Issue No. 2017-4
October 2017

Ernst & Young LLP Sales and Use Tax Quarterly Update

This edition of the *Ernst & Young LLP Sales and Use Tax Quarterly Update* provides a summary of the major legislative, administrative and judicial sales and use tax developments for the fourth quarter of 2017.

Will the U.S. Supreme Court reconsider Quill? We're about to find out.

On October 2, 2017, the South Dakota Attorney General formally submitted a petition for writ of certiorari[1] to the U.S. Supreme Court in the challenge brought by three remote sellers – Wayfair, Overstock.com and Newegg – to the state's economic presence nexus provision. This new standard, passed in 2016 as SB 106, requires remote sellers that sell tangible personal property, electronically transferred products or taxable services for delivery into South Dakota to register, collect and remit South Dakota sales taxes on those sales as if the seller had a physical presence in the state. The registration requirement applies only if, in the previous calendar year, the seller either: 1) had over $100,000 in gross revenue from delivery of these goods into South Dakota, or 2) sold these goods for delivery into South Dakota in 200 or more separate transactions. Similar provisions have been implemented in at least 11 other states since 2015.[2]

As in many of those other states, the South Dakota provision was challenged by a group of remote sellers that lacked a physical presence in the state, but were required to register and collect under the new law on the grounds that the nexus standard imposed exceeded the constitutional limitation established by the U.S. Supreme Court in *Quill Corp. v. North Dakota*.[3] On September 13, 2017, the South Dakota

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Supreme Court issued its opinion in the case, agreeing with the plaintiffs that the provision is unconstitutional, noting specifically that "however persuasive the State's arguments on the merits of revisiting the issue, *Quill* has not been overruled… [and] remains the controlling precedent. … "[4]

In its petition to the U.S. Supreme Court, the state argues that "the legal and practical developments of the past 25 years strongly recommend revisiting" the *Quill* physical presence standard, as it has "grown only more doctrinally aberrant, and has been roundly criticized by members of [the] Court, including Justices Kennedy, Thomas and Gorsuch."[5] The petition also notes that while the "legal rationales [behind the *Quill* decision] have imploded with experience, its practical impacts have exploded with the rapid growth of online commerce." In support of this position, the state specifically references Justice Kennedy's concurring opinion in the 2015 *Direct Mktg. Ass'n. v. Brohl* decision,[6] in which he noted that "given these changes [in the retail economy] . . . it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*." Finally, the state explains that the inability to effectively collect sales tax from internet sellers "imposes crushing harm on state treasuries and brick-and-mortar retailers alike."

Once all the response petitions have been filed (anticipated to be completed by the end of 2017 or early 2018), the Court will decide whether to hear the case; four of the nine Justices must agree to grant a petition for certiorari. In spite of the opinions expressed by some members of the Court, it is uncertain whether the state's petition will be granted, especially in light of the fact that the law was found unconstitutional in violation of *Quill*, and therefore no controversy; and if it is granted, whether the Court will reject the case on the basis of *stare decisis* — the principle by which the courts "are slow to interfere with principles announced in … former decisions and often uphold them even though they would decide otherwise were the question a new one."[7] Added to this uncertainty is the *Quill* Court's express reminder that it is Congress that has the power to regulate interstate commerce and to protect it "from intolerable or even undesirable burdens." As such, the Court noted, "in this situation, it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.'"

Our observation:

In spite of the recent spate of states directly or indirectly challenging the *Quill* standard, it would seem that the odds of the Court revisiting that decision are long. However, should the Court decide to rehear the issue, it is likely that *Quill* could be overturned, as a denial of certiorari would have the same effect as a direct affirmation without taking up space on the Court's limited docket. In either event, it seems unlikely that Congress will act to upset the status quo in the short term, and more states will try to devise new laws and regulations to expand the scope of the physical presence doctrine and compel more remote sellers to register and collect tax on sales subject to their jurisdiction.

Other recent developments

Nexus

Massachusetts: The Massachusetts Department of Revenue (DOR) has adopted a regulation, 830 CMR 64H.1.7, that imposes a modified bright-line nexus standard for purposes of determining nexus and sales or use tax collection responsibilities for out-of-state internet vendors. The new regulation adopts nexus rules that are slightly more narrow than the broad, bright-line nexus standard previously set out in Directive 17-1 (issued by the DOR on April 3, 2017), which the DOR repealed before it went into effect with Directive 17-2 (issued on June 28, 2017).

The regulation establishes a bright-line nexus rule, with exceptions. Under the regulation, the DOR will assert nexus over an out-of-state internet vendor "for each calendar year beginning with 2018, if during the preceding calendar year it had in excess of $500,000 in Massachusetts sales from transactions completed over the internet and made sales resulting in a delivery into Massachusetts in 100 or more transactions." From Oct. 1, 2017 through Dec. 31, 2017, the same test will be applied using Massachusetts sales and transactions occurring during the prior 12-month period (i.e., the period from Oct. 1, 2016 through Sept. 30, 2017).

The regulation asserts that the DOR is not adopting a broad economic presence standard. Rather, it states the DOR is basing nexus on the following in-state activities:

- Property interests in or the use of in-state software (e.g., "apps") and ancillary data (e.g., "cookies") that are distributed to or stored on the computers or other physical communications devices of an internet vendor's Massachusetts-based customers, and may enable the vendor's use of such physical devices;
- Contracts or other relationships with content distribution networks[8] resulting in the use of Massachusetts-based servers or the receipt of other related Massachusetts services; or
- Contracts or other relationships with online marketplace facilitators or delivery companies resulting in the provision of Massachusetts sourced services, including, but not limited to, payment processing and order fulfillment, order management, return processing or otherwise assisting with returns and exchanges, the preparation of sales reports or other analytics and consumer access to customer service.

The bright-line test established under the regulation does not apply to other types of vendors. Nevertheless, the regulation states that the nexus creating activities described above also would create nexus for other taxpayers.

The regulation provides certain exceptions to the bright-line test. These exceptions appear intended to protect internet vendors whose websites can be accessed from Massachusetts but that have no other direct or indirect contacts with the commonwealth and who do not engage in any of the nexus-creating activities described in the regulation.

