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March 31, 2015

Via email: mike.gamble@revenue.alabama.gov and Federal Express

Mr. Michael D. Gamble
Secretary
Alabama Department of Revenue
Room 4131 Gordon Persons Building
50 North Ripley Street
Montgomery, AL 36132

Re: Comments on Proposed Amendments to Regulation 810-6-5-.09 (Leasing and Rental of Tangible Personal Property)

Dear Mr. Gamble:

My name is Stephen Kranz and I am a Partner at the Washington, DC office of McDermott, Will & Emery, where I specialize in state and local tax. I am a member of the Board of Directors of the Tax Foundation and have served as President of the Business Advisory Council to the Streamlined Sales Tax Governing Board, where I worked with the Governing Board member states to develop the definitions used by the states that have chosen to legislatively tax digital content. Since 2007 I have represented a national coalition of companies and organizations concerned about state transaction taxes on digital goods and services, the Digital Goods and Services Coalition ("Coalition"). On behalf of the Coalition, please accept the following comments on the proposed amendments to Ala. Admin. Code r. 810-6-5-.09 ("Amended Regulation"), issued by the Alabama Department of Revenue ("Department") on February 27, 2015. At the outset, we note our comments are focused solely on streaming content, and we do not comment on the cable television provisions.

THE ALABAMA RENTAL TAX

The Alabama Leasing and Rental Tax ("rental tax") is imposed on the lessor for the privilege of leasing or renting of tangible personal property within the state, although the lessor is entitled pass on the tax to its lessee.[1] The tax is administered and collected consistent with the sales and use tax provisions.[2] The gross proceeds from the leasing or rental of tangible personal

[1] Ala. Code § 40-12-220 *et seq.*
[2] Ala. Code § 40-12-224 (linking administration and collection of the rental tax to Ala. Code § 40-23-1).

property are subject to the tax.[3] This amount includes the full value of the proceeds from the lease.[4] The Alabama Code defines "leasing or rental" as:

> "a transaction whereunder the person who owns or controls the possession of tangible personal property permits another person to have the *possession or use thereof* for a consideration and for the duration of a definite or indefinite period of time without transfer of the title to such property."[5]

"*Tangible personal property*" is defined, for purposes of the rental tax, as "[p]ersonal property which may been seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses."[6]

DESCRIPTION OF THE AMENDED REGULATION

There is no provision in the Alabama Code that explicitly imposes tax on streaming content, nor on an out-of-state provider of streaming content, nor is there any Department regulation or revenue ruling or reported appellate court ruling to that effect. Indeed, as pointed out below, the reported court cases and official Department revenue rulings are all contrary to the Amended Regulation. The Amended Regulation seeks to impose tax on streaming content by interpreting the definition of tangible personal property to include a number of so called "digital transmissions,"[7] including:

> "'on demand' movies, television programs, streaming video, streaming audio, and other similar programs that are made available to customers, regardless of the method of transmission, whether rented by subscription for a definite or indefinite period, or on an on-demand basis for a definite or indefinite period."[8]

Providers of digital transmissions, such as "[c]able or satellite television providers, on-line movie and digital music providers, app stores and other similar providers" would be explicitly defined to be engaged in the business of leasing tangible personal property for purposes of the rental tax.[9]

The Amended Regulation would base the rental tax obligation on "gross receipts derived from charges for digital transmissions which are *used* in Alabama."[10] Specifically, "a digital

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[3] Ala. Code § 40-12-220.1; Ala. Code § 40-12-222(b) (gross proceeds includes including any license or privilege taxes passed on to a lessee by a lessor).
[4] *Id.* at § 40-12-220(4). Gross proceeds are determined "without any deduction on account of the cost of property so leased or rented, the cost of materials used, labor or service cost, interest paid, or any other expense whatsoever . . ." *Id.*
[5] *Id.* at § 40-12-220(5).
[6] *Id.* at § 40-12-220(8).
[7] Prop. Reg. 810-6-5-.09(4)(a).
[8] *Id.*
[9] *Id.* at 810-6-5-.09(4)(b).
[10] *Id.* at 810-6-5-.09(4)(c).

transmission is considered used in Alabama if the customer's service address is within Alabama."[11]

According to the Economic Impact Statement (EIS) submitted with the Amended Regulation, the changes will admittedly raise a substantial amount of revenue (although that figure is not quantified) yet are needed to "*clarify* that [streaming services] are taxable in the same way that hard copies are taxable."(emphasis supplied). But the EIS cites to the fact that "Brick and Mortar video rental stores are closing all over the state and opting for streaming video services . . . eroding the tax base for these items."

