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Tax Policy

The South Carolina Department of Revenue published Draft Revenue Ruling No. 16-XX May 11, and is currently soliciting public comments until June 1. In this article, McDermott, Will & Emery's Arthur R. Rosen and the University of Illinois College of Law's Hayes R. Holderness discuss the draft with respect to issuers of credit cards and providers of remote access to software.

South Carolina Department of Revenue Wishing for Rain?

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South Carolina, the original alchemist of economic nexus,¹ appears eager to reenter the fray, at least if its Department of Revenue's recent draft revenue ruling is any indication.² S.C. Draft Revenue Ruling No. 16-XX laudably provides written guidance to taxpayers regarding the DOR's positions on a wide range of income tax nexus-creating events. And while the draft ruling neither is an officially issued revenue ruling (yet) nor would be a legally binding document on

¹ *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (SC 1993), cert. denied, 510 U.S. 992 (1993).

² S.C. Rev. Rul. No. 16-XX (draft, published May 11, 2016).

courts and taxpayers if officially issued, it contains provisions that would aggressively expand the scope of the economic nexus concept in South Carolina. Although the draft ruling covers virtually all businesses and many types of transactions, this article examines this proposed expansion only with respect to issuers of credit cards and providers of remote access to software (otherwise known as cloud computing or Software as a Service).

I. The Notable Statements in the Draft Revenue Ruling

Most of the statements in the draft ruling are beyond the scope of this article; while many of them seem to be consistent with both settled law and good tax/economic policy, others seem to be attempts at inappropriate overreaching. The statements to which we wish to draw attention in this article are those numbered J.4., J.7., and L.1.-L.4.

J.4. and J.7. provide the DOR's position regarding the nexus implications stemming from certain financial activities. J.4. provides that "issu[ing] credit cards to residents of South Carolina" is a nexus-creating event for an out-of-state corporation. J.7. provides that "mak[ing] personal loans to residents of South Carolina who traveled across the state-border to obtain the loans" is not a nexus-creating event for an out-of-state lending corporation.

L.1.-L.4. provide specific positions regarding the nexus implications stemming from cloud computing transactions. L.1. provides that "provid[ing] access to its software to South Carolina customers and pay[ing] independent contractors to perform configuration/setup services in South Carolina" creates nexus for an out-of-state corporation. Similarly, L.2. provides that "provid[ing] access to its software to South Carolina customers and ha[ving] employees solicit [non-P.L. 86-272 protected sales] in South Carolina" creates nexus for an out-of-state corporation. Finally, L.3. and L.4. provide respectively that an out-of-state corporation without a physical presence in South Carolina has nexus with the state if it "provides access to its software to South Carolina customers" and either "has a substantial number of customers with billing addresses in South Carolina" or "earns a substantial amount of revenue from customers in South Carolina." Though the statements in L.1.-L.4. do not specifically mention "remote" access to software (i.e., traditional cloud computing or SaaS transactions), we assume that the statements intend primarily to address transactions involving such access as the statements are categorized under "Cloud Computing Transactions or Software as a Service (SaaS) Transactions."

II. Expanding Economic Nexus

In 1993, the South Carolina Supreme Court decided the *Geoffrey* case, declaring that a "taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. . . . We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substan-

tial nexus' with South Carolina."³ Unlike other states, such as West Virginia through case law⁴ and New Hampshire through statute, the South Carolina Supreme Court did not adopt a "substantial economic presence" standard, which vaguely looks to the level of economic activity a person engages in that has some connection to the state. Additionally, unlike states such as Ohio and California,⁵ South Carolina has not adopted a "factor presence" statute which similarly looks to a person's level of sales (or payroll or property) in a state to determine whether to subject the person to tax.⁶

The draft ruling pushes past the *Geoffrey* standard, though apparently only for a limited set of activities, including the issuance of credit cards and providing remote access to software that is actually being used by the provider, not the party accessing it. Neither activity constitutes the licensing of intangible property in the state, thus *Geoffrey* does not control here. As such, the draft ruling is breaking new ground, but despite this effort, the draft ruling's positions on these types of transactions seem difficult to justify, especially because the draft ruling gives no indication of what makes these transactions unique from a legal nexus point of view.

