

33rd Annual TEI-SJSU High Tech Tax Institute
November 13, 2017

Indirect Taxes in the Digital Economy

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Changing of the Board

▶ AB 102 and AB 131

- ▶ The Taxpayer Transparency and Fairness Act of 2017.
- ▶ Creates California Department of Tax and Fee Administration (CDTFA) effective July 1, 2017.
- ▶ Transfers all non-constitutional functions of Board of Equalization (SBE) to CDTFA.
- ▶ Property tax, insurance tax and alcoholic beverage tax functions stay with SBE.
- ▶ Hard stop on the SBE's statutory adjudicatory functions on December 31, 2017.
- ▶ Creates Office of Tax Appeals (OTA) to be operational January 1, 2018.

Taxing Sales of Software in CA

General Background

- Unlike many states, California does not tax:
 - Custom software
 - Electronically delivered software
 - “Load-and-leave” delivered software
 - Software as a Service
- SBE’s *Intel* Memorandum Opinion and Technology Transfer Agreements (TTAs)

Technology Transfer Agreements

Codification of the *Intel* Decision

- ❖ AB 103 (Quackenbush) added TTA provisions to the definitions of “sales price” and “gross receipts”
- ❖ Cal. Rev. & Tax. Code, §§ 6011(c)(10), 6012(c)(10)
- ❖ TTA definition: “Any agreement under which a person who **holds** a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to **use a process** that is subject to the patent or copyright interest.”
- ❖ Statutory exclusion from “sales price” and “gross receipts” (cascading as follows):
 - ❖ (A) “The amount charged for intangible personal property transferred with tangible personal property in any technology transfer agreement, **if** the technology transfer agreement **separately states** a reasonable price for the tangible personal property.”

If Not Separately Stated ...

- ▶ (B) If a seller has sold or leased or offered for sale or lease the **same or similar TPP** to third parties at a separately stated price, this price shall be used to establish the retail fair market value of the TPP subject to tax under the TTA.
- ▶ (C) If neither of the above methodologies are feasible, the price of the TPP under the TTA shall be deemed to be equal to **200% of the cost of the materials and labor** used to produce the TPP (i.e., 100% markup).

Preston v. SBE (2001) 25 Cal.4th 197

- A professional artist entered into written agreements to provide copyrighted artwork for use as book illustrations and rubber stamp designs.
- Excluded intangible copyrights from taxation when transferred to someone who made and sold a product embodying the copyright.
- TTAs are not subject to the “all-or-nothing” rule (which focused on “physical usefulness”) that courts applied to determine the taxability of combined sales of tangible and intangible personal property: For TTAs, the TPP is subject to tax and the intangible personal property is not.
- TTAs are not limited to “high technology” transfers (i.e., transfers of patent **and** copyright interests).
- TTA exemption applies to **any** transfer of patent **or** copyright interests.
- Led to the promulgation of Sales and Use Tax Regulation 1507 in 2002.

Nortel Networks, Inc. v. SBE (2011)

191 Cal.App.4th 1259

- ▶ Sale of hardware and licenses of software (including prewritten) to operate telephone switching equipment.
- ▶ “Process” includes prewritten software.
- ▶ TTA need not expressly reference patent or copyright interest.
- ▶ Referred to software as “intangible information.”
- ▶ Invalidated the following sentence from Regulation 1507(a)(1):
 - ▶ “A technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing*.”

Lucent Technologies, Inc. v. SBE (2015)

241 Cal.App.4th 19

- ▶ If at first you don't succeed...
- ▶ Court reaffirms *Nortel*, holding:
 - ▶ (1) transfer of software via magnetic tapes does not turn software (or rights to use it) into TPP;
 - ▶ (2) a TTA includes intangible right to copy software; and
 - ▶ (3) at a minimum, "subject to" includes products that are (or incorporate) licensed copies or are made using patented processes.
- ▶ Retail fair market value of the TPP was established by separately stated price for similar sales of blank storage media.

Post-*Lucent* Issues

- ▶ Rulemaking at CDTFA has not yet formally commenced.
- ▶ At an informational legislative hearing in January 2017, SBE (now CDTFA) staff testified that in their view:
 - ▶ Tax hinges on whether the storage media is “physically useful” to the subsequent use of the assigned or licensed patent or copyright interests in the programs; if it is, then the programs stored on the media should be treated as TPP for purposes of the TTA statutory attribution of sales price or gross receipts to the TTP.
 - ▶ *Lucent* and *Nortel* do not apply to non-TTA transactions, where Section 6016, Regulation 1502, *Navistar*, and *Touche Ross* remain California law.
 - ▶ Embedded software, pre-loaded software, and essential storage media (such as some game cartridges and dongles) satisfy the physical usefulness test.