In promulgating the Amended Regulation, the Department has apparently relied on a decision issued in a 2006 administrative appeal[12] (hereinafter referred to as *FlipFlopFoto* or "final order"). *FlipFlopFoto* involved a determination of whether the "electronic transfer of digital photographic images from a seller to a purchaser for a price" was a sale for purposes of the sales tax.[13] The former Chief Administrative Law Judge (and current Chief Judge of the Alabama Tax Tribunal), Bill Thompson, determined that the transfer constituted the sale of tangible personal property.[14] Judge Thompson relied upon what he saw as relevant Alabama case law in concluding that photographic images from the photographer-seller in Opelika to an in-state purchaser for a price were tangible personal property, even when delivered electronically. Judge Thompson concluded that "the form in which photographs (and other digital goods) are delivered is irrelevant."[15] The taxpayer did not appeal that ruling.

While an unofficial draft of the Amended Regulation contained an effective date of October 1, 2015, a specific effective date was not included in the official version. Thus, the Amended Regulation will apparently be effective immediately (upon satisfaction of all the Administrative Procedure Act requirements, including a 35 day review period for the Legislature's Joint Committee on Administrative Regulation Review).[16]

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[11] *Id.*

[12] *Robert Smith d/b/a FlipFlopFoto v. State of Alabama Dep't of Revenue*, Docket No. S. 05-1240 (Admin. Law Div. Nov. 17, 2006, final order issued (April 30, 2007)).

[13] *Id.*

[14] *Id*; The Department has since amended their regulation on the taxation of photographs to be consistent with the narrow holding in this decision. *See* Ala. Admin. Code r. 810-6-1-.119(1) (stating "[t]he transfer of digital images . . . from a seller to a purchaser for a price constitutes the sale of tangible personal property. The form in which tangible personal property is delivered by the seller to the purchaser is of no consequence").

[15] *Id.* at 5; *see also Wal-Mart Stores, Inc. v. City of Mobile,* 696 So.2d 290 (Ala. 1996) (holding, prospectively, that canned computer software delivered electronically in-state is tangible personal property).

[16] Ala. Code § 41-22-22; Ala. Code § 41-22-23(b).

COMMENTS ON THE AMENDED REGULATION

I. STREAMING IS NOT TAXABLE BECAUSE IT IS NOT TANGIBLE PERSONAL PROPERTY AND IS NOT AN ENUMERATED SERVICE

Alabama, like almost every state, taxes the sale, lease or rental of tangible personal property and does not (with minor exceptions not relevant here) automatically impose tax on services; rather, there is a legal presumption that services are not taxable, unless specifically enumerated by statute.[17] Tax can thus only be imposed on products if those products are either (1) tangible personal property, or (2) an enumerated service. Because streaming music and video is not tangible personal property or an enumerated service, it is not taxable under Alabama law.

A. Streaming Content is Not Tangible Personal Property

The purchase of streamed music and movies is not the equivalent of the purchase of a CD or DVD. Some, including the Department, have argued that the purchase of downloaded music and movies is the same as the purchase of a CD or DVD. The Department defended this position in *FlipFlopFoto*, and it is our understanding that the Department believes the case not only supports the imposition of tax on downloaded content, but also supports the Amended Regulation's imposition of tax on streaming.[18] As explained below, *FlipFlopFoto* does not apply to streamed content. While we do not endorse the holding in the final order with respect to downloaded content, even if the case was correctly decided, the Department is attempting to expand its application beyond the facts in the case to an entirely new set of transactions.[19]

The Department's argument in *FlipFlopFoto* was that downloaded photographs delivered through electronic means are subject to sales tax just as sales of such content on physical media are taxable.[20] However, in concluding that the photographs were tangible personal property, Judge Thompson determined that the "means of delivery" were not relevant to whether the products were tangible personal property, but did not review whether such products were taxable when no delivery occurred. *FlipFlopFoto* thus cannot be relied upon with respect to streaming content. Aside from the fact that the decision was rendered in the context of the sales tax, not the rental tax, no delivery occurs when movies and music are streamed.

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[17] *See generally* Ala. Code § 40-23-1(a)(6); Ala. Code § 40-23-60(10).

[18] *Supra* n. 12 (finding "no principled reason why the retail sale of goods that can now be ***delivered*** electronically due to advances in technology, i.e., photographs, music, movies, books, etc., should be taxed any differently than the sale of those goods delivered by traditional means" [emphasis added]); *but see* Rev. Rul. 94-011, Ala. Dep't of Revenue, Sept. 26, 1994 (subscriptions to an electronically transmitted newsletter not subject to sales and use tax under Alabama law because electronically transmitted data is not tangible personal property).

