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Jeffrey A. Friedman, Sutherland
Harley T. Duncan, KPMG

"Hey You! Get Off Of My Cloud!"

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Agenda

- Cloud Computing
  - What is Cloud Computing?
  - Nexus
  - Characterization Determines Taxability
  - State Taxability Positions
  - Sourcing
  - What's a Taxpayer To Do?

What is Cloud Computing?

- Various Definitions (from Urban Dictionary…)
  - A pointless catchphrase (marketing strategy) for technology that has existed for years
  - Cloud computing is a style of computing in which dynamically scalable and often virtualized resources are provided as a service over the Internet
  - Utilizing the resonance of water molecules in clouds when disturbed by wireless signals to transmit data around the globe from cloud to cloud. "I use cloud computing so I don't have to worry about viruses, I only have to worry about birds flying through my cloud."

What is Cloud Computing?

- There is really no "one" definition – it is a manner of providing a service.
- Cloud Computing generally means using multiple server computers accessed via a digital medium (generally the Internet) as though they were one computer
- With Cloud Computing, software is hosted remotely and accessed via the Internet
- Because businesses can access applications without installing software on each employee's computer, companies can outsource their entire IT operation without transfers of tangible personal property

What is Cloud Computing?

- One type of Cloud Computing is called "software as a service" or "SaaS," which refers to the cloud provider's ability to continually update and upgrade cloud software applications
  - Eliminates the need for version upgrades or license management on individual computing devices
- A cloud provider that provides "SaaS" services is often referred to as an "Application Service Provider" or "ASP"
  - The ASP may or may not own or license the software but will generally own and maintain the hardware and networking equipment required for the user to access the software
  - The ASP may charge the user a license fee for the software (if the ASP owns the software) and/or a subscription fee for maintaining the software/hardware used by its customers
- Main advantage is that the SaaS provider makes the technology investment

Application Service Providers ("ASPs")

- An entity retains custody over (or "hosts") software for use by third parties
- Users of the software hosted by the ASP typically will access the software via the Internet
- The ASP may or may not own or license the software, but generally will own or maintain the hardware and networking equipment required for the user to access the software
- The ASP may charge the user a license fee for the software (in instances where the ASP owns the software) and/or a fee for maintaining the software/ hardware used by its customer

Software as a Service ("SaaS")

- The SaaS model allows the consumer to use the provider's software applications running on a cloud infrastructure.
- The applications are accessible from various client devices through a client interface such as a web browser (e.g., web-based email).
- The consumer does not manage or control the underlying cloud infrastructure including networks, servers, operating systems, storage, or application capabilities.
- Under the SaaS model a service agreement is almost always executed (vs. a software license agreement or services agreement for an ASP).
- SaaS model is familiar to most Internet users and includes such offerings such as web-based email, calendars, word processing, and digital photo applications.

