



## Ohio Business Tax Seminar – June 8, 2022

# Sourcing for Sales Taxes and Income Taxes: Addressing the Quagmire and Issues to Watch

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# Presentation Objectives

- ▶ Discuss the relationship between sourcing and nexus rules
- ▶ Examine strategies for sourcing software sales and related services
  - Background and issues; multiple points of use; planning opportunities
- ▶ Discuss sourcing digital products for sales and use tax purposes under a patchwork of non-uniform state tax laws
  - Issues; best practices; strategies for compliance
- ▶ Updates on sourcing receipts for income and gross receipts taxes
  - Case law; regulations; SUT audit methodology to reconcile with other taxes
- ▶ Examine issues for sourcing receipts from tangible personal property



# Trends and Issues





# Trend Towards Market Based Sourcing

- ▶ General Trend to Market Based Sourcing
  - Purpose to reflect the taxpayer's market
  - Increased globalization and digitization
  - Increasing significance of the service economy
  - Trend towards weighted sales factors for income tax apportionment and more gross receipts taxes
  - Economic development: increased focus on sales factor may benefit companies with in-state property and payroll



# Sourcing Rules and Nexus

- ▶ Trend towards market-based sourcing places increased significance on the question as to whether a business has nexus
  - The hallmarks of income-producing activity/cost of performance sourcing are employees and property that generally create nexus
- ▶ Economic nexus and *South Dakota v. Wayfair*, 138 S.Ct. 2080 (2018)
- ▶ However, the U.S. Supreme Court’s *Wayfair* decision punted on the “undue burdens,” of imposing a tax and it was not resolved when the case was settled – does P.L. 86-272 dealing with mere solicitation have any applicability from a temporary law enacted in 1959 to its continued existence in today’s economy?
- ▶ Should *de minimis* factors require considerations for both direct and indirect taxes (*e.g.*, MTC factor nexus model)?
- ▶ Pre-*Wayfair* Cookie Nexus. See, *e.g.*, *U.S. Auto Parts Network, Inc. v. Comm’r*, Dkt. No. C339523 (Mass. App. Tax Bd., Dec. 7, 2021) (cookies, apps and content distribution networks do not create physical presence and *Wayfair* cannot be applied retroactively – on appeal at Mass. Sup. Judicial Court).



# Sourcing IT Contracts for Sales and Use Taxes





## Sourcing IT Contracts for Sales and Use Tax

- ▶ Generally, sales are sourced to the destination state upon delivery for sales
- ▶ For certain IT contracts, may be appropriate to allocate among the states
  - Including SaaS—Software as a Service
  - Enterprise software
  - Seat licenses and concurrent licenses may be used in multiple states concurrently



## Sourcing IT Contracts for Sales and Use Tax

- ▶ Three different models are used by the states, with variations:
  - Place of first use either actually or per contract
    - Other states would then give credit for tax paid
    - Server/data center or where software users located?
  - Multiple points of use exemption certificate
  - Informal allocation process





## Sourcing IT Contracts for Sales and Use Tax

### **Indiana Dept of State Rev. Letter of Finding No. 04-20191189R, 12/01/2020.**

- The Taxpayer has its headquarters in Indiana with employees throughout the U.S.
- The software was transmitted by the seller to third-party servers outside the state.
- The location of the taxpayer's use of the software was deemed irrelevant as the software was made available to the taxpayer at a location outside of Indiana and it was from that location which the taxpayer “took possession” of the software.