Provisions of the regulation apply to sales starting on Oct. 1, 2017. The prior 12-month period is used to measure Massachusetts sales and Massachusetts transactions. Out-of-state internet vendors that have nexus under the new rules, but not otherwise, would not be considered vendors for any prior periods. If, however, an internet or non-internet vendor established nexus under the prior rules in previous periods, the DOR will apply the tax retroactively under the generally applicable look back rules.

Rhode Island: On August 3, 2017, Rhode Island Governor Gina Raimondo (D) signed the state's FY18 appropriations bill, (HB 5175, Sub. A), which contains a number of provisions aimed at compelling remote sellers to collect and remit sales and use taxes on transactions with in-state customers. Rhode Island's new laws are the most expansive provisions aimed at remote sellers enacted by any state to date, as they effectively cobble together economic, affiliate, click-through, warehouse and marketplace provider nexus measures that currently are in place in other states along with nonregistered remote seller notification requirements. The provisions took effect on August 17, 2017.

The bill creates a new chapter under Title 44 of the General Laws of Rhode Island that begins by noting that while "the Commerce Clause of the United States Constitution prohibits states from imposing an undue burden on interstate commerce . . . it is no longer an undue burden for non-collecting retailers to accurately compute, collect and remit and/or report with respect to their sales and use tax obligations to Rhode Island." The bill also notes that the existence and/or presence of a non-collecting retailer's or its facilitator's "in-state software on the devices of in-state consumers constitutes physical presence," as required under *Quill Corp. v. North Dakota*.[9] "In-state software" is defined as:

> "software used by in-state customers on their computers, smartphones, and other electronic and/or communication devices, including information or software such as cached files, cached software, or **'cookies', or other data tracking tools**, that are stored on property in this state or distributed within this state, for the purpose of purchasing tangible personal property, prewritten computer software delivered electronically or by load and leave, and/or taxable services." **Emphasis added**.

Under the newly enacted provisions, any non-collecting retailer that had in-state sales of $100,000 or more or engaged in 200 or more transactions with in-state customers in the preceding calendar year must register for a sales tax permit and begin collecting and remitting sales tax on all taxable sales in the state or comply with detailed notice and reporting requirements, similar to those that took effect in Colorado and other states on July 1, 2017.[10] The bill broadly defines a "non-collecting retailer."

In-state referrers must provide written notice within 30 days to retailers that their sales may be subject to Rhode Island sales and use tax. The bill defines an in-state referrer as any person who contracts or agrees with a retailer to list or advertise for sale in the state tangible personal property or taxable services sold by the non-collecting retailer, that receive more than $10,000 in commissions in any calendar year.

Beginning January 15, 2018, retail facilitators must provide the Rhode Island Division of Taxation with a list of the retailers for whom the facilitator provided services (regardless of whether the facilitator collected sales or use taxes on their behalf). The bill defines retail facilitators generally as persons who facilitate a sale by a retailer by using in-state software, listing or advertising goods for sale, or directly or indirectly collecting payments from in-state customers and transmitting those payments to the retailer.

The new law includes limited exceptions for referrers and facilitators that can provide a Rhode Island sales tax permit or a Rhode Island or Streamlined Sales Tax exemption certificate. Noncompliance with any of the new provisions, whether by a non-collecting retailer, referrer, or facilitator, is subject to a $10 per incident penalty, with a minimum annual penalty of $10,000, in addition to any other penalties that may be imposed under the state's tax laws. For additional information on this development, *see* EY Tax Alert 2017-1296.

Virginia: Out-of-state dealers whose only contact with Virginia is the storage of resale inventory of tangible personal property in fulfillment centers located in the state as of June 1, 2017, have sufficient in-state activity to require them to register for sales and use tax purposes. The Virginia Department of Taxation explained that under a recent law change, which took effect June 1, 2017, a dealer has sufficient activity to require registration if the dealer owns tangible personal property that is for sale located in Virginia. Accordingly, the dealers must file monthly out-of-state dealer's sales tax returns (Form ST-8) and Schedule of Local Sales and Use Taxes (Form ST-8A) to allocate local tax to the localities where the tangible personal property is delivered. Additional information about the law change is available in Virginia Tax Bulletin 17-3 (May 3, 2017). Va. Dept. of Taxn., Ruling of the Tax Comr. 17-102 and Ruling of the Tax Comr. 17-104 (both issued June 21, 2017).

Washington: The U.S. Supreme Court will not review the Washington Court of Appeals ruling in *Irwin Naturals*, in which it held an out-of-state company selling nutritional supplements at wholesale and retail to Washington customers has nexus with the state for sales and use tax purposes. Nexus-creating activities the company engaged in within Washington included having $5 million in retail sales; participating in various marketing activities such as new item presentation, category review, promotional planning, and educating sales staff and trade show exhibitions; and engaging in a wide variety of activities with its wholesale customers. *Irwin Naturals v. Wash. Dept. of Rev*., No. 73966-2-I (Wash. Ct. App., Div. 1, July 25, 2016), *cert. denied*, Dkt. No. 17-91 (U.S. S. Ct. Oct. 2, 2017).

Washington: On July 7, 2017, Governor Jay Inslee signed HB 2163 (Ch. 28, 2017 Laws 3rd Special Session), key provisions of which expand the state's sales and use tax nexus provisions to require marketplace facilitators to collect and remit tax or comply with notice and reporting requirements. The new law also expands the business and occupation (B&O) tax economic nexus provisions to retailers.

Beginning on January 1, 2018, remote sellers, referrers and marketplace facilitators that meet the economic nexus threshold or have a physical presence in Washington must elect to either: (1) collect and remit Washington's retail sales or use tax on taxable sales into the state; or (2) comply with notice and reporting requirements. Until January 1, 2020, these requirements do not apply to retail sales of digital products and digital codes, other than: (a) specified digital products and digital games; and (b) digital codes used to redeem specified digital products and digital games, by a marketplace seller through a marketplace facilitator or directly resulting from a referral.

The election requirements apply to remote sellers and marketplace facilitators that, in the current or immediately preceding calendar year, have gross receipts from retail sales sourced to the state of at least $10,000. For referrers, the threshold amount for the current or immediately preceding calendar year is the business's gross income from the referrer's referral services apportioned to Washington, and from retail sales sourced to the state, of at least $267,000.

