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Nuts-and-Bolts Answers On Cloud Computing

by Timothy P. Noonan

I know, I know. Another article on cloud computing? Sometimes we tax commentators are like our favorite sales tax auditors: We're dogs with a bone, and we can't let go. The tax implications of cloud computing have received tremendous coverage, both in this publication and others. Perhaps it's because we tax people really just can't get enough of the clever metaphors ("cloud computing is a gray area," "the fog of cloud computing," and so on).

I'll try to do something different in this column. First, I promise: no cloud computing metaphors. It might be difficult to restrain myself, but I think I can. Second, I will avoid an extensive discussion of the technology driving cloud computing and focus more on nuts-and-bolts questions. Indeed, for most vendors and consumers in this area, the intricacies of the different technological aspects of cloud computing (software as a service (SaaS), platform as a service (PaaS), infrastructure as a service (IaaS), and so on), while possibly more interesting, are less important than more nuts-and-bolts questions. As outlined in the excellent piece by Cara Griffith in an earlier issue of this publication, some states make distinctions between the different tax implications of SaaS, PaaS, IaaS, and so on, but most don't.[1] So perhaps the most important nuts-and-bolts question for taxpayers is: Are my sales subject to tax in x state? So that's what I will endeavor to do in this article. We will essentially take a trip around the nation and visit several states to see how they treat cloud computing questions. That's practical, and I hope it will be a handy resource for those who have questions in particular states. It also shows the problem states are having with defining how to treat those technologies when a differing and sometimes arbitrary position is being taken.

Introductory Questions

Before delving into specific states, a few notes are important. First, many terms are used to refer to the different types of arrangements we will be discussing in this article. The essence of the cloud computing arrangement is that for a fee, usually recurring, a provider allows a customer access, usually through the Internet, to a server over which the provider retains control. The customer makes use of the server in one of a variety of ways (for example, as hardware on which to run programs or store data, often called IaaS; as a platform on which to develop its own software (PaaS); or as a portal capable of accessing a service, perhaps to process the customer's data (SaaS). Other phrases used to refer to one or all those arrangements include "application service provider," "remotely accessible software," and, of course, "cloud computing." Second, besides nuts-and-bolts rulings, regulations, and policy pronouncements from the states, several other factors can determine if tax is imposed on cloud computing-type transactions. We will address those factors tangentially in this article. One, of course, is jurisdiction or nexus. A vendor is on the hook to collect tax only if it has nexus in a jurisdiction. We'll leave that discussion for another article. Next, of course, are sourcing questions. When a customer in one state uses software stored on a server in another state, it could be difficult to determine where the transaction actually occurred. Many, though not all, states consider SaaS or electronic-software delivery transactions to occur when the buyer actually receives or uses the software. And finally, we must not forget about our favorite "primary function" or "true object" test that has been popping up in different jurisdictions in the cloud computing context. Many states use a primary function test to discover the purpose of the transaction and decide taxability on

[1]Cara Griffith, "Will PaaS Get a Pass From State Sales Tax?" *State Tax Notes*, July 23, 2012, p. 267, *Doc 2012-14953*, or *2012 STT 141-7*.

that basis. Again, a topic for another article, and partly addressed in this space before.[2]

A Trip Around the Nation

So let's dive in. What are states doing? How are they treating cloud computing transactions? As you will see below, states have taken a variety of different approaches, mostly regulatory rather than statutory. States that do not tax electronic sales of software generally left SaaS alone, while those that do have taken several different positions. Some have interpreted SaaS transactions as sales based on the customers' "control" of the software involved. Others have called SaaS transactions services or more specifically exempted them. A few have taken no position, or the fight has played out in courts or in the legislature. One thing is certain: More than ever you need a tax lawyer to help you figure this out. I like it when that happens.