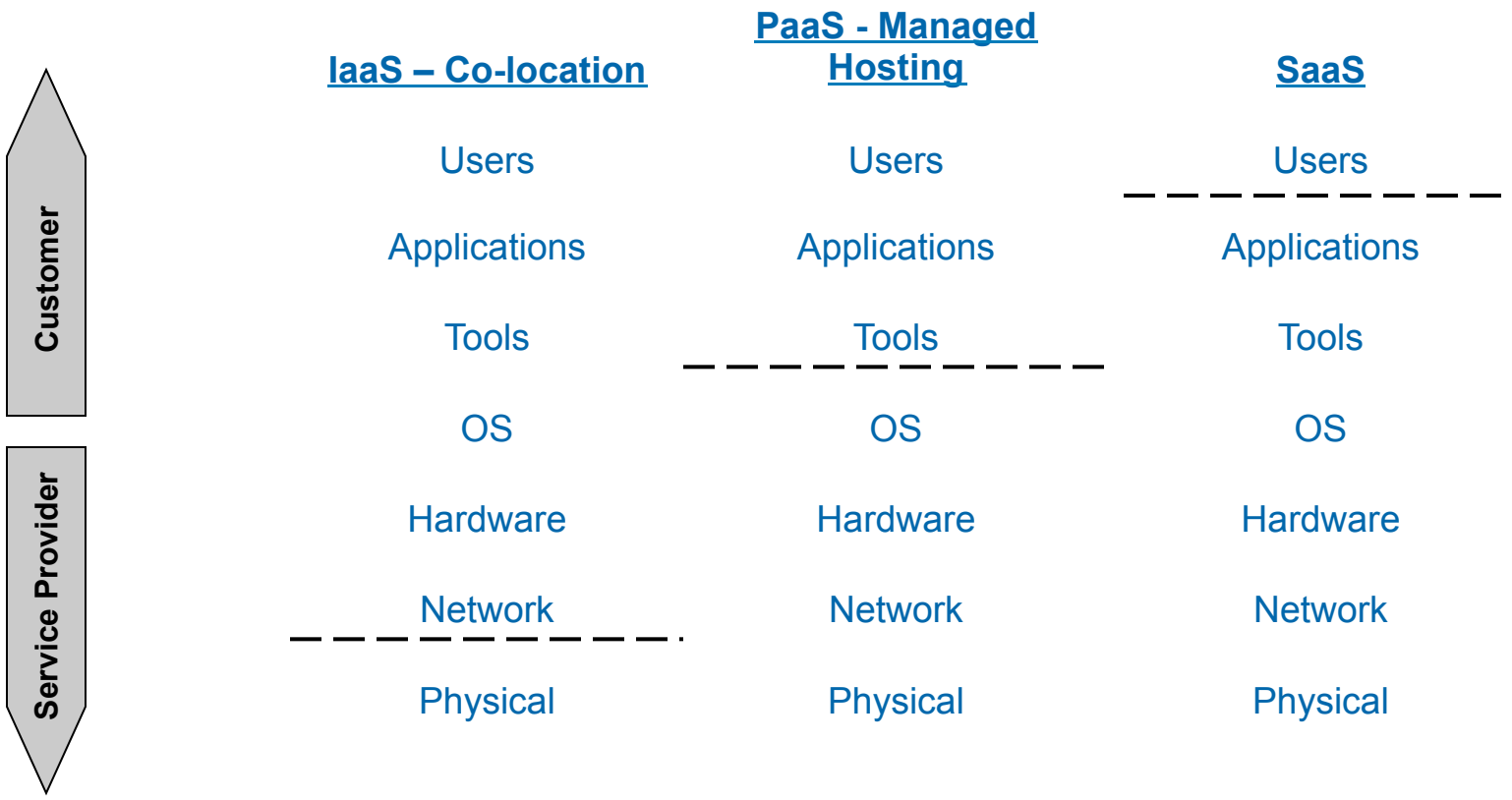
Platform as a Service ("PaaS")

- The PaaS model allows the consumer to run consumer-created or acquired applications on the cloud provider's platform
- The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, or storage, but has control over the deployed applications and possibly the application hosting environment configurations
- An example of a PaaS model includes web hosting and managed services

Infrastructure as a Service ("IaaS")

