Cloud Computing: State Sales and Use Tax Implications

2013–Issue 5—In this challenging economic climate, businesses are exploring cost–cutting strategies to increase profits. Cloud computing offers businesses the opportunity to effectively offload their software and infrastructure functions to third parties who specialize in providing hardware and software in a virtual (i.e., "cloud") environment. Cloud computing refers to software, hardware and/or services that are hosted at a central location and provided to multiple users by remote access via the Internet. Rather than incur the expense of purchasing and personally hosting hardware and software, cloud computing allows users to access these services only as needed. By reducing infrastructure–related costs, businesses are free to invest newly available resources in profit–creating activities. Determining whether cloud–based digitally transferred goods are subject to state sales and use tax has proven an arduous task for sellers, buyers and state taxing authorities. In recent years, states have sought to expand sales tax laws to capture revenue from sales of digital products by addressing the taxability of electronically downloaded software, information services and other digitally transferred goods, largely because of their inability to bridge their own budget gaps and the continuing evolution of digital technology. What Is Cloud Computing? The term "cloud computing" primarily refers to the three models of outsourcing software and infrastructure: (1) infrastructure as a service (IaaS), (2) platform as a service (PaaS) and (3) software as a service (SaaS). Infrastructure as a Service The IaaS model refers to services provided when a business outsources the equipment used to support its internal operations, including hardware, servers and related networking components; however, the business maintains control of its software environment. Platform as a Service The PaaS model allows businesses to run applications the business has created or acquired on the cloud vendor's platform. PaaS offers businesses a remotely hosted environment to develop and deploy applications (software and product development tools) over the Internet, such as virtualized servers and operating systems. An example of PaaS includes Microsoft's Windows Azure platform, which allows users to build and deploy applications written in a variety of programming languages and hosted on a Microsoft–managed datacenter. Software as a Service The SaaS model offers businesses the opportunity to remotely access software applications hosted by a cloud vendor and made available over the Internet. The software is accessible from various devices through an interface such as a web browser. Taxing the Cloud: Sales and Use Taxation of Cloud Computing Traditionally, businesses purchased software that was delivered through a tangible medium (e.g., compact disc). When vendors began selling electronically delivered software, states were challenged with applying a tax imposed on tangible personal property to electronically delivered software. While there is some disparity, many states have taken the position that the software, if treated as the equivalent to tangible property purchasable in canned form, is taxable and the primary issue is whether the seller has taxable nexus with the state. The growing popularity of SaaS has created a service that is further removed from the definition of tangible personal property than electronically delivered software because, in addition to electronic delivery, software code may never be transferred or licensed. Of the three types of cloud computing, states have begun addressing SaaS in particular. Some states, such as Pennsylvania, have treated prewritten software as tangible personal property, while other states, such as California, treat electronically delivered software as a non–taxable service.   Cloud–based software poses the next challenge to states as they struggle to classify whether software, which is neither transferred on a tangible medium nor electronically deliverable, should be taxed as a service, taxed as tangible personal property or not subject to tax at all. Because of the varying approaches taken by different jurisdictions to cloud–based software, it makes determining whether a transaction is subject to tax much more difficult than more common sales of tangible goods. For example: Pennsylvania recently changed its sales tax guidance to include charges for the use of canned computer software that is hosted on a server and accessed electronically by a taxpayer's employees if the user is located in Pennsylvania. (Pennsylvania LR No. SUT–12–001, May 31, 2012)
New York considers the sale of

