



CLOUDY WITH A CHANCE OF APPORTIONMENT

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**The pinnacle is
always small.**



Agenda

- Overview of Cloud Computing and SaaS
- How to Approach Taxation
- Multistate Perspective and SSTA
- State Income Tax Implications



What is Cloud Computing?

- 2010 Yankee Group report defines “cloud computing” as
 - “dynamically scalable virtualized information services delivered on demand over the Internet.”
- Cloud computing is predicated on borderless global networks.



What is Cloud Computing?

- **Software as a Service (SaaS):** software distribution model where applications are hosted by a vendor and made available to customers over a network.
- **Platform as a Service (PaaS):** a way to rent hardware, operating systems, storage and network capacity over the Internet. It allows customers to rent virtualized services and associated services for running existing applications or developing and testing new applications.
- **Infrastructure as a Service (IaaS):** when an organization outsources the equipment used to support operations, including storage, hardware, servers and networking components. Includes remote storage and web hosting services.

Concerns: Chasing the Cloud

- If the location of a cloud cannot be pinpointed, which state's laws apply in taxing the cloud?
 - If a state taxes the point of use, what if service are free at the point of use?
 - If tax is based on location of the servers or the office the cloud computing provider, will providers move to low-tax jurisdictions?
 - How does a provider or purchase avoid being taxed in two locations when states apply different sourcing rules for sales/use tax purposes?
- Economic consequences: companies cutting costs v. Departments of revenue generating revenue.

SaaS

- SaaS is often used interchangeably with ASP (“application service provider”)
 - With SaaS, a service agreement is almost always executed
 - With ASP, customer may execute a software license agreement or a services agreement
- SaaS provider will: Host commercially available software and store data in the “cloud”
- Access is provided over the Internet as a service
- SaaS provider can license software to customers either "On-demand" or on a “Subscription basis”

How to Approach Taxation?

- Faced with growing budget deficits and decreasing tax, electronic commerce is one of the most notable, recent targets in the states' search for revenue
- Some states have enacted legislation imposing sales tax on specific digital transactions or through the creation of a new class of taxable transactions, including taxation of digital services (i.e. WA).
- States are struggling to harmonize the treatment of cloud computing for sales tax and income tax.

Key State Sales Tax Issues for Cloud Computing

- Nexus (sufficient contacts with the state?)
- Taxability (are cloud computing transactions products or services of a type that are subject to state sales tax?);
- Sourcing (which state (or states) can tax a particular cloud computing transaction?)

Sales Tax Nexus

- No definitive answer to the question of how the concept of sales-tax nexus applies to a cloud computing transaction.
- *Quill* substantial nexus standard still applicable.
 - Must a vendor own or use servers located in the state?
 - Is it sufficient that the vendor is licensing software to customers in the state and a portion of the software resides, at least temporarily, on the customer's computer located in the state?

Sales Tax Nexus

- Agency Nexus:
 - What if affiliate of vendor located in the state?
 - Does Affiliate and Amazon "Click-through" Nexus Apply?
- Does state treat licensee as constructively possessing software even if there is no actual download?

Sales Tax Taxability Issues

- Characterization of Item Being Sold:
 - Could be mixture of transactions: the customer may be consuming services (computer and data services) and space, while simultaneously purchasing applications and the right to access data (lease of server space).
- Private v. Public Cloud: A customer-specific application may be created that can be constantly updated and manipulated to interface with a vendor's database.
- Lack of statutory (or other) authority: particularly related to PaaS and IaaS models.