California — Not Taxable

California regulations exclude electronic transfers of software from sales tax as long as the customer does not obtain tangible property, like storage media. The State Board of Equalization recently attempted to take a more aggressive position on software matters, but the state court of appeal rejected the BOE's efforts. Accordingly, SaaS transactions are likely not subject to sales tax in California.[3]

Connecticut — Unclear

Interpreting state statutes, the Connecticut Department of Revenue has laid out three categories of software transactions: (1) sales of prewritten software, subject to sales and use tax; (2) "computer and data processing," taxed at a lower rate; and (3) the "development, hosting, or maintenance" of a website, not subject to tax. An argument could be made for including SaaS transactions in any of those categories, so the exact tax effect on any given transaction is unclear. Careful decisions in drafting contracts and formulating billing arrangements may be particularly helpful to SaaS providers in Connecticut.[4]

Florida — Not Taxable

The Florida Department of Revenue has stated that transfers of "electronic images which appear on the subscriber's video display screen," including most transfers of information over the Internet, are not taxable. In advisory opinions, the DOR has indicated that licenses to use or access software over the Internet are not taxable, as long as no tangible personal property is transferred. Accordingly, SaaS transactions are not subject to sales tax in Florida.[5]

Georgia — Not Taxable

Georgia regulations exclude electronically delivered software from the state's definition of tangible personal property, so if the electronic nature of a transaction is documented, the transaction will not be subject to sales tax. State regulations also exempt "computer-related services." Given those overlapping exemptions, SaaS transactions clearly would not be subject to sales tax in Georgia.[6]

Illinois — Unclear

Illinois taxes all software sales but exempts software licensing. Yes, I had to read that a few times too before comprehending it. There are five requirements to use the exemption, and the Department of Taxation has recently emphasized that failure to strictly abide by all the requirements renders a transaction taxable. In particular, the requirement for a contract with written signatures could trip up SaaS providers, especially in smaller transactions for which a click-through agreement might be the standard. The department has also indicated that it is considering rulemaking in this area soon. Accordingly, Illinois's position on taxing SaaS transactions appears unsettled.[7]

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[2]Timothy P. Noonan and Mark S. Klein, "Information Services: Taxation by Administrative Fiat in New York," *State Tax Notes*, Oct. 4, 2010, p. 63, *Doc 2010-20524*, or *2010 STT 191-7*.

[3]California's position on software sales and electronic delivery is described in Cal. Code Regs. section 1502(f)(1)(D) (2003).

[4]Computer and data processing includes "data scanning, creating custom software, computer training, and online access to information" and "electronically delivered software." The distinctions here are described in more detail in two advisory letters: Department of Revenue Services Policy Statement 2006(8) (Mar. 23, 2007) and Policy Statement 2004(2) (Oct. 21, 2004).

[5]The "electronic images" language is listed at Fla. Admin. Code. Ann. section 12A-1.062(5) (2001). For the advisory opinions, see Florida Technical Assistance Advisement No. 10A-052 (Dec. 3, 2010) (holding not taxable an agreement to provide access to database, along with Web-based tools for data processing); Florida Technical Assistance Advisement No. 05A-025 (June 2, 2005) (declaring a license to use software over Internet not taxable as long as no tangible personal property is exchanged). The department relies upon a state court case for the proposition that electronic transfers of information are not taxable. *Dep't of Revenue v. Quotron Systems*, 615 So.2d 774 (Fla. 3d Dist. Ct. App. 1993).

[6]The "computer-related services" language is contained in Ga. Comp. R. & Regs. 560-12-2-.111(6)(b). The department has acknowledged this exemption in state court. *ChoicePoint Servs. v. Graham*, 699 S.E.2d 452, 456 (Ga. Ct. App. 2010).

[7]Software licensing is described at Ill. Admin. Code tit. 130, section 1935 (2000). Under section 1935(a)(1) the requirements are: (A) a written (non-click-through) agreement must exist; (B) the agreement must restrict the customer's right to duplicate and use the software; (C) the agreement must prohibit the customer from licensing or transferring the software without the licensor's permission; (D) the licensor must provide replacement copies of the software to the customer at minimal charge, and document this policy in

(Footnote continued on next page.)

