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BILL ANALYSIS

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Senate Bills 82 and 83 (as reported without amendment)
Sponsor: Senator Peter MacGregor (S.B. 82)
Senator John Proos (S.B. 83)
Committee: Finance

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RATIONALE

In recent years, "cloud computing" has been gaining in popularity. The term "cloud" is a metaphor for the internet, and the phrase "cloud computing" generally refers to a practice in which the infrastructure or servers of a company such as Compuware, Apple, or Google, are used to remotely store and manage the data of its clients, which might include private companies, governmental agencies, and individuals. Cloud computing is considered advantageous because clients can increase or change computing capabilities or capacity without purchasing new equipment, training personnel, or investing in licensed software. Customers may receive cloud computing services by subscription or on a pay-per-use basis. Now that cloud computing has become more prevalent, some are questioning Michigan's tax treatment of transactions in which the service is provided. The taxation of these transactions has been challenged at least three times in Michigan courts, and thus far, decisions have found in favor of the taxpayers. (Please see **BACKGROUND**, below, for a discussion of *Auto-Owners Ins. Co. v. Department of Treasury*, *Rehmann Robson & Co. v. Department of Treasury*, and *Thomson Reuters, Inc. v. Department of Treasury.*)

Reportedly, the Department of Treasury in the past issued a letter indicating that such a transaction was not subject to the sales or use tax, but the Department has since taken the position that the tax applies. In order to assist the businesses that rely on cloud computing services, as well as make the State attractive to the companies that provide them, it has been suggested that tax exemptions be enacted.

CONTENT

Senate Bills 82 and 83 would amend the Use Tax Act and the General Sales Tax Act, respectively, to exclude from the definition of "prewritten computer software" granting the right to use prewritten software installed on another person's server.

The Acts impose a 6% tax on the sale or consumption of tangible personal property, and each Act's definition of "tangible personal property" includes prewritten computer software. The Acts define "prewritten computer software" 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. Under the bills, the term would not include granting the right to use prewritten computer software installed on another person's server.

Each bill states that the amendment "is curative and is intended to express the original intent of the legislature concerning the taxation of prewritten computer software" under the Act.

MCL 205.92b (S.B. 82)
205.51a (S.B. 83)

BACKGROUND

As mentioned earlier, the taxation of cloud computing services has been challenged in Michigan courts. Three decisions were handed down in 2014 by either the Court of Appeals or the Court of Claims. All three decision ruled against the taxation of such services using similar rationales. Each case is discussed below.

Auto-Owners Insurance Co. v. Department of Treasury (Case No. 12-000082-MT)

Auto-Owners is a Michigan corporation headquartered in Lansing, Michigan. It engages in third-party provider transactions to service its clients and independent agents. The transactions often involve complex computing arrangements, and can be roughly grouped into six categories: insurance industry providers, marketing and advertising providers, technology and communication providers, information providers, payment remittance and processing support providers, and information and technology providers of equipment maintenance support.

The Court of Claims found on March 20, 2014, that all of the transactions in question were not subject to Michigan use tax. The Court first analyzed whether the transactions in question involved "tangible personal property", and specifically "prewritten computer software", as defined in the Use Tax Act. Under the definition, for computer software to constitute tangible personal property, it must be "delivered by any means". The Court found, "When Auto-Owners engaged in its various transactions with third-party providers, there is scant evidence on the record that it took 'delivery' of the prewritten computer software within the common and approved meaning of the word. The software used to produce the results that Auto-Owners obtained was not handed over, left, or transferred."

The Court also determined that the requisite "use" of the software was not made under any of the stated facts in the case. Even if Auto-Owners had used the prewritten computer software within the meaning of the Act, the Court held that any such use was merely incidental to the services rendered by the third-party providers and would not subject the overall transactions to use tax. In making this determination, the Court applied the "incidental to services" test adopted by the Michigan Supreme Court to determine whether a business transaction that involves both the provision of services and the transfer of tangible personal property is a service or a tangible property transaction. In the transactions at issue, Auto-Owners sought out a service, not software. The underlying software used to provide the service was generally not available to customers without the service, and the value of the software was incidental to the services offered alongside it.

The Department of Treasury has appealed the decision to the Court of Appeals.

Thomson Reuters, Inc. v. Department of Treasury (No. 313825)

Thomson Reuters sells information products including CD-ROM computer software and online-research products and tools. The case centered on a product called Checkpoint, which was an online tax and accounting research program that provided subscribers access to a wide collection of information. The Department of Treasury determined that the sale of Checkpoint subscriptions constituted the sale of taxable "prewritten computer software"; however, the plaintiff asserted that it was primarily the sale of a service. The Court of Claims had previously found on behalf of Treasury, reasoning that the case involved an evolution of services, and because the product had been taxable when it was in book or CD format, it remained taxable. The Court of Claims also concluded that the primary purpose of selling subscriptions was the sale of tangible personal property because what the customer wanted was the "information", which was tangible personal property.

