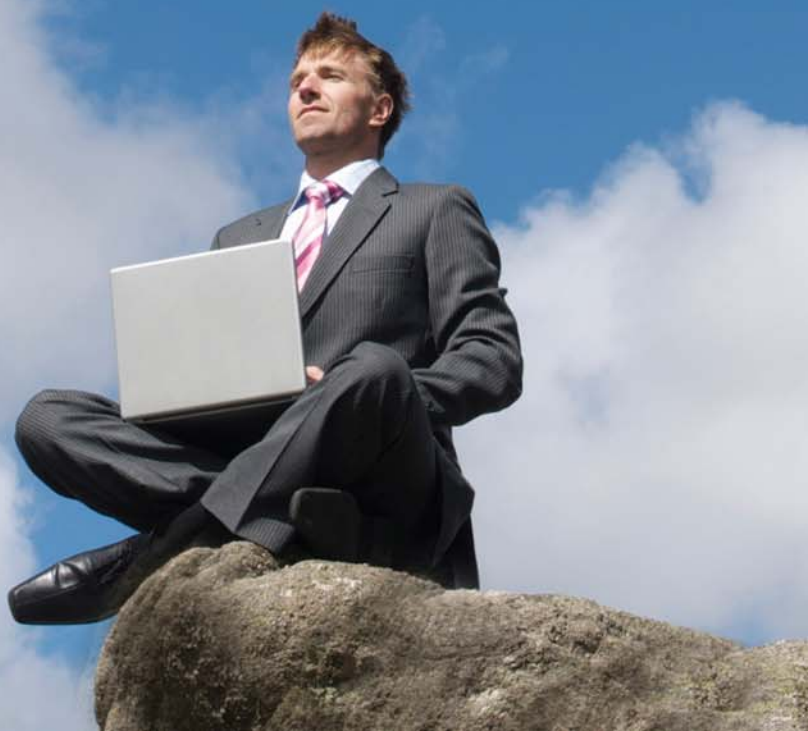
Transcending the Cloud

A Legal Guide to the Risks and Rewards of Cloud Computing

Pennies From Heaven – U.S. State Tax Implications Within Cloud Computing



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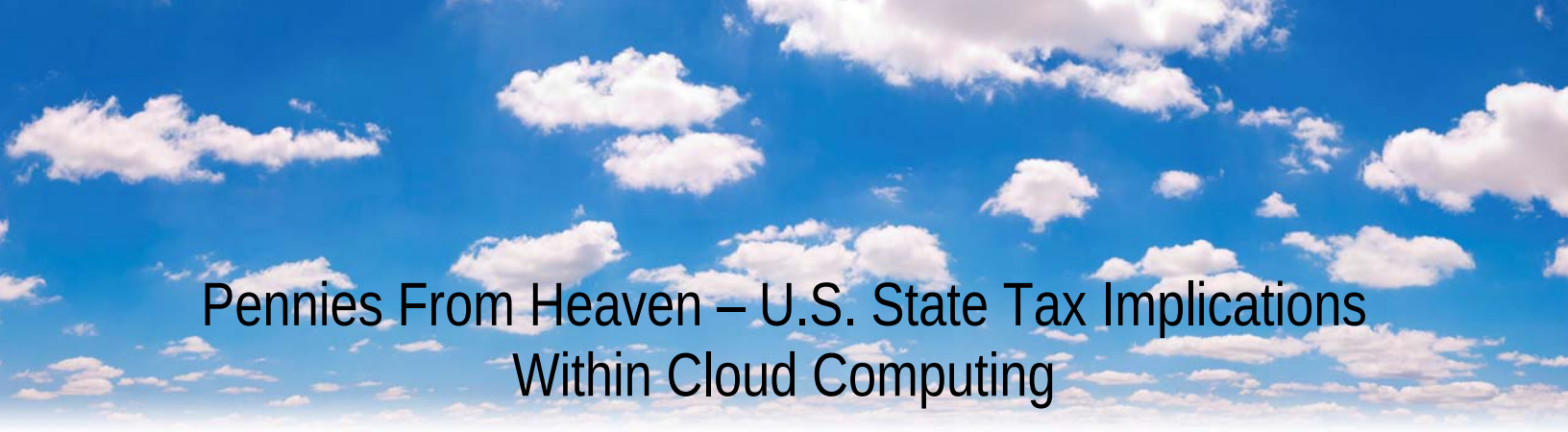

