The Sales Tax Implications of Software as a Service

Lenore Vidal
Director of Taxes
Forsythe Technology, Inc.
Skokie, IL
lvidal@forsythe.com

Kyle Brehm
State and Local Tax Manager
PricewaterhouseCoopers LLP
Minneapolis, MN
kyle.m.brehm@pwc.com
I. WHAT AM I PURCHASING?

II. WHERE AM I PURCHASING IT?

III. IS MY PURCHASE TAXABLE?

IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?

V. DOES THIS PURCHASE IMPACT MY COMPANY’S NEXUS FOOTPRINT?

VI. WHAT ELSE?
I. WHAT AM I PURCHASING?
I. WHAT AM I PURCHASING?

Pitfalls

- No consistency between taxing jurisdiction on how to characterize purchases

- Basic issue of whether it's a service or a good (true object test)
I. WHAT AM I PURCHASING?

**Services**
- Internet Hosting
- Data Processing
- Website Design
- Security Services
- Information Services

**Goods**
- Software?
- Digital Content?
I. WHAT AM I PURCHASING?

Prewritten Software
• Mode of Delivery
  – Taxability
  – Sourcing

Custom Software

Digital Goods
• Streamlined Definitions
• Mode of Delivery
I. WHAT AM I PURCHASING?

SaaS v. MPU

Software as a Service (SaaS)
- Software resides on vendor’s server.
- Taxpayer accesses vendor’s server to use software.
- Software is never located on taxpayer’s server.

Multiple Points of Use (MPU)
- Software is delivered onto taxpayer’s server in State A.
- Software is used by people inside and outside of State A.
- MPU election allows taxpayer to take up-front sales tax exemption.
- Taxpayer is responsible for accruing use tax based on user locations.
I. WHAT AM I PURCHASING?

States are still in the process of ruling on the taxability of SaaS.

- Some states have passed statutes addressing the issue, other states rely on court cases or administrative guidance.
- Some states view SaaS as a non-taxable service, other states view it as taxable tangible personal property.

New York
- SaaS is taxable as prewritten software. Accessing software remotely is deemed a transfer of possession of the software because the user gains constructive possession.

Virginia
- SaaS is a non-taxable service under the statute. Services which provide access to or use of software and data are not taxable unless tangible personal property is exchanged.
I. WHAT AM I PURCHASING?

Many cloud based products are combinations of hardware, software and multiple services so the conversation often surrounds the “true object” of the sale:

- *Technical Bulletin TB-72, New Jersey Division of Taxation, July 3, 2013*

- Private Letter Ruling #12-2, South Carolina Department of Revenue, June 11, 2012


- Formal Ruling 2015-01, Vermont Department of Taxes, (undated) 2015

- Colorado General Information Letter, GIL-12-004 Colorado Department of Revenue, April 4, 2012.
II. WHERE AM I PURCHASING IT?
II. WHERE AM I PURCHASING IT?

Pitfalls

• Purchasing companies buying hosted software vs. MPU = different situs

• States interpret situs ever more broadly in this area

• States allowing allocation by user have implemented it differently (even among Streamlined states!)
II. WHERE AM I PURCHASING IT?

Hosted Software Delivered via SaaS Model

- Software resides on procurement company’s server.
- Users access software via SaaS model.
- Software purchase is taxable in the procurement company’s state.
- User access may be taxable if states impose tax on SaaS.
II. WHERE AM I PURCHASING IT?

MPU Model

- Software initially delivered to procurement company server.
- Software relicensed/resold to end users.
- Procurement company purchases are exempt for resale.
- Sales to users are sourced to end-user jurisdictions; taxed accordingly.

Vendor

Procurement Company

User A
User B
User C
II. WHERE AM I PURCHASING IT?

Website hosting company’s receipts from Arizona customers are subject to Transaction Privilege Tax

- Taxpayer is a website creation and hosting business.
- Taxpayer made sales of software tools to customers located in Arizona.
- Department explained that software, whether located on remote servers, downloaded on a local network, or delivered as hardware, is tangible personal property.
- Taxpayer’s customers gain sufficient control and possession sufficient to constitute a taxable rental.
- Department stated that it is the location where a user uses the software that is essential.

LR15-005, Arizona Department of Revenue (May 14, 2015)
II. WHERE AM I PURCHASING IT?

