

Technology: what's taxed or exempted

Mark A. Loyd, Esq., CPA



Constant and sometimes rapid innovations in technology have the potential to create both uncertainty and opportunities, particularly in the state and local tax area.

Sales and Use Tax

States like the Commonwealth of Kentucky enact various types of taxes for many purposes including perhaps the most basic of purposes - generating revenue on which to operate. For example, the Kentucky General Assembly enacted the sales and use tax in 1960, the revenues from which now go to the Commonwealth's General Fund out of which the vast majority of the Commonwealth's expenses are paid. Naturally, the sales tax laws were written within the context of the then primarily manufacturing-based economy (circa 1960) and also the technology that was then in use.

As a historical note, the sales tax was originally enacted for the purpose of paying military veterans a bonus, *i.e.*, a temporary tax, but was repurposed so to speak and is now a permanent fixture. It was not until 2008 that the General Assembly deleted the statutory reference to the sales tax's prior purpose.

In the last half-century, numerous technological innovations have occurred. Most obvious, perhaps, are the development of computers, software, the Internet, cell phones, etc. These have many uses, including those in manufacturing businesses, service

businesses and others. Of course, there have also been technological advances specific to certain businesses - like manufacturing, for instance. And, developments continue in the form of new products and services as well as new methods and channels of delivery; but, technological innovations also occur in the form of enhancements to old technology, like mediums for the delivery of music.

The Commonwealth's sales and use tax, like that of most states, is primarily levied on the retail sale or use by a consumer of tangible personal property that is not otherwise exempt from tax, and there are a plethora of exemptions, *e.g.*, for certain manufacturing machinery, materials, supplies and industrial tools. In contrast, sales tax is levied only on certain services specifically enumerated in the tax imposition statute, such as rentals of hotel rooms, sewer services, admissions, prepaid calling services (including wireless calling services),

communication services, ring tones, and others; all other services are not subject to tax.

It cannot be a coincidence that the purpose and effect of the most recent amendments regarding the taxation of services was to impose tax on prepaid calling services in 2005 and on ring tones in 2007.

Computers and software

Given the structure of the sales tax, *i.e.*, taxing all non-exempt tangible personal property and not taxing services unless it is one specifically identified as taxable, the taxation of new technologies depends on what they are. Take for example a computer (whether a mainframe, server, desktop, laptop, etc.), because it is a thing, it is quite obviously tangible personal property and thus subject to tax unless it is otherwise exempt.

While it is relatively obvious that a computer is tangible personal property, the classification of software as tangible versus intangible property for sales tax purposes is, perhaps, not quite so obvious. Revenue Policies 51P170 and 51P171, non-regulatory administrative guidance issued by the Department of Revenue (then the Revenue Cabinet) circa 1990 and 1986, respectively, distinguished between "canned" software which was subject to tax and "custom" software which was not. Canned software was apparently a reference to software "out-of-a-can" which had

the connotation of being tangible property. In contrast, custom software was considered to be more akin to a non-taxable intangible or service. A couple of Kentucky Board of Tax Appeal Orders involving Bank of Louisville and Allied Sporting Goods issued in the mid-1980s reached inconsistent conclusions as to the taxation of software.

Given that software had to fall under the definition of tangible personal property to be taxable, a necessary predicate to the taxation of software was delivery via a tangible medium (*e.g.*, floppy disks, CDs, etc.). This was how software was initially delivered, but the popularity of the Internet as a method of delivery created a question as to the taxability of downloaded software and music because of the absence of a tangible medium. The 2003 General Assembly addressed this issue with its enactment of the Uniform Sales and Use Tax Administration Act, which went into effect on July 1, 2004. The Act redefined tangible personal property to be such “regardless of the method of delivery” and specifically included prewritten computer software within this definition. Notably, software more akin to a service continues to be non-taxable.

Technological developments in manufacturing

As stated, technological developments not only take the form of new products, but also take the form of improvements to existing

technology, much like music, which has evolved from being primarily delivered via tangible mediums (vinyl records, eight-track tapes, cassettes, CDs) to intangible mediums over the Internet. This same concept is also evident in manufacturing.

A multitude of exemptions from sales and use tax are provided for by statute. For instance, there are exemptions provided for “tangible personal property which is directly used in manufacturing or industrial processing, if the property has a useful life of less than one (1) year” [KRS 139.470(10)(a)2] which are categorized as exemptions for materials, supplies and industrial tools. The latter two exemptions, in particular, provide a snapshot of the technology of that time period because the General Assembly wrote examples of exempt items into the statutory text itself.

As to supplies, the statutory text provides, “This category includes supplies such as lubricating and compounding oils, grease, machine waste, abrasives, chemicals, solvents, fluxes, anodes, filtering materials, fire brick, catalysts, dyes, refrigerants, explosives, etc.” KRS 139.470(10)(a)2. b. These are all examples of technology common in the 1960’s. One of the more interesting items in the list is “fire brick,” used to line industrial high-temperature blast furnaces that manufacture metals. Over the past half-century, there have been substantial technological developments in this area. Now more commonly

known as refractory materials, these new materials come in all shapes and sizes.

And, regarding industrial tools, the statutory text provides, “This group is limited to hand tools ... and to tools attached to a machine such as molds, grinding balls, grinding wheels, dies, bits, cutting blades, etc. Normally, for industrial tools to be considered directly used in manufacturing, they shall come into direct contact with the product being manufactured ...” KRS 139.470(10)(a)2.c. Again, these are all examples of technology common in the 1960s. Here, cutting blades stand out. As with manufacturing supplies, there have been major technological advances in cutting technology – lasers, for example.

Because these exemptions were enacted at a point in time, they were, by their very nature, influenced by the technology and terminology commonly in use at that time. Thus, depending on your perspective, this can either pose an obstacle or present an opportunity.

About the author: Mark A Loyd, Esq., CPA, is a member of Greenebaum Doll & McDonald in Louisville and chairs its State and Local Tax Team. He is a member of the KyCPA board of directors; chair of the editorial board; member of the industry task force; and former chair of the taxation committee. He can be reached at mal@gdm.com; 502.587.3552.