Legislative Analysis

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"CLOUD COMPUTING": SALES/USE TAX ON PREWRITTEN COMPUTER SOFTWARE

Senate Bill 142 without amendment
Sponsor: Sen. John Proos

Senate Bill 143 (Substitute S-1)
Sponsor: Sen. John Pappageorge

Senate Committee: Finance
House Committee: Tax Policy

Complete to 9-16-13

A REVISED SUMMARY OF SENATE BILLS 142 & 143 AS PASSED BY THE SENATE 6-20-13

Prewritten computer software is subject to tax under both the General Sales Tax Act and the Use Tax Act as tangible personal property. The bills would amend the acts in order to exempt granting the right to use prewritten software installed on another person's server from sales and use tax. The bills would do this by excluding that activity from the definition of prewritten computer software (and, by extension, from the definition of tangible personal property).

Each of the bills contains an enacting section that says it is curative and intended to express the original intent of the Legislature concerning the taxation of prewritten computer software.

The term "prewritten computer software" is currently defined in both acts, generally, as "computer software, including prewritten upgrades, that is delivered by any means and that is not designed and developed by the author or other creator to the specifications of a specific purchaser." Both acts specifically include "prewritten computer software" in the definition of "tangible personal property," with the proceeds of the transfer of tangible personal property being subject to taxation under the acts.

Senate Bill 142 would amend the Use Tax Act (MCL 205.92b). Senate Bill 143 would amend the General Sales Tax Act (MCL 205.51a).

FISCAL IMPACT:

As written, the bills would reduce sales and use tax revenue, primarily impacting the School Aid Fund, General Fund, and Constitutional revenue sharing. The exact amount of the reduction is unknown, but it is likely to rise in the future. According to industry reports, total sales of cloud software in the U.S. were between $20 and $22 billion in 2012. Using this number as a base, the amount of forgone revenue is estimated to be

between $10 and $15 million for FY 2013-14. In addition to this amount, the bills' enacting provisions, by making the bills curative, could reduce revenue by an additional $12-$15 million, but in FY 2013-14 only. This sector is expected to grow into the future, with one industry analysis suggesting growth of 19% per year over the next three years, which will cause the amount of foregone tax revenue to increase in the future.

BACKGROUND INFORMATION:

The increased use of cloud computing as a standard business practice raises the question of how cloud computing transactions are treated under the sales and use tax acts—primarily whether accessing the cloud involves a taxable transfer of tangible personal property (e.g., prewritten computer software) or a nontaxable sale of a service.[1]

The term "cloud computing" generally refers to the remote use of networks, servers, infrastructure, and software for various computer applications by consumers. In these transactions, rather than maintaining the hardware, equipment and other IT resources to utilize computer applications (software), consumers access these applications remotely, with the supporting IT infrastructure and software maintained by a service provider.[2] Cloud computing, for instance, allows a business to use a software application (often the proprietary creation of the service provider) without installing it on its computers (and without needing to install periodic updates to the software), and without maintaining much of the usual IT infrastructure that supports the use of that application.[3]

In recent years, several state revenue departments have issued various guidance documents opining on the tax treatment of cloud computing transactions under their respective state tax laws. These viewpoints, many tax practitioners have asserted, have attempted to apply long-standing sales and use tax principles regarding tangible personal property and services to this ever-evolving method of transacting business.[4] On this topic, tax practitioners have noted,

> *State tax agencies have issued several opinions and letter rulings addressing whether [cloud computing transactions] are taxable. Nevertheless, the law in this*

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[1] For an overview see, Cara Griffith, "Sales and Use Taxation of Cloud Computing: A Primer," State Tax Notes, May 6, 2013, http://ntj.tax.org/taxbase/stnmagsample.nsf/ConNavLink/0068STN0447-0001?OpenDocument. See also, Lee Sweet-Maier, Mike Eschelbach, Steve Skiba, and Greg Nowak, "Taxing the Use of Computer Software," presentation before the Michigan Association of CPAs 2012 Michigan Tax Conference, November 7, 2012, http://www.michcpa.org/Content/Files/Public/Documents/Presentations/MTChandouts/MTC2/Q_Taxing_the_Use_of_Computer_Software.pdf.

