# New York Ruling Raises Questions About The Taxation of Cloud Computing Services

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In this article, Noonan and Reilly review the New York tax department's position on taxing cloud computing services and a Division of Tax Appeals ruling on that position.

In *Matter of SunGard Securities Finance LLC*, an administrative law judge ruled that SunGard was exempt from sales tax because it provides an information service that is personal and individual to the customer.

When you were a child, lying faceup on a grassy knoll in the yard, staring at the clouds, what did you see? Animals? Faces? Tall ships on the high seas? Or perhaps you felt left out and never understood why people claimed to see images in the clouds? For the past few years, the New York State Tax Department has been lying back (or presumably sitting) in their offices, staring at the digital cloud, and seeing one thing: taxable sales of prewritten software.

But a recent ruling from the New York Division of Tax Appeals may give taxpayers the opportunity to challenge the department's position regarding the taxability of some cloud computing services, also known as software as a service (SaaS). In *Matter of SunGard Securities Finance LLC*,[1] an administrative law judge rejected the tax department's position that SunGard Securities Finance's Smart Loan service was subject to tax as the sale of tangible personal property, and held instead that SunGard was providing an information service exempt from tax because of the personal and individual nature of the service. In this article, we take a closer look at *SunGard* and analyze what relief it may provide taxpayers who offer cloud-based services.

## I. Taxability of Cloud Computing

New York imposes sales and use tax on retail sales of tangible personal property.[2] This should come as no surprise to regular readers of this column. (But if it does, and you've been making retail sales in New York, call us: New York has a voluntary disclosure program that you'll want to discuss!) For everyone else, it's worth unpacking how the tax department interprets that basic rule to support the imposition of sales and use tax on SaaS vendors.

SaaS is a software distribution method that vendors use to provide consumers access to applications over the Internet using cloud computing technology. Instead of consumers purchasing and installing the software on their own computers, the vendor hosts the software on its server and charges the consumer according to the amount they use the software or by a monthly or annual fee. Unlike going to the local electronics shop, the consumer doesn't purchase a physical medium containing the software. Instead, the consumer pays for a license to use the vendor's software. In the digital world, consumers use the cloud to access everything from customer relationship management software to instant messaging and Web-based chat rooms. How then does the tax department argue that a license to use a nontangible computer program can qualify as the sale of tangible personal property?

First, New York's definition of the term "tangible personal property" includes prewritten computer software.[3] And the terms "sale, selling or purchase" include "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume."[4] Regarding a "license to use," a transfer of possession occurs if the purchaser takes actual or constructive possession of the property, or if there has been a transfer of "the right to use, or control, or direct the use of tangible personal property."[5]

[1] *Matter of SunGard Securities Finance LLC*, No. 824336 (N.Y. Div. of Tax App. 2014).

[2] Tax Law section 1105(a).
[3] Tax Law section 1101(b)(6).
[4] Tax Law section 1101(b)(5).
[5] 20 NYCRR section 526.7(e)(4).



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Piecing those definitions together, the tax department argues that when a consumer accesses a software application via the cloud, that consumer gains constructive possession of tangible personal property and gains the right to use, control, or direct its use, making it a taxable sale.[6] Not all states agree with New York.[7] We don't agree either. But SaaS vendors doing business in the Empire State need to understand that New York takes a hard line on this issue.

Following the recent *SunGard* determination, however, SaaS vendors doing business in New York also need to know when to push back against the department on this issue. As *SunGard* highlights, not all cloud computing services delivered in New York — especially those in which the software at issue is merely a small piece of a larger service — are properly characterized as taxable sales of tangible personal property.

## II. *Matter of SunGard*: Licensing Software vs. Outsourcing Services

At issue in *Matter of SunGard Securities Finance LLC* was whether one of SunGard's cloud computing services, Smart Loan, was taxable as the sale of prewritten computer software. SunGard, a financial consulting and data processing firm, offers the Smart Loan service to its customers as a way for SunGard to process and maintain data regarding SunGard's customers' securities lending and borrowing transactions. In other words, SunGard's customers use the Smart Loan service to outsource to SunGard the back-office functions of tracking and processing the customer's own securities lending activities. SunGard's data processing services include reviewing transactions for regulatory compliance, verifying pricing accuracy, and making the processed data available to customers in a variety of formatted reports for the customer's own analysis.

