Multistate Tax Update -- June 26, 2014

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HOUSE JUDICIARY COMMITTEE PASSES PERMANENT INTERNET TAX BAN

On June 18, 2014, the House Judiciary Committee of the U.S. Congress passed the Permanent Internet Tax Freedom Act bill by a 30 to 4 vote, moving it forward to be considered by the House of Representatives. The Permanent Internet Tax Freedom Act bill seeks to modify the Internet Tax Freedom Act by permanently banning state and local governments from taxing access to the Internet and from imposing multiple or discriminatory taxes on electronic commerce. (See prior Multistate Tax Update articles on **June 12, 2014** and **October 24, 2013**, in which the Illinois courts and legislature dealt with the impact of the Internet Tax Freedom Act on certain tax laws aimed at remote sellers.) Currently, the Internet Tax Freedom Act only places a temporary moratorium on state and local government taxing access to the Internet or imposing multiple or discriminatory taxes on electronic commerce. This ban has been extended three times and is set to expire on Nov. 1, 2014.

The Internet Tax Freedom Act currently allows for a small number of grandfathered states to tax Internet access if they were already imposing an Internet access tax at the time the law was originally enacted. The House's Permanent Internet Tax Freedom Act bill would also remove the grandfather clause in the current legislation, prohibiting those states from continuing to impose an Internet access tax. The affected states are Hawaii, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington, and Wisconsin.

The Permanent Internet Tax Freedom Act was introduced by Republican Rep. Bob Goodlatte. In a **statement** by Rep. Goodlatte concerning the bill, he provided his main reasoning for advocating for a permanent ban in taxing Internet access: "[t]he Internet is a meritocracy...It offers opportunity to anyone willing to invest time and effort. It is the greatest gateway to knowledge and engine for self-improvement that has ever existed. That is precisely why Congress has worked assiduously to keep Internet access tax free." Rep. Goodlatte also justified removing the grandfather clause that allows certain states to tax access to the Internet by explaining that the purpose of the grandfather clause was to allow those states to modify their tax codes. He noted that these states have had 16 years to change their tax codes.

On the other side of the debate, many Democrats attempted to challenge the bill by backing an amendment proposed by Democratic Rep. John Conyers. The amendment would have simply extended the current law by another four years and allow the states which were given the exception under the current bill to continue to tax Internet access. The House Judiciary Committee defeated this amendment by 12 to 21. Conyer's **argument** supporting the amendment pointed out that the law "may adversely impact State revenues and thereby impede the ability of those States to provide needed services to their residents. Unfortunately, [the bill], if enacted as it is, will result in some States losing millions of dollars in revenue."

Some political pundits think Congress will quickly pass the modified bill before it leaves for a five week summer recess on July 31. However, others believe that since the similar Senate bill, the Internet Tax Freedom Forever Act, has been held up since last year, that the House bill will face a similar fate. Bill passage may also be held up by some legislators who wish to tackle the issues of the ban on Internet access taxes and the ban on discriminatory taxes on electronic commerce in the same law as the issue surrounding states' abilities to tax out-of-state merchants for online sales made to customers within their borders. Currently, the Permanent Internet Tax Freedom Act bill does not address the remote sales tax issue (which has been discussed in several other Multistate Tax Update articles including in **Colorado** and **Illinois** and in articles about the **Marketplace Fairness Act**).

However, it is clear if Congress does nothing, then the ban will expire and state and local governments would be permitted to pass laws imposing Internet access taxes and may be able to impose certain discriminatory taxes on electronic commerce (subject to the risk of various Constitutional challenges against inter-state discrimination). The Multistate Tax Update will keep you updated about the status of the Internet Tax Freedom Act.

KENTUCKY: GOVERNOR SIGNS SMALL BUSINESS TAX CREDIT LAW

Kentucky Gov. Beshear signed **H.B. 301**, a law designed to help make it easier for Kentucky small businesses to receive nonrefundable tax credits from the Small Business Tax Credit Program (the Program). Some of the main changes are measuring new job positions in a more flexible manner. The time at which a new job position is measured from is no longer measured by comparing Dec. 31 to the prior Dec. 31. The new law also enables businesses to use averages in terms of hourly wages and hours given to new employees instead of meeting the minimum standards uniformly throughout the measurement period. As such, more small businesses should qualify for the tax credit.

