting the nature of the service or product offer
 - Maintenance for the length of applicable statute of limitations period (generally 3 or 4 years) at a minimum.
 - Note:** Anticipate employee turnover when saving documentation.

General Sales/Use Tax Risk Practices – Audit Defense

- Manage expectations
- Keep a professional relationship with auditor.
- Define “winning” in the context of the particular audit circumstances
- Establish goals
- Develop accurate cost/benefit analysis
- Properly track deadlines so as not to miss one

Questions?

Thank You!