

## NEW BUSINESS

### CLOUD COMPUTING AND STATE TAX: A PARADIGM SHIFT?

Technology has made it possible for businesses to “outsource” the performance of many tasks that were traditionally built into their organizational structure, including data storage, financial reporting, human resource management, e-mail and communications services, etc. Using a network of remotely-housed servers, applications, and data processing software that are offered, maintained, and supported by other companies, businesses can often perform more efficiently. However, as businesses purchase more cloud-based goods and services, they move away from tangible personal property. The emergence of cloud computing is forcing state revenue departments to reconsider the tax consequences associated with the digital delivery of digital products and services.

#### WHAT IS CLOUD COMPUTING?

Specific definitions will vary, but cloud computing transactions possess certain common characteristics:

- Use of the Internet or other digital communications network;
- Seller provision of some form of remote storage, analysis, power, and/or service via Internet or digital network; and
- Generally, a service agreement for provision of the service based on actual use.

Common examples of cloud computing transactions include e-mail hosting; photo storage and editing services; document and data storage and archive services; and access to computing power, among others.

#### IMPLICATIONS FOR STATE TAX

Cloud computing invites business owners move away from the use of tangible personal property in favor of more efficient and less costly digitally-hosted options, options that often escape taxation under existing state laws. As these transactions increase in size and frequency, states must consider how to categorize them for tax purposes.

##### A. TPP

Computer software, cloud computing’s most recent ancestor, has provided the baseline for the tax analysis, and continues to provide the model in many jurisdictions.

- Many states now tax the provision of computer software when delivered by any method, which may depart from Quill’s physical presence requirement.
- Other states have expressly rejected the taxability of computer software when not delivered by a physical medium.
- Under the National Institute of Standards and Technology models, this type of cloud computing transaction would be considered Service as a Software (“SaaS”)<sup>1</sup>, an analogy to the provision of canned software.
- The digital nature of the product and the delivery raises questions over constitutional standards for the imposition of sales and uses taxes, and many states have begun to shift away from the TPP model.

##### B. DIGITAL PRODUCTS

Some states have moved beyond trying to fit cloud computing into the TPP model and have explicitly recognized the existence of “digital products” or “digital goods.” Although cloud computing

---

<sup>1</sup> NIST has developed three models by which many cloud computing services may be characterized. Although these categories do not translate directly into taxation models, they do provide some guidance for classification. In addition to SaaS, Infrastructure as a Service (“IaaS”) models the transactions at the opposite end of the spectrum, where the service is highly customized. The Platform as a Service (“PaaS”) model falls somewhere between SaaS and IaaS, having characteristics of both. Generally, the degree of buyer control differentiates the models.

often encompasses much more than these digital products, such a definition does provide guidance by at least limiting the portion of the transaction that remains in tax limbo.

- Examples include digital versions of books, movies, and/or music. Generally, products that may be purchased digitally but would otherwise be purchased in a brick-and-mortar location fall into this category.

### **C. DATA PROCESSING SERVICES**

States differ greatly in their taxation of services, and some have approached cloud computing as the provision of a service rather than the sale of property. As with the tax on many services, these “digital processing,” “information processing,” and “analysis” services are generally defined by statute or regulation. This approach depends less upon the definition of the “product” being provided and allows the transaction to be considered as a whole.

- Some states do, however, consider the degree to which TPP may be included in the transaction price. If the purchase includes a non-negligible amount of TPP, the transaction may be taxed as the sale of a good rather than a service.

## **THE NEXUS INQUIRY**

### **A. PHYSICAL PRESENCE**

Judicial guidance on this Constitutional issue varies from state to state, and the federal courts have largely managed to avoid the issue.<sup>2</sup> To the extent that the physical presence requirement is satisfied by a sourcing analysis, many states are transitioning to a destination-based system.

- For example, some states take the position that the location of “first use” is the destination for sourcing purposes. The transaction can then be categorized for tax treatment according to that jurisdiction’s rules. Does “first use” require a physical presence, however, especially when the good or service purchased is “used” in one state while the server or equipment facilitating the transaction is actually located in a warehouse in another state?

### **B. A SHIFT IN FOCUS**

Rather than tackle the Quill issue, some states have taken the position that nexus is not created through a digital relationship. Others have chosen to subject businesses providing these types of services to a gross receipts tax. For example, a state may impose a gross receipts tax on businesses that sell data processing-type services. However, moving from a sales tax to a gross receipts tax does not eliminate the state’s need to satisfy Constitutional standards, but it may reduce the burden. Another approach considers how similar the use of cloud computing services is to the use of utilities, and suggests that a similar regulatory treatment may be appropriate.

## **CONCLUSION**

Although the phrase “cloud computing service” is frequently used to describe the purchase of time, space, access, or power provided by a remote seller, the transaction is not necessarily the sale of a service and certainly should not be assumed to be exempt or nontaxable. Each jurisdiction must determine how to cross the TPP issue, whether by excluding digital transactions altogether, by developing “click-thru nexus” or other similar concept, or by explicitly addressing such transactions through law or regulation. The erosion of the tax base caused by the prevalence of cloud computing services will ultimately require states to reassess their methods of generating revenue.

---

<sup>2</sup> The Eastern District of Texas considered the question and yet avoided establishing precedent by filing a slip opinion. See Gemalto S.A. v. HTC Corp., 2011 WL 5838212, slip opinion, Nov. 18, 2011 (E.D. Tex. 2011).