The Smart Loan service operates as follows: SunGard's customers transfer securities lending and borrowing data to SunGard. SunGard uses more than 25 employees to analyze and process the data before making that information available to the customers' employees in processed formats. Because its employees are necessary to provide the data processing services, Smart Loan is only available during regular business hours. SunGard's customers are billed based on the volume of services delivered to the customer and on the number of people receiving the service. Based on those facts, the tax department said SunGard licensed its Smart Loan computer software to its customers and that the license constituted a taxable sale of tangible personal property. The ALJ disagreed.

Before expanding on the ALJ's reasoning, however, and to avoid raising the hopes of our readers looking to challenge the tax department's treatment of SaaS, let's begin by noting that *SunGard* does not refute the underlying statutory rationale on which the tax department taxes SaaS. We'll have to wait for another case for that. Instead, *SunGard* highlights important limitations on the department's position. Namely, the ALJ's opinion suggests that New York may be failing to recognize an important distinction between licensing prewritten software and outsourcing back-office services.

According to the ALJ, SunGard's charges to access its Smart Loan service are not receipts from the sale of prewritten computer software. Instead, SunGard itself, rather than its customers, uses the proprietary software to process its customers' transactional data. In other words, SunGard retains constructive possession of the software. Importantly, SunGard's service agreement says Smart Loan provides a "processing service." And the service agreement specifically states that it is not an agreement of sale, and that title and all rights to the Smart Loan software remain exclusively with SunGard. As discussed in more detail below, prior tax department advisory opinions failed to give much credence to service agreement terms,[8] but the ALJ in *SunGard* considered it relevant.

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The ALJ also determined that SunGard's customers do not, in fact, have access to the Smart Loan software and cannot modify the software in any manner. Rather, the

[6] *See, e.g.*, TSB-A-13(22)S (July 25, 2013) (finding that a company's receipts from sales of access to forms via software stored on the company's website are subject to sales tax when accessed by a customer located in New York because the company's product is prewritten software); TSB-A-08(62) (Nov. 24, 2008) (finding that a company's charges for access to its software that allows a customer to upload an image onto the company's servers and manipulate the image are subject to sales tax when accessed by a customer located in New York because the company's customers have access to prewritten computer software).

[7] In many states, including, for example, California and Georgia, transfers of software or information by electronic means are not taxable, and SaaS is not listed as a taxable service. SaaS vendors are therefore exempt from sales and use tax on sales of cloud computing services in those states. *See, e.g.*, Cal. Rev. & Tax. Code sections 6006, 6016; 18 Cal. Code Regs. section 1502; Ga. Comp. R. & R. section 560-12-12-.111. *See also* Timothy P. Noonan, "Nuts and Bolts Answers on Cloud Computing," *State Tax Notes*, Aug. 20, 2012, p. 527.

[8] *See, e.g.*, TSB-A-09(15)S (Apr. 15, 2009) ("Although Petitioner's contract with its subscribers characterize its product as a 'service,' and states that the subscriber does not have the right to 'alter, change, or control' the software, this characterization is not controlling"); TSB-A-09(8)S (Feb. 2, 2009) ("Although the sample contract between XYZ and its subscribers provides that no license to use software is transferred to the purchaser, this characterization is not controlling"). *But see Matter of Voicemate.com Inc.*, No. 819864 (N.V. Div. of Tax App. 2005).



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software is modified, revised, and updated only by Smart Loan's employees. Further, the Smart Loan service is available only during designated business hours, when SunGard's employees, who provide the data processing services, are available. As said by the ALJ, "It would appear entirely inconsistent for one who purchases prewritten software, either outright or by license to use, to be limited in the hours during which it can access and use the same."

