

No Improved Visibility For Cloud Computing Taxation

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In the past year or so, there have been several articles written on the topic of cloud computing and the potential tax consequences of various types of “cloud” transactions.¹ Nevertheless, only about seven publications (in four states) of particular note in 2010 and 2011 are directed at cloud computing fact patterns, and those range from providing clear guidance on very discrete questions to refusing to address the question posed in the request for ruling. As the dearth of published guidance from the states makes clear, taxpayers must continue to rely on their “instruments” (that is, generally understood tax principles and benchmarks) to guide flight in the clouds. Still, we think many taxpayers prefer to rely on their instruments than the states’ existing, but in some respects deficient, “flight plans” for cloud transactions and service arrangements.

Altitude Indicator

As aviators know, the best way to avoid crash-landing when the horizon is invisible is to establish the altitude indicator — that is, use instrumentation to keep aircraft wings level and nose balanced. When navigating the cloud, referencing all available state guidance that touches on the tax treatment of cloud computing transactions or service arrangements is how a taxpayer establishes its altitude indicator. A search of “cloud computing” in various tax databases identifies few pieces of published guidance, in part because few states use this term in their guidance and in part because few states have directly addressed the taxation of cloud computing services. We discuss below seven rulings from 2010² and 2011, ranging from an Arizona ruling that explains cloud computing and directly addresses the sales taxation of same to an Illinois ruling that acknowledges the taxpayer’s request to address cloud computing but refuses to rule on the question of taxation.

²There certainly have been instances before 2010 when states have issued guidance that touches, directly or indirectly, on fact patterns that involved hosting services or otherwise could be analogized to cloud computing transactions or service arrangements. See, e.g., New York Advisory Opinion TSB-A-08(62)S (Nov. 24, 2008) (ruled that charges for Adobe Systems’ OnDemand ASP Software are subject to New York sales tax, as prewritten software); New York Advisory Opinion TSB-A-09(41)S (Sept. 22, 2009) (ruled that receipts from licenses for software modified for insurance companies to serve insurance customers constitute taxable receipts from prewritten software); Michigan Letter Ruling (Apr. 20, 2009) (ruled that subscription charges to access on-demand application software that is not customized to each subscriber is analogous to a license to use prewritten computer software and hence is taxable); Utah Private Letter Ruling 08-012 (Jan. 21, 2009) (ruled that charges for access to software located on an application service provider’s server located outside of Utah is not subject to Utah sales tax, because although the transaction is deemed to be a sale of prewritten computer software, the sale does not take place in the state). Our article focuses on the lack of more recently issued guidance.

¹Marianne Evans, “Cloudy with a Chance of Fog: The Outlook for Cloud Computing Income Tax Issues,” KPMG What’s News in Tax (Oct. 11, 2010); Kendall L. Houghton, with John Paek and Sahang-Hee Hahn, “Partly Cloudy Forecast for State Taxes on Cloud Computing,” *State Tax Notes*, Sept. 20, 2010, p. 781, Doc 2010-19404, or 2011 STT 181-2; Stephen P. Kranz with Lisbeth A. Freeman and Mark W. Yopp, “Taxing the Virtual World . . . and Beyond,” *State Tax Notes*, May 2, 2011, p. 345, Doc 2011-8540, or 2011 STT 84-4.

1. Sourcing a Software License to Arizona Based on Server Location

In Taxpayer Information Ruling LR10-007 (Mar. 24, 2010), the Arizona Department of Revenue addresses whether some cloud services are subject to the Arizona transaction privilege tax, an excise tax on a seller for the privilege of doing business in Arizona, assessed on gross receipts from sales. Here, the taxpayer licenses software to a licensee domiciled outside Arizona that provides data processing services to clients. The licensee has a data center in Arizona where the licensed software will be installed, but the software may be accessed by the licensee's clients from other locations. The taxpayer asked Arizona whether software licenses hosted from an Arizona center or stored on Arizona servers and accessed from and used at remote locations were subject to the Arizona transaction privilege tax or use tax.

