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Does the Massachusetts Department of Revenue Still Believe SaaS is Subject to Sales Tax?

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As noted in an earlier blog post, "[a] trend is developing in response to aggressive Department of Revenue/Treasury policy-making regarding cloud computing." This trend has not been friendly to aggressive Departments, and it appears that the Massachusetts Department of Revenue (Massachusetts Department) may be subtly moving away from its own aggressive position regarding one type of **cloud computing transaction, software as a service (SaaS).**

Following in the footsteps of the **New York Department of Taxation and Finance**, the **Massachusetts Department** has been one of the more aggressive departments in the current debate over the **taxability of SaaS** (*see, e.g.*, Mass. Regs. Code 64H.1.3(3)(a); Mass. Letter Ruling 13-5 (June 4, 2013); Mass. Letter Ruling 12-13 (Nov. 09, 2012); Mass. Letter Ruling 12-10 (Sept. 25, 2012); Mass. Letter Ruling 12-6 (May 21, 2012)). In its various letter rulings on the subject, the Massachusetts Department has routinely stated its position as follows:

Charges for prewritten software, whether it is electronically downloaded to the customer or accessed by the customer on the seller's server (including the "Software as a Service" business model), are generally taxable. However, the marketing description of a product as "software -as-a-service" does not determine taxability of a product, nor does the fact that customers do not download software or otherwise install software on their own computers or other devices.

The Massachusetts Department applies a **"true object of the transaction**" test to distinguish between situations where a transaction is for taxable software as opposed to a non-taxable service, noting in its guidance that "[w]here use of a software application is bundled with substantial non-taxable personal or professional services or non-taxable services such as database access or data processing, the object of the transaction may be the non-taxable service rather than a sale of software."

Though the Massachusetts Department has continued to assert that charges for SaaS are generally subject to tax—both in its published guidance and during taxpayer audits—it has been over a year since the Massachusetts Department has published guidance finding that a specific SaaS offering was subject to tax (*see* Mass. Letter Ruling 13-5 (June 4, 2013)). During that year, the Massachusetts Department has issued two new letter rulings, Mass. Letter Ruling 14-4 (May 29, 2014) and Mass. Letter Ruling 14-1 (Feb. 10, 2014), and revised one, Mass. Letter Ruling 12-8

(Revised Nov. 8, 2013), all of which have relied on the “object of the transaction” test to conclude that the offerings at issue were not taxable transfers of prewritten software.

In Mass. Letter Ruling 14-4, the Massachusetts Department considered the requestor’s SaaS offering through which it provided customers with remote access to interactive training programs hosted on its servers, seemingly a ripe fact pattern for finding that the true object of the transaction was prewritten software, especially in light of the Massachusetts Department’s position in other letter rulings *(see, e.g.*, Mass. Letter Ruling 12-10, finding the true object of a SaaS transaction to be the underlying software, noting that “the customer must interact with the software in order to reach an objective”). However, the Massachusetts Department determined the offering was a non-taxable “database access service” rather than a taxable transfer of prewritten software after ruling that “[w]here the Company is the primary source of the content or information accessed by customers on-line . . . the object of the transaction is the information and not the use of any software used to communicate that information.”

Taxpayers are encouraged to keep an eye on the direction of further guidance. Do the Massachusetts Department’s most recent letter rulings indicate a move away from its prior aggressive position regarding SaaS by using the “out” of the true object test, or is it coincidental (and clear) that the true objects of the transactions in these recent rulings were not prewritten software? Regardless of the answer to this question, the Massachusetts Department’s recent approach towards SaaS offers some basic lessons. First, when entering into SaaS agreements, providers and customers alike should memorialize what the transaction is for (*i.e.*, what its “true object” is). The Massachusetts Department has displayed a willingness to rely on the object of the transaction test, so it is vital that the object of the transaction be made as clear as possible. Second, language regarding the transfer of a license of the provider’s software to the customer should be avoided unless absolutely necessary for other reasons.

Though the Massachusetts Department observes that the particular means of transfer is not controlling in any taxability determination, “license” language is likely to draw unwanted attention of auditors and to be used to support assertions that the object of the transaction is the transfer of the licensed software. Finally, if audited, taxpayers should not stand for unsupported assertions that a SaaS offering is subject to tax as a transfer of prewritten software; instead, they should hammer home the true object of the transaction by showing such things as the benefit to the customer and the types of activities performed by the provider’s employees (which can demonstrate that a service, not software, is being offered).

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