Massachusetts DOR Issues Draft Directive on "Cloud Computing"

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The application of sales and use taxes (collectively referred to herein as the “sales tax”) to services and products provided in what is called the “cloud” (often referred to as “cloud computing” or “Software-as-a-Service”) is a complicated issue which has not been dealt with by many states. The Massachusetts Department of Revenue (the “Department”) has released several letter rulings providing some guidance on the Department’s view of the application of sales taxes to certain cloud computing products and, motivated by the large number of ruling requests pertaining to cloud computing, most recently the Department has issued a draft directive containing criteria for determining whether a cloud transaction is taxable as pre-written software or is a nontaxable service.

Most online services will involve some form of software[1] and may involve the transmission of data online. Since Massachusetts imposes a sales tax on pre-written software regardless of the form of delivery and also imposes a sales tax on telecommunication services, it is important to determine when an online service may be subject to sales tax. Generally, the starting point of the Department’s analysis is the application of the “object of the transaction” test—that is, identifying the customer’s true object in purchasing the products. When the object of the transaction is the use of pre-written software, it is taxable.

While admonishing that no single factor is determinative, the draft directive lists certain criteria indicating whether a transaction is a taxable transfer of pre-written software or a nontaxable service. Criteria indicating a transaction is a transfer of taxable pre-written software include:

- an agreement for the transfer of software for consideration;
- customer has access to and manipulates software on its own;
- customer has use of software with little or no personal intervention by the seller;
- seller refers to itself as an application service provider or to its product as “Software-as-a-Service”;
- seller provides access to software, even if it is in the cloud;
- seller provides customer with an organization tool or function such as screen sharing;
- pre-written software is bundled and sold for a single price with a nontaxable service but the

software constitutes the predominant value of the sale; and

- seller provides an application that is downloaded to any device for a fee.

Factors indicating a nontaxable service include:

- seller's employees provide data processing and other services;
- seller provides information to the customer;
- customer does not interface with or enter information for further manipulation by the pre-written software on its own (search inquiries by customer on seller's database do not constitute interfacing with the software or entering information);
- a personal or professional service is provided;
- transaction is an optional maintenance contract that does not include software updates or upgrades;
- seller provides custom software;
- seller provides data storage and backup;
- customer runs its own software—on seller's hardware—in cloud computing environment;
- seller provides customized reports to customer; and
- substantial personal and professional services are provided by seller's employees and are the predominant value of sale when service is bundled with software for a single price.

While the Department's list provides helpful guidance, some questions remain unanswered. For example, in a recent ruling, the Department concluded that a cloud computing product was taxable as software when the customer paid an increased fee for the product when it included software but was not taxable when the customer used its own software or software obtained for free online to access the cloud product. See Letter Ruling 12-8. The Department did not explain why the "object of the transaction" should change for the same product when the product is accessed using different software. It appears that the Department's conclusion may have been premised on the fact there is an additional charge for the software and that customers have the ability to manipulate or control the licensed software. The ruling states that "[c]ustomers have the ability to access and configure the software and its functionality within the Cloud Computing product." In prior rulings, the Department has determined that access to certain software is taxable or not depending in part on the customer's ability to control or manipulate the software. In Letter Ruling 11-2, the Department concluded that separate charges for certain "workflow add-ons" were subject to the sales tax because the object of the transaction was to access the software for the purpose of manipulating information that the customer inputs. In contrast, in Letter Ruling 11-4, the Department concluded that sales of information services provided through the seller's software were not subject to sales tax where there was no separate charge for the software and customers did not have the ability to operate, direct or control the software.

It would be helpful to cloud computing providers if the directive provided guidance on the extent to which an increased fee is relevant in determining taxability when software is bundled with an otherwise nontaxable cloud product.

It would also be helpful if the directive clarified when the cloud product is taxable as a

telecommunications service. In Letter Ruling 12-8, the Department concluded that fees charged by the taxpayer for data transferred to and from a customer in Massachusetts and the taxpayer's server located outside of Massachusetts were taxable as charges for telecommunications transmissions. This ruling appears to be inconsistent with the ruling that a remote storage service is not taxable. Since storage would always require the uploading of information, utilizing remote storage would appear to result in a taxable transaction, at least where there is a separate charge for transferring the data to and from the storage unit. It appears the separate charge for the transfer may be the motivation for the Department taking a different position than in other rulings. For example, in Letter Ruling 12-11, there was a single charge for storage and the movement of data, and the Department determined that such charge was not subject to the sales tax because the true object of the transaction was to acquire remote data back-up storage and restoration.

The Department has requested comments on the draft directive by Friday, February 22, 2013. While the draft directive provides helpful guidance, we are hopeful that the Department will consider providing further guidance based on comments. If not, many cloud computing providers may still want to seek a ruling in certain circumstances not clearly within the guidelines.

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[1] Unless otherwise stated, references herein to software include only pre-written software.

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