Minnesota Data Center Exemption: DOR's Revised Guidance Shows Progress

by Masha M. Yevzelman

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Masha M. Yevzelman is a shareholder in the Minneapolis office of Fredrikson & Byron PA.

In this article, Yevzelman discusses the Minnesota Department of Revenue's revised guidance regarding its data center sales and use tax incentive.

Minnesota's promised tax incentives, cold climate, and status as home to over a dozen *Fortune* 500 companies' headquarters, have made it a data center hub. The state's Department of Employment and Economic Development (DEED) has been seeking to bring additional investment in data centers to Minnesota to spur economic growth, innovation, and jobs. To that end, the Legislature enacted a sales and use tax incentive program in 2011, which it expanded in 2013.[1]

Minnesota's data center sales and use tax incentive provides that in exchange for their investments in qualifying facilities, taxpayers may receive up to 20 years of sales and use tax exemptions on purchases of electricity, computer hardware, and computer software purchased for use in a qualified data center. To take advantage of the incentive, a company making qualifying purchases must first pay the tax and then seek a refund. To become "qualified," a data center must achieve certification with DEED.

The tax incentive has indisputably achieved its purpose. Since its enactment, companies have invested over $2 billion dollars in building and refurbishing data centers in Minnesota. Accordingly, DEED has certified approximately 40 data centers as "qualified" or "qualified refurbished" in Minnesota.

As data centers were certified by DEED, Minnesota taxpayers filed sales and use tax refund claims for electricity, hardware, and software. While initial refund claims were largely approved by the Minnesota Department of Revenue, the claims exceeded all expectations. For example, the governor's February 2019 budget provided that the exemption was originally estimated to cost "approximately $24 million in 2014 and approximately $4 million in 2015," but by February 2019 was forecast to cost $70 million in 2018 and over $101 million in 2019.

After receiving refund claims in larger-than-anticipated amounts, the DOR began interpreting the data center sales and use tax exemption narrowly. First, the DOR categorically disallowed refund claims for distributed software — software that is loaded at the data center and then distributed or pushed out to devices outside the data center. Second, the DOR accepted only original invoices with ship-to addresses reflecting the data center address as sufficient documentation for proving that purchases were made for use in the qualifying data center. Taxpayers appealed their refund claim denials, arguing that the DOR's interpretations were too narrow and not supported by statute.

[1] *See* Minn. Stat. section 297A.68, subd. 42.

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After considering arguments and facts presented during litigation commenced by one of the taxpayers, on November 13, 2020, the DOR updated its website guidance,[2] finally recognizing what taxpayers and practitioners have been arguing for years — that some distributed software should qualify for the data center sales and use tax exemption and that the DOR should consider evidence other than just the ship-to address on an invoice as documentation of location.

Qualified Data Center Exemption History

In 2011 the Legislature enacted a statutory incentive for companies to invest in data centers in Minnesota and expanded the scope and applicability of the exemption in 2013. Companies that constructed new data centers or refurbished existing data centers could the centers certified as "qualified" or "qualified refurbished" data centers:

- to be eligible for certification as a qualified data center, the new facility must be at least 25,000 square feet, and the total cost of construction and investment in technology and software must be at least $30 million over a 48-month period; and
- to be eligible as a "qualified refurbished data center," at least 25,000 square feet must be rebuilt or modified, and the total investment in technology and software must be at least $50 million within a 24-month period.

To obtain certification, taxpayers must (a) submit a rigorous application demonstrating that the minimum investment and facility square footage requirements have been met and (b) allow DEED and the DOR to tour the facility.[3]

In exchange for investing in Minnesota data centers, the Legislature provided that "purchases of enterprise information technology equipment and computer software for use in the qualified data center" would be exempt from sales and use tax. Since 2013, the statutory exemption has defined computer software broadly, to include "software utilized or loaded at a qualified data center or qualified refurbished data center, including maintenance, licensing, and software customization."[4]

Relying on the incentive, companies invested in qualified data centers and later began to file sales and use tax refund claims with the DOR. However, after initially approving most of these refund claims, the DOR began to interpret the data center sales and use tax exemption narrowly and denied millions of dollars in refund claims.