The decision was appealed to the Court of Appeals, which issued an unpublished opinion on May 13, 2014. The Court noted that the use tax applied, by its plain language, to tangible personal property, not to services. Applying the Michigan Supreme Court's "incidental services test", the

Court of Appeals found that in this case, the transfer of property was incidental to the service of providing to subscribers information relevant to their needs. It also determined that the manner in which Checkpoint was marketed indicated that the plaintiff was in the business of selling an information service, distinct from its print and software products. While it may have been true that prior versions of the product constituted prewritten computer software subject to the use tax, the nature of the product had changed, thus changing the nature of the transaction. In whole, the transaction at issue was primarily the provision of a service, not the transfer of tangible personal property. Therefore, the imposition of the use tax was improper.

Rehmann Robson & Co. v. Department of Treasury (Case No. 12-000098-MT)

This case also involved the Checkpoint software. Rehmann is a large accounting firm headquartered in Saginaw, Michigan, that subscribed to Checkpoint. The Court of Claims decided on November 26, 2014, that Rehmann's subscription to Checkpoint was a nontaxable service rendered through an online information service. In addition to relying on the findings of *Thomson Reuters*, the Court reasoned that the software used to produce the results that Rehmann obtained from Checkpoint was not handed over, left, or transferred. What was transferred was tax and audit information that had been processed using the Bureau of National Affairs and Thomson Reuter's own software, hardware, and infrastructure. It also found that Rehmann did not exercise a level of control over the software sufficient to qualify as "use" under the Use Tax Act (UTA). Finally, any use of the software by Rehmann was merely incidental to the services rendered, and would not subject the overall transaction to the use tax.

The decision included two noteworthy observations. First, with the evolution of "on-demand" access to third party providers' networks, servers, and application software, businesses no longer need to install, download, or transfer software to a computer. The technology allows access to another's computer power with little or no transfer of tangible personal property. The Court also noted, "Unless and until the Legislature expresses an intent to specifically tax transactions involving the remote access to a third party provider's technology infrastructure, transactions such as those described in this case do not fit under the plain meaning of the UTA and are not properly subject to the tax."

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

"Cloud computing" is a very broad term that encompasses many different concepts, practices, uses, and applications. Although there is no universal definition, virtually all descriptions of cloud computing refer to it as a service. No transfer of ownership is involved when cloud computing services are provided, and the clients who contract for the services receive no tangible product. When the definition of "prewritten computer software" was added to the statutes in 2004, cloud computing was unheard of, and the purchase or sale of software involved the delivery of material goods. Since then, technology and practices have evolved. With the evolution of "on-demand" access to third-party providers' networks, servers, and application software, businesses no longer need to install, download, or transfer software to a computer. The technology, as it stands today, allows for access to another's computer power with little or no transfer of tangible personal property, including software. What formerly was a product has migrated to a service.

Subjecting cloud computing transactions to the sales and use taxes is inconsistent with Michigan's tax treatment of most services. In addition to imposing a cost on the State's businesses and residents who rely on cloud computing, the Department of Treasury's varying positions have resulted in uncertainty and confusion, as well as the cost of litigation both to the Treasury and to taxpayers.

An example given by Kelly Services helps illustrate the situation. The company, which is headquartered in Troy, Michigan, provides temporary staffing for clients across the country, as

well as internationally. Kelly Services relies on cloud computing vendors to obtain workers' "time card" information. The clients deliver the information electronically to the vendors, which then deliver the data electronically to Kelly Services. When the vendors send a bill to Kelly Services, some include tax and others do not, due to the confusion over the taxation of cloud computing transactions in Michigan. Compounding the problem is that a vendor might collect time card information from Kelly Services clients in multiple states, including Michigan, and collect tax on 100% of the transactions, even though only a small portion occurred in this State.

If the Department of Treasury previously determined that a cloud computing transaction was not taxable, and there has been no change in the statute or rules, it is not clear why the Department would reverse its stance.

Response: Evidently, a number of years ago, the Department issued an incorrect technical advice letter indicating that a cloud computing transaction was not taxable. That was corrected and, since then, the Department has issued technical advice letters holding that these transactions are taxable. Although technical advice letters do not set policy or precedent, the Department's position has been consistent and is well known. Furthermore, there is still some question as to whether a cloud computing transaction involves strictly the provision of a service with no materiality whatsoever.

Supporting Argument

Not taking action on the taxation of cloud services has left the State open to a growing liability from demands for tax refunds. Since the decisions made in 2014 by the Court of Claims and the Court of Appeals, it is becoming clear to businesses that they should not be assessed these taxes, in the opinion of Michigan courts. Some businesses are reportedly holding the taxes in escrow and withholding payment until the current cases have run through the court system, but many others have paid the tax and will likely seek refunds if Treasury ultimately loses. The longer the State goes without taking action, the greater the potential liability becomes. In 2011, it was estimated that the total revenue loss in fiscal year (FY) 2011-12 would be approximately $5.0 million to $8.0 million if cloud computing services were excluded from the sales and use tax. That number included both refunds due and foregone revenue because of the change. Currently, the Department of Treasury estimates that the cost of refunds, if the bill became law, would be approximately $30.0 million to $100.0 million.