The department ruled that a taxpayer that licenses software supported on servers in Arizona is deemed to be engaged in the licensing of tangible personal property, and the gross receipts from those transactions are subject to the transaction privilege tax. The taxpayer in this case licensed midrange and mainframe software at data processing centers in Arizona and installed the midrange software on a distributed basis worldwide. When the taxpayer licenses server software, it is (1) delivered by the taxpayer on physical media or electronically to the server location; or (2) is delivered to the data center in Arizona either on media or electronically and then is distributed by the licensee to server locations.

The taxpayer asserted that it should not be subject to the transaction privilege tax on the gross receipts from license fees for its software products because, even though the taxpayer is licensing software products to a licensee that maintains a data center in Arizona, the licensee has servers worldwide that serve particular clients on an outsourced basis, and the clients receive the benefit of the data processing services at locations all over the world — only a small part of that service base is in Arizona.

The Arizona transaction privilege tax regime entails several classifications, including retail and personal property rental classifications. Products sold under this classification are not limited to physical goods, but rather need only be tangible personal property, which is defined to include "personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses."³ The personal property rental classification includes the business of leasing

or renting tangible personal property for consideration. Later use of the licensed software by parties other than the licensee does not affect the taxation of the gross receipts arising from the original license.

To determine whether the taxpayer's license fees were taxable under either classification, the department provided a detailed discussion of how hosted software applications work and how they differ from the traditional model of prewritten or "canned" software. The biggest difference was that for software sold at retail, the purchaser buys a license from a software producer to use the software and installs that software locally on hardware under the control of the customer. Under the hosted software applications, the customer does not own the software license; rather, the customer has purchased a subscription to use the software that terminates if the customer stops paying the subscription fee. The department determined that the taxpayer is leasing software and therefore was taxable under the personal property rental classification on gross receipts derived from activities associated with leases to an Arizona customer.

2. Is a Safe Harbor for the Cloud Evolving in Kansas?

Kansas has diligently attempted to study and address taxability questions regarding both application service providers (ASPs) and cloud transactions in 2010 and 2011. In Opinion Letter No. 0-2010-005 (June 22, 2010), the Kansas Department of Revenue addresses the taxation of ASP services, holding that a number of separately stated fees charged by ASPs to their customers for ASP services are not subject to sales tax. Those include recurring monthly charges, setup fees, support fees, training fees, data migration fees, and form programming fees. The letter does note that if an ASP sells a client canned software that can be used independently of the ASP service, the software charge is subject to sales tax. Similarly, charges for additional service manuals and software backup that are separately billed to a customer are subject to sales tax. Service manuals and provider software are not subject to sales tax when they are provided to the customer as part of the ASP service package.

In Private Letter Ruling No. P-2011-004 (June 16, 2011), Kansas addresses the question of taxability of the purchase by retail consumers of digital content for use in an online video game. The virtual goods are accessed by customers online and typically involve either accessing a complete game or accessing additional content within a game that resides on a third-party computer server. Kansas ruled that it does not tax a provider's charges that allow a customer to electronically access information on a remote server. Therefore the fee charged for a code to access the third-party server is not

³ARS 42-5001(16).

subject to Kansas sales or use tax, whether sold in a physical retail environment or via the Internet.

In combination, we think that the above described guidance is favorable to taxpayers and shows that Kansas takes its responsibility to provide guidance seriously because it publishes rulings to assist taxpayers in making determinations regarding the taxability of cloud transactions.

3. Texas Takes Positions on Internet Hosting and Data Processing

On June 17 Texas Gov. Rick Perry (R) signed into law HB 1841, which states that a company providing Internet hosting services is not engaged in business within the state of Texas and is thus not subject to taxation within the state. HB 1841 defines Internet hosting to mean providing computer services over the Internet using equipment that the provider owns. Further, the user may process its own data or use the provider's software or its own on the equipment. HB 1841 also states that an Internet hosting service provider is not required to examine the user's data to determine the applicability of this statute, report to the comptroller about a user's activities, or advise a user on the applicability of this section. HB 1841 states that the term "Internet hosting services" does not include telecommunication services.

Thus, it appears that if a company has servers located in Texas and uses these servers to provide Internet hosting services as defined above, that company is not deemed to be doing business within Texas solely as a result of those servers (that is, the company might engage in other activities in Texas that *would* constitute engagement in business in Texas).

