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Software-Service Distinction 'Clouds' Application of Sales Tax

By: Joseph Lipari

Open any state tax publication in the past two years and you will find an article on "cloud computing".[1] Cloud computing"[i]n the simplest terms, . . . means storing and accessing data and programs over the Internet instead of your computer's hard drive."[2] Products[3] like Google Drive (which gives users access to word processing, spreadsheet, and presentation software in their web browsers), and Salesforce.com (which provides "sales force automation" and customer relationship management tools, among others) continue to proliferate and replace desktop software and locally-provided services alike. These products often provide functionality and features unavailable from boxed or downloaded-but-locally-installed software.[4] State tax authorities have struggled in recent years to determine how to apply their sales tax laws and regulations to cloud computing. For obvious reasons, tax departments do not wish to exempt these products from imposition of sales tax. However, it is often difficult to conclude that cloud computing products fall within the statutory definitions needed to subject them to tax. A recent determination by an administrative law judge ("ALJ") of the New York State Division of Tax Appeals, *Matter of SunGard Securities Finance LLC*,[5] illustrates some of the problems faced.

As background, a brief overview of the New York State Sales Tax imposed on computer software and services is useful. Tax Law section 1105(a) imposes sales tax on "[t]he receipts from every retail sale of tangible personal property."[6] Tax Law section 1101(b)(6) specifically includes in the definition of tangible personal property "pre-written computer software, whether sold as part of a package, as a separate component, or otherwise, and *regardless of the medium by means of which such software is conveyed to a purchaser*."[7] Amounts paid to rent tangible property or to license pre-written computer software are also subject to tax.[8] Although custom software is exempt from sales tax, such exemption will not generally apply to cloud computing products since they are ordinarily made available to multiple users.[9]

In contrast to tangible personal property, which is subject to sales tax unless an exemption applies, a service is subject to sales tax only if it is specifically enumerated in Tax Law section 1105(c). Paragraphs (1) and (9) of Tax Law section 1105(c) impose a sales tax on information services, "but exclud[e] the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons."[10]

This blurring of the line between software and services, and gradations within both software and services, frustrates taxpayers and state taxing authorities alike when it comes to determining the applicability of sales tax. Depending upon the particular facts applicable to a cloud computing product, for purposes of sales tax, it may be: (1) a license of pre-written software or (2) non-individual information services, each of which is subject to sales tax. Alternatively, the cloud computing product may be (3) custom software, (4) individual information services, or (5) other, non-enumerated services, each of which is not subject to sales tax.

Petitioner in *SunGard* was "engaged in the business of providing consulting and related data processing services to customers in the financial industry. Its customers include[d] broker-dealers, custodian banks, third-party agency lenders and other financial institutions." Four of petitioner's products were at issue in the determination: (a) Smart Loan; (b) Lending Pit; (c) Board Reporting; and (d) Performance Analytics. The ALJ ruled that Smart Loan was not subject to sales tax as an individual information service, and that the latter three products were subject to sales tax as non-individual information services.

Smart Loan was a product that provided "'back office' functions for . . . customers, including analyzing, processing and maintaining ancillary accounting ledgers regarding the customer's securities lending and borrowing transactions and making such information available to the customer's employees in various processed formats." The Tax Division argued that the transaction was a license of the Smart Loan computer software and was as such subject to sales tax. In determining that Smart Loan was a service and not a software license, the ALJ looked to four factors. First, that a customer's use of Smart Loan "out-source[d] . . . the expense and potential risks associated with [certain] 'back office' functions."[11] Among other things, the services that petitioner provided as part of Smart Loan included

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interfacing with third-party trust companies, legal compliance monitoring, and maintaining and verifying customers' accounting ledgers. Second, the ALJ noted that the agreement between petitioner and its customers was, by its terms, for services and not software: the agreement was called a "Service Agreement"; it explicitly states that there was no transfer of title of the software used for the Smart Loan product; and customers were not permitted to modify the Smart Loan software in any manner. Third, the ALJ noted that Smart Loan was not always available. Rather, customers could only use Smart Loan 7:15 a.m. to 6:00 p.m. Monday through Friday (excluding holidays); customers had to upload their data onto the system by 3:00 a.m. in order to have it available for use later that same business day. Lastly, the ALJ noted that petitioner, and not petitioner's customers, actually used the Smart Loan software.[12] The ALJ found that the portion of the software that petitioner used to transmit information to customers was "integrally related" to the performance of the service, and did not constitute a software license in and of itself. Although the ALJ found that Smart Loan added to the "intelligence" of customers' data, making it an information service, he concluded that Smart Loan was a non-taxable *individual* information service, as only a customer's own data was used, and that data was not used for other customers.