Web-based services are taxable in Chicago under the city’s lease transaction tax

- Tax is imposed on charges paid for the use of personal property, including charges for the use of a non-possessory computer lease.
- Use must be from a Chicago location.
- Effective January 1, 2016.

II. WHERE AM I PURCHASING IT?

Indiana allows taxpayer to source software licenses outside of state based on user locations

- Taxpayer was assessed tax on audit for software licenses initially delivered to Indiana.
- Taxpayer successfully demonstrated that several software licenses were destined for use outside of Indiana.
- Assessment was reduced to related to software licenses that qualified for the state’s temporary storage exemption.


Minnesota Department of Revenue rejecting MPU “elections” applied for after the time of purchase

- Department recently expressed their position that the State’s MPU provision does not provide a sales and use tax exemption.
- Department states that MPU provision only affords a business purchaser the option to apportion use tax to multiple taxing jurisdictions if all of the statutory requirements are satisfied.
- MPU statute requires that purchaser provide an exemption certificate to the seller at the time of purchase indicating MPU.

Rev. Notice 15-03, Minnesota Department of Revenue (Sept. 28, 2015)
II. WHERE AM I PURCHASING IT?

Texas refuses to allow taxpayer to allocate software expense to locations outside of the state; denies sales and use tax refund.

- Taxpayer purchased software licenses and maintenance agreements, paying Texas tax on all licenses; claimed refund of tax on certain licenses and maintenance agreements used by employees outside of Texas.
- Administrative Law Judge denied refund claims related to software licenses, stating that the tax code allows for allocation of services, not of tangible goods.
- Administrative Law Judge denied refund claims related to software maintenance, as taxpayer was unable to demonstrate that services supported a separate, identifiable business segment.

201506259H; SOAH Docket No. 304-15-1731.26; TCPA Hearing No. 111,499; Texas Comptroller of Public Accounts (Jun. 9, 2015)
III. IS MY PURCHASE TAXABLE?
III. IS MY PURCHASE TAXABLE?

Pitfalls

• Characterization drives the majority of these decisions, and the states are taking creative positions to fit round objects into square holes

• If it’s a service, what kind of service?
III. IS MY PURCHASE TAXABLE?

Colorado taxes cloud-based photo sharing as intrastate telephone services.

- Taxpayer sells cloud service plans allowing customers to send and photos through the use of wi-fi or cellular network, photos are stored on taxpayer’s cloud storage website.
- Colorado does not levy sales/use tax on use of computer software sold or used by application service providers (“ASP”); taxpayer is deemed to be an ASP.
- Since taxpayer uses cellular service to transmit data, the sale of this service offering is subject to the states tax on intrastate telephone and telegraph services.

GIL-15-003, Colorado Department of Revenue (Jan. 27, 2015)

Services provided by enterprise messaging service provider are not taxable in Colorado

- Taxpayer provides integrated desktop messaging (“IDM”), electronic data interchange (“EDI”), broadcast fax, and notification email services to customers.
- IDM, EDI and broadcast fax are cloud-based services not subject to tax; any purchase of telephone/telegraph services is independently subject to tax.
- Internet Tax Freedom Act (“ITFA”) preempts state taxation of notification email services.

PLR-15-003, Colorado Department of Revenue (Jan. 27, 2015)
III. IS MY PURCHASE TAXABLE?

Software used by telecom companies not taxable in California

• Court of Appeals held that a software contract and related licensing to operate telephone switching equipment constituted a 'technology transfer agreement' and were exempt from tax.

• Court affirmed that the software did not constitute tangible personal property subject to sales tax.

III. IS MY PURCHASE TAXABLE?

Software licenses in Illinois are not taxable if meet the five-pronged test:

1. the license is evidenced by written agreement,
2. the license agreement restricts the customer’s duplication and use of the software,
3. the license agreement prohibits the customer from licensing, sublicensing, or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor.
4. the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and
5. the customer must destroy or return all copies of the software to the licensor at the end of the license period.

86 Ill. Admin. Code § 130.1935(a)(1)

Sales of cloud-based texting services deemed non-taxable in Illinois

- Taxpayer provided cloud-based texting services to Illinois customers.
- Since transactions do not involve the transfer of tangible personal property, these services are not subject to Illinois’ Service Occupation Tax or Service Use Tax.

III. IS MY PURCHASE TAXABLE?

Kansas issues guidance on sales of online gaming products

- Department clarified that initial sale of access codes for downloadable digital content are treated as a taxable sale of downloadable prewritten software.
- Sale or redemption of access codes purchased to access games hosted on third-party servers are not taxable.
- Sale of cards containing subscription time, notional dollars, or points to be used to access online networks are not taxable.

