Multistate Tax Update -- December 19, 2013

ALERT | DEC 19, 2013

MASSACHUSETTS: TIME IS RUNNING OUT FOR TECH TAX ABATEMENT CLAIMS

The Massachusetts Department of Revenue (“Department”) is reminding taxpayers that they have until Dec. 31, 2013 to electronically file abatement claims if they reported state sales tax under the recently repealed so-called “tech tax” on computer and software services.

The computer and software services tax was vehemently opposed by the technology industry. Such opposition led to the retroactive repeal of the tax on Sept. 27, 2013. When the tax was repealed, language was included which changed the normal abatement deadlines to give taxpayers until Dec. 31, 2013 to electronically file abatement claims.

The Department has set up a special process to expedite such abatement applications and to refund the taxes to vendors as soon as possible. In turn, vendors must make every reasonable effort to refund the abatement to their customers from whom they collected the tax. No refund will be made until the vendor establishes that the tax has been repaid or credited to the retail customer.

In its **Release**, the Department noted that out of the 252 taxpayers who filed a return and paid the computer and software services tax, 195 have still not filed an abatement application or followed the special procedures to expedite their claims. Taxpayers who reported a tax on computer and software services but did not remit payment of the tax to the Department should file an amended return through the expedited process in order to avoid being assessed.

The Dec.11 Release provides additional guidance regarding the abatement process.

NEW YORK: WHAT CAN WE LEARN FROM THE COMMISSION’S NOVEMBER REPORT ON STATE BUSINESS CREDITS?

“With state business credits, everyone wins.” Some variation of the mantra has been touted by state lawmakers and administrators with increasing frequency since not long after the trough of the recession. While advocates of state tax credits generally have great talking points, do these credits ultimately help the citizens of the state as much as we think?

The New York State Tax Reform and Fairness Commission (the “Commission”) released a 143 page **report** last month titled "New York State Business Tax Credits: Analysis and Evaluation" (the “Report”) that sought to address the usefulness of tax credits and to analyze other aspects of tax credits. New York Governor Andrew M. Cuomo created the Commission roughly a year ago. The Commission is charged with addressing long term changes to the state tax system and helping create economic growth.

The Commission has a resounding New York answer to the question of whether these state tax credits generally help the state – we’re unsure.

The Commission cited the lack of conclusive research in studies conducted since the mid-1950s to show that the use of tax incentives creates net economic gains above and beyond those which would have been attained in the absence of tax incentives. The Commission also concluded that, in general, there is a lack of conclusive evidence that state and local taxes have an impact on business location and expansion decisions. The fact that there appears to be a dearth of evidence that these incentives work suggests that they often result in a zero net sum or, worse, result in a net loss to the state or locality.

Nonetheless, the lack of affirmative proof that these credits really do benefit the states has not slowed the granting of tax credits. In fact, 2013 will prove to be a record year for New York in granting such credits.

In 2013 alone, New York gave an estimated $1.8 billion in tax credits. Compare this figure to the over $600 million the state gave out in 2005. In a word, the growth (roughly 300 percent in eight years) could best be described as astounding. This drive in growth comes in large part to businesses “shopping” for tax credits among various states, causing competitive offers. No state wants to be left out of the prospect of adding additional companies or retaining jobs. As such, for the last several years, states have been willing bidders. This level of willingness to provide tax incentives could even be categorized as exuberance when compared to the tax incentive activities of the past decades.

It was also telling that few businesses actually obtain these tax credits. Only one percent of corporate franchise tax returns, .6 percent of corporations that filed as an S-Corporation, and 1.2 percent of partnership returns claimed one or more tax credits. Of these corporate filers, the average corporate filer claiming any tax credits claimed under $190,000 in tax credits.

As the report states, economic neutrality, equity, adequacy, simplicity, transparency, and competitiveness are all tenants of good tax policy. However, business tax incentives directed at a select few recipients violate all of these tenants. These tax credits also take businesses’ focus off of the creation of economic value and growth, causing businesses to choose activities that they believe will net it a worthwhile tax gain, but not the kind of gains or growth the business would seek in the absence of the credit. Also, these tax credits may provide a credit for activity that would have taken place anyhow. In fairness, the Commission acknowledged that these credits do have a place – in disadvantaged areas and for industries where the state needs to incentivize growth. However, when the government is the driver of economic growth, and not the free market, the economic watchdog becomes the government. This can be a tenuous situation when the government does not properly monitor its activity and development is inadequately incentivized.

