

POLICY VOICES

CHICAGO MODIFIES CLOUD TAX

By: Stanley R. Kaminski¹, Co-Chair, Chicagoland Chamber Tax Policy Forum

Plagued with negative comments and controversy over the issuance of a revenue ruling² that expanded the enforcement of the Chicago Lease Transaction Tax to various web-based subscription services, and to the access and use of computers and software in the cloud, the Chicago Department of Finance ("Department") has now explained its position, along with some changes to the law and its enforcement procedures, through the issuance of a new Information Bulletin³.

This Information Bulletin on Non-Possessory Computer Leases follows on the heels of the Chicago City Council's amendment to the Chicago Lease Transaction Tax (formally known as the Chicago Personal Property Lease Transaction Tax or Chicago Transaction Tax) to add a new reduced rate of tax for some cloud services and an exemption for certain new small businesses.

Simply put, on November 19, 2015, the Department issued an Information Bulletin explaining the recent amendment to the Chicago Lease Transaction Tax and the application of the Tax to non-possessing computer leases, including access and use of computers and software in the cloud. (The cloud is generally a reference to internet based services.)

In essence, the Bulletin explains the broadening of the scope of the Tax to most forms of cloud accessed computer hardware and software, such as Platform as a Service (PaaS), Infrastructure as a Service (IaaS), and Software as a Service (SaaS).

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² Chicago Personal Property Lease Transaction Tax Ruling #12.

³ Department "Information Bulletin -- Non-Possessory Computer Leases," issued 11/19/2015.



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Government Relations Updates

- The Chamber released a dissenting report in response to the Mayor's 'Working Families Task Force' on April 3.
- The Chamber announced new leadership for its Public Policy Committee: Chair, Robin L. Brown of Ingredion, and Vice-Chair, Matthew Summy of Comcast.
- Michael Reeve, the Chamber's VP of Government Relations, testified against a City ordinance that threatened the future of O'Hare on March 10. It was defeated on a vote of 10-1.
- The Chamber will host Fred P. Hochberg, Chairman of the Export-Import Bank, on April 21 for a roundtable discussion. Immediately following the roundtable will be an informational networking reception at Eno Wine Bar.

The Bulletin likewise explains the recent City Council amendment to this Tax reducing the rate for some cloud services, the Department's application of Ruling #12, the effective dates of some of the changes to the Tax, the new small business exemption, the ability for some providers and taxpayers to qualify for voluntary disclosure to settle past tax liability, as well as answers to fifteen (15) frequently asked questions.

History

However, to understand how Chicago ended up taxing the cloud and where we are now, requires a brief review of history. For almost 30 years, the City of Chicago has had a tax on both normal leases or rentals of computers and computer software, as well as non-possessing leases of computers and computer software. As noted above, the Tax is commonly known as the Chicago Transaction Tax. The Department of Revenue (now part of the Chicago Department of Finance) has enforced this Tax against all types of possessory transfers (leases, rentals, licenses, etc.) of computers and software⁴.

As to non-possessing leases, the Department has also enforced this Tax on various taxpayers for the remote access and use of computers and software. For example, in *Meites v. City of Chicago*, 184 Ill. App. 3d 887 (1st Dist. 1989), the Appellate Court upheld the Department's application of this Tax to charges for remote access and use of Lexis/Nexis (a search engine with searchable data) to search and obtain information.

Over the years, the Department has issued various revenue rulings explaining the application of the Tax to the remote use of computer hardware and software; Chicago Transaction Tax Rulings #4, #5 and #9. These Rulings explain how the non-possessing use of computers and software are taxable, including the time-sharing of computers. They also made it clear that the terminal location (or similar device location) where the user accesses and uses the computer or software is deemed the place of use for purposes of the tax on non-possessory leases.