However, the result may differ if the taxpayer is providing "data processing" services. Texas issued Policy Letter Ruling No. 201004665L (Apr. 29, 2010), which specifically addressed the taxable status of medical transcription services that used a "software as a service" or SaaS cloud platform to perform and deliver those services. Unsurprisingly, given Texas's consistently broad interpretation of the term "data processing service" for sales tax purposes, the comptroller ruled that those services constitute taxable data processing services.

To access this medical transcription service, clinicians dictate the desired text over the phone or by digital voice recorder; the service provider's automated software then converts the audio file into a text document that is placed in the patient's file. Further, the service's speech models enable medical transcribers to quickly edit draft documents produced by the software, and based on corrections made to the documents, the software continually improves, resulting in more accurate draft generation over time. This software also allows clinicians to securely review, revise, and electronically sign docu-

ments from remote locations, and it enables streamlined digital document distribution via e-mail or electronic fax. The ruling notes that an exclusion from tax exists for medical transcription services provided for by a medical transcriber, but no such exclusion exists for similar services that are provided by software. The comptroller further ruled that charges for reviewing the documents and making corrections by a medical transcriber to the converted speech are services in connection with data processing services and hence are also subject to tax.⁴

It should also be mentioned here that in 2008, the Texas comptroller's office issued Texas Policy Letter Ruling No. 200805095L (May 28, 2008), which held that when a taxpayer domiciled outside Texas provides remote access to business management, accounting, or tax preparation software to Texas customers, this taxpayer is deemed to be providing data processing services to its customers and is taxed as such.⁵ The Web-based application at issue in this case supported the customer's entire business operations, allowing the customer to manage inventory, record sales, fulfill orders, process payroll, and so on, with all customer data held in a single database entered by the customer's employees. The taxpayer believed that those services were not taxable as data processing services because the customer's employees entered the data. The Texas comptroller disagreed, ruling that data entry by customers has no effect on the taxpayer's provision of taxable data processing services.⁶

4. Illinois Refuses to Rule on Taxation of Cloud Computing Services; Cites Need for Regulation

Although the Arizona, Kansas, and Texas guidance provide reasonably detailed explanations of different software services, including cloud computing fact patterns, and directly address the taxability of those services, the Illinois Department of Revenue has declined in general information letters ST-10-0062-GIL (Aug. 4, 2010) and ST 10-0113-GIL (Dec. 14, 2010) to provide similar guidance, noting that Illinois has not adopted any regulations specifically addressing the taxability of cloud computing services. In ST-10-0062-GIL, the request for information was a survey of questions relating to cloud computing. The questions posed in the request included whether Illinois imposes sales tax on particular cloud computing services, and if so, how the point of taxation was determined (that is,

⁴The ruling notes that 20 percent of the value of data processing services is exempt, *cf.* Texas Code 151.351.

⁵Texas Policy Letter Ruling No. 200805095L (May 28, 2008).

⁶*Id.*

location of user, location of service, office of the cloud computing provider, or other). In ST-10-0113-GIL the taxpayer asked a question regarding the taxability of specific products delivered digitally or accessed on a third-party server.

In both letters, the department further opines that the “proper forum for providing guidance regarding transactions involving computer software [ASPs] . . . and software hosting is through a formal administrative rulemaking process rather than through individual inquiries such as letter ruling requests.” The December ruling did note that the department is researching the nature and type of services and products provided in cloud computing transactions, including discussions with “industry participants.” The department said that there is “no universal agreement as to the nature of services and products that sellers provide to their customers” and until the department has adopted a rule, taxpayers must determine whether the products they provide are computer software as defined in section 2-25 of the Retailers’ Occupation Tax Act. As one would expect, the department could not provide a time frame in which the taxpayer could expect a rule or rules to be promulgated in either GIL.

Although the department did not address the cloud computing issues at hand, the GILs did note that information or data that is electronically downloaded is not considered the transfer of tangible personal property. However, an electronic transfer of canned or pre-written software is considered the transfer of tangible personal property and is taxable under the retailers occupation tax and the use tax.