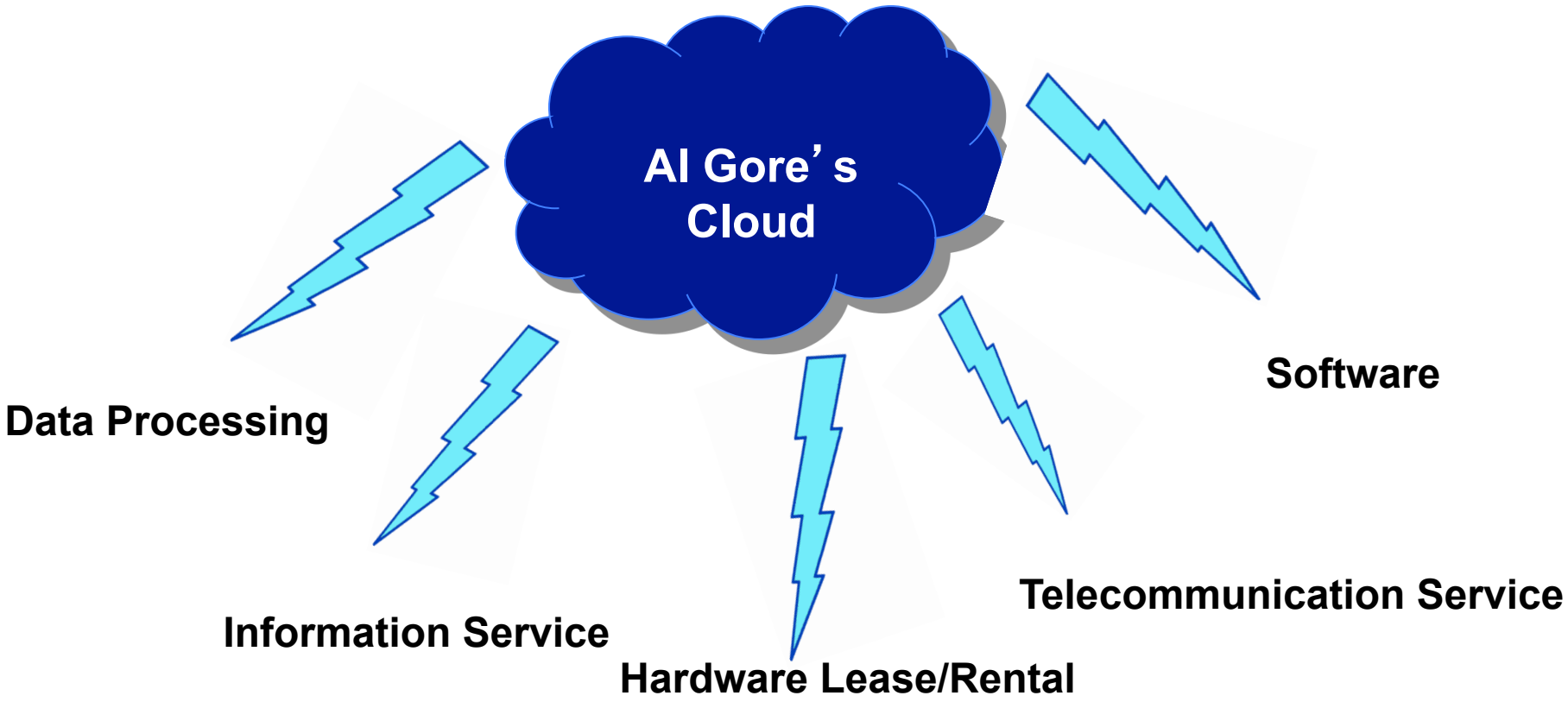
- The IaaS model provides the consumer with processing, storage, network capabilities, and other fundamental computing resources where the consumer is able to deploy and run software, which can include operating systems and applications
- The consumer does not manage or control the underlying cloud infrastructure but has control over operating systems, storage, deployed applications, and possibly limited control of select networking components (e.g., host firewall)
- An example of an IaaS model includes co-location services

