Navigating the Cloud: A Sales & Use Tax Guide

Prepared by Carolynn S. Iafrate Kranz, CPA, JD, founder and Managing Member of Industry Sales Tax Solutions, LLC and her colleague Iris Kitamura, an associate with Kranz & Associates, PLLC.

It's an undeniable fact that technology evolves faster than the law, and nowhere is this more apparent than in the cloud. Although cloud computing service offerings continue to proliferate, states have been slow in addressing the application of sales and use taxes to the different types of cloud computing service models. Lacking specific legislation, many state taxing authorities increasingly rely on letter rulings, administrative notices and audits to shape their policy regarding the sales and use tax treatment of cloud computing services – all with varying results.

In order to better prepare and plan for future sales and/or purchases, sales and use tax audits, and to mitigate any potentials risks, a business needs to understand the basics of how a state will approach the sales and use taxation of cloud computing services.

Three Service Models

Cloud computing services allow businesses or individuals to access software, data storage space, computing platforms or databases from a cloud service provider for a usage or subscription fee. There are three generally accepted service models for cloud computing with distinct characteristics. The three models are as follows:
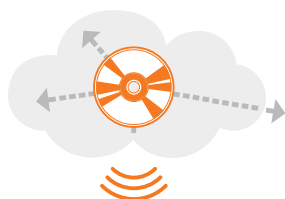
1. **Software as a Service** (SaaS) is the most popular service model and the one most commonly addressed by state taxing authorities from a sales tax perspective. SaaS allows the customer to access the provider's software via a cloud infrastructure. The customer does not exercise any control, custody or possession over the software or the hardware on which it is hosted. Examples of the SaaS model include web-based email, calendars and digital photo applications.
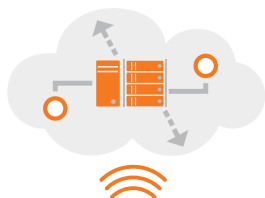
2. **Platform as a Service** (PaaS) allows customers to launch their own applications on the cloud infrastructure using programming languages and other tools supplied by the cloud service provider. For example, developers can use a PaaS platform to develop applications and games using tools, services and computing power supplied by the cloud service provider.

3. **Infrastructure as a Service** (IaaS) allows customers to outsource the equipment needed to support the cloud infrastructure. The cloud service provider provides the customer with storage space and processing power on a network to run software, applications and operating systems. Examples of the IaaS model include web hosting and remote storage service.

As technology and business models evolve, we will see more cloud service providers offering services that integrate elements of all three service models. However, sales and use tax laws still lag behind. As a result, many state taxing authorities are attempting to tax the various cloud service models using existing statutes and regulations based on a state's characterization of the service.

It's the Characterization that Counts
The most important consideration when analyzing the taxability and sourcing of a cloud service is to determine how the transaction will be characterized by the state. Whether the sale of cloud services is subject to sales tax depends on whether SaaS, PaaS or IaaS is characterized as tangible personal property, a service or an intangible. The majority of guidance issued by states so far have addressed the characterization of the SaaS model of cloud computing.

States that impose a sales tax on SaaS transactions tend to classify SaaS into these two primary categories:

1. SaaS is a sale of prewritten or canned software, and subject to the transaction of sales tax as the sale of tangible personal property. For example, in New York, the state's sales tax law expressly includes prewritten computer software in its definition of tangible personal property. As a result, New York has often ruled that SaaS constitutes the sale of prewritten computer software and, as a result, a taxable sale of tangible personal property.

2. SaaS may be classified as a computer or data processing service, which is expressly taxable in many states. For example, Texas generally treats SaaS transactions as a taxable data processing service.

At least one state, Washington, has expressly enacted legislation that specifically imposes a sales tax on "the right to access and use prewritten computer software."

Sourcing the Cloud
If the cloud service is deemed taxable, the next important consideration is to identify the state or states to which the transaction should be sourced. Sourcing is largely dependent on how the cloud service transaction is characterized.

If the cloud service transaction is characterized as the sale of tangible personal property, it will be sourced based on its destination or use. However, determining use is a controversial question. Some states will argue that use is where the software resides on a server, while others will argue that use is where the users are located. For states that tax cloud services as the sale of tangible personal property, the prevailing view is that use is where the user is located.

If the cloud service transaction is characterized as a service, it will be sourced to the location where the benefit of the service is derived, which may include more than one state. Given that sales tax is charged at the time of sale, this can create its own challenges. Indeed, purchasers of cloud services may not know in advance where the services will be used.

In the case of services in which there is a multi-state benefit, a taxpayer should apportion the tax base and tax only that portion of the service for which the benefit is being received in the taxing jurisdiction. Without this information being contained in the contract, a purchaser may deliver to the seller, in conjunction with its purchase, a form disclosing the fact that the service will be concurrently used in multiple jurisdictions or attest to the percentage of use in each taxing jurisdiction.

