Cloud Computing, Practically Speaking

by Brian Strahle


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In this article, Strahle writes about cloud computing, focusing on the taxation of software as a service (SaaS). Strahle summarizes the various ways states apply sales tax to SaaS. He also offers some practical advice for taxpayers dealing with these issues.

Multiple articles regarding the sales taxation of cloud computing have been written describing how most states have not addressed it directly, relying solely on existing statutes and regulations. The states that have addressed the taxation of cloud computing have done so through informal guidance or rulings. The states' lack of guidance makes it extremely difficult for taxpayers to obtain certainty.

Also, practitioners have disagreed with the positions states have taken in their guidance. Indiana has said that prewritten computer software maintained on computer servers outside the state is subject to tax when accessed electronically via the Internet.[1] Accordingly, the accessing of prewritten computer software by Indiana residents constitutes a transfer of the software because the customers gain constructive possession and the "right to use, control, or direct the use of the software." Arthur Rosen, for one, has argued that states that take that position, which is based on the idea of "constructive possession," are wrong.[2]

Inaction by some states and the controversy surrounding the positions taken by others creates an environment of ambiguity in which taxpayers must find some daily, practical method to reach reasonable conclusions. This article will describe positions taken by states, as well as a useful approach for addressing cloud computing transactions.

[1]Ind. Info. Bull. No. 8 (Nov. 1, 2011).

[2]Arthur R. Rosen of McDermott Will & Emery, Institute for Professionals in Taxation's Sales Tax Symposium in Washington (Sept. 22, 2014).

Definition

Cloud computing is generally defined similarly to the New Jersey definition — "services that allow a customer to access and use the software of a service provider."[3] The software is hosted by a seller that owns, operates, and maintains the software. The seller houses the software on its own servers. Customers access the software via the Internet. The software is not transferred to the customer, and the customer does not have the right to download, copy, or modify the software. Rather, customers merely receive access to the software. Cloud computing is offered in three product categories: software as a service (SaaS),[4] platform as a service, and infrastructure as a service. New Jersey's position is that cloud computing is distinguishable from the purchase of downloaded or otherwise electronically delivered software.

States With Specific Guidance — Taxable

Some states have directly addressed the taxation of SaaS. For example, Utah[5] and Washington[6] define SaaS as taxable. Pennsylvania states that charges for the use of canned computer software hosted on a server and accessed electronically by a taxpayer's customers are subject to Pennsylvania sales and use tax if the user is located in Pennsylvania.[7] Pennsylvania regards electronically accessing software as taxable because it considers the software to be tangible personal property. Pennsylvania asserts that the user is exercising a license to use the software, as well as exercising control over the software at the user's location when it accesses the software. Arizona maintains that the licensing of software is a taxable lease of tangible personal property whether accessed remotely or downloaded.[8] And New York has held different types of SaaS to be taxable in numerous rulings.[9]

[3]N.J. Tech. Bull. TB-72 (July 3, 2013).

[4]For purposes of this article, "cloud computing" refers to SaaS or software as a service.

[5]Utah Pub. 64; Utah Code Ann. section 59-2-103(1)(m), section 59-12-102(82)(b); Utah Admin. Code Rule R865-195-92(2).

[6]Wash. RCW 82.04.050(6)(b); WAC 458-20-15502.

[7]Pa. Legal Letter Ruling No. SUT-12-001 (May 31, 2012).

[8]Ariz. Ruling LR10-007 (Mar. 24, 2010).

[9]N.Y. TSB-A-13(22)S (July 25, 2013); TSB-A-09(44)S (Sept. 24, 2009); TSB-A-09(25)S (June 18, 2009); TSB-A-08(62)S (Nov. 24, 2008).