[2] For an overview of the basic elements and various service and deployment models of "cloud computing" see, Lee Badger, Tim Grance, Robert Patt-Corner, and Jeff Voas, "Cloud Computing Synopsis and Recommendations: Recommendations of the National Institute of Standards and Technology,", National Institute of Standards and Technology, Special Publication 800-146, May 2012, http://www.nist.gov/customcf/get_pdf.cfm?pub_id=911075.

[3] This generally describes a cloud computing transaction known as "software as a service" (SaaS).

[4] See, for example, Dolores W. Gregory, Steven Roll, and Christine Boeckel, "Cloud Computing Emerges as a Tax Conundrum as States Seek to Squeeze 'New Paradigm' Into Old Ways of Thinking," *Tax Management Weekly State Tax Report*, December 9, 2011. See, also, Scott D. Smith, "Peering Through the Clouds of State Taxation: Software as a Service ("SaaS") Does Not quite Fit Existing State Tax Regimes," *Tax Management Weekly State Tax Report*, October 26, 2012.

area is not well defined, as is the taxability of pre-written software delivered on a physical medium or electronically for loading onto the customer's computer.

Most state tax agencies' letter rulings have compared [cloud computing transactions] with the sale of canned software, which under the states' statutes and regulations is treated as the sale of tangible personal property. The rulings state that under a true object test, the purchaser is buying access or the right to use the pre-written software, which is tangible personal property taxable under the applicable law.[5]

Michigan Discussion

At various times the Department of Treasury—through technical advice letters in response to taxpayer requests for guidance and in its stated positions during litigation before the Michigan Tax Tribunal, the Michigan Court of Claims, and the Court of Appeals—has argued that certain cloud computing transactions involving software as a service are subject to sales and use taxes.[6] An April 20, 2009, technical advice letter from the Department of Treasury noted,

It is the department's determination that a right to access/use prewritten computer software is analogous to a license to use prewritten computer software. Therefore, the purchase of a license for the use of prewritten computer software or the purchase of the right to access or use prewritten computer software in Michigan is subject to Michigan tax.

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…When a license to use remote computer software or the access/use of computer software is purchased, that license or access to use is a right or power over the software, which is exercised in Michigan when the purchaser, at a Michigan computer, brings up the software, sends information or instructions to the remote software, or receives back from the remote software, information, documents, or data.

Therefore, your client as an Application Service Provider or the provider of Software as a Service business would be liable for Michigan use tax on the charges to its customers in Michigan.[7]

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[5] Martin I. Eisenstein and Barbara J. Slote, "Let the Sunshine In: The Age of Cloud Computing," *State Tax Notes*, November 28, 2011. For further discussion on these state rulings see a series of *State Tax Notes* articles by Arthur R. Rosen, Leah Robinson, and Hayes R. Holderness – "Cloud Computing: The Answer is 'No'" (October 8, 2012), "Cloud Computing: The Answer is Still 'No'" (February 25, 2013), and "Cloud Computing: Just Say No" (August 5, 2013. The February article includes a discussion of applicable Michigan law.

[6] Arthur R. Rosen, Leah Robinson, and Hayes R. Holderness, "Cloud Computing: The Answer is Still 'No'," *State Tax Notes*, February 25, 2013. The authors cite an April 20, 2009 letter by the department asserting the taxable nature of software as a service transaction. They also refer to a January 31, 2007 technical advice letter in which department held that a similar SaaS transaction was not subject to sales tax.

[7] Unpublished, on file with the HFA. The Department of Treasury notes that a technical advice letter "is issued by designated personnel in response to an inquiry by a taxpayer for technical assistance. Technical Advice Letters are based upon statutes, administrative rules, regulations, and court decisions having precedential value. These documents are not published and may be relied upon only by the taxpayers requesting their issuance." See Michigan

A September 7, 2012 technical advice letter explains the rationale and analysis used by the department in determining the taxable nature of a cloud computing transactions.

