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Diagnosing Sales Tax Rules for Digital Health Products

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The development and deployment of new technologies has led to an evolution in the delivery of health care products and services. In particular, health care providers and others increasingly use cloud-based software applications and other technologies accessed remotely through web browsers or applications.

The purchase and use of these new digital technologies has led to uncertainties under sales and use tax regimes, which traditionally have distinguished between the taxable sale of physical tangible property and the nontaxable sale of services. The sale of a cloud-based software application used to deliver services, for example, complicates the traditional distinction between the sale of software and services.

Further, the sales and use tax landscape is constantly changing, wide-ranging and nuanced, which can make compliance daunting for technology companies operating in the digital economy, including digital health companies.

Overview of Digital Health Companies

Digital health companies are a broad, fast-growing sector of businesses that deploy technology in order to improve health and wellness. Digital health technologies are wide-ranging and include wearable health devices, electronic medical records, telemedicine and wellness apps, other forms of mobile health and artificial intelligence.

Digital health companies target various phases of the care cycle, from digital services that help individuals initially locate care by directing them to available medical providers, to those that improve the ultimate delivery of care to patients.

Further, some technologies assist in the actual delivery of care, such as applications that facilitate direct messaging with licensed providers or other telemedicine interactions, while other technologies may simply provide back-end services such as data analytics on health outcomes.

These new technologies are often designed to address an increasingly critical need in modern health care — namely, the exchange of large amounts of data between a variety of sources in order to both deliver and improve upon the delivery of care. The flow of data between an ever-expanding range of players — including health care providers, patients, researchers and insurers — has become a critical feature of the health care system.

Data as a driver has led to increased usage of cloud-based applications, which permit the sharing, storage and processing of information from multiple sources in a consistent, centralized manner. Accordingly, health care companies and providers are increasingly reliant upon cloud-based software to provide information critical to the delivery and improvement of health care services.

Taxation of the Digital Economy Varies Across Sales Tax Regimes

Advancing technology — including in the digital health space — has required states and municipalities to modernize their sales tax regimes to capture revenue from companies making digital sales in their jurisdiction. States and localities generally lack the authority to impose sales tax if there is no nexus between the jurisdiction and the items taxed.

Traditionally, nexus relied on concepts of physical presence. However, recent court decisions are expanding the concept of nexus, and, therefore, jurisdictions' ability to tax digital sales. South Dakota v. Wayfair Inc., a 2018 U.S. Supreme Court decision, arose from a challenge to a South Dakota law designed to capture sales tax revenue from online sales made by remote sellers having no physical presence in the state.[1]

The Wayfair court held that a company having sufficient "economic and virtual contacts" with a state had adequate nexus to require the company to collect and remit sales tax, even if it lacked physical presence in the jurisdiction.[2] Since Wayfair, states have implemented various thresholds to measure a remote seller's economic and virtual contacts. These thresholds typically consist of sales dollar volume, the number of transactions into a given state or some combination thereof.

This variety in standards has made it difficult for digital health companies to comply with state laws. As a result, companies must evaluate their sales tax collection obligations on a jurisdiction-by-jurisdiction basis, especially because the decision in Wayfair has emboldened taxing authorities to take more aggressive positions in sales and use tax audits.

States and municipalities also have taken dramatically different approaches to the imposition of tax on digital sales. While the majority do not tax sales of most services, they do impose tax on sales of physical tangible property, including software.

As software sales have shifted from physical media to digital downloads and cloud-based hosting, taxing authorities have taken more aggressive positions with respect to what constitutes the sale of tangible property in an attempt to subject the maximum amount of sales within the digital economy to sales or use tax, even in the absence of clear statutory authority.

The use of software to provide services complicates the distinction between nontaxable services and taxable software. Thus, players within the digital economy often find themselves in disputes with revenue officials over whether they are, in fact, selling nontaxable services or taxable software.

This disparate treatment is best viewed through specific examples. On one end of the spectrum, states like California do not treat cloud-based software sales as transfers of tangible personal property and, therefore, do not impose sales tax on such sales.[3]

At the opposite end of the continuum, other states, including Iowa, explicitly provide that sales of software as a service are subject to sales tax.[4] Iowa simultaneously expanded its business-to-business exemption to include software as a service "furnished to a commercial enterprise for use exclusively by the commercial enterprise."[5]

Many jurisdictions take a middle ground and follow the approach taken in Massachusetts, where sales tax determinations are made by considering the object of the transaction, a test that looks to the primary purpose of a customer's purchase.[6] If the sale of software is incidental to the underlying service or product provided, the whole transaction is treated as a sale of a service (or the other underlying nonsoftware product).

