SALT Considerations for the Technology Industry

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In this installment of Taking SALT for Granted, the authors explore opportunities for businesses in the technology industry to consider when thinking about their state tax footprints.

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Technology has driven tremendous change in how we do business, and these changes have resulted in interesting and increasingly complex state tax implications. State tax law and associated guidance, often developed when a brick-and-mortar, goods-oriented economy was the norm, is frequently insufficient to address technological advances. This leaves many of us wondering how antiquated rules are supposed to apply to our modern economy. At the same time, an ironic issue to consider is whether the technology that has made application of state tax law so difficult can itself be applied to support favorable tax positions, gain efficiencies within an organization, reduce tax exposures, or obtain various other benefits. In this article, we explore opportunities for businesses in the technology industry to consider when thinking about their state tax footprints.

Apportionment Sourcing, but Where To?

One of the most important state income tax considerations for businesses with multistate reach is how to apportion income among jurisdictions. Most state income tax calculations start with federal taxable income. State-specific modifications to the federal income tax base are made and then an apportionment formula is applied to determine state taxable income. This formula compares in-state activity with everywhere activity and has evolved over time, historically using a standard three-factor (property, payroll, and sales) formula, with most states now following a single sales factor.

Even though the property and payroll factors are not as common as they once were, automation within the technology industry could have a significant effect in the states where these factors are still considered. As roles requiring employees to perform repetitive tasks are replaced with robotics or other automated functions, a company's payroll factor could decrease while the property factor increases based on this shift in activity, which may not always take place in the same state. Modeling the effect of expanding or changing operational

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practices in a state allows taxpayers to make an informed decision on whether the push to automate is favorable from a tax perspective.

The reliance on the sales factor to apportion income creates several opportunities and issues for taxpayers to consider. The first step in analyzing the construction of the sales factor is to properly categorize each revenue stream. Revenue characterization determines which method of sourcing a state will apply, and they are often different depending on the type of revenue. This is particularly challenging within the technology industry because companies often have many different types of revenue that do not intuitively fall into one category. A prime example relates to how revenue generated from software-as-a-service (SaaS) offerings should be categorized. This could be viewed as service revenue, the sale of a tangible product, or the licensing of an intangible, depending on a state's statutes, regulations, and interpretive guidance, and how sales contracts are structured. This determination dictates which sourcing rules apply.

Pennsylvania's recent legislation can be viewed as an instructive case study for apportionment approaches and highlights how critical it is to characterize revenue correctly when taxpayers analyze their apportionment factor computations. For tax years beginning before January 1, 2023, Pennsylvania followed market-based sourcing rules for sales of services, but a cost-of-performance approach for sales of intangible property.

Sales of services are sourced to Pennsylvania if "the service is delivered to a location in this State."[1] In contrast, sales of intangibles were sourced to Pennsylvania if "the income-producing activity is performed in this State."[2] Taxpayers generally viewed this approach to require the sourcing of revenue from intangibles to the location where direct costs are incurred or development takes place. In contrast, the Pennsylvania Department of Revenue generally took the position that the location of the income-producing activity occurred where the intangible property was used, which led to significant disputes at the audit level. Ultimately, in July 2022, Pennsylvania adopted new sourcing rules for the receipts from sales of intangible property applicable to tax years beginning on and after January 1, 2023.[3] Under this legislation, the sourcing of revenue from intangible property now depends on a variety of factors that look to source this type of revenue to the state to the extent the property is used in Pennsylvania, which is more in line (though not completely consistent) with the state's method for sourcing sales of services.

The difference between the old and new sourcing rules used for intangibles versus services in Pennsylvania could bring massive differences to a taxpayer's sales factor calculation and could do so in an inconsistent manner from taxpayer to taxpayer depending on the location of operations and where these items are used or delivered. In any event, determining the place of delivery, or use, of a service or intangible, may require significant consideration of the facts and circumstances surrounding the item being sold and the operations of the overall business. The use of technology to automate aspects of delivery exacerbates this challenge because it can often be difficult to pinpoint where such automation or digital delivery occurs.

