Grant Thornton

Taxing software as a service (SaaS): Lessons learned

Insights for software companies September 2010

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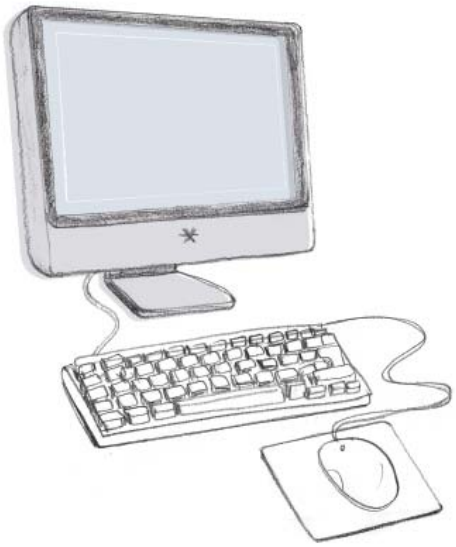
In the summer of 2009, studies indicated that many large companies were migrating to the software as a service (SaaS) delivery model or were in the trial stages of doing so.[1] Clearly, SaaS (also referred to as cloud computing or hosted, on-demand or subscription-based software)[2] has thrived, with companies selling to customers in multiple states and across the world.[3] (For an introduction to the potential tax liabilities of SaaS, read our Summer 2009 *TechDashboard* article, "Taxing software as a service: What SaaS providers may not know about their tax liabilities.")



As SaaS sales grow, SaaS providers' risk of sales tax exposure expands. We've found that state interpretations of SaaS technology and how it should be treated under existing state law have become increasingly difficult for companies to navigate.

Sales tax exposure risk — noncompliance

New computing technologies have grown organically and swiftly; in fact, these advances have outpaced the ability of states to rule on their taxability. What hasn't changed is the cost of noncompliance. Companies with nexus (a taxable presence in a state) must register, file and remit applicable sales taxes. Failure to comply with these basic requirements can allow auditors to reach back in time into a company's coffers beyond the usual statute of limitations in order to recover all unpaid sales taxes, penalties and interest. And uncollected sales taxes can, under FAS 5/ASC 450, require a company to reserve for and/or disclose the exposure in its financial statements. In addition, state audits can result in scrutiny of a seller's customers, which could potentially harm the beneficial, hard-won relationship between seller and buyer. These are risks that few sellers would willingly overlook.

Limited state legislative changes

As of July 2009, no state had changed its statutes or regulations to specifically address the taxability of SaaS. Not surprisingly, the general trend has been for states to tax SaaS under existing laws; however, that trend is beginning to shift, albeit slowly. Recently, North Carolina[4] and Washington[5] enacted laws explicitly addressing the taxability of remotely accessed software. And while many states struggle with declining revenue, the overall trend continues to move toward expansion of the tax base. States seem eager to tax more services, and SaaS may be a welcome target.

1 Ann Bednarz, "Cloud adoption draw F5's attention," *Network World*, (Aug. 24, 2009) http://www.networkworld.com/newsletters/accel/2009/082409netop1.html.
2 The National Institute of Standards and Technology (NIST), an agency of the U.S. Department of Commerce, has published a definition of cloud computing (drafted in collaboration with the industry and the government), available at http://csrc.nist.gov/groups/SNS/cloud-computing.
3 According to a recent analysis, SaaS-indexed stocks outperformed the NASDAQ composite index for the first seven months of 2010 (http://www.williamblair.com/emarketing/cfin_cloud_insights/cloud_insights_082010.pdf).
4 Ch. 451 (S.B. 202), Laws 2009.
5 Washington Revenue Code §§ 82.08.010(1)(a), 82.12.020(1)(e); H.B. 2075, § 201.

Questions companies are asking

Many SaaS providers have begun asking the question: "SaaS is just a service — so it's not taxable, right?" The short answer is: There is no short answer. In fact, this could be a dangerous assumption. The problem is, while most states do generally exempt services, many of those same states enumerate certain services as taxable.[6]

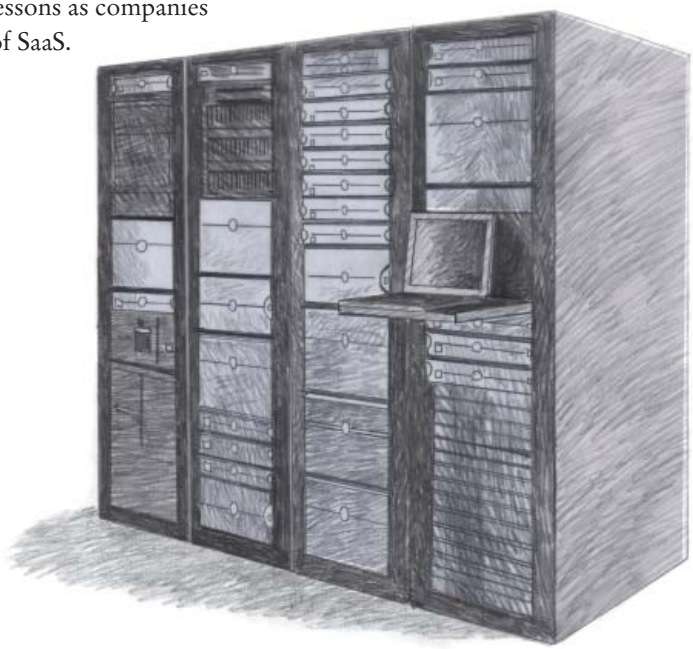
Historically, a transaction could be clearly identified as the sale of a service, the sale of tangible personal property or a combination of both. For example, more than a decade ago "downloaded software" was a relatively new concept. Today, its taxability is defined by state law, and vendors have the benefit of clear guidance in determining how those products should be taxed. This level of clarity took years to achieve. While the rocky history of electronically delivered software seems distant, the wait for clear guidance was long and costly for countless providers. That history provides valuable lessons as companies look to the future of SaaS.

