

# Taxing software as a service:

## What SaaS providers may not know about their tax liabilities

Insights for technology companies July 2009

By Brian Balingit, senior manager,  
State and Local Tax Services

The software as a service (SaaS) sector has never looked better. Also known as on-demand hosting or subscription-based software, SaaS enables customers to pay for the use of Web-based software instead of purchasing or licensing the software outright. The software application delivery model has grown exponentially in the past few years, and it continues to attract buyers in a cash-strapped economy. But surprisingly few SaaS providers are aware of the relevant state sales tax rules affecting their organizations. This can be an extremely costly lesson for companies that become state audit targets.

### States are coming to terms with SaaS

As with many new advancements, states are trying to analyze how to treat new types of products or services from a sales tax perspective. About a decade ago, electronically downloaded software was a relatively new concept. Prior to electronic delivery, software always had been delivered on a tangible medium such as a CD, DVD or magnetic tape, and the tangible product generally was taxable. States and electronic software sellers grappled with the taxability of electronically delivered software, asking questions such as:

- What if tangible backup copies are provided to the licensee?
- What if the associated maintenance agreements include tangible updates?
- Should “load and leave” software be treated in the same manner as electronically downloaded software?

Today, electronically downloaded software is defined by state sales tax statutes and regulations, and most software companies have clear guidance in determining how their electronic sales should be taxed. That said, software vendors have had to deal with states’ growing pains to get to this position.

As in the early days of electronically downloaded software, most states still are analyzing SaaS and do not treat its taxability in a uniform manner. In determining whether SaaS is subject to sales tax, states are asking a number of questions.

- Should SaaS be treated like electronically delivered software?
- In those cases where there is no license agreement between the provider and its customers, can the state tax SaaS as a “license to use”?
- Should SaaS be defined as an information service or database access?
- Can a state classify one of its enumerated taxable services to SaaS?

In response to these taxability questions, taxpayers (sellers and buyers of SaaS), state legal counsel and tax auditors are arriving at different conclusions. Most are struggling to determine whether SaaS should be treated as software or a service.

To date, no state has changed its sales tax statutes or regulations specifically to address the taxability of SaaS. As a result, companies must rely on private letter rulings and general pronouncements for guidance. Even as the taxability of SaaS is evolving, more than a dozen states — including Massachusetts<sup>1</sup> and Texas<sup>2</sup> — have taken the informal position that SaaS is taxable.

In all cases, the taxability of SaaS is based on the specific facts of the company providing SaaS. For example, some states may exempt SaaS if the server hosting the software is not located in their state.

### Many SaaS providers are unaware of tax implications

Many SaaS providers do not realize they are required to collect sales tax in states where they have been selling their services, instead assuming that their customers are responsible for any state sales taxes. That assumption may be faulty. States often make the case that there is a connection — or nexus — between the state and the activities of an out-of-state SaaS provider.

continued >

<sup>1</sup>Massachusetts TIR 05-15

<sup>2</sup>Private Letter Rulings: 200009754L, dated September 28, 2000; 200401223L, dated January 14, 2004; and 200002080L, dated February 29, 2000.

## Taxing software as a service

Before a state can impose a sales tax collection on sales made through interstate commerce, it must be able to show a connection between the state and the economic activities of the company based outside that state. The Due Process and Commerce Clauses of the United States Constitution define the limitations on a state's authority or jurisdiction to tax.<sup>3</sup> The nexus requirements of both clauses must be satisfied before an out-of-state business may be subject to the taxing jurisdiction of a given state.

SaaS providers often are unsure when they have sales tax nexus in a particular state. Most are aware that having property or employees in a state is enough to result in sales tax nexus. However, many providers do not realize that visits by sales representatives to a neighboring state can be sufficient to justify the collection of that state's sales taxes.

If a SaaS company utilizes independent contractors or agents to solicit sales or to perform services, this may create a connection with the state. The definition of "agency" varies from state to state; however, in certain jurisdictions the definition is consistent with Uniform Commercial Code definitions or common law interpretations. The principle of agency rests on the premise that one who acts through another is himself responsible. As such, the company's agents' activities are treated as the activities of the SaaS provider. Despite this simple definition, states diverge widely as to the degree of authority and control required

for an agency relationship. Identical facts often produce differing results from state to state.

Many SaaS agreements include language in their contracts that mandates that any state sales tax related to SaaS is the sole responsibility of the purchaser. SaaS providers believe that this contractual language protects them from exposure to state sales taxes. However, pursuant to individual state statutes, sales tax liability may rest on the seller, the buyer or both. Assuming nexus, the seller is required to collect and remit the sales tax regardless of who contractually bears the burden. State tax auditors look to their own statutes — not SaaS legal contract language — to determine who must remit taxes to their state.

### Recording and reporting contingencies

The taxability of SaaS also has Financial Accounting Standards Board No. 5, Accounting for Contingencies (FAS 5), implications for companies that are audited for financial statement purposes. FAS 5 addresses recording and reporting contingencies for financial accounting. It is the principal standard governing the recording and reporting of sales and use tax uncertainties.

For FAS 5 purposes, an uncollected sales tax results in a contingency for which a reserve — or possibly a disclosure — is required. Companies that have sales tax exposure in a given state that is "probable and estimable" are required to record a reserve for each

of those states. Even if such a reserve is determined to be unnecessary, a disclosure of the exposure item in a footnote to the financial statements still may be required. Many SaaS companies are required to record additional tax reserves for liabilities owed as a result of where the services were taxable.

### Cash-strapped states are becoming more aggressive

Considering many states' substantial budget shortfalls, states are being more aggressive than ever in their audits. If state tax auditors contact a company that is not registered and does not file sales tax returns, the state may have the authority to assess the company for all past sales tax exposure in that state, plus penalties and interest. It is very common for there to be no statute of limitations for non-filers. For companies that already file in a particular state, those limitations generally are more limited.<sup>4</sup>

The bottom line is that if a SaaS company has nexus in a given jurisdiction, it may be required to collect and remit state and local sales taxes. Most companies consider a state's sales tax as a "pass-through" tax (i.e., the tax is paid by the purchaser to the seller, not imposed or based on the seller's income). But if companies fail to properly collect and remit sales taxes, they put themselves at a significant risk of having to remit (or reserve) substantial back taxes, penalties and interest to states where they could — and should — have been collecting from SaaS buyers all along. •

This document supports Grant Thornton LLP's marketing of professional services, and is not written tax advice directed at the particular facts and circumstances of any person. If you are interested in the subject of this document we encourage you to contact us or an independent tax advisor to discuss the potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this document may be considered to contain written tax advice, any written advice contained in, forwarded with, or attached to this document is not intended by Grant Thornton to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

<sup>3</sup>As discussed in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>4</sup>The applicable limitation depends on the state, but generally is three to four years from the date a return is filed.

### Contact information

**Immanuel John**  
Partner-in-charge, Software sector  
T 215.656.3049  
E [Immanuel.John@gt.com](mailto:Immanuel.John@gt.com)

© Grant Thornton LLP  
All rights reserved.  
U.S. member firm of Grant Thornton International Ltd  
[www.GrantThornton.com](http://www.GrantThornton.com)

Content in this publication is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information on the issues discussed, consult a Grant Thornton client service partner.