After properly characterizing each revenue stream, taxpayers must consider the ultimate sourcing determination and the data that is used in sourcing activity between jurisdictions. Market-based sourcing of sales from items other than tangible personal property, like the single sales factor, has become predominant among the states. Despite state tax law requiring a particular market-based sourcing method to be used (such as delivery location or the location of customer benefit), taxpayers sometimes default to using a billing address because this data point is generally easy to access and summarize within their books and records. However, this may not comport with the state's preferred sourcing determination. Also, in states using the location of customer benefit concept, it is increasingly

[1] 72 Pa. Stat. section 7401(3)(2)(a)(16.1)(C).

[2] 72 Pa. Stat. section 7401(3)(2)(a)(17) (repealed).

[3] Act 53 (Pa. H.B. 1342), Laws 2022.

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common for states to question who the ultimate beneficiary of a transaction is depending on the type of transaction, requiring taxpayers to explore whether their customer or their customer's customer is the true beneficiary of the transaction.

While considering these many factors, states often view technology companies as having all relevant data at their fingertips when audit inquiries are opened. Practically speaking, this is not always accurate, and obtaining the support necessary to withstand an audit is particularly complex when it requires looking through to the location of benefit for a taxpayer's customer's customer. In the case of digitally delivered goods and services, especially those delivered to a third party on behalf of the customer, determining the appropriate sourcing for the transaction can be particularly challenging and is often an area of dispute between taxpayers and the tax authorities. This leaves technology companies either unable to satisfy an auditor's request on this issue, or having to invest significant time and resources to pull data that the state assumes is easily accessible.

Ultimately, if requested data cannot be provided, states sometimes fall back on a method of sourcing called "reasonable approximation," which they can interpret in a number of ways. Depending on the type of transaction, we have seen state tax authorities try to apply a variety of methods to "reasonably" approximate the benefit of digitally delivered goods and services. This application is often done through the use of raw or weighted population data designed to reflect what the state tax authority perceives to be a reasonable marketplace measure. These approaches could substantially inflate the sales factor percentage in some states, and exploring what data alternatives are available to more equitably source revenue among the states could be a worthwhile exercise. In the event of a controversy, determining whether the taxpayer's method or the tax authority's method is the most "reasonable" often places the burden of proof on the taxpayer, which can be time-intensive and costly.

If states are going to assume data is available, why not explore what data alternatives exist to support tax positions and consider how that data can be easily demonstrated on audit? By using artificial intelligence or other automation tools there might be a better, more efficient way to approach apportionment sourcing. Using third-party software solutions that can link directly to an enterprise resource planning system can also automate apportionment factor calculations. This type of solution can often be linked with Power BI or other platforms to display dashboards or other visuals that are easier for auditors to digest, which can be a powerful tool when demonstrating the validity of a filing position on audit.

A New Type of 'Cookie' Monster

Public Law 86-272 is a 1959 federal law prohibiting a state from imposing tax on the net income of a business if the only income derived within the state is from the sale of tangible personal property and its business activities within the state are limited to sales solicitation and other de minimis activities.[4] This protection applies only if orders are sent outside the state and, if accepted, are fulfilled by shipment or delivery from outside the state.

In August 2021 the Multistate Tax Commission issued a revised statement of information that provided guidance on what constitutes protected and unprotected activities conducted over the internet. Given advancements in how business is conducted over the internet, the MTC decided that clarification was needed to determine what activities in a modern economy exceed the protection of P.L. 86-272.

The statement of information includes examples of 11 activities with guidance on whether protection under P.L. 86-272 would still apply. Some activities listed as unprotected are commonly found on company websites and may invalidate a taxpayer's P.L. 86-272 filing position if not thoroughly vetted.

Perhaps the most complex example of an activity that defeats P.L. 86-272 immunity is when a business places internet cookies (a small piece of data, commonly a text file, that is stored

[4]P.L. 86-272, 15 U.S.C. sections 381-384.