Post-*Lucent* Issues

(Continued)

- ▶ Embedded and pre-loaded software fact patterns?
- ▶ TTAs as mixed vs. bundled transactions?
- ▶ What is the proper definition of “holder”?
- ▶ Interested parties process in early 2018?



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- Efforts to Overturn *Quill*
- Efforts to Circumvent *Quill*
- Click-Through Nexus
- Taxation of Marketplace Service Providers
- Taxation of Services (including e-commerce services)
- Income Taxes – Market Sourcing Rules
- Gross Receipts Taxes
- Questions

- Marketplace Fairness Act and Similar Legislation
- Application of Income Tax “Economic Nexus” theory (Alabama, South Dakota (Wayfair litigation))
- No Regulation Without Representation Act (“NRRA”) seeks to Codify *Quill*

- Colorado Approach
 - Compel sellers to identify purchasing customers and amounts purchased
- Massachusetts Approach
 - “Cookie” Nexus
- Iowa (KFC)
 - “Functional equivalent of physical presence”

- First statute was adopted by New York in 2008
- State response to e-commerce referrals
- Nexus-creating activities include links to vendor websites
- Treats electronic solicitation from within a state as the virtual equivalent of in-person solicitation (*Scripto* and *Tyler Pipe*)
- Legislation has been adopted in 20+ states

■ Strategies for Dealing with Click-Through Nexus Provisions

If you are an “affiliate marketer”

- Try to limit overly broad indemnities and conditions
- Example. Resist (if possible) provisions prohibiting “employees in State X.” (this restriction is not consistent with *Tyler Pipe*)
- Restrict and be able to distinguish “in-state” activities from out-of-state

If you are a seller

- Identify rebuttable presumption and irrebuttable presumption states
- Determine if the provision only applies to “commission or other consideration for the completed sale of TPP.”
- Based on these considerations, strike a balance between nexus protections without unduly inhibiting market making activities (e.g., CPC (“cost per click”) v. CPA (“cost per action”) arrangements), language of nexus certification, etc.
- Add appropriate indemnities

- States focused on non-sellers “connected” with a transaction (form of *Quill* circumvention)
- Legislation adopted in Minnesota and Washington
- South Carolina assessment of Amazon directly
- Amnesty previously offered to FBA sellers
- Carefully analyze statutes to identify permitted activities

- Traditional imposition of sales and use tax on tangible personal property
- Expansion of tax base to services because of changing economy
- Taxable services are enumerated in most states
- Some states tax all services unless specifically excluded (NM, HI, WV and SD)
- Services that are “part of the sale of TPP” have always been taxable

- Particular problems for e-commerce service transactions
 - Multiple points of use, exemption documentation
 - Sales for resale v. consumption
 - Document resale transactions appropriately
 - Obtain resale certificates from customers
 - Draft agreements to support resale position (e.g., product to be delivered directly to purchaser's customer, "this product will be incorporated into purchaser's final product," etc.)
- Separately state non-taxable services on customer invoices where feasible

- Switch from costs of performance to market
- COP method creates a disincentive for in-state expansion
- When is COP really market? Texas rulings 201604750L and 201703005L
- “Look through” for certain sales to location of purchaser’s customer (i.e., market is the ultimate consumer market)

- Washington B&O Tax, Texas Franchise (Margin) Tax
- Method of taxing all businesses, not just profitable companies
- Potential “pyramiding of tax”
- Problems for advances and reimbursements because of no deductions
- Particularly problematic for some e-commerce businesses (e.g., event tickets) with respect to identifying the business’ gross receipts

TEI-SJUSU HIGH TECH TAX INSTITUTE (33RD ANNUAL) INDIRECT TAXES IN THE DIGITAL ECONOMY

Birgit Jürgensmann

Palo Alto, November 13 & 14, 2017



 **MAZARS**

Roever Broenner Susat Mazars

AGENDA

EUROPEAN VAT DEVELOPMENTS

1. Legal Framework of the European VAT System

- European Level
- National Legal Environment
- Jurisdiction

2. Systematic of the European VAT Scheme

- Overview
- Place of Supply Rules
- VAT Registration / Reverse Charge / Input VAT Refund