For marketplace facilitators, the election requirement only applies to retail sales made through a marketplace facilitator's marketplace by (or on behalf of) a marketplace seller that is not physically present in the state, and a marketplace facilitator's own retail sales, if the marketplace facilitator is not physically present in the state. For referrers, the election only applies to retail sales directly resulting from a referral of the purchaser to a marketplace seller that is not physically present in the state, and a referrer's own retail sales, if the referrer is not physically present in the state.

An election to collect tax is binding on the remote seller, referrer and marketplace facilitator until January 1 of the calendar year that is at least 12 consecutive months after the remote seller, referrer and marketplace facilitator began collecting sales and use tax under the election. An election to collect or to comply with the notice requirement may be changed by providing the written notice to the Washington Department of Revenue. Changing an election from complying with the notice requirement to collecting tax can be made at any time by collecting and remitting tax on taxable retail sales sourced to the state. A remote seller, referrer or marketplace facilitator that fails to elect to collect or to comply with the notice requirement will be presumed to have made an election to comply with the notice requirements.

The department will assess a penalty (that could exceed $100,000) on remote retailers, referrers and marketplace facilitators that fail to comply with these new requirements.

Wyoming: Wyoming will not enforce HB 19, the state law that requires out-of-state vendors to remit taxes on remote sales, which was enacted in March 2017, pending the outcome of a legal challenge brought against remote sellers that lacked a physical presence in the state and did not comply with the registration and collection requirements of the law. *Wyoming v. Newegg, Inc*., No. 34238 *joint answer of defendants* (Wyo. Dist. Ct. September 22, 2017).

Tax base

North Carolina: Customers who take advantage of a cash discount offered by a company for prompt or early payment of a balance due on an invoice are subject to sales and use tax on the gross sales price less the discount allowed by the company. The general tax rate applies to an item's sales price (the total consideration for which tangible personal property, digital property, or services are sold, leased or rented), and a cash discount is a reduction in the sale price. N.C. Dept. of Rev., Private Letter Ruling No. SUPLR 2017-0003 (August 15, 2017).

Rhode Island: The monthly service fee a restaurant pays a vendor for use of mobile point of sale devices is subject to sales and use tax as a sale at retail (which includes the lease or rental of tangible personal property). The restaurant's sale of premium content to its customers through the devices also is subject to sales and use tax because the definition of "sales" includes the furnishing, preparing, or serving for consideration of food, meals or drinks, including any cover, minimum, *entertainment* or other connected charge. Commissions for fees paid by the restaurant's customers for premium content (e.g., games, news, social media content and songs) and shared with the vendor, however, are not subject to sales and use tax as the rental of tangible personal property because the commissions are not directly related to price reductions or sales discounts. The Rhode Island Division of Taxation noted that the vendor must apply for a retail sales permit and collect and remit tax on its sales to the restaurant. R.I. Div. of Taxn., Ruling Request No. 2017-03 (August 10, 2017).

South Carolina: A book seller's club memberships are included in its gross proceeds of sales and, therefore, are subject to South Carolina's sales tax. In reaching this conclusion, the South Carolina Administrative Law Court cited both the plain meaning of applicable statutes (S.C. Code Ann. §§ 12-36-910(A) and 12-36-90) and applicable case law, finding that the membership fees constitute value proceeding or accruing from the sale of tangible personal property. In this case, the court determined that because the membership program is so intertwined with and inseparable from the sales of tangible personal property, the membership program is part of the sales of that tangible personal property. *Books-A-Million, Inc. v. S.C. Dept. of Rev*., No. 16-ALJ-17-0113-CC (S.C. Admin. Law Ct. June 6, 2017).

Exemptions and refunds

California: A new law (AB 398) extends and expands the sales and use tax exemption for manufacturing. The exemption is extended through periods before July 1, 2030, and expanded as follows: (1) effective on and after July 1, 2014, and before July 1, 2030, the exemption applies to qualified property purchased for use primarily in the generation or production, or storage and distribution, of electric power; (2) effective on and after January 1, 2018, through July 1, 2030, the exemption applies to special-purpose buildings and foundations used for the generation or production or storage and distribution of electric power; and (3) effective on and after January 1, 2018, through July 1, 2030, the definition of a qualified person is expanded to include a person primarily engaged in the business of electric power generation. Cal. Laws 2017, Ch. 135 (AB 398), signed by the governor on July 25, 2017.

Illinois: An Illinois company that leases medical trailers and other mobile equipment was not entitled to a temporary storage exemption from use tax for three mobile units that were temporarily stored in Illinois and subsequently leased out of state, because these units were later returned to Illinois for passive storage until they were again leased outside the state. In reaching this conclusion, the Illinois Appellate Court found the units' return to Illinois for additional storage defeats the temporary storage exemption requirement that the property be used solely outside of Illinois after its initial post-purchase storage. Further, in determining what constitutes "temporary storage," the court declined to set any bright-line span of time rule, but reasoned that storage in the state "for no more than 47 days while awaiting transport to out-of-state lessees falls within the scope of a 'limited time,' 'impermanent,' and 'transient.'" The court also concluded the lessor was entitled to credit for taxes paid to other states on the units, as well as a depreciation deduction on the units' selling price for the time after the initial temporary storage in Illinois and before their return to Illinois. The lessor, however, was not entitled to the expanded temporary storage exemption, the credit for out-of-state taxes paid, or depreciation deductions for the units for which it did not possess the required exemption permit; in this instance the use tax immediately applied on the full value of the property and at that point no out-of-state taxes had been paid. *Shared Imaging, LLC v. Hamer*, No. 1-15-2817 (Ill. App. Ct., 1st Jud. Dist., June 28, 2017).

Missouri: A new law (SB 16) exempts from sales and use tax usual and customary delivery charges that are separately stated from the sales price. This change took effect August 28, 2017. Mo. Laws 2017, SB 16, signed by the governor on July 5, 2017.