In June of 2015, the Department went even further and issued Ruling #12 which explained the farthest reach today of the Tax, making it clear that various web-based subscription services are taxable, as well as the access and use of computers and software in the cloud. But this led to push-back by the business community which resulted in a delay in the enforcement of Ruling #12 to January 1, 2016. It also resulted in the recent amendments to the tax ordinance and the issuance of the new Information Bulletin discussed herein on Non-Possessory Computer Leases.

So What Is The Current State Of the Tax?

So this leads us to the predicament businesses now face in the City of Chicago with regard to the purchase of cloud services. That is, the City has made it crystal clear that it will impose the Chicago Transaction Tax on these web-based services, where the customer uses a terminal or similar device from a Chicago location to access such services. Moreover, the fact that these web-based services are considered services by the technology industry is not determinative of whether they are taxable under the Chicago Transaction Tax.

Rather, the deciding factor is whether the customer is the one who accesses the computer and information and then manipulates the software or computer to search or do other functions to obtain the data that is desired. This includes a customer paying a company to allow the customer to do online data research, obtain consumer credit reports, obtain real estate listings and prices, car prices, stock prices, job listings, or obtain numerous other data that has been compiled, entered, and stored on the provider's computer.

⁴ See, Chicago Muni. Code, Ch. 3-32-020.

It also includes performing functions such as word processing, calculations, data processing, tax preparation, etc. through the use of a provider's computer or its software.

And, as Ruling 12 instructs, this specifically includes all types of cloud computing. (Note, however, that the Tax only applies to accessing and using software, data, and information, and not to entertainment materials such as copyrighted books, musicals, or other sound recordings, or feature-length or other films.)

In addition, Ruling 12 goes into detail on how to determine the sourcing location for the Tax when it is not obvious as to whether a customer is using a terminal or a similar device from the City location to access and use the data or information. It also explains that charges for the mere storage of information on the computer, such as a back-up copy of a database, is taxable at the location of the storage facility and not the terminal that accesses the storage. (Note: this provision on storage is under review by the City).

On the other hand, Ruling 12 clarifies that the purchases of services, such as having a provider accumulate data and provide or write a report or analysis that is accessible electronically, is not a taxable rental or lease charge. The reason for that is the charge being paid for is not the access and use of a computer to obtain the data, but the creation of the data and report by the provider. Ruling 12 further explains that any charges for services as part of the lease transaction, if not separately stated and optional, are included in the taxable rental charge. An exception to this is if the services are more than 50% of the total price, then an allocation can be made even if not separately stated and optional.

Similarly, the Information Bulletin explains to a lesser degree the scope of the Tax. And, it discusses three of the exemptions contained in the Tax, *i.e.*, the exemption for security trading, accessing and managing financial accounts, and the special exemption for the *de minimis* use of a computer by a customer. Leases of personal property for release are likewise noted as being a proper exemption, if appropriate documentation is received from the lessee.

In addition, the Information Bulletin addresses the new exemptions from the Lease Transaction Tax for certain cloud services and for certain small new businesses. Basically, starting January 1, 2016, there will be a lower rate of tax of 5.25% (rather than the full rate of tax of 9%) for certain non-possessory leases of computers. However, this partial exemption (or lower rate) is limited to an non-possessory lease of a computer primarily for the purpose of allowing the customer to use the provider's computer and software to input, modify, or retrieve data or information that is supplied by the customer⁵.

Nevertheless, the lower rate of tax appears to apply to a broad category of cloud based products and services, such Microsoft 360, where customers use this cloud based software and computers to perform tasks on their own data. On the other hand, when the data or information being accessed or retrieved is not the customers, then the full rate of tax applies to the lease.

The other new exemption is the new small business exemption⁶, which is limited to a very small number of businesses that hold valid and current business licenses issued in the City or another jurisdiction, and during the most recent full calendar year prior to the annual tax year for which the exemption is sought, the business had under \$25 million in gross receipts or sales. Moreover, only businesses in operation fewer than 60 months qualify for the exemption.