> *The position of the Department is evolving as the "cloud computing" market evolves. Currently, the Department's position as to whether a purchase of a product involving prewritten computer software is subject to the General Sales Tax Act or the Use Tax Act depends on the facts and circumstances of each transaction.*
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> *In some instances, a transaction may be considered a single mixed transaction including both taxable tangible personal property (license to use prewritten software) and an exempt service. In such a situation, the 'incidental to service' test outline by the Michigan Supreme Court in Catalina Marketing Sales Corp. v. Department of Treasury, Docket No. 121673, 470 Mich 13 (2004),[8] would be applied to determine the nature of that transaction, and whether sales or use tax would apply.*
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> *In general, the determination as to whether a specific transaction triggers Michigan use/sales tax involves an analysis of the specific facts of a transaction. However, if the transaction is predominantly the lease/license of prewritten software it will be subject to Michigan sales/use tax assuming the transaction is sourced to Michigan and that no exemption otherwise applies to the transaction.*[9]

Under the sales and use tax act, proceeds from the transfer of "tangible personal property" are subject to taxation. Both acts specifically include "prewritten computer software" in the definition of tangible personal property.[10] In Revenue Administrative Bulletin 1999-5, the department indicated that prewritten computer software includes software delivered electronically, stating,

> *The Michigan statutes define sales of canned [prewritten] software as sales of tangible personal property and sales at retail for the Use Tax Act and the Sales Tax Act, respectively, without distinguishing between methods of delivery…Accordingly, neither the software medium nor the method of delivery (i.e., tangible or electronic form) has any bearing on the taxability of the software. Canned computer software programs number in the thousands and are*

Department of Treasury *Issuance of Bulletins and Letter Rulings,* Revenue Administrative Bulletin 1989-34 (April 25, 1989), http://www.michigan.gov/treasury/0,1607,7-121-44402_44415_44416-7320--,00.html.

[8] http://publicdocs.courts.mi.gov:81/OPINIONS/FINAL/SCT/20040505_S121673_53_catalina4nov03_op.pdf.

[9] Unpublished. On file with HFA.

[10] The Use Tax Act (MCL 205.92b) defines "computer" as "an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions." The act (MCL 205.92b) further defines "computer software" as "a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task."

available for purchase and download via networks, intranets, and the Internet, or electronic methods. All of subject to Michigan sales or use tax.[11]

Great Lakes Home Health Services, Inc. v. Michigan Department of Treasury

Among the issues before the Michigan Tax Tribunal in this case was whether GLHHS's use of data services provided by out-of-state application service providers (ASPs) was a taxable "use" of prewritten computer software or the purchase of an exempt service. GLHHS purchased a license from two data providers that allowed GLHHS to enter data into a program (via a website). The software maintained by the ASPs was used to analyze the data provided by GLHHS and generate a multitude of reports. In both cases the software used was not custom made for GLHHS and was not installed/downloaded by GLHHS onto its computers and servers, but remained on the servers of the ASP. GLHHS argued that because it did not have direct access to the software, there was no taxable "use" of it. Treasury argued that GLHHS "may not be allowed into the code of the software, but it is allowed into the functionality of the software to see its data and to see the data relationships that that code instructs it to perform."[12] The tax tribunal held that "accessing the functionality of the software as described by the witnesses and the license agreements is a taxable use of prewritten computer software, in the same manner as if the software was physically delivered to Michigan for use on [GLHHS's] computers."[13] This case has been appealed to the Court of Appeals.[14]

Thomson Reuters (Tax and Accounting) Inc. v. Department of Treasury

At issue in this case pending before the Court of Appeals, on appeal from the Michigan Court of Claims, is whether Thomson Reuter's remote access tax and accounting information service, known as Checkpoint, involves the use of taxable prewritten computer software or a nontaxable service.[15] Accessed by consumers via the Internet, the service provides information on international, federal, state, and local taxation issues, financial accounting issues, SEC documents, and access to industry publications. It's maintained on servers located in Minnesota, with no software downloaded onto the computers/servers of the consumer.

In granting the Department of Treasury's motion for summary disposition, the Michigan Court of Claims held that Checkpoint involves the use of prewritten computer software, noting that prior iterations of the service (via a CD-rom) were taxable and the information provided, now remotely accessed, is still the same. In this instance, in the court's view, the nature of the product/service didn't change, just its method of delivery.

In its filings before the Court of Appeals, Thomson Reuters has argued that the product actually provided through Checkpoint is just information, and information is not tangible

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[11] Michigan Department of Treasury, *Sales and Use Taxation of Computer Software*, Revenue Administrative Bulletin 1999-5, approved September 28, 1999, http://www.michigan.gov/documents/rab99-5_109067_7.pdf.

