Cloud Computing:
1.5 Steps Forward, 2 Steps Back

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In this edition of The Art of SALT, the authors discuss state efforts to tax the sales of cloud computing products. In particular, they review situations in Illinois, which applied its laws to the transaction at issue; Utah, which they say properly applied part of the state law but failed to address more basic issues; and New York, which they say ignored the facts and clear case law.

Recently overheard . . .
Hayes: Hey Art, I know it’s been decades since you’ve needed a barber, but I just got a haircut and had a weird experience.
Art: What happened — did the barber insist on giving you a Mohawk cut?
Hayes: Nothing that dramatic, but I was shocked when the barber told me that I had to pay sales tax for having rented the scissors!
Art: So you actually cut your own hair?
Hayes: No, no, no. I just told the barber exactly how I wanted my coif to be cut.
Art: Oh, I get it. The barber used to work at the New York State Department of Taxation and Finance and so he believes that a service provider constructively transfers his/her/its tools to the customers?
Hayes: Exactly. And he did say that he missed living in Albany.

While we suspect anyone would scoff at the idea of renting his barber’s scissors, not all state revenue departments find the basic issue of taxable transfers so clear-cut, as demonstrated by recently issued guidance from three departments concerning sales of cloud computing products.¹ One department, the Illinois Department of Revenue (IDOR), applied its state’s laws appropriately to the transaction at issue;² another, the Utah State Tax Commission (USTC), applied part of the state’s law properly but failed to address more basic issues;³ and the last one, the New York State Department of Taxation and Finance (NYSDTF), recalcitrant as ever, again failed to kick its habit of ignoring facts and clear case law to find taxable sales where none exist.⁴

¹By using the term “product” we hope to avoid any implication that cloud-based functionalities are per se taxable tangible personal property or enumerated services or nontaxable intangible property or unemumerated services. The facts of each transaction involving cloud computing must be closely examined to determine its proper treatment under state law. While we fully believe that most providers in this space are selling services, we don’t want to “bootstrap” by using the term “service.”
As we have noted in several past articles regarding cloud computing transactions, the questions regarding whether sales of cloud computing products such as software as a service (SaaS) and infrastructure as a service (IaaS) are subject to sales and use taxes represent real concerns of both sellers and purchasers of such products. Statutes directly answering those questions remain rare and do not exist in Illinois, New York, and Utah. Thus, taxpayers and revenue departments must apply the general sales and use tax laws — statutes as well as case law — to transactions involving cloud computing products. Those general statutes require a transfer of possession or control of tangible personal property, including pre-written computer software, or of taxable services before the taxes are imposed on a transaction. Case law has fleshed out what type of “transfer” is required in that statutory context, and the courts have concluded that such transfers often do not occur in situations analogous to cloud computing transactions. Nevertheless, many state revenue departments have ignored or skewed their states’ case law in finding taxable transfers in cloud computing transactions.

SaaS involves a seller providing a service to its customers that approach the seller, perhaps through the seller’s website. The seller uses its own hardware, operating software, application software, and operational personnel to provide the service, and customers provide the seller with the data necessary to produce the desired result. For instance, a SaaS provider of legal research services, such as West, presumably uses its own hardware, software, and operating personnel to perform research and provide results to a customer at that customer’s request, without the customer ever accessing the provider’s hardware or software.

IaaS is roughly equivalent to a full outsourcing of a customer’s IT functions to the provider. The provider uses its own hardware, operating system, application software, and personnel to meet the customer’s IT needs, often without granting the customer any access to that hardware and software.

One Step Forward: Illinois

The IDOR recently issued two general information letters addressing SaaS products. General information letters are not binding on the IDOR but do indicate the thinking of the department as to the appropriate law to apply to a situation. In both letters, the IDOR stated that “computer software provided through a cloud-based delivery system — a system in which computer software is never downloaded onto a client’s computer and is only accessed remotely — is not subject to tax.” The letters cautioned that the “Department continues to review cloud-based arrangements” and noted that “if a provider of a service provides to the subscriber an API, applet, desktop agent, or a remote access agent to enable the subscriber to access the provider’s network and services, the subscriber may be receiving computer software” and there may be a taxable transaction.

That general conclusion seems to be a faithful application of Illinois law. The Illinois tax law imposes tax on all transfers of ownership or title to tangible personal property, including computer software, even if incident to the provision of a service. In determining when ownership of property is transferred, Illinois courts have looked to whether the transferee has relinquished possession of the property with no right of reclamation, such that the transferee “has the ability, at a given time, to exercise dominion and

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7 Id.


92 Ill. Adm. Code 1200.120.


Our prior articles detail these findings and their errors, as well as the merits of some state revenue departments’ findings that appropriately apply their states’ law to such transactions. See articles cited supra note 5.
control over that property."\textsuperscript{13} A SaaS provider typically does not permit its customers to exercise dominion and control over its software, so the IDOR is correct to characterize providers of SaaS as providing a service and not transferring tangible personal property. Because Illinois provides by statute that transfers of tangible personal property incident to the provision of a service can be taxable, the IDOR was also correct to caution that the transfer of such things as applets could trigger tax.