[19] *See, e.g.,* Rev. Rul. 95-011, Ala. Dep't of Revenue, January 31, 1996 (satellite and cable television services are not subject to sales or use tax because the signal transmitted is not tangible personal property); Rev. Rul. 95-002, Ala. Dep't of Revenue, March 17, 1995 (satellite television services are intangible, not tangible personal property, and not subject to sales or rental tax).

[20] *Supra* n. 15.

The recipient of an emailed or downloaded digital photograph has content delivered because the recipient has all the incidents of ownership of a true owner (including the ability to share with others, print, etc.); on the other hand, the customer of a streaming service acquires no such rights. In fact, streaming allows only temporary access to data by the customer's device that is automatically deleted and never stored (in full or in part) on the device. Because of this limited access, the customer cannot use the streamed content in the same way as someone who bought or rented a copy of the content on a disk or downloaded it. For instance, a consumer of streamed content cannot watch the content perpetually[21] or allow someone else to borrow the content before the rental period expires. This fundamental difference in the customer's rights and abilities with respect to streamed content should be distinguished from the delivered photos in *FlipFlopFoto*. Just as there is no delivery when music is performed at a concert, or a movie is shown in a theater, no delivery occurs when the same content is streamed to a customer.

Because the Alabama appellate courts and Legislature have not even tangentially addressed the application of the rental tax to streaming, interpreting a single, distinguishable administrative opinion to impose this new tax is a stretch of authority. It would lead to the absurd conclusion that ***any*** digital service is taxable as tangible personal property. For these reasons, we believe the Department is overstepping its authority by attempting to classify streaming movies and music as tangible personal property. Nor does the Department seem to be considering the legal and administrative difficulties in attempting to enforce such a new tax.

B. Streaming Content is Not an Enumerated Service

Because streaming is clearly not tangible personal property, the next question that arises under Alabama law is whether streaming is a taxable service.[22] While there are several possible ways to classify this service, we believe it is most akin to an information service where the customer can access the type of information (audio or video) they desire.[23] Such services are not

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[21] For instance, if a consumer cancels a subscription to a streaming service, the consumer no longer has any right to that content.

[22] *See White v. Storer Cable Commc'ns, Inc.*, 507 So. 2d 964, 968 (Ala. Civ. App. 1987) (finding a service fee for the provision of cable television programming and a converter is not subject to rental tax because the converter "had no function apart from giving subscribers access to the [non-enumerated] cable service. That is, they were 'useless' in and of themselves. The substance of the transaction was [the non-taxable] cable service; the converters were merely a means serving that end").

[23] *See* Rev. Rul. 2010-001, Ala. Dep't of Revenue, Oct. 1, 2010 (finding web-based services that provided customers data hosted on the providers out of state server were not subject to sales tax as tangible personal property, but were better characterized as nontaxable electronic information services); *see also* Rev. Rul. 02-002, Ala. Dep't of Revenue, July 3, 2002 (personal television service that provides electronic programming guides, specialized electronic television viewing guides, and specially created programming content is not subject to sales and use tax, rather it is a nontaxable information service); Rev. Rul. 94-002, Ala. Dep't of Revenue, October 5, 1994 (information service provided electronically to subscribers using satellite technology is not considered to be tangible personal property for purposes of the Alabama sales tax statutes and is therefore not subject to sales and use tax because the essence of the service is the transfer of nontaxable information).

statutorily enumerated in Alabama's tax code and the Department has issued three public Revenue Rulings that seem to contradict the Amended Regulation.[24]

II. STREAMING INVOLVES NO LEASE OR RENTAL OF PROPERTY WITHIN THE MEANING OF THE RENTAL TAX STATUTE BECAUSE THERE IS NO "POSSESSION OR USE"

As discussed above, under the Alabama Code the "leasing or rental" of tangible personal property requires that the lessee obtain "***possession*** or ***use***" of the leased property.[25] While the lease and rental tax statute contains no definition for the term "use," the term is defined by the Alabama use tax statute as "[t]he exercise of any right or power over tangible personal property incident to the ownership of that property, or by any transaction where possession is given, except that it shall not include the sale of that property in the regular course of business."[26] According to Black's Law Dictionary, "possession" is defined to mean "[t]he fact of having or holding property in one's power; the exercise of dominion over property . . . or [t]he right under which one may exercise control over something to the exclusion of all others; the continuing exercise of a claim to the exclusive use of a material object."[27]

Streamed music and video is neither possessed nor used within the meaning of these definitions. When music and movies are streamed, the customer has no control, particularly no exclusive control, over any right or power rising to the level of an incident of ownership. Specifically, the music and movies are stored on the provider's server at all times and the customer never obtains the ability to copy or manipulate the content, as opposed to downloaded content. The ability of the customer to hear the streamed song or see the streamed movie is momentary. Thus, even if streamed content is tangible personal property, and it is not, the rental tax cannot apply because there is no transfer of possession or use of the content.