[12] *Great Lakes Home Health Services, Inc. v. Michigan Department of Treasury*, Michigan Tax Tribunal, Docket No. 410962, Proposed Opinion and Judgment, August 30, 2012.

[13] Ibid. This aspect of the proposed opinion and judgment was confirmed by the tribunal in the final opinion issued on October 23, 2012, http://www.michigan.gov/documents/taxtrib/410962_429072_7.pdf.

[14] Court of Appeals docket number 315835.

[15] Court of Appeals docket number 313825

personal property (citing Texas case law and drafting documents of the Streamlined Sales and Use Tax Agreement). Moreover, they argue that the method of delivery does matter. Physical books are taxable, whereas digital books are not under the Michigan sales and use tax acts. Physical books are taxable because they are delivered in a physical (tangible) form. Electronic books, though the content is the same, are not taxable because they are not tangible. In this instance, a prior version was Checkpoint was taxable because it was provided in a taxable (tangible) form, but that tax status is not relevant in determining whether Checkpoint is also now taxable, as the Court of Claims had decided. In their view, Checkpoint delivers an intangible product.

Thomson Reuters also argues that Checkpoint is not software that is delivered to consumers. The software to run the program is maintained on servers in Minnesota, with consumers unable to access its proprietary codes. Consumers' interface with the program requires the use of JavaScript (computer programming language), which is common for many other websites. An expert appearing on behalf of Thomson Reuters notes that,

> *An analysis based solely on whether a product contains software is not adequate because, in our modern world, nearly everything contains software. Cars, DVD players, microwave ovens, and even small children's toys contains software that is both essential and integral to the operation and functionality of those process, but that does not mean that a new Cadillac <u>is</u> software, "prewritten" or otherwise.*

The Department of Treasury argues that Checkpoint is "prewritten computer software" as defined within the sales and use tax acts that is clearly "used" by Michigan consumers. Citing experts for both parties, Treasury notes that Checkpoint involves the use of computer programming codes (i.e., software) within the Thomson Reuters servers and within the computers of the individual consumers that enables the consumers to interface with the server, allowing Checkpoint to function. Checkpoint would not exist without the programming codes, and consumers could not use or access Checkpoint without the appropriate programming code (JavaScript) residing on their computers.

Treasury further argues that the fact that Checkpoint is web-hosted (remotely accessed) does not change the tax status of the product. The statutes include software that is "delivered by any means" which, in the department's view, includes web-hosted software products. Drawing a parallel between physical books being subject to taxation while their electronic versions are nontaxable is not on point because, in the case of prewritten computer software, the statute specifically includes products that are not delivered in a physical format.

Noting the Tax Tribunal's opinion in *Great Lakes Home Health Care Services*, the department notes that consumers are engaged in a taxable "use" of Checkpoint because the licensing agreements grant them access to the functionality of the software and their control over how the web browser interfaces with the server in their access and use of the program.

The department's September 2012 technical advice letter indicates that in cloud computing transactions the department would analyze the transaction utilizing the "incidental to service" test outlined by Michigan Supreme Court in *Catalina Marketing Sales Corp. v. Department of Treasury* (2004). This test is to be used to determine whether a single transaction involving both the transfer of tangible personal property and the sale of services is, for tax purposes, principally a taxable transfer of tangible personal property or a nontaxable service. The factors articulated by the Court in *Catalina* include,

1. What the buyer sought as the object of the transaction;
2. What the seller or service provider is in the business of doing;
3. Whether the goods were provided as a retail enterprise with a profit-make motive;
4. Whether the tangible goods were available for sale without the service;
5. The extent to which intangible services have contributed to the value of the physical item that is transferred; and
6. Any other factors relevant to the particular transaction.

In applying these factors Thomson Reuters argues, among other things, that Checkpoint customers sought the information provided by the Checkpoint, not the software that powers it. They also note that software that powers Checkpoint is not available for sale.

Treasury, in response, argues, among other things, that Checkpoint customers sought to use the software (web-interface) to provide them with the information. To the fourth criterion, the department also notes that information provided cannot be extracted from the software that produces it.

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