A. Issuing Credit Cards. Two possible justifications for treating the issuance of credit cards as nexus-creating immediately come to mind. First, if the credit cards remain the property of the out-of-state corporation and are merely leased, lent, or consigned to the account holder, then under the principles of section C of the draft ruling—regarding "Ownership/Leasing of In-State Property"—it may make sense to treat the credit cards as constituting property of the owner in the state. However, this does not appear to be the rationale used by the DOR, because the statement about credit cards does not occur in section C of the draft ruling, but rather in the financial transactions section. Even if this were the rationale of the DOR, in the standard situation, the issuer retains no right in the physical card. Further, the types of property section C refers to are real estate, automobiles, inventory, and equipment. These types of property are useful in their own right. In contrast, the cards are merely evidence of the right, revocable by the issuer, to borrow under certain terms as recognized by the Tennessee Court of Appeals in *J.C. Penney National Bank*.⁷ As such, credit cards should not be treated similarly to owned/leased property in the state covered by

³ *Geoffrey*, 437 S.E.2d at 18.

⁴ *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 232 (W.Va. 2006), cert. denied, *FIA Card Services, N.A. v. Tax Comm'r*, 551 U.S. 1141 (2007); N.H. Rev. Stat. Ann. §77-A:1, XII.

⁵ See, e.g., Ohio Rev. Code Ann. §5751.01(I); Cal. Rev. & Tax. Code §23101(b).

⁶ We are not endorsing either the "substantial economic presence" or the "factor presence" approaches as appropriate or constitutional.

⁷ *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W. 3d 831, 840 (Tenn. App. 1999), appeal denied (Tenn. May 8, 2000) ("Credit cards, in and of themselves, are virtually worthless. The 'value' of these cards is found in the right which the card represents, namely the credit account. The card is merely representative of the customer's right to charge goods and services. The actual card is not even necessary to the transaction. It merely serves as a convenient article on which to record the necessary information regarding the customer's account. As the chancellor correctly determined, the real asset is the intangible account which the card represents.").

the statements that appear in section C of the draft ruling.

Second, if a credit card is correctly viewed as the mere physical representation of an intangible right (even if the card remains the property of the issuer), then issuing credit cards is correctly viewed as the creation of an unsecured loan to the account holder in the state. In light of the remainder of the draft ruling which clearly treats secured loans as non-nexus-creating, treating loans generated through the issuance of credit cards as nexus-creating seems contradictory. As noted above, J.7. provides that “mak[ing] personal loans to residents of South Carolina who traveled across the state-border to obtain the loans” is not a nexus-creating event for an out-of-state corporation. The draft ruling goes even further, declaring in sections J.2. and J.3. that making loans secured by real estate or tangible personal property is also not a nexus-creating event. Simply put, making a loan to a resident of the state is not a nexus-creating event in the DOR’s view, and, thus, the issuance of credit cards should not be as well.

B. Providing Remote Access to Software. The draft ruling’s statements regarding the provision of remote access to software suffer from a wide degree of inconsistency with themselves and with the balance of the ruling.

The inconsistency of the cloud computing statements becomes evident by first considering the first two statements. L.1. and L.2. are not really statements about the provision of remote access to software; they are mere reaffirmations of the fact that having independent contractors or employees operating on the out-of-state corporation’s behalf in the state (i.e., fulfilling the out-of-state corporation’s legal obligations in the state) are nexus-creating activities. What L.1. and L.2. appear to indicate, then, is that providing remote access to software *on its own* does not create nexus.

This interpretation is consistent with the remainder of the draft ruling, particularly the statement found in section A.2. that neither making remote sales (through a 1-800 number) nor advertising in the state establishes nexus. South Carolina treats the provision of remote access to software as the provision of a database access service,⁸ and unless the draft ruling is relying on P.L. 86-272 for its statement in A.2. (of which there is no indication, unlike other statements of the ruling), there is no basis for treating remote sales of this service any differently than remote sales of anything else to residents of the state.⁹ Further, as section J.7. provides that making loans to a resident that comes to the out-of-state corporation does not create nexus, it would seem reasonable to conclude that a resident that comes to the cloud computing provider for the service would also not create nexus.¹⁰

⁸ S.C. Code Regs. 117-329.4(k); S.C. Rev. Rul. No. 03-5 (Dec. 9, 2003) (reinstated by S.C. Rev. Rul. No. 11-2 (Nov. 18, 2011)).