**A Half-Step Forward and a Step Back: Utah**

In a recent public letter ruling, the USTC considered the taxability of a cloud-based storage product and a virtual computing environment product.\textsuperscript{14} Both products appeared to be a form of IaaS. The company provided both products using its own data centers and clusters of servers.\textsuperscript{15}

The storage product allowed “customers to store and retrieve content, data, applications, and software on equipment within the [Company’s] network.” Storage customers did not receive “access to, or possession of, tangible personal property including software in connection with the [Storage Item] offering” and did not have “physical access to or knowledge of the exact location of the server equipment hosting their data.”

The virtual computing product provided customers with “computing resources to perform a variety of activities, including, but not limited to, running applications, monitoring computer use, and hosting web domains — essentially anything computer equipment, especially a computer server, can do.” Though the product was customizable to a degree, customers could “neither download the operating system software for their own use nor access the physical location where the servers hosting the software are located.”\textsuperscript{16}

Utah imposes sales tax on retail sales of tangible personal property, including pre-written software, and certain services made within the state\textsuperscript{18} and defines a sale as “any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property,” including transfers of possession.\textsuperscript{19} Utah case law establishes that a taxable transfer of possession requires the transfer of the ability to freely manipulate the underlying property — exclusive access to the property must be transferred.\textsuperscript{20} Utah also imposes its sales tax on amounts paid for tangible personal property that is used within the state.\textsuperscript{21}

Relying on Utah’s “essence of the transaction test,”\textsuperscript{22} the USTC determined that the storage product and the virtual computing product should be characterized as transactions for the use of computer hardware. However, the USTC found that those transactions were not taxable because the hardware at issue resided outside the state.

While the USTC’s approach toward sourcing is laudable, its initial characterization of the transactions as effectuating transfers of computer hardware for the customers to use themselves is questionable.

Because the company provided both products using its own hardware and software, to which customers had no access (or even knowledge of their location), it is hard to conclude that the transactions were ones in which the customers actually “use” the computer hardware themselves. Not only did the customers fail to receive the requisite

\textsuperscript{13} Honeywell International Inc. v. Department of Revenue, 366 Ill. App. 3d 187 (2006); see also Sta-Ru Corp. v. Mahn, 64 Ill. 2d 330 (1976); The Boge Needle Co. v. Department of Revenue, 45 Ill. 2d 484 (1970); and Solomon Colours Inc. v. Department of Revenue, No. 4-10-0814 (III. App. Nov. 14, 2011).

\textsuperscript{14} Utah State Tax Commission, PLR 16-004 (Mar. 31, 2017).

\textsuperscript{15} Id.

\textsuperscript{16} Id.

\textsuperscript{17} Utah Code section 59-12-102(125)(b).

\textsuperscript{18} Utah Code section 59-12-103(1).

\textsuperscript{19} Utah Code section 59-12-102(110).

\textsuperscript{20} See Rosen, Robinson, and Holderness, “Cloud Computing: The Answer Is ‘No,’” supra note 5; see also Snarr Advertising Inc. v. Utah State Tax Commission, 432 P.2d 882 (Utah 1967); and Utah Advisory Opinion No. 00-009 (Aug. 29, 2000).

\textsuperscript{21} Utah Code section 59-12-103(1).

\textsuperscript{22} B.J.-Titan Services v. State Tax Commission, 842 P.2d 822, 825 (Utah 1992) (“The essence of the transaction theory[] focuses on the nature of what was sold and whether it primarily entails tangible personal property. . . . This theory examines the transaction as a whole to determine whether the essence of the transaction is one for services or for tangible personal property. The analysis typically requires a determination either that the services provided are merely incidental to an essentially personal property transaction or that the property provided is merely incidental to an essentially service transaction”).
One of the following attributes of ownership has been transferred: (i) custody or possession of the tangible personal property, actual or constructive; (ii) the right to custody or possession of the tangible personal property; [or] (iii) the right to use or control or direct the use of tangible personal property.”

As we have observed, New York law requires a transfer of exclusive possession for more than a fleeting moment and actual control over property for a taxable sale or license to use property to have occurred.

As described by the NYSDTF, the petitioner in TSB-A-17(4)S was a company that “turn[ed] customers’ photos and video clips into professional videos.” The company created those videos through the following process: First, customers uploaded their photos and videos and negotiated their preferences, the company used its “proprietary software . . . that is hosted on Petitioner’s server, and that customers do not download or directly interact with,” to create the requested professional videos. The advisory opinion explained the five different accounts that the company offered to customers, but this same basic fact pattern applied to all five types. The more expensive the account, the more options the customer had regarding video length, quantity, and customization.

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25 Some IaaS transactions do provide for the leasing of hardware, which would be taxable under the appropriate circumstances. The facts in PLR 16-004 do not indicate whether the customers leased hardware from the company.