Missouri: Entities that provide telecommunications services to customers (including television, internet and telephone) were not entitled to a sales and use tax exemption for manufacturing equipment on their purchases of replacement equipment used in part to deliver telephone services because the items did not qualify as manufacturing equipment. In reaching this conclusion, the administrative law judge (ALJ) of the Missouri Administrative Hearing Commission found that *IBM*[11] abrogates the expansive view of what constitutes manufacturing activity in the two *Southwestern Bell* cases (*Bell I* [12] and *Bell II* [13]). The Missouri Supreme Court found in *IBM* that, "To the extent cases such as *Bell I* and *Bell II* suggest that an expansive interpretation of the word 'manufacturing' is authorized by the 'manufacturing' exemption, and to the extent that they hold that the electronic transfer of voices is itself manufacturing as that term is used in the exemption, they are no longer to be followed." In addition, the ALJ concluded that *IBM* was not "unexpected," as it was reasonably foreseeable to anyone who knew the Missouri Supreme Court's 2010-2015 decisions on the issue. Finally, the Missouri Director of Revenue was not required to notify taxpayers whose tax obligation was changed by the IBM decision. *Cebridge Acquisition LP and Friendship Cable of Ark. Inc. v. Mo. Dir. of Rev*., No. 13-1629 RS (Mo. Admin. Hearing Comn. May 19, 2017).

North Carolina: A new law (SB 257) eliminates the existing 1% privilege tax on certain purchases of manufacturing equipment and machinery and exempts from tax the sales of certain equipment, or an accessory, an attachment or a repair part for equipment used at a fulfillment center. Previously, mill machinery and mill machinery parts and accessories were exempt from sales and use tax, but subject to a privilege tax at the rate of 1% of the sales price with a maximum tax of $80 per article. SB 257 eliminates the privilege tax on such property and adds various mill machinery, property, repair or replacement parts, and equipment to the list of sales that are specifically exempt from retail sales and use tax. This change is effective July 1, 2018, and applies to sales made on or after that date. In addition, SB 257 exempts from tax the sale of equipment, or an accessory, an attachment or a repair part for equipment that meets all of the following requirements: (1) is sold to a large fulfillment facility; (2) is used at the facility in the distribution process, which includes receiving, inventorying, sorting, repackaging or distributing finished retail products; and (3) is not electricity. SB 257 also defines "large fulfillment facility." The sales and use tax exemption for fulfillment centers is effective beginning July 1, 2017, and applies to sales made on or after that date. Lastly, effective July 1, 2017, and applicable to sales made on or after that date, an owner or lessee of a business that is the recipient of a grant under the Job Development Investment Grant Program on or before June 30, 2019, for a transformative project as defined in N.C.G.S. §143B-437.51(9a) is allowed a refund of the sales and use tax paid by it on building materials, building supplies, fixtures and equipment that become a part of the real property of the facility. N.C. Laws 2017, Sess. Law 2017-57 (SB 257), override of governor veto on June 28, 2017. For additional information on other tax changes contained in SB 257, see EY Tax Alert 2017-1137.

Texas: A limited liability company (LLC) is entitled to a partial exemption on its purchases of taxable items if: (1) one or more of its members qualifies for an exemption from the sales and use tax as a religious, educational or public service organization; (2) it has a medical purpose; (3) it operates similarly to a joint venture; (4) it files as a partnership for federal income tax purposes; and (5) the items purchased relate to the tax-exempt purpose of the exempt member. The partial exemption is equal to the percentage of the LLC owned by an exempt member(s), while the total tax exemption claimed by the LLC cannot exceed the amount of charity care and government-sponsored indigent health care it provides. This ruling applies to all open periods; thus, eligible LLCs that did not claim a sales tax exemption on qualifying purchases may file a refund claim. Tex. Comp. of Pub. Accts., No. 201707003L (July 7, 2017).

Wisconsin: A new law (SB 89) codifies a sales and use tax exemption for medical records and clarifies the imposition of tax on a transient lodging provider's charges for telecommunications services, ancillary services, internet access services and cable TV services used in providing lodging. Specifically, SB 89 codifies *Cannon & Dunphy, S.C*.,[14] enumerating an existing exemption for paper copies of medical records sold to a patient or authorized person. According to a legislative summary issued by the Wisconsin Department of Revenue, sales of electronically transmitted medical records remain nontaxable. Provisions of SB 89 also clarify that hotels, motels and other lodging providers are deemed to be consumers of the telecommunications services, ancillary services, internet access services and cable TV services used in providing lodging services, even if the service provider charges its customer separately for the services. Therefore, a lodging provider's charges for these services are not taxable, but the lodging provider's purchase of these services is subject to tax. Lastly, SB 89 prohibits the department from issuing assessments or acting on refund or adjustment claims after the end of the calendar quarter that is four years after the year in which a county enacts a repeal ordinance. These provisions took effect June 23, 2017. Wis. Laws 2017, Act 17 (SB 89), signed by the governor on June 21, 2017. See also Wis. Dept. of Rev., Wis. News for Tax Professionals: 2017 Wisconsin Act 17 (June 22, 2017).

Transactions and services

Indiana: An out-of-state company's sales of online banking, online bill payment and mobile banking products (collectively, "online products") are not subject to Indiana's sales and use tax; however, its sales of a finance and budget tool and electronic downloads of its mobile banking application within Indiana are subject to sales and use tax. The Indiana Department of Revenue found the company's sales of its online products are sales of nontaxable services and do not meet the definition of telecommunications services. The department further reasoned the online products have limited functionality in that the basic software platform only allows account holders access to their bank accounts and the provision of tangible personal property with the service was incident to the service provided. Further, the department found the true object of the sale at a single, bundled price is the provision of a service when the financial institution's aim is to provide custom information services for account holders. The company's sales of finance and budget tools and the electronic download of the mobile banking application within Indiana are transfers of tangible personal property and, therefore, are subject to sales and use tax unless a federal credit union purchases them. The finance and budget tool provides greater functionality and allows account holders to exercise a greater amount of control over the software, which makes the product taxable. Ind. Dept. of Rev., Rev. Ruling No. 2015-09ST (April 13, 2017).

Illinois: A new law (SB 1434) amends the Use Tax Act (UTA) and the Retailers' Occupation Tax Act (ROTA) to create the Rental Purchase Agreement Occupation and Use Tax Act, which imposes a 6.25% occupation tax on the gross receipts of persons engaged in the business of renting merchandise for use by a consumer for personal, family or household purposes, for an initial term of four months or less, that is automatically renewable. A corresponding 6.25% use tax is imposed on the privilege of using merchandise rented under a rental-purchase agreement in the state. SB 1434 exempts sales to lessors of property intended to be re-leased under rental-purchase agreements, and provides lessors a onetime transitional use tax credit for tax already paid on merchandise subject to tax under the UTA or ROTA. The credit applies to property purchased during the six months immediately prior to the effective date of the act; it has to be claimed within three months of the effective date of the act; and it can be applied against the tax imposed under the act. The provisions of SB 1434 take effect January 1, 2018. Ill. Laws 2017, Pub. Act 100-0437 (SB 1434), signed by the governor August 25, 2017.