Supporting Argument

The State should not tax itself out of the opportunity to attract the cloud computing industry. The servers used for data storage and management require considerable space, and Michigan has abundant brownfield sites with large structures that could be used. Since the infrastructure can be located anywhere, however, a service provider might be inclined to select a state that does not require it to collect tax on its services or require its customers to pay tax when they purchase or subscribe to the services. The proposed tax exemptions could encourage the industry to bring its business to Michigan, creating jobs and expanding the State's economic base.

Opposing Argument

The fact that a software program is stored on "another person's server" should not determine taxability. Although people usually think of cloud computing as the use of services at a location distant from the site of the physical infrastructure, software installed on another person's server could be across the country or right next door.

Furthermore, the State already has determined in statute that prewritten computer software is tangible personal property for purposes of the sales and use taxes. When a person "buys" a software program, he or she is purchasing a license to use the program, not the software itself. Also, when an individual buys a software program and when a business contracts for a cloud computing service, some software evidently is installed on the individual's or the business's own computer. Therefore, the nature of the transaction is the same regardless of whether a person buys a program or enters into a contract with a cloud computing vendor, and the tax treatment should be the same.

Rather than simply exempting cloud computing transactions from the sales and use taxes, the State should take a deliberative and comprehensive approach to the taxation of electronic commerce. That approach needs to be consistent with the streamlined sales and use tax laws, and any tax exemption should be narrowly written.

Response: In both online service and "software as a service" (SaaS) transactions, the customer does not enter into an agreement to license the software, but is merely subscribing to a service. Michigan courts have ruled that in these transactions, the software is not "delivered" by any means, nor is it under the control of the subscriber for the purpose of defining "use". Access to another's computer servers is not the same as use of the software contained on those servers. Finally, even if the software is somehow delivered and used within the meaning of the Use Tax Act, any such use is merely incidental to the service being provided, and would not subject the overall transaction to the use tax. Also, if the company providing the service is located in a jurisdiction subject to sales tax, the software purchase would already have been taxed when it was originally purchased. If the business then uses the software to provide a service for its clients, it is inconsistent to also tax those users for the software purchase.

Opposing Argument

This legislation could present a significant cost to the State's General Fund budget and the School Aid Fund. Because cloud computing is a rapidly growing part of the economy, the potential revenue loss could grow as well.

Response: The revenue loss could be mitigated or reversed if businesses chose to stay or locate in Michigan due to the proposed tax exemptions. On the other hand, if the law is not changed, the State might lose businesses, tax revenue, and jobs.

Legislative Analyst: Ryan M. Bergan

FISCAL IMPACT

The bills would reduce State revenue by an unknown amount that would likely increase over time. According to the Michigan Department of Treasury, the annual revenue loss in FY 2015-16 would total approximately $70.0 million, although it is unknown what portion of this would represent actual revenue losses from tax that is currently being paid or would represent foregone revenue that the State is not currently collecting because taxpayers believe the transactions are not taxable. If the bills became effective during FY 2014-15, revenue would decline by some portion of the annual estimate. To the extent that the industry activity increases and/or would increase as a result of the bills, the revenue impact would be larger.

As currently written, the bills would exempt a wide array of software-related activity. IBM's website defines "cloud computing" as "the delivery of on-demand computer resources--everything from applications to data centers--over the internet on a pay-for-use basis". While most of the terms in this definition are not defined in current law or in the bills, the bills would exempt a broader spectrum of activity than what would be included in IBM's definition. For example, if a taxpayer purchased and owned software and installed it on a server owned by another person (perhaps a leased server), the bills would appear to exempt the transaction from taxation. Similarly, the bills would appear to exempt sales and use no matter how essential or incidental the access was to the service or goods being purchased. For example, the bills would not distinguish between accessing a word processing program to compose documents essential to a taxpayer or merely accessing software on a website to enter data for a later service such as billing or analysis.

The 2012 Economic Census reports that software publishers nationally had total receipts of approximately $170.0 billion. The share of that total derived from Michigan sales is unknown, as is the portion that would be affected by the bills; however, if Michigan's share equaled the Michigan share of Gross Domestic Product and 25% of the sales were affected by the bills, the potential sales and use tax revenue from this activity could total approximately $66.0 million.

It is estimated that the enacting sections of the bills, expressing legislative intent that the legislation "is curative", would reduce revenue by an unknown amount depending on the degree to which taxpayers have paid tax on transactions affected by the bills. The Department of Treasury estimates that the loss could be between $30.0 million and $100.0 million. Any loss of revenue attributable to the enacting provisions would likely affect only the first fiscal year in which the bills would be effective.

Any revenue loss would affect General Fund revenue, School Aid Fund revenue, and revenue sharing to local units of government, with the relative impact across the funds depending on the relative magnitude of reduction in sales tax revenue compared to the reduction in use tax revenue.

Fiscal Analyst: David Zin

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