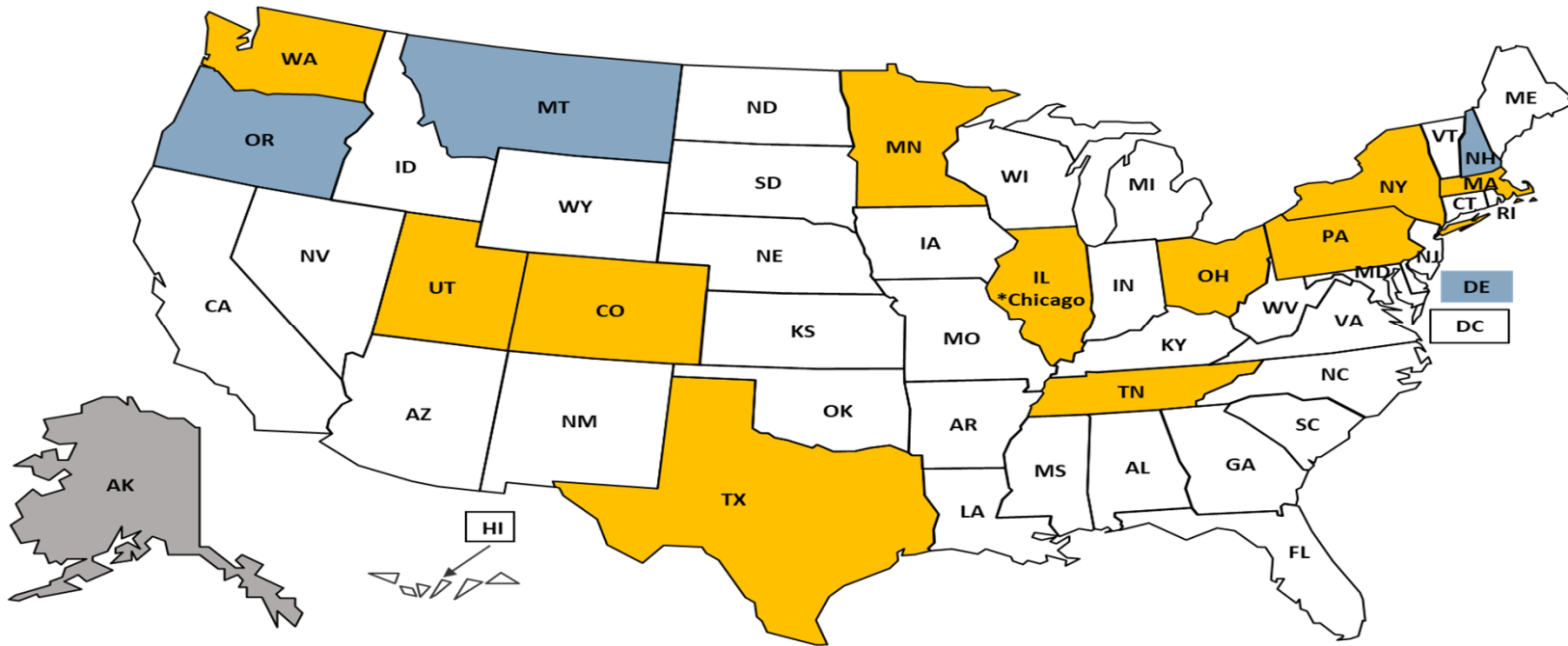
## Sourcing IT Contracts for Sales and Use Tax

- ▶ Some purchasers choose to pay the initial tax and then claim credit
- ▶ Other purchasers, especially in states that recognize multiple points of use (MPU) exemption should consider use of MPU
  - Purchaser gives exemption certificate and then is responsible for paying use tax
- ▶ Several states have a process for sourcing software used in more than jurisdictions to those jurisdictions, per the chart on the next slide



# States Allowing Apportionment of Software

- State with an apportionment process for software used in multiple jurisdictions
- States with no sales tax



Source: COST Preliminary review of states' laws for upcoming 2021 Sales Tax Systems Scorecard



# Ohio Multiple Points of Use Exemption



- Computer software, digital good, or service being used concurrently in multiple locations
- OH R.C. §5739.033(D)(2), use any reasonable but consistent and uniform, method of apportionment
- List shows unique id and location per user. Unique id can be name, email address, associate number or another unique identifier
- Any user id without a location will be assigned to Ohio
- Tax is due based on apportioned amount to each jurisdiction.



## *Oracle USA, Inc. v. Commissioner of Revenue, No. SJC-13013 (May 21, 2021)*

### ► **Facts:**

- The case involved the Business to Business (B-to-B) sale of software.
- Vendors charged sales tax on 100% of sales price of software based on purchaser's billing address. Purchaser informed vendor that most users were outside of Massachusetts; vendors sought refunds.
- The Massachusetts Department of Revenue (DOR) denied the refunds because proof of use location was provided after the sales tax return due date (by means of an abatement application).

