Face the Cloud: How Wayfair Could Affect the IT Industry

by Carolynn Kranz and Iris Kitamura

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In this article, the authors outline how the U.S. Supreme Court’s Wayfair decision could affect not only sales and use tax compliance for retailers, but also transactions involving technology and cloud computing.

While much has been said about the impact of the U.S. Supreme Court’s landmark opinion in South Dakota v. Wayfair Inc. on online retailers, there has been little discussion of its effect on other nontraditional retailers, such as those in the technology and cloud computing industries. The Court’s decision will undoubtedly have a profound impact on the burgeoning cloud service industry, which lacks the same uniform definitions of products and services, long history of interpretive guidance, and uniform rules that exist for sellers of tangible goods. With the cloud computing industry forecasted to grow from $186.4 billion in 2018 to $302.5 billion in 2021, it is important for cloud service providers to understand the unique challenges they may face as they attempt to understand and comply with new sales and use tax collection obligations in a post-Wayfair world.

Wayfair dramatically changed the sales tax nexus landscape. In a 5-4 opinion authored by Justice Anthony M. Kennedy, the Court overturned the bright-line physical presence requirement — established by National Bellas Hess in 1967 and reaffirmed in Quill in 1992 — as “unsound and incorrect.” The Court stated that “stare decisis can no longer support the Court’s prohibition of a valid exercise of the States’ sovereign power.” Kennedy further observed that every year the physical presence rule “becomes further removed from economic reality and results in significant revenue losses to the States.” Thus, the Court ruled that the correct standard in determining a state tax law’s constitutionality is whether the tax applies to an activity that has “substantial nexus” with the taxing state and that respondents had established substantial nexus through the

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6Id. at 2096.

7Id. at 2092.
company’s “economic and virtual contacts” with South Dakota.8

At the center of Wayfair is South Dakota’s economic nexus law, which applies to out-of-state retailers that annually deliver more than $100,000 of goods or services into the state or engage in 200 or more separate transactions. The Supreme Court noted that “South Dakota’s tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce”:

First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. S. B. 106, [section] 5. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs: It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the State. Sellers who choose to use such software are immune from audit liability.9

The Court’s opinion in Wayfair addressed the facts at hand — that is, the sale of tangible personal property by large online remote sellers. What it left largely unaddressed is the impact on nontraditional retailers such as cloud service providers, technology companies, and similar sellers.

Sellers of traditional tangible personal property have been afforded ample guidance in determining the taxability of their product offerings. Indeed, many states have published detailed guidance for retailers that provide specific examples of items of tangible personal property that are or are not subject to sales and use taxes, especially in states with exemptions for specific tangible personal property such as groceries, clothing, etc.10 In contrast, state tax authorities have been slow to address the taxability of various cloud service offerings such as software as a service (SaaS),11 infrastructure as a service (IaaS),12 and platform as a service (PaaS).13 as most taxing jurisdictions lack clear statutory authority to tax those services and many fail to understand the complex, constantly evolving technologies and business models.

In fact, the streamlined sales tax effort, which has been at the forefront of developing uniform definitions, including the first uniform definitions for digital goods, has avoided providing guidance on cloud services — recognizing how complicated and varied they can be. Yet the Wayfair Court noted that one aspect of South Dakota’s tax system that was designed to prevent discrimination and an undue burden on interstate commerce was the state’s adoption of the Streamlined Sales and Use Tax Agreement, which provides for “uniform definitions of products and services . . . and other uniform rules.” These same features do not exist for cloud computing services.

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8 Id. at 2099.
9 Id. at 2099-2100.
10 For example, Pennsylvania generally exempts clothing and footwear from sales and use tax and has provided clear guidance regarding the taxability of specific items: Biking clothing and bridal apparel are taxable, but girdles and gym suits are not. See 42 Pa. Bull. 7776 (Dec. 22, 2012). Similarly, New York exempts clothing and footwear (costing less than $110 per item) from sales and use tax and has issued guidance as well. NY Tech, Service Bureau Memorandum TSB-M-12(3)S (Mar. 6, 2012).
11 Software as a service provides users with access to software and applications owned by the SaaS provider and hosted on its computer hardware or servers.
12 Infrastructure as a service provides users with access to processing, storage, network capabilities, and other computing resources on the IaaS provider’s computer hardware or servers.
13 Platform as a service provides users with access to tools for the design, development, deployment, and management of the user’s applications. The PaaS provider hosts the hardware and software on its own infrastructure.
<table>
<thead>
<tr>
<th>Product/Service</th>
<th>SSUTA Uniform Definition</th>
<th>SSUTA Uniform Sourcing Rules</th>
<th>SSUTA Taxability Matrix</th>
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<tbody>
<tr>
<td>Tangible personal property</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>SaaS</td>
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<td>PaaS</td>
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While all sales tax states consistently tax the retail sale of tangible personal property (unless an exemption applies), the same cannot be said for cloud services. States vary widely in the sales tax treatment of SaaS, characterizing it as anything from the sale of tangible personal property (that is, prewritten computer software), to a taxable service (for example, data processing service, computer service, telecommunication service, etc.), to a nontaxable service. While South Dakota generally taxes all services (except for those that are specifically exempt), including SaaS, the Department of Revenue has never issued any specific guidance. Nebraska and New Jersey, both SSUTA member states, have determined that SaaS constitutes a nontaxable service. In contrast, another SSUTA member, Utah, treats SaaS as the taxable sale of prewritten computer software. Still another streamlined state, Indiana, recently ruled that a SaaS transaction is the taxable sale of telecommunications services and, partially because of this ruling, legislation was recently enacted to provide a temporary exemption for remotely accessed software. And Washington, also a member of the agreement, expressly imposes sales and use taxes on remotely accessed software, as well as digital automated services.

