Cloud Computing: The Answer Is 'No'

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Although tax practitioners have seen quite a few articles published in the tax press regarding the state and local tax effects of cloud computing (especially sales and use tax concerns), there has been a notable paucity of any conclusions regarding what is correct under today's laws. This article hopes to fill part of that gap by analyzing the laws of those states in which the revenue departments have administratively determined that the purchase of a service offered in or through the cloud is subject to sales and use taxes — a very real concern of not only sellers of those services but also of purchasers of the services (virtually every business in the United States) — and reaches conclusions on the validity of those administrative rulings. States with specific statutes that explicitly — directly or indirectly — impose tax on data processing are not part of this study. Furthermore, normative policy issues (that is, what "should be" taxed) are also not discussed here.

Several state revenue departments — those in New York, Arizona, Indiana, Pennsylvania, and Utah — and a state appellate court in Colorado have determined that obtaining a service from the cloud is obtaining constructive possession of the prewritten (or "canned") software that resides on the service provider's server. And because prewritten software is considered tangible personal property (through statutes or case law), the central question in determining taxability is whether the purchaser of that service really has a degree of control over the software so as to constitute possession as intended by the relevant sales and use tax statutes.

Although the relevant state statutes are not identical, they all have similar goals. New York imposes sales tax on receipts from transfers of *possession* of tangible personal property.[1] Arizona likewise imposes a transaction privilege tax on any transfer of *possession* of tangible personal property.[2] Indiana imposes a gross retail sales tax on transfer of *possession* or *control* of tangible personal property,[3] and Pennsylvania imposes sales tax on each transfer of the *possession* of tangible personal property.[4] Utah imposes sales tax on any transaction under which right to *possession*, operation, or use of tangible personal property is granted.[5] Finally, the local sales tax ordinance at issue in the Colorado Court of Appeals decision imposes sales tax on any transfer of *possession* to tangible personal property.[6] Regarding these sales taxes, it appears that possession is, in fact, ten-tenths of the law.

Key Terminology

What Do 'Application Service Provider' and 'Software as a Service' Mean?

It is now common for businesses to provide traditional and newly developed services to customers through a computer network, usually the Internet. At the onset of the Internet age, these businesses were called application service providers (ASPs). Now, their services are often referred to — in a somewhat less than tax-careful manner — as "software as a service" (SaaS, usually pronounced "sass").[7] Generally speaking, SaaS involves an ASP's use of its own hardware infrastructure (terminals,

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[1]N.Y. Tax Law section 1105(a); N.Y. Tax Law section 1101(b)(5).

[2]Ariz. Rev. Stat. section 42-5008(A); Ariz. Rev. Stat. section 42-5071; Ariz. Rev. Stat. section 42-5001(13).

[3]Ind. Code section 6-2.5-2-1(a); Ind. Code section 6-2.5-1-21(a).

[4]Pa. Stat. Ann. section 7202(a); Pa. Stat. Ann. section 7201(k)(1); Pa. Code section 31.1(1).

[5]Utah Code section 59-12-103(1)(a); Utah Code section 59-12-102(104).

[6]City of Boulder Code section 3-2-2; City of Boulder Code section 3-1-1.

[7]SaaS is a category within the realm of "cloud computing," but the term cloud computing encompasses more activities than just SaaS. "Infrastructure as a service" (IaaS) and "platform as a service" (PaaS) are other categories of cloud computing. While SaaS is used on a daily basis by millions of businesses and individuals, only a limited set of businesses use IaaS, and PaaS is generally used by computer programmers and developers. Thus, IaaS and PaaS are not addressed in this article.

computer servers, and so on) and its own software (usually proprietary) to provide some service to customers that access the ASP's front-end portal (a Web page) using the customers' own computer hardware and software. Customers can access data or can request that the ASP perform various functions to produce the desired result. Some ASPs require a customer to download some minor communications software onto the customer's own computer to allow receipt of the ASP's service, while other ASPs do not.

SaaS is generally available on the basis of a per-transaction fee or on a subscription or other long-term contractual basis.

Although some ASPs provide remote access to Web-based services that are similar to prewritten software that a customer could purchase in a shrink-wrapped box, others provide unique services. An example of the former are ASPs that provide remote access to word processing programs similar to Microsoft's Word software that can be purchased at an office supply store. An example of the latter are ASPs that provide Web-based services that cannot be purchased "in a box," often because various constantly changing data points are required for the services (such as check verification services that access several third-party data sources in real time to determine the likelihood that a check will be honored by a bank); because customer data will be stored on the ASP's server and connection to that server is required; or because — as is common — significant ASP employee involvement is required. Thus, although the function of some SaaS is essentially the same as canned software, other types of SaaS could never be sold off the shelf. Most of this article focuses on the latter type of ASPs — those that provide functionality above and beyond what is, or could be, available in a shrink-wrapped box.

How Do ASP Services Work?

Unless a person is a highly sophisticated computer hacker, he has absolutely no ability to access the software used by the ASP's servers. Customers can and do access the ASP's external portal in the form of a Web page, through either the Internet or a private network, through which the customers submit data and order various services from the ASP.

Once a customer is logged on to the website, she sends a request to the ASP to verify that customer's information and to allow the customer access to the subscription-only portions of the website. Once that is accomplished, the ASP redirects the customer to another Web page that often contains a variety of blank data fields in which the customer enters data for use by the ASP. Under some arrangements, the ASP's software automatically pulls data from the customer's databases.

Once the customer enters data into the search fields, the data is transmitted to the ASP by, for example, the customer clicking "enter." By clicking "enter," the customer is merely requesting that the ASP use the ASP's own software either to perform a search of the various databases (either the ASP's or third parties') to find information that meets the customer's need or to process the data, or both. The ASP may or may not accept the customer's request. For example, if the ASP's server is experiencing too high a demand for services, the customer may have to wait to get her request fulfilled. Other reasons that may cause an ASP to reject a customer's request include the customer having entered incorrect, incomplete, or inconsistent data, or the ASP's systems having trouble operating or undergoing system maintenance.

Once the ASP begins performing the service, the customer is usually unable to stop the service (in fact, even if she logs off or even turns off her computer, the ASP usually continues processing the request). If there is a problem with the software, the customer cannot access it to correct that problem. In sum, a customer has absolutely no ability to access, alter, copy, or delete the ASP's software.

With that limited operational framework, we now analyze the various states' positions, beginning with the ringleader, New York.

New York

Possession

New York imposes sales tax on receipts from transfers of "title or possession" to items of tangible personal property.[8] Tangible personal property includes prewritten software.[9] No New York statute or regulation explains when a license to use exists regarding software. However, the regulation defining the terms "rentals, leases, and licenses to use" states that "the terms 'rental, lease and license to use' refer to all transactions in which there is a transfer for a consideration of possession of tangible personal property without a transfer of title to the property."[10]

The New York State Department of Taxation and Finance has taken the position that cloud computing sales made by ASPs are taxable licenses to remotely use prewritten software. In its opinions, the department concludes that the ASP's receipts are derived from providing customers with access and control of software (that is, a license to use tangible personal property) rather than from the ASP itself using its software in conjunction with the provision of its services. The "license" is based on the purchaser's presumed ability to "use, direct, or control" the software on a remote basis.

[8]N.Y. Tax Law section 1105(a); N.Y. Tax Law section 1101(b)(5).

[9]N.Y. Tax Law section 1101(b)(6).

[10]N.Y. Comp. Codes R. & Regs. tit. 20 section 526.7(c)(1).

However, the department's advisory opinions do not address whether the ASP's customers actually use, direct, or control the ASP's software. Rather, the opinions appear to assume that a customer's use of an ASP's services is the same as the customer using the ASP's software, thus creating constructive possession of and sufficient control over the software for the transaction to be a taxable license to use prewritten software. However, the relevant — and abundant — New York legal authority does not support the department's assumptions. In most situations, ASPs' customers do not receive a license to use the ASPs' software because they never have constructive possession of or control over the software.