The DOR Agrees That Some Distributed Software Qualifies for Exemption

The DOR primarily denied portions of taxpayers' qualified data center refund claims because they sought refunds for purchases of distributed software. The DOR's position was that only software that was "installed and remained" on servers at the data center qualified for the data center exemption. This position was not reflected in Minnesota's statutes and was, instead, only stated on the DOR's website and expressed to taxpayers during audits and appeals. The DOR did not go through the rulemaking process and did not issue a revenue notice reflecting its position.

The DOR's former website guidance provided that to qualify for the data center exemption, the software must (a) operate, maintain, or monitor data center equipment or (b) manage, manipulate, analyze, collect, store, process, distribute, or allow access to a "large amount of data." The DOR denied that software loaded at the data center and then distributed or pushed out to devices outside the data center was purchased "for use" in the data center (e.g., human resource management software installed on devices at company headquarters, word processing software licenses deployed to devices outside the data center, etc.).

For several years, the governor and the DOR tried to pass legislation retroactively enacting this narrow interpretation, often offered as mere "technical corrections" to existing law. The rationale in the governor's February 2019 budget was economic, providing that refund claims far exceeded the anticipated expenses of the data

[2] Minnesota Department of Revenue, "Qualified Data Centers: Sales Tax Exemption."

[3] Minnesota Department of Employment and Economic Development, "Minnesota Data Center Program Guide and Application."

[4] Minn. Stat. section 297A.68, subd. 42(c)(iii).

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center exemption. Accordingly, the proposed legislation sought to *retroactively* limit the type of software that would qualify. The retroactive nature of the proposed legislation would have adversely affected taxpayers' pending refund claims and appeals of denied claims for distributed software. Although the proposed legislation did not pass, the DOR's stance did not change until a taxpayer commenced litigation by appealing a refund claim denial to the Minnesota Tax Court.

In November the DOR finally agreed that some distributed software should qualify for the data center exemption. This agreement reflects a significant change in its position regarding distributed software. Under the new guidance (published on its website[5]), rather than requiring software to be installed and remain on servers at the data center, the DOR now provides that *either* the original software license *or* original software must be *loaded* at the data center and remain on the servers at the data centers. Although the distinction between installed and loaded is subtle, the change reveals a critical shift in the DOR's understanding of distributed software.

The guidance also added the following types of software as qualifying for the data center exemption:

- software accessed through the data center servers, including remote access;
- software that generates data that is stored on the data center servers and is accessible from outside the data center; and
- software that has its licensing centralized at the data center, with remote access to the data center servers for license verification.

Conversely, the DOR clarified that the following software does not qualify for the data center exemption: "Software that is loaded at the data center but neither the original license nor the original software remains at the data center." Consistent with its change in position, the revised guidance no longer excludes "software that is loaded at the data center for distribution or deployment (pushed out) to devices outside the data center" from qualifying software.

Accordingly, the DOR has finally agreed that software loaded at the data center and then distributed to "end users" throughout the enterprise may, under certain circumstances, qualify for the data center sales and use tax exemption.

Substantiating Location of Software and Hardware

The DOR's second basis for denying qualified data center refund claims was when the ship-to address on vendor software or hardware invoices did not reflect the data center address. The DOR did not accept invoices created through collaboration software (e.g., Ariba) or other evidence of location (such as IP addresses or taxpayer affidavits). In other words, only the ship-to address on the original vendor-issued invoice was acceptable proof even when software was downloaded rather than physically shipped.

The revised website guidance issued in November clarified the types of documentation the DOR will accept from taxpayers to prove that software or hardware was purchased for use in the data centers. As before, the guidance continues to provide that such documentation may include:

- installation invoices;
- invoices with ship-to, delivery addresses, or installation location information; or
- software license agreements.

However, the revised guidance added the following note: "This list is not all-inclusive and we may require a combination of records. The records provided must be relevant, reliable, and consistent."

The new guidance, therefore, recognizes that even if the ship-to address on an invoice does not match the data center address, taxpayers may provide additional documentation or information to establish that the software or hardware was in fact purchased for use *in* the data center.

Conclusion

The DOR's revised guidance is a step in the right direction. Taxpayers and practitioners are looking forward to working with the DOR in resolving pending appeals and refund claims based on the new guidance. ■

[5] *See* DOR, *supra* note 2.

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