3. Action Plan of European Commission

4. Excerpt of Relevant Business Models

5. Attitudes of European Tax Authorities

6. Discussions & Questions



1. LEGAL FRAMEWORK OF THE EUROPEAN VAT SYSTEM

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European Level

- VAT Directive
- Council Implementing Regulation (282/2011)
- Cross-border input VAT refund procedure (2008/9/EG)
- Union Customs Code 952/2013 (May 1st 2016)
- Customs Delegated Regulation (EU) 2015/2446
- Customs Implementing Regulation (EU) 2015/2447

National Legal Environment

- Per 28 member states, e. g. Germany:
 - German VAT Code (UStG)
 - VAT Guidelines (UStAE)
 - VAT Implementing Ordinance (UStDV)

Jurisdiction

- European Court of Justice (ECJ)
- Local Courts of Member States, e. g. German Fiscal Court / Federal Tax Court (BFH)



2. SYSTEMATIC OF THE EUROPEAN VAT SCHEME

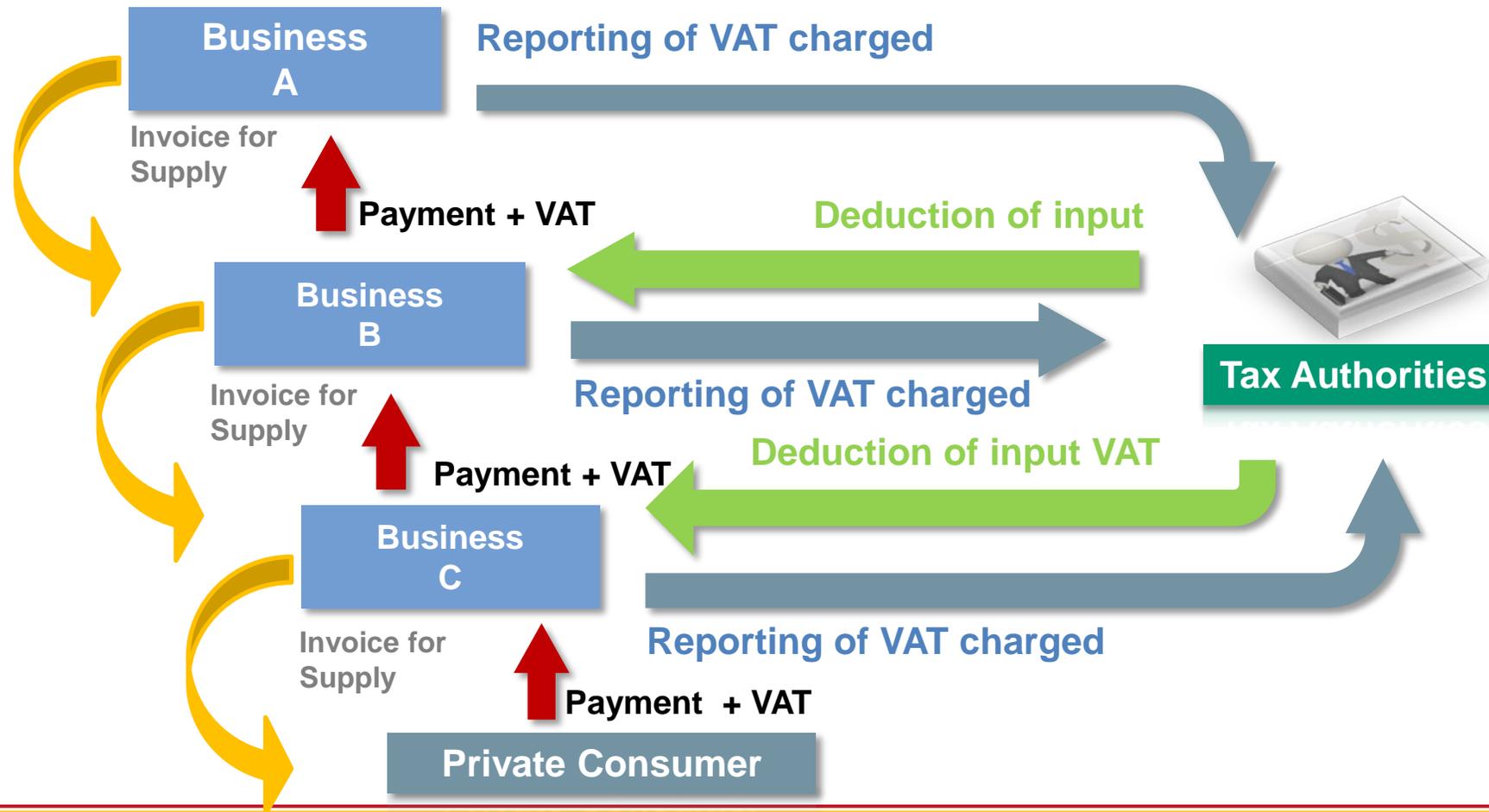
2. SYSTEMATIC OF THE EUROPEAN VAT SCHEME