Under the New York sales tax regulations, a transfer of possession for a "license to use" has occurred when "one of the following attributes of ownership has been transferred: (i) custody or possession of the tangible personal property, actual or constructive; (ii) the right to custody or possession of the tangible personal property; [or] (iii) the right to use or control or direct the use of tangible personal property."[11] That aligns perfectly with the property law concept of a possessory interest, such as a fee simple absolute or a leasehold — constructive possession or control is necessary in both situations.

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If possession or control is required for a transaction to be a taxable license to use, how much possession or control is needed? The department apparently assumes that almost any possession or control is sufficient. But under controlling law, possession must be "exclusive" and for more than a fleeting moment and control must mean actual control.

In *In re Darien Lake Fun Country Inc. v. New York State Tax Comm'n.*,[12] the department asserted that amusement park admission tickets were actually taxable licenses to use the amusement park rides. The department argued that park visitors had possession of the rides while they rode on or in them. However, holding for the taxpayer, the New York Court of Appeals said that "it has long been the rule that something more than temporary possession is required before there is, within the meaning of section 1105(b), a 'license to use' taxable as a retail sale." Thus, park visitors lacked sufficient possession over the park rides for the admission tickets to constitute taxable licenses to use the rides. Similarly, in *In re Smarte Carte Inc.*,[13] a New York administrative law judge, relying on *Darien Lake Fun Country*, determined that providing access to luggage carts at airports for a fee was a taxable license to use the carts because there was no time limitation on use and no use restrictions that interfered with the intended purpose of the carts (that is, possession was more than merely fleeting).

Darien Lake Fun Country and its progeny are clear: Temporary possession of property is insufficient to constitute a license to use that property. In the ASP model, customers are not granted actual, physical possession of the software. Indeed, the department concedes as much.[14] However, the department asserts that the customer obtains constructive possession of the software because the department assumes that the customer controls the ASP's software. In so asserting, the department fails to recognize that the ASP is the entity using and controlling the software. Clearly, a customer "uses" an ASP's service, but that is a far cry from controlling the ASP's software.

The Court of Appeals recognized the distinction between "use" and "control" in *American Locker Co. v. New York City*.[15] In that case, a locker company argued that the rentals of its lockers did not constitute a "transfer of title or possession or both, exchange or barter, license to use, license to consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore," and thus were not subject to New York City's sales tax.

The court agreed, stating, "the purpose of the sales tax law is not to impose a tax on all transactions, but only on transactions which involve the passage of title . . . or transactions in which the actual, exclusive possession is transferred."[16] After indicating that it was clear that title to the lockers

[11]N.Y. Comp. Codes R. & Regs. tit. 20 section 526.7(e)(4).

[12]*In re Darien Lake Fun Country Inc. v. New York State Tax Comm'n.*, 496 N.E.2d 217 (N.Y. 1985).

[13]*In re Smarte Carte Inc.*, Dkt. No. 812942 (N.Y. Tax App. Trib. 1996).

[14]*See, e.g.,* TSB-A-10(28)S (July 2, 2010).

[15]*American Locker Co. v. New York City*, 125 N.E.2d 421 (N.Y. 1955). *American Locker* involved a sales tax imposed by New York City under N.Y.C. Admin. Code sections N41-1.0(5) and N41-2.0. The tax was similar to the current sales tax and was imposed "upon the amount of the receipts from every sale of tangible personal property sold at retail" and defined a sale as "any transfer of title or possession or both, exchange or barter, license to use, license to consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore."

[16]*Id.*

did not pass to the customers, the court stated that "neither can there be said to be a transfer of actual physical possession of the lockers to the patrons. The lockers are physically and permanently attached to each other, having been manufactured so as to comprise a cabinet unit. The patron has no right to move any of the lockers." Even so, the city argued that customers were in constructive possession of the lockers and that constructive possession was enough to render the transaction taxable. The court rejected that position because the customers, although able to use the lockers, did not have control over them:

> It is true, of course, that the patron may keep his baggage on the locker for a period up to 24 hours and that during that period he may exclude all others from use of the locker. However, that is, at best, a limited type of constructive possession. The patron has the right only to lock and unlock the locker once during a period not in excess of 24 hours. After the door has been locked, the patron may not open the locker without ending his right to its further use. If the transaction were one in which real, exclusive possession were transferred, it seems to us that the patron would have the right or privilege of opening and closing the door as many times as he wanted during the 24 hour period.[17]

Thus, mere "use" without "control" — including the ability to exclude others — does not constitute constructive possession sufficient to create a taxable license to use.[18] *Smarte Carte*, described above, provides a good example of a transaction in which a customer enjoyed both use of and control over property (airport luggage carts). In such a case, the transaction is properly classified as a taxable rental, lease, or license to use.

The distinction between use and control is demonstrated well by the operation of a jukebox. A customer inserts coins and requests songs to be played by the jukebox. However, the customer does not actually control the jukebox; for example, he cannot cause the machine to play a song backwards and cannot delete a song from the jukebox's library. Indeed, a New York appellate court concluded that because the customer's control and possession over a jukebox is so limited, using a jukebox — inserting coins and selecting songs — clearly fails to create a taxable license to use tangible personal property.[19]

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The department certainly recognizes — or, at least, used to recognize — the use and control distinction. For example, in *McKelvey (Advisory Opinion)*,[20] the department addressed a transaction in which a customer hired a truck to move asphalt. The customer had the ability to instruct the truck driver when and where to load and unload the asphalt but could not instruct the truck driver how to do so or what routes to take between locations. The advisory opinion concluded that the trucking company had "exclusive possession of the trucks and a sufficient degree of control over them while performing the service paid for by the customer so as to be furnishing a transportation service and not renting, leasing, or licensing trucks." Thus, although the customer used the trucks to move its asphalt, it did not control them and therefore did not rent, lease, or license them.

Furthermore, in TSB-M-86(3)S,[21] the department determined that a storage unit customer only has "control" over the storage unit when the "lessor [has] relinquish[ed] all control of the space rented. The lessee's possession and control of the space must be to the complete exclusion of the lessor" to be taxable.

Although ASP customers submit data through an ASP's website and request that the ASP perform specific tasks, the customers have absolutely no control over the ASP's software; for example, the software relies on the ASP's underlying operating system and computer server hardware (operated and monitored by the ASP), customers cannot force the software to perform, customers cannot stop the software once it has begun performing, and customers cannot copy or alter the software or correct a

[17]*Id.*

[18]*See, e.g.*, *Shanty Hollow Corp. v. New York State Tax Comm'n.*, 111 A.D.2d 968 (N.Y. App. Div. 1985) (relying on *American Locker* for "the firmly established principle that only transactions involving passage of title or of actual exclusive possession constitute sales"); *Bathrick Enterprises Inc. v. New York State Tax Comm'n.*, 27 A.D.2d 215 (N.Y. App. Div. 3d Dep't. 1967) (the ability to make a jukebox play music was not the result of a license to use the jukebox because "it was never intended that there be (nor was there) any passage or transfer of title nor were they such that actual, exclusive possession was transferred. . . . No title ever passed nor was any possession ever transferred.").

[19]*See Bathrick Enterprises Inc. v. New York State Tax Comm'n.*, 27 A.D.2d 215 (the ability to make a jukebox play music was not the result of a license to use the jukebox because "it was never intended that there be (nor was there) any passage or transfer of title nor were they such that actual, exclusive possession was transferred. . . . No title ever passed nor was any possession ever transferred.").

[20]*McKelvey (Advisory Opinion)*, TSB-A-97(1)S (Jan. 23, 1997).

[21]TSB-M-86(3)S (Jan. 16, 1986).

problem with the software. All the customers are able to do is send a request to the ASP, which may or may not be accepted. Control would necessitate that the customer be able to access the underlying computer code, force the software to perform or to stop its performance, alter the way the software functions, correct a flaw or virus in the software, or modify the software. An ASP customer can do none of those things. Moreover, an ASP customer cannot prevent the ASP from doing any of those activities. Simply put, ASP customers have an insufficient amount — indeed, a nil amount in most cases — of control over the software to be treated as constructively possessing it.