Cloud Service – Division of Ownership



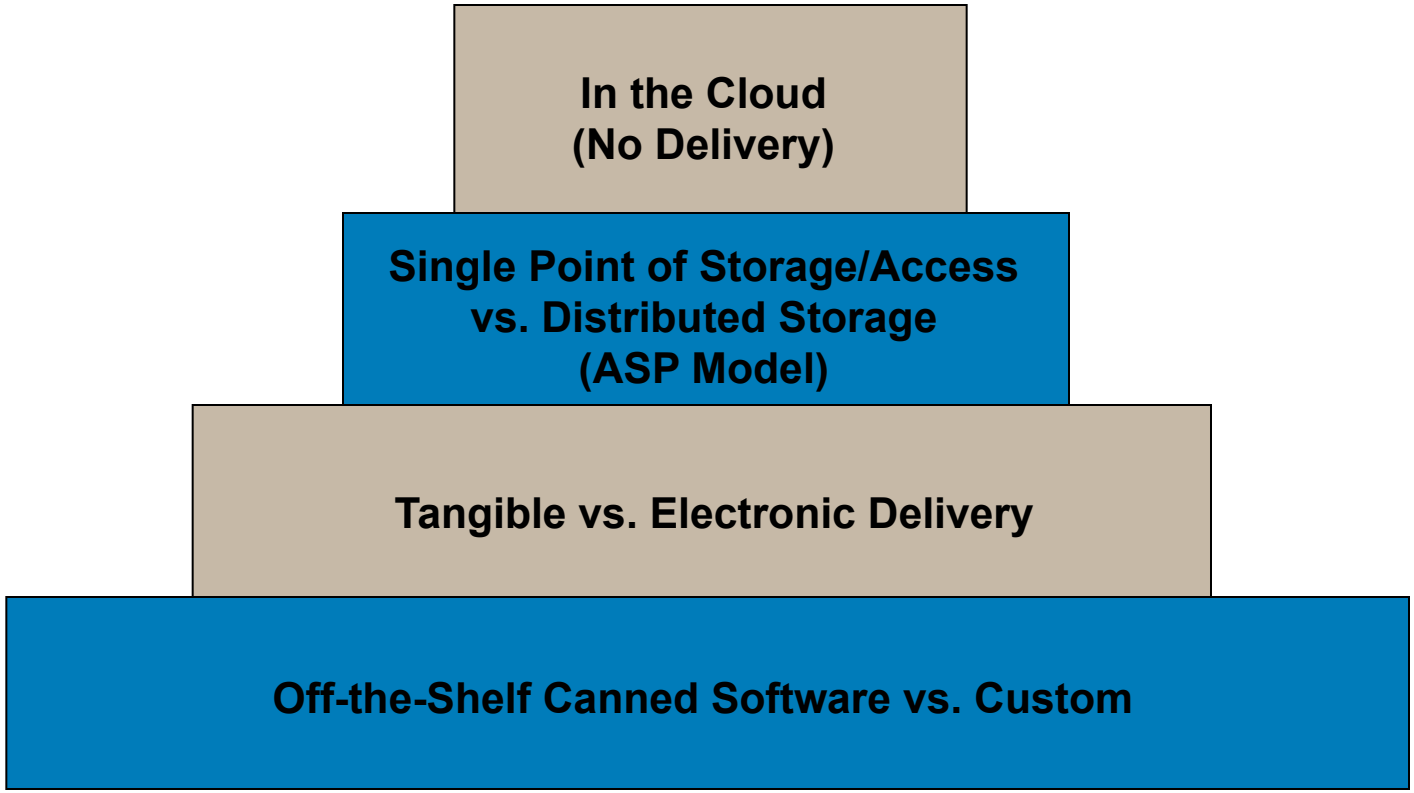
– – – – – – – – – – Indicates separation between Provider and Customer

Characterization



Most Cloud Computing offerings do not fit neatly into traditional state tax categories

Evolution of Technology Taxation



Characterization – Important Considerations

- Right to use technology?
- Right to access technology?
- Right to use tangible personal property (software or hardware)? Exclusive use?
- Right to own or possess?
- Nature of right – limited or unlimited?
- Receipts from a service (e.g., telecommunications)?
- Internet access?

Characterization – Tax Ramifications

- Is it taxable?
  - Characterizations determine taxability
- Nexus considerations
- Sourcing for sales/income tax
- ITFA application

Nexus

- If the vendor lacks nexus with the taxing state, it cannot be subject to sales tax in that state
- If the transaction occurs in the "cloud," does the transaction have sufficient contacts with any state to establish nexus?
  - *See Quill Corp. v. North Dakota* (1992) wherein Court reaffirmed physical presence nexus standard
- Relevant inquiries?
  - Whether vendor owns or uses servers in state
  - Whether vendor is licensing software to customers in the state or from servers in the state
  - Whether any of the software resides on customers' computers located in the state
  - Whether the software is actually downloaded or just accessed by the customers
  - Where the vendor's solicitations are being made
- Does P.L. 86-272 apply for income tax purposes?