Louisiana: A new law (HB 264) expands the types of construction contracts excluded from the imposition of a new sales and use tax to include construction contracts for sales of materials or services in lump sum, unit price, fixed-fee or guaranteed maximum price. These provisions apply to any additional state sales and use tax enacted on or after July 1, 2017. La. Laws 2017, Act 209 (HB 264), signed by the governor on June 14, 2017. For more on other legislation enacted during 2017 Louisiana general session, see EY Tax Alert 2017-1121.

Louisiana: A new law (HB 313) codifies the definition of "inventory" as set forth by the Louisiana Court of Appeals in its ruling in *Louisiana Machinery*,[15] which states that items previously rented and, which in the good-faith and ordinary course of business are ultimately sold, may qualify as "inventory" for purposes of the inventory tax credit against ad valorem property taxes. HB 313 also defines short-term rentals and clarifies the definition of a retailer. Provisions of HB 313 apply retroactively to tax periods beginning on or after January1, 2016. La. Laws 2017, Act 338 (HB 313), signed by the governor on June 22, 2017. For more on other legislation enacted during the 2017 Louisiana general session, *see* EY Tax Alert 2017-1121.

Massachusetts: The Massachusetts Supreme Judicial Court has affirmed an appellate tax board ruling that certain deliveries by an out-of-state wholesale distributor that had nexus with Massachusetts to Massachusetts customers are subject to the state's sales tax because, under the state's drop shipment rule, Massachusetts treats the party that supplied the product and ultimately affected its delivery into the state as the vendor who sold the products to the ultimate consumer. In so holding, the court rejected the wholesaler's burden-shifting argument that before the drop shipment rule can be applied to a wholesaler, the Massachusetts Commissioner of Revenue must make a preliminary determination that a retailer is not actually engaged in business in the state. The court found the commissioner "must provide an evidentiary basis for an assessment," the assessment is "presumptively correct," and the taxpayer bears the burden of proof that they are entitled to an abatement. Here, the wholesaler, even though it had a business practice of requiring retail customers to disclose states in which they did business, failed to rebut the presumption that its retail customers were doing business in Massachusetts. Lastly, the court ruled that the drop shipment rule does not discriminate against interstate commerce because scenarios involving in-state and out-of-state vendors are equally subject to tax and there is no greater burden on the transaction using an out-of-state vendor. *D&H Distributor Co. v. Massachusetts Comm'r. of Rev*., No. 477 Mass. 538 (Mass. S. Jud. Ct. July 31, 2017).

Michigan: A convenience store's sales of electronic personal identification numbers (EPIN), but not its sales of PIN-less top-up transactions, for wireless calling arrangements for prepaid cellphones are subject to Michigan's sales tax because only the EPINs fall within the definition of a taxable prepaid authorization number for telephone use. In interpreting for the first time the statute (Mich. Comp. Laws Sec. 205.52(2)(b)) imposing sales tax on the sale of prepaid telephone calling cards or prepaid authorization numbers for telephone use, the Michigan Court of Appeals found the Legislature's intent was "to tax the sale of both prepaid tangible (calling cards) and intangible authorization number for telephone services, as well as reauthorization of those numbers." Based on the plain meaning of the statute, the court held the Michigan Tax Tribunal erred in finding both the EPIN and the PIN-less top-up calling arrangement to be new types of taxable telephone calling cards. EPINs nevertheless are taxable as they represent prepaid authorization numbers. The court reasoned the EPIN purchaser receives a PIN on a receipt that must be entered on his/her cellphone in order to access the telephone services associated with the PIN. Sales of "PIN-less top-up minutes," however, are not subject to sales tax, because no authorization number or PIN is needed to access the phone service as the additional minutes are downloaded instantly to the purchaser's cellphone. *Garfield Mart, Inc. v. Mich. Dept. of Treas*., No. 333094 (Mich. App. Ct. August 8, 2017).

New Mexico: The New Mexico Department of Taxation and Revenue is not preempted by federal law from collecting gross receipts tax on a company's transportation of railroad crew members from point to point in New Mexico because this service does not qualify as "transportation of a passenger traveling in interstate commerce by motor carrier" under a federal statute (49 USC § 14505). In reaching this conclusion, the New Mexico Court of Appeals found that the company's service may affect interstate commerce provided by railroads, but it does not provide the direct link in the stream of commerce as addressed in *Yellow Cab*.[16] Additionally, the company's activity is not an integral part of the flow of commerce that Congress addressed in the federal statute, which was intended to overrule *Jefferson Lines*,[17] and the company's business activity is outside the scope of both the federal statute and *Jefferson Lines* when it transports railroad crew members apart from ticketed travel between states. In addition, the preemption exclusively applies to state taxation and charges, and it does not relate to persons who, like the railroad crew members, did not generate revenues for the entity traveling in interstate commerce that could be subject to state taxation. *Renzenberger, Inc. v. N.M. Taxn. and Rev. Dept*., No. 34,999 (N.M. Ct. App. July 26, 2017).

New York: The New York Department of Taxation and Finance issued guidance on the recent statutory change that eliminated the resale exemption from sales tax for sales of tangible personal property between certain related entities and the narrowing of the use tax exclusion for purchases made out of state by nonresident businesses. Specifically, under the provisions of the FY2018 Budget Act, a disregarded single member limited liability company (SMLLC) or subsidiary is precluded from claiming the resale exemption when purchasing property that it will resell (including by lease or rental) to its own member or owner. Instead, such purchases will be deemed to be retail sales immediately upon purchase and subject to sales tax. The change also applies to transactions involving other related-party entity structures, including partnerships and trusts. The guidance includes an example of how this provision applies. In this example, the Department noted that a disregarded SMLLC purchasing artwork from a supplier not only must pay sales tax to the supplier (i.e., can no longer claim resale exemption), but that a subsequent sale or lease of the property to its single member is also a taxable sale. The Department noted that sellers accepting a valid exemption document in good faith from a purchaser will not be liable for any tax due. Both changes were enacted earlier this year as part of the FY 2018 Executive Budget and apply to sales made and uses occurring on or after April 10, 2017. N.Y. Dept. of Taxn. and Fin., TSB-M-17(4)S (August 14, 2017). For more on this development, *see* EY Tax Alert 2017-1401.