Recently, the Massachusetts Supreme Judicial Court held that sales of virtual video and audio conference services were taxable because software (albeit software hosted on the seller's servers) was the primary object of the transaction.[7] The object-of-the-transaction test applied in Massachusetts and many other states is an inherently factual inquiry that varies by jurisdiction, and will continue to lead to uncertainty for taxpayers going forward.

Constant changes in state law add to the complexity and uncertainty. For instance, in a 2019 Alabama case, a taxpayer relied on a long-standing regulation stating that custom software programs were not taxable.[8] However, the Alabama Supreme Court disagreed and held that all software was tangible personal property, and, thus, subject to sales tax.[9] Now, only the services provided by a software company — not the software itself — are exempt from tax in Alabama.[10]

In Connecticut, a recent bill increased the tax rate on software by more than 5%, but included a carve out for business-to-business use of electronically accessed software.[11] Vermont has swung back and forth, with cloud-based software originally deemed taxable before becoming statutorily exempt from sales tax.[12] Now, the Vermont legislature is considering removing the exemption — even though a bill proposing to do just that was defeated last year. [13]

Taxation of Digital Health Companies' Sales

The wide variance in sales tax regimes presents uncertainties and compliance challenges for digital health companies. A January 2020 private letter ruling by the South Carolina Department of Revenue is illustrative of the challenges digital health companies face.

The letter ruling involves a cloud-based business management software provider that simplifies the billing and claim submission process for durable medical equipment suppliers through storage and sharing of customer data.[14] The software collects and stores customers' billing and revenue data, provides inventory management and reporting analytics based on the stored data, and assists in electronic claim submissions to public and private payers.[15]

The letter ruling concluded that the charges for the company's software subscriptions were "tangible personal property" subject to sales and use tax. The ruling reasoned that tangible personal property includes communication services under the South Carolina sales tax statute,[16] and database access transmission services and online information services are subject to sales and uses tax as communications services under the department's regulations.[17]

South Carolina's ruling is not binding in other jurisdictions, which may take completely different approaches. For instance, in Massachusetts database access and information services are not subject to sales tax.[18] Thus, the digital health company that obtained the ruling from South Carolina must separately evaluate its sales tax obligations across all jurisdictions where it has nexus.

An added layer of complexity in the digital health space is the bifurcation of many health care entities into professional and nonprofessional (i.e., management) companies, in what is often known as the friendly professional company model. In such situations, the professional company provides clinical services to patients while the management company provides administrative and other nonprofessional services to the professional company.

In states where sales of software are taxable but professional services are not, if the management company develops or holds a license for software used to deliver services by the professional company, regulators may view the software application as divorced from the professional services furnished by the professional company. As a result, companies in the digital health space must think through both regulatory structuring issues and potential downstream tax issues.

Conclusion

As digital health technologies and sales tax regimes evolve, digital health companies must continue to evaluate their sales tax collection obligations. Companies may face significant exposure for uncollected sales tax, as the payment obligation shifts to the seller if it fails to collect and remit the tax at the time of the sale.

Taxing authorities are becoming increasingly aggressive during sales tax audits, emboldened by the Wayfair case, recent state court decisions regarding the taxation of the digital economy, and their own regulatory guidance.

It is thus important for digital health companies to consider what precisely they are selling under each jurisdiction's law, whether their sales are taxable in the jurisdiction (which may turn on how the sales are made), and whether they have nexus there. The answer to each question likely will vary by jurisdiction, and may continue to change over time.

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[1] South Dakota v. Wayfair Inc., 585 U.S. ___ (2018).

[2] Id.

[3] Cal. Code Regs., tit. 18, § 1502.

[4] Iowa Code § 423.2(6)(bu).

[5] Iowa Code § 423.3(104)(a).

[6] Mass. Regs. § 64H.1.3(14)(a).

[7] Citrix Systems Inc. v. Commissioner of Revenue, No. SJC-12741, slip. op. at 16 (Feb. 5, 2020) (830 CMR § 64H.1.3(14)(a)).

[8] In re: Russell County Community Hospital LLC, d/b/a Jack Hughston Memorial Hospital v. State Department of Revenue, No. 1180204, slip op. at 7 (Ala. May 17, 2019).

[9] Id., at 9.

[10] Id., at 10-11.

[11] Conn. Dept. of Rev., Special Notice 2019(8).

[12] Vermont 2015 Acts and Resolves No. 51, Sec. G.8.

[13] Specifically, bill H. 756, "An act relating to repealing the sales and use tax exemption for cloud-based services," was introduced in the Vermont General Assembly on Jan. 6.

[14] South Carolina Department of Revenue Private Letter Ruling #20-1 (Jan. 16, 2020).

[15] Id.

[16] S.C. Code Ann. §§ 12-36-920(B)(3); 12-36-1310(B)(3).

[17] S.C. Reg. § 117.329.4.

[18] Massachusetts Department of Revenue Letter Ruling 14-1 (Feb. 10, 2014).