Sales Tax Taxability- Characterization

- Tangible Personal Property (TPP) vs. Service (or both)
 - Definition of TPP is often something that can be felt, touched, held, or possessed.
 - Is it a taxable or non-taxable service?
 - Public or private cloud?
- True Objective vs. Incidental to Services Test in bundled transactions
- Itemization of Services from TPP may be critical
- Some states measure TPP or service based on percentage of one or other to the total

Sales Tax Taxability

- Issues being considered by taxing jurisdictions:
 - What is the characterization of transaction? What are you buying?
 - Tangible personal property vs. services vs. intangible
 - Traditional TPP include books, music, software, databases
 - Sale of software?
 - If so, where was it accessed; was it accessed from more than one jurisdiction?
 - Electronic delivery?
 - Information service or database access?
 - Other enumerated taxable/non-taxable service?
- How will the transaction be sourced?
 - Customer location? (New York)
 - Multiple customers? Will state look to billing address?
 - Server location? (Alabama)

Sales Tax Taxability

- Determine characterization. What are you buying? What is in the agreement as being conveyed? Rights of use? Often the terms “Cloud” or “SaaS” are used in marketing but may not be reflective of true transaction
 - Is the Cloud operated solely for one organization or it is accessible by the general public?
- What is the true object? Software vs. data processing in an environment that is part of an overall information technology service.
 - Characterization of SaaS when taxable: States that tax services view SaaS as a service.
 - Some states that do not tax services may shoehorn it in as taxable prewritten software.

Other Considerations

- It is critically important to consider the impact of bundled charges

The SSUTA allows for unbundling of transactions

- Itemization avoids "tainting" of the transaction and overpayment of sales tax
 - AZ taxes everything unless purchase is itemized
- For example, software enhancements or further developments, repair parts and labor, etc. must be separately stated in the invoice
 - In NY, custom software enhancements of pre-written software are not taxable, but the remainder of the order is

Sales Tax Sourcing

- States may not have specific guidance on how to source cloud computing.
- States are definitely in a catch-up mode trying to update or enact new and current relevant legislation
 - Nat'l Conference of State Legislatures working on principles for States to use for taxation of cloud computing services
 - States trying to develop policy before the Digital Goods and Services Tax Fairness Act is passed
 - Act would limit State's ability to tax digital services
 - Act would give federal courts jurisdiction

Sales Tax Sourcing

- Should transaction be sourced as follows:
 - Location of the seller;
 - Where the order is accepted (IL),
 - Location of the User;
 - Secondary location? (billing address)
 - What happens when there are multiple user locations for company's cloud.

Sales Tax Sourcing

- 24 states, covering 33% of the population have adopted the Streamlined Sales and Use Tax Agreement (SSUTA) which might differ from the specific state's sales tax provisions
- SSUTA impacts sourcing of the sales for multi-state taxpayers
- Ordering or cascading rules for sourcing purposes must be followed where applicable



Sales Tax Sourcing

- SSTA: Uniform definition of prewritten software which is electronically “delivered” Is delivered different than transferred?
- SSTA Section 310: Sourcing Seller Location:
 - Delivery - where received by purchaser including delivery instructions
 - Business Address of Purchaser - in seller's business records
 - Business Address of Purchaser - obtained at sale or payment info
 - Origination of Seller - where TPP first shipped or electronic prewritten software first available for transmission.
 - Business Location of Seller
- SSTA Section 311 defines "receive" as "taking possession of TPP" or "making first use of services."

Multistate Perspective- Overview

- In response to BNA survey, 13 states indicated that sales tax would apply to fees paid by in-state customers to remotely access canned or prewritten software that is hosted on a web server.
 - WA statute taxes remotely accessed software
 - Most other states- address matter in letter rulings or administrative guidance



Multistate Perspective

- CO: After July 1, 2012, sales tax not imposed on software that is not delivered in a tangible medium, which includes software provided by ASP.
 - Change of position from current law- all standardized software subject to sales tax no matter how delivered.
- IL: If seller is providing access to a database of information and not transferring any software or TPP to customer – not taxable. (ST 11-0052-GIL, June 30, 2011).
 - However, the IDOR has indicated that it will not issue policy for taxing ASP's without clear statutory or regulatory authority.