III. IS MY PURCHASE TAXABLE?

Certain Michigan cloud computing services not subject to use tax; Department of Treasury issues Notice to Taxpayers

- Michigan Court of Appeals found contracts for delivery of prewritten software as merely incidental to services performed were not subject to use tax.
- Taxpayer did not exercise a right or power over the software (tangible personal property), which is critical to the imposition of use tax.
- Ongoing issue surrounding access to functionality of software that is hosted on third-party servers (see Rehmann Robson & Co. PC, GXS Inc.)


- Portions of RAB 1999-5 are not consistent with Auto-Owners and are no longer the policy of the Department.
- Decision in Auto-Owners will be applied to all open tax years.

**Notice to Taxpayers Regarding Auto-Owners Insurance Company v. Department of Treasury** (Mich. Dept. of Treasury, January 6, 2016)
III. IS MY PURCHASE TAXABLE?

A subscription for hosted computing power is a non-taxable service in New York

- Department held that the sale of hosted computing power, which allows users to run applications over the internet using the seller’s hardware, is a non-taxable service.
- Administrative Law Judge found that even though the user needs to acquire an operating system to use the computing power (normally a taxable event), the operating system is simply incidental to the subscription’s primary purpose which is allowing the user to run its own applications.


Sale of hosted online meeting products are non-taxable in New York

- Taxpayer sells access to online meeting products to customers.
- Software used in providing online meeting products is located on taxpayer’s server.
- New York deemed that that taxpayer’s sales do not constitute the sale of prewritten software.

TSB-A-15(28(S); Petition No. Z120320B, New York Department of Taxation and Finance (Jul. 9, 2015)
Cloud-based security services taxable in New York

- Taxpayer sold cloud-based security services to corporate and individual customers in New York
- Taxpayer transfers prewritten computer software plug-ins to customers which enable its mobile and roaming functionalities.
- Commissioner held that:
  - Sale of cloud-based security services is subject to sales tax (protective services are taxable)
  - Sale of software plug-ins is not subject to sales tax if transferred as part of the sale of service. Use tax liability exists for taxpayer if plug-ins were purchased from third party.
  - Sale of software plug-ins are subject to tax if separately stated.

III. IS MY PURCHASE TAXABLE?

Taxable software includes “the access and use of software that remains in the possession of the dealer” in Tennessee

- New statute is intended to tax SaaS.
- Reverses Department policy that SaaS is a non-taxable service.
- Effective July 1, 2015.

Tenn. Code. Ann. § 67-6-231(a)(2)
III. IS MY PURCHASE TAXABLE?

Texas taxes advertising plug-ins as data processing or information services

- Taxpayer provided software to subscribers, free of charge, which monitored subscriber information technology (“IT”) networks.
- Taxpayer also provide plug-ins which function as advertising links, notifying subscribers when an IT warranty is about to expire, and taxpayer is compensated by company advertising through the link.
- Auditor treated the creation of the link as either taxable data processing or taxable information services. Assessment upheld by Administrative Law Judge (“ALJ”)

201502046H; SOAH Docket No. 304-14-2175.26; TCPA Hearing No. 109,109, Texas Comptroller of Public Accounts (Apr. 15, 2015)
III. IS MY PURCHASE TAXABLE?

Utah continues to tax online access of prewritten computer software

- Taxpayer made purchases of business-use software from several vendors, all of which was prewritten and accessed over the internet (not downloaded).
- The Commission determined that the use of the prewritten software, as tangible personal property, constituted a taxable sale.
  - Primary object of the transaction is the use of prewritten computer software

Appeal No. 10-2086, Utah State Tax Commission (Jul. 15, 2015)

Utah clarifies that custom computer software is not subject to state sales and use tax

- Taxpayer is a medical testing company engaged in diagnostic testing.
- Taxpayer internally developed a software suite allowing connectivity between a number of healthcare information suites, part of this required hiring vendors to create interfaces between information platforms.
- Purchases from vendors were deemed as non-taxable sales of services.

III. IS MY PURCHASE TAXABLE?

Cloud-based meeting collaboration product not subject to Vermont sales and use tax

- Taxpayer sells cloud-based meeting collaboration products to customers.
- Customers are not provided with disks or downloads of the software, and does not directly access the software in any way.
- Software merely provides customers with additional capabilities during an audio or video conference.
- Sale of meeting collaboration products is not subject to Vermont sales or use tax.