### ► **Decision:**

- The Massachusetts Supreme Judicial Court found for the vendors - determining that the DOR did not have authority to deny the right to apportion B-to-B sales of digital software in this instance.
- This case sets an important precedent because the right to apportion B-to-B sales of software (and information services) is under utilized, and the ability to provide "after-the-fact" documentation is critical.



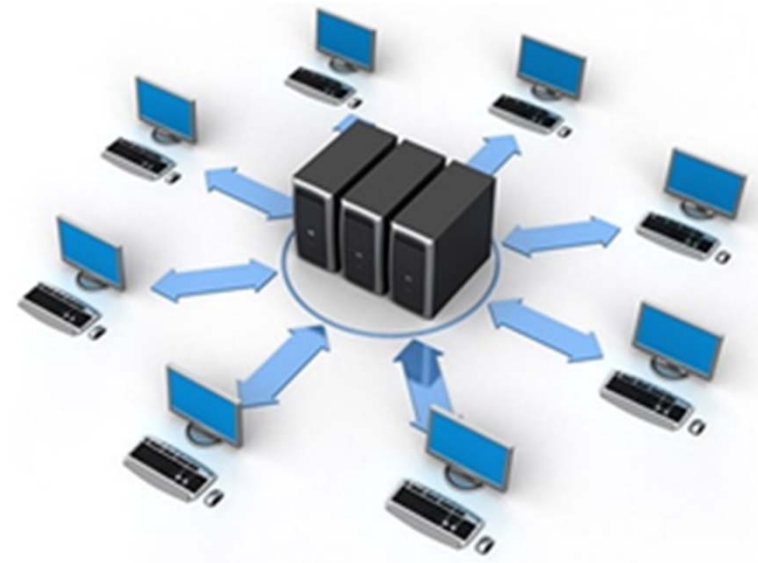
## Sourcing IT Contracts for Sales and Use Tax

- ▶ What of other states when claiming the exemption?
  - Should not be responsible for additional tax for other states that focus only on first use
  - Could be subject to assessment in other states based on concurrent use in the other states
- ▶ If relying on the “first use” of the software, should be mindful of applicable tax rate and unlike the days when software was downloaded, may need to look at contract for determining the “first use” of the software.



# Sourcing IT Contracts for Sales and Use Tax

- ▶ Important to establish sourcing methodology and documentation at the time of contract/sale.
- ▶ When claiming the benefit of MPU exemption, cannot seek refunds in Minnesota.
- ▶ Look for other states to place heavier burden on refunds when not using contemporaneous records.
  - Need to show use at time of purchase and not upon audit.





## Sourcing IT Contracts for Sales and Use Tax

- ▶ State may bore down into records and ensure that the method of allocating is correct.
  - State may demand detail about nature of software and likely users of the software.
  - *E.g.*, state may object to sourcing engineering software across all states in which the purchaser does business when only certain staff would use the software.
  - Use of software by contractors, agents, or subsidiaries vs employees





# Digital Products

- ▶ Digital economy has led to large revenue base erosion for states and localities
  - Digital goods and services are often not captured by state sales tax
- ▶ Attempts to recapture lost revenue in the form of sales tax base expansion or gross receipts taxes
- ▶ States have many non-uniform approaches to how digital products are classified for tax purposes (*e.g.*, service, TPP, specified digital product)
  - See, Natalia Garrett, Grant Nulle, *Digital Goods and Services: How States Define, Tax and Exempt These Items*, Tax Notes State (May 18, 2020); see also, Streamlined Sales and Use Tax Agreement (“SSUTA”), at §§ 332 and 333.
  - Classification may depend upon legislation, administrative code or informal administrative guidance.





# Digital Products

## Sourcing of Digital Products

- While states (and most businesses) want the sourcing location to approximate a customer's location – unlike tangible personal property with a delivery location – digital products are transmitted to devices that are located anywhere in the world
- Where should these issues be addressed: Congress, MTC, SSUTA, NCSL, other organizations?



