



Cloud Computing and SaaS Present a Host of Foggy Tax Issues

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The increasing adoption of cloud computing requires tax auditors and accountants to confront a host of new issues that have tremendous bearing on technology providers of all sizes. Chief among them is how to approach the taxation of software as a service, commonly known by its acronym, SaaS.

Cloud computing's flexibility has made SaaS—which provides e-mail, financial, research, and other applications over the Internet—a prominent offering from many vendors and a much-sought-after solution for many customers seeking greater IT efficiency and lower costs. Yet the taxation of SaaS is a challenge for all parties involved: states, vendors, and customers.

First and foremost is determining what's really being provided and how it fits into a state's sales and use tax laws. Unfortunately, each state approaches SaaS differently, and many state tax codes have yet to catch up with this new service trend, despite its near-ubiquity.

Some states have passed laws specifically addressing SaaS, others rely on interpretations of existing laws to fit SaaS within existing definitions, while still others struggle to determine how to approach it at all. As a result, this sale and use of "invisible" IT resources presents new and complex tax implications.

So what's the best approach for providers of cloud-based software? The most important thing is to assess what your product enables customers to do. For example, does the software provide customers with a place to store data? Does it provide data for customers to research? Or does it enable customers to process transactions? Perhaps it even does more than one of these things.

This assessment should include what you're charging and the specific nature of your agreements with customers. Are you granting them a license to copy and use the software, or are your customers instead subscribers with limited rights to use of the software? If an electronic download is involved, the software may be classified as an intangible. However, if a security key, token, or other hardware is delivered to your customer to allow the use of the software, the classification can change to a tangible item.

The next step is to examine the tax laws in the states where you're operating and the states where you have the largest revenues. If those states don't mention SaaS or other cloud-based software in their tax codes yet, your research should include an analysis of how they tax analogous items, such as information services, data processing, or telecommunications services.

correct jurisdiction to determine taxability? Not surprisingly, each state has a different view, which makes it hard for providers to limit or cover their tax exposure in this area.

Once again, the answer often depends on whether a state considers what you're selling tangible or intangible. The encouraging news here is that some states have a methodology, a bright-line test stipulating that if you follow their rules, they won't hold you liable, even if you tax incorrectly. This is especially helpful since providers usually have little choice other than to trust the information their customers provide.

These rules can include using the customer's shipping or billing address as the jurisdiction to which to source the sale. Still, electronic delivery of IT resources makes it very difficult for providers to know when—and how—their products are being used. After all, customers don't often readily provide this information.

It's also essential to look at your customer base and assess which customers you'll have to tax and which will claim exemption from taxes. This can be complicated, because some states accept exemption certificates for services and others do not.

The ultimate takeaway for SaaS and other cloud-computing service providers is to stay focused on the relevant tax issues. For their part, accounting professionals must keep educating themselves and their IT clients about the latest developments and rulings that pertain to this fast-moving and often amorphous innovation, which is clearly making itself felt in the technology marketplace.

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Once you review this, it's important to determine how each state treats the sourcing of these types of sales. Proper sourcing can result in tax savings, but because SaaS resides virtually, on the Internet, it's very hard to determine where the incidence of tax should be: Is it where the vendor is located or where the actual computing—the people actually using the software—is being carried out? How much effort does a vendor need to exert to make sure it's looking at the



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