February, 2015

SALES & USE TAX

TAXATION OF THE CLOUD STILL HAZY

While the coined term "cloud computing" no longer sounds foreign to consumers or businesses, and most certainly not to tax professionals, taxpayers continue to struggle when trying to identify the sales tax issues surrounding the cloud. Taxpayers are increasingly seeking guidance from tax advisers or from state revenue departments via letter rulings to determine the taxability of their products. Often, taxpayers are taken by surprise when a product they have been providing to their customers has morphed into a taxable item due to software elements or enhancements.

Tax challenges stretch across the three major cloud service offerings: software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS). As far as state-issued guidance is concerned, over the last few years, SaaS has seen a wide variety of responses across many states. However, with limited, fact-driven guidance from the states, there is still a great deal of uncertainty about whether variations of SaaS offerings are subject to sales tax in a number of states, and many states still lag in providing clear statutory or regulatory guidance.

In addition, how sales tax applies to SaaS sales is just a small piece of the unknown territory of cloud taxability. Most states are still silent as to how PaaS and IaaS are taxed both for state income and sales and use tax purposes, with minimal guidance available on the nexus and sourcing issues surrounding any cloud services.

Storm Clouds ahead as noted above, in recent years, many states have begun to specifically address the taxability of the SaaS product model through administrative and regulatory guidance. Below are a few notable examples.

Pennsylvania

In May 2012, Pennsylvania publicly reversed its prior position on the sourcing of SaaS for tax purposes. Per a 2012 letter ruling, a SaaS provider was purchasing and installing software on servers that was accessible by both its employees and its customers for a fee. The Department of Revenue ruled that the provider was subject to use tax on software used by its employees, while the charges to the customers for electronically accessing the same software were subject to sales tax. Since Pennsylvania defines computer software as tangible personal property, it is subject to sales and use tax. In accessing the software, the user, whether the employee or the customer, is exercising a license to use it and has control or power over the software at the user's location, not where the server hosting the software is located. Consequently, canned software accessed remotely is subject to sales and use tax when the end user is located in Pennsylvania. Earlier, the commonwealth had issued a ruling indicating that the location of the server was paramount in determining whether SaaS was subject to tax. With this more recent ruling, Pennsylvania alerted taxpayers that, for sales tax to apply, it was no longer taking the position that the server hosting the application must be located in the commonwealth.

Texas

In July 2012, Texas issued a detailed ruling on cloud computing. The topics addressed included (1) data-processing services, including data storage, manipulation, and retrieval; (2) data transfer fees and incidental usage fees; (3) bulk and transactional email-sending services for businesses and developers; (4) taxable information services, such as gathering data from around the web and making it available to customers in the form of lists and searchable data; (5) the sourcing of data-processing and information services for local tax purposes; and (6) determining the proper local sales tax rate in the event a sales office, technology development office, or data center is created in the state. The state continues to tax most cloud-computing services as data processing services with a few of the other services being taxed as information services or telecommunications. The definition of data processing services includes computerized data and information storage or manipulation, as well as use of computer time for data processing. In addition to discussing common cloud offerings, incidental usage fees associated with cloud computing are also highlighted as subject to tax as data processing. It should be noted that Texas exempts 20% of data processing and information services charges from sales tax.

The Friendly Skies

While some states are looking for ways to tax cloud service offerings, other states have decided not to tax SaaS products. The

following are a few examples of these efforts, which may serve to encourage cloud service providers to relocate to these states.