## Digital Services Taxes (DSTs)

- Digital Advertising (only MD); Personal Data/Information Sharing (proposed); Social Media Provider (proposed)
- Sourcing rules problematic when DST providers do not have location information on customers where income is generated
- Ignoring revenue from a customer when no location is known will likely lead to distortive results – especially with that revenue/income remains in the apportioned tax base



# Sourcing Digital Products

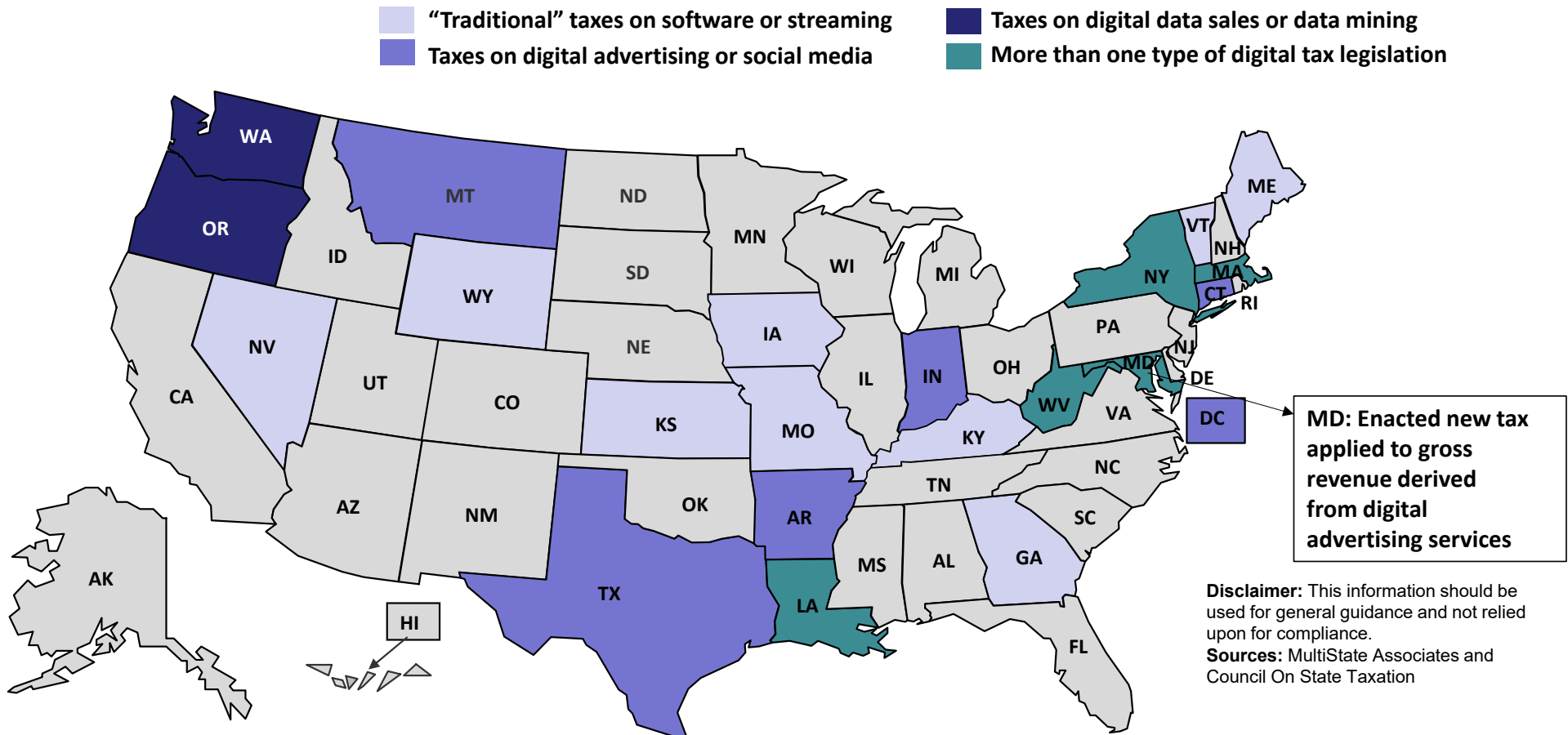
## Sourcing – SSUTA Hierarchy

- Receipt of a product (§ 311 of SSUTA):
  - For tangible personal property it is “taking possession;”
  - For a service it is “first use;”
  - For digital goods it is “taking possession” or making “first use.”
- SSUTA is reviewing sourcing hierarchy rules: SSUTA § 310 (A.1 – over-the-counter; A.2 – delivery address, A.3 – business record, A.4 – billing address, and **A.5 – default to seller’s origin location**).
