IT 14-0003 PLR 04/24/2014 APPORTIONMENT – SALES FACTOR
For sales factor purposes, cloud computing services described in this ruling request re sales of service, not rental of tangible personal property or sales or licenses of intangible personal property. (This is a PLR.)
April 24, 2014

Re: Request for Private Letter Ruling
Company

Dear Xxxxx:

This is in response to your letter dated March 29, 2013, in which you request a Private Letter Ruling on behalf of Company and its subsidiaries. Review of your request for a Private Letter Ruling indicates that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code 1200.110 is contained in your request. This Private Letter Ruling will bind the Department only with respect to the combined group that includes Company. Issuance of this ruling is conditioned upon the understanding that Company and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

Company 2, as an authorized agent for Company & Subsidiaries ("Company" "Company" or "taxpayer"), requests a Private Letter Ruling regarding the sourcing of receipts from Dedicated Cloud hosting and Public Cloud computing for purposes of computing the sales factor used to determine the percentage of a non-resident's business income taxable by Illinois.

DISCLOSURES

In accordance with 2 Ill. Adm. Code 1200.110(b)(3), the subject of this request is not being examined as part of an audit by the Illinois Department of Revenue ("Department").

In accordance with 2 Ill. Adm. Code 1200.110(b)(4), to the best of the knowledge of both the taxpayer and the taxpayer's representative, the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor. In addition, the taxpayer and its representatives have not previously submitted the same or a similar issue to the Department and withdrawn it before a letter ruling was issued.

TAX YEAR

The ruling is requested for tax years ended on or after December 31, 2009.

TAXPAYER

For purposes of this request, Company includes itself and all of its subsidiaries included in its combined Illinois income tax return. Company is submitting this Private Letter Ruling request in accordance with 2 Ill. Adm. Code 1200.110(a)(3)(A)(i), which permits one ruling request by a member of a unitary group with reference to issues common to it and other members of the unitary group. Company has a calendar year ending December 31st.

STATEMENT OF FACTS

Company is an information technology (“IT”) hosting services provider; with more than X employees and Y customers as of December 31, 2012, most of which are small and medium businesses. Company operates eight data-centers around the world: two located in City, State 1; one in City, State 2; one in City, State 2: one in City, Illinois; one in City, COUNTRY 1; one in City 2, COUNTRY 1 and one in City 3, Country 2. Company is incorporated in State A and primarily operates in one legal entity within the U.S. The company is listed on the Z Stock Exchange and its headquarters is located in City 2, State 1.

Company is a hosting specialist, which means that its entire business is related to the delivery and support of hosting solutions for its customers. Company is the world’s leading specialist in the hosting and cloud computing industry. Company generates revenue from two main hosting services: Dedicated Cloud and Public Cloud Computing.

Dedicated Cloud, sometimes known as “Dedicated Hosting” refers to IT services that are provided on a server or servers reserved for a specific customer. These servers are owned and located at a Company secure business data-center. Company customers may select one of the eight data-centers located around the world, but Company at its sole discretion determines which of its servers will be used to house customer data. Company customers have full administrator privileges and are responsible for most administrative functions. Company provides a customer management portal and other management tools. This service removes the burden of managing the data-center, network, and hardware devices for the customer. Due to the dedicated nature of the services provided, Dedicated Cloud is largely recurring and billed as a subscription-based business. Dedicated Cloud is a core Company service offering. Included in Dedicated Cloud hosting is private cloud, which refers to a pool of computing resources that is dedicated to one particular customer, rather than being used by multiple customers.

Public Cloud computing is a technology that uses the internet and central remote servers to maintain data and applications. Public Cloud computing allows customers and businesses to use applications without installation on the customer’s computers or servers and allows consumers and businesses to access their files at any computer with internet access.

Cloud computing is broken down into segments: “application,” storage,” and “connectivity.” Cloud computing providers deliver applications via the internet which are accessed from web browsers, desktop and mobile applications, while the business software and data are stored on servers at a remote location. Company’s Cloud computing services refer to pooled computing resources, delivered on-demand over the internet. Cloud technologies allow Company to effectively manage a pool of computing resources (or a “cloud”) across a large base of customers and deliver more computing resources to businesses when they need them. There are multiple varieties of cloud hosting services that are priced on a pay-per-use basis and can be quickly and easily scaled based on demand. Company offers products and services that includes email, collaboration services and file back-ups. Company provides and is known for its unique brand of customer support which is provided from locations outside of Illinois.

