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SHOP TALK

Tangible Personal Property Goes Digital: State Tax Implications

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The working definition of "tangible personal property" is slowly expanding. In the not too distant past, there was a general consensus that tangible personal property was something physical that you could touch, like a hammer, a basketball, or a shoe. But the working definition of tangible personal property is much broader now. Today digital products, software, and even services purchased online may be statutorily defined, or interpreted by state tax administrators, as "tangible personal property."

This broadening definition has consequences for almost all state tax types. Most obviously, it has relevance for sales tax. But tangible personal property is a key concept within the corporate income tax and property tax, too, so the broadening definition of tangible personal property has relevance for those tax types as well.

This article explores ways in which the digitization of tangible personal property impacts the sales tax, the corporate income tax, and the property tax.

Sales and use tax/nexus

Digitization of tangible personal property is leading to assertions that remote sellers have nexus due to software downloads by in-state smartphone users.

This position is most explicitly advanced in Massachusetts DOR Directive 17-1 (the "Directive"), which has been revoked in anticipation of forthcoming regulations.[1] The logic is that: (1) software is tangible personal property; (2) "software" includes smartphone app downloads; and (3) therefore, a vendor has tangible personal property and physical presence wherever its software apps are downloaded.

A remote vendor with no physical presence in a state therefore acquires a physical presence when an in-state user downloads its smartphone app. Interestingly, the Directive conceives of a download as occurring not only when a user affirmatively downloads an app, but also when a "browser" or "web" app is automatically installed on the user's smartphone while browsing a website. Either way, the Directive takes the position that the remote vendor owns in-state software and, hence, has a physical presence in the state: "the ownership of in-state software by large Internet vendors would apparently constitute an in-state physical presence within the meaning of *Quill.*"[2]

Massachusetts is not the only state threatening to use in-state software as a basis for asserting nexus over remote vendors. Recently, Ohio inserted a provision into its 2018-2019 operating budget bill defining the term "seller" to include a company that "uses in-state software to sell or lease tangible personal property or services."[3] The term "in-state software" is defined to mean software that is "stored on property in this state or is distributed within this state." In all likelihood, this statutory language will be used by the Ohio Department of Taxation to assert an aggressive nexus position similar to the one in the Massachusetts Directive.

By interpreting "tangible personal property" broadly to include smartphone downloads, Massachusetts and Ohio suggest a way to assert nexus over remote vendors while claiming not to be inconsistent with *Quill.*[4]

Sales and use tax/taxability

States impose sales tax on receipts from sales of tangible personal property. As states look to expand what they can tax, they are pushing the envelope of what constitutes "tangible personal property" so that sales tax can be imposed on receipts from an ever-broadening array of items. Nowhere is this more evident than with respect to "software." Classically, software was tangible personal property if it was physical and non-customized, such as a CD-ROM purchased at a retail store. Now, some states are taking the position that a monthly license or subscription fee to access a website is the purchase of tangible personal property (canned software).

New York has been at the forefront of this trend. It started with a 2008 advisory opinion that caught many taxpayers by surprise, as it was not preceded by any statutory or regulatory change, but rather was a new, unanticipated administrative position.[5] The advisory opinion addressed a product accessed online that allowed users to manipulate photos. The product was available by license subscription. Customers accessed the product by "logging in" using an email address and password. On these facts, the New York

Department of Taxation and Finance concluded that the subscription fee was a "license" to use canned software (tangible personal property). As such, sales tax applied to the receipts from the subscription fee. This advisory opinion has since been cited as guidance to support imposing sales tax on a variety of cloud computing products on the basis that cloud computing is the licensing of tangible personal property (canned software).

As New York and other states interpret tangible personal property more broadly to include cloud computing and other online services, more and more products will become subject to sales tax, including products that would not have been taxable in the recent past.

Corporate income tax/Public Law 86-272

Broad interpretations of "tangible personal property" can help taxpayers seeking to claim PL 86-272 protection.

PL 86-272 provides that no state may impose a net income tax on a person if the person's activities within the state are limited to soliciting orders for sales of tangible personal property.[6] It is thus necessary, to qualify for PL 86-272 protection, to show that salespeople are soliciting orders for sales of tangible personal property, and not services or intangibles. An expanding definition of "tangible personal property" should make it increasingly easier to make this showing.

