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SALES TAX

A Sticky Situation: Sourcing Sales and Use Tax on Cloud-Based Transactions

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SuperSoft just landed the biggest software contract in its short history. BigCo has agreed to make SuperSoft's cloud-based email system, SuperNote, the exclusive email solution for its employees throughout the United States. SuperSoft will run SuperNote on its own servers, where SuperSoft will also host all of BigCo's email. SuperSoft will run the hardware and software for SuperNote, and BigCo will focus on writing millions of emails. Both parties are extremely happy, and a well-deserved celebration ensues in the SuperSoft office.

As the confetti settles, a call comes in to SuperSoft's financial manager from SuperSoft's trusty tax attorney. "Congratulations! This is certainly a big day for you," says the attorney. "Not to spoil the fun, but have you thought about where you should collect sales tax on this deal? It's really pretty complicated, and if you get it wrong, SuperSoft could be in a world of hurt." Dejected, SuperSoft's finance manager puts down the phone and gulps another flute of champagne. He hadn't thought about sales tax. Bummer.

The basic trouble with the taxation of cloud-based transactions is that cloud-based products and services delivered over the Internet test the limits of existing sales tax rules. Are cloud-based transactions categorized as goods, services, or both? Should cloud-based goods and services be taxable at all, and on what basis? States have responded differently to these questions. Some have passed new laws and regulations, some have issued interpretations of their existing laws, and others have remained silent. While the taxation of cloud transactions is far from consistent, more states are issuing guidance specifically addressing these technological advances. However, these rulings and policy pronouncements typically leave the sourcing of cloud transactions up for interpretation.

Cloud-Computing Developments in 2015

Building on the rulings and policy pronouncements issued in 2014, several states have either issued new administrative rulings or introduced legislation to specifically address the taxation of cloud-computing services and products.

Colorado

On April 5, 2015, the Colorado Department of Revenue released a general information letter, Colorado GIL-15-003, dated January 27, 2015, addressing the taxability of "cloud service plans" used to store and view images. The request for guidance was made by a company that manufactures solar-powered wireless cameras and, in conjunction, sells cloud service plans that allow customers to send and view photos on the camera by accessing the company's website.

Generally, Colorado does not levy sales or use tax on the sale or use of computer software by "application service providers"[1] that retain custody over or host computer software for use by third parties. The Colorado Department of Revenue determined that "it appears likely that [the company] is an application service provider" and therefore, the Department would treat customer's use of the company's software as nontaxable. Further, the Department stated that "[e]ven if this was a taxable rental of [the company's servers], the Department would likely not assert that there was a taxable use in Colorado if the servers are located outside Colorado."

Michigan

Michigan introduced bills HB 4018 and HB 4019 on January 15, 2015, and SB 82 and SB 83 on February 5, 2015, which exempt the taxation of cloud-based services anytime an individual uses prewritten computer software installed on another's server. Specifically, the bills would exclude such activity from the definition of "prewritten computer software" and, by extension, from the definition of "tangible personal property." On February 4, 2015, the House Tax Policy Committee held a hearing on the

[1] "Application service provider" means an entity that retains custody over or hosts computer software for use by third parties. *See* Colorado GIL-15-003.

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bills, and on February 11, 2015, the bills were referred for a second reading. These bills follow on the heels of two cases finding that cloud transactions were not subject to tax.[2] If passed, the bills would override the Department's historical position that cloud computing transactions are taxable.

Vermont

Vermont continues to flip-flop regarding the taxability of cloud transactions. A temporary moratorium on the taxation of cloud computing expired on July 1, 2013, at which time Vermont reinstated its sales tax on cloud computing services. However, Vermont's legislature has recently introduced two bills to exempt cloud computing from state sales and use taxes. An economic development bill, S 138, includes a provision to exclude "[c]harges for the right to access and use prewritten software run on underlying infrastructure that is not managed or controlled by the purchaser or any related company" from the definition of tangible personal property. S 138 was approved by the Senate and is now in the House Committee on Commerce and Economic Development. In addition, a stand-alone bill with similar language, S 97, was approved by the Senate on February 28, 2015. S 97 has been sent to the House and is now in the House Committee on Ways and Means.