States With Specific Guidance — Not Taxable

Virginia treats SaaS as expressly exempt from taxation, unless tangible personal property is transferred.[10] Florida's position is that the license to use software delivered via electronic download is not subject to Florida sales tax regardless of whether the software is customized or canned.[11] Georgia has maintained that sales and use tax does not apply to software delivered electronically because it wasn't available in a tangible medium.[12] Georgia has also ruled that the sale of cloud subscription services is not taxable because the services do not include the transfer of tangible personal property. Iowa exempts online computer services when the substance of the transaction is delivered electronically.[13]

States With Specific Guidance — Don't Download

In Rhode Island, software that is accessed but not downloaded is not considered taxable, prewritten software delivered electronically.[14] Nebraska has informed taxpayers that the transfer of computer software is taxable, no matter the delivery method.[15] However, Nebraska also says charges for SaaS are not taxable when customers remotely access software applications, operating systems, servers, and other network components by the Internet or other online connections. Minnesota asserts that a taxpayer does not have title, possession, or authority over software that is accessed remotely and not downloaded.[16] Thus, Minnesota regards SaaS as a nontaxable information service, not a "license to use." Alabama has concluded that SaaS is not taxable when software is not transferred to a customer's computer and that SaaS does not fall within the Department of Revenue's definition of canned computer software.[17] Kansas asserts that remote access to software is not taxable because software is not delivered to the customer and is not considered a lease.[18] Thus, remote access to software would not be taxable unless the software is downloaded or tangible personal property is transferred.

States Using General Guidance — No Transfer of Tangible Personal Property

Some states have not issued any direct guidance and are relying on existing statutes and regulations for the tax treatment of SaaS. For example, according to California statutes and regulations, if there is no transfer of possession or control of tangible personal property, SaaS is not taxable.[19] Oklahoma may regard SaaS as nontaxable "electronic data processing unless tangible personal property is transferred."[20] Remote access to software or even downloading software may be a nontaxable service in Colorado because there is no transfer of tangible personal property.[21] Statutes in Maryland,[22] Missouri,[23] and Nevada[24] indicate that access to software and downloading software may be a nontaxable service because electronically delivered software is expressly stated as not taxable.

States Using General Guidance — Taxable

Indirect guidance in Connecticut may treat remotely accessing software or downloading software as taxable computer and data processing services when no tangible personal property is provided.[25] New Mexico taxes software transferred electronically and computer services, implying that remote access to software may be taxable as well.[26]

States With Intricate Rules — It Depends

Massachusetts regulations provide insight into the complexity of determining SaaS taxability. For example, charges for the access or use of software on a remote server are generally subject to tax. However, when there is no charge for the use of the software and the object of the transaction is acquiring a good or service other than the use of the software, sales or use tax does not apply.[27]

> **Example 1:** Bob goes to an Internet website that hosts auctions of tangible personal property and bids $100 on an item. Although Bob has accessed and used software on a remote server, the object of the transaction is acquiring the item on which he is bidding. No tax applies to the access. If Bob wins the auction, sales or use tax is due on any tangible personal property purchased at the online auction that is shipped to a Massachusetts customer.

[10]Va. section 58.1-609.5(1); Va. Ruling PD 13-182; Ruling PD 12-215; Ruling PD 12-191.

[11]Technical Assistance Advisement No. 10A-028, Florida Department of Revenue (June 21, 2010).

[12]Ga. Letter Ruling SUT-2014-01 (Feb. 20, 2014).

[13]Iowa Policy Letter 12300002 (Jan. 11, 2012); Iowa Code section 423.3(67).

[14]R.I. Gen. Laws section 44-18-7; Reg. SU 11-25.

[15]Neb. Info. Guide 6-511-2011 (June 2011, updated Jan. 2014).

[16]Minn. Rule 8130.0500(2).

[17]Revenue Ruling 2010-001, Alabama DOR (Oct. 1, 2010); Ala. Admin Code r. 810-6-1-.37.

[18]Kans. Opinion Letter No. 0-2012-001 (Feb. 6, 2012); PLR No. P-2005-011 (May 31, 2005); PLR No. P-2009-005 (June 26, 2009); Opinion Letter No. 0-2010-005 (June 22, 2010); Information Guide No. EDU-71R.

