



Illinois provides guidance on characterization and sourcing of cloud computing receipts for sales factor apportionment purposes

TAX AND BENEFITS CHALLENGES | JUL 02, 2014

On April 24, 2014, the Illinois Department of Revenue (the Department) replied to a request for a Private Letter Ruling requesting a ruling that the taxpayer's (Company's) "dedicated hosting, cloud computing and remote customer support are services for Illinois sales factor apportionment purposes and should be sourced to its customers' billing addresses." The Company is incorporated outside of Illinois, but maintains several data sites around the world, including one in Illinois.

Characterization as service contracts for apportionment purposes

Illinois uses sales factor apportionment rules to determine the amount of nonresident business income that is subject to taxes in Illinois where income is derived from Illinois and other states. Illinois law includes various rules for determining when income received from sales is sourced to Illinois. Sales from leases of tangible personal property are sourced to Illinois if the leased property is located in Illinois during the lease period. However, sales of services are sourced to Illinois if the services are received within the state. Therefore, in order to determine the proper applicable sourcing rules, the Department had to determine whether the Company's contracts were service contracts or leases.

In the ruling, the Department used the following six factors from the Internal Revenue Code Section 7701(e), and reviewed case law, to distinguish whether a contract is for services or should be treated as a lease of property:

1. Whether the customer physically possesses the property
2. Whether the customer controls the property
3. Whether the customer has significant economic and possessory interests in the property
4. Whether the service provider bears any risk of substantially diminished receipts or substantially increased expenditures as a result of nonperformance of the contract
5. Whether the service provider uses the property concurrently to provide significant services to entities unrelated to the customer in question
6. Whether the total contract price exceeds the rental value of the property during the contract period

After a thorough analysis of these factors, the Department concluded that a Company's contracts are services contracts. The Department's determination was based on an analysis of the Company's contracts, which showed, among other things, the following:

- The Company's customers do not physically possess or control the Company's hardware and software
- The Company is responsible for all of the costs of the data center, including repairs and replacements
- The Company must credit the customer's account a certain percentage of the customer's fee if the data center network is unavailable at any time
- The software is accessed concurrently by unrelated customers
- The Company provides support services in addition to the customer's use of the servers and software

Determining when services are received in Illinois

After finding that the Company's contracts are services contracts, the Department determined that receipts from the sale of those services would be sourced to Illinois if such services are received by the customer in Illinois, pursuant to the provisions of IITA Section 304(a)(3)(C-5)(iv). This law also provides that if a taxpayer cannot determine in which state its customers are receiving the services, then services are deemed to be received at the location of the office of the customer from which the services were ordered in the ordinary course of the customer's business. If a taxpayer cannot determine where the ordering office of a customer is located, then the services are deemed to be received at the customer's billing address. If a taxpayer is not taxable in the state in which the services are determined to be received, then those sales must be excluded from the numerator and the denominator of the sales factor being used in to apportion the income of the taxpayer to Illinois.

The Company contended, and the Department agreed, that it cannot determine where a customer is physically located at the time it accesses the Company's servers. Therefore, the Department said that under Illinois law, the Company's services are deemed to be received at the location of the office of the customer from which it ordered the services in its regular course of business. The Department further stated that if the Company cannot determine the ordering location, then the services are deemed to be received at the customer's billing address. However, if the Company is not taxable in a state in which the services are deemed to be received, then the Company must exclude the sales from both the numerator and denominator of the sales factor that it uses for apportioning its income to Illinois.

Though not binding on the Department for other taxpayers, this private letter ruling provides helpful guidance for similar cloud computing companies who need to apply the sourcing

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rules for Illinois income tax apportionment purposes.