Colorado

Effective March 1, 2010, through June 30, 2012, standardized software was subject to sales and use tax in Colorado, regardless of how the software was acquired by the purchaser or downloaded to the purchaser's computer.
Effective July 1, 2012, the tangible personal property definition excludes standardized software that is not delivered via a tangible medium. Software provided through an application service provider, delivered by electronic software delivery, or transferred by a load-and-leave software delivery is not considered delivered to the customer in a tangible medium. The legislation effectively reinstates an exemption for electronically delivered software that was in effect prior to March 1, 2010. In addition, there has been some uncertainty about how Colorado taxed SaaS during the brief period that electronically delivered software was subject to tax. This is a perfect illustration of how difficult it is for taxpayers to track the numerous changes in the sales tax treatment of these items, even changes that happen in a single state. It should be noted that, although Colorado does not tax SaaS at the state level, this may not be true

Virginia

In April 2012, Virginia issued a ruling supporting its long-established exemption from retail sales and use tax for "services not involving an exchange of tangible personal property which provide access to or use of the Internet and any other related electronic communication service, including software, data, content and other information services delivered electronically via the Internet." In the ruling, the Department of Taxation ruled that a taxpayer providing access to a web-based portal via the internet is not providing tangible personal property. As such, charges for access to a web-based portal that the taxpayer refers to as cloud computing services are not subject to the Virginia retail sales and use tax.

Fact-Specific Predictability

Many states that tax cloud service offerings have issued rulings that hinge on specific fact patterns. In those states, determining SaaS taxability must be done on a case-by-case basis. Several tests have developed in the analysis of the applicability of sales tax to SaaS, including the transfer of ownership and control, the transfer of title, and the true object test.

Massachusetts

In Massachusetts, several fact-specific rulings have been issued over the past several years, many dependent on the true object of the transaction. In addition to these, the commonwealth recently issued a ruling outlining various cloud scenarios and their taxability. For example, sales of cloud computing may result in two different tax outcomes based on whether the customers are using their own software or open-source (free) software provided by third parties or using the software licensed by the provider:

1. Sales of cloud-computing services using the customer's own software or software available free on the internet are not taxable when sold to customers in Massachusetts.
2. However, sales of cloud-computing services that use the provider's software licenses are taxable when sold to customers in Massachusetts, whether or not there is a separately stated charge for the software and whether or not the customer sublicenses the software.

Further, on Feb. 7, Massachusetts issued a draft directive for public comments that were due by Feb. 22. The directive was drafted in response to a large number of ruling requests pertaining to the computer industry and addressed the application of the Massachusetts sales and use tax to sales of software- and computer-related services. Specifically, the directive addressed sales of SaaS, cloud-computing, and business solutions, all of which involve software, sometimes bundled with services that are not subject to sales tax. The directive states that a transaction will be considered a taxable transfer of prewritten software, based on a list of factors, which will be considered cumulatively with no one factor being determinative, including the following: a transfer of ownership; the ability of a customer to access the software at any time, enter and manipulate its own information, and run reports; little intervention in the functionality of the software by the seller; the seller's use of the term ASP in describing itself or SaaS in describing its product; and granting a customer access to the software even when no software is transferred to the customer. For a transaction to be treated as a nontaxable service factors that will be locally, as discussed later considered include: the seller is providing data-processing services or information services; the customer does not interface with the prewritten software; the seller provides a personal or professional service; and the seller provides custom software. Taxpayers and practitioners should follow any updates from the Department of Revenue resulting from the feedback to the directive.

South Carolina

South Carolina is unique in that it taxes ASP services, including them as a subset of tangible personal property-communications. Nonetheless, the state recently issued a taxpayer-favorable ruling. In this ruling, a medical practice's non itemized monthly charge for a medical billing service and a software product accessed via an ASP in South Carolina was not subject to sales and use tax because the transaction was considered a sale of nontaxable data processing. As a general rule, software accessed via an ASP is subject to the South Carolina sales tax when sold alone. In this case, however, the state looked to the true object of the transaction.
Consequently, the portion of the charge for software was not taxable, since the true object of the transaction in which the software and billing service were sold for one no itemized monthly charge was data processing.