Under the Program, a small business may qualify for up to a $25,000 credit each year. A "small business" under the Program is "any business entity organized for profit...that has fifty (50) or fewer full-time employees at the time it applies." In order to be eligible for the credit under the revised Program, a small business must create and fill one or more eligible positions and invest at least $5,000 in qualifying equipment or technology within a six month period. Further, any eligible position created must be maintained for at least 12 months, provide an average wage of no less than 150 percent of the federal minimum wage, and provide an average of at least 35 weekly hours to the employee. In addition, any unused credits may be carried forward for up to five years. However, as noted above, the credit is nonrefundable.

After signing the bill, Gov. Beshear touted the merits of the law and economic progress in Kentucky in a **release** from his office. "Entrepreneurship is at an all-time high in Kentucky, and we need to support these companies every step of the way," said Gov. Beshear. "This new law will provide a much-needed financial boost to small businesses as they grow their ideas and create more jobs."

ILLINOIS PROVIDES GUIDANCE ON CHARACTERIZATION AND SOURCING OF CLOUD COMPUTING RECEIPTS FOR SALES FACTOR APPORTIONMENT PURPOSES

On April 24, 2014, the Illinois Department of Revenue (the Department) replied to a request for a **Private Letter Ruling** requesting a ruling that the taxpayer's (Company's) "dedicated hosting, cloud computing and remote customer support are services for Illinois sales factor apportionment purposes and should be sourced to its customers' billing addresses." The Company is incorporated outside of Illinois, but maintains several data sites around the world, including one in Illinois.

Characterization as service contracts for apportionment purposes

Illinois uses sales factor apportionment rules to determine the amount of nonresident business income that is subject to taxes in Illinois where income is derived from Illinois and other states. Illinois law includes various rules for determining when income received from sales is sourced to Illinois. Sales from leases of tangible personal property are sourced to Illinois if the leased property is located in Illinois during the lease period. However, sales of services are sourced to Illinois if the services are received within the state. Therefore, in order to determine the proper applicable sourcing rules, the Department had to determine whether the Company's contracts were service contracts or leases.

In the ruling, the Department used the following six factors from the Internal Revenue Code Section 7701(e), and reviewed case law, to distinguish whether a contract is for services or should be treated as a lease of property:

1. Whether the customer physically possesses the property;
2. Whether the customer controls the property;
3. Whether the customer has significant economic and possessory interests in the property;
4. Whether the service provider bears any risk of substantially diminished receipts or substantially increased expenditures as a result of nonperformance of the contract;
5. Whether the service provider uses the property concurrently to provide significant services to entities unrelated to the customer in question; and
6. Whether the total contract price exceeds the rental value of the property during the contract period.

After a thorough analysis of these factors, the Department concluded that a Company's contracts are services contracts. The Department's determination was based on an analysis of the Company's contracts, which showed, among other things, the following:

- The Company's customers do not physically posses or control the Company's hardware and software;
- The Company is responsible for all of the costs of the data center, including repairs and replacements;
- The Company must credit the customer's account a certain percentage of the customer's fee if the data center network is unavailable at any time;
- The software is accessed concurrently by unrelated customers; and
- The Company provides support services in addition to the customer's use of the servers and software.

Determining when services are received in Illinois

After finding that the Company's contracts are services contracts, the Department determined that receipts from the sale of those services would be sourced to Illinois if such services are received by the customer in Illinois, pursuant to the provisions of IITA Section 304(a)(3)(C-5)(iv). This law also provides that if a taxpayer cannot determine in which state its customers are receiving the services, then services are deemed to be received at the location of the office of the customer from which the services were ordered in the ordinary course of the customer's business. If a taxpayer cannot determine where the ordering office of a customer is located, then the services are deemed to be received at the customer's billing address. If a taxpayer is not taxable in the state in which the services are determined to be received, then those sales must be excluded from the numerator and the denominator of the sales factor being used in to apportion the income of the taxpayer to Illinois.

The Company contended, and the Department agreed, that it cannot determine where a customer is physically located at the time it accesses the Company's servers. Therefore, the Department said that under Illinois law, the Company's services are deemed to be received at the location of the office of the customer from which it ordered the services in its regular course of business. The Department further stated that if the Company cannot determine the ordering location, then the services are deemed to be received at the customer's billing address. However, if the Company is not taxable in a state in which the services are deemed to be received, then the Company must exclude the sales from both the numerator and denominator of the sales factor that it uses for apportioning its income to Illinois.

Though not binding on the Department for other taxpayers, this private letter ruling provides helpful guidance for similar cloud computing companies who need to apply the sourcing rules for Illinois income tax apportionment purposes.

For additional information regarding these subjects or any other multistate tax issues, please contact:

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