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SHOP TALK

Treasury's Proposed Cloud Computing Regulations: From a State Sales Tax Lens

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The Treasury Department recently issued proposed regulations that thoughtfully address the federal income tax treatment of cloud computing transactions (the "Proposed Regulations").[1] From a state tax perspective, the chief interest in the Proposed Regulations is that they list factors that should be taken into account in determining whether cloud computing transactions are better classified as "property" or as a "service." Of course, a similar analysis must also be done for state sales tax purposes, i.e., it must be determined whether cloud computing transactions should be classified as non-taxable services or as taxable tangible personal property. How does the Treasury Department come out on this important issue? On the whole, Treasury generally agrees with the consensus of most states and tax practitioners that cloud computing transactions are better characterized as a service, not a lease of property.

This article summarizes the Proposed Regulations' approach to classifying cloud transactions. It also discusses the analogous issue for state sales tax purposes and provides examples of several states that have taken an approach to cloud computing transactions that differs from the approach taken in the Proposed Regulations.

The Proposed Regulations' approach to classifying cloud transactions

The Proposed Regulations define "cloud transactions" as transactions through which a person obtains on-demand network access to computer hardware, digital content, or similar resources. The provision of downloaded digital content stored or used on a person's computer or network device, on the other hand, is not a cloud transaction.

Cloud transactions are to be classified as either: (1) leases of computer hardware, digital content, or other similar resources; or (2) the provision of services.

The Proposed Regulations state that the following factors indicate that a cloud transaction should be classified as the provision of services:

- The customer is not in physical possession of the property.
- The customer does not control the property, beyond the customer's network access and use of the property.
- The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property.
- The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated.
- The customer does not have a significant economic or possessory interest in the property.
- The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.
- The provider uses the property concurrently to provide significant services to entities unrelated to the customer.
- The provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time.
- The total contract price substantially exceeds the rental value of the property for the contract period.

The Proposed Regulations state that no one of these factors is dispositive, and a facts-and-circumstances analysis should be applied, but application of these factors will generally yield the result that cloud transactions are to be taxed as the provision of services. This result is further made clear by several examples in the Proposed Regulations.

Examples from the Proposed Regulations

The Proposed Regulations address common cloud computing fact patterns. Example 4, in particular, is the classic cloud computing fact pattern. In Example 4, Corp B accesses software from Corp A over the cloud. The software is hosted on Corp A's servers, and Corp B has no ability to alter the software code. Corp A updates the software periodically and makes the newest version of the software available to Corp B over the cloud for the duration of the contract. It is concluded that this is the provision of a service, rather than the lease of property, taking into account factors including: (1) Corp B does not have physical possession of the software platform and server, (2) Corp B lacks control over the software platform and server, (3) Corp A maintains the right to replace or upgrade the software platform and server, and (4) Corp A provides access to the server and platform to Corp B and other customers concurrently.

Other examples rely on substantially similar factors to yield the same result (cloud computing transactions are a service). For example, one example concludes that an online website development product accessed over the cloud is a service.[2] Another example concludes that data storage is a service.[3]

Tax practitioners generally agree with Treasury's approach to classifying cloud transactions, but not all states do

Treasury devoted considerable time to preparing the Proposed Regulations and received input from tax practitioners. Most practitioners agree that the approach taken in the Proposed Regulations is correct—cloud computing is a service and not a lease of property.

The states have every incentive to bend over backwards to reach the opposite conclusion from that Treasury reached. If the states classify cloud computing transactions as a service, then they will generally be non-taxable as sales tax is typically imposed only on sales of tangible personal property and certain services. However, by taking the position by statute or administrative fiat that cloud computing transactions are a taxable lease of tangible property there is the potential to considerably increase state coffers.

Notably, most states follow the approach in the Proposed Regulations and consider cloud computing transactions a service. But not all states agree. A few states take the position that cloud computing transactions are a lease of property. Below are several examples. Note how these positions are contrary to the approach in the Proposed Regulations. All these state positions arise in the sales tax context, with the state concluding that cloud computing is subject to sales tax as the sale or lease of tangible personal property.