Although SunGard furnishes its customers with ancillary software that establishes a secure connection between SunGard and the customer for the purpose of transferring data, SunGard offers that software without additional charge. The software cannot function independently of the Smart Loan service, and customers cannot alter or manipulate the ancillary software. Under those facts, the ALJ disagreed with the tax department's view that SunGard's Smart Loan service constituted a license of prewritten software by which customers receive and use SunGard's Smart Loan software on their own computers. Instead, the ALJ found no evidence that SunGard's customers, as opposed to SunGard, use the Smart Loan software to perform the relevant data processing services and that the ancillary software used to transfer data between the customer and SunGard is integral to SunGard's overall service.

The ALJ concluded, however, that SunGard's Smart Loan service qualifies as an information service as defined in Tax Law section 1105(c)(1). Although information services are generally taxable in New York, the ALJ concluded that SunGard's service is exempt from tax because the information that it furnishes to specific customers is personal and individual in nature and not included in reports furnished to any other customer.[9] The ALJ therefore canceled all tax assessed regarding the Smart Loan service.

### III. What Does *SunGard* Mean for Your SaaS Business?

The *SunGard* determination should come as welcome news to all New York SaaS vendors. The tax department took the position that SunGard's receipts from its Smart Loan services were taxable as sales of prewritten computer software. SunGard disagreed, and on appeal, its tax assessment was canceled. But before technology firms across the state stop collecting sales and use tax (not our recommendation), we should note that the services at issue in *SunGard* could be distinguishable from other cloud-based products. The facts underlying the *SunGard* determination — restrictive terms in the service agreement, customers' limited access to the software, and the high level of involvement by SunGard's employees in providing the data processing services — do not apply to every cloud computing application. If a customer is given unfettered access to software stored in the cloud and is encouraged to use that software as it pleases, the department will still likely treat that as a taxable sale. Of course, taxpayers still have a variety of arguments against that position, not the least of which being that customers never have possession or control of software when it is accessed via the cloud.

> **Although *SunGard* is not a break in the clouds for all SaaS vendors, the determination is, at the very least, a silver lining for vendors who use cloud computing technology as a component in providing a more comprehensive service.**

But what if a company charges its subscribers for access to an online loan origination and processing service? The company's contract with its subscribers characterizes the product as a service and expressly states that the subscriber does not have the right to "alter, change, or control" the software. And as part of its offering, the company's own employees review the subscribers' loan information to ensure the completeness, accuracy, and compliance of the loan documents. That sounds very similar to SunGard's Smart Loan service, but the tax department analyzed those facts in a 2009 advisory opinion and concluded that the company's charges for access to the service described above were receipts from the sale of prewritten computer software.[10] According to the tax department, the company's subscribers gained constructive possession of the company's software and gained the "right to use, control or direct the use" of the software. The tax department did not find the terms of the company's contract with its subscribers, which characterized the product as a service, to be controlling, nor did the tax department discuss the offline loan review services provided by the company's employees as part of its overall service. These are two facts the ALJ in *SunGard* determined to be relevant in canceling SunGard's tax assessment. And although the department speculated in the advisory opinion that the product may also have some aspects of an information service, the department determined that it need not resolve that issue, because it believed the company's product was prewritten computer software.

Second, what if a company charges its subscribers for access to an Internet-based financial transaction settlement platform that facilitates the settlement of transactions in the syndicated bank loan market? Again, the company's contract with its subscribers provides that no license to use the software is transferred as part of the purchase. But the subscribers, who are sellers of financial instruments, have the option of establishing a data link and inputting their own information onto the platform, rather than relying

[9] *See* Tax Law 1105(c)(1) ("excluding the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons").

[10] *See* TSB-A-09(15)S.