Pennies From Heaven – U.S. State Tax Implications Within Cloud Computing

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Introduction—The Landscape

Faced with growing budget deficits and decreasing tax bases, some states in the United States are searching for new and broader avenues for revenue generation. Digital products and electronic commerce are two of the most notable, recent targets in the states' search for revenue. Just as many states have begun to expand their sales-tax laws to reach digital products, such as music, software, and audio-visual downloads, the cloud computing phenomenon, and the shift from downloaded products to Internet-based access to applications and data "in the cloud," has the potential to once again take a large segment of digital transactions outside of the states' taxing reach. At the very least, cloud computing promises to raise a series of new questions, the most basic of which is how states will presumably impose sales tax on digital transactions.

Currently, 46[1] U.S. states impose some sort of sales tax, at least 12 states impose a sales tax on digital goods, and another 17 states are likely to consider legislation to impose a sales tax on digital transactions this year. Thus, sales-tax issues are likely to be a significant concern not just for cloud computing vendors, but also for most consumers of cloud computing services with U.S. operations.

Taxing Digital Transactions—Sales Tax Implications for Cloud Computing Vendors

Historically, state sales taxes were taxes imposed on sales of tangible personal property, and a few specified services. However, as the U.S. economy has evolved, states have moved to expand their sales-tax bases to include more services, as well as digital products and transactions. Some states have enacted legislation imposing sales tax on specific digital transactions, such as music downloads, either through an expansion of the definition of tangible personal property, or through the creation of a new class of taxable transactions. The rationale behind this legislation has been to ensure that, as consumers substitute purchases of digital products for their tangible counterparts, state sales-tax bases do not continue to erode.

Recently, and perhaps with the emergence of new digital technologies like cloud computing in mind, some states (*e.g.*, Kentucky, North Carolina, Washington, and Wisconsin) have expanded their sales-tax laws even further, by enacting provisions that tax digital products with service-like characteristics, such as access to data and data processing[2]. Notably, Washington imposes sales tax on digital services, which is broadly defined to include a "service that is transferred electronically that uses one or more software applications."[3] This expansion of state sales-tax bases to encompass "digital services" is evidence that states are gaining awareness of the Internet-based nature of cloud computing. This development also crystallizes an important state sales-tax question for cloud computing vendors—namely, what components of cloud computing pose state tax implications?

Pinning Down the Clouds

The key issues in applying state sales-tax laws to cloud computing are: (i) nexus (does a cloud computing transaction have sufficient contacts with a state in order to allow the state to impose sales tax on the transaction?); (ii) taxability (are cloud computing transactions products or services of a type that are subject to state sales tax?); and (iii) sourcing (which state (or states) can tax a particular cloud computing transaction?). Each of these questions is addressed below.

The answers to these questions vary by state, and are neither definite nor consistent. For example, for purposes of determining taxability, some states may view a cloud computing transaction as the provision of a taxable computing service. Other states may characterize a cloud computing transaction as a series of distinct transactions—each with its own sales-tax treatment. Thus, a state could characterize a cloud computing transaction as the provision of computing services, coupled with a lease of server space, and the sale of a software product.

Nexus

Before the complex issues of taxability and sourcing can be addressed, a vendor of cloud computing services must first consider the threshold issue of nexus. "Nexus" is the term used to describe the amount and degree of business activity that an entity must have in a state before the state can subject the entity to state tax. Nexus determinations tend to be highly fact-specific, and rely on an application of a complex mix of U.S. constitutional and state statutory law. Cloud computing adds another layer of complexity to the determination of whether sufficient contacts exist to create nexus for sales-tax purposes. If a transaction occurs "in the cloud," does the transaction have sufficient contacts with any state to allow the state to pull the cloud, and its users, down to earth (*i.e.*, establish nexus)?

