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# Michigan Ponders Taxability of Cloud Computing

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As companies change the way they do business, politicians and taxing authorities in Michigan are now grappling with the issue of whether "cloud computing" should be subject to tax. Cloud computing, also called "software as a service," takes place on virtual servers over the Internet. It has gained credibility as an efficient and viable means of doing business as an increasing number of businesses have moved their IT operations to the cloud.

Michigan is currently debating whether companies that sell software and data accessed through the cloud are peddling a taxable good or a nontaxable service. Factors to be considered in determining taxability can include whether a license of software is granted by the agreement, how pricing is structured under the agreement, the location of the server, and to what extent the service or software is accessed from a point within state or in multiple states. Also relevant is whether the service provider has a taxable presence in the state where the customer accesses the application, and whether the customer has a taxable presence where the servers running the application are located.

Depending on the nature of the transaction, the question of whom to tax and for what can be a difficult one. For example, consider a scenario in which a Michigan-based company purchases server space and cloud-based "software as a service" (SaaS) from a California-based company. Simple enough, but further consider that the California company has servers in New Jersey and Illinois, and the Michigan company has subsidiaries around the country that utilize the server space. This becomes a much more complex transaction from a tax collection standpoint.

Two cases in Michigan have particular significance to the taxation of cloud computing transactions. In *Catalina Marketing Sales Corp v Dep't of Treasury*, 470 Mich 13; 678 NW2d 619 (2004), the Michigan Supreme Court adopted the following six-factor "incidental to services" test for determining whether a transaction involves a non-taxable sale of a service or a taxable transfer of tangible personal property:

1. What the buyer sought as the object of the transaction,
2. What the seller or service provider is in the business of doing,
3. Whether the goods were provided as a retail enterprise with a profit-making motive,
4. Whether the tangible goods were available for sale without the service,
5. The extent to which intangible services have contributed to the value of the physical item that is transferred, and
6. Any other factors relevant to the particular transaction.

The *Catalina* test must be applied to determine whether a given transaction qualifies as a service or a taxable license of "pre-written computer software." The second question, assuming a "use" of software is involved as opposed to a service, is – where does the use take place? The Michigan Department of Treasury contends that *Fisher & Company, Inc v Dep't of Treasury*, 282 Mich App 207; 769 NW2d 740 (2009), supports the conclusion that if a transaction involves a license of software, the software need not operate on a computer within Michigan to be "used" in Michigan, but must merely be viewed by a user in Michigan. In *Fisher*, the Court determined that the plaintiff's purchase of a time-share interest in an airplane not physically in Michigan amounted to a "use" in Michigan, because entering into a contract to give up some of one's rights to possession or control is, itself, an exercise of those rights. Treasury contended in a 2009

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private letter ruling that "the purchase of a license for the use of pre-written computer software or the purchase of the right to access or use pre-written computer software in Michigan is subject to Michigan tax."

A group of eight Michigan state senators recently introduced bills (Senate Bills 335 and 336) that would amend the Michigan General Sales Tax Act and Use Tax Act to clarify that software as a service, or cloud computing, falls outside the definition of "pre-written computer software" and is, therefore, not subject to Michigan's 6% sales or use taxes. The bills were passed by the Senate on June 16, 2011, and are currently pending before the Committee on Tax Policy in the Michigan House of Representatives, which has heard testimony in support of the bill from business interests and testimony opposing the bill from the Michigan Department of Treasury. The bills would operate retroactively and specify that the right to use pre-written software installed on another person's server is not a taxable transaction. It's too early to know whether these bills will become law. However, anyone engaged in providing cloud computing services as well as consumers of these services should closely monitor what develops.

In another recent development, the Michigan Department of Treasury approved a claim for refund submitted by a Michigan workforce management firm, represented by Miller Canfield, for use tax paid for "cloud computing" provided by an out-of-state provider. It is not yet clear whether the approval of this refund signals reversal of the 2009 ruling position and recognition by the Michigan Department of Treasury that a cloud computing transaction is not taxable in Michigan. However, it clearly indicates that the Department is far from certain regarding the legal basis for the taxation of cloud computing transactions under current Michigan law.

Miller Canfield is monitoring this issue closely and working to help its clients navigate these "cloudy" skies. For more information, please contact a member of the Miller Canfield State and Local Tax group, or the author:

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