- Issues with Sourcing of Digital Products:
  - Where is the customer located for sourcing – “delivery address” not needed
  - Privacy concerns with certain digital products
  - Seller may not have any address information – e.g., use of gift cards, crypto currency, credit card with no verification, etc.
  - Some sellers only have 5-digit zip code for credit/debit card verification – local tax issue
  - States and many sellers with address data want to limit sourcing under § 310.A.5





# Tech Tax (Tax on Digital Economy) Proposals



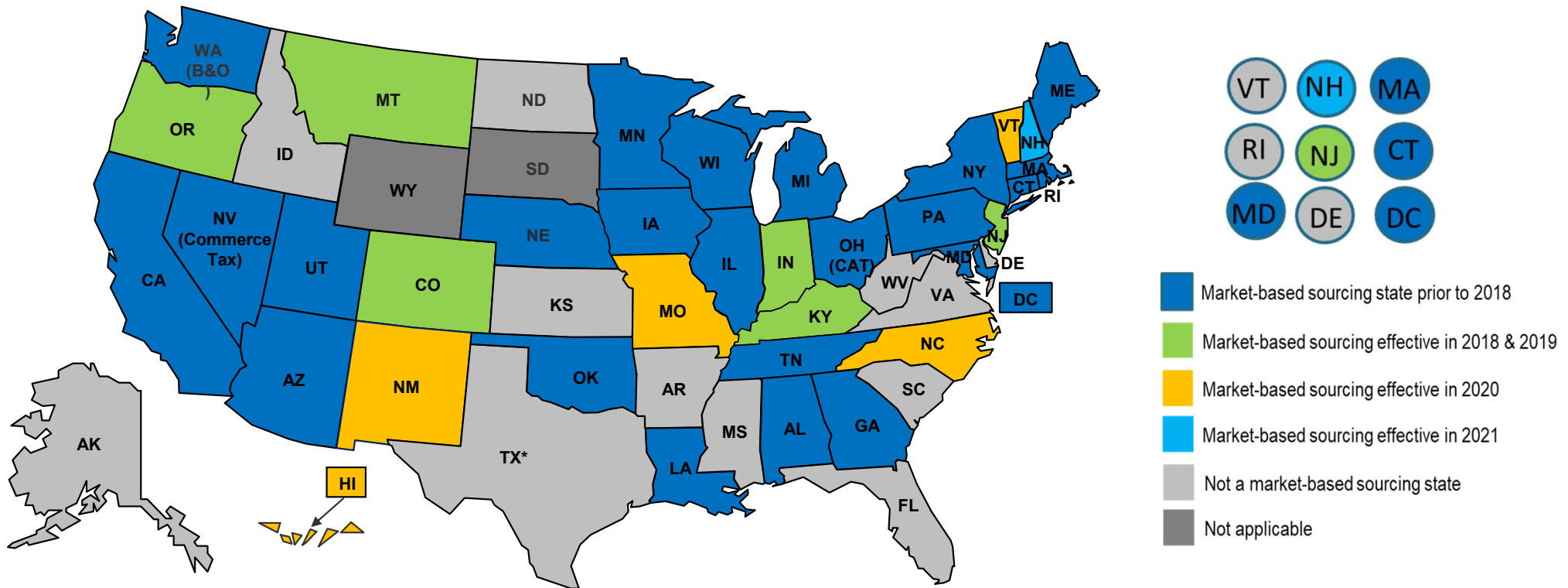


# Sourcing Services for Income Taxes





# Corporate Income Tax – Market-Based Sourcing



\*Receipts from the sale of services are sourced to **Texas** if the service is performed in Texas. If the service is performed both inside and outside of Texas, the receipts are sourced to Texas on the basis of the fair value of services rendered in the state.

