

## Tax: How the Cloud Can Trap You

This is the first of a series of news briefs that will keep my clients, potential clients and non-clients informed of tax and accounting news that may affect them. In short, this will give small business owners an update on how new developments in tax law may affect them.

An article in the Business Technology section of the *Wall Street Journal* of February 7, 2013, “Idaho Further Stirs Debate Over Taxing Cloud-Software Services”, is the inspiration for this article because it concerns sales tax as applied to the cloud. Historically, software has been downloaded from either the web or the cloud. A new practice has emerged where software and data remain on and/or are accessed from the cloud. Subscribing to software services on the cloud is known as software as a service (SAAS).

Since the cloud is new, there is not a large body of case law on cloud transactions. States are beginning to tax these transactions (the “Cookie Monster” effect”) and, because sales taxes are levied on proceeds from transactions (i.e. usually gross receipts from a sale), they are expensive and must be paid. For example, at one of my former employers I had to wire \$1 million per week in sales tax payments to one jurisdiction alone.

The bar for levying these taxes is low. Whereas in the past members of the Streamline Sales Tax group (SST) asserted taxpayers owed sales tax when the taxpayer’s sales in their jurisdictions were \$250,000 or more per year, many states now assert that sales tax is owed to them when there are destination sales in their state (e.g. no minimum sales in these states) and total sales everywhere are more than \$250,000. The bottom line: taxpayers who either provide services in the cloud or subscribe to them on the cloud may have to charge and/or pay sales tax.

Idaho is the lead state on this. As the article points out, SAAS is a service and services are ordinarily not subject to sales tax. Yet, according to the article, Arizona, Indiana, New York, Texas and Washington have adopted various approaches to taxing sales on the cloud. Kansas, Nebraska, Rhode Island, Tennessee, Virginia and Wisconsin will generally not tax these services, provided the taxpayer does not download the software.

However, Idaho asserts that SAAS transactions are taxable whether or not the customer downloads the software. Here’s what happened. A provider of time tracking software learned that Idaho had assessed a

sales tax deficiency on one of its clients. When the provider questioned the Idaho tax authorities, they audited him. Idaho is so far the most aggressive state on this issue.

Many startups in the Ann Arbor area are software firms and SAAS is a natural way of delivering software. I have seen startups that easily meet the \$250,000 bar. Failure to address this issue properly can result in very expensive deficiencies that may include interest and penalties. The ability for states to audit is greater than you many think. States have large audit staffs throughout the country. Chicago has an entire building staffed strictly with auditors who prowl the Midwest auditing clients.

Small businesses have to deal with this issue when one of their large customers gets audited. This happens when an auditor chooses a sample that includes smaller companies and startups. The small business owner who is not aware they have an out-of-state liability may get a shock.

If you should get a letter from either Michigan or another state, by all means call me. I have ample experience in sales/use tax audits and can put that experience to work for you. I would be happy to give you an estimate of what it would cost to for me to analyze the potential impact this new development may have on your situation.