OVERVIEW (1)

- Within the European Union, the following transactions are subject to VAT:
 - the **supply of goods** by a taxable person within the territory of an EU-Member State
 - The **importation of goods** from outside the EU
 - **Intra-community acquisitions** of goods in an EU-Member State, whereby goods are transported from one EU-Member State to another
 - the **supply of services** if the recipient is established within the EU
 - **Deemed supply of goods / services**
- Ultimately, **VAT is borne by the final consumer** in the form of a percentage added to the final selling price of the goods or services
- The **supplier** (the business identified for VAT) **pays the VAT** due on the supply of goods or services to the local tax authorities after deducting the VAT incurred from purchases at its suppliers

Also of relevance for digital economy!

2. SYSTEMATIC OF THE EUROPEAN VAT SCHEME OVERVIEW (2)



2. SYSTEMATIC OF THE EUROPEAN VAT SCHEME

PLACE OF SUPPLY RULES

- Place (country) where the transaction is subject to VAT
- Different 'place of supply rules' for services and supplies of goods
- For **supplies of goods**:
 - Country where supply has been carried out (statutory supplies)
 - Country where transportation begins (moveable supplies)
- For **supplies of services**:
 - place (country) where **a service is treated as being supplied**
 - B2B supplies are usually subject to VAT in the country where the customer is established
 - B2C supplies are, in general, subject to VAT in the country where the supplier has its place of establishment
 - B2C services relating to cultural, artistic, sporting, scientific, educational, entertainment and similar activities → subject to VAT in the country where these activities actually take place
 - B2C electronically supplied services → subject to VAT in the country where the customer has a permanent address or is resident

2. SYSTEMATIC OF THE EUROPEAN VAT SCHEME

VAT REGISTRATION / REVERSE CHARGE / INPUT VAT REFUND

- VAT registration or Fiscal Representative ?
- VAT registration does generally not result in any CIT obligations and does not require any legal vehicle / Permanent Establishment
- General Rule: VAT registration before starting with the proposed business activities; however: retrospective VAT registration in several countries possible without penalization
- (Mini) One Stop Shop - Registration
- Reporting obligations in the registration countries; input VAT deduction via 'normal' VAT return filing procedure
- Reverse-charge-mechanism for supplies of goods not in all EU-countries implemented



3. ACTION PLAN OF EUROPEAN COMMISSION

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- On **7 April 2016**, EU commission started initiative to amend the European VAT System fundamentally ('Action Plan')
- As an outcome, on **4 October 2017** EU commission published suggestions for amendments ('follow up to action plan'):
 - Supplies are VAT able in the country of destination; no longer VAT exempt supplies of goods
 - VAT registration of the supplier in the country where he is located - OSS (One-Stop-Shop)
 - Implementation of 'Certified Tax Payer' – with simplifications in case the certificate will be granted
 - Harmonized rules for consignment stocks, VAT Id No. as proof for VAT exemption, binding guidance in case of chain transactions, unified proof in case of intra-community supplies of goods
 - Supplies of services: taxation where the recipient is located; reverse charge rule shall be replaced by OSS
- Principle of unanimity in the EU / Considerations of OECD



4. EXCERPT OF RELEVANT BUSINESS MODELS

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- App developer and VAT aspects in the EU
- Supplies of goods via market places
- Tax Machines
- Cloud computing and European VAT aspects



5. ATTITUDES OF EUROPEAN TAX AUTHORITIES

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- International cross-border communication works quite well
- Working groups established at tax authorities in order to identify businesses from third countries (also with a focus on the US) acting in the digital economy
- European tax authorities approach identified companies directly and ask for proofs stating that they are registered for VAT in the European Union
- Tax fraud investigations against Management / Penalties
- **In contrast** the viewpoint of the businesses: “We do not provide any services – there is no need to care about!”



6. DISCUSSION & QUESTIONS