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on a user's electronic device) onto the computers or other electronic devices of in-state customers, and these cookies gather customer search information that is used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale. To make things more complicated, the MTC lists another example, in which the cookies are used only for purposes ancillary to the solicitation of orders for tangible personal property, and this activity is deemed to be protected under P.L. 86-272. This distinction reflects the MTC's view that it is acceptable for a business to collect cookies, but the way the cookies are used determines if protection under P.L. 86-272 still applies.

Other examples that serve to invalidate protection under P.L. 86-272 in this guidance are as simple as having a chat function or email that in-state customers can activate through clicking on an icon on a website to initiate post-sale assistance, or if a business website invites viewers in a customer's state to apply for non-sales positions. Some of these items raise many questions: Does someone in a state have to click on or apply to the job posting, or is simply putting it on the website enough to break protection? How would a state determine if the person clicking on a chat function on the website is in the state or not? As AI chatbots and other automated technologies are put into service, it raises questions on how these items are viewed when not specifically addressed in the MTC's statement of information.

Another complexity relative to this guidance is that the MTC's statement is not a formal statute or regulation that states have adopted through a legislative process. Therefore, it is uncertain whether states can rely on this guidance without a formal adoption mechanism. California, New York, and New Jersey have released formal guidance with substantially similar examples to the MTC's, so there is momentum among states that have published their views on the subject that they will follow the same thought process relative to these activities.

We may soon get clarity on this issue from California. It issued Technical Advice Memorandum (TAM) 2022-01, which adopts a substantially similar version to the P.L. 86-272 examples listed in the MTC's statement. In response to California's TAM, the American Catalog Mailers Association (ACMA) filed a complaint in the superior court seeking to have this guidance invalidated.[5] Recently, the ACMA petitioned for summary judgment, but was denied, despite the court's confirming that ACMA had the right to seek declaratory relief and had standing to proceed, and concluding that the TAM was a regulation subject to the California Administrative Procedures Act. The court concluded that ACMA could not meet the summary judgment standard to show that the TAM contradicts P.L. 86-272 on its face. While the summary judgment standard that would have summarily overturned the TAM was not met, the court is left to decide the substantive issues in this case. The outcome of this case should give taxpayers more insight into how the MTC's P.L. 86-272 interpretations will be applied elsewhere.

Confirming how information collected or posted on a company's website is ultimately intertwined into the company's operations is not something that the company's tax department can easily discover. Collaborating with internal development teams that may have a more extensive working knowledge of what cookies are collected through a company's website and how those cookies are ultimately used will be critical to making an informed decision on how this updated guidance affects P.L. 86-272 positions. Taxpayers claiming P.L. 86-272 protection should thoroughly vet their activities conducted over the internet to confirm how the MTC's guidance could affect these positions.

It's a Whole New World

There is no shortage of indirect tax issues within the technology industry. As SaaS, infrastructure as a service, platform as a service, non-fungible tokens, and other innovative offerings become increasingly popular, we may see states adopt a broader view of what is considered taxable for indirect tax purposes.

Digital advertising taxes are an approach that may take hold, depending on whether the

[5] *American Catalog Mailers Association v. Franchise Tax Board*, No. CGC-22-601363 (Cal. Super. Ct., San Francisco County), *motion for summary judgment denied* (Aug. 29, 2023).

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Maryland iteration of this tax passes constitutional muster in the courts. Maryland introduced a digital advertising tax in 2021, imposing a tax on gross revenue from this activity in Maryland ranging from 2.5 to 10 percent. This tax was quickly challenged on constitutional grounds and has been considered by both state and federal courts.[6] Given the posture of these cases, it could be several years until there is further clarity regarding what type of digital advertising tax, if any, can be imposed.

As challenges continue, taxpayers have been left wondering how to approach the compliance aspect of the tax, which became effective during 2022 and was due for the first time on April 17, 2023. While administrative remedies continue to work their way through the courts, taxpayers should be filing their returns and remitting the tax payments as required by statute. The technology community is keeping a close eye on the developments, which are likely to have ripple effects across other states that are considering similar taxes.