prewritten computer software to be tangible personal property regardless of the medium by which it is transferred and disregards the location of the software's programming code because the state sees no difference between software the customer physically receives and software that is accessed through a remote server. (NY St Dept. of Taxation & Fin Advisory Op No. TSB–A–09(19)S, May 21, 2009)
In contrast, a Texas letter ruling classifies web–based business application software as a taxable data–processing service and not the transfer of tangible personal property. (Texas LR No. 200805095L, May 28, 2008)
South Carolina, while exempting computer software delivered electronically from sales and use tax, determined that charges to access remotely hosted software are considered a taxable communications service. (South Carolina Revenue Ruling No. 03–5, Dec. 9, 2003)
California determined that "the sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction." (Cal. Code Regs. tit. 18, Section 1502(f)(1)(D)) In addition to the various state laws, taxpayers also face the challenge of categorizing their cloud–based software transaction. A threshold question is whether the transaction includes tangible personal property, a taxable service or a non–taxable service. If deemed a service transaction, is it a data–processing service or an information service? Does the customer touch the software? Does the service provider control all of the software and simply provide a service that is highly automated? While taxpayers can make all of the proper determinations in classifying their transactions, because conclusions made by state authorities continue to be suspect and the states continue to apply laws that were originally designed for a traditional mercantile environment, state determinations could be subject to challenge. Revenue Sourcing Once the transaction has been classified, the next challenge is to determine which state or states to source the revenue to. States may determine the taxability of a transaction based on the server's location, the customer's location, the cloud vendor's location or the location(s) from where the customer or its employees access the software. Who Is a Cloud Vendor? As previously discussed, determining whether a service should be categorized as taxable cloud computing is challenging enough, but determining who is a cloud vendor may be just as challenging. The sales tax profession has seen similar situations in the past; for example, a financial services company may provide dedicated private lines to its key clients, thus becoming a unexpected telecommunications services retailer; or a construction contractor may sell materials at retail but is required to consider itself a service provider that consumes all materials purchased, and cannot buy for resale and make retail sales. Because sales taxes are imposed on specific types of transactions and are form driven, intercompany sales and companies that do not consider themselves to be service providers could be considered sellers of cloud computing in certain circumstances. A wholesaler of tangible personal property that purchases all goods for resale and sells all of its goods exempt from tax to retailers may be considered a cloud vendor if it also offers a cloud–based fulfillment application to its customers. A company that decides to consolidate all of its information technology in a specific legal entity may inadvertently deploy taxable cloud computing services to related parties. In other words, any service provider of public or private software or infrastructure hosting services may be considered a cloud vendor. Of course, state laws differ depending on the service. States are well aware of these potential foot faults. Mississippi law states "the principal line of business of the seller is not material when determining the taxability of sales of computer programs or software. Any bank, savings and loan or other thrift institution, accounting firm, computer program developer, dealer or other person is deemed to be a retailer when selling computer programs or software at retail to the final user or consumer." (Miss. Reg. Section 35.IV.5.06(101)(2)(b)) Mississippi currently does not tax cloud computing services provided from a server located outside of the state; however, this is a perfect example of how states realize that information–technology–related products and services can be provided by companies that are not in the information technology industry. How Big Is the Cloud? Broad network access and on–demand self–service are advantages cloud computing has over the traditional model of purchasing and maintaining hardware and software. Users of cloud computing can expand their cloud bandwidth from almost any location with the click of a button. While enhanced access may be an advantage for a company's sales force, rapidly expanding into new markets can be a major risk for that company's VP of tax. Cloud VoIP providers may have to comply with a litany of telecommunications taxes whenever a sale is made into a new market. SaaS providers may have new customers across the country before the tax department has determined the taxability of the company's products or services. In addition, cloud–based services can easily expand into foreign jurisdictions that have broadly imposed value–added tax regimes. Alvarez & Marsal Taxand Says: For a company to identify whether its cloud–based transactions are subject to state sales and use tax, it must first answer several threshold questions. Once the following questions have been answered, only then can a proper determination of the taxability of these transactions be made: For a seller, does the company have nexus for sales and use tax purposes in the jurisdiction? (Note, this may not absolve the buyer from the corresponding use tax.)
Does the state have specific guidance on the tax treatment of SaaS, IaaS or PaaS?
Is the transaction considered the sale or license of tangible personal property or the performance of a service?
If the sale is of tangible personal property, is the software considered canned or custom software?
If it's a service, is the transaction considered a data–processing

service, information service or other type of service?
If the transaction is considered a taxable product or service, where is the service provided — the server's location, the customer's location, the cloud vendor's location or the location from where the customer or its employees access the software? While a number of states have addressed the taxability of cloud services, they have done so primarily through letter rulings and other informal administrative guidance. As a consequence, these determinations carry less authority and continue to evolve. Furthermore, very few states have addressed the taxability of IaaS and PaaS transactions. It's important for the tax, marketing and information technology departments to communicate about purchases, sales and related–party use of cloud computing services to timely identify sales and use tax savings and ways to potentially mitigate risk. Author: Managing Director, New York
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