Further, if computer software consists of custom computer programs, the sales of that software may not be taxable retail sales.⁷ Custom computer programs may not be taxable retail sales if specific criteria are met. The criteria are:

- the transaction is evidenced by a written agreement;
- the agreement restricts the customer’s duplication and use of the software;
- the customer is prohibited from licensing, sub-licensing, or transferring the software to a third party without the permission of the lessor;
- the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software; and
- the customer must destroy or return all copies of the software to the licensor at the end of the license period.⁸

It should also be mentioned that the Illinois department has issued at least one other letter

ruling in which the taxpayer requested a ruling on the taxability of the licensing of software to help customers direct phone calls to call centers and keep track of the centers’ call volume. In that ruling, the department did not take a position on any of the issues presented, but rather reiterated general rules about the taxability of software.⁹

Turbulence in 2011

While we have described four states’ issuance of guidance in 2010 and 2011, Louisiana recently withdrew¹⁰ its Revenue Ruling No. 10-001 (originally published on Mar. 23, 2010), which addressed the taxability of remotely accessed software, digital or media products, stored data, and related items. In essence, the ruling had concluded that any consideration paid for electronic receipt of or access to data, information, materials, media, software, and applications on equipment located in Louisiana is subject to sales and use or lease tax. What will be substituted for this guidance remains to be seen.

New York, however, continues to produce rulings on the taxability of cloud transactions. In New York Advisory Opinion TSB-A-11(17)S (June 6, 2011), the Department of Taxation and Finance ruled that a hosted marketing service provided by a California-based company that provides marketing services to clients that use e-mail, direct mail, and other marketing channels to reach their customer bases is subject to New York sales and use tax as — you guessed it — the sale of prewritten software. The taxpayer licenses to clients the right to use the software housed on the taxpayer’s servers for the purpose of marketing campaigns. The department ruled that the taxpayer’s charges for optional training and consulting services were not taxable, however.

Another piece of guidance in 2011 came from Vermont, which provided one sentence in a Vermont use tax bulletin, “Use Tax Frequently Asked Questions” (June 7, 2011), to address remote server transactions. Vermont stated that software, including both downloaded software and that accessed on a remote server, are common types of business purchases on which Vermont use tax is incurred. However, there was no further discussion of cloud computing services.

Massachusetts provided some clearer guidance on remote server transactions in April 2011. In Letter Ruling No. 11-4 (Apr. 12, 2011), Massachusetts addressed the use of software on a remote server in connection with the provision of a service, in this

⁷See 86 Ill. Adm. Code 130.1935(c).

⁸86 Ill. Adm. Code 130.1935(a)(1).

⁹See Department of Revenue State of Illinois Letter No. ST 10-0083-GIL (Sept. 8, 2010).

¹⁰See Revenue Information Bulletin 11-010 (May 23, 2011).

case, organization and management of client workforces. Massachusetts ruled that sale, license, and right to use software on a server hosted by the taxpayer or a third party are taxable under Massachusetts sales and use tax laws. However, when there is no charge for the use of the software, and the object of the transaction is acquiring a good or service other than the use of the software, sales or use tax on the software doesn't apply. In the letter ruling, Massachusetts found that the taxpayer provided information services to its customers based on data it gathers from prospective employees and then provides this information to its customers in a report. The ruling found that the object of the transaction was the database access, including reports prepared by the taxpayer, rather than use of the software. Thus, the transaction was a nontaxable sale of services.

Spatial Disorientation

The current cloud computing tax environment is one in which a taxpayer may suffer from spatial disorientation, or the disconnect between reality and a pilot's perception of direction that results from a flight with poor or no visibility.

Where Are the Regulations?

Whereas Illinois recognizes that the ideal way to address these issues is through the promulgation of regulations, which entails public comment and measured consideration of the proposed rules, ST 10-0113-GIL states that in the meantime, taxpayers are left to guess whether their product falls within the definition of computer software found in the Illinois tax code. If the products clearly fell within or outside this definition, the taxpayer would not have initiated the GIL process asking how the products are taxed. There was a four-month span between the August and December rulings, and while Illinois seemed to be "researching" the nature of cloud computing products, it gave no indication that guidance would be forthcoming anytime soon.

