Michigan Court of Appeals Holds That Cloud Computing Applications Are Not Taxable as Software

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On October 27, 2015, the Michigan Court of Appeals issued a much-anticipated decision in *Auto-Owners Insurance Company v. Michigan Department of Treasury* that has relevance to most Michigan companies concerning whether sales and use tax is due on cloud computing applications or "software as a service." The Court found that use tax was not due on a broad range of cloud applications used by Auto-Owners. This is the second published decision on the topic, and the case has been watched closely since it involves such a broad range of cloud transactions.

The Court applied a dictionary definition to the term "delivered" and held that, "the transactions at issue in this case were taxable under the UTA if plaintiff exercised control over a set of coded instructions that was conveyed or handed over by any means." With respect to the majority of the transactions at issue the Court concluded that plaintiff "never had access to any of the code" that enabled the particular "system."

The Court observed that the Court of Claims "correctly determined that the mere transfer of information and data that was processed using the software of the third-party businesses does not constitute delivery by any means of prewritten computer software." *See* MCL 205.92b(o). In that situation, no prewritten computer software is delivered, and only data resulting from third-party use of software is delivered.

In the limited cases where some software code was found to have been conveyed or handed over, the Court addressed the factors of the Michigan Supreme Court's *Catalina* case, which include: 1) what the customer sought, 2) what the seller is in the business of doing, 3) whether the seller sold tangible property at retail, 4) whether the property could be purchased without related services, 5) the extent that services contributed to the value of the tangible item conveyed, and 6) any other relevant factor(s). The Court found that all the factors favored characterization as a service for two transactions and 5 of the 6 factors favored service characterization for two others, thus all 4 transactions were deemed services under the Catalina test.

There is pending legislation that would retroactively clarify the nontaxable status of these transactions, and this decision may serve as a catalyst to the enactment of that clarifying legislation. Whether such legislation is enacted or not, the case may give rise to refunds for taxpayers since the state has been asserting that cloud transactions were taxable for the past several years.

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