New York regulations further support the conclusion that an ASP does not transfer control of its software to its customers. Specifically, the regulations provide the following example of a situation in which there has *not* been a transfer of possession:

> Example 13: A corporation contracts with a computer center to use the computer on the center's premises for 10 hours weekly. The corporation provides its own materials and the computer center provides and directs the operator. During the 10 hour period, no one else may use the machine. In this case, there is no transfer of possession to the corporation as it has no control over the operation of the computer. However, the transaction may be taxable [as an information service].[22]

The situation presented in this example is analogous to an ASP scenario. For example, customers might retain an ASP to provide them with certain electronic banking services. The ASP, like the computer center in the example, "provides and directs" the operation of its electronic services, because the operating systems and the hardware on which the software operates are not under the constructive possession or control of the ASP's customers. Unlike in *Smarte Carte*, the ASP's customers cannot do as they wish within the software's "parameters" (as could the luggage cart patrons within the airport's "perimeter"). Rather, the ASP software is useless to the customers without the active coordination and essential concurrent activities performed by the ASP's employees operating and maintaining the software, operating systems, and hardware. The ASP's customers have no control over the underlying operations of the ASP's business.[23]

Similarly, the regulations provide a second example of a situation where there has not been a transfer of possession:

> Example 14: A corporation contracts with a computer center for access time on the computer center's equipment through the use of a terminal located in the corporation's office. The terminal is connected to the computer by telephone. *The corporation's access to the computer through the terminal is not deemed to be a transfer of possession of the computer subject to tax.* However, the transaction may be taxable [as an information service].[24]

That example further demonstrates that use of another entity's computer systems, without more, is insufficient to constitute a taxable sale. Remote use of the computer was simply insufficient to constitute a transfer of possession. Clearly, the corporation had no right to control or operate the underlying computer systems. That is exactly the case with respect to an ASP. An ASP's customers enter data into a Web-based application form and click "enter." The customers' actions stop there. Those actions are simply insufficient to constitute control over the ASP's software. Therefore, the department's position regarding the taxability of ASP services is not sustainable.

Primary Purpose Test

Instead of demonstrating that ASP services do not fit within the statutory and regulatory definitions of a taxable license to use, one could simply argue that the "primary purpose" or "true object" of the transaction is to receive services and not to receive tangible personal property (that is, the software). That is the test the New York Tax Appeals Tribunal has traditionally used when uncertainty exists regarding what has actually been purchased.[25] Under the test, if the customer's primary purpose or true object for making the purchase is to receive a service, the purchase is a purchase of services and not a purchase of tangible personal property.[26]

That test certainly has appeal here, particularly since — we suspect — ASP customers likely view their purchases as purchases of services and would be surprised to learn that the department believes they are actually leasing tangible personal property when they use an ASP's services.[27] After all, as the tribunal said:

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[22]N.Y. Comp. Codes R. & Regs. tit. 20 section 526.7(e)(5).

[23]*Compare* N.Y. Comp. Codes R. & Regs. tit. 20 section 526.7(e)(5) (example 12) (in which the corporation — not the computer center as in example 13 above — provides its own operator, then a taxable sale is deemed to have occurred).

[24]N.Y. Comp. Codes R. & Regs. tit. 20 section 526.7(e)(5) (emphasis added).

[25]*See, e.g, SSOV 81 Ltd. d/b/a People Resources*, DTA No. 810966 (N.Y. Tax. App. Trib. 1995); *In re Principal Connections, Ltd.*, DTA No. 818212 (N.Y. Tax App. Trib. 2004).

[26]*See Marriott Int'l. Inc.*, DTA No. 821078, etc. (N.Y. Tax App. Trib. 2010). ("For tax to apply, there has to be a separate transaction that has as its primary purpose the furnishing of something that is taxable.")

[27]Indeed, the department apparently shares the view that the primary purpose test requires that cloud computing transactions are exempt from tax where the primary purpose

(Footnote continued on next page.)

> [T]he proper focus should be on the primary function itself and not upon whether the service might, as an incident thereof, involve the provision of [some taxable service]. . . . To neglect the primary function of petitioner's business in order to dissect the service it provides into what appears to be taxable events stretches the application of [the sales tax statute] far beyond that contemplated by the Legislature.[28]

However, because the primary purpose was created judicially and is not contained in statute, the test should be asserted in conjunction with the statutory and regulatory arguments presented above.

Arizona

Possession

Arizona imposes a transaction privilege tax on the privilege of doing business in the state, and the tax is applied to various classifications of business.[29] The retail classification is composed of businesses selling tangible personal property at retail and the personal property rental classification is composed of businesses leasing or renting tangible personal property for a consideration.[30] "Sale" means any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatever, of tangible personal property.[31] The statute does not define either leasing or renting.

Although the Arizona Department of Revenue's regulations provide that "gross receipts derived from the sale of computer software programs are taxable, regardless of the method that a retail business uses to transfer the programs to its customers,"[32] neither the regulations nor the statute offer a definition of possession for the purposes of the transaction privilege tax. However, the department has determined that ASPs' services are taxable under the personal property rental classification as leases of computer software.[33]

The Arizona Supreme Court has determined that because the statute does not define either leasing or renting, the ordinary meaning of the terms must be used.[34] In reaching the conclusion that the use of coin-operated laundry equipment and car washing equipment were taxable rentals of tangible personal property, the court stated:

> Webster's Third International Dictionary defines the verb "to rent" as "(1) to take and hold under an agreement to pay rent," or "(2) to obtain the possession and use of a place or article for rent." There is no question that when customers use the equipment on the premises of the plaintiffs herein, such customers have an *exclusive use* of the equipment for a fixed period of time and for payment of a fixed amount of money. It is also true that the customers themselves *exclusively control* all manual operations necessary to run the machines. In our view such *exclusive use and control* comes within the meaning of the term "renting" as used in the statute.[35]

In *City of Phoenix v. Bentley-Dille Gradall Rentals, Inc.*,[36] the Arizona Court of Appeals, following *Peck*, stated that "the principal characteristic of a rental or lease is the giving up of possession to the lessee so that he, as opposed to the lessor, exercises control over and uses the leased or rented property."[37] Also, in *Energy Squared, Inc. v. Ariz. Dep't. of Rev.*,[38] the Arizona Court of Appeals stated that the personal property rental classification "hinges on the degree of control over the property in question that is ceded to its putative 'lessee' or 'renter.'"[39] In *Energy Squared*, customers paid to use the tanning equipment of a tanning salon, but because the tanning salon's employees limited the use based on various factors — thus exercising control over the equipment — the court found that the customers were not renting the equipment, rather they were purchasing a service.[40]

The department has recognized and followed those decisions in its rulings in areas other than

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is to obtain an ASP's services. *See* TSB-A-12(22)S (Aug. 29, 2012) (finding that online access to software and directory of consultants was not taxable where the primary purpose of the transaction was obtaining a nontaxable service and the use of the software was not necessary to receive the service).

[28] *In re Telecheck Svcs. Inc.*, DTA No. 822275 (N.Y. Tax App. Trib. 2009) (citing *SSOV 81 Ltd. d/b/a People Resources*, DTA No. 810966 (N.Y. Tax App. Trib. 1995)).

[29] Ariz. Rev. Stat. section 42-5008(A); Ariz. Rev. Stat. section 42-5071.

[30] Ariz. Rev. Stat. section 42-5061(A).

[31] Ariz. Rev. Stat. section 42-5001(13).

[32] Ariz. Admin. Code R15-5-154(B). Arizona exempts "application services that are designed to assess or test student learning or to promote curriculum design or enhancement purchased by or for any school district, charter school, community college or state university. For the purposes of this paragraph: (a) "Application services" means software applications provided remotely using hypertext transfer protocol or another network protocol." Ariz. Rev. Stat. Ann. section 42-5061(A)(55). That may imply that other application services are taxable under the retail classification.

[33] Arizona Private Taxpayer Ruling LR09-007 (Dec. 3, 2009).

[34] *State Tax Comm'n v. Peck*, 476 P.2d 849 (Ariz. 1970).

[35] *Id.* (emphasis added).

