

*“Recent Developments in the Taxation of  
Digital Products and the Cloud”*

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- Introduction to Cloud Computing
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- MPU- Allocation or Apportionment
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- Cloud Computing Services
  - “Cloud computing is a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.” (National Institute of Standards and Technology)
- Cloud Computing Benefits
  - Cost savings and efficiency.
  - Businesses no longer need to expend their limited resources on purchasing and maintaining costly computer hardware and software.
  - Limits IT costs associated with managing computer hardware and software resources.
- Cloud services market grew to \$68.3 billion in revenue in 2010, a 16.6 % increase from 2009.
- The research firm Gartner predicts that in 2014 cloud services revenue will balloon to \$148.8 billion worldwide.

# Application Service Providers (“ASPs”)

- An entity retains custody over (or “hosts”) software for use by third parties.
- Users of the software hosted by the ASP typically will access the software via the Internet.
- The ASP may or may not own or license the software, but generally will own or maintain the hardware and networking equipment required for the user to access the software.
- The ASP may charge the user a license fee for the software (in instances where the ASP owns the software) and/or a fee for maintaining the software/hardware used by its customer.

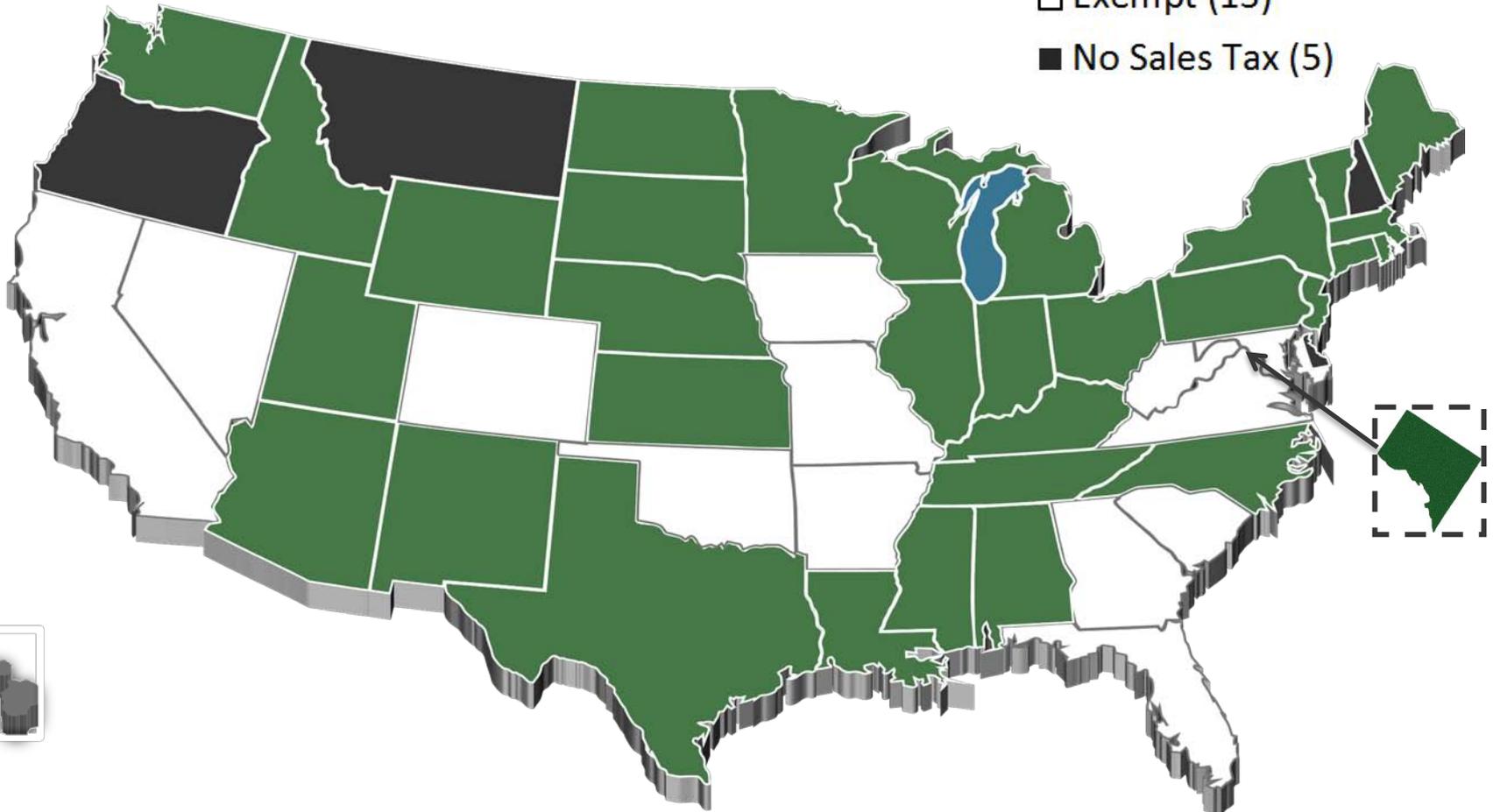
# Software as a Service (“SaaS”)