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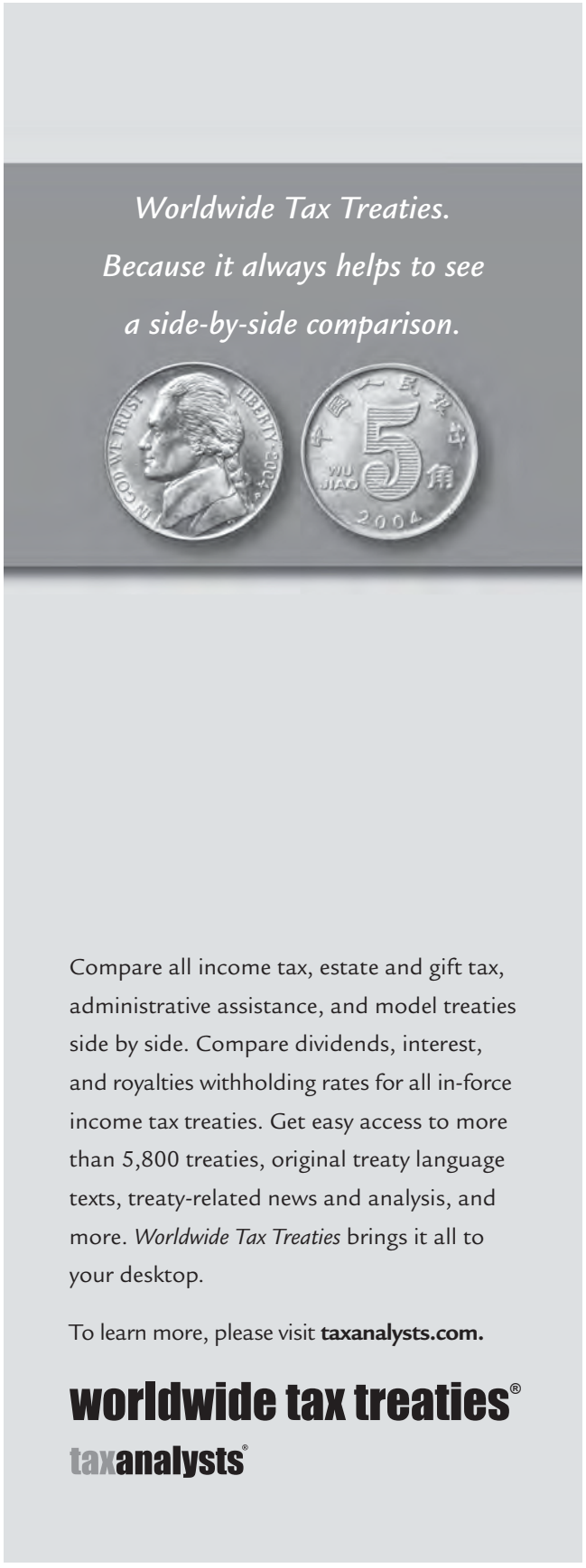
solely on the company to input the data. Subscribers are then charged for each settled transaction. That also sounds similar to the service provided by SunGard, but according to the tax department, the provision of that product constitutes the sale of prewritten computer software.[11] Because the subscriber has the option of establishing a data link to input its own information and to generate and obtain various reports via that link, the tax department found that subscribers had the right to control the company's software sufficient to constitute a taxable sale. But in *SunGard*, customers were also furnished with ancillary software that established a secure connection between SunGard and the customer for the purpose of transferring data. And the ALJ determined that the ancillary software was integral to SunGard's nontaxable overall service.

### IV. Conclusion

Although *SunGard* is not a break in the clouds for all SaaS vendors, the determination is, at the very least, a silver lining for vendors who use cloud computing technology as a component in providing a more comprehensive service. Of course, the case is under appeal, and because ALJ decisions are not precedential, the decision is far from the last word on the subject. Still, the tax department has shown little regard for the distinction between licensing cloud-based software and outsourcing services over the Internet. *SunGard* will hopefully help illustrate the differences between those two transactions — that is, when constructive possession of software is transferred to a customer versus when it is retained by a vendor.

While we continue to question whether any SaaS providers are properly subject to New York sales and use tax, *SunGard* will at least help protect those online vendors that sell services as opposed to just access to online software. The tax department should not impose sales tax on a vendor making use of its own software to provide a service over the Internet as though it is providing others with constructive possession of that same software. So online vendors, lie back, relax, and keep looking to the clouds: a tax break may be in your future. ☆

[11] *See* TSB-A-09(8)S.



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