[36] *City of Phoenix v. Bentley-Dille Gradall Rentals, Inc.*, 665 P.2d 1011 (Ariz. Ct. App. 1983).

[37] *Id.*

[38] *Energy Squared, Inc. v. Ariz. Dep't. of Rev.*, 56 P.3d 686 (Ariz. Ct. App. 2002).

[39] *Id.*

[40] *Id.*

cloud computing.[41] As previously discussed, consumers of ASP services do not exercise exclusive use or exclusive control over the software of the ASP. Therefore, in line with Arizona authority, purchases of those services cannot be considered the lease or rental of personal property as the department contends. Thus, the department's position regarding the taxability of cloud computing is wrong.

Primary Purpose Test

Similar to New York, Arizona applies a primary purpose test to determine the taxability of a transaction when it may be unclear what exactly was intended to be purchased, such as when the transaction involves a mix of taxable property and nontaxable services. Also, the Arizona courts apply a "common understanding" test that considers whether a particular business is commonly understood to sell property or services. The Arizona Court of Appeals has explained both tests recently in *Val-Pak East Valley, Inc. v. Ariz. Dep't. of Rev.*:[42]

> To decide whether a transaction fits in the first or second scenario, we apply two tests: the "dominant purpose," also known as the "true object" test, and the "common understanding" test.
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> As its name suggests, under the "dominant purpose" test, a court decides whether the transaction is all taxable or all nontaxable by identifying the dominant purpose of the transaction.
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> Under the "common understanding" test, whether a mixed transaction is all taxable or all nontaxable is determined by the "common understanding of whether a trade, business, or occupation involves selling products, on the one hand, or rendering services . . . on the other."[43]

In *Val-Pak*, the company had contracted with another company to provide it with coupons that it planned to distribute. The Arizona DOR argued that Val-Pak had purchased tangible personal property because the coupons were printed on paper provided to Val-Pak. However, the court, applying the dominant purpose test, determined that Val-Pak had actually purchased printing and design services, because "simply put, by itself, the paper is of little practical value to Val-Pak without [the] design, printing, and mailing services."[44]

Furthermore, the court also found that Val-Pak had purchased services by applying the common understanding test. After explaining that in applying the common understanding test, "we attempt to identify characteristics of the transaction at issue that make it either more analogous to what is reasonably and commonly understood to be a sale of goods, or more analogous to what is generally understood to be the purchase of a service or intangible right," the court determined that "no one would think Val-Pak is in the business of buying paper."[45] Thus, the transaction could not be properly identified as a taxable sale of tangible personal property.

As argued earlier, ASP customers would likely view their purchases as purchases of services and not the lease of software. Indeed, the software is of little practical value to the ASP customers, and no one would think ASP customers are in the business of buying software. Thus, under the dominant purpose and common understanding tests used in Arizona, cloud computing is correctly identified as the provision of nontaxable services, not taxable tangible personal property as the department argues.

Indiana

Possession

Indiana imposes a gross retail sales tax on retail transactions made in Indiana.[46] For the purposes of the tax, a "retail transaction" means a transaction of a retail merchant that constitutes selling at retail.[47] A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he transfers tangible personal property to another person for consideration.[48] Renting or leasing tangible personal property is considered engaging in selling at retail.[49] "Lease" or "rental" means any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration and may include future options to purchase or extend.[50]

The Indiana Department of Revenue has determined that purchases of ASP services are taxable as sales of prewritten computer software because "it appears that when Taxpayer's customers access the [ASP service], the customers are purchasing access to prewritten computer software for which they, the

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[41]*See, e.g.*, Arizona Taxpayer Information Ruling LR10-006 (Mar. 5, 2010); Arizona Transaction Privilege Tax Ruling 93-4 (Feb. 19, 1993).

[42]*Val-Pak East Valley, Inc. v. Ariz. Dep't. of Rev.*, 272 P.3d 1055 (Ariz. Ct. App. 2012).

[43]*Id.* (citing *Qwest Dex, Inc. v. Ariz. Dep't. of Rev.*, 109 P.3d 118 (Ariz. Ct. App. 2005)).

[44]*Id.*

[45]*Id.*

[46]Ind. Code section 6-2.5-2-1(a).

[47]Ind. Code section 6-2.5-1-2.

[48]Ind. Code section 6-2.5-4-1(b).

[49]Ind. Code section 6-2.5-4-10; Ind. Admin. Code 2.2-4-27.

[50]Ind. Code section 6-2.5-1-21(a).

customers, have a possessory interest."[51] Presumably because the department believes that the customer has a possessory interest in software that is used in providing ASP services, it has concluded that "the fact that a computer software program is accessed via the Internet as opposed to on the customer's own computer is irrelevant to the taxability of the program; the program in whatever form constitutes tangible personal property, and the company's charges for access to the program is subject to sales and use tax."[52]

In *Indiana Dep't of State Rev. v. Indianapolis Transit System, Inc.*,[53] the Indiana Court of Appeals considered, in the context of determining whether a taxable lease had occurred, what it meant to have possession and the "right of control" over a bus that had been chartered:

> In the case at bar [the bus company] furnished the drivers with the bus, it retained the right to direct the movement of the buses, it was obligated to pay all costs and repairs as well as fuel costs. [The bus company] had the responsibility to garage the vehicle and make all insurance payments, license payments as well as payments for any damages caused by the bus. It is apparent that [the bus company] retained the "right to control."[54]

As can be seen from this discussion, possession — or the "right to control" — something in Indiana depends on who has the responsibility for the object in terms of maintaining it and which party is able to direct how the object will be used.

The department has also considered what constitutes possession and control in its rulings. In the context of the lease of heavy equipment along with an operator,[55] the department makes the following observations:

> The Taxpayer owns the equipment and employs the drivers of the equipment. The two shareholders of Taxpayer are the only operators of the equipment. Taxpayer determines how to perform the job and prepare the site for construction to the specifications of the lessee corporation. Taxpayer exercises control over the equipment. And directs the movement of the equipment. None of the employees of lessee corporation ever operate the equipment. Taxpayer also pays sales tax at the time of the purchase of the equipment. Lessee does not have exclusive use of the property. Further the lessee does not have the right to control the machinery or direct the manner of the use of the property. Therefore, Lessor is leasing the service of an operator and equipment to perform a specific function for lessee.[56]

In Indiana Letter of Finding No. 96-0067 ST,[57] the department determined that the supplying of photocopying equipment and operators was not the taxable rental of tangible personal property but the provision of nontaxable services. Relying on the same logic as in the heavy equipment ruling, the department noted that "in this case, the vendor has control over the equipment. The vendor's personnel operate, maintain and supervise the duplication of documents for the taxpayer. The taxpayer maintains no exclusive control over the tangible personal property used by the vendor. Thus, taxpayer is not renting tangible personal property."[58]

The department considered the meaning of "possession" in Indiana Letter of Finding No. 02-0478[59] and Indiana Letter of Finding No. 08-0580,[60] concerning the provision of propane tanks to customers:

> Taxpayer's agreements with both the small and large tank customers do not constitute lease agreements because the customers do not come into "possession" of the tanks. "Possession" means the right to "exercise control over something to the exclusion of all others." *Black's Law Dictionary* 1183 (7th ed. 1999). By the terms of the agreement, the customer is not entitled to move the tanks or to allow another supplier to fill the tanks with the competitor's

[51]Indiana Revenue Ruling ST 11-05 (Oct. 11, 2011).

[52]Indiana Letter of Finding No. 09-0418 (Jan. 1, 2010); Indiana Revenue Ruling ST 09-03 (Mar. 30, 2009).

[53]*Indiana Dep't of State Rev. v. Indianapolis Transit System, Inc.*, 356 N.E.2d 1204 (Ind. Tax Ct. 1976); *see also Mason Metals Company, Inc. v. Indiana Dep't of State Rev.*, 590 N.E.2d 672 (Ind. Tax Ct. 1992).

[54]*Id.*

[55]There is admittedly a regulation on point: 45 IAC 2.2-4-27(d)(3)(B) concerns the lease of tangible personal property with an operator. That regulation states:

> The rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator shall be considered the performance of a service rather than a rental or lease provided the lessee cannot exercise control over such property and operator.