North Carolina: A new law (SB 628) amends various sales and use tax law provisions. Changes in the bill do the following: (1) apply the general principle that a service is sourced to where the purchaser can potentially make first use of the service; (2) define/amend various terms, including capital improvement, service contracts, mixed transaction contracts, new construction, remodeling and reconstruction; (3) modify provisions related to real property contracts and provide that a service to real property is subject to tax as retail sales of or the gross receipts derived from repair, maintenance and installation services unless the taxpayer substantiates that the transaction is a real property contract, is subject to tax as a mixed transaction or it is not subject to tax; (4) modify sales and use tax exemption provisions for motor vehicles, installation charges, and repair, maintenance or installation services, among others; (5) establish a no assessment grace period (March 1, 2016, through December 31, 2017) for specific sales tax base expansion changes that took effect in 2016 (certain assessments are not prohibited); (6) permit the North Carolina Department of Revenue to reduce by 90% a sales and use tax assessment against a taxpayer when it is based on the incorrect application of certain linen charges furnished by a facilitator, rental agent or other person; and (7) exempt from sales and use tax human blood and human tissue, and the sales price of or the gross receipts derived from the repair, maintenance, and installation services and service contracts of an aircraft with a gross take-off weight of more than 2,000 pounds (applicable to sales made on or after July 1, 2019). These changes have various effective dates. N.C. Laws 2017, S.L. 2017-204 (SB 628), signed by the governor on August 11, 2017.

Tennessee: A lump-sum price charged by a business to engineer, procure, and construct a fiber-to-the-home network infrastructure for a high-speed internet provider (client) is subject to sales and use tax because the business sells and installs tangible personal property that remains tangible personal property after installation. Under Tennessee law, the sale and installation of materials is subject to sales and use tax if the materials remain tangible personal property following installation, but are exempt from tax if they become affixed to realty upon installation. Here, the Tennessee Department of Revenue determined the client's legal right to remove the materials installed by the business showed a clear intent for the client to retain ownership of the materials such that they remain personalty after installation. Based on the reasoning in *ANR Pipeline Co*.[18] and *American Fiber Systems, Inc*.,[19] the department found the materials do not become affixed to the real property upon installation and remain tangible personal property that the client owns. Tenn. Dept. of Rev., Rev. Ruling No. 17-09 (June 21, 2017).

Texas: The Texas Comptroller of Public Accounts issued a letter ruling addressing the sales and use taxability of various labor charges for work related to an underground pipeline. Labor charges for the following are not subject to sales/use tax as either new construction or complete demolition: (1) the placement of a new pipeline next to existing pipeline, (2) the construction of a new pipeline in a new trench that is "substantially deeper" (at least one-third greater depth) than the trench of the existing pipeline, (3) the placement of a new pipeline in a new trench that is substantially shallower (existing pipeline is at least one-third greater depth) than an existing pipeline, (4) the removal of existing pipeline from a trench before constructing a new pipeline at a depth that is at least one-third greater than the depth of the existing pipeline, and (5) the labor to fill an existing pipeline with concrete in order to abandon the pipeline. Labor charges for the following, however, are subject to sales/use tax as nonresidential real property repair or remodeling: (1) the replacement of the existing pipeline with a new pipeline at the same depth, (2) the excavation of the existing pipeline, (3) the labor to insert a new pipeline inside of an existing pipeline, (4) the connection of new pipeline to an existing pipeline, and (5) the labor to cap the ends of an existing pipeline. Charges to remove excavated, nonoperational pipe from the job site and transport it to the taxpayer's service yard or to a recycler are subject to sales/use tax as a taxable real property service. Finally, a contract that includes both taxable tie-in labor and nontaxable new construction labor is rebuttably presumed to be taxable in total if the tie-in labor represents more than 5% of the total charge, unless the charge for new construction labor is separately stated. Tex. Comp. of Pub. Accts., No. 201706007L (June 26, 2017).

Technology

New York: Cloud collaboration services constitute prewritten software and, therefore, a company's charges for such services are subject to state and local sales taxes. The New York Department of Taxation and Finance found the essence of the company's product is the provision of software because it facilitates the operation of a customer's telecommunication system by allowing the customer to remotely access its software, which then "instructs" the customer's own equipment to perform various functions (e.g., voice, video, messaging, presence, audio conferencing, web conferencing and mobility services). Moreover, the company's receipts from the service constitute receipts from the sale of prewritten software since the customer obtains constructive possession of the software when engaging in a contract to purchase a license to use the product (i.e., the customers have the right to use, control and direct the use of the company's software to facilitate the operation of the customers' telecommunication systems). The company's start-up charges for modifying its software to enable it to interact with and direct the customer's telecommunication system constitute receipts from custom software and are not subject to sales tax, provided the charge for the customization is reasonable and separately stated on the invoice. Additionally, the company's purchases of hardware it uses to provide the cloud collaboration service will not be subject to sales or use tax if the hardware is not delivered or used by the company in New York. Finally, if the company purchases software in New York that is intended exclusively for resale to its customers, the purchases would be exempt from sales tax, provided the company provides the vendor with a resale certificate. N.Y. Dept. of Taxn. and Fin., TSB-A-17(9)S (July 6, 2017).

Pennsylvania: The Pennsylvania Department of Revenue has advised that a company's information retrieval products (e.g., subscription to specialized internet-based research services) are subject to the state's sales and use tax as tangible personal property. The information retrieval products are an electronically accessed subscription fee-based product maintained on servers located outside Pennsylvania, but that also can be accessed from a mobile device application. Subscribers interact with the product through an advanced search function. Through this function, search commands are transmitted by the subscriber's web browser to the company's servers then application software processes the search command and returns results to the subscriber. The department determined that by utilizing the search function, the subscriber "is exercising a license to access canned computer software … [and] is exercising power and control over the software." Further, the subscriber is accessing tangible personal property when he/she accesses content of the information retrieval products; thus, the "resource content constitutes electronic access to taxable tangible personal property." Pa. Dept. of Rev., PA Sales and Use Tax No. SUT-17-002 (May 17, 2017).

