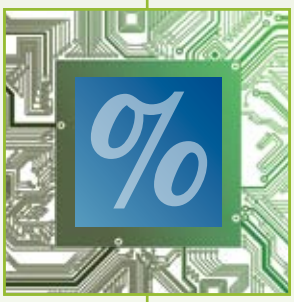
IS THERE TAX ON THE CLOUD?

We've all heard the well publicized debate raging in a number of states over whether to force retailers to collect sales tax for online transactions. A lesser known – but perhaps every bit as important – discussion involves whether to tax another technology innovation, in this case "cloud computing."



Cloud computing, also called "software as a service," takes place on virtual servers over the Internet. It has gained credibility as an efficient and viable means of doing business as an increasing number of businesses have moved their IT operations to the cloud.

As companies change the way they do business, politicians and taxing authorities are now grappling with the issue of whether cloud computing should be subject to tax. Specifically, a handful of states, including Michigan, are debating whether companies that sell software and data accessed through the cloud are peddling a taxable good or a nontaxable service. Factors to be considered in determining taxability can include whether a license of software is granted by the agreement, the location of the server, and whether the service or software is being delivered to individuals or businesses resident in a state. Also relevant is whether the service provider has a taxable presence in the state where the customer accesses the application, and whether the customer has a taxable presence where the servers running the application are located.

Depending on the nature of the transaction, the question of whom to tax and for what can be a difficult one. For example, consider a scenario in which a Michigan-based company purchases server space and cloud-based software from a California-based company. Simple enough, but further consider that the California company has servers in New Jersey and Illinois, and the Michigan company has subsidiaries around the country that utilize the server space. This becomes a much more complex transaction from a tax collection standpoint.

Michigan's General Sales Tax Act and Use Tax Act include within their scope "pre-written computer software." A group of eight Michigan state senators recently introduced bills (Senate Bills 335 and 336) that would amend these acts to clarify that software as a service, or cloud computing, falls outside the definition of pre-written computer software and is, therefore, not subject to Michigan's 6% sales or use taxes. The bills were passed by the Senate on June 16, 2011, and are currently pending before the Committee on Tax Policy in the Michigan House of Representatives. The bills would operate retroactively and specify that the right to use pre-written software installed on another person's server is not a taxable transaction. It's too early to know whether these bills will become law. However, anyone engaged in providing cloud computing services as well as consumers of these services should closely monitor what develops.

For more information about legislation or litigation involving technology, intellectual property protection of information technology assets, or any other information technology law issue, please contact the author or Gregory A. Nowak at 313.496.7963.

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