⁹ We admit that section E.4. of the draft ruling considers the licensing of canned software to residents as nexus-creating, but since South Carolina treats remote access to software as a service, E.4. should not affect the analysis.

¹⁰ Indeed, though undeveloped by case law, the due process clause of the Fourteenth Amendment appears to prohibit a state from claiming nexus over an out-of-state corporation whose only connection to the state is making sales to residents

If providing remote access to software on its own does not create nexus, then it is difficult to justify nexus based on providing a lot of remote access to software, as sections L.3 and L.4. would do. This is a clear attempt to incorporate an economic nexus standard similar to the “substantial economic presence” or “factor presence” standards, but it is misguided. If an activity itself is not nexus-creating, then it should not matter how often the activity is engaged in for purposes of determining nexus. The counter-argument is likely that once a “substantial” level of that activity is reached, then nexus is created—which is really a way of relying on a *de minimis* rule to exclude the provision of remote access to software from the list of nexus-creating events. However, *de minimis* rules negate the legal impact of something that *has legal significance in the first place*. For instance, in *Wrigley* (on which the draft ruling explicitly relies), the court considered only whether Wrigley’s “nonimmune activities” were *de minimis*, not whether all of its activities were *de minimis*.¹¹ Basically, a small amount of a legally significant event is treated as a null amount of that event. Since the provision of remote access to software is not a legally significant event in the context of income tax nexus, there is no need for a *de minimis* or “substantial” approach. A small amount of a “zero” factor is “zero,” just as a substantial amount of a “zero” factor is “zero.”

Perhaps recognizing the appropriate use of *de minimis* rules, the draft ruling does not provide for a comparable “substantial” customers- or revenue-based nexus creation in any other context and only specifically refers to the *de minimis* concept for activities that otherwise create nexus (the *de minimis* concept is also mentioned as a general rule). As the draft ruling treats providing remote access to software—indeed, the making of any kind of remote sales as well as advertising in the state—as not nexus-creating on its own, there appears to be no justification for introducing the “substantial” customers or revenue approach in the context of cloud computing, especially because the approach finds no support in other contexts.

III. Wishing for Rain?

Given the above analysis, what then drives the DOR’s approach in the draft ruling to the issuance of credit cards and the provision of remote access to software? We are certainly aware of the fact that state revenue agencies and taxpayers have had a difficult time determining the appropriate taxability of cloud computing transactions in the sales and use tax area, and it is unsurprising that issues would arise in the income tax area as well. However, as we have argued in the sales and use tax area,¹² these are not issues for administrative agencies to determine; they should be addressed by

that approach the corporation. See Hayes R. Holderness, *Taking Tax Due Process Seriously: The Give and Take of State Taxation*, 19 Fla. Tax Rev. __ (forthcoming 2017) (manuscript available at <http://ssrn.com/abstract=2703577>, and on file with authors).

¹¹ *Wis. Dep’t of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 235 (1992).

¹² Arthur R. Rosen, Leah Robinson, and Hayes R. Holderness, *Cloud Computing: Revenue Departments’ Cloudy Minds Lead to Inappropriate Assessments—Parts 1-3*, Bloomberg BNA Tax Management Weekly State Tax Report (2013 Weekly

state legislatures and courts. The expansion of South Carolina's economic nexus standard is beyond the scope of the DOR's authority.

We suspect the DOR is aware of these limitations, and as noted earlier, we recognize that the draft ruling is not a pronouncement of law but of the DOR's posi-

State Tax Report 3, 10/11/13) (2013 Weekly State Tax Report 3, 10/18/13) (2013 Weekly State Tax Report 3, 10/25/13).

tions. By taking these aggressive positions and limiting them to an area decided by other courts (issuing credit cards) and an area full of controversy (remote access to software), the DOR appears to be priming the pump for legal challenges which could establish these rules judicially or spur legislative action. What remains to be seen is whether the storms of litigation or legislation would favor the DOR or litigants. Or maybe the DOR is simply hoping for another type of rain (\$\$\$). Be careful what you wish for.