Michigan, another SSUTA state, was the hotbed of controversy and litigation surrounding the taxability of SaaS in *Auto-Owners Insurance Co. v. Department of Treasury*. In *Auto-Owners*, the taxpayer appealed the Department of Treasury's assessment of use tax on some purchases involving the use of remotely accessed prewritten computer software. The department maintained its long-held position that use of remotely accessed software such as SaaS constituted the use of prewritten computer software and was thus subject to sales and use tax. However, the Michigan Court of Appeals ruled that the software that the taxpayer accessed online without downloading was not subject to use tax because it was not delivered to the taxpayer.

The characterization of SaaS is also largely inconsistent in non-streamlined states. For example, New York imposes sales and use tax on SaaS as the "constructive use" of prewritten computer software, while Texas and Connecticut treat SaaS as a taxable data processing service and computer service, respectively. Texas and Connecticut also apply unique rules to data processing services and computer services: In Texas, 20 percent of the value of data processing services is exempt from tax, while in Connecticut computer processing service.

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14 S.D. Codified Laws section 10-45-4.
16 Utah Private Letter Ruling No. 13-003 (Dec. 4, 2013); and Utah Informational Publication No. 64, (May 1, 2012).
18 See Ind. Code section 6-2.5-4-16.7. The new law, which became effective July 1, provides that "a transaction in which an end user purchases, rents, leases, or licenses the right to remotely access prewritten computer software over the Internet, over private or public networks, or through wireless media: (1) is not considered to be a transaction in which prewritten computer software is delivered electronically; and (2) does not constitute a retail transaction."
19 See Wash. Rev. Code section 82.04.050(6)(c); and Wash. Rev. Code section 82.04.050(8).
services are subject to tax at a reduced rate of 1 percent. The subtleties of the tax base and rates create additional challenges and burdens for cloud service providers.

Unfortunately, there is even less tax guidance for IaaS and PaaS. Consistent with their determination that SaaS does not constitute a taxable service, Nebraska and New Jersey have also concluded that IaaS and PaaS are exempt. New Jersey determined that IaaS is not subject to sales tax “as there is no exchange of title or possession,” and as such, “these charges are not treated as rentals.” In contrast, Utah has determined that IaaS constitutes the sale or lease of computer hardware. However, noting that a transaction for the use of computer hardware is sourced to the place where a purchaser receives or takes possession of the hardware, the State Tax Commission ruled that because the company’s data centers were located outside Utah, the sale should be sourced outside Utah and not subject to sales and use tax.

Not surprisingly, the characterization and taxability of IaaS in non-streamlined states is inconsistent as well. Texas has ruled that information technology infrastructure services used to perform various activities — including, but not limited to, running applications, monitoring computers and computer usage, sending electronic communications, and hosting web domains — constitute taxable data processing services. However, 20 percent of the value of data processing services is exempt from tax. In contrast, New York has ruled that a taxpayer providing customers with access to computing power is not subject to sales and use tax because the product constitutes a nontaxable service.

Although states have issued some guidance regarding the taxability of cloud-based services, there is less guidance and consistency when it comes to situsing the sale of cloud services. Situsing is largely dependent upon how a state characterizes the transaction; given inconsistencies in characterization, two states may potentially attempt to tax the same transaction. Further, the lack of physical delivery and the fact that cloud services are often used in multiple states makes properly collecting sales tax almost impossible, particularly given systematic limitations in which sellers can rarely charge multiple state taxes on one transaction.

While there is still much uncertainty about the impact of Wayfair on nontraditional retailers, cloud service providers need to be proactive in understanding and complying with their multistate sales and use tax obligations and anticipate that states will aggressively seek compliance. In this regard, sellers should take the following steps to prepare for collection:

1. Start investigating sales and use tax systems to determine which ones will integrate easily with the seller’s existing invoicing systems.
2. Review invoices and contracts to ensure that descriptions clearly reflect the product or services being sold and the delivery method, if applicable.
3. Research and review the characterization and taxability of products and services or seek clear guidance from state taxing authorities.
4. Understand Wayfair’s implications to determine a company’s sales and use tax nexus footprint in other states, including effective and enforcement dates.
5. Understand and quantify exposure for prior periods, if any. Consider mitigation of exposure through amnesty, voluntary disclosure, or other settlement agreements.
6. Understand the implications of Wayfair on other state and local levies such as income, gross receipts, and franchise taxes.
7. Monitor new state legislation, effective compliance dates, and states’ published guidance regarding Wayfair.

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29 Id.
characterization of products, taxability, and sourcing.

The impact of Wayfair will evolve in the coming years. Whatever the long-term outcome, the economic nexus standard set forth in Wayfair has clearly changed the sales and use tax landscape in a way that is likely to have a profound effect on nontraditional retailers, including the cloud services industry. If states want to hold cloud service providers accountable for remote sales tax collection, Wayfair makes clear that it is incumbent on the states to put into place safeguards, including uniform definitions of products and services, taxability guidance, simplified tax rate structures, and uniform sourcing. Anything less could result in “discrimination against or undue burdens upon interstate commerce,” setting the stage for yet another round of legal challenges.