



Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536



BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bills 335 and 336 (as passed by the Senate)
Sponsor: Senator John Pappageorge (S.B. 335)
Senator John Proos (S.B. 336)
Committee: Finance

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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 Amazon, Apple, or Google, are used to remotely store and manage the data of its clients, such as 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 private letter rulings indicating that such a transaction was not subject to the sales or use tax, but the Department presently believes that the taxes apply. 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 should be enacted.

CONTENT

Senate Bills 335 and 336 would amend the General Sales Tax Act and the Use 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 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 205.51a (S.B. 335)
205.92b (S.B. 336)

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.

Subjecting cloud computing transactions to the sales and use taxes is inconsistent with Michigan's standard 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. If the Department 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: If the Department issued letter rulings on this subject in the past, they merely addressed individual circumstances. Unlike Revenue Administrative Bulletins, letters do not set forth policy or have the effect of law.

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

Whether a cloud computing transaction involves strictly the provision of a service with no materiality whatsoever remains a gray area. Also, the fact that a software program is stored on a server out of State, rather than on a personal computer in Michigan, should not necessarily determine

taxability. 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, and that approach needs to be consistent with the streamlined sales and use tax laws.

Opposing Argument

This legislation could present a significant cost to the State. Because cloud computing is a rapidly growing part of the economy, the potential revenue loss could double in a year or two.

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 revenue loss in FY 2011-12 would total approximately \$5.0 million to \$8.0 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 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 the reduction in sales tax revenue compared with 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.