Many streaming content providers do not charge their customers based on the number of songs or videos they stream during a particular month. Instead, the content provider simply charges a flat monthly fee, regardless of usage. Thus, the flat monthly charge bears no relation to the customer's actual usage of the service. Wouldn't the Department be required to exempt those charges from this new tax when the customer didn't actually *use* the service that month? Would the Department require the content provider to monitor each Alabama customer's monthly usage habits in calculating its liability (assuming it has nexus) for this tax?

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[24] *Id.*

[25] *Supra* n. 5; *see also State v. Steel City Crane Rental, Inc.*, 345 So. 2d 1371 (Ala. Civ. App. 1977) (noting that the Legislature in enacting the rental tax statute did not seek to expand the phrase "possession or use" of property for rental tax purposes beyond that normally ascribed to such terms. The Court of Civil Appeals held that the furnishing of cranes with operators was not taxable under the rental tax regime because the requisite giving up of possession never occurred).

[26] Ala. Code § 40-23-60(8).

[27] POSSESSION, Black's Law Dictionary (10th ed. 2014).

III. THE SOURCING PROVISION IS UNDEFINED AND CREATES UNCERTAINTY FOR PROVIDERS OF STREAMING SERVICES

As proposed, the Amended Regulation would source receipts to the state (and presumably a county and a municipality) if the digital transmissions are "used in Alabama."[28] Digital transmissions are considered used in the state if the customer's "service address" is within Alabama.[29] At the outset, we are concerned that the Amended Regulation simply assumes that the State (and local governments) have constitutional nexus over the content provider and the particular transaction. We are also concerned that the Amended Regulation does not define the customer's service address.

In the streaming context, using a service address to source use to a particular state is problematic. For example, a college student from Alabama, using an Alabama service address but attending college in another state, could use all of their streaming services outside of Alabama. There are many other examples where a service address does not meet the constitutional requirement for sourcing: linked family accounts with devices in multiple states; a person who resides in Alabama but travels extensively for work; or a person who moved but has not changed the service address in the vendor's system.

This problem becomes exponentially more difficult in Alabama since most municipalities and a handful of counties levy their own parallel rental tax. Thus, if an individual with a Hoover or Vestavia Hills service address commutes to work in downtown Birmingham daily and uses their laptop at work or during lunch, or travels frequently within the state, the local tax sourcing issues could be overwhelming and would require a rule of their own. The Department will be forced to choose winners and losers among the local governments, which it is now attempting to avoid in the local sales/use tax context. The service address sourcing provisions are undefined and do not apply coherently to streaming services.

IV. THE AMENDED REGULATION WOULD IMPOSE A NEW TAX, WHICH IS THE PROVINCE OF THE ALABAMA LEGISLATURE

If the State of Alabama wishes to impose a new tax on streaming content, even assuming the State has nexus over out-of-state content providers, there is a more appropriate and legitimate way than through the issuance of a regulation based on its interpretation of a single ruling by its administrative law judge in 2006,[30] which is not on point. Of utmost concern is the expansion of the rental tax base without the imprimatur of the Alabama Legislature and the use of a Department regulation to raise a substantial amount of revenue, which the Department either cannot quantify or refuses to set forth its estimate in its EIS. The rental tax was first enacted by the Legislature in 1971, long before the types of transactions that are the object of the proposed regulation were even technologically possible. When considering the scope of a taxing statute,

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[28] *Supra* n. 10.
[29] *Id.*
[30] Ala. Code § 40-2A-9(e) (repealed effective Oct. 1, 2014) (stating that ALJ orders carry the same weight as an order issued by an Alabama circuit court).

the Alabama courts, and the Department's former Administrative Law Division, instruct the Department to consider the facts and circumstances in existence when the statute was enacted.[31] Unquestionably, the Legislature did not have streaming video over the Internet in mind when it enacted the tax forty-four years ago.