⁵ See Muni. Code of Chicago § 3-32-030(B.1).

⁶ See Muni. Code of Chicago § 3-32-050(A)(13).

Significantly, the \$25 million limit for gross receipts or sales will be combined with related businesses if they are received by members of a single unitary business group as defined for Illinois income tax purposes. Unitary business is a concept used in the Illinois income tax and other State income taxes to combined gross receipts and income from businesses that are commonly owned and which are functionally integrated.

Significantly, the exemption applies to a new small business whether as a lessor or lessee under the Tax. For a small business lessee to claim the exemption however, an exemption certificate must be issued by the small business lessee to the lessor, using a form provided by the Department.

As a result of these significant changes in the Chicago Lease Transaction Tax, the Department has provided through the Information Bulletin a special "Voluntary Disclosure Offer." This enhanced Voluntary Disclosure program allowed certain businesses that are not under audit or investigation by the Department, to come forward and pay some back tax without paying the full amount of back tax possibly owed.

But, a business needed to file its voluntary disclosure form by January 1, 2016 to qualify for the enhanced Voluntary Disclosure Program. As to charges for non-possessory computer leases that qualified under the *de minimis* computer use exemption as interpreted by the Department prior to Ruling #12, the City offered under the enhanced Voluntary Disclosure Offer to abate any tax, interest, or penalty for periods ending before January 1, 2016.

As for other non-possessory computer leases, the City allowed a payment of back tax for only one year from January 1, 2015 through December 31, 2015, with abatement of all interest and penalty. This is a significant change for the City of Chicago since its normal and current voluntary disclosure program requires a payment of back taxes for four years, plus interest. The Information Bulletin provides how the voluntary disclosure can be claimed, including calling the Department's customer service line at 312-747-4747.

Lastly, the Information Bulletin lists a number of commonly asked questions and provides detailed answers. This includes who is required to pay the tax, how do I know if a customer is a Chicago customer, what type of digital uses are covered by the Tax, how to determine if my transaction is taxable or primarily for proprietary information, and so on.

Conclusion

While the City's taxation of the cloud will continue to be controversial, the Department's new Information Bulletin along with Ruling 12 comes a long way in explaining its position. Nevertheless, it is apparent that neither the Department's Information Bulletin nor Ruling 12 resolves all of the issues or concerns raised in its expanded enforcement of the Chicago Transaction Tax to cloud services. There are still be many questions and controversies out there, including whether the City has authority to tax some of these transactions to begin with, and what is the City test for tax nexus for cloud or subscription providers.

The conflict between whether something is actually a service or merely the remote use of computers will also be a thorn in the City's side. For example, is the charge actually for a service being provided or merely the non-possessory use of a computer or computer software.

No doubt, many subscription services may raise the same question of whether they are providing more of a membership or other service to a customer versus merely a database to search. Likewise, with respect to the City's *de minimis* computer use exemption, the passive receipt and proprietary tests now being used by the Department may create controversy when applied to some cloud transactions.

Whether the City can legally tax cloud services, or to what extent it can tax such services, will probably be a issue for years to come as more and more businesses move to the cloud rather than taking ownership or possession of computers and computer software. As controversies across the country have shown taxing the cloud is not a simple task. Some state courts have treated cloud use as a service, while others have looked at it as merely the remote use of software or computers.

Where to legally source the use of a cloud service may also become an issue, since the cloud sourcing issue has never been ruled upon an Illinois court. In any event, the next few years will surely be interesting on how far the reach of the City of Chicago will continue to expand under its Lease Transaction Tax.

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** Originally published in State Tax Notes, February 22, 2016*

** This is a thought leadership contribution from a member of the Chicagoland Chamber of Commerce. The opinions, beliefs and viewpoints expressed by the authors and forum participants on this publication do not necessarily reflect the opinions, beliefs and viewpoints of the Chicagoland Chamber of Commerce.*

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