Documentation

Although the taxability of cloud computing still lacks clarity in many states, many times the determination is made on a case-by-case basis through considering all available facts and documentation. Taxpayers should be prudent in maintaining readily retrievable records with a detailed product description, as well as books and records breaking down the charges made into product categories. Though cumbersome, in an audit situation a good set of supporting facts may favorably shift the taxability determination or at least reduce some penalties due to a good-faith error.

For instance, a Texas taxpayer was unable to establish by clear and convincing evidence the number and type of nontaxable software transferred to customers for their use. Even though the taxpayer could prove by clear and convincing evidence that the software transferred was not subject to sales tax, an assessment was affirmed due to lack of support of the exact amounts of the transfers. In addition, the taxpayer failed to show by a preponderance of the evidence that it exercised due diligence in determining the products' taxability and, as a result, was not entitled to a waiver of penalties.
Two rulings in Indiana also provide good examples of the importance of having support documentation. Although Indiana taxes SaaS, it does not tax prewritten software. Last year, the state issued two rulings with two different tax consequences. In one ruling, software license purchases made by a legal services provider in Indiana were not exempt from the Indiana use tax because they were purchases of tangible personal property. The taxpayer claimed that the purchases were exempt because the provider acquired a license to retrieve and store information, and additional users could only access the information. The taxpayer also argued that the software license purchases did not involve a transfer of tangible personal property and therefore should not be subject to the Indiana sales and use tax. The state relied on the broad definition of tangible personal property to impose Indiana use tax. For

Indiana sales tax purposes, tangible personal property includes prewritten computer software. Only custom software specifically designed for the purchaser is not subject to sales tax. Further influencing the ruling, the taxpayer's position was hurt because the taxpayer could not provide documentation supporting its position.

In the other ruling, an Indiana retailer was not liable for sales and use tax on its charges for the sale of "Automation Services" and "Tracker Services." Indiana initially determined that these "web-based computer programs" involved prewritten computer software and, therefore, were taxable. However, the taxpayer provided enough support (service contracts, brochures, and other information about the services) to establish that the "Automation Services" and "Tracker Services" sold did not involve the right to use prewritten computer software.

Moratorium

In various renditions of one of its tax bulletins, Vermont addresses the taxability of various services that are similar to, or may be viewed as, components of cloud computing. Originally, the state took the position that the sale of computer memory storage for large volumes of computer data, either created through the customer's use of a computer program on a remote computer or downloaded from the customer or third party's computer to the remote server, was subject to sales tax as the sale of tangible personal property. The bulletin was later revised to remove computer memory storage as taxable. To take this position even further, Vermont statutorily enacted a temporary moratorium on taxation of sales of prewritten software accessed remotely, effective retroactively for sales made after Dec. 31, 2006, and before July 1, 2013. Taxpayers may apply for refunds of those sales taxes, which will be refunded if the requests are made within the statute of limitation and documented to the state commissioner's satisfaction.

Nexus

With many states considering the remote access of software to be the use of tangible personal property, it is not a far stretch for states to assert that the use of that property in a state could create nexus for a SaaS provider. Recently, in a New Mexico ruling about a web-based tool, the Taxation and Revenue Department concluded that an out-of-state taxpayer was engaged in business in New Mexico due to having subscribers in the state because it was selling a license to use the web-based tool and the license was a form of property in the state. For gross receipts tax purposes, the location of the license is the place where it will normally be used. Since the location of the license was presumed to be the end user's business location, the out-of-state taxpayer was deemed to have property in the state. This

aggressive approach not only subjects the transaction to sales tax, but also may create income tax nexus in the state.

Conclusion

As the above discussion highlights, the tax issues around cloud computing are far from being resolved. In approximately 20 states, determining cloud taxability relies on the existing rules around the taxability of software or enumerated services, such as data processing. Other states have taken the position that cloud offerings are not tangible personal property or enumerated services and are, therefore, not subject to tax in those states. However, as cloud-computing technology continues to evolve, so will state tax positions. The challenge for taxpayers is to stay current on the changes in the various tax jurisdictions.