Indiana — Taxable

Indiana law imposes sales tax on electronic transfers of software, and the Indiana DOR has stated that any transaction in which customers gain the right to use, control, or direct software, even on a remote server, is a taxable transfer. In advisory letters, the department has held cloud computing arrangements taxable, unless the taxpayer can prove receipt of no tangible personal property.[8]

Massachusetts — Likely Taxable

The Massachusetts DOR has issued a regulation stating that electronic software transfers, including "transfers of rights to use software installed on a remote server," are taxable, and has applied that language to SaaS transactions. However, the department has also refrained from taxing some electronically provided services, even when the parties used the term SaaS in referring to their agreement. It is unclear exactly where the department draws the line between taxable transfers of control over software and untaxable online services, so consultation with the department may be required for any individual SaaS provider.[9]

Michigan — Unclear

The Michigan Department of the Treasury taxes all software sales, including electronic transfers, and officials have indicated in private correspondence that licenses to use software on a remote server are taxable. However, the Michigan Supreme Court overruled the department in one case, describing as a service rather than a taxable sale a coupon delivery system involving client stations, network communications, and a centralized provider database. Also, the Senate has passed bills exempting SaaS transactions, though the House of Representatives has not acted on them. Given the department's lack of public statements on SaaS, the court's willingness to override the department, and the possibility of statutory change, the taxability of SaaS transactions in Michigan appears an unsettled issue.[10]

Minnesota — Not Taxable

Minnesota has passed a statute imposing tax on all sales of software regardless of the delivery method. However, an existing regulation exempts "the making available of a computer on a time-sharing basis for use by customers securing access by remote facilities," and that exemption has been understood to apply to SaaS transactions. Gov. Mark Dayton (DFL) proposed repealing this rule in his 2012-2013 budget, and bills to that effect were introduced in both houses of the Legislature, but they were not acted on. Accordingly, at least for the moment, SaaS transactions are likely not subject to sales tax in Minnesota.[11]

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writing; and (E) the customer must destroy all software copies when the license expires. The Department of Taxation's recent emphasis on the need for all five criteria (*see, e.g.,* Department of Taxation General Information Letter ST 10-0113 (Dec. 14, 2010)) contrasts slightly with its earlier statements (*see, e.g.*, Department of Taxation General Information Letter 02-0105 (May 3, 2002) (saying that "generally, canned computer software transferred or downloaded electronically in this State by itself would not meet the physical presence requirement of the Quill case" and "information that is downloaded is not taxable because it is considered an intangible.")). The suggestion of further rulemaking is contained in a number of advisory letters, including Department of Taxation General Information Letter ST 10-0113.

[8]Software transfers are referenced under state law at Ind. Code. section 6-2.5-4-16.4 (2010). The discussion of remote control of software is in Department of State Revenue Information Bulletin #8 (Nov. 2011). Cloud computing is referred to in Department of State Revenue Letter of Finding No. 04-20110421 (Apr. 1, 2012). For an example of an arrangement that was *partly* considered to consist of an untaxable service, though also partly taxed for transfer of property, see Department of State Revenue Ruling No. 2011-05-ST (Oct. 11, 2011).

[9]Remote servers are mentioned in 830 Mass. Code Regs. 64H.1.3(3)(a) (2006). For consideration of SaaS transactions, see, e.g., Letter Ruling 12-6 (May 21, 2012). An example of a more lenient approach to taxation of SaaS is Letter Ruling 12-5 (May 7, 2012), which declares a transaction described in the contract as "Software as a Service" and involving the processing and reporting of data to the customer as not taxable due to the "minimal manipulation of the data."

[10]For the position on electronic transfers, see Department of Treasury Revenue Administrative Bulletin 1999-5 (Sept. 28, 1999) ("a computer program transferred electronically by a network, intranet, the Internet or by any other electronic method is taxable, if the software being transferred is within the definition of canned software."). The private letter is cited in part on the Streamlined Sales and Use Tax Agreement website. Terry McDonald, Technical Services Private Letter Ruling (Apr. 20, 2009), *available at* http://www.streamlinedsalestax.org/uploads/downloads/ CI%20CRIC%20Meeting%20Docs/2011/CI11034%20BAC%20Compliance%20Review% 202011%20Report%20%20Group%202%20States.pdf. The court case is *Catalina Mktg. Sales Corp. v. Dep't of Treasury*, 678 N.W.2d 619 (Mich. 2004). Notably, the court rejected the real object test the department had used in imposing taxation, setting forth instead an alternate "incidental to service" test involving consideration of a number of different factors. *Id.* at 627. The bills are: SB 335, *available at* http://www.legislature.mi.gov/documents/2011-2012/billengrossed/Senate/pdf/2011-SEBS-0335.pdf, and SB 336, *available at* http://www.legislature.mi.gov/documents/2011-2012/billengrossed/Senate/pdf/2011-SEBS-0336.pdf.