Texas: An out-of-state company's charges for provision of a cloud-based software platform that allows subscribing businesses to manage customer communications and use data and analytics functions through a dashboard application are subject to sales and use tax because the company is engaged in a taxable data processing service. The Texas Comptroller of Public Accounts found that the company engages in data processing services by storing customers' messages and related information for subsequent retrieval, translating incoming messages into an accessible format and creating analytic reports for subscribers' uses. Further, the dashboard service is software as a service (SaaS), which is a taxable data processing service. It should be noted that the first 20% of data processing service charges are exempt from sales and use tax under Texas law. Lastly, the provider's separately stated charge for the rental of specialized printers is subject to sales and use tax as the rental of tangible personal property. Tex. Comp. of Pub. Accts., No. 201705045L (May 30, 2017).

Controversy and compliance

Connecticut: The Connecticut Department of Revenue Services recently mailed notices to several unregistered online retailers demanding electronic sales records for all individual sales made to customers with Connecticut addresses over the past three years. In lieu of providing sales records, the department is offering the option of voluntarily registering for Connecticut sales and use tax purposes and prospectively collecting and remitting tax on sales to Connecticut customers. While the notices require the recipient to respond within a specific deadline, they do not address potential penalties or other consequences of failing to respond. On July 7, 2017, however, Governor Dannel Malloy signed Public Act No. 17-147 into law, which gives the Commissioner authority to impose a civil penalty of $500 per violation for failing to comply with these types of information requests, effective July 1, 2017. For additional information on this development, see EY Tax Alert 2017-1203.

Connecticut: A new law (HB 7312) provides that, effective October 1, 2017, sales and use tax permits will expire every two years unless otherwise specified. Permits issued before then expire every five years. In addition, effective January 1, 2018, HB 7312 codifies Connecticut's requirement to remit sales tax on an annual basis for parties whose total tax liability for the 12-month period ending on the previous June 30 was less than $1,000. Conn. Laws 2017, Pub. Act No. 17-147 (HB 7312), signed by the governor on July 7, 2017.

Cook County, IL: On October 10, 2017, the Cook County Board of Commissioners voted 15-1 to repeal the penny-per-ounce "soda tax" on sales of sweetened beverages. The tax is set to expire on December 1, 2017, which is the first day of the county's FY18. The controversial tax had been the subject of numerous lawsuits. Most recently, on July 28, 2017, the Cook County Circuit Court dismissed a suit[20] filed by the Illinois Retail Merchants Association challenging the constitutionality of the tax. *See* EY Tax Alert 2017-1248. The county must now determine how to compensate for the loss of $200 million in revenue that was projected to come from the tax.

Illinois: A new law (HB 821) amends the Use Tax Act, the Service Use Tax Act, the Service Occupation Tax Act, the Retailers' Occupation Tax Act, the Prepaid Wireless 9-1-1 Surcharge Act, the Public Utilities Act and the Environmental Protection Act, to require certain tax returns filed under those Acts to be filed electronically. Vendor discounts under those Acts are allowed only for returns that are filed electronically. An exemption is provided for taxpayers without access to the internet. While the new electronic filing mandate carries no statutory penalty for failing to comply, taxpayers who continue to file on paper forfeit the vendor discount. The provisions of HB 821 took effect upon enactment. Ill. Laws 2017, Pub. Act 100-0303 (HB 821), signed by the governor August 24, 2017.

Kansas: A new law (HB 2212) increases the threshold filing amounts for retailers to submit sales taxes to the Kansas Department of Revenue. Effective on and after January 1, 2018, the threshold amounts are increased as follows: (1) $400 (from $80) for annual filings; (2) $4,000 (from $3,200) for quarterly filings; and (3) $40,000 (from $32,000) for monthly filings. Kan. Laws 2017, HB 2212, signed by the governor on June 23, 2017.

Louisiana: A new law (HB 601) establishes the Louisiana Uniform Local Sales Tax Board, whose main goal is to establish uniformity and efficiency for the collection and administration of sales and use taxes. The Board has the authority to support and advise local tax collectors, establish rules related to the collection of local sale and use taxes, and develop a coordinated multi-parish audit process, among other things. La. Laws 2017, Act 274 (HB 601), signed by the governor on June 16, 2017. For more on other legislation enacted during the 2017 Louisiana general session, see EY Tax Alert 2017-1121.

Massachusetts: The Massachusetts Department of Revenue has initiated a suit against subsidiaries of an online retailer to force the companies to provide sales data and identifying information with respect to the third-party vendors that use the online retailer's marketplace, and have sales to in-state customers and inventory held within the state. The department has stated that the purpose of the action is to assess the potential tax liabilities of the marketplace sellers. On September 25, 2017, the same day that the department filed suit, a Superior Court judge ordered the companies to produce to the department the names, addresses and federal identification numbers of their third-party vendors within 20 days. The department originally had sought information from the companies regarding any third-party vendors that "store, or who have stored, any tangible personal property in any location in Massachusetts that is, or was, owned or leased by the online retailer or any other affiliated entity after January 1, 2012." *Massachusetts. v. Amazon Tech., Inc*., Mass. Super. Ct., No. 17-3065E, *order* (September 25, 2017).

Massachusetts: As part of the FY18 state budget, Massachusetts has proposed an "accelerated sales tax" program, which is projected to generate a onetime revenue benefit of $125 million. The provision, (HB 1, §§94 and 95), which would require sales tax on debit and credit card sales to be remitted to the Department of Revenue on an immediate basis, would not result in any new revenue to the state. The proposal does direct the department to certify the cost-effectiveness of the program, as well as its June 1, 2018, proposed implementation date, by November 1, 2017, prior to moving forward. Potentially affected parties were invited to submit comments by October 1, 2017. 2017 Acts, ch. 47, H. 3800, §§94-95.

Missouri: An in-state company may accept an out-of-state exemption certificate from an out-of-state exempt organization for its sales to a Missouri contractor who is purchasing building materials for a project for the exempt organization. Missouri law permits an exemption from sales tax for all purchases on behalf of an entity located in another state when the entity is authorized to issue the exemption certificate for purchases to a contractor under that state's laws. Contractors making purchases on an entity's behalf must maintain a copy of the entity's exemption certificate. Mo. Dept. of Rev., LR 7861 (July 19, 2017).