Massachusetts: In 2005, as canned software programs increasingly became available for download online, the Massachusetts Legislature amended the definition of "tangible personal property" to include "a transfer of standardized computer software, including but not limited to electronic, telephonic, or similar transfer...."[4] The statute, on its terms, defines tangible personal property to include all non-custom software. Given the date of the amendment, it is almost certain that the Legislature had in mind canned software that could be purchased for download (for example, a word processing program purchased for download rather than purchased in CD-ROM form from a retailer). But the statute is being interpreted more broadly to also cover cloud computing transactions that the Proposed Regulations would consider services.

A Massachusetts Appellate Tax Board decision upholds application of the statute to an online meeting platform.[5] An appeal is currently before the Massachusetts Supreme Judicial Court with a decision anticipated in 2020.

Regardless of how the case is decided, note the stark contrast between the Massachusetts approach and the logic of the Proposed Regulations. The Proposed Regulations conclude that a transaction is a service if the customer is not in physical possession of the software, does not control it, and only accesses it remotely. In contrast, Massachusetts takes the position by regulation that software has been transferred to a purchaser even where the purchaser only has the right to use the software and the software is stored on a remote server controlled by the seller.[6]

New York: The New York State Department of Taxation and Finance's approach to cloud computing likewise directly conflicts with the approach taken in the Proposed Regulations. In a series of advisory opinions (New York's equivalent of letter rulings), New York's tax department has advanced the view that the sale of cloud computing products is the sale of leased (or licensed) tangible personal property, not a service.[7] In contrast to the Proposed Regulations, the advisory opinions conclude that purchasers of cloud computing products have been transferred the underlying property through the cloud and they constructively control and possess that property by having the ability to access it remotely.[8] On the whole, the New York advisory opinions consider similar factors to the ones set forth in the Proposed Regulations, but reach polar opposite conclusions on issues like control and transfer of possession to arrive at the end result of treating cloud computing transactions as a taxable transfer of tangible personal property.

Pennsylvania: The Pennsylvania Department of Revenue issued a letter ruling in 2012 concluding that software products and services accessed through the cloud constitute taxable transfers of property (canned software).[9] The letter ruling does not explain why cloud computing should not be considered a non-taxable service and ducks issues like whether cloud computing products are transferred to purchasers. Subsequent administrative rulings and guidance suggest that, depending on the years at issue and the nature of what is being sold, at least some cloud computing transactions may be considered nontaxable in Pennsylvania as information retrieval services or for other reasons.[10] Overall, the Pennsylvania Department of Revenue takes a revenue-friendly "canned software" approach to cloud computing transactions without offering an analysis of the key classification considerations presented in the Proposed Regulations.

Conclusion: The Proposed Regulations get to the heart of the issue

The Proposed Regulations commendably get right to the heart of the issue when addressing how best to classify cloud computing transactions. If the software being used to deliver the product to the customer resides on the seller's server, and the seller may update or change the software without notice to the customer, then the customer plainly does not control the software, and has purchased a service rather than software. Most states agree with this approach. As outlined above, several states take a different view, as do other states like Texas and Washington. To the extent a state's law does not clearly tax cloud computing transactions as tangible personal property, the Proposed Regulations helpfully support arguments that cloud computing transactions are properly classified as non-taxable services.

[1] Prop. Reg. 1.861-19.

[2] *See* Example 3.

[3] *See* Example 1.

[4] Mass. Gen. Laws ch. 64H, §1.

[5] *Citrix Systems, Inc. v. Mass. Comm'r of Rev.*, Docket Nos. C321160, C325421 (Nov. 2, 2018).

[6] 830 Mass. Code Regs. §64H.1.3(3)(a) ("[T]axable transfers of prewritten software include sales effected in any of the following ways regardless of the method of delivery, including...transfers of rights to use software installed on a remote server...").

[7] *See* TSB-A-08(62)S (Nov. 24, 2008) and its progeny.

[8] *See id.* and its progeny.

[9] Pennsylvania Letter Ruling No. SUT-12-001 (May 31, 2012).

[10] *See, e.g., In re Fischer Scientific Co.*, Docket Nos. 1700833, 1700849 (Penn. Bd. Of Fin. and Rev. June 12, 2018); *In re Houghton International, Inc.*, Nos. 1705455, 1720398 (Penn. Bd. Of Fin. and Rev., April 3, 2018).