A Super Sticky Sourcing Problem

Despite recent increased clarity regarding the *taxability* of cloud-based goods and services, there remains a dearth of guidance regarding the proper *sourcing* of cloud computing transactions. Some states that have decided to tax cloud-based products and services have not directly addressed how these transactions should be sourced, but continue to rely on general sourcing provisions applicable to the sale of tangible personal property and taxable services. States that have addressed sourcing tend to focus on the location of the user and/or the server for purposes of sourcing. These approaches can cause conflict and confusion when transactions are not constrained to a single taxing jurisdiction. Not only are cloud-computing products mobile, but the purchasers and users of the goods or services may be mobile as well. In addition, multiple users in different jurisdictions may use a single cloud-based product or service, a scenario that can make sourcing a challenge.

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So why is the lack of clarity surrounding cloud computing a real problem? Can't a multistate taxpayer simply do its best and roll on? Unfortunately, both sellers and purchasers potentially face risks for getting the sales tax on cloud transactions wrong, even if their error is made in good faith. Sellers have collection obligations in states where they have sales tax nexus. If they undercharge tax, they face remitting additional tax on audit—usually out of their own pockets—to states that disagree with their conclusions. But on the other hand, if sellers take a conservative approach towards the states and collect tax even when the requirement to collect is uncertain, sellers face class-action lawsuits from consumers who feel they were overcharged tax on their purchases. For their part, purchasers can easily find themselves with an uncertain use tax liability in cases where the seller of the cloud-based product either concludes that no tax is due or lacks sales tax nexus with the purchaser's state. And as the story below will illustrate, states may come looking for use tax even if the purchaser pays sales tax on 100% of the charges.

The SuperSoft Scenario: Multiple Tax Burdens

To demonstrate the complexity, let's return to our SuperSoft scenario, but with some additional facts. A multistate corporation, BigCo, enters into a multimillion-dollar contract with SuperSoft to license its web-based email software, SuperNote, and receive support services. BigCo will pay SuperSoft an upfront lump sum covering the entirety of the contract. BigCo negotiates and executes the contract from its headquarters in Salt Lake City, Utah, but the license agreement allows all of BigCo's employees in the United States to use the software. BigCo maintains employees in 15 states, 25% of whom are based in New York City. SuperSoft negotiated and executed the contract with BigCo from its headquarters in California, but hosts SuperNote from servers it rents in Georgia, where BigCo has no employees. SuperSoft bills BigCo for the SuperNote contract using BigCo's address at its Utah headquarters, and BigCo does not inform (nor has any obligation to inform) SuperSoft of the location of the employees using SuperNote under the contract. SuperSoft has sales tax nexus with Utah, but not with New York. To what states, if any, do the parties have sales or use tax obligations? Although complex,

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[2] *See Thompson Reuters, Inc. v. Dep't of Treasury*, No. 313825 (Mich. Ct. App. May 13, 2014) (holding that access to an online legal research tool is the provision of a nontaxable service); *Auto-Owners Ins. Co. v. Dep't of Treasury*, No. 12-000082 (Mich. Ct. Claims Mar. 20, 2014) (holding that a cloud computing transaction was not taxable because no delivery of software occurred).

this scenario is not dissimilar from those faced by tax professionals at multistate companies around the country.

As the seller, SuperSoft must decide if and how to collect sales tax on the purchase price of the contract. SuperSoft must first determine which state's law applies to the transaction. Under the terms of the contract, BigCo is under no obligation to tell SuperSoft where its employees will use the software. Relying on the premise that sales tax is generally sourced on a destination basis, SuperSoft decides to source the entire transaction using the sourcing rules for the state where BigCo executed the contract and will receive the invoice—Utah.

Accordingly, SuperSoft examines the tax rules of Utah. Utah taxes software delivered electronically.[3] SuperSoft finds that Utah has adopted the Streamlined Sales and Use Tax Agreement ("SSUTA") sourcing rules. Utah's version of the second SSUTA sourcing rule provides:

> If tangible personal property, a product transferred electronically, or a service that is subject to taxation under this chapter is not received by a purchaser at a business location of a seller, the location of the transaction is the location where the purchaser takes receipt of the tangible personal property or service.[4]

Thus, the question becomes, where does BigCo receive SuperNote? Is it in Utah, where SuperSoft delivers to BigCo the *right* to use the product? Is it in the states of BigCo's employees, where BigCo actually uses the software? Or is it in Georgia, where the servers are located? The basic SSUTA rule does not provide an answer. Fortunately for SuperSoft, however, Utah has published additional informal guidance on the topic:

> [i]f remotely accessed software is used at more than one location and at the time of the transaction, the buyer provides the seller a reasonable and consistent method of allocating the transaction between those locations, the seller must source the transaction to those locations. [Otherwise], the seller must source the transaction to the buyer's address.[5]

BigCo provided no method to allocate the SuperNote transaction. Accordingly, SuperSoft sources the entire contract to BigCo's address in Salt Lake City and, because SuperSoft has sales tax nexus with Utah, charges Utah sales tax on the full price of the contract.