- The SaaS model allows the consumer to use the provider’s software applications running on a cloud infrastructure.
- The applications are accessible from various client devices through a client interface such as a web browser (e.g., web-based email).
- The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, storage, or application capabilities.
- Under the SaaS model, a service agreement is almost always executed (vs. a software license agreement or services agreement for an ASP).
- The SaaS model is familiar to most Internet users and includes such offerings as web-based e-mail, calendars, word processing, and digital photo applications.

## Taxability of Prewritten Software Delivered Electronically\*

Updated through July 2013

- Taxable (33)
- Exempt (13)
- No Sales Tax (5)



\***Note:** Prewritten software is defined as a canned (non-custom) software delivered through an electronic medium



# Platform as a Service (“PaaS”)

- The PaaS model allows the consumer to run consumer-created or acquired applications on the cloud provider’s platform.
- The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, or storage, but has control over the deployed applications and possibly the application hosting environment configurations.

- The IaaS model provides the consumer with processing, storage, network capabilities, and other fundamental computing resources where the consumer is able to deploy and run software, which can include operating systems and applications.
- The consumer does not manage or control the underlying cloud infrastructure but has control over operating systems, storage, deployed applications, and possibly limited control of select networking components (e.g., host firewall).
- An example of an IaaS model includes web hosting and managed services.

## SST Definition of Digital Products:

“Specified digital products” means electronically transferred:

1. “Digital Audio-Visual Works” which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any,
2. “Digital Audio Works” which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones, and
3. “Digital Books” which means works that are generally recognized in the ordinary and usual sense as “books”.

For purposes of the definition of “digital audio works”, “ringtones” means digitized sound files that are downloaded onto a device and that may be used to alert the customer with respect to a communication.