[11]The tax on software sales is at Minn. Stat. section 297A.61 subd. 3(f) (2011). The regulation is Minn. R. 8130.0500 (2008). The governor's proposal is available online. Minnesota Biennial Budget, FY 2012-2013, State Taxes and Local Aids and Credits, *available at* http://www.mmb.state.mn.us/doc/budget/narratives/gov11/tax-policy.pdf. The House bill, HF 1548, is accessible at https://www.revisor.mn.gov/bin/bldbill.php?bill=H1548.0.html&session=ls87. The Senate bill, SF 0925, is *available at* https://www.revisor.mn.gov/revisor/pages/search_status/status_detail.php?b=Senate&f=SF0925&ssn=0&y=2011.

New Jersey — Unclear

A 2006 New Jersey statute imposed taxation on a broad range of transactions, and taxation of SaaS seemed likely when the Department of Taxation described "application service provider" transactions as "license[s] to use prewritten computer software delivered electronically" and electronic delivery of software as a taxable sale. However, a later tax note retracted the former description and described "application service provider" transactions without commenting on their taxability. Accordingly, it is unclear if the department now views SaaS transactions as taxable software transfers. If it did, the use of the "software" exclusively within the customer's "business, trade, or occupation" would exempt the provider from taxation.[12]

New York — Taxable (for now)

New York's broad statute imposes sales tax on transfers of prewritten computer software regardless of how the customer gains access to the software. Under that authority, the Department of Taxation and Finance has explicitly stated that "application service provider" arrangements transfer control of software and are therefore subject to sales tax. But as outlined in one of my previous columns, the tax department has seemingly taken a different position in earlier advisory opinions.[13] And I know of several pending cases in which taxpayers are challenging the department's position. So stay tuned on this one.

North Carolina — Unclear

North Carolina in 2010 passed a law taxing software purchases regardless of the means of delivery. However, the statute contained exemptions for (1) software designed to run on an "enterprise operating system" and (2) software sold to "a person who operates a datacenter" and used within the datacenter. Those exemptions seem to apply to SaaS; in particular, SaaS software will almost certainly run on most enterprise operating systems. However, those broad exemptions cut against the clear intent of the statute to expand tax liability. Therefore, absent clarification, it is unclear whether SaaS transactions are taxable in the state.[14]

Ohio — Likely Taxable

Ohio law states that "automatic data processing or computer services . . . provided for use in business" are subject to sales tax. In *MIB, Inc. v. Tracy*, the Ohio Board of Tax Appeals considered an arrangement in which customers used various means, including computers, to connect to a series of computers at a provider, receiving back specialized reports containing the provider's own data. The board unanimously found this arrangement taxable, because "the [customer's] computers . . . worked in direct concert with the [provider's computers] to provide that [customer] with access to the information sought by that [customer]." By the same token, the computers of customers in most SaaS arrangements work in concert with the provider's servers to provide access to at least some new information sought by those customers. Accordingly, it seems that SaaS transactions are probably taxable in Ohio.[15]

Pennsylvania — Taxable

Although Pennsylvania's statute does not actually include software within its definition of tangible personal property, state courts have recently ruled that the definition includes software by implication. Under this authority, the Pennsylvania DOR directly addressed SaaS in a May 31, 2012, letter ruling. Changing its previous position, the department stated that because the customer in a SaaS transaction receives a "license to use," as well as "control or power over the software," those transactions are taxable sales under state statute.[16]

Puerto Rico — Unclear

Puerto Rico's first sales and use tax took effect in 2007. The statute and the regulations implementing it include computer programs within the definition of tangible personal property and define licenses to use as sales. That language certainly makes taxation of SaaS transactions a possibility. However, the Departamento de Hacienda has been focused on implementing the new tax on the more common

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[12]The relevant statute is N.J. Stat. Ann. section 54:32B-3(b)(12). For the initial advisory materials, see Division of Taxation Tax Notes — Information Services (Jan. 22, 2007); Division of Taxation Technical Bulletin TB-51R (Mar. 13, 2007). For the revision, see Tax Note — Information Services (Feb. 25, 2008).The note listed the taxability of 13 other transactions, but described "application service provider" arrangements as merely "not an information service" without further explanation. *Id.* Finally, for the "business, trade, and occupation" language, see Division of Taxation Technical Bulletin TB-51R.