[19]Cal. Rev. & Tax. Code section 6006; Cal. Rev. & Tax. Code section 6016; Reg. 1502, 18 CCR.

[20]Okla. Rule 710:65-10-86(a); 68 O.S. section 1354; LR-11-072.

[21]Colo. CRS section 39-26-102.

[22]Md. Tax Gen. Art. section 11-219(b); Tax Gen. Art. section 11-101.

[23]Mo. 12 CSR 10-109.050(2)(c); 10-109.050(I).

[24]Nev. NRS section 372.060.

[25]Conn. Policy Statement 2004(2) (Oct. 21, 2004).

[26]NMAC 3.2.1.15(J); NMAC 3.1.2.18.

[27]Mass. reg. 830 CMR 64H.1.3(14); reg. 830 CMR 64H.1.3(3); reg. 830 CMR 64H.1.3(13); TIR 05-15; Letter Ruling 11-4; Letter Ruling 12-10.

Example 2: Ann wants to acquire prewritten computer software to prepare her personal income tax return. The vendor of the software gives her the option of purchasing the software on a disk that will be mailed to her home or she can pay to securely access the software on the vendor's server through the Internet and use of a personal access code. In either case, the functionality of the software is the same. The object of the transaction here is the use of the software. Charges for the prewritten software will be subject to sales or use tax regardless of the delivery method.

In New Jersey the question is whether SaaS is a taxable or nontaxable service. In general, New Jersey treats the sale of SaaS as a sale of a service, not tangible personal property.[28] Consequently, the use of a software application is not listed as a taxable service. However, if SaaS meets the definition of an information service, it is taxable. When the software is accessed and used as a tool for providing information to customers by an information service provider, the transactions are sales of information services. The law defines information services as "the furnishing of information of any kind, which has been collected, compiled, or analyzed by the seller, and provided through any means or method, other than personal or individual information which is not incorporated into reports furnished to other people."[29] Common examples of taxable information services conveyed through SaaS are Westlaw and LexisNexis.

South Carolina rulings regarding the taxability of SaaS are convoluted. For example, under the rulings, charges by an application service provider that allow access to the provider's website on which the customer uses the software are taxable.[30] Other rulings suggest that charges for remote access or the transfer of tangible personal property are taxable, but charges to download software are nontaxable.

Tennessee has published several letter rulings on the state's treatment of cloud computing. For example, in one ruling, Tennessee determined that the monthly fee paid by a taxpayer to a software vendor for online access to customer relationship management software was not subject to Tennessee sales and use tax.[31] Tennessee said no sale or use of tangible personal property occurs in Tennessee when the taxpayer accesses the software application via the Internet, because the vendor does not transfer title, possession, or control of the software application to the taxpayer. In Tennessee, the granting of a license to use computer software constitutes a taxable sale; however, if the server is located outside Tennessee, the sale is not taxable. In another ruling, Tennessee treated application service provider services as nontaxable data processing and information services because the primary purpose of the transaction was the management and processing of its inventory data and information.[32] The taxpayer did not transfer title, possession, or control of the applications to the customer or install them on the customer's computers. In another ruling, charges to access a database were not subject to Tennessee sales and use tax.[33] The transaction was not a sale of software because the database software remained on the taxpayer's servers, the taxpayer maintained control of the software at all times, and the software was not transferred to its customers.

In Texas the licensing of software is generally regarded to be equivalent to the leasing or rental of tangible personal property.[34] Also, SaaS may be taxable if considered a data processing service or information service.