BigCo's director of indirect tax looks at the invoice from SuperSoft and starts to get nervous. She understands why SuperSoft made the decision to collect Utah sales tax, but she sees a problem ahead. BigCo stations 25% of its employees in New York, and New York will likely want to assess sales tax on 25% of the SuperNote contract as a consequence. In particular, New York levies sales tax on prewritten computer software delivered electronically.[6] New York has also concluded that "if a purchaser has employees who use the software located both in and outside New York State, the seller of the software should collect tax based on the portion of the receipt attributable to the users located in New York."[7] Unlike Utah, New York does not give sellers the ability to source the transaction to the purchaser's address if the seller does not know how to allocate the use of the software. Thus, under its sourcing rules, New York will assert a right to tax 25% of the SuperNote contract—even if SuperSoft correctly sourced the entire transaction to Utah. SuperSoft did not charge New York tax on the SuperNote invoice (and never would have, because it has no nexus with New York). Thus, BigCo may have a use tax liability to New York on 25% of the price of the transaction.

No problem, right? New York will allow BigCo a use tax credit for the sales tax it paid to Utah. Well, that's not certain. New York allows a use tax credit for retail sales tax "legally due and paid" in another state.[8] Though SuperSoft made a determination that tax on its contract with BigCo was due and payable to Utah, New York may not respect that decision. SuperSoft only came to that determination because BigCo did not tell SuperSoft where its employees would use SuperNote. BigCo paid SuperSoft a large sum of money for this contract, and BigCo's tax director is not so sure that New York will let itself get cut out of substantial sales tax revenue simply because BigCo neglected to tell SuperSoft that one quarter of its employees work in New York. Thus, BigCo may find itself in a position where it pays sales tax to Utah on 100% of the transaction, and then later is assessed New York use tax on 25% of the transaction. The tax burden could grow if states other than New York take a similar position.

What to Do?

3 Utah Info. Pub. No. 64 (May 1, 2012).

4 Utah Code Ann. § 59-12-211(3).

5 Utah Info. Pub. No. 64 (May 1, 2012).

6 *See* N.Y. Sales Tax Bulletin No. TB-ST-128 (Aug. 5, 2014).

7 *Id.*

8 N.Y. Tax Law § 1118(7)(a).

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"Communication between a company's tax department and its business departments is key."

The issues surrounding sourcing are clearly complex, even for this single transaction between SuperSoft and BigCo. When you consider that BigCo is not likely SuperSoft's only customer and that BigCo will contract for many other services through cloud-based transactions, the complexities can become fairly daunting—particularly given the competing interests among parties and varying sourcing rules among states. In order to be in the best position to address these issues, a company, whether purchaser or seller, should outline the approach that it is going to take with respect to taxability and sourcing of products and services delivered via the cloud.

Communication between a company's tax department and its business departments is key. Moreover, purchasers and sellers should be clear about the obligations of each party, as set forth in the sales contract. In general, a company's taxation and sourcing approach should be informed by the states with the largest markets or greatest potential liability. If there are specific cloud sourcing rules for these states, then those rules should influence overall policy. Any policy should be reasonable and should be applied consistently, subject to the specific sourcing rules for a particular jurisdiction. In the above example, BigCo could have provided SuperSoft with a breakdown of its employees' locations and tax could have been allocated among the jurisdictions. Above all, it is important to document each transaction—how the services are delivered, where they are delivered, and where the users are located.

Conclusion

Dealing with the myriad tax issues that arise when doing business in the cloud is difficult at best. Fortunately, there are fewer obstacles to determining whether a particular transaction may be subject to tax in a jurisdiction, as the states appear to be issuing more guidance as to taxability. Unfortunately, this guidance typically does not address sourcing. It is likely that the next wave of rulings and cases will deal with how to source multistate cloud transactions. Staying cognizant of the complexities of cloud computing taxation is the first step toward minimizing potential tax risks and liabilities surrounding cloud computing transactions.