

Texas Comptroller Rules Software Rights Create Remote Seller Use Tax Nexus

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Overview

The Texas Comptroller of Public Accounts (“Comptroller”) recently issued an Order¹ that upheld an Administrative Law Judge (“ALJ”) Decision, thus approving a use tax assessment against a Utah-based retailer (the “Taxpayer”) of computer programs and digital content. The Taxpayer licensed its products to Texas users for a one-time fee, delivering these items primarily by digital download over the Internet but also by common carrier. In these transactions the Taxpayer retained all ownership rights and interests in the products, including intellectual property rights. The Taxpayer’s only other contact with Texas involved sending three employees in 2002 and one employee in 2009 to software industry conferences held in Texas. With respect to the conferences, the employees’ activities were for educational purposes only and were not directed at establishing or maintaining a market in Texas. Central to the ALJ’s Decision and the Comptroller’s Order was the ALJ’s finding that the Taxpayer failed to challenge the statutory characterization of software as tangible personal property for purposes of addressing the U.S. Supreme Court’s Commerce Clause requirement that substantial physical presence exist as a prerequisite for imposing use tax nexus on a remote seller.² In this Tax Alert we discuss this issue and the related ALJ and Comptroller analysis and findings, and we provide some taxpayer considerations.

ALJ Analysis and Findings Regarding Taxpayer’s Retained Property Rights

The determinative factor that drove the ALJ’s decision involved the Taxpayer’s retained rights in the computer programs and digital content that it licensed to customers, with such rights serving, as expressed by the ALJ, as the Taxpayer’s “sole physical presence in Texas”³ In arriving at this conclusion, the ALJ pointed out that Texas Tax Code § 151.009 considers software and digital images as tangible personal property for sales and use tax purposes.⁴ The ALJ then noted, however, that nexus, as based upon satisfaction of the substantial physical presence requirement under the U.S. Commerce Clause, “is not automatically conferred by the statutory characterization of a computer program as tangible personal property[, but is ultimately] . . . determined by the character of the rights and interests . . . retained [in such computer program].”⁵

As applied to the Taxpayer’s facts, the ALJ emphasized that “although the statutory characterization of software as tangible personal property is not . . . determinative that there is the requisite physical presence in Texas, what is ultimately determinative is that [the Taxpayer] has not challenged this characterization.”⁶ As explained by the ALJ,

[I]n light of [the Taxpayer’s] apparent concession that [its] products are tangible personal property, the software and digital downloads must necessarily be treated as tangible personal property for the purposes of applying the Supreme Court’s bright-line test requiring substantial physical presence. This is true even though the record is not clear [regarding] the nature or extent of the rights [the Taxpayer] retained in this tangible personal property. If the software and digital images resided on compact computer disks or floppy computer disks, as in QUILL CORP., the nature of the rights retained would be palpably clear. However, in the instant case, the record does not establish what comparable rights [the Taxpayer] could exercise over the software and digital downloads once they were downloaded into an electronic form. Nevertheless, the record establishes that [the

¹ SOAH Docket No. 304-13-5657.26 (Sept. 19, 2014) (the “Order”), with all footnote references herein to the applicable Order page number.

² Tex. Tax Code § 151.009 provides, in relevant part, “Tangible personal property’ means personal property that can be seen, weighted, measured, felt, or touched or that is perceptible to the senses in any other manner, and, for the purposes of this chapter, the term includes a computer program”

³ Order, at 11.

⁴ Order, at 10.

⁵ *Id.*

⁶ Order, at 11.

Taxpayer] had retained all property rights in tangible personal property that was present in Texas throughout the periods in question.⁷

Thus, it was *not* the statutory characterization of software as tangible personal property that swayed the ALJ but, instead, the Taxpayer's failure to provide evidence regarding "the nature or extent" of the property rights that it retained. In the absence of such information, the ALJ concluded that the Taxpayer had "retained all property rights" in its licensed products and, on that basis, found that the Taxpayer had substantial nexus with Texas thus creating an obligation to collect and remit the state's use tax.

Comptroller's Conclusions Appear to Follow ALJ's Interpretation

Although the Comptroller acknowledged that the Taxpayer's other Texas activities (including industry conference attendance) did not create the requisite "substantial nexus,"⁸ the Comptroller determined that the Taxpayer established Texas use tax nexus by retaining property rights to the computer programs and digital content licensed to customers. It would appear that the Comptroller based this determination on the ALJ's analysis and findings regarding the effect of the Taxpayer's retention of property rights in the products that it licensed to its Texas customers. Following the ALJ's reasoning, the Comptroller noted in her "Findings of Fact" that the Taxpayer "did not challenge Staff's characterization of the . . . software and digital images as constituting tangible personal property for sales and use tax purposes."⁹ The Comptroller went on to state, in her "Conclusions of Law," that the Taxpayer's "property rights to the software and digital images that were licensed to its users in Texas . . . were sufficient to establish the requisite physical presence in Texas to constitute substantial nexus necessary to subject [the Taxpayer] to the obligation to charge and collect Texas use tax"¹⁰

Taxpayer Considerations

Taking into account the analysis and conclusions contained in the Comptroller Order, remote sellers that sell software products to customers in Texas should consider whether their retention of property rights attributable to the software may create Texas use tax nexus. What is suggested by this decision is that not all retained rights constitute the substantial physical presence (nexus) required to obligate a remote seller to collect and remit Texas use tax and that close inspection of the type and degree of retained rights is necessary (along with proper documentation) to determine if the nexus threshold has been met. However, remote sellers should note that the ALJ's Decision and the Comptroller's Order lack specific guidance regarding the "nature or extent" of retained rights that would *not* create nexus.

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⁷ *Id.*

⁸ Order, at 17.

⁹ Order, at 15.

¹⁰ Order, at 18.

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