Ruling Requested

Company requests the Department to issue a ruling that 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.

Discussion

Despite the fact that Illinois does not have a specific definition of what constitutes “sales of services,” dedicated hosting, cloud computing and customer support are best categorized as a “service” for sales factor sourcing purposes. Company is considered to be a service provider since it is receiving revenue from a transaction in which its customer’s objective is to obtain the performance of an act by Company rather than receiving an item of tangible personal property or an intangible asset. Although Dedicated Hosting and Public Cloud Computing can be associated with intangible personal property, the income streams that Company receives from its customers for the activities that it performs on behalf of its customers over the internet should properly be classified as “sales of services.”

The State of Illinois in P.A. 95-707, effective January 11, 2008 for tax years ending on or after December 31, 2008, adopted a market based approach for sourcing services in calculating the sales factor under the Illinois Income Tax Act (“IITA”). A new provision to IITA Section 304(a)(3) was added. IITA Section 304(a)(3)(C-5)(iv) provides:

> Sales of services are in this State if the services are received in this State. For the purposes of this section, gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer’s trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor. The Department shall adopt rules prescribing where specific types of services are received for special types of services, including but not limited to, broadcast, cable, advertising, publishing, and utility services. (The last sentence to this subsection was amended by P.A. 96-793, effective August 25, 2009, for tax years ending on or after December 31, 2008 to exclude broadcast, cable, advertising, because IITA Section 304(a)(3)(B-7) was added to address the sourcing of receipts for this industry.)

To date, the Department has not yet promulgated any regulations as authorized by the statute to provide guidance on where services should be received under the new sourcing provisions.

In the case of services provided by Company, Dedicated Cloud Hosting and Public Cloud computing are performed at non-customer locations. The services Company performs for its customers are located at the location of Company servers or at the headquarters in State 1 with support and then is accessed by Company customers via the internet. In Illinois Private Letter Ruling IT-11-0002-PLR, dated September 6, 2011, the taxpayer provided educational courses via the internet and the taxpayer could not readily determine where the services were being received. The Department agreed that the taxpayer should use the “deemed received” provisions of the sourcing statute.

IITA Section 304(a)(3)(C-5)(iv) addresses the situation where the services are not readily determinable.

> If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of the

office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor.

Under the framework of the statute, if the location of the services received is not readily determinable, the services are "deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business." Although Company knows the identity of its customers, it does not track the location of where the customer actually accesses the server.

The statute does provide for a default sourcing provision for services. "If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed." The statute further limits the sourcing for all services, "if the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and denominator of the sales factor."

If Company cannot readily determine from where the services they provide to its customers are being ordered from, the "deemed received" location will be the "billed" location of its customers. These are the "identifiable and the logical choices" for sourcing Company services.

The statute further limits the sourcing for all services, "if the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor." If Company is not taxable in the state in which the services are billed, the sale must be excluded from both the numerator and the denominator of Company's sales factor.

RULING

Section 304 of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/304) contains apportionment rules that determine the amount of business income of a nonresident that is taxable in Illinois where the income is derived from Illinois and one or more other states. Under Section 304(a) and (h), the general apportionment rule requires a taxpayer to multiply its business income for the taxable year by its sales factor. Section 304(a)(3)(A) defines the "sales factor" as the fraction consisting of the taxpayer's total sales in Illinois during the taxable year over its total sales everywhere during the taxable year. The apportionment required under Section 304(a) is to be performed following the close of the taxpayer's taxable year. The taxpayer determines its total business income for the taxable year, and then apportions to Illinois that part of such income that bears the same ratio as the taxpayer's Illinois sales for the taxable year bears to total taxable year sales.

IITA Section 304(a)(3) provides various rules for determining whether sales are sourced to Illinois for sales factor purposes. Section 304(a)(3)(C-5)(ii) provides that sales from the lease or rental of tangible personal property are sourced to Illinois if the property is located in Illinois during the rental period. Section 304(a)(3)(C-5)(iii) provides that income from intangible personal property is sourced to Illinois where, (i) if the taxpayer is a dealer with respect to the item of intangible personal property, the income is received from a customer in Illinois, or (ii) if the taxpayer is not a dealer, the income-producing activity of the taxpayer is performed in Illinois. Section 304(a)(3)(C-5)(iv) provides that sales of services are sourced to Illinois if the services are received in Illinois.