Multistate Perspective

- IA: Software and web-based training are cloud computing services. Hosted software is not to be considered TPP and therefore is not taxable. (IA Policy letter; Cloud Computing; Jan. 11, 2012).
- KS: Software that is only hosted is not taxable as pre-written software. (KS Letter number O-2012-001).
 - Software of that type is hosted remotely and never installed on the purchasers server

Multistate Perspective

- MN: Charges for access are not subject to tax if: (1) Hosted on Service Provider's server; (2) Customer only has remote access; (3) Customer has use for processing only; and (4) No title, possession or authority over the software.
 - Considered to be more like an information service.
- MI: Even though SaaS is accessed via the Internet and not "delivered," Michigan takes the position that accessing software via the Internet is taxable as a taxable sale of pre-written computer software.
 - Prewritten computer software taxable when delivered by any means.



Multistate Perspective

- NE: Charges by an ASP for services that allow customers remote access to software applications via the Internet are not taxable when the ASP retains title to the software and does not grant a license with ownership rights to the customer (Nebraska Information Guide No. 6-511-2011, 07/27/2011).
 - This is true regardless of whether the software is located on a server in Nebraska or on a server outside the state.
- NY: Fees charged to access software over the Internet subject to sales tax as a license of prewritten computer software. NY Advisory Opinion TSB-A-09(33)S, Aug. 13, 2009.



Multistate Perspective

- PA: PA user accessing cloud software over the internet is subject to sales or use tax. (Sales and Use Tax No. SUT-12-001). Treats using remotely accessed software from location in PA as purchase of TPP in the state.
 - Change from 2010 ruling which provided that internet access of software not taxable transfer unless server is in PA (ruling SUT-10-005 no longer on PA DOR website).
- SC: Services provided by an ASP that include charges to access communication system are subject to sales and use tax as a communication service. S.C. PLR No. 10-2 (July 29, 2010).

Multistate Perspective

- TN: Fees charged to access online software is not taxable where there is no transfer of title, possession or control of software to the taxpayer and the server is located outside the state. Letter Ruling No. 11-58.
- TX: Services provided through a SaaS model taxable as a data processing service. Texas Comptroller's Decision No. 47,246 (Nov. 2, 2007).
- TX: With regard to IaaS model:
 - Virtual hosting packages are taxable data processing services.
 - Data backup services are taxable data processing services.
 - Texas Policy Letter Ruling No. 200209314L (Sept. 4, 2002), Texas Policy Letter Ruling No. 200908438L (Aug. 3, 2009).

Multistate Perspective

- UT: License fees for remotely accessed prewritten software are taxable if the purchased software is used in Utah (Utah Informational Publication No. 64, 05/01/2012).
 - A company's sales of web services to subscribers located in Utah were subject to sales tax as a retail sale of tangible personal property made within the state. Private Letter Ruling 10-011 (Feb. 24, 2012).
- VT: In May 2012 VT passes a bill (H782) that temporarily suspends sales taxation of remotely accessed pre-written software through July 1, 2013.
 - The bill also provides for a refund any taxes paid on sales of pre-written software collected for the periods of January 2007 through May 2012.

State Income Tax Issues for Cloud Computing

- Nexus
 - (sufficient contacts with the state?)
- Characterization of Transactions
 - (TPP or services or other)
- Sourcing



Income Tax Nexus

- Most states only require economic nexus.
 - Under this theory, nexus asserted even if intangible property used in the state, regardless of physical presence.
 - With cloud computing, determining where intangible property is used is difficult, i.e. Difficult to know where customer with multiple users in different states access the application.
 - Reasonable argument that only have nexus in state based on readily available info such as billing address.
- Factor Presence Nexus Considerations:
 - Nexus established if met certain thresholds related to property, payroll or receipts.

Income Tax Nexus

- In response to BNA survey, 30 states said that a cloud-based service provider that hires independent contractors to perform set-up or configuration services within their state would be sufficient to create income tax nexus.
- 29 states said that nexus would arise from having employees solicit sales within their borders.
- 14 states said that nexus would arise if cloud-based service provider had a substantial number of customers with billing addresses in the state or earned a substantial amount of revenue from customers in the state.

