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Precedential Cloud Victory in Michigan Court of Appeals

Article By:

Stephen P. Kranz

Eric Carstens

On Tuesday, a three-judge panel sitting for the *Michigan* Court of Appeals unanimously affirmed a lower court decision finding that the use of cloud-based services in Michigan is not subject to use tax in ***Auto-Owners Ins. Co. v. Dep't of Treasury,*** No. 321505 (Mich. Ct. App. Oct. 27, 2015.) While there have been a number of cloud-based use tax victories in the Michigan courts over the past year and a half, this decision marks the first *published* Court of Appeals opinion (*i.e.*, it has precedential effect under the rule of *stare decisis*). *See* Mich. Ct. R. 7.215(C)(2). Therefore, the trial courts and Michigan Court of Appeals are obligated to follow the holdings in this case when presented with similar facts, until the Michigan Supreme Court or Court of Appeals say otherwise. While the ultimate outcome (*i.e.*, not taxable) of the lower court decision was affirmed, the analysis used by the Court of Appeals to get there was slightly different and the court took the time to analyze over a dozen different contracts, as discussed below. Given the fact that a petition for review is currently pending in another Court of Appeals case (*Thomson Reuters*) decided on similar issues in 2014, it will be interesting to see if this development increases the Michigan Supreme Court's appetite to hear a use tax case on cloud-based services. The Department of Treasury (Department) has approximately 40 days to request that the *Auto-Owners* decision be reviewed by the Michigan Supreme Court.

Facts

Auto-Owners is an insurance company based out of Michigan that entered into a variety of contracts with third-parties to provide cloud-based services. These contracts were grouped into six basic categories for purposes of this case: (1) insurance industry specific contracts, (2) technology and communications contracts, (3) online research contracts, (4) payment remittance and processing support contracts, (5) equipment maintenance and software customer support contracts and (6) marketing and advertising contracts. The contracts all involved, at some level, software accessed through the internet. Michigan audited Auto-Owners and ultimately issued a use tax deficiency assessment based on the cloud-based service contracts it utilized. In doing so, the Department cited the Michigan use tax statute, which like many states, provides that tax is imposed on the privilege of using tangible personal property in the state. *See generally* Mich. Comp. Laws Ann. § 205.93. The Department took the position that the software used in Michigan by Auto-Owners was "tangible personal property," which is defined to include prewritten, non-custom, software that is "delivered by any means" under Michigan law. *See* Mich. Comp. Laws Ann. § 205.92b(o). The taxpayer paid the

tax under protest and filed a refund claim, which was the focus of the Court of Claims decision being appealed.

Procedural History

At the trial court level, the Court of Claims determined that the application of use tax to the software used in Michigan by Auto-Owners would be improper. In doing so, the court issued three separate holdings—all in favor of the taxpayer. First, the court held that use tax did not apply because prewritten computer software was not "delivered by any means." The court concluded that the vendors "did not surrender possession and control of the software … or actually transfer the software…." Software was not transferred, only information and data was transferred. Further, the court concluded that "delivery by any means" was likely intended to mean the electronic and physical delivery of software, not the remote access of a third-party provider's technology infrastructure because the business model was "essentially unheard of at the time the use tax statute was enacted." Second, the court held that the software was also not "used" by Auto-Owners (*i.e.*, they did not have control over the software as it only had the "ability to control outcomes by inputting certain data to be analyzed"). The court rejected the argument that mere access to property equates to use because Auto-Owners did not "exercise a right or power incident to ownership in the underlying software." Finally, the court held that even if prewritten computer software was delivered and used, the use was "merely incidental to the services rendered by the third-party providers and would not subject the overall transactions to use tax." Michigan case law provides that if a transaction includes the transfer of tangible personal property and non-taxable services, the entire transaction is not taxable if the transfer of property is incidental to the services, similar to the "true object" test implemented in many other states. The Michigan Supreme Court articulated a six factor test in *Catalina Marketing* to determine the proper application of the test, and the trial court found that any use of property was "merely incidental" under the factors.

Court of Appeals Holding

Reviewing the Court of Claims decision *de novo*, the Court of Appeals rejected the Department's argument that the lower court erred in its determination that the cloud-based transactions were not taxable. The court noted that "the transactions at issue in this case were taxable under the [Use Tax Act] if plaintiff exercised control over a set of coded instructions that was conveyed or handed over by any means and was not designed and developed by the author or another creator to the specifications of a specific purchaser." Similar to the Court of Claims, the Court of Appeals found that a majority of transactions in this case were not subject to use tax because they did not involve the delivery of prewritten computer software by any means; however, the Court of Appeals noted two caveats to the trial court's holdings. First, the appellate court pointed out that the Court of Claims erred to the extent it found all software was located on third-party servers (a factual discrepancy). Second, and more significantly, the Court of Appeals held that the lower court "improperly narrowed the scope of the term 'deliver' to preclude electronic delivery." Nonetheless, the appeals court conceded that "the Court of Claims correctly determined that the mere transfer of information and data that was processed using the software of the third-party businesses does not constitute delivery by any means of prewritten computer software" noting that "[i]n that situation, only data resulting from the third-party use of software is delivered."

After analyzing each of the contractual transactions at issue, the Court of Appeals disqualified most of them from the alleged use tax obligation in Michigan on that basis that Auto-Owners lacked sufficient control over the software (*i.e.*, they never exercised an ownership-type right or had access to any of the code that enabled the system). Because of the factual discrepancy noted by the court

above, the court proceeded to evaluate the remaining transactions under the six-part *Catalina Marketing* test. For each of the remaining transactions, including Cisco WebEx and a Wolters Kluwer online insurance research subscription that included print materials in conjunction with the online subscription, the Court of Appeals found that any tangible personal property controlled by Auto-Owners was merely incidental to the services received. Specifically, the court noted that "[t]here is no indication that [Auto-Owners] could purchase the software or other tangible personal property independent of the services, and the services gave value to the software and other tangible personal property."

Practice Note

The Department has roughly 40 days to request review of the Michigan Supreme Court, which has no obligation to take the case. It will be interesting to see how the Department reacts to the binding precedent that will certainly set them back in their quest to enforce the use tax against cloud-based service providers. It should be noted that a similar unpublished Court of Appeals case decided in 2014 (*Thomson Reuters*) currently has a petition for review pending in the Michigan Supreme Court. If the Michigan Supreme Court refuses to take either case, the Department will be bound by the holding and barred from ignoring the binding precedent—at least in the courts. It should also be noted that the Michigan Legislature has considered legislation in the past two regular sessions that would amend the definition of "prewritten computer software" to explicitly exclude granting the right to use software installed on another person's server for sales and use tax purposes. If judicial defeat does not stop the Department from enforcing use tax on cloud-based services, legislative action may be the only option.

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