The IITA does not define "services," or otherwise provide rules to distinguish between service contracts and contracts involving the lease or license of tangible or intangible personal property. However, under federal income tax law, Internal Revenue Code Section 7701(e) provides:

> A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not –
> (A) the service recipient is in physical possession of the property,
> (B) the service recipient controls the property,
> (C) the service recipient has a significant economic or possessory interest in the property,
> (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
> (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
> (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

See also Tidewater Inc. v. U.S., 565 F.3d 299 (5th Cir. 2009). In addition, case law interpreting the IRC prior to the enactment of Section 7701(e) is useful in determining whether an agreement should be characterized as a service contract or a rental agreement. Boston Professional Hockey Club v. Commissioner, 820 N.E.2d 792, 806 (Ma. 2005). In Xerox Corp. v. U.S., 656 F.2d 659 (Fed. Ct. Cl. 1981), the court summarized the several factors relied upon by IRS to distinguish service contracts from leases:

> While these factors overlap in some respects, they generally relate to two broad areas: first, the nature of the possessory interest retained by the taxpayer; and, second, the degree to which the property supplied a customer is a component of an integrated operation in which the taxpayer has other responsibilities.
> The cited rulings indicate that the following factors relative to the possessory interest retained by the taxpayer in the property were deemed relevant by IRS to a determination that a service arrangement existed: (1) retention of property ownership by the taxpayer, (2) retention of possession and control of the property by the taxpayer, (3) retention of risk of loss by the taxpayer, (4) reservation of the right to remove the property, and replace it with comparable property.
> …
> The second area of focus used by IRS in determining whether an agreement is a service involves the degree to which the property is part of an integrated operation. In this area, IRS has drawn a distinction between property used by the taxpayer to provide services to its customers, and property placed with the customer to allow it to provide services to itself. Xerox, 656 F.2d at 674-5.

See also Smith v. Commissioner, T.C. Memo. 1989-318 (1989), Musco Sports Lighting, Inc. v Commissioner, 943 F.2d 906 (8th Cir. 1991), and Vest v. Commissioner, T.C. Memo 1993-243 (1993).

Application of the factors set forth in both IRC Section 7701(e) and the prior case law indicates that the agreements Company enters into with its cloud computing customers are properly characterized as service contracts. This conclusion is based on the description of Company's activities as set forth in your ruling request, and the following sample contracts you provided, entitled, "Hosting Services Agreement: General Terms and Conditions," "Cloud Terms of Service," "Managed Hosting Services (Intensive) Terms and Conditions," "Managed Hosting Services Terms and Conditions," "Managed Colocation Terms and Conditions," and "Mail Hosting Services Terms and Conditions." These sample

contracts are incorporated as part of your ruling request. Where Company agrees with a customer to undertake the duties and obligations as set forth in those contracts, it is engaged in the provision of services. In particular, the contractual provisions demonstrate the following:

(1) **Company's customers are not in physical possession of Company provided hardware and software**. The Company's hosting agreement states that the customer does not acquire any ownership interest in or right to possess the Hosted System, and has no right of physical access to the Hosted System. The sample contracts define "Hosted System" to mean the combination of hardware, software and networking elements to be used by the customer in the context of either a dedicated system maintained solely for the customer or a shared system that Company maintains for many customers. In addition, your letter indicates that Company provides IT services on servers owned by Company, and that are located at one of Company's eight data-centers around the world. Although Company customers may select one of the data-centers, Company at its sole discretion determines which of the servers will be used to store customer data. Your letter indicates that in the case of Public Cloud computing, customers use applications without installing the software on the customers' computers or servers. Instead, customers access applications and files stored on Company servers via the internet. Thus, Company retains physical possession of Company provided hardware and software.

(2) **Company's customers do not control Company provided hardware and software**. The Company's hosting agreement requires that each customer consent to Company's Acceptable Use Policy. This policy limits the manner in which Company customers may use the Hosted System, and Company reserves the right to add or modify restrictions on the customer's use of the system, provided such modifications are reasonable and consistent with industry practice. The sample contracts also indicate that Company retains the right to migrate a customer's data to a different server within the same data-center where Company determines that server migration is required to remediate service degradation or shared resource constraints. Company's control over the system is evidenced in other ways as well. Company installs certain services management software on a customer's hosted system. This software allows Company to track system information in order to manage service issues, such as patching exceptions and product life cycles, and to identify security vulnerabilities. Customers must agree not to interfere with this software. Customers are permitted to access the Hosted System using either the Company Cloud control panel or Company provided application programming interface. Company retains the right to modify these devices at any time, or transition to a new interface. Regarding Company provided software, customers are precluded from copying or modifying the software unless permitted under the agreement, and Company applies software patches according to its own procedures. Thus, Company retains control over the hardware and software used by its customers.