[56]*Id.*, Indiana Letter of Finding No. 98-0081 ST (May 1, 1999).

[57]Indiana Letter of Finding No. 96-0067 ST (July 1, 1999).

[58]Indiana Letter of Finding No. 96-0067 ST (July 1, 1999). For other operator rulings, see also Indiana Letter of Finding No. 00-0467 (Nov. 1, 2002); Indiana Letter of Finding No. 09-0540 (Jan. 1, 2010); *but see* Indiana Letter of Finding No. 04-0037 (July 1, 2005). ("The regulation is written to address the rental of heavy equipment that is used by the operator of the equipment in a manner determined by the operator. . . . A ceremonial casket is not a piece of heavy equipment that requires an operator in order for the function and the use of the ceremonial casket to be fulfilled.")

[59]Indiana Letter of Finding No. 02-0478 (Aug. 1, 2004).

[60]Indiana Letter of Finding No. 08-0580 (Mar. 1, 2009).

> propane supply. Of course, the tanks are located on the customers' property, but that does not mean that the customers have "possession." Although the tank is located on the customer's property, taxpayer retains most of the rights to control the tank. Unlike an actual lease agreement, the customer does not acquire the usual rights to control the object of the lease. Instead the tanks are merely an extension of the agreement by which taxpayer provides propane to its customers with the customer assessed an additional cost for the use of the storage container which — by nature of the transaction — is necessarily located on the customer's property. The fact that the parties' agreement is called a "lease" does not change the fact that taxpayer is not in the business of leasing propane tanks nor the fact that the customers are not interested in leasing propane tanks. Taxpayer's interest lies in selling its product to its customers and receiving compensation for the cost of doing so. The customers' interest is in obtaining that fuel. Given the fact that the tanks have a limited decorative or utilitarian value outside of their capability of storing taxpayer's propane, it is apparent that the object of the parties' agreement is the delivery, storage, and consumption of propane.[61]

The department also considered the meaning of "possession" in Indiana Letter of Finding No. 04-0444,[62] concerning the rental of golf simulators:

> The Department is unable to agree that taxpayer transfers "possession" of the simulators to its customers. "Possession" means "The fact of having or holding property in one's power; the exercise of dominion over property." Black's Law Dictionary 1183 (7th ed. 1999). "Possession . . . is evidence of ownership; the possessor of a thing is presumed to be the owner of it, and may put all other claimants to proof of their title." *Id.* The simulator customers do not take "possession" of the simulators, they merely have the right to use the simulators for a fixed period of time. In that sense, the simulators are analogous to the electronic games found in video arcades. The video game customer pays for the privilege of using the game without interference from other customers and controls the manner in which the game is played. The video game customer may have the exclusive right to use the video game for a short period, but the video game customer does not take "possession" of the device. Both taxpayer and the arcade owner would look askance at any customer who backed up a truck and attempted to take possession of either the simulator or the video game.
>
> In contrast, a person who rents or leases a car is entitled to take possession of the car and to continue to exercise that possessory interest for a fixed period of time. The person who visits a local rental store and arranges to rent a lawn mower over the weekend, takes "possession" of the lawn mower for the weekend. The automobile rental business and the local rental store purchase the car and the lawn mower without paying sales tax pursuant to IC 6-2.5-5-8 but must thereafter collect sales tax from their customers each time the car or lawn mower is rented. (*See* IC 6-2.5-4-10).
>
> Taxpayer is in the business of providing a service to its simulator customers; that service consists of permitting its customers to use — not truly possess — the golf simulators for a fixed period of time. Although the transitory "use" of the simulators possesses qualities which mimic the attributes of "possession," nevertheless, the simulator customers do not acquire uninhibited possession of the simulators.[63]

Following all those cases and rulings, it is clear that under Indiana law, in cloud computing transactions between an ASP and its customers, the customers do not typically receive possession or control over the software, so no taxable sale of tangible personal property can be deemed to have occurred. In the case of ASP services, the ASP has the responsibility for maintaining the software and is the only party able to direct how the software operates. Furthermore, the provision of ASP services is analogous to the equipment rentals, propane tank rentals, and leasing of the golf simulators. The ASP owns the software. The software operates on its servers. The ASP determines how to perform the requested services and exercises control over the software that the customer does not. Customers do not operate the software but rather make requests of it. Customers do not have the exclusive use of the software and have no right to control or direct the manner in which the software operates. Therefore, the customers are purchasing services from the ASPs, not tangible personal property. As in the case of the golf simulators, the ASP customers merely have the right to use the software for a fixed period. Neither the ASP nor the customer expects the customer to "take" the software for itself, that is to say, remove it from the ASP's server so that no one else can access it. Thus, the department's position that

[61] *Id.*; Indiana Letter of Finding No. 02-0478 (Aug. 1, 2004).
[62] Indiana Letter of Finding No. 04-0444 (Apr. 1, 2006).
[63] *Id.*

the ASP customers take possession of the software, creating a taxable sale of tangible personal property, is untenable.

Primary Purpose Test

Indiana also applies a true object test to determine the taxability of a transaction that might include both nontaxable services and taxable property. This test has been developed through case law and also has been written into the Indiana DOR's regulations regarding bundled transactions. Those regulations provide that "[a] 'bundled transaction' does not include a retail sale that is . . . comprised of a service that is the true object of the transaction, and tangible personal property that is essential to the use of the service and is provided exclusively in connection with the service."[64]

The Indiana Supreme Court developed the true object test in 1952 in *Samper v. Indiana Dep't. of Rev.*,[65] when it held that parts sold as a necessary incident to the repair of a radio were exempt from sales tax because the actual purpose of the transaction was to have the radio repaired, a service, and not the retail sale of parts. In so holding, the court stated that "the nature and purpose of such a contract contemplates and intends that, if new parts are needed in the repair, this part of the contract is . . . [dependent on] that part of the contract which calls for the labor and services necessary to complete the repair. Such a contract could not be completed in part only . . . by performing the labor and services required without furnishing . . . necessary [parts]."[66]

In *Chrome Deposit Corp. v. Indiana Dep't. of State Rev.*,[67] the Indiana Tax Court developed a "but for" test to determine the true object of a mixed transaction, stating that "but for its customers' desire to purchase the chromium sleeve, Chrome Deposit would not render the incidental services of attaching the sleeve to the work roll . . . on behalf of its customers." Thus, the court found that the contract at issue was for the sale of a chromium sleeve and services provided to attach that sleeve to iron rolls were merely incidental to the sale.

Again, ASP customers would likely view their purchases as purchases of services and not leases of software. Indeed, "but for" the services, the customers would not seek any access to the software. Therefore, the software is merely a necessary incident to the services of the ASP and under Indiana's true object test, cloud computing is correctly identified as the provision of nontaxable services, not taxable tangible personal property as the department argues.

Pennsylvania

Possession

Pennsylvania imposes sales tax upon each separate sale at retail of tangible personal property or services within the state.[68] Sale at retail is defined as "any transfer, for a consideration, of the ownership, custody or possession of tangible personal property, including the grant of a license to use or consume whether such transfer be absolute or conditional."[69]

Without explanation of how a consumer exercises control or power over the software used in providing the ASP's services, the Pennsylvania Department of Revenue has determined that remote access of ASP services are taxable because "in accessing taxable software the user is exercising a license to use the software, as well as control or power over the software, at the user's location."[70]

Interestingly, the department had previously held — and there has been no relevant change to the controlling statute — that access to software "solely through the Internet" was not a taxable transfer of software.[71] In that earlier decision, the department noted that:

> Other than an applet necessary to access the service, the service does not entail the transfer of any Taxpayer software to the subscriber and does not allow subscribers to access the Taxpayer software code or manipulate the software in any way. Rather, the service is provided through the Taxpayer's own data centers on its proprietary equipment and software, which is at all times owned by and under the control of the Taxpayer.

It is difficult to reconcile those two decisions, which are separated from each other by only two years. Furthermore, considering the relevant authority in Pennsylvania, it is clear that the department's original position was correct.