Income Tax Characterization

- In response to BNA survey, 25 states indicated that they characterize cloud computing receipts as follows:
 - Characterize as other than TPP and source according to COP method (AZ, HI, MO, NE, NM, ND, OR, TN, VA and WV)
 - Characterize as other than TPP and source according to market method (AL, FL, GA, IA, KY, ME, RI, UT and WI)
 - Characterize as TPP (CO, IN, KY, MI, PA and WV)

Income Tax Sourcing

- Sourcing of items OTHER than receipts from tangible personal property.
- States are struggling with whether to harmonize the income tax and sales tax treatment of software.
 - Sourcing of revenue depends on whether the receipts result from the provision of tangible personal property, services or intangible items.
 - States may not have specific guidance on how to source SaaS, and are in a "catch-up" mode, trying to update or enact new and current relevant legislation.
 - Rules that will apply to SaaS generally will be under the broad category of sourcing rules which apply to OTHER than tangible personal property.

State Income Tax Implications

- Sourcing Methodologies
 - Cost of Performance
 - All or Nothing
 - Pro-Rata
 - Time-Spent
 - Market Based Sourcing
 - Location of the taxpayer's customers; or
 - Location taxpayer's customers received the benefit of the services.
- In many states, receipts arising from personal services will be sourced in a different manner than receipts from other types of services.



State Income Tax Implications

- Trend: States are moving more towards Market-Based Sourcing.
 - Not an easy determination.
- What is the primary sourcing rule?:
 - Where the benefit (access of cloud) of the service is received?
 - Location of the impetus for the sale?
 - Is it important where the customer "directly or indirectly receives" the benefit of the service?
 - Is the location or billing address of the customer the determinative consideration, as opposed to where the benefit of the service is received?
 - What if customer has multiple billing addresses?
 - Does it matter if the customer is an individual or a business?
 - Is there a set of cascading rules that govern how a taxpayer should determine where to market-source revenue?
 - Does the state have industry-specific rules for applying market-based sourcing for services?

State Income Tax Implications

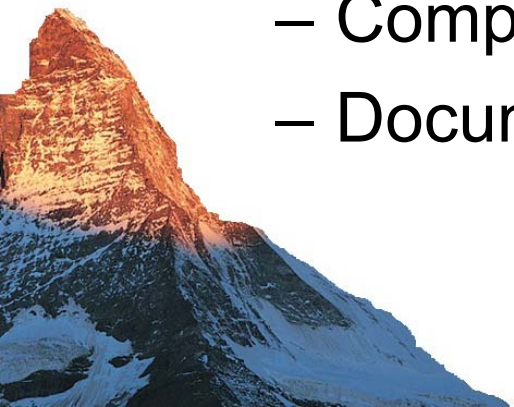
- Planning Considerations – Shifting tax base to tax-preferred jurisdictions
 - Typically, SaaS providers earn income from bundled transactions, which consist of the sale of a combination of tangible personal property, services and intangible items
 - Bundled transactions are not treated in a uniform manner for purposes of computing the state tax base and sales factor
 - Rules governing the state income tax base (and apportionment) may treat income related to technical assistance, subscription fees, hosted software and related revenue differently than a “pure” royalty

State Income Tax Implications

- Planning considerations – Shifting tax base to tax-preferred jurisdictions
 - Historically, companies utilized intangible property to achieve “base shifting” from high-tax rate states to low-tax rate states or states that treat intangible property in a tax-preferred manner
 - The form of “base shifting” has taken on many forms in terms of transfer pricing between affiliated members, including the creation of sales companies, management companies, contract manufacturing arrangements and similar structures
 - A thorough analysis of previous planning may indicate existing opportunities for companies to plan for state income taxes without complicated or costly restructurings

Planning Considerations

- Until a state enacts legislation or promulgates clear guidance, consider the following:
 - Determine jurisdiction
 - Determine possible characterization.
 - Research guidance.
 - Compute tax base (research sourcing provisions).
 - Document findings.





THANK YOU

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