(3) **Company customers do not have a significant economic or possessory interest in Company provided hardware or software**. Under the contract provisions, Company is responsible for the costs of the data center, including power and climate control of the area where the servers are located. In addition, Company is responsible for the costs of servers, firewalls, load balancers, attached storage devices, and network attached storage devices. Company makes certain contractual guarantees as to the availability of these items for use by the customer, and is responsible to repair or replace these items within a designated time period if a problem occurs. Thus, Company retains the economic or possessory interest in the hardware and software.

(4**) Company bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract.** As indicated above, Company is responsible for the repair or replacement of various hardware and software devices, including the servers, firewalls, and storage devices, and makes guarantees to its customers regarding the availability of these items for the customer's use. In addition, Company guarantees its

data center network will be available to its customers 100% of the time. These obligations of Company, as well as others, include liquidated damages clauses in which Company is obligated to credit a customer's account for a certain percentage of the customer's fee, up to 100%, where Company fails to satisfy its contractual guarantees. Therefore, Company bears the risk of both substantially diminished receipts and increased expenditures if there is nonperformance under the contract.

(5) **Company uses the hardware and software concurrently to provide services to unrelated customers.** The sample contracts indicate that, in the case of Public Cloud, Company servers are used to provide computing services concurrently to multiple customers. Further, Company customers do not have exclusive rights to Company provided software. Rather, the software may be accessed concurrently by multiple users.

(6) **The total contract price substantially exceeds the rental value of the hardware and software for the contract period**. Although you have not provided any information regarding the price of any particular contract, or any information with regard to the rental value of the property used by Company to perform its obligations under any particular contract, we note that the sample contracts provided reference services provided to customers in addition to the customer's use of Company servers and software. In particular, Company provides remote customer support. The hosting agreement defines this support to include the management of the Hosting Service by a service delivery team that includes a team leader, account manager, and specialists trained in hosted systems, the availability of live support year round, twenty-four hours per day, seven days per week, and the use of the Company customer portal.

Based on these factors, the arrangements between Company and its cloud computing customers are properly characterized as service agreements for Illinois sales factor purposes. Therefore, where Company agrees with a customer to undertake the duties and obligations as set forth in the sample contracts, it is engaged in the provision of services. Accordingly, receipts from those contracts are sourced for sales factor purposes under the provisions of IITA Section 304(a)(3)(C-5)(iv). Section 304(a)(3)(C-5)(iv) provides as follows:

> Sales of services are in this State if the services are received in this State. For the purposes of this section, gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor. The Department shall adopt rules prescribing where specific types of service are received, including, but not limited to, publishing, and utility service.

In Letter Ruling IT-11-0002-PLR (September 6, 2011), the Department addressed the application of IITA Section 304(a)(3)(C-5)(iv) to tuition receipts of an educational institution that provided online classes to its student-customers. The facts of that ruling indicate that the educational institution was unable to determine either the physical location of a student engaged in an online session/class, or the physical location of a student when they ordered an online course. The Department ruled that because the educational institution was unable to determine the physical location of the student-customer, the services should be deemed to be received in the state of the student's billing address,

and should be excluded from the sales factor entirely where the educational institution was not taxable in the state of the student's billing address.

The facts in this case are similar to those in IT-11-0002-PLR. Company is not able to determine where a customer is physically located at the time it accesses the Company servers. Therefore, Company's services are deemed received at the location of the office of the customer from which the services were ordered in the regular course of business. However, if Company cannot determine the ordering office, then its services are deemed received at the office of the customer to which the services are billed. In either case, if Company is not taxable in the state in which its services are deemed received, the sale must be excluded from both the numerator and denominator of the sales factor.

This ruling shall bind the Department for taxable years ending on and after December 31, 2009, except as limited pursuant to 2 Ill. Adm. Code 1200.110(d) and (e). The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited and incorporated in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Sincerely,

Brian L. Stocker
Chairman, PLR Committee (Income Tax)