

## Reaching for the Clouds: Tennessee Taxes Cloud Computing Services

by Christopher A. Wilson



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In this article, Wilson discusses the recent Tennessee sales and use tax changes related to cloud-based software access services as well as how the Department of Revenue is likely to enforce the new law and potential problems with its application.

The Tennessee General Assembly recently enacted a substantial change in Tennessee's taxation of cloud-based software access platforms as part of the new Revenue Modernization Act (RMA). The RMA imposes Tennessee sales and use tax on the sale of online computer software access provided under an application service provider (ASP) or software as a service (SaaS) platforms. The RMA was signed by Gov. Bill Haslam (R) on May 20, 2015, and the ASP and SaaS provisions will become effective July 1, 2015.

Commonly referred to as cloud computing, both ASP and SaaS providers host software or other applications on their servers and provide customers with online access to that software over the Internet in exchange for periodic access fees under either licensing or service agreements. Under these arrangements, software remains on the ASP or SaaS provider's server and is never transferred to the customer. As evidenced by the fiscal note to the RMA, revenue from cloud-based software access services have grown significantly over the last several years — likely due to customers seeking to reduce software and information technology-related costs.

Cloud computing transactions are not addressed by Tennessee's sales and use tax code. As a result, the Tennessee Department of Revenue, in a series of rulings, has consistently classified the provision of software access via ASP or SaaS platforms as a nontaxable service because (1) no transfer of tangible personal property or taxable software occurred and (2) the provision of software access was not a specifically enumerated taxable service in Tennessee. However, if an ASP or SaaS provider maintained its servers in

Tennessee, then Tennessee sales or use tax applied to the acquisition of software used in providing ASP or SaaS services.

Under the RMA, ASP and SaaS software access will be classified as a taxable "use of computer software" in Tennessee when accessed by a customer from a Tennessee location "as indicated by the residential street address or the primary business address of the customer." Rather than classifying the provision of software access under the ASP or SaaS platforms as a taxable service, as several states have done, the RMA instead provides that a taxable "use of computer software" in Tennessee "shall be deemed equivalent to the sale or licensing of the software and the electronic delivery of the software for use in this state." While subjecting ASP or SaaS software access to Tennessee sales and use tax, the RMA also permits providers to purchase software used solely for providing ASP or SaaS access to customers using resale certificates. However, resale treatment will not apply for software purchased by qualified data centers for use by affiliated entities.

When the purchase price of ASP or SaaS software access relates to users both inside and outside Tennessee — again as indicated by residential street address or primary business address — the RMA permits the ASP or SaaS seller to allocate the sales price based on the percentage of in-state and out-of-state end-users. However, by sourcing user location based on primary business address, it is unclear whether ASP or SaaS providers selling software access to multistate businesses with software users in multiple states, but which have a primary Tennessee business address, will be permitted to allocate. A logical resolution would be for the DOR to permit allocation when a purchasing multistate business provides documentation regarding end-user location — although even this approach fails to contemplate the various scenarios that might arise in light of today's increasingly mobile workforce.

The legislative history behind the RMA suggests an intent to pursue all ASP and SaaS providers selling to Tennessee customers, with Rep. Gerald McCormick (R) saying during an April 16 House session:

For example, you used to go into a store and literally buy software off the shelf. Now it's cloud-based in many cases and we're trying to keep up with the

technology and make sure these companies that sell these services and products are actually paying taxes on them.<sup>1</sup>

While ASP and SaaS providers with Tennessee-based operations or servers will be required to collect and remit Tennessee sales and use tax on their provision of software access over the Internet, the extent to which the DOR will assert taxing nexus over ASP and SaaS operators whose servers and operations are located outside Tennessee remains unclear. Under the U.S. Supreme Court decision in *Quill Corp. v. North Dakota*,<sup>2</sup> a state may only require a taxpayer to collect and remit sales and use tax when the taxpayer establishes physical presence nexus within the state. Although courts have held that physical presence may be established in a variety of manners, such as through the presence of agents, independent contractors, or inventory, case law has yet to directly address the extent to which an ASP or SaaS provider might be deemed to have a physical presence within a state through the provision of online software access.

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Because the RMA states that Tennessee sales and use tax should be applied to the fullest extent possible under the U.S. and Tennessee constitutions, the DOR will likely take aggressive physical presence nexus positions regarding out-of-state ASP and SaaS providers to force those vendors to collect and remit Tennessee sales and use tax from their Tennessee customers. While Tennessee's consumer use tax will apply to ASP and SaaS transactions to the extent not collected and remitted by ASP and SaaS providers, imposing nexus over out-of-state ASP and SaaS providers is a preferable result for the state because the self-reporting and payment of use tax by Tennessee individual consumers has historically been low.

An aggressive nexus stance is suggested by the fiscal note accompanying SB 603 and HB 644, in which the DOR estimates that Tennessee's taxation of ASP and SaaS software access will create approximately \$13.3 million in new state

and local sales and use tax revenue during its first year. In estimating this revenue stream, the DOR made the following assumptions:

- based on the IT research and advisory company Gartner's data on worldwide and North American SaaS revenue, and assuming that Tennessee represents 2 percent of the U.S. market, the remote access software market in Tennessee is estimated to be approximately \$288 million; and
- accounting for the sales to exempt entities and for noncompliance, it is estimated that sales and use taxes will be imposed on 50 percent of those sales, or over \$144 million.<sup>3</sup>

To the extent Tennessee aggressively asserts nexus over out-of-state ASP and SaaS vendors whose only connection to Tennessee are sales of software access sales to in-state customers, it will not be alone. In Bloomberg BNA's 2015 Survey of State Tax Departments, officials from Arizona, the District of Columbia, Hawaii, Massachusetts, New Mexico, and North Dakota responded that they would impose taxing nexus for sales and use tax purposes over an out-of-state taxpayer that "sells remote access to canned software to customers located in [each jurisdiction]."<sup>4</sup> Officials in Arizona, Hawaii, and Utah further responded that they would impose taxing nexus for sales and use tax purposes over an out-of-state taxpayer that "charges fees to in-state customers for the right to access non-downloadable prewritten software that is hosted on a server in another state."<sup>5</sup> Finally, officials in Hawaii, New Mexico, and Utah noted that they would impose taxing nexus in instances in which an out-of-state taxpayer "charges fees to in-state customers for the right to access information on its website that is hosted on a server in another state."<sup>6</sup> The individual bases for these taxing policies are not clear. While leading commentators have expressed doubt that an out-of-state ASP or SaaS provider's sale of software access, without more, would result in the creation of physical presence nexus as required by *Quill*, courts have yet to address this issue.<sup>7</sup>

In light of Tennessee's shifting taxation of ASP and SaaS services, as well as the stated legislative intent to aggressively impose taxing nexus over out-of-state sellers to the extent legally possible, ASP and SaaS providers should begin evaluating the extent of their Tennessee-based customers as well as the extent of their presence within Tennessee. ☆

<sup>3</sup>Fiscal note to SB 603 and HB 644.

<sup>4</sup>Bloomberg BNA 2015 Survey of State Tax Departments, at S-352 through S-353.

<sup>5</sup>*Id.* at S-372 through S-375.

<sup>6</sup>*Id.* at S-376 through S-379.

<sup>7</sup>See Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, at para. 19.03.

<sup>1</sup>Comments of Gerald McCormick, House of Representatives (Apr. 15, 2015). McCormick made similar comments during a March 25 meeting of the House Finance, Ways and Means Committee.

<sup>2</sup>504 U.S. 298 (1992).