



Senate Fiscal Agency
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BILL  ANALYSIS

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Senate Bill 142 (as passed by the Senate)
Senate Bill 143 (Substitute S-1 as passed by the Senate)
Sponsor: Senator John Proos (S.B. 142)
Senator John Pappageorge (S.B. 143)
Committee: Finance

Date Completed: 7-31-13

RATIONALE

In recent years, "cloud computing" has been gaining in popularity. The term "cloud" is a metaphor for the internet, and the phrase "cloud computing" generally refers to a practice in which the infrastructure or servers of a company such as Compuware, Apple, or Google, are used to remotely store and manage the data of its clients, which might include private companies, governmental agencies, and individuals. Cloud computing is considered advantageous because clients can increase or change computing capabilities or capacity without purchasing new equipment, training personnel, or investing in licensed software. Customers may receive cloud computing services by subscription or on a pay-per-use basis. Now that cloud computing has become more prevalent, some are questioning Michigan's tax treatment of transactions in which the service is provided. Reportedly, the Department of Treasury in the past issued a letter indicating that such a transaction was not subject to the sales or use tax, but the Department has since taken the position that the tax applies. In order to assist the businesses that rely on cloud computing services, as well as make the State attractive to the companies that provide them, it has been suggested that tax exemptions be enacted.

CONTENT

Senate Bills 142 and 143 (S-1) would amend the Use Tax Act and the General Sales Tax Act, respectively, to exclude from the definition of "prewritten computer software" granting the right

to use prewritten software installed on another person's server.

The Acts impose a 6% tax on the sale or consumption of tangible personal property, and each Act's definition of "tangible personal property" includes prewritten computer software. The Acts define "prewritten computer software" as computer software, including prewritten upgrades, that is delivered by any means and that is not designed and developed by the author or other creator to the specifications of a specific purchaser. Under the bills, the term would not include granting the right to use prewritten computer software installed on another person's server.

Each bill states that the amendment "is curative and is intended to express the original intent of the legislature concerning the taxation of prewritten computer software" under the Act.

MCL 205.92b (S.B. 142)
205.51a (S.B. 143)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

"Cloud computing" is a very broad term that encompasses many different concepts, practices, uses, and applications. Although there is no universal definition, virtually all

descriptions of cloud computing refer to it as a service. No transfer of ownership is involved when cloud computing services are provided, and the clients who contract for the services receive no tangible product. When the definition of "prewritten computer software" was added to the statutes in 2004, cloud computing was unheard of, and the purchase or sale of software involved the delivery of material goods. Since then, technology and practices have evolved, and what formerly was a product has migrated to a service. As an article in *Business Week* explained, "Companies that once installed racks of servers in their offices and bought software on CDs are replacing them with offsite solutions sold by IBM, Amazon.com, and Google, among others" ("Hey (Hey), You (You), Stop Taxing My Cloud", *Business Week*, 8/29/11-9/4/11).

Subjecting cloud computing transactions to the sales and use taxes is inconsistent with Michigan's tax treatment of most services. In addition to imposing a cost on the State's businesses and residents who rely on cloud computing, the Department of Treasury's varying positions have resulted in uncertainty and confusion.

An example given by Kelly Services helps illustrate the situation. The company, which is headquartered in Troy, Michigan, provides temporary staffing for clients across the country, as well as internationally. Kelly Services relies on cloud computing vendors to obtain workers' "time card" information. The clients deliver the information electronically to the vendors, which then deliver the data electronically to Kelly Services. When the vendors send a bill to Kelly Services, some include tax and others do not, due to the confusion over the taxation of cloud computing transactions in Michigan. Compounding the problem is that a vendor might collect time card information from Kelly Services clients in multiple states, including Michigan, and collect tax on 100% of the transactions, even though only a small portion occurred in this State.

If the Department of Treasury previously determined that a cloud computing transaction was not taxable, and there has been no change in the statute or rules, it is not clear why the Department would reverse its stance.

Response: Evidently, a number of years ago, the Department issued an

incorrect technical advice letter indicating that a cloud computing transaction was not taxable. That was corrected and, since then, the Department has issued technical advice letters holding that these transactions are taxable. Although technical advice letters do not set policy or precedent, the Department's position has been consistent and is well known. Furthermore, there is still some question as to whether a cloud computing transaction involves strictly the provision of a service with no materiality whatsoever.

Supporting Argument

The State should not tax itself out of the opportunity to attract the cloud computing industry. The servers used for data storage and management require considerable space, and Michigan has abundant brownfield sites with large structures that could be used. Since the infrastructure can be located anywhere, however, a service provider might be inclined to select a state that does not require it to collect tax on its services or require its customers to pay tax when they purchase or subscribe to the services. The proposed tax exemptions could encourage the industry to bring its business to Michigan, creating jobs and expanding the State's economic base.

Opposing Argument

The fact that a software program is stored on a "another person's server" should not determine taxability. Although people usually think of cloud computing as the use of services at a location distant from the site of the physical infrastructure, software installed on another person's server could be across the country or right next door.

Furthermore, the State already has determined in statute that prewritten computer software is tangible personal property for purposes of the sales and use taxes. When a person "buys" a software program, he or she is purchasing a license to use the program, not the software itself. Also, when an individual buys a software program and when a business contracts for a cloud computing service, *some* software evidently is installed on the individual's or the business's own computer. Therefore, the nature of the transaction is the same regardless of whether a person buys a program or enters into contracts with a cloud computing vendor, and the tax treatment should be the same.

Rather than simply exempting cloud computing transactions from the sales and use taxes, the State should take a deliberative and comprehensive approach to the taxation of electronic commerce. That approach needs to be consistent with the streamlined sales and use tax laws, and any tax exemption should be narrowly written.

Opposing Argument

This legislation could present a significant cost to the State's General Fund budget and the School Aid Fund. Because cloud computing is a rapidly growing part of the economy, the potential revenue loss could grow as well.

Response: The revenue loss could be mitigated or reversed if businesses chose to stay or locate in Michigan due to the proposed tax exemptions. On the other hand, if the law is not changed, the State might lose businesses, tax revenue, and jobs.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bills would reduce State revenue by an unknown amount that would likely increase over time. According to the Michigan Department of Treasury, the annual revenue loss in FY 2013-14 would total approximately \$12.0 million. To the extent that the industry activity that would be affected by the bills increases in future years, the revenue loss would be larger. The enacting provisions in the bills are estimated to reduce revenue by an additional \$8.0 million to \$12.0 million, but would affect FY 2013-14 only. The loss would affect General Fund revenue, School Aid Fund revenue, and revenue sharing to local units of government, with the relative impact across the funds depending on the relative magnitude of reduction in sales tax revenue compared to the reduction in use tax revenue.

Fiscal Analyst: David Zin

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.