[13]Timothy P. Noonan and Joseph N. Endres, "Taxation of Internet-Based Software: Examining Recent Trends in New York," *State Tax Notes*, Mar. 9, 2009, p. 791, *Doc 2009-4546*, or *2009 STT 44-5*. For the statute, see N.Y. Tax Law section 1101(b)(6). The reference to "application service providers" is in Office of Counsel Advisory Opinion TSB-A-08(62)S (Nov. 24, 2008).

[14]The statute is N.C. Gen. Stat. section 105-164.13(43a) (2010).

[15]That language is located in Ohio Rev. Code Ann. section 5739.01(3)(e) (2011). For an application, see, e.g., *Amerestate, Inc. v. Tracy*, 648 N.E.2d 1336 (Ohio 1995). For the case, see *MIB, Inc. v. Tracy*, 1997 Ohio Tax LEXIS 636, at *42 (Ohio Board of Tax Appeals, June 6, 1997).

[16]The court decision is at *Dechert LLP v. Commonwealth of Pennsylvania*, 998 A.2d 575 (Pa. 2010). For the SaaS discussion, see Department of Revenue Letter Ruling SUT-12-001 (May 31, 2012).

physical sales, and it has not directly addressed the question of SaaS, so there is no final answer as yet.[17]

Texas — Taxable

Texas statute mandates the taxation of "data processing services." The Office of the Comptroller of Public Accounts has interpreted the statutory language broadly, including "software as a service" and "application service provider" arrangements, even when they do not provide unique data to the customer. Given that guidance, SaaS transactions are clearly taxable in Texas.[18]

Virginia — Not Taxable

Virginia's taxing statute does not apply to electronic sales of software. Accordingly, the tax commissioner does not impose sales tax on those transactions as long as providers document the delivery method. Because Virginia does not impose a tax on electronic information services either, SaaS transactions are not subject to taxation in Virginia.[19]

Washington — Taxable

A 2009 Washington law imposed sales tax on all transfers of software regardless of the method of delivery. Under that authority, the Washington DOR issued a regulation setting forth a taxable category of software called "remote access software," which explicitly includes "application service provider" arrangements, though the exact rate at which those arrangements would be taxed is unclear.[20]

Conclusion

It seems almost every state has a different answer or has arrived at an answer in a different way. Perhaps, really, that's why state and local tax people are so interested in the topic, and for good reason. And as we have seen with other state tax developments such as "Amazon" laws, state tax departments tend to pile on when they see developing issues. As electronic commerce grows more common, and as states increasingly rely on sales tax for revenue, that trend is likely to continue. So it doesn't look like the skies will be clearing any time soon.

Sorry. Just couldn't help myself. ☆

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[17]The tax is imposed at P.R. Laws Ann. tit. 13, section 9091 (2006) et seq. For the regulation, see Regulation No. 7249 (Nov. 20, 2008).

[18]For the broad interpretation of the language, see Comptroller of Public Accounts Rule 3.330(a) (2000) (including within statute "the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information."). For an example with no unique data provided to the customer, see Tax Policy Division STAR 200805095L (May 28, 2008).

[19]The statute is located at Va. Code. Ann. section 58.1-609.5(1) (2006). For an examination of a transaction, see Virginia Public Document Ruling No. 10-241 (Oct. 4, 2010).

[20]For the law, see 2009 Wash. Sess. Laws Ch. 535 section 301(6)(b). The categories are located at Wash. Admin. Code section 458-20-15501(401)(g) (2009). The statute itself, and some advisory opinions, suggest that a "retail sales" rate would apply. *See, e.g.*, Advisory — Digital Products Bills (ESHB 2075 and SHB 2620) (May 3, 2010); Washington Excise Tax Advisory No. 9002.2009 (July 24, 2009). The regulation seems to imply that a "business and organization" rate would apply unless an actual download occurs. *Id.*