30 N.Y. Tax Law sections 1101(b)(5), 1105(a).

31 N.Y. Tax Law section 1101(b)(6).
All customers were required to agree to the company’s terms of service. That agreement stated that the company was providing customers with “the ability to have a video . . . automatically created by [Petitioner] using uploaded photographs, graphics, or video clips . . . set to a selected or uploaded music track.” The terms also provided that “Petitioner’s ‘services,’ which are defined to include its website and applications, are owned and operated by Petitioner, and that Petitioner retains all proprietary rights to its site.” Also, the terms granted customers “a ‘limited right to use’ the ‘software and services’ that are available on Petitioner’s site.”

Despite observing that the company uses “proprietary software . . . that is hosted on Petitioner’s server, and that customers do not download or directly interact with” to create the requested professional videos for its customers, the NYSDTF determined that the company’s customers had been granted “the ability to control the video-generating software by selecting the content of a video, the order in which this content appears, and various other aspects of a video, including what music and logos are used, and the video’s ‘style.’” The NYSDTF thought it was important to its determination that the company’s web-based interface permitted its customers to convey their preferences to the company. Having determined that control over the software was transferred to the customers, the NYSDTF found that taxable sales had occurred.

That reasoning is deeply flawed — and troubling. A customer does not control the company’s software by expressing her preferences through a website any more than a bride and groom control their wedding photographer’s camera when they tell her what shots they want. The core idea behind a transfer of control of something is that it grants someone the exclusive right to consume it. Under the facts presented in TSB-A-17(4)S, it is exceedingly clear that no customers were granted such exclusivity regarding the software. No customer could prevent other people from using the software; indeed, “Petitioner’s customers [could] not directly interact with the video generating software located on Petitioner’s server.” The customers could not turn the software off, move it, reprogram it, update it, or otherwise maintain it. The company owned and operated the software — and, of course, the hardware and the operating system — and retained all proprietary rights. Simply put, in no way was the video-generating software transferred to the company’s customers.

What’s more, the NYSDTF has found on multiple occasions that digital video-editing services are not taxable services. For instance, in one advisory opinion considering the taxability of the service of “editing digitized audio, video, or music files into a cohesive presentation,” the NYSDTF stated that “since digitized audio, video, and music files delivered electronically or online are, with the exception of prewritten software, not tangible personal property, charges for the editing services electronically delivered to the customer are not subject to sales tax.” We do not understand TSB-A-17(4)S to claim that the video-generating software is being edited, and thus there is no reason to stray from the NYSDTF’s earlier conclusions. The customers of the petitioner in TSB-A-17(4)S send the company media, request it to be edited in a certain manner, and are given an edited final (intangible) product. Neither the editing service nor the final product are taxable, and the NYSDTF is misguided in its attempt to twist the

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34 Id.
35 Id.
37 Id.
provision of an editing service into the transfer of license to use the tools employed in providing that service.\textsuperscript{38}

In addition to the questionable taxability determination, the NYSDTF arrived at a very questionable sourcing conclusion. TSB-A-17(4)S concludes that “the situs of the sale for purposes of determining the proper local tax rate and jurisdiction is the location associated with the right to use Petitioner’s software, i.e., the location of the customer or its employees (if applicable).” It looks like the NYSDTF is attempting to determine situs based on where the “benefit is received” or where “the service is delivered.” Neither of those concepts is provided under New York law.\textsuperscript{39} If software is indeed transferred to the remote customer, where does the customer use it? Where it resides, on the hardware that is in exclusive possession of the provider? For example, if a U.S. Air Force captain is sitting in Colorado remotely controlling a drone over Afghanistan, where is the drone used? As Americans, we hope that it is not being used in Colorado!

Conclusion

The state revenue departments of Illinois, New York, and Utah have all recently released guidance concerning the taxability of specific cloud computing products. Although the NYSDTF unfortunately continues its cavalier approach toward the taxability of SaaS, the IDOR and the USTC both offered examples of more careful applications of state law. The USTC’s approach would benefit from a reexamination of the basic transaction behind IaaS but does show an improvement over the commission’s prior guidance regarding SaaS.\textsuperscript{40} One hopes that all state revenue departments and taxpayers will continue to refine their analyses of the taxability of cloud computing products for the better as technology continues to evolve. In a broader sense, let us hope that new laws and changes in existing laws properly remain in the province of legislatures, not that of executive branch agencies. Until then, we’ll be getting our haircuts in Chicago.

\textsuperscript{38} It should be noted that although the petitioner’s terms of service provided for a “limited right to use” the software, the facts of the case do not indicate that that grant resulted in the transfer of a taxable license to use the software. The NYSDTF has relied on such contractual language in the past to find taxable transfers resulting from SaaS transactions, but did not explicitly do so in TSB-A-17(4)S, perhaps recognizing that substance must control the determination (though incorrectly characterizing that substance). Many providers of SaaS include such grants in the terms of service, but the reason for doing so is not always clear and the grants seem to be anachronistic in many instances. We have encouraged SaaS providers to revisit such grants in their contracts to determine their necessity, given the undue sway they may have over state revenue departments.

\textsuperscript{39} We discuss this sourcing issue in further depth in Rosen, Robinson, and Holderness, “Cloud Computing: The Answer Is ‘No,’” supra note 5.

\textsuperscript{40} Rosen, Robinson, and Holderness, “Cloud Computing: The Answer Is ‘No,’” supra note 5.