Although the Pennsylvania statutes do not define control for the purposes of determining whether a taxable transaction has occurred, court decisions provide guidance regarding the meaning of the term.

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[64]Ind. Code section 6-2.5-1-11.5(d).

[65]*Samper v. Indiana Dep't. of Rev.*, 106 N.E.2d 797 (Ind. 1952). *See also Ind. Dep't. of State Rev. v. Klink*, 112 N.E.2d 581 (Ind. 1953).

[66]*Id.*

[67]*Chrome Deposit Corp. v. Indiana Dep't. of State Rev.*, 557 N.E.2d 1110 (Ind. Tax Ct. 1990). *See also Mid-America Publishing, Inc. v. Ind. Dep't. of State Rev.*, No. 49T10-9912-TA-239 (Ind. Tax Ct. 2004); *Cowden & Sons Trucking, Inc. v. Ind. Dep't. of State Rev.*, 575 N.E.2d 718 (Ind. Tax Ct. 1991).

[68]Pa. Stat. Ann. section 7202(a).

[69]Pa. Stat. Ann. section 7201(k)(1); Pa. Code 31.1(1).

[70]Pennsylvania Sales and Use Tax Ruling No. SUT-12-001 (May 31, 2012).

[71]Pennsylvania Sales and Use Tax Ruling No. SUT-10-005 (Nov. 8, 2010).

Perhaps one of the more thorough discussions of the concept of control was given by the Pennsylvania Court of Common Pleas in *Commonwealth v. Sun Shipbuilding & Dry Dock Co.*,[72] concerning the sales of five tankers constructed in Pennsylvania to out-of-state-purchasers. In holding that the sales had not occurred in Pennsylvania, and thus were not subject to the Pennsylvania sales tax, the court determined that the shipbuilder retained control over the tankers up until the points of delivery — which occurred outside the state — at which time the sales were made. The court based its holding on the following facts:

> [The shipbuilder] had complete possession and control of the vessel[s] and of the construction, and was responsible for all injuries, damages and repairs due to any cause whatever. The inspectors for the purchaser were to have access to the shipyard and to the materials throughout construction, but were required to promptly accept or reject all work and materials. The [shipbuilder] was required to pay all fees and royalties in connection with construction and classification. All expenses of the trial trip were to be born by the [shipbuilder]. The [shipbuilder] guaranteed that the vessel would have a certain carrying capacity and was to be penalized if the vessel upon completion was found not to reach that capacity . . . [the shipbuilder] agreed to pay all taxes imposed on the vessel prior to delivery and any taxes on the sale of the vessel.[73]

The essence of the court's discussion is that the shipbuilder had control over the tankers before delivery because it was ultimately responsible for how they were constructed, their maintenance, and any liabilities arising from them. After delivery, those responsibilities would presumably fall to the purchasers.

That understanding of control has been adopted in other contexts as well. In *City of Philadelphia v. City of Philadelphia Tax Review Board*,[74] the Pennsylvania Commonwealth Court determined that Expedia, which operates a website through which customers can reserve hotel rooms, was not an "operator" of a hotel — the definition of which the court determined inferred "ownership or control of the premises" — because it had "no control over which room is furnished to the traveler[,] . . . does not own the brick and mortar hotel, has no physical presence at the hotel, and has no responsibility for the operation or management of the hotel." The commonwealth court has also said that a manufacturer retains control over personal property where there is "the possibility that the property could undergo further changes, the property is still within the production cycle."[75] In *House of Lloyd v. Commonwealth*,[76] the court held that "House of Lloyd transfers only custody of the kits (tangible personal property) and continues to exercise control until the end of a selling season" when:

> Salespeople are instructed to carry the sample kit to every home party; not to take any samples from the kit until the last party; to prepare labels for each sample product showing its name, item number, and price; to minimize wear and tear on the boxes; and to save unused packing in order to enhance the value of the kit for when the salesperson returns or sells it at the end of the season. Under the terms of their contracts, each district manager, supervisor, and demonstrator is entitled to keep a sample kit when $1,500 of demonstrator commissionable sales have been paid for and shipped. District managers must account for all sample kits at the end of a selling season and must either return or pay for any kits not "earned" by the salesperson.[77]

Finally, the Pennsylvania Supreme Court noted that when an individual "assumes control over the operation of [a] vehicle," a taxable lease would occur; however, if the operation of the "vehicle [would] be under the control of the owner," the transaction would not be taxable.[78]

In all those court decisions, the concept of control is developed to include the ultimate responsibility for the way property is used, maintained, or operated. Essentially, the person who controls property has the ability to change the property and is responsible for any liabilities arising from the property.

When those authorities are taken into consideration, it cannot be contended that in the context of cloud computing the customers achieve control over the ASP's software. As has been discussed, the customers have no ability to change or manipulate the underlying software and are not responsible for any liabilities arising from the software. Only the ASPs have the responsibility for maintaining the software and the ability to change

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[72]*Commonwealth v. Sun Shipbuilding & Dry Dock Co.*, 75 Dauph. 1 (Pa. Common Pleas, 1960).

[73]*Id.*

[74]*City of Philadelphia v. City of Philadelphia Tax Review Board*, 37 A.3d 15 (Pa. Cmwlth. 2012). *See also Marwood Rest Home, Inc. v. City of Philadelphia Tax Review Board*, 535 A.2d 281 (Pa. Cmwlth. 1987).

[75]*Lancaster Laboratories, Inc. v. Commonwealth*, 578 A.2d 988 (Pa. Cmwlth. 1990), *exceptions denied in part, granted in part*, 611 A.2d 815 (Pa. Cmwlth. 1992).

[76]*House of Lloyd v. Commonwealth*, 684 A.2d 213 (Pa. Cmwlth. 1996), *aff'd*, 694 A.2d 375 (Pa. Cmwlth. 1997).

[77]*Id.*

[78]*In re J & R Transport Co.* (Pa. Sup. Ct. July 24, 1962).

the software as they see fit. Therefore, the department's current position that the customers are given control over the software is incorrect.

Primary Purpose Test

Pennsylvania applies an essence of the transaction test to determine whether a transaction involving both taxable property and nontaxable services should be classified as a taxable sale of property or a nontaxable sale of services. The Pennsylvania Commonwealth Court explained the test in *Graham Packaging Co., LP v. Commonwealth*:[79]

> The test focuses on whether the essence or true object of the sale is tangible personal property or intangible property or a service with tangible property serving only as the medium of transmission. If the essence of the transaction or true object of the transaction is the intangible property or service, the intangible object/service does not assume the taxable character of the tangible property serving as the medium of transfer.[80]

In the case of cloud computing, the essence of the transaction is not the purchase of software, but the provision of services. Therefore, under the Pennsylvania test, the transactions between ASPs and their customers are correctly classified as nontaxable sales of services. That software is used as the medium of the transfer of the services does not affect that conclusion.

Utah

Possession

Utah imposes sales tax on the purchaser for amounts paid or charged for retail sales of tangible personal property made within the state.[81] Sale is defined to include "any transfer of title, conditional or otherwise, in any manner, of tangible personal property" and "any transaction under which right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made."[82]

Though the Utah Department of Revenue originally determined that ASP services were not taxable because there was no transfer of possession to the customer,[83] it has since changed its mind after changes to the state's sales tax statute:

> The transfer of the Web Services for a fee meets the broad definition of sale found in section 59-12-102(99). . . . When the Company sells Web Services, it in substance grants Subscribers the right to use the Company's proprietary software under a lease or contract. The Company is not using the proprietary software to sell services.[84]

The changes to the statute are found in Utah Code section 59-12-102(113), defining tangible personal property to include "prewritten computer software, *regardless of the manner in which the prewritten computer software is transferred*,"[85] and in Utah Code section 59-12-211(12), providing the location of sales specifically when "*a purchaser uses computer software and there is not a transfer of a copy of that software to the purchaser*."[86] However, the department apparently fails to recognize that the new laws still require a transfer of the prewritten software, and in the case of ASP services, there is no such transfer.