Taxability Is Not the Only Concern for Sellers of SaaS

Vendors or sellers of cloud computing must also determine whether owning the rights to software that is electronically downloaded to a customer's computer creates nexus for the seller. For example, on September 19, 2014, the Texas Comptroller of Public Accounts ruled that the licensing of software downloaded over the Internet to Texas customers established substantial nexus for sales and use tax purposes because the software was tangible personal property and the taxpayer retained title to the software, which was physically present in Texas on customers' computers.[35]

In essence, Texas is asserting that electronically downloaded software is tangible personal property. Texas is obviously not following California's definition of tangible personal property.[36] Several states impose sales tax on canned software even if it is electronically delivered. However, Texas is saying that simply holding title to electronically delivered software in Texas is equivalent to holding tangible property in Texas and creates nexus for the taxpayer. Consequently, electronically delivered software alone creates nexus. Practitioners have argued that Texas has overreached in treating electronically downloaded software as tangible personal property and that the ruling should not be followed.[37] I agree.

The Texas ruling, albeit incorrect, reminds taxpayers that it is important to clarify how software will be delivered. For example, will the software simply be accessed or will it be

[28]N.J. Tech. Bull. TB-72 (July 3, 2013); N.J. Stat. Ann. section 54:32B-8.56.

[29]N.J.S.A. 54:32B-3(b)(12).

[30]S.C. Revenue Ruling 03-5 (Dec. 9, 2003); Revenue Ruling 12-1 (Mar. 20, 2012); S.C. reg. 117-329; S.C. Code section 12-36-910(B)(3) and section 12-36-1310(B)(3).

[31]Tenn. Letter Ruling No. 11-58 (Oct. 10, 2011).

[32]Tenn. Revenue Ruling No. 13-3 (Jan. 14, 2013).

[33]Tenn. Letter Ruling No. 11-21 (June 10, 2011).

[34]Texas section 151.009; Texas section 151.010; 34 TAC section 3.3.08(b)(2); Texas section 151.0035; 34 TAC section 3.330(a).

[35]SOAH Dkt. No. 304-13-5657.26; CPA Hearing No. 106,632 (Sept. 19, 2014).

[36]"Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or is in any manner perceptible to the senses. Cal. Rev. & Tax. Code section 6016.

[37]Rosen and Nicole R. Ford, "Texas Comptroller Defies the Laws of Physics," *State Tax Notes*, Dec. 8, 2014, p. 553.

downloaded? According to the Texas ruling, allowing customers to download the software onto their computers will create nexus for the seller. It is unknown whether Texas would have reached the same conclusion if the software was simply accessed remotely by Texas customers (not electronically downloaded) and remained on the seller's servers outside Texas.

Practical Considerations

Despite the multifaceted and shifting landscape, it is possible for taxpayers to take sustainable positions regarding the taxability of SaaS.

Tax practitioners often create a taxability matrix when managing the taxability of products or services on a multistate basis. The problem with creating a matrix for SaaS is that a simple T for taxable and NT for nontaxable just won't cut it — the analysis is too complex. A chart or matrix should be built using general decision criteria and providing detailed answers. However, taxpayers must diligently follow state guidance as it continues to evolve, and they must update the chart. The chart is never final and should not be relied on for future transactions. Consequently, a new analysis is required for each transaction (if the transactions are not occurring within the same time frame).

In combination with the matrix, each purchase should be analyzed within the following framework or questions:

- What is the mode of delivery?
  - — Remote access only?
  - — Downloaded to customer server or computer?
  - — Receipt of tangible personal property (that is, disk, CD, hardware, etc.)?
  - — Required to lease or purchase hardware?
- Location of users?
- Location of vendor server?
- Location of customer server and computer to which software is downloaded (if applicable)?
- What is the true object or dominant purpose of the purchase?
  - — Access to software only (access database to obtain information; no calculation, no input; information compiled and provided by vendor, information service)?
  - — Use software (input data, manipulate data, calculate results, store data; manipulation of data by customer)?
  - — Receive service (data processing (manipulation of customer information by vendor))?
  - — Access to storage on vendor's hardware?
  - — Access to vendor's platform with tools so customer can create something?
  - — Access to vendor's computers on a time-sharing basis?

Once the answers are obtained, taxpayers should be able to use the matrix to determine the taxability of the purchase by state (or complete additional research to confirm the matrix is up to date). ☆