What can be learned from this report, assuming it is applicable everywhere? First, business tax incentives are just another race to the bottom among the states. States have frequently provided incentives based on projections that do not materialize. Second, it seems that attractive businesses can obtain significant incentives assuming the business has a good story. Third, many of these tax credits result in little, if any, net gain to the state or locality.

This does not mean that businesses should not pursue these tax credits. To not pursue these credits could leave one business at a competitive disadvantage versus its competitor which has received a valuable incentive. Consequently, it is in your best interest to pursue these credits when it is appropriate provided it does not cause a significant distraction to your operations. Ideally, the successful pursuit of tax credits and/or incentives may allow you to pursue an expansion that might not have otherwise been possible.

When approaching economic development departments for tax credits and/or incentives, it is helpful to work with an advisor who has secured such credits in the past. This way you can present your business and the reasons for which it is seeking a credit in a compelling manner, follow the appropriate procedures in your request, and properly complete forms.

Note: All data referenced in this article is derived from the Report.

MASSACHUSETTS: DEPARTMENT OF REVENUE PROVIDES GUIDANCE ON APPLICATION OF SALES TAX TO CLOUD COMPUTING

Due to the rapid advancements in technology and software-related products, states and sellers are struggling to properly determine whether the sale is considered a sale of software-related products that are taxable sales of pre-written software or a sale of software-related products that are non-taxable sales of services, which may involve incidental use of pre-written software. The Massachusetts Department of Revenue (“Department”) has recently provided updated guidance (LR 12-8) on the application of Massachusetts sales and use tax to cloud computing services in response to a recent letter ruling request.

Background

The company requesting the letter ruling sells “Cloud Computing” products to customers. These products allow customers to access computing resources and storage capacity through the Internet without a significant hardware or software outlay. In order to use such Cloud Computing products, the customers must either: (1) use their own operating system software or open-source operating system software; or (2) use designated third-party operating system software that the company has licensed from a third party. For option two, the software is not downloaded or transferred to the customer and there is no contractual sublicensing of the software to the customer.

The company provides a few bundled pricing options for the Cloud Computing products. There is no specific charge for utilizing the company’s designated third-party software (option two), but the bundled prices for the Cloud Computing products utilizing such software are higher than if the customer utilized its own software or open-source software.

The company also separately sells “Remote Storage Services,” which allow customers to store, retrieve and maintain content, data, applications and software on the company’s servers. Customers purchasing the Remote Storage Services do not use any software provided by the company. Pricing is based on storage capacity and the amount of data uploaded or downloaded.

Determinations

The Department explained that where both non-taxable services and the right to use software are bundled in one transaction, the Commissioner will apply an “object of the transaction” test. If the object of the transaction is the purchase or use of the software, then the transaction is taxable. If the object of the transaction is a non-taxable service, and any use or access to pre-written software is incidental to the service, then the entire transaction will be non-taxable.

The Department determined that sales of Cloud Computing products are non-taxable, even if the customer utilizes the company’s licensed third-party operating software. The Department determined that the object of the transaction is access to the company’s computing resources and storage capacity, and the provision of any third-party operating software is incidental to the transaction because the operating system merely facilitates the customer’s use of the company’s computing resources and storage capacity. However, the Department noted that the company is liable for use tax on the share of the cost of the pre-written operating software that it uses in the provision of the non-taxable services to customers in Massachusetts.

The Department determined that the sale of the Remote Storage Services were also a non-taxable service, even though such services involve the lease of the company’s hardware to store and back-up the customers’ information. In this case, the transaction is non-taxable because the customer does not operate, direct or control the computer hardware.

The Department went on to explain that in general, the sales of cloud computing services and software services are taxable sales of pre-written software, unless: (1) the customer is only acquiring computing resources or storage capacity services as opposed to the right to use the software; or (2) the non-taxable computing resources or storage capacity services are bundled with the provision of pre-written operating software that is incidental to the provision of such services.

Click here to read the entire letter ruling.

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Businesses must be vigilant and careful in managing their state and local tax liabilities and exposures. We understand this can be a daunting task. McDonald Hopkins Multistate Tax Services provides a broad range of state and local tax services including tax controversy, tax evaluation, tax planning, and tax policy. With professionals who have worked both inside and outside government agencies, our multistate tax team leverages its knowledge and experience to help clients control their complex multistate taxes.