The ALJ came to a different result with respect the taxability of Lending Pit, Board Reporting, and Performance Analytics (collectively, the "Lending Pit Products"), a suite of related-but-sold-separately products. Lending Pit "allow[ed] customers to view their own current lending data in comparison to their own historical lending data, as well as to view their own current and/or historical lending data in comparison with benchmarks formulated by petitioner using raw data from *all of its customers*."[13] Board Reporting provided an evaluation to customers of "performance of the customer's securities lending program data against market performance benchmarks, as derived from the information in petitioner's . . . database." Performance Analytics "evaluate[d] a customer's lending program [by] comparing that customer's results with the results of other securities lending agents." The determination did not need to address the possibility that the Lending Pit Products were licensed software since they would be subject to sales tax anyway as an information service. In contrast to Smart Loan, the Lending Pit Products used customers' data for other customers, meaning that the individual information service exception was not applicable. Petitioner's only hope in avoiding sales tax on the Lending Pit Products was the ALJ finding the products to be a non-enumerated service.

The ALJ begins his analysis of the Lending Pit Products by noting that services are only subject to sales tax if they are enumerated in the Tax Law, and that such a form of statutory structure requires the ALJ to construe such the language "most strongly against the government and in favor of the citizen." The ALJ tempers that statement observing that it is still "petitioner's burden . . . to show that [its] services [are] not one of those set out in" the statute. The ALJ mostly rests his determination of the nature of the Lending Pit Products by means of the "primary function" test. Stated simply, under this formulation, if the "primary function" of a service is to provide information, then it is an information service. If the provision of information is merely incidental to the service, then the service is *not* an information service. The ALJ found that the primary function of Lending Pit was "collecting information, compiling and analyzing the same and furnishing such information, either in raw or aggregate form or as analyzed by petitioner, in reports to customers." He also found that the primary function of the other two Lending Pit Products was essentially the same.[14]

As a secondary matter, and only with respect to Board Reporting and Performance Analytics, the ALJ notes that petitioner failed to substantiate that it provided exempt non-information consulting services. Specifically, petitioner did not provide qualifications for the employees performing the analysis, and that petitioner only gave "bare assertions and generic descriptions" of such employees and the alleged value-added reports those employees generated.

In general, taxpayers and their representatives will be pleased with the ALJ's analysis in *SunGard.* The Tax Division, in asserting sales tax on cloud computing products, generally argues that the customer's ability to access the cloud web platform constitutes a license of software even if the customer's access is limited to that necessary to enable the customer to upload data onto the system. The ALJ's ruling that there was no software license of the Smart Loan software is significant. With respect to the tax on information services, the Tax Division has objected to the use of the primary function test and instead has argued that virtually anything involving the providing of information to a customer is a taxable information service.

Nevertheless if Smart Loan was available on demand 24/7/365 or if its customers could take actions beyond the uploading of their data, such as customizing reports, one could imagine an ALJ finding it to be pre-written software and not a service. If a taxpayer with through cloud based platforms is better able to substantiate that it is providing services more than mechanical reports, it may be better able to escape sales tax by characterizing its services as consulting instead of information services at least in part. In fact, the best lesson from *SunGard* may be that taxpayer's need to focus both on what they do and how they describe what they do.

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1 *See, e.g.*, David J. Shakow, *The Taxation of Cloud Computing and Digital Content*, 69 STATE TAX NOTES 221 (July 22, 2013), and Arthur R. Rosen, Leah Robinson & Hayes R. Holderness, *Cloud Computing: The Answer Is 'No,'* 66 STATE TAX NOTES 101 (Oct. 8, 2012).

2 Eric Griffith, *What is Cloud Computing?* PCMAG.COM (Mar. 13, 2013), http://www.pcmag.com/article2/0,2817,2372163,00.asp. For a more technical definition, *see* PETER MELL & TIMOTHY GRANCE, THE NIST DEFINITION OF CLOUD COMPUTING (Sep. 2011), *available at* http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf.

3 The rest of this article will refer to Internet-delivered software and services as "products," so as not to prejudge whether any particular product is software or a service.

4 *See* Rosen, *supra*.

[5] DTA No. 824336 (Feb. 6, 2014).
[6] With exceptions.
[7] Emphasis added.
[8] *See* N.Y.C.R.R. section 526.7(a)(1), (2), and (e)(4).
[9] *See* Tax Law section 1101(b)(14) (defining "pre-written software," and implicitly exempting custom software from sales tax). *See also* Citibank, N.A., TSB-A-01(2)S (June 23, 2000).
[10] Tax Law section 1105(c)(1).
[11] The position that outsourced functions that replace personnel and not merely local software is consistent with the Sales and Use Tax Regulations. *See* N.Y.C.R.R. section 527.3(b)(2) ex. (3) (outsourced payroll is an individual information service).
[12] The New York State Department of Taxation and Finance has itself taken the position that *who* actually operates the software can be determinative in whether a product is software or a service. *See* TSB-A-09(8)S (finding that a product that was otherwise ruled a service became a software license when petitioner's customers inputted information into software directly and could retrieve reports on demand).
[13] Emphasis added.
[14] *See* Matter of Petition of SSOV '81 Ltd. d/b/a People Resources and Matter of Petition of Susan A. Wallace, Tax Appeals Tribunal, DTA Nos. 810966 and 810967 (Tax App. Trib. Jan. 19, 1995) (articulating the "primary function" test, and finding that the primary function of a dating service was "not to provide information services" but rather "to allow members to meet others").