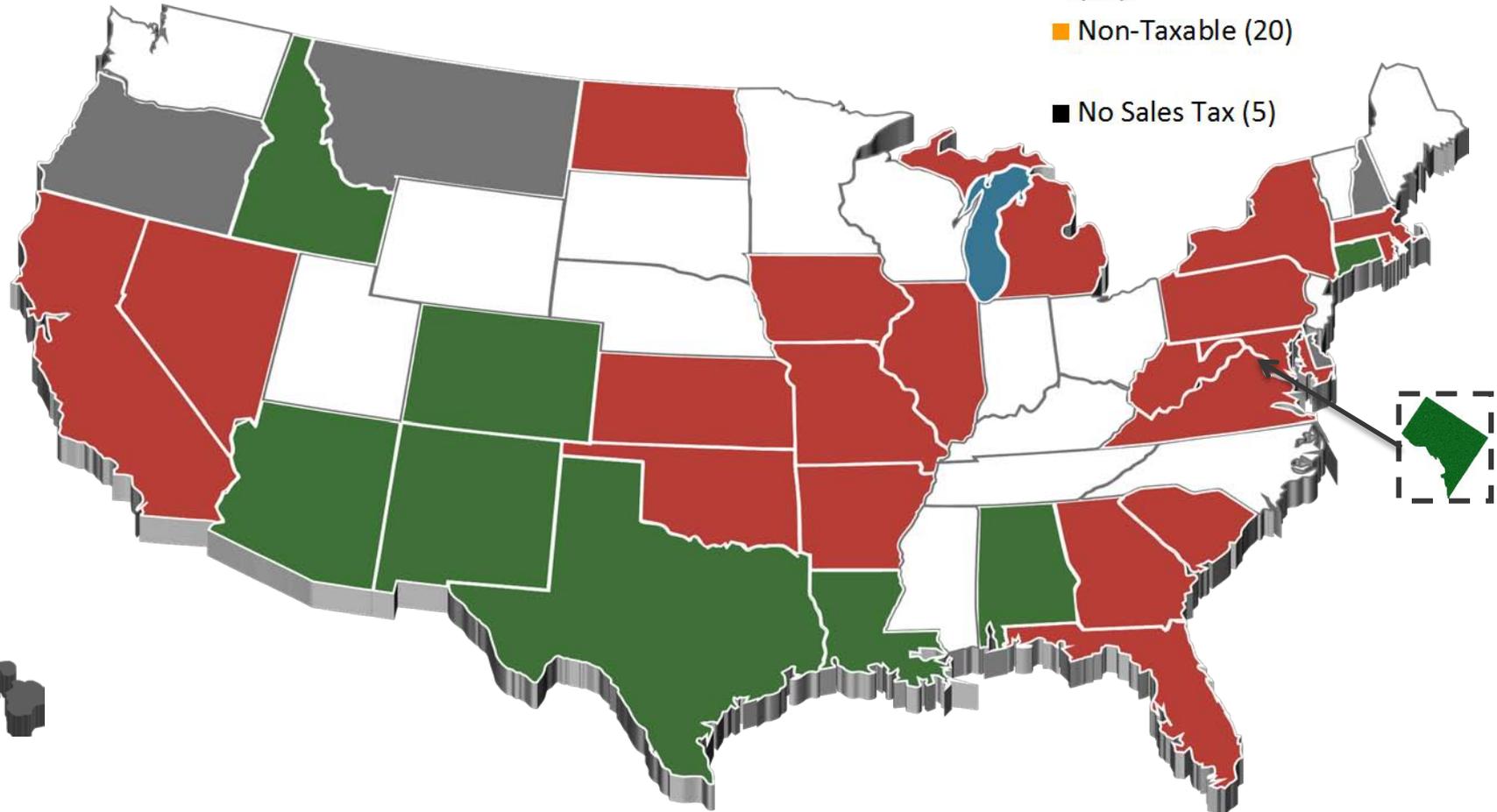
For purposes of the definitions of specified digital products, “transferred electronically” means obtained by the purchaser by means other than tangible storage media.

*NOTE: The amendment to the Streamlined Sales and Use Tax Agreement is effective January 1, 2009.*

## Taxability of Specified Digital Products\*

Updated through July 2013

- Taxable by DOR Interpretation (10)
- Taxable by Statute (16)
- Non-Taxable (20)
- No Sales Tax (5)



**\*Note:** Specified Digital Products are defined as digital audio, digital audio-visual, and digital books delivered electronically

# Characterization - SaaS

- States have taken varying approaches. For example:
  - **New York** – Taxable as sales of tangible personal property (prewritten computer software).
  - **Texas** – Taxable as data processing services (20% of service exempt from tax).
  - **South Carolina** – SaaS taxable as telecommunications services.
  - **SST States (ongoing discussion):**
    - **Utah** – Taxable as the sales of tangible personal property (prewritten computer software).
    - **Wisconsin** – Exempt data processing services.
  - **Idaho** – Newly enacted legislation creating a carve-out for remotely accessed software, but the carve out has two exceptions: (1) software for entertainment use; and (2) software where the vendor of that computer software offers for sale, in a storage media or by an electronic download, to the user's computer or server, and either directly or through wholesale or retail channels, that same computer software or comparable computer software that performs the same functions.

- What are you buying?
  - Tangible personal property
  - Software
  - Service
  - Digital Good
  - Something else
- How is it delivered?
  - Tangible form
  - Electronically delivered
  - Electronically accessed
  - Electronically streamed

What does the Agreement state you are buying?

Auditors and courts heavily rely on the contractual language in characterizing the item being purchased. If a software license agreement is executed, it will be difficult to argue that you are not licensing software.

- Sourcing is dependent upon characterization. For interstate sales, if taxable as:
  - Tangible Personal Property
    - Generally destination
    - Consider subsequent use
    - Consider concurrent use (prewritten computer software)
  - Services
    - Varies by state. May be:
      - Benefit
      - Performance
      - Consider multi-state benefit
  - Digital Goods
    - Not clearly defined. May be:
      - Destination
      - Benefit
      - Consider multi-state use

- Many states not only permit allocation or apportionment of the sales tax base, but require it.
- State statutes and regulations often do not provide an answer/approach. Rather, a “range” of acceptable answers is the norm. Consider Washington state:
  - **The taxable amount is determined by the number of users in this state compared to users everywhere.**
- Most auditors will look for a sensible approach that assigns sales to locations where the service is being “received.”