Although at this time there is no definitive answer to the question of how the concept of sales-tax nexus applies to a cloud computing transaction, there is a base of authority to guide taxpayers, states, and the judiciary as cloud computing becomes the norm. In the 1992 case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the court ruled that before a state could impose a sales-tax collection obligation on an entity, the Commerce Clause of the U.S. Constitution required the entity to have a "substantial nexus" with the state, as indicated by physical presence. Since *Quill*, the challenge has been to determine how much and which type of physical presence is sufficient to satisfy *Quill*'s requirement of "substantial nexus."

In the case of cloud computing service providers, questions are likely to arise regarding whether a vendor providing cloud computing services to a customer in a state has sufficient nexus with that state to be required to collect the state's sales tax. In order to satisfy the "substantial nexus" requirement, must a vendor own or use servers located in the state? Or is it sufficient that the vendor is licensing software to customers in the state and a portion of the software resides, at least temporarily, on the customer's computer located in the state? Although a handful of states have provided a legislative safe harbor for presence of data on servers located within those states, the United States Supreme Court has yet to revisit its decision in *Quill* as to whether the mere presence of electronic data is a physical presence sufficient to establish nexus. Accordingly, the elements of and issues inherent to the taxability of cloud computing transactions are currently being addressed on a state-by-state basis.

Taxability of Services, Leases, and APIs

A cloud computing transaction typically involves providing a consumer with a combination of an Internet-based hosting platform, support for programming languages, disk space, a back-end database, and bandwidth. The signature characteristic of cloud computing is that it allows a consumer to simultaneously engage servers, storage, and bandwidth on an "as needed" basis. The result is that the customer may be consuming services (computer and data services) and space, while simultaneously purchasing applications and the right to access data (lease of server space). Additionally, there is a plethora of cloud computing types. For example, cloud computing vendors may offer: increased computing power or storage space (infrastructure); a platform on which providers may develop and access specific applications (service and data platforms); and customer-specific software development and hosting. With respect to the latter, a customer-specific application may be created that can be constantly updated and manipulated to interface with a vendor's database. An application program interface (API) then allows the customer-specific application to interact with the API, often across multiple servers. In sum, cloud computing transactions may be described as a web of interactions between vendor and consumer, involving multiple, simultaneous exchanges of services and products occurring in numerous locations.

From a state tax perspective, this web of interactions presents many issues, the most significant of which are:

- How will a state elect to impose sales tax on a cloud computing transaction that bundles together the sale of services, with access to server or disk space (which would likely be structured through a lease), and the ability to interface with vendor applications? Each of these services or products would typically be afforded very disparate state tax treatment if sold separately.
- How will a state elect to tax customer-created applications that interact with its database? Will these applications be deemed to be akin to custom software, which is exempt in many states?

While it is unclear as to how the states will address the taxation of cloud computing, there is some indication as to the direction in which some states are heading. The Washington tax referenced above on digital services is a key example. By encompassing a broad range of digital services, including those that utilize software applications—the very essence of cloud computing—Washington's tax on digital services is evidence of one state adopting a very broad approach to bundle the elements of cloud computing into a single taxable transaction.

Outside of the cloud computing context, some states tax transactions that involve the provision of a combination of taxable and non-taxable goods and/or services by looking to the essence of such "bundled" transactions. In contrast, other states have taken the position that if a bundled transaction involves the provision of more than a de minimis amount of taxable goods or services, then the entire transaction is taxed. The states that have opted for this "all or nothing" approach to bundled transactions will likely opt to treat cloud computing transactions as taxable in their entirety, regardless of any elements that might be nontaxable if provided separately. However, other states may allow vendors to bifurcate cloud computing transactions between taxable elements (such as generic or non-custom applications and data services) and exempt products (like access services, custom-applications, and leases of server space, dependent, of course, on whether there is nexus.