**Disclaimer:** This information should be used for general guidance and not relied upon for compliance.



# Sourcing Services for Income Taxes

- ▶ Sourcing services generally
  - Where the benefit is received, not where the service is performed
    - See, *Synthes USA HQ, Inc. v. Commonwealth*, 236 A.3d 1190 (Comm. Ct. PA 2020) (discussing 2014 amendment to corporate net income tax sales receipts factor).
  - Standards are still being developed across the country
  - Some states distinguish between marketing and other activities
    - For marketing activities, look through immediate customer to customer's customer to source the service
    - For non-marketing activities, focus on benefit received by customer
  - Default, especially for larger states, is population in the state compared to nation or nations in which sales are made



## *Hegar v. SiriusXM Radio, Inc.*

- 643 S.W.3d 402 (Tex. 2022)
- SiriusXM provides subscription satellite radio services throughout the United States. Nearly all transmission equipment and production activity was performed outside Texas. Subscription revenue was the primary source of revenue for SiriusXM.
- For Texas franchise tax purposes, SiriusXM sourced its revenue based upon the location where it produced its programming. The Texas Comptroller determined that the services SiriusXM provided were descrambling radio signals at the radio receiver and sourced revenue based upon the location of radio subscribers.
- Refund claim; trial court grants SiriusXM summary judgment and orders refund; on appeal, the intermediate court of appeals reversed and held that the subscription revenue should be sourced based upon where the subscribers received the signals.
- Issue: Are receipts from Texas subscribers from a service performed in Texas?
- Held: Texas Supreme Court holds that service performed for subscribers is producing radio shows and transmitting the radio signal, which is mostly out of state
  - The service that Sirius performs should not be characterized as the decryption of radio signals in Texas; analogy to characterized the Wall Street Journal as a “paywall-removal service”
  - Comptroller may raise evidentiary issue on remand to the court of appeals





## Sourcing – California



- California Rev. & Tax Code 25136 sets forth the basic rules for sourcing sales other than sales of tangible personal property:
  - (1) Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state.
  - (2) Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
  - (3) Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
  - (4) Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.



## Sourcing Services – California



- California has regulations for sales to businesses:
  - Regulations are being used for audits.
  - Create a cascading presumption for services rendered:
    - The first priority is that the location of the benefit of the service shall be presumed to be received in this state to the extent the **contract** between the taxpayer and the taxpayer's customer or the taxpayer's **books and records** kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, shall be presumed to indicate the extent to which the benefit of the service is received in this state.
    - This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.
    - Reasonable Approximation. See also, 830 Mass. Code Regs. Section 63.38.1(9)(d)(4)-(7).
- See 18 Cal. Code Regs. Section 25136-2



## California – Marketing Intangibles



- Many states distinguish between receipts from a “marketing intangible” versus a “nonmarketing intangible.” For example, in California these terms are defined by CCR §25136-2(b)(4)(A)-(B) as:
  - A “marketing intangible” includes, but is not limited to, the license of a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services or other items.
  - A “non-marketing and manufacturing intangible” includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.
- Who is the customer? When is a “look through” approach required?
  - The rules for marketing intangibles generally look to the location of the ultimate customer. See, CCR §25136-2(d)(2)(A).
  - The rules for non-marketing and manufacturing intangibles generally look to the location of direct customer use of the intangible property. See CCR §25136-2(d)(2)(B).



# Income Taxes Compared to Sales/Use Taxes

## ▶ “Look-Through” Issue

- Source to the customer or the customer’s customer?
- Where is the benefit received? Context matters

## ▶ Reasonable Approximation

- Reasonable Approx. based upon U.S. population
- Global business complicates matters; burden of proof

## ▶ Best Practices

- Plan ahead; reasonable, consistent, uniform approach to sourcing; contracts and books/records kept in the ordinary course of business may support sourcing of sales



# Audit Issues





# Audit Methodology

- ▶ States sometimes use reconciliations to income tax as part of their audit methodology. Should they?
- ▶ Also Ohio Commercial Activity Tax; Hawaii General Excise Tax
- ▶ Among different taxes there are differences in the tax base and sourcing methodologies
- ▶ Does it matter if the taxpayer provides requested records or not?
- ▶ Does it matter if the records are voluminous?