A New Jersey Tax Court opinion, *Accuzip*, illustrates this issue.[7] The taxpayer, who sold computer discs, sent salespeople into New Jersey. It argued that it had PL 86-272 protection because the salespeople were merely soliciting orders for sales of the tangible computer discs. The New Jersey Director challenged this position and denied PL 86-272 protection, arguing that the taxpayer was licensing intangible personal property into the state because the computer discs included a licensing agreement. In ruling for the taxpayer, the Tax Court used the New Jersey Director's expansive sales tax definitions of "canned software" and "tangible personal property" against the Director, holding that the taxpayer's computer discs were tangible personal property under those definitions and, accordingly, PL 86-272 protection applied.

Accuzip thus illustrates that if a state interprets "tangible personal property" broadly for sales tax purposes, it may be possible to use that broad definition in arguing for PL 86-272 protection.

Corporate income tax/apportionment

In states that still have a property factor, whether property is included in the property factor often depends on whether it is tangible or intangible. Generally, tangible personal property is included in the factor but intangible property is not. New York no longer has a property factor, but a New York decision considered how the definition of tangible property gradually evolved over time for property factor purposes (which is true in other states as well): "The definition of tangible personal property for purposes of the corporate franchise tax . . . has not been changed in nearly a century. Technology, however, has advanced dramatically since the statute was adopted giving rise to an abundance of potential issues in discerning what constitutes tangible personal property."[8]

This language is from a decision holding that television programming sent via satellite is tangible personal property (and, thus, included in the property factor) because it is functionally equivalent to television programming delivered via videotape (which is included in the property factor). So new technologies can be considered "tangible personal property" if analogous to older technologies deemed tangible personal property, even if the new methods might not seem like "tangible personal property" if considered independently. As a result, more and more things will count as tangible personal property for property factor purposes.

Even in states that no longer have a property factor, the definition of tangible personal property is still relevant for apportionment purposes, specifically for the receipts factor. Under the receipts factor, there is generally a different sourcing rule for sales of tangible personal property than for sales of intangible property or services. Accordingly, it must be determined whether something is "tangible personal property" to determine which sourcing rule applies. A broader definition of tangible personal property means that more products will be sourced using the tangible personal property sourcing rule.

Property tax

Analogous issues exist in states that impose property tax on tangible personal property. In such states, it is necessary to determine if "software" is "tangible personal property" (subject to tax) or "intangible property" (not subject to tax). Washington State has a rather detailed regulation to assist taxpayers in making this determination.[9] However, in other states guidance is often sparse and it may be necessary to look to sales tax definitions of tangible personal property or other authorities to aid in determining whether software is tangible personal property subject to property tax.

Conclusion

The working definition of "tangible personal property" is expanding. It once narrowly described physical objects you could touch, but it now, depending on the state, may also include digital products, software, or even services provided online. This expanding definition generally hurts taxpayers since a wider array of products and services are becoming subject to tax. However, the broadening definition could also be helpful in some areas, such as with respect to claiming PL 86-272 protection or for apportionment purposes. Businesses should consider their assets and products and whether they should be considered tangible personal property for various state tax purposes.

[1] *See* Massachusetts DOR Directive 17-2 (June 28, 2017). The Directive was evidently revoked because there was concern it might be declared invalid for violating Massachusetts Administrative Procedure Act notice requirements.

[2] Massachusetts DOR Directive 17-1.

[3] Ohio H.B. 49 (making amendments to Ohio Rev. Code Ann. § 5741.01).

[4] It is not clear that their position can be squared with *Quill.* In particular, footnote 8 of the *Quill* decision states that "[w]e . . . conclude that Quill's licensing of software in this case does not meet the 'substantial nexus' requirement of the Commerce Clause." The software downloads could be analogized to the software licensing that was determined not to have satisfied the substantial nexus requirement in *Quill.*

[5] TSB-A-08(62)S (Nov. 24, 2008).

[6] 15 U.S.C. § 38115 U.S.C. § 381.

[7] *Accuzip Inc. v. N.J. Division of Taxation*, No. 005744-2003 (N.J. Tax Ct. Aug 13, 2009).

[8] *Meredith Corp.v. N.Y. Tax Appeals Tribunal*, 956 N.Y.S.2d 585 (N.Y. App. Div. 2012).

[9] *See* Wash. Admin. Code § 458-12-251.