As recognized by the National Conference of State Legislatures, expansion of the tax base to include cloud-based services like streaming is something particularly within the province of the state legislatures, not an executive branch agency.[32]

In other states where the issue of taxing digital services has been considered, it is being done so legislatively. We are aware of one state, Idaho, where the revenue authority proposed a draft rule similar to this Amended Regulation.[33] The response of the state legislature was to immediately introduce and pass legislation exempting streaming content from that state's sales tax.[34] Even the states that are members of the Streamlined Sales and Use Tax Agreement, under which sales of "Specified Digital Products" must be taxed separately, and not simply swept into the definition of tangible personal property (which the SSUTA prohibits),[35] have taxed only *downloaded content*. They have avoided taxing streaming content unless those services are separately addressed by express legislative imposition.[36] If Alabama continues to desire to become a full member of the SST Agreement, it should not attempt to impose a new tax that will take it further out of conformity with the Agreement.

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[31] *See Ex parte Dixie Tool & Die Company, Inc.*, 537 So.2d 923 (Ala. 1988) (a statute must be construed with the presumption that the Legislature was aware of the applicable law and facts when the statute was enacted); s*ee also Abbot Laboratories, et al. v. Cecil Burrett, et al.*, 746 So.2d 316, 339 (Ala. 1999) ("... we have followed the well-settled rule of statutory construction that it is permissible in ascertaining [the purpose and intent of a statute] to look to the history of the times, the existing order of things, the state of the law when the instrument was adopted, and the conditions necessitating such adoption."); *Beauty & More, Inc. v. State of Alabama Dep't of Revenue*, Docket No. S. 12-336 (Admin. Law Div. June 12, 2013).

[32] *See Cloud Based Services Principles*, National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation, adopted August 6, 2012, available at: http://www.ncsl.org/research/telecommunications-and-information-technology/cloud-computing-principles.aspx (stating that "[t]o ensure that taxation is clear, efficient, and fair, states choosing to impose a tax on Cloud Based Services should: (1) Avoid imposing any tax on Cloud Based Services through administrative action and only consider imposing the tax through statutory imposition, (2) Carefully draft definitions to provide clarity to buyers and sellers of Cloud Based Services, (3) Recognize the broad range of services included in Cloud Based Services and address those differences within the statutory scheme, (4) Design any tax impositions only on specific and clearly delineated services or where state statutes provide for broad taxation of services, exclusions or exemptions, if any, for certain Cloud Based Services should be clearly delineated, (5) Encourage the involvement of providers of Cloud Based Services in any drafting efforts involving the taxation or sourcing of those services; and (6) Provide clear and consistent rules to govern bundled transactions involving Cloud Based Services").

[33] *See* Idaho State Tax Comm'n, Notice of Proposed Rulemaking Docket No. 35-0102-1401 (Oct. 2014).

[34] H.B. 209, 63rd Leg., 1st Reg. Sess. (Id. 2015).

[35] *See* SSUTA Sections 332-333.

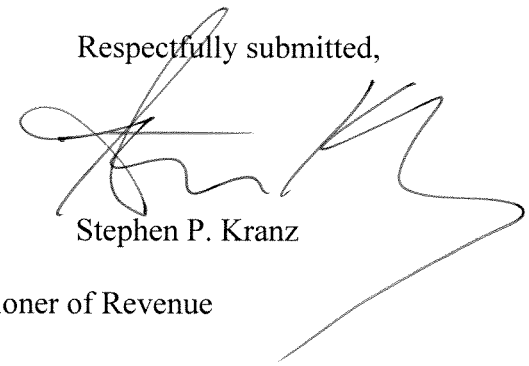
[36] *See, e.g.,* S.D. Codified Laws § 10-45-4 (imposing tax on **all** services except for those services that are specifically exempt); *see also* Wash. Rev. Code § 82.04.192(8) (imposing tax on all digital products and digital automated services "transferred electronically", which was specifically defined by legislation to require only access and not a physical transfer (i.e., download) of a copy of the product).

Imposing a state and local tax on streaming content is clearly a new tax on services, even assuming the state and localities could lawfully tax out-of-state content providers. And while such a tax could be imposed on certain content providers by properly crafted legislation, there are many issues, such as sourcing, characterization, the method of imposing tax (either by the rental tax or sales tax), bundling, and potential use or content-based exemptions, that the Amended Regulation cannot and does not address.

CONCLUSION

As set forth above, the proposed Amended Regulation goes well beyond the Department's authority under Alabama law and is thus fatally flawed. We urge the Department to withdraw the proposed Amended Regulation. Thank you for your consideration and please do not hesitate to contact me at 202-756-8180 or skranz@mwe.com with any questions or if you wish to meet either before or after the APA hearing.

Respectfully submitted,



Stephen P. Kranz

cc: Hon. Julie P. Magee, Commissioner of Revenue
Christy Edwards, Esq.
Bruce P. Ely, Esq.