## *Lending Tree, LLC v. Dept of Revenue*

460 P.3d 640 (Wash. App. Ct. 2020)

- ▶ LendingTree operated an online marketplace matching consumers with multiple lenders for financial products including loans. Prospective borrowers provided financial information and LendingTree analyzed this data to make referrals to lenders. Lenders pay LendingTree fees related to the referral services.
- ▶ For purposes of the Washington business and occupations (B&O) tax, the Department of Revenue argued that LendingTree should have sourced income from the fee revenue based upon the location of the borrower, not the lender.
- ▶ Washington Court of Appeals held for the taxpayer that the benefit of LendingTree's services was received at the lender's place of business – the taxpayer's direct customer.
- ▶ Washington DOR subsequently issued a directive distinguishing marketing services from non-marketing services. Under the ruling, marketing services sourced to customer reached by marketing.



## *Walter Dorwin Teague Associates, Inc. v. Dept. of Revenue*

2021 WL 5896680 (Wash. Ct. App. Dec. 14, 2021)

- ▶ Teague is headquartered in Washington and provides interior design services to Boeing as a contractor and it argued that its income should be sourced to the location where airlines used its designs rather than Boeing's location in Washington where the airplanes are manufactured
- ▶ On appeal, Court of Appeals focused on where the benefit is received and sources to where Boeing used the interior designs during the manufacturing process in Washington
- ▶ As in Lending Tree, the Washington Court of Appeals did not allow "look-through" sourcing to the customer's customer





## Sourcing Intangibles for Gross Receipts and Income Taxes





## *Defender Security Co. v. McClain*

- ▶ 162 Ohio St.3d 473 (2020)
- ▶ ADT provides security services to property owners throughout the U.S. Defender Security Co. is an authorized dealer of ADT but not an agent. Defender collects new Ohio alarm-services contracts at its Indianapolis headquarters and forwards them to ADT's dealer support unit in Aurora, Colorado for ADT acceptance and assignment or rejection.
- ▶ The gross receipts in question are those that ADT pays to Defender when it accepts the assignment of a customer contract for services provided to Ohio properties.
- ▶ Ohio Supreme Court determines that ADT purchased intangible contract rights from Defender
- ▶ R.C. 5751.033(I) is applicable. This statute sources to where benefit is received with the physical location where the purchaser ultimately uses or receives the benefit being the paramount consideration.



## *Defender Security Co. v. McClain (cont.)*

- ▶ Refund claim; Ohio BTA and Court of Appeals sourced receipts to Ohio because the benefit to ADT occurs at the location where the security services are rendered to Ohio real property
- ▶ Held: On appeal, Ohio Supreme Court reverses and agrees with Defender’s position that “ADT’s physical locations outside Ohio are the places where ADT actually used and received the benefit of [its intangible contract rights.]” \* \* \*

“[W]hat ADT purchased from Defender consisted of intangible contract rights, and the benefit derived from the purchase lay in receiving payments from Ohio customers in consideration for ADT providing the contracted-for monitoring services from its locations outside Ohio.”



## *NASCAR Holdings, Inc. v. McClain*

- ▶ *NASCAR Holdings, Inc., et al. v. McClain* (Apr. 5, 2021), BTA No. 2015-263, on appeal to the Ohio Supreme Court, Sup. Ct. No. 2021-0578.
- ▶ Oral Argument held on Jan. 25, 2022 before the full Ohio Supreme Court; BTA held for the Tax Commissioner; Ohio Chamber of Commerce filed an amicus brief
- ▶ Tax Commissioner used Nielsen ratings data on cable televisions and other information relating to Ohio's proportion of national NASCAR fans to source broadcasting rights.
- ▶ Tax Commissioner sourced license and sponsor fees to Ohio by applying the state's percentage of the national population to the receipts, based on U.S. Census population data.
- ▶ Taxpayer argues that receipts should be sourced to its corporate offices in Florida.