Taxability – Guidance

- Guidance comes in various forms:
  - Statutes
  - Regulations
  - Letter Rulings / Advisory Opinions
  - Informal Department Guidance
  - Silence
- Difficult for taxpayers to rely on variety of non-precedential guidance that is often conflicting
- State may also completely change their position on the issue in mere months (e.g., Louisiana, Colorado & Utah)

Taxability – Software as a Service

- State taxability positions range from:
  - Not an enumerated taxable service
  - Expressly exempted – VT (temporarily), RI (remote access)
  - Taxable service
    - Information service
    - Data processing service – TX, OH
    - Digital automated service – WA
    - Computer-related services – CT
    - Communication service – SC
      - But electronically downloaded software is not taxable
  - Taxable rental if software resides on a server in the state – (previously PA, UT & KS)
  - Taxable or Not Taxable "Computer Time Sharing" arrangement – FL, CA

Taxability – Software

- Most Cloud Computing offerings contain some provision of software. The provision of software through the cloud can come in a few different forms:
  - The software is the main purpose of the transaction, where the access to the cloud is for the purpose of accessing one piece of particular software. Commonly referred to as SaaS (e.g., Microsoft Office Live, Google Apps, Salesforce.com)
  - Remote access to a network is the main purpose of the transaction, and the customer may sublicense software from the provider, or use its own license for software. Commonly referred to as PaaS (e.g., Microsoft Azure, Amazon's EC2)
  - Remote access to a network is the main purpose of the transaction, and the customer may be able to access software, but technically won't be granted a sublicense of the software
- Taxability involves a determination of the state's taxation of software (licensing, remote access, rental), and an analysis of the state's bundling rules and true object test

Taxability – Software Transfer

- Many states tax the electronic transfer of software
- Some states have chosen not to tax electronic transfers if the information is located on a server outside the state (Kansas)
- Other states have attempted to tax the electronic transfer using different theories, including:
  - A taxable transfer is effected by any means, including electronic access (Illinois, and several others)
  - A taxable transfer occurs when there is a remote access (Massachusetts)
  - A taxable transfer occurs when there is a license to use the software
  - Constructive Possession: A taxable transfer occurs when a customer has the right to control, use, or direct the use of software (New York)
    - But what constitutes "use"?
      - Utah has a new broad interpretation

Taxability - Infrastructure as a Service

- Outsourcing or "rental" of storage, processing, network, and other computing resources
  - Does customer have right to designate server location?
  - Does customer have right to specified amount of server space?
- Controversial area of taxation – outdated tax statutes and regulations often do not address Infrastructure as a Service ("IaaS")
- Commonly includes provision of various service components that are commonly subject to sales/use tax, including but not limited to:
  - Hardware maintenance, software maintenance, repair labor, security services, electricity
- Non-possessory interest in the underlying hardware and service components
  - Cannot separately state
  - True object/bundling

Taxability – Services – Generally

- Various states have attempted to expand their definition of services to cover a broader array of digital services
- Washington began taxing "digital automated services," which are defined as "any service transferred electronically that uses one or more software applications"
- Rhode Island recently considered, but rejected, taxing "digital automated services" in its 2012 budget bill
- D.C. and Texas tax "data processing"
- Many states tax "information services," including D.C., New York, New Jersey, and Texas

Taxability – Information Services

- Originally targeted companies that sold information and delivered it electronically (e.g., reporting services)
- Some states have attempted to expand information services to include Cloud Computing
  - New York issued guidance that the following activities are considered information services: Internet-based data and Web search services; investment reports and services; reporting services, etc. NY TSB-M-10(7)S (July 19, 2010)
  - Texas issued a ruling that accessing a training course through the Internet constitutes information services, even when no software is used. Texas Policy Letter Ruling No. 200812241L (December 16, 2008)
  - Connecticut issued guidance that "online access to information" is subject to tax if server is located in CT. Policy Stm. 2006(6) (April 18, 2006)