Sourcing

While the characterization of cloud computing components as taxable or nontaxable is an essential part of understanding the state tax implications of cloud computing, it is the first level of a two-part inquiry. Both the characterization and the source of the taxable commodity must be determined in order to understand the overall state tax implications of a transaction. The second part of the inquiry—sourcing—is important in cloud computing because it determines which state may tax a particular transaction. The states use two traditional methods for sourcing transactions for sales-tax purposes: origin- and destination-based sourcing. Under the origin-sourcing method, a transaction is generally taxed by the jurisdiction where the taxable service or product originates, while under the destination-sourcing method, a transaction is generally taxed by the jurisdiction where the taxable service or product is consumed. Currently, most states use a destination-based sourcing.

Cloud computing raises a multitude of novel sourcing issues for states using both the origin- and destination-sourcing methods. For example, in the minority of states that use the origin-sourcing method (*e.g.*, Arizona, California, Illinois, Mississippi, Missouri, New Mexico, Pennsylvania, Tennessee, Texas, Utah, and Virginia), the sourcing of cloud computing services will raise complex issues because the very nature of cloud computing may make it difficult, if not impossible, to attribute the origin of the service to any one jurisdiction. Even for those states that employ destination-based sourcing, the flexible and interactive nature of cloud computing presents unresolved issues. For example, what is the destination of a cloud computing transaction in which a consumer accesses multiple vendor servers with no discernable location, or if applications are created and data is accessed and stored for the consumer's use on multiple servers? Overall, the true hallmark of cloud computing—the ability for vendors and consumers alike to access and interact with a completely Internet-based scheme—obviates the ability to determine where the consumer is located and where it is using the objects of cloud computing.

Metering

One unique and potentially helpful characteristic of cloud computing from a state sales-tax perspective is that cloud computing services can be (and often are) sold on a metered basis. Thus, cloud computing vendors typically charge customers only for actual use of bandwidth computing time, and disk space. This metering may allow the various components of a total cloud computing transaction to be itemized into discrete charges. From a sales-tax perspective, metering may allow some vendors to itemize their charges in such a manner that their invoices show separate charges for the taxable and non-taxable portions of a cloud computing service. However, not all cloud computing vendors are currently selling their services on a metered basis. Instead, many vendors treat cloud computing as a bundled transaction, and invoice customers a single charge for what may otherwise be a combination of taxable and exempt components.

Summary of Essential State Tax Considerations

In summary, cloud computing raises numerous and unresolved state sales-tax issues. These issues are likely to be resolved piecemeal on a state-by-state basis. However, as they are being resolved, cloud computing will present vendors and consumers with potential sales-tax planning opportunities. In many cases, cloud computing will make it possible for consumers to obtain many of the benefits that were once associated with taxable purchases

of software and digital products, through the purchase of a nontaxable service. In addition, because of the uncertainties regarding the sourcing of cloud computing transactions, vendors and consumers may have opportunities to achieve more advantageous sourcing for transactions by moving them to the cloud. For instance, there may be opportunities to move data processing services from origin-sourcing states that tax such services, to the cloud.

However, to take advantage of these opportunities, and to avoid pitfalls, cloud computing vendors and consumers will need to focus on the following factors:

- In what state is the cloud computing vendor located? In what state is the consumer and its server(s) located?
- Does the cloud computing vendor have nexus in the state where the customer is located? Where are the vendor's server(s) located? Are certain servers (or server space) "fixed" and dedicated for specific consumers?
- What type of cloud computing is being provided (computer or data service, server space, software applications)? Is there a primary component?
- With respect to applications, are the applications created specifically for the consumer? Does the consumer receive a copy of or have access to the application outside of any interface with the vendor's API?
- Who is "using" the application created for the consumer? Is the vendor using the software application to provide a service to the consumer, or is the vendor licensing the software application to the consumer for its use?
- How are the provision of data processing or computer services and the provision of software taxed (characterization and sourcing rules) in the states where the vendor, consumer and server(s) are located?

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— Endnotes —

1 Hawaii imposes a tax similar to a sales tax on businesses.

2 Kentucky HB 347 (Ch. 73, Acts of 2009, signed March 24, 2009); North Carolina State Laws 2009-451; Washington Engrossed Substitute HB 2075 (Ch. 535, Laws 2009, signed May 19, 2009); Wisconsin Act 2.

3 Washington Engrossed Substitute HB 2075 (Ch. 535, Laws 2009, signed May 19, 2009).