Formal Ruling 15-01, Vermont Department of Taxes (May 1, 2015)
IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?
IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?

Pitfalls

• A few states have actually enacted exemptions, but they may just shift the burden/imposition of tax.

• Taxing jurisdictions also are narrowly interpreting these exemptions
IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?

Equipment charges for cloud computing are not taxable in Georgia

- Taxpayer purchased equipment used for remote data processing and server services.
- Taxpayer charges customers an amortized fee for use of the equipment.
- Since customer did not receive title or take possession or control of the equipment, no ‘sale’ has occurred.
  - Charges billed to customers for equipment used in data processing and cloud computing are not subject to tax in Georgia.
  - Tax is due at the time of equipment purchase.

IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?

Canned software and related maintenance qualify for manufacturing exemption in Missouri; locals refuse to assimilate

- Taxpayer engineers and builds custom heavy equipment, and makes purchases of canned CAD software used in the engineering of products for customers.
- Missouri Department stated that purchases of software and yearly maintenance fees are exempt from State sales and use tax, as well as local use tax under the manufacturing exemption.
- Manufacturing exemption does not apply to local sales tax.

LR 7545, Missouri Department of Revenue (Apr. 10, 2015)
New York Department refuses to extend Internet data center exemption to provider of co-location facility

• Taxpayer operates a facility where customers may “co-locate” their own computer servers and equipment.
• Taxpayer charges customers for facility space as well as climate control, security services, online access to stored equipment, and limited technical support.
• Petitioner is not allowed to make purchases exempt from tax as an Internet data center, as they do not host customer websites.

IV. DOES MY PURCHASE QUALIFY FOR AN EXEMPTION?

Texas expands resale exemption to include computer programs sold to Internet hosting provider

- Sale for resale includes the sale of a computer program to a provider of Internet hosting who:
  - acquires the computer program from an unrelated vendor for the purpose of selling the right to use the computer program
  - to an unrelated user of the provider's Internet hosting services
  - in the form or condition in which the provider acquired the computer program.

SB 755, signed by Governor 6/10/2015
V. DOES THIS PURCHASE IMPACT MY COMPANY’S NEXUS FOOTPRINT?
V. DOES THIS PURCHASE IMPACT MY COMPANY’S NEXUS FOOTPRINT?

Pitfalls

• Consider goods vs. services argument again

• The states are largely silent on the issue
V. DOES THIS PURCHASE IMPACT MY COMPANY’S NEXUS FOOTPRINT?

Does remote software access create nexus with the state in which the software is located?

• Most states do not specifically address.
• States often consider:
  – Whether the software constitutes sufficient physical presence in the state, especially considering that the location of the software is usually not in the buyer’s control.
  – Whether any such physical presence can be linked to expanding the buyer’s market in that state.
V. DOES THIS PURCHASE IMPACT MY COMPANY’S NEXUS FOOTPRINT?

Some states have addressed whether nexus is created by software residing in the state by responding to State tax surveys or enacting Statutory or administrative guidance

- Nexus **is not** created by remotely accessing software that resides in **Iowa** or **Hawaii**.

**CCH Nexus Survey (2010)**

- Nexus is not created if a person’s only activity in **Texas** is as a user of internet hosting services.


- The fact that a person owns software that resides on servers located in **Washington** will not be considered in determining whether the person has nexus.

**Wash. Code Ann. § 82.32.532(1).**
VI. WHAT ELSE?
VI. WHAT ELSE?

Data center legislation continues to complicate decision making for taxpayers

• Within the last year, several states have approved legislation intended to attract data centers:
  o Michigan (SB0616 and SB0617, approved 12/23/2015)
  o Missouri (SB149, approved 04/14/2015)
  o Nevada (SB170, approved 06/09/2015)
  o Texas (HB2712, approved 06/10/2015)
  o Washington (SB6057, approved (07/01/2015)

• Issues created by data centers:
  o Sourcing of software
  o Taxability of software
  o Nexus
  o Ownership
VI. WHAT ELSE?

What information is available?

• In an era of mobile workforce, software users could be ANYWHERE

• How do we defend assumptions or default rules under audit, in the absence of good data?

• Talk to your vendors and/or customers to see what their defaults/assumptions are. They are likely to be different than yours.
QUESTIONS?