Taxability – Telecommunications Services

- Many states impose sales tax or other taxes on the provision of telecommunications services
- Some Cloud Computing offerings include the provision of "telecom as a service," or have other data transmission or telecommunications component of the Cloud Computing offering
  - e.g., VOIP "as a service"
- Depending on how the services are bundled, charged, and invoiced, Cloud Computing may be taxed as the provision of telecommunications services

Taxability – Internet Access Service

- The Internet Tax Freedom Act ("ITFA") generally prohibits the taxation of Internet access, multiple taxation, and discriminatory taxation
- Some states are allowed to tax Internet access because their taxes were grandfathered under ITFA
- If a Cloud Computing offering includes dedicated Internet access, it may be (partially) protected from taxation by ITFA
- If Cloud Computing offerings are equivalent to "traditional" sales/services, ITFA may afford protections from taxation

Taxability - Bundling

- Because Cloud Computing offerings contain multiple types of services, taxpayers should be aware of state bundling rules
- The Streamlined Sales Tax Agreement provides that a bundled transaction occurs when two or more distinct products are sold together for one price
- States may impose tax on the full sales price of the bundled transaction if any part of the bundle is taxable, or may look to use a "true object" or "primary function" test to determine whether the true object of the transaction is taxable. (California and New York)
  - In some states these tests are statutory, in some states they are "common law," and some states simply tax the entire price
  - Some states (e.g., New York) apply the bundling rules inconsistently, and apply them differently if services are involved
  - Mass. recently issued a taxpayer favorable letter ruling finding that the object of the transaction was simply to obtain information, so the transaction was not subject to tax. Ltr. Rul. 11-2 (Mar. 4, 2011).

Taxability - Sale for Resale

- Cloud Computing providers may sell services to other third-party companies that sell global computing solutions
- Taxability and nexus would depend on whether the sale is characterized as a true sale for resale, or whether the third party is characterized as acting as the Cloud Computing company's agent
- Further complications arise if the third party bundles its own services or software with the Cloud Computing provider's services or software

Sourcing – Sales Tax

- If Cloud Computing transactions are taxable, in which state or states should the transaction be taxed?
- States generally use one of two methods for sales tax sourcing:
  - Origin-based sourcing – sourced to the location where the product or service originates
  - Destination-based sourcing – sourced to the location where the product or service is ultimately consumed
- The very nature of Cloud Computing makes origin-based sourcing difficult to measure
  - Multiple locations for infrastructure
  - Network of computers and software
- Mobile access to cloud services presents unresolved issues for destination sourcing
  - Will states come up with a system similar to that implemented by Congress for mobile phones that defaults to home address?
  - Some states (e.g., New York) have issued guidance which indicates that services are presumed to be sourced to state – presumption can be rebutted by proving where the user is located

Sourcing – Income Tax

- The characterization of Cloud Computing is important for income tax apportionment purposes
  - States have issued very little guidance, which present "challenges and opportunities"
- If Cloud Computing is a service then it will be necessary to source pursuant to each states sales factor sourcing rules
- If a state uses costs-of-performance sourcing for sales then a company's costs for providing the Cloud Computing service will need to be determined
- If a state uses market sourcing, then a company will need to evaluate where the benefit of its service is received

What's a taxpayer to do?

- Know your business
  - What does your company do in terms of services?
  - What is your company procuring from others?
  - What do your suppliers do with respect to taxes?
- Assess the state guidance
- Assess the impact of alternatives
- Seek guidance
- Educate state personnel
- Document positions

Questions?

Jeffrey A. Friedman
jeff.friedman@sutherland.com
202.383.0718

Harley T. Duncan
hduncan@kpmg.com
202.533.3126