# Exemptions Rejected and Tax Impositions Adopted Legislatively in 2013

## ■ Minnesota –

- The Tax Omnibus Bill (H.F. 677) passed in May of 2013 expands the Minnesota sales tax to cover digital products, including digital audio works, digital audiovisual works, digital audio books, and online video or electronic games.
- The tax is effective for sales made on or after July 1, 2013.

## ■ Maine –

- The 2014-2015 budget, (LD 1509) originally vetoed by the governor, was enacted on June 26, 2013 when the Legislature overrode the veto.
- The budget clarifies state law by legislatively adopting the Department of Revenue's stated position that taxable "products" delivered electronically are taxable.
- LD 1572, the technical corrections bill, attempted to clarify the budget by adding language that taxable "products" and "services" delivered electronically would be taxable. The governor has threatened to veto the technical corrections bill, which did not pass with the 2/3 majority required to override the veto.

# Exemptions Rejected and Tax Impositions Adopted Legislatively in 2013 (cont'd)

## ■ Massachusetts –

- The transportation finance bill (H.3535) included a proposed tax on services associated with implementation of custom computer software.
- It passed the Massachusetts legislature on July 24, 2013, overriding Governor Deval Patrick's veto.
- The bill imposes sales and use tax upon computer system design services and the modification, integration, enhancement, installation or configuration of standardized software.
- The bill has been denounced by the Massachusetts Taxpayers Foundation, Senator Karen Spilka, and local businesses.
- It is now subject to a repeal effort supported by both MA Republicans and Democrats.

# Exemptions Rejected and Tax Impositions Adopted Legislatively in 2013 (cont'd)

## ■ Vermont –

- In May, the Vermont legislature declined to extend a sales tax moratorium on cloud computing.

## ■ Ohio –

- The Ohio budget (H.B. 59) expanded the sales tax base to certain services including specified digital products, effective for sales occurring after January 1, 2014.
- The Governor signed the budget on June 30, 2013.
- On July 9, the Governor directed the Tax Commissioner to apply for full member status under the Streamlined Sales and Use Tax Agreement.

# Exemptions Passed and Imposition Efforts Defeated Legislatively in 2013

## ■ California –

- A legislative Conference Committee rejected language in Budget Trailer Bill 415 that would have amended the definition of storage media to result in taxation of software delivered or accessed electronically.

## ■ Connecticut –

- The proposal to impose the full sales and use tax rate on digital products was rejected as part of the budget. (Bill No. 6704).

## ■ Idaho –

- In April, Idaho enacted legislation (H. 243) to specifically exempt certain types of remote access software from sales tax.

# Exemptions Passed and Imposition Efforts Defeated Legislatively in 2013 (cont'd)

## ■ Louisiana –

- The enacted Louisiana budget did not contain an expansion of sales tax to digital products as originally proposed.

## ■ Kansas –

- The Kansas Fair Tax Act (HB 2355), which would have expanded the sales tax base to include digital products, was introduced in February but did not progress.

## ■ Utah –

- In March, Utah enacted an exemption from sales tax for charges for remotely accessed databases (SB 214).

## ■ Michigan –

- Bills to exempt remotely accessed software have progressed in Michigan.
- Senate Bills 142 (use tax) and 143 (sales tax) would amend the definition of prewritten software so that the term does not include granting the right to use prewritten software installed on another person's server.
- The bills unanimously passed the Senate.
- On September 18, the Michigan House Tax Policy Committee approved the bills and sent the measures to the House floor.

# Digital Goods and Services Tax Fairness Act of 2013

- S.1364; Introduced July 25 2013 by Senators Ron Wyden (D-OR) and John Thune (R-SD).
- The act would regulate state taxation of digital goods and services and all forms of cloud computing.
- The act provides sourcing rules for digital goods based on a customer's "tax address."
- The goal is to prevent "multiple and discriminatory" taxation of digital goods.
  - Digital goods cannot be taxed at a higher rate than the rate for comparable tangible personal property or services that are not delivered electronically.

# Questions?

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