Where Are the Cases?

Above, we discussed seven items of published administrative guidance and legislation addressing different cloud computing services. However, we did not uncover any significant judicial decisions that directly address the taxation of cloud computing services. One possible reason for the lack of judicial decisions is the relative newness of cloud computing services and the extended time it takes to undergo an audit, receive an assessment, protest and appeal the assessment, file a complaint with a court, and then fully litigate the case to decision.

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It appears that many states are developing and testing their positions on the sales taxability and sourcing of cloud computing transactions on audit, so the precedent that emerges will be shaped by the usual vagaries (that is, the facts presented, arguments made, analogies drawn, state of the law in the forum state, and so on).

Is It Appropriate to Develop Policy Via Audit?

Cloud computing transactions and service agreements are a relatively new technology, and clearly, states are unsure how they will treat those services for tax purposes. Therefore, it is unsurprising that states' positions are being developed on audit. It is during review of a company's operations that the auditor learns about how the cloud computing services operate and are offered to customers. Before issuing published guidance, states seem to want to learn more about how cloud computing works in multiple settings. Illinois has clearly stated its belief that the better practice is to issue rules than to deal with cloud computing based on specific fact patterns in the context of ruling requests. However, how can the taxpayer ensure that the auditor understands the technology and services and comes to the right conclusion regarding taxability, sourcing, and related questions?

Instrument Flight Rules

Taking a further cue from aviators, state taxpayers will continue to draft their contractual provisions, develop their return filing positions, and defend their returns on audit under the following instrument flight rules that pertain when there is insufficient visibility to fly using visual markers alone:

- Know what guidance *does* exist, and consider how it might apply to your fact pattern.
- In the absence of specific guidance, analogize to the nearest (possibly most favorable) factor — for example, states tend to analogize to canned software (taxable, sourced like tangible personal property), and taxpayers tend to analogize to services (typically nontaxable).
- Apply nexus principles (or uncertainty) that relate to the type of tax under review.

- Consider whether the sourcing of a transaction may be influenced by the structure of an agreement (for example, delivery and transfer of title versus remote access; how does in-state equipment come into play?).
- Establish a position regarding the character of the transaction: Does the transaction or services arrangement involve tangible personal property versus services versus intangibles, and what about bundled transactions? Income tax treatment of the revenue arising from cloud computing transactions or arrangements may be driven by sales tax classifications or may turn on other factors (see, for example, the recent *Microsoft* decision from the California Superior Court, in which software license revenues were apportioned as sales of tangible goods, under the statutory destination-sourcing rule).¹¹

¹¹*Microsoft Corp. v. Franchise Tax Board*, CGC-08-471260, (Sup. Ct. San Francisco Feb. 2, 2011). Microsoft argued that for income tax purposes, royalties it received for licensing software were attributable to licensing of intangible property and were properly sourced to Washington state, where Microsoft incurred the preponderance of its costs of performance with respect to this income-producing activity. The superior court ruled, however, that the software royalties were attributable to the licensing of tangible personal property. To reach this outcome, the court reviewed the manner of classification of software by other jurisdictions for sales tax or property tax purposes, and it used the tangible personal property classification to justify market-based sourcing of the receipts at issue. The case is pending appeal in the California Court of Appeal.

The detailed ruling requests being submitted to various states show that some taxpayers are looking for direct guidance concerning the proper tax treatment of some cloud transactions and service arrangements. Because of the growing popularity of cloud computing among businesses and consumers, we expect that from this subset of taxpayers, states will only receive more pressure to publish their views of these transactions. Nevertheless, we are equally certain that there are other taxpayers that will feel perfectly comfortable relying on their "instruments" rather than a hodge-podge of state guidance that may well prove to be internally inconsistent or poorly reasoned, given that many taxpayers have (1) a strong understanding of the operative sales and income tax principles, (2) a deep familiarity with factual aspects of the transactions under review, and (3) a keen sense of the desired tax outcomes of the transactions. Those cloud computing service providers and consumers will be prepared to ride out some potential turbulence while training an eye on the horizon for signs of improved visibility. ☆

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