Other states have already started to pursue unique tax structures to increase their tax bases relative to taxpayers' growing online footprints. This year Massachusetts introduced legislation related to taxes on digital advertising, commercial data collection, and the sale of personal information. Massachusetts is not alone in pursuing these types of taxes. Taxpayers should consider how the activities subject to tax will be sourced among the states and consider whether automated tools can help them with analyzing the impact and the ultimate compliance process.

Incentives to Consider

With enactment of the CHIPS and Science Act of 2022, the United States has increased investment in domestic semiconductor research and production.[7] This was a strategic priority to ensure that the U.S. will have a reliable supply of semiconductor chips and increase manufacturing activity domestically.

Several states have expanded or enacted tax incentives to entice companies in the semiconductor industry to invest in or expand operations in their states. These incentives have generally been in the form of credits and exemptions or through direct funding from grants or other programs. The technology industry is familiar with the operation of research and development credits, but companies may be surprised at how many other opportunities are available.

An additional factor to consider is the length of each incentive that the state is authorized to provide. Companies need to weigh whether short-term incentives that could lead to higher taxes down the road but allow for more flexibility in their operations are preferable to more lucrative incentives packages that may not be as flexible from a long-term perspective. As companies in this industry plan for investment, it is worthwhile to consider what incentives each state has to offer or if there would be an opportunity for negotiated incentives if proposed expansions do not qualify for existing programs.

Automation Valuation

As the technology industry expands because of the CHIPS Act and other investment opportunities in the U.S. market, property tax valuations will be an important component to achieving cash tax savings for industry players. With companies replacing or supporting employee roles at their facilities with robotics or other automated tools, these shifts could have an adverse property tax effect if assets are not classified or valued correctly.

Cost segregation studies may be used to identify potential savings across a variety of taxes. These studies are often undertaken to accelerate depreciation deductions for income

[6] In May the Maryland Supreme Court overturned a lower state court's decision that the tax violated the dormant commerce clause, in part because the taxpayer was deemed not to have exhausted its administrative remedies. *Comptroller of Maryland v. Comcast of California, Maryland, Pennsylvania, Virginia, West Virginia LLC*, 294 A.3d 1108 (Md. 2023). In July the court issued an opinion explaining its order. *Comptroller of Maryland v. Comcast of California*, 297 A.3d 1211 (Md. 2023). The federal case is at the Fourth Circuit, with the original action dismissed by a U.S. district court on the basis that the lower state court's decision had invalidated the tax.

[7] P.L. 117-167. CHIPS is an acronym for Creating Helpful Incentives to Produce Semiconductors.

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tax purposes, but it may be efficient to simultaneously consider how such studies could affect property tax valuations.

Finally, using the technology that has been developed over time to address historic compliance issues is important. In the property tax arena, taxpayers must account for due dates arising at various times throughout the year depending on the jurisdiction. The use of automated tools to gather data and process filings may achieve substantial savings and reduce the burden within a company's property tax function. This automation also maintains proper internal controls over these filing deadlines while allowing internal teams to focus on more value-added tasks.

Final Thoughts

As the technology industry continues to expand, the property tax and indirect tax impact can be one of the most significant expenses a business will face. These expenses can be reduced through incentives or correct valuation of the properties. Considering the impact upfront can allow taxpayers to maximize the incentive package they are offered by a state during expansion.

Also, with ChatGPT, Bard, other AI platforms, and automation tools becoming more widely adopted, it will be interesting to see what changes state tax authorities implement to account for their economic impact. It stands to reason that states will start to use these tools themselves to help identify noncompliance within the tax base. These technologies can bring a tremendous amount of value when dealing with large datasets or pulling information from multiple databases, especially where sampling is an accepted audit method. They can also provide an environment for taxpayers to handle audit requests that involve identification of data that would have been impossible to achieve just a few years ago. This increased visibility into what data is available can also help support taxpayers subject to audit and assist in tax planning.

While exploring the benefits these new technologies bring, businesses should consider how they can be used to improve efficiency and quality within their tax functions. These technologies can often pay for their own implementation cost over time, so having whiteboarding sessions with a tax technology adviser may be a worthwhile investment when considering the adoption of new technologies within an organization. ■

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