# Sourcing for Tangible Personal Property

- ▶ Ohio Commercial Activity Tax: Ultimate Destination
  - *Greenscapes Home and Garden Products Inv. v. Testa*, 2019-Ohio-384 (Ohio Ct. App. 2019)
  - Provision, for most part, copied from former Corporate Franchise Tax
- ▶ Sales/Use Tax: Place of Delivery (First Use)
  - *Quad Graphics, Inc. v. North Carolina Dept. of Revenue*, 2021 WL 2584282 (Sup. Ct. NC 2021).



## *Greenscapes Home & Garden Products, Inc. v. Testa* 2019-Ohio-384 (Ohio Ct. App. 2019)

- ▶ Did the taxpayer have sufficient connections with Ohio to satisfy Due Process and Commerce Clause requirements under the U.S. Constitution to impose Ohio's Commercial Activity Tax ("CAT")?
- ▶ Greenscapes was a wholesaler that sold tangible personal property to "big-box" retailers. Retailers took title and possession to the products at Greenscapes facility in Calhoun, Georgia and shipped products to Ohio and elsewhere via common carrier or their own trucks.
- ▶ Ohio Tax Commissioner asserted that items the retailers shipped to Ohio were taxable gross receipts to Greenscapes under R.C. 5751.033(E), based on "ultimate destination."
- ▶ The Court of Appeals, applying the four-part test in *Complete Auto*, 430 U.S. 274 (1977), concluded *Complete Auto* overruled *Dilworth*, 322 U.S. 327 (1944), and held that the application of the CAT to Greenscapes did not violate the dormant Commerce Clause or Due Process Clause. Ohio Supreme Court denied appeal, 2019-Ohio-439.



# *Quad Graphics, Inc. v. NC Dep't of Revenue 2021*

WL 2584282 (N.C. Sup. Ct. 2021)

- ▶ Appeal pending before the North Carolina Supreme Court - Was North Carolina's imposition of sales tax a violation of the Commerce Clause?
- ▶ Quad was an out-of-state retailer based in Wisconsin with a sales representative located in North Carolina who solicited customers within the State selling printed materials shipped directly to customers located in North Carolina and printed materials shipped to third-party designees located in North Carolina (direct mail).
- ▶ North Carolina DOR issued an assessment for uncollected sales tax on these transactions consistent with its sales and use tax statutes, N.C. Gen. Stat. §§ 105-164, *et seq.*
- ▶ On appeal, questions presented to the N.C. Supreme Court are whether the sourcing of the sales to Wisconsin was proper under North Carolina state law, whether *Dilworth* formalism has survived recent U.S. Supreme Court precedent, and whether North Carolina's imposition of sales tax as opposed to use tax passes constitutional scrutiny.



## Questions – Speakers Contact Info

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Fred Nicely is Senior Tax Counsel for the Council On State Taxation. Fred's role as Senior Tax Counsel at COST extends to all aspects of the COST mission statement: "to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities."

Before joining COST, Fred served in the Ohio Department of Taxation for four years as Deputy Tax Commissioner over Legal and for the prior seven years as the Department's Chief Counsel. Fred's responsibilities at the Department included testifying before legislative committees, participating as an alternative delegate for Ohio at Streamlined Sales Tax Project meetings, and reviewing legal documents issued by the Department, including deciding the merits of filing an appeal.

He is a frequent speaker and author on Ohio's tax system and on multistate tax issues generally. Fred also has extensive experience in public utility tax law, having served as an administrator of the Department's public utility tax division.

Fred's undergraduate degree in psychology (with a concentration in accounting) is from the Ohio State University. He obtained his MBA and JD from Capital University in Columbus, Ohio.

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Dave additionally serves as a trusted advisor to clients on state and federal tax issues that arise in connection with entity formation, business transactions, estate and succession planning, and tax-exempt entities.

Dave attended The Ohio State University Max M. Fisher College of Business, where he earned his B.S. with honors in Accounting and Finance. He also attended The Ohio State University Moritz College of Law as Moritz Merit Scholar and graduated with honors.