Stepping away from Tax Reform for a moment, we’d like to briefly shift our focus to an important topic that has repeatedly surfaced with our friends in the tech industry: the taxability of Software as a Service (“SaaS”).

SaaS taxation is one of the most common (and complex) issues facing companies and tax jurisdictions today. As a general rule, states (and some municipalities) impose a sales tax on the sale or lease of tangible personal property. Most services (though not all), on the other hand, are exempt from sales tax. Traditionally, prewritten software has been treated by states as tangible personal property, and as such, the sale or lease of such software to an end user was generally subject to sales tax.

In the SaaS model, a seller provides online access to hosted software for use by customers. No actual transfer of possession occurs. Instead, the seller is economically providing a service to the buyer. Further, many sellers also provide other services connected to the hosted software platform, many of which, when considered alone, would constitute services that are not subject to sales tax.

In an attempt to tax hosted software, states have generally attempted to include “application software” in the state’s definition of tangible personal property subject to sales tax. While many states have relied on interpretations of long-standing rules to subject SaaS and other hosted product offerings to sales tax, others have passed new legislation to specifically tax web-based technology products. For example, in 2009 Washington enacted legislation which specifically taxes among other digital products, “remote access software,” such as SaaS and products which meet the definition of the state’s newly created “Digital Automated Service” category. Accordingly, states which assert tax on SaaS and/or hosted product offerings generally do so under one or more of the following classifications:

- As a sale or lease of prewritten software, i.e., statutory tangible personal property, for which the user has received “constructive,” if not physical possession (thereby sidestepping the need for a direct sale or license);
- As the sale or lease of a (modern) digital equivalent to traditional tangible personal property, i.e., the 21st century web-version of a product traditionally delivered via tangible medium in the 20th century (e.g., e-books as opposed to traditional books);
- As the sale of a product which conforms to the definition of a specific digital product or “digital good;”
- As the provision of an enumerated taxable service (e.g., Data processing service, Digital Automated Service or Information Service);
- As a generally taxable transaction which does not qualify for a specific exemption.

As can be seen, the rules used by states to tax SaaS vary widely by state. Generally, these rules attempt to treat hosted software use as being the constructive equivalent to a taxable sale or license.

A further complication arises when a seller bundles SaaS with other services. Often, a seller will use a hosted platform to provide data-related analytics to customers, or to allow customers access to the platform in order to perform analytics themselves. Many times, these bundled transactions reflect taxable and non-taxable elements such as SaaS, data processing and information services, among others. If the seller does not separately state the price of the taxable and non-taxable portions of the transactions, a state may impose its tax on the entire amount of the transaction. In this manner, the bundling of taxable and non-taxable components of a service offering may cause the otherwise non-taxable amount to be subject to tax.
In practice, many companies offer a variety of services, including hosted software, for one overall price. This is perceived by those companies as being attractive to customers. However, many sellers in this situation may not have considered whether or not their hosted software offerings are taxable SaaS products in the states where they do business. Further, many have also not considered the effect that bundled offerings of taxable and non–taxable services can have on the overall taxability of their service offerings. Upon audit by states, unexpected (and very large) assessments can result.

We recommend that sellers review their SaaS product offerings to determine which may be subject to sales tax, and then to review how those offerings are presented and billed to customers. Doing so can help companies avoid an unexpected and unpleasant surprise.

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We’d love to get your thoughts: Has your company evaluated whether hosted software might be subject to sales tax? Please call [2] or email us [3] and let us know!

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