Missouri: A new law (SB 49) continues to prohibit the Missouri Department of Revenue from sending notice to any taxpayer regarding taxability of transactions under *IBM*[21] until August 28, 2018 (from August 28, 2017). In *IBM*, the Missouri Supreme Court found that the taxpayer was not entitled to a use tax exemption for hardware and software sold to a large credit card company because the credit card company's use of the materials for processing credit and debit card transactions did not qualify as "manufacturing of any product" under the statute. In addition, SB 49 limits the combined county and city sales tax rates counties and cities can submit for voter approval. SB 49 took effect August 28, 2017. Mo. Laws 2017, SB 49, signed by the governor on July 10, 2017.

Multistate: Application to the Multistate Tax Commission's (MTC) National Nexus Program voluntary disclosure initiative (VDI) for sellers that make sales through online marketplaces that originally was offered from August 17 through October 17, 2017, has been extended through November 1, 2017. Participating states will consider VDI applications and, in exchange for executing a voluntary disclosure agreement (VDA), most states will waive sales/use and income/franchise tax liabilities for online marketplace sellers, including penalties and interest, for prior tax periods without regard to any lookback period. Both Wisconsin and Colorado have deviated from the general waiver, with Wisconsin requiring payment of back sales/use tax liability and interest beginning January 1, 2015, and back income/franchise tax liability for the 2015 and 2016 tax years. Further, Wisconsin is limiting the lookback period to prior years in which the marketplace seller had nexus. Colorado is providing relief from back tax liability for sales/use tax purposes, but for income/franchise tax purposes is requiring payment of back tax liability and interest for a four-year lookback period. Participating states include: Alabama, Arkansas, Colorado, Connecticut, District of Columbia, Florida, Idaho, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, Missouri, Nebraska, New Jersey, North Carolina, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont and Wisconsin. Multistate Tax Commission, *Online Marketplace Seller Voluntary Disclosure Initiative* (Notice updated October 11, 2017).

Rhode Island: A new law (HB 5175, Sub. A) provides that new exemption certificates for charitable, educational and religious organizations will be valid for four years from the date of issue. Exemption certificates issued before July 1, 2017, to such organizations will expire four years from the effective date of this provision. HB 5175 also exempts from sales and use tax sales of seeds and plants used to grow food. These changes took effect July 1, 2017. R.I. Laws 2017, HB 5175, Sub. A, signed by the governor on August 3, 2017.

South Carolina: On June 21, 2017, the South Carolina Department of Revenue initiated a suit against Amazon Services LLC, asserting that the company, which operates an online marketplace for third-party sellers, was operating as a retailer or consignor within the state with respect to sales made through its marketplace, and should have been collecting tax on such sales to South Carolina customers. Amazon Services has argued that it lacks due process nexus with South Carolina because it does not have direct purposeful contact with the state when it provides services to third-party sellers in other states. The case is expected to be heard in early 2018. *Amazon Services LLC v. South Carolina Department of Revenue*, No. 17-ALJ-17-0238-CC (2017).

Endnotes

1. *South Dakota v. Wayfair, Inc. et al, petition for cert. filed*, Dkt. No. 17-494 (U.S. S. Ct. Oct 3, 2017).
2. To date, economic nexus provisions have also been enacted or implemented in Alabama, Indiana, Maine, Massachusetts, North Dakota, Ohio, Tennessee, Rhode Island, Vermont, Washington, and Wyoming.
3. 504 U.S. 298 (1992).
4. *South Dakota v. Wayfair, Inc. et al*, 2017 S.D. 56 (S.D. S. Ct. Sept. 13, 2017). During oral arguments before the South Dakota Supreme Court in August, the state agreed that the provision exceeded the Quill standard, and urged the court to swiftly issue a ruling to that effect so that the issue could be brought before the U.S. Supreme Court.
5. It is worth noting that Justices Kennedy and Thomas are the only two members of the *Quill* Court who remain on the Court today.
6. 135 S. Ct. 1124, 1135 (2015) (Kennedy, J., *concurring*).
7. *See Oklahoma County v. Queen City Lodge No*. 197, 156 P.2d 340 (Okla. 1945).
8. The term "contract distribution network or CDN" is "a person that operates an organized network of servers and other computer hardware that is generally placed in geographically distributed data centers within close proximity to internet users."
9. *504 U.S. 298 (1992).*
10. *See* EY Tax Alert 2017-1104.
11. *IBM v. Director of Revenue*, 491 S.W.3d 535 (Mo. banc 2016).
12. *Southwestern Bell Tel. Co. v. Dir. of Revenue*, 78 S.W.3d 763 (Mo. banc 2002).
13. *Southwestern Bell Tel. Co. v. Dir. of Revenue*, 182 S.W.3d 226 (Mo. banc 2005).
14. *Cannon & Dunphy, S.C. v. Wisconsin Department of Revenue*, No. 13-S-221 (Wisc. Tax App. Comn. August 15, 2015).
15. *La. Mach. Co., LLC v. Bridges*, 2015 La. App. unpub. LEXIS 365 (La. App. 2015) writ denied 187 So. 3d 1003 (La. 2016).
16. *United States v. Yellow Cab Co*., 332 U.S. 218 (1947), *overruled on other grounds by Copperweld Corp. v. Indep. Tube Corp*., 467 U.S. 752 (1984).
17. *Oklahoma Tax Commission v. Jefferson Lines, Inc*., 514 U.S. 175 (1995).
18. *ANR Pipeline Co., et al. v. Tenn. Bd. of Equal*., Nos. M2001-01098-COA-R12-CV, M2001-01117-COA-R12-CV, M2001-01119-COA-R12-CV (Tenn. Ct. App. December 19, 2002), *perm. app. denied*, June 30, 2003.
19. *American Fiber Systems, Inc. v. Chumley*, No. 06-574-II (Tenn. Ch. Ct. October 14, 2008).
20. *Illinois Retail Merchants Ass'n. et al v. Cook Cnty. Dept. of Rev*., No. 17 L 50596 (Cir. Ct. of Cook Cnty., Ill. July 28, 2017).
21. *IBM Corp. v. Mo. Dir. of Rev*., 491 S.W.3d 535 (Mo. 2016).

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CSG no. 1710-2468036
SCORE no. 06072-171US
ED None.

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