The seminal case in Utah regarding the type of possession needed to effect a transfer of property is *Snarr Advertising, Inc. v. Utah State Tax Comm'n*.[87] In that case, involving the lease of a billboard, the lessee neither owned the property where the billboard was located nor had the right to access the billboard. Therefore, the Utah Supreme Court concluded that the lease was not taxable because "the Legislature meant to tax those pieces of personal property the possession or use of which was given over to the lessee."[88] Indeed, the department followed *Snarr Advertising* in ruling that a lease of property would not be subject to sales tax when the lessee neither owned the property where the personal property was located nor had the ability to access or control the leased property.[89] The essence of those rulings, similar to those in the other states discussed, is an ability to manipulate the underlying property, to be able to personally change the property however the person wishes.

ASP services should likewise not constitute taxable leases of tangible personal property because the customers cannot be said to have been granted possession or control over the software used by the ASP. The customers neither possess the servers that the software is located on nor have the right or ability to access or control the software code. They can do nothing to change the software. Those rights remain with the ASP, and the transactions between

[79] *Graham Packaging Co., LP v. Commonwealth*, 882 A.2d 1076 (Pa. Cmwlth. 2005). *See also Dechert LLP v. Commonwealth*, 922 A.2d 87 (Pa. Cmwlth. 2007).
[80] *Graham Packaging*, 882 A.2d 1076.
[81] Utah Code section 59-12-103(1)(a).
[82] Utah Code section 59-12-102(104).
[83] *See* Utah Private Letter Rulings No. 08-012 (Jan. 21, 2009); Utah Private Letter Rulings No. 09-003 (Apr. 7, 2009); Utah Private Letter Rulings No. 01-027 (Oct. 31, 2001).
[84] Utah Private Letter Rulings No. 10-011 (Feb. 24, 2012).
[85] Utah Code section 59-12-102(113) (emphasis added).
[86] Utah Code section 59-12-211(12) (emphasis added).
[87] *Snarr Advertising, Inc. v. Utah State Tax Comm'n*, 432 P.2d 882 (Utah S. Ct. 1967).
[88] *Id.*
[89] Utah Advisory Opinion No. 00-009 (Aug. 29, 2000).

the ASPs and their customers are thus services, not leases of tangible personal property. The additions to the Utah statutes do not change this fact and should not have changed the department's approach to ASP services. The department fails to comprehend that the additions do nothing to change the type of possession needed to create taxable transfers. Though in fairness, and perhaps in anticipation of the type of criticism this article offers, the department has left itself some wiggle room by declaring that the seller in the transaction in its most recent ruling was "*not* using the proprietary software to sell services."

Primary Purpose Test

Utah applies a primary purpose, or true object, test to determine whether a transaction is taxable. The test is codified in Utah Code Ann. section 59-12-102(18)(b)(iv) defining bundled transactions: "bundled transaction" does not include . . . the retail sale of tangible personal property and a service if the tangible personal property is essential to the use of the service and is provided exclusively in connection with the service and *the service is the true object of the transaction*."[90] Furthermore, the Utah tax regulations provide that "computer generated output is taxable *if the primary object of the sale* is the sale of the output and not the services rendered in producing the output."[91]

In *BJ-Titan Services v. Utah State Tax Comm'n*,[92] the Utah Supreme Court, in considering the taxability of a transaction, found it necessary "to determine if the essence of the transaction is one for services or for tangible personal property." The court continued:

> The analysis typically requires a determination either that the services provided are merely incidental to an essentially personal property transaction or that the property provided is merely incidental to an essentially service transaction. Since the law imposes a tax only on the sale of tangible personal property, transactions that are essentially services are not taxable.[93]

The court described several factors to consider under the test, including:

- (1) the value of the tangible property to the customer in relation to that of the services;
- (2) the cost of the property to the seller;
- (3) the customer's rights to possession or ownership of the property;
- (4) the ability to separately itemize charges for the property and services;
- (5) the extent to which the services increase the value of the property or to which the property increases the value of the services; and
- (6) the extent that such services are rendered in similar transactions.[94]

The primary purpose and essence of the transactions between the ASPs and their customers are the provision of services, not the sale of tangible personal property. The customers likely put a relatively small, if not a zero, value on the ASP's software, but a high value on the services they receive. Simply put, it is unlikely that the ASP customers care what software is used, only that the job they need done gets done. Furthermore, the customers have no rights of ownership over the software, as discussed previously. Also, the value of the services is what drives the price of the transaction with the ASP, not the value of the software. Finally, ASPs are all providing services, not transfers of tangible personal property. There is no concern that one oddball is trying to cheat the system by claiming that a random service it provides with the sale of tangible property is the primary purpose of the transaction. Under the Utah authorities, the primary purpose or essence of cloud computing transactions is the provision of services, not the transfer of tangible personal property, and as such these transactions are not properly taxable.

Colorado

Possession

The city of Boulder, Colo., imposes a sales tax on all retail sales of tangible personal property within the city.[95] "Sale" means "the acquisition for any consideration by any person of tangible personal property or taxable services that are purchased, leased, sold, used, stored, distributed, or consumed" and includes any "[t]ransfer, either conditionally or absolutely, of title or possession or both to tangible personal property."[96] "Use" means "the exercise, for any length of time, by any person with the City of any right, power, dominion, or control over tangible personal property or taxable services when leased or purchased at retail."[97] The sales tax specifically applies to "each transfer of ownership, possession, and control" of tangible personal property within the city.[98]

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[90]Utah Code Ann. section 59-12-102(18)(b)(iv) (emphasis added).

[91]Utah Admin. R. section R865-19S-92(3) (emphasis added). "Computer-generated output" is microfiche, microfilm, paper, discs, tapes, molds, or other tangible personal property generated by a computer. Utah Admin. R. section R865-19S-92(1).

[92]*BJ-Titan Services v. Utah State Tax Comm'n*, 842 P.2d 822 (Utah S. Ct. 1992).

[93]*Id.*

[94]*Id.*

[95]City of Boulder Code section 3-2-2.

[96]City of Boulder Code section 3-1-1.

[97]*Id.*

[98]City of Boulder Code section 3-2-1.

Although the city of Boulder's tax regulations provide that a "lease, lease purchase agreement, rental or the grant of a license to use software is subject to sales/use tax,"[99] neither the regulations nor the code define ownership, possession, or control for the purposes of the sales tax. However, the Colorado Court of Appeals has determined that, in purchasing an ASP's services, a company had purchased a taxable right to use the ASP's software.[100] The court provided no insight into what ownership, possession, or control the company had over the ASP's software, despite noting that for the sales tax to apply, "the buyer [must be granted] any right, power, dominion, or control" over the software.[101]

Though authority from the Colorado courts regarding the definition of possession for the purposes of sales taxation is noticeably lacking, the Colorado Supreme Court has considered the definition of ownership evidencing a person's "right to possession, use, enjoyment, and profits of [] property" with respect to the taxation of possessory interests in real property.[102] The court stated that three factors must be considered when determining whether a person had a sufficient ownership interest to be taxed: (1) the interest provides a revenue-generating capability to the possessory interest owner independent of the property owner; (2) the possessory interest owner has the ability to exclude others from making the same use of the interest; and (3) the possessory interest is of sufficient duration to realize a private benefit therefrom.[103]

The Colorado Department of Revenue has offered some guidance as to what constitutes possession for purposes of the sales tax. In a General Information Letter, the department considered the example of a purchaser leasing a tractor with an operator. The department said that, in determining whether the transaction would be for a taxale lease of the tractor or for the nontaxable services of the operator, the "true object" of the transaction would be considered, determined at least in part by "whether the lessee has obligations normally associated with someone who has a possessory interest in the property (for example, obligations for risk of loss and insurance), and whether the operation of the property requires special skills not possessed by the lessee."[104]

The department applied the same test in a private letter ruling regarding whether or not sales of medical catheters were exempt under the sales tax as sales for resale. In determining that the sales were not sales for resale, the department said:

> [T]he healthcare provider is specially trained to perform this invasive medical procedure and the procedure is typically performed at the provider's facility. The person with the special training is often viewed as the user and consumer of the goods.
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> In addition to the provider's special training, the patient does not exercise any meaningful control over the catheter. The healthcare provider places the catheter into the patient, operates both the catheter and generator during treatment, and removes the catheter when the treatment is completed. The catheter does not leave with the patient after the treatment. Although it is not necessary that a purchaser have control of property in order to constitute a sale, the absence of control is indicative of a service transaction.
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> Moreover, the fact that the system is sold to providers and not patients, that providers are trained to operate the system and patients are not, and that the provider has exclusive control of the catheter, at least suggests that the use of the catheter is inseparably linked to the service provided by the healthcare provider. This close relationship between the service performed by the provider and use of the catheter suggests that the provider's service is the dominant and controlling component of this transaction. We might have a different view of this transaction if Company also sold or leased the system directly to a patient and if the patient could oeprate the system without employing a healthcare provider.[105]

As odd as the comparison may seem, consumers of ASP's services are analogous to the patients receiving medical catheters. The ASP's employees are specifically trained to operate the software backing the ASP's services; the software is run at the ASP's facilities (that is, servers); the consumer does not exercise any meaningful control over the software and does not retain the software after the service is completed; and consumers cannot operate the software without employing the ASP. Furthermore, consumers of ASPs' services do not possess any obligations for rik or loss associated with the software and do not possess the software to the exclusion of others or for their own benefit. Therefore, the Colorado

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[99]City of Boulder Tax Reg. 11.

[100]*Ball Aerospace & Tech. Corp. v. City of Boulder*, 2012 COA 153 (Colo. Ct. App. Sept. 13, 2012).

[101]*Id.* However, it appears as though the company purchasing the ASP's services in this case did not dispute that it had purchased the right to use the ASP's software.

[102]*See Bd. of County Comm'rs v. Vail Assocs., Inc.*, 19 P.3d 1263 (Colo. 2001) (citing *Mesa Verde Co. v. Bd. of County Comm'rs*, 495 P.2d 229 (Colo. 1972)).

[103]*Id.*

[104]Colo. General Information Letter No. GIL-09-29 (June 23, 2009).

[105]Colo. Private Letter Ruling No. PLR-10-4 (Aug. 17, 2010).

Court of Appeals in *Ball Technologies* has misapplied the relevant authorities in Colorado. The provision of an ASP's services does not represent the taxable transfer of a right to use the underlying software.

Primary Purpose Test

Additionally, Colorado applies a "true object" or primary purpose test (as mentioned above) to determine whether a transaction is for the transer of taxable property or services or for the transfer of nontaxable services.[106] Indeed, the city of Boulder tax regulations specifically adopt the test: "[t]o determine if a transaction is a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service, one must look to the true nature of the transaction."[107]

The Colorado Supreme Court, in discussing the true object test, has noted that the underlying objective of the test is to "identify characteristics of the transaction at issue that make it either more analogous to what is reasonably and commonly understood to be a sale of goods, or more analogous to what generally understood to be the purchase of a service or intangible right.[108]

As discussed, the transactions between an ASP's customer and the ASP have the characteristics of the purchase of a service, not tangible personal property. Thus, under the Colorado true object test, these transactions are not subject to sales tax.

Sourcing

Though this article is concerned only with the various state tax authorities' interpretations regarding the taxability of cloud computing transactions under their various sales tax statutes, a quick observation on the sourcing of those transactions in New York sheds light on the inherent incorrectness of the tax authorities' positions.

> ***The New York tax department's approach to sourcing is, at best, schizophrenic or, more accurately, exposes the fundamental flaw in the department's position.***

The New York tax department's approach to sourcing is, at best, schizophrenic or, more accurately, exposes the fundamental flaw in the department's position. On the one hand, the department takes the position that a customer is "using" software that actually resides on and is used only by the ASP's server — that very well may be located outside New York; but on the other hand, the department takes the position that the software is being used by the customer at the customer's location in New York. That is clearly internally inconsistent.

According to the department:

> The location of the code embodying the software is irrelevant, because the software can be used just as effectively by the customer, even though the customer never receives the code on a tangible medium or by download. The accessing of [an ASP's] software by [its customer] constitutes a transfer of possession of the software, because [the customer] gains constructive possession of the software and gains the "right to use, or control or direct the use of" the software. Therefore, [the ASP] should collect tax from [its customer] where the software is being used.[109]

If, as the department contends, the customer has constructive possession of software residing on an ASP's server, that is where the software (taxed as tangible personal property) is located. The department asserts, however, that the software (that is, the tangible personal property) is transferred at the location from where the customer *remotely accesses* the software. The department seems to be taking the position that correct "sourcing" for the transaction is where the benefit is received. However, that is a concept applicable to sales of services, not sales of tangible personal property!

Where does one remotely use tangible personal property? Consider a U.S. military drone flying in Afghanistan. Suppose the drone is operated from the military base in Rome, N.Y., while the drone is in Afghanistan. Where is the drone being used? The department's position would lead to the conclusion that the drone is being used in New York because that is where the operator is located. That conclusion makes no sense — the drone is being used in Afghanistan. The department seems to be focusing on where the benefit of the use of the remotely controlled tangible personal property is enjoyed. That, however, is a test for some taxable services, but never for the sale or license of tangible personal property. The department's approach to sourcing reveals the reality of the situation — an ASP provides a service.

Thus, if the department continues to insist that ASPs are in the business of licensing prewritten software, the department — if it is forced to use proper, consistent sourcing rules — seems to be inadvertently laying the groundwork for unsound tax policy for New York. State taxing authorities

[106]*See* Colo. General Information Letter No. GIL-09-29 (June 23, 2009).

[107]City of Boulder Tax Reg. 40.

[108]*City of Boulder v. Leanin' Tree, Inc.*, 72 P.3d 361 (Colo. 2003).

[109]TSB-A-10(28)S (July 2, 2010).

must consider the actual type of possession, use, or control of the ASPs' software the customers are receiving in order to determine the taxability of the transactions. Merely claiming that the customers are granted sufficient possession, use, or control, or relying on contract language between the ASP and the customer that may refer to a license will not suffice. If the use of software to deliver a service is deemed a taxable sale of tangible personal property, savvy taxpayers can simply defeat the tax by moving their servers outside New York.

If the department were to abandon its schizophrenic approach to sourcing, its ASP position would have little effect. There is no question that absolutely no software is delivered to ASP customers in the normal ASP scenario (the department concedes that point) and so, if an ASP's servers are located outside New York, none of the software would be "used" by the customer in New York. Thus, no sales tax would be due from ASPs whose servers are outside New York. Only by disregarding that reality and conflating tangible personal property sourcing with services sourcing does the department actually raise a meaningful amount of revenue from its new position.

In other words, if it is appropriate to treat a customer's use of an ASP's software as a license to use, then the department, if it wants to be intellectually consistent, has to concede that the software is being used on the ASP's server and the receipts from the sale should be sourced to wherever the server is located (even if that is outside New York).

Conclusion

This article has examined the troubling approach of a handful of states toward the classification of cloud computing for sales and use tax purposes. The tax authorities of those states, through administrative rulings, and one state appellate court have disregarded the relevant legal authorities in their states and are inappropriately subjecting cloud computing transactions to their sales taxes under the guise that the transactions are the transfers of taxable tangible personal property rather than the provision of nontaxable services.

This article passes no judgment on whether cloud computing transactions should be taxable, and that is the point of the article. Those types of judgments are for state legislatures to make, not tax administrators or us.[110] When state legislatures have not expressed an intent to tax ASP services, state tax authorities should not ignore the facts of the transactions in order to fit them into the definition of other taxable transactions merely because the tax authorities believe that such transactions should be taxable. In so doing, those tax authorities have overstepped their bounds. Taxpayers affected by those rulings should challenge them as invalid exercises of administrative power, and state courts should strike the rulings down. ✰

[110]Arthur R. Rosen and Mark W. Eidman, "Non-Legislated Tax Legislation," *State Tax Notes*, Jan. 24, 2011, p. 301, *Doc 2010-27224*, or *2011 STT 15-3*.