Questions companies should be asking

A key consideration in determining whether SaaS may be deemed taxable is the "true object" of the transaction. Simply put, what is the customer's objective in purchasing the SaaS? To answer this, a company may want to start with the following questions:

- How does my company market itself? Does it portray itself as a SaaS provider on websites, in brochures and in advertising?
- Does my company merely collect or store a user's data, or does it perform analysis, calculations or manipulations?
- What language is contained in our sales agreements? Are those agreements called professional services contracts, subscription agreements, license agreements or something else entirely?
- Am I providing services that are merely facilitated by software/SaaS? (For instance, do we just use the software/SaaS internally to provide professional services to our customers? Or is the customer actually using the software/SaaS?)
- Is my service purely automated or is human intervention (i.e., transcribing user-provided data manually) essential to rendering the service? If so, is there a point where my service more closely resembles a nontaxable professional service (rather than a taxable service)?

As noted in the July 2009 *TechDashboard*, the majority of states still have not passed laws addressing the taxability of SaaS and rely instead on rulings, pronouncements and notices. Some have determined that a specific SaaS application is "tangible personal property" subject to tax, while others have deemed SaaS to be a service that is taxable (or exempt) under existing laws. Many jurisdictions have not addressed the treatment of SaaS at all. What does this mean? It means that a long road lies ahead for taxpayers — and states — as both sides work to achieve legal certainty, predictability and a level playing field.



[6] For example, SaaS falls under the definition of taxable "data processing" in Texas (Texas Administrative Code §3.330 and Texas Ruling 20080509L, May 28, 2008).

Streamlined Sales and Use Tax Agreement

Many SaaS companies had hoped the Streamlined Sales and Use Tax Agreement (SSUTA) would address SaaS. The stated purpose of the SSUTA is to minimize costs and administrative burdens on retailers that collect sales tax, particularly retailers operating in multiple states, and encourage "remote sellers" selling over the Internet to collect tax on sales to customers located in the 23 SSUTA-member states. The SSUTA has adopted definitions of "prewritten computer software" and "digital products."[7] Regrettably, SaaS does not fit neatly within either definition, and the SSUTA has not adopted a separate definition of SaaS.

As states increasingly turn their attention to this sector of the market, many questions remain. Many states are still struggling to determine whether SaaS should be treated as software or as a service. They do not define SaaS, much less treat its taxability, in a uniform manner. In determining whether SaaS is subject to a state's sales tax, companies still face a variety of challenges and questions.

How should I source my sales?

A common question among SaaS providers is: "My customers access SaaS from several states; how should I source the sale (i.e., where do my sales occur)?" Unfortunately, there is currently no one-size-fits-all answer. This leaves SaaS vendors frustrated with how to source their sales and asking the following questions:

- Should I source the sale to the customer's billing/shipping address?
- Should I source the sale to where the hosting server is located, because the software is "used" in that state?
- Should I source the sale to where users access it? What if I don't know where all the users are?

For example, let's assume a SaaS provider headquartered in New York sells to a customer with users in California, Pennsylvania and Texas. The provider would find that those states source/tax SaaS very differently. Assuming the SaaS provider was required to file in each state (i.e., nexus), the California portion of the transaction would not be subject to tax;[8] Pennsylvania would impose sales tax only if the users and the hosting servers were in that state;[9] and Texas would impose tax only to the extent the SaaS benefitted in-state users.[10] As this example shows, the intricacies of a multistate SaaS transaction can be very complicated for providers and consumers.

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7 Streamlined Sales and Use Tax Agreement as amended April 30, 2010, Appendix C, Library of Definitions, pp 128-131.
8 Cal. Rev. & Tax Code §6006(a); Cal. Code Reg. §§1502(b), (f)(1)(D).
9 PA Sales and Use Tax Ruling SUT-08-005 (Feb. 11, 2008).
10 Sec. 151.101, Tax Code ; Sec. 151.102, Tax Code.

Federal action

Against this backdrop of conflicting state positions, Congress may provide uniform guidance. The Digital Goods and Services Tax Fairness Act of 2010 (H.R. 5649) was introduced on June 30, 2010, to promote "neutrality, simplicity and fairness in the taxation of digital goods and digital services."[11] One of the most significant portions of the bill proposes sourcing the sale of digital goods (including software) to a single location for sales tax and use tax purposes.[12] The passage of this bill, or any similar legislation, could go a long way in helping SaaS companies make informed decisions, plan strategically and continue to grow.

What lies ahead?

As SaaS remains a new frontier in technology, providers will continue to have little authority to rely upon when it comes to state sales taxes. Unfortunately, the taxability of SaaS will be based on the vendor-specific facts. As states continue to analyze how to treat SaaS in rulings and through legislation, we should anticipate the broadening base of taxable services. The only sure thing is that the landscape of SaaS taxation will continue to change, and we'll have new lessons to learn. •

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[11] Digital Goods and Services Tax Fairness Act of 2010, H.R. 5649, 111th Congress (2010).
[12] Giles Sutton, Dale Busacker, Jamie Yesnowitz and Chuck Jones, "Federal legislation introduced to promote fairness in the state and local taxation of digital goods and services," SALT Alert, Grant Thornton LLP (July 14, 2010).