Upon receipt of such documentation, the seller may charge sales tax based on the percentage of use allocated to each of the applicable taxing jurisdictions in which it

has a collection responsibility (i.e. sales tax nexus). In those jurisdictions, where the seller does not have nexus and does not charge sales tax, the purchaser would be responsible for remitting use tax on the service. In most states, there is no specific form for this allocation, but this type of documentation can be incorporated into the contract to protect all parties in the event of an audit.

Multiple Points of Use
Some states provide for a specific exemption in which sales tax will not apply to the sale of prewritten computer software, remote access prewritten computer software or computer services if the buyer provides the seller with an exemption certificate claiming multiple points of use (MPU). In other words, the software or service will be concurrently available for use in multiple jurisdictions.

An exemption certificate claiming the MPU Exemption relieves the seller of the obligation to collect sales tax; the burden is then placed on the purchaser to remit use tax on the service directly to the applicable taxing jurisdiction based on an apportionment percentage. The purchaser must use a reasonable, consistent and uniform method of apportionment that is supported by its business records. The seller must receive an actual exemption certificate to be relieved of liability for collecting the tax.

Contracts – Reading the Fine Print
In determining the proper tax treatment of cloud services, auditors will often review any supporting contracts or agreements. Whether the agreement is structured as a service agreement or a license to use software may impact the taxability of the transaction.

Even when the service provided is supported by a service agreement (vs. a software license), an auditor may not deem this controlling and will often consider the following factors to determine whether the transaction should be treated as the taxable sale of prewritten computer software:

- Is software transferred to the customer's computers (an applet, for example)?
- Is the software transferred incidental to the service being performed?
- What is the customer's level of access to the software; is the customer manipulating or controlling the software?
- What is the nature and extent of the service being provided? For example, is data being compiled and analyzed by the service provider or simply reformatted?

In drafting contracts and agreements supporting cloud service transactions, the following should be considered to mitigate risks associated with the taxability of the transaction:

- Cloud service providers should be aware that references to "software" or "software as a service," in the agreement or on the company's website, will often lead an auditor to conclude that what is being provided to the customer is prewritten computer software and not a service.
- If possible, agreements should identify the location of users of the cloud service.
- The contract or agreement should include indemnification language to indemnify the cloud service provider with regard to any sales and use tax liability.

Tools for Navigating the Cloud
As states continue to determine their policies, enact legislation and promulgate rules on taxing cloud services, businesses should take the following into consideration to better position themselves in the event of an audit, or when planning for future purchases:

- Determine the possible characterization of the transaction: is the transaction the purchase of tangible personal property, a service or something else?
- Understand what is being purchased; closely examine invoices and agreements supporting the sale, and be aware of how it is being characterized in agreements, on invoices and on the company's website and/or marketing materials.
- Identify the state or states to which the transaction may be sourced. Consider server location and the location of the users benefitting from the cloud service.
- Consider whether the state allows an apportionment of the tax base (for example, multi-state benefit) or provides for a MPU Exemption.
- Determine if the state has issued any guidance with regard to the taxability of cloud services; are there, for example, regulations, rulings and policy statements?

Forecasting the Cloud
Although cloud computing services were relatively unheard of several years ago, such services have become the "new normal" for many companies. Yet, as the proliferation of cloud computing services continue, states have lagged behind in addressing the taxability of the next generation of Internet-based products and services.

The lack of clear tax guidance from states has led to uncertainty for many companies from a sales tax perspective. Nevertheless, using the framework discussed above should assist companies in mitigating sales and use tax consequences as they migrate to the cloud.

About Avalara

Avalara was founded by a team of tax and software industry veterans to fulfill a vision of delivering an affordable, scalable sales tax solution. Thus making what was not economically feasible in the past for mid-sized business not only affordable, but more accurate as well – all with the latest and most innovative technology available. From Bainbridge Island, close to Seattle, Avalara's knowledgeable staff works tirelessly to help customers put the hassles of sales tax compliance out of mind. Avalara's mission is to transform the tax process for customers by creating cost-effective state-of-the-art solutions. The company does so through integrated on-demand, Web-based software services that provide transparent transactions, accurate tax compliance, painless administration and effortless reporting.
More information at : www.avalara.com

About Industry Sales Tax Solutions

Industry Sales Tax Solutions (ISTS), LLC, offers a subscription database containing the sales and use taxability of software related transactions, including everything from traditional software to cloud services. ISTS follows cutting edge developments, updating its content daily to help subscribers comply with this ever changing and complex area of sales and use taxation. ISTS is also proud to be a strategic partner of Avalara, with whom it shares its leading sales and use taxability content for software, digital content, and cloud services. www.industrysalestax.com

Get Started.

To learn more about pricing, view online demonstrations, or chat about AvaTax's capabilities, visit:

www.avalara.com
or call
877.780.4848 today.

Navigating the Cloud_A Sales & Use Tax Guide
© Avalara 2014. 012415