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## Cloud Computing Poses State Tax Risks

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Providers of software or other digital products over the Internet, including providers of cloud computing and, in particular, software as a service ("SaaS") providers, face potential liability for sales and use taxes as states expand the coverage of their sales and use tax laws beyond the original tangible personal property base to electronically delivered or accessed products and services.

Cloud computing allows businesses to use or access software applications over the Internet without installing software on their own computers and without having to update the software, which is maintained and updated by the provider. While cloud computing offers other benefits, such as off-site storage, a principal feature is SaaS.

Historically, state sales and use taxes have applied to the sale and use of tangible personal property, unless the property was specifically exempt under the particular state's statute. Some states have adopted legislation or administrative rules to subject these new electronic products to sales and use taxes. To evaluate potential exposure, a SaaS provider must engage in a multistep analysis answering several initial questions.

### **Nexus**

*First*, the SaaS provider must determine where it is subject to state tax jurisdiction (i.e., where it has so-called "nexus"). For sales and use tax purposes, nexus is normally established if the seller has physical presence within a state. Sellers frequently believe they are not subject to a state's tax jurisdiction if they have no permanent place of business within the state. However, having employees or representatives within a state, even on a temporary basis, or owning or leasing property within a state may be sufficient to establish nexus with that state.

### **Product Classification and Delivery**

*Second*, the provider must determine if its product or service is taxable under the laws of the states where the provider has nexus. This determination can be particularly complex and sometimes confusing since tax laws vary from state to state. Taxability can vary depending upon how a state classifies a product, which may result in different treatment of the same product in different states. While online access to software may not be taxable in one state, another state may treat it as an information service, a word processing service or a database service, which may or may not be taxable under the laws of that state.

The taxation of software also may depend upon the method of its delivery. Downloading software electronically from the Internet is not subject to tax in some states, such as California and Florida. However, other states, such as Massachusetts, impose a tax upon software regardless of the form of delivery, and even if it is not downloaded but merely accessed online. Several recent Massachusetts rulings demonstrate the subtle nuances in determining whether a product or service is subject to sales and use taxes. While access or use of software on a remote server is subject to sales and use taxes in

Massachusetts, the Massachusetts Department of Revenue has ruled that a seller's online use of software may not result in a taxable transfer of software where the purchaser's objective is to obtain a particular product or service and not the use of the software itself.

## **Sourcing of Sale or Use**

*Finally*, once a seller has identified the states where it has nexus and where its product or service may be subject to sales and use taxes, the seller needs to determine where its product or service is being sold and/or used. This can be particularly difficult when a customer's employees in multiple states download or access the product.

Cloud computing further complicates these issues. A cloud provider needs to consider whether it has physical presence in the state by virtue of the locations of the cloud's network of servers in addition to other servers which it owns or leases. Also, cloud computing's expanded network of providers and servers may make it more difficult to determine where customers are using the product. Some states have provided guidance for sourcing sales and uses when it becomes difficult or impossible to identify the location of the software user.

## **What SaaS Providers and Users Must Do**

SaaS providers need to review each of the above steps with their tax advisors. While the ultimate burden of the sales or use tax normally falls on the purchaser or consumer, a seller usually has an obligation to collect sales or use taxes from a purchasing consumer. Failure to do so could result in substantial tax liabilities, as well as interest and potential penalties. Where there are possible liability issues, a provider should assess the exposure by

conferring with its tax advisors and, in some cases where there is an absence of clear guidance, obtaining a ruling or other advice from a state. When there is a possibility of exposure for unpaid liabilities for prior periods, a provider may be able to enter a state's voluntary compliance program, thereby eliminating penalties and potentially reducing overall liability.

Users of SaaS also need to be concerned about their exposure to use taxes when the SaaS provider is not collecting sales or use taxes. When sellers fail to collect the tax, the purchaser or user can be held liable for a use tax. A user must assess risks using much of the same multistep analysis outlined above.

If you would like to discuss whether you have any of these state tax risks in your particular situation or for further information on this or other tax matters, please contact either of the attorneys listed above.

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