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Kentucky Department of Revenue: SaaS Provider's App Not Subject to Sales Tax

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Cloud-based computing has increasingly become the go-to for individuals and businesses looking to securely store their data, files, photos, and more. Given the ever-evolving nature of this technology, questions often arise as to how the sales and use tax applies to transactions related to cloud-based software and ancillary services. In Private Letter Ruling KY-PLR-21-01 ("PLR"), the Kentucky Department of Revenue ("KDOR") recently determined that an application provided as part of a Software as a Service model, also known as SaaS, was not subject to Kentucky sales tax.

The taxpayer requesting the ruling provides web-based service via a SaaS model, which involves its customers accessing prewritten computer software hosted online with no physical download or transfer. In the PLR, the Department confirms that such transactions are not subject to Kentucky sales and use tax because there is no transfer or sale of tangible personal property. This is in contrast to the purchase of prewritten computer software via physical copy, for example, on a CD or thumb drive, which involves the transfer of tangible personal property and which is thus taxable.

The taxpayer requested guidance regarding a subsequent free offer of a downloadable prewritten computer software application which enhanced the primary software's usefulness, but which ultimately provides limited functionality. Specifically, the taxpayer requested a ruling as to whether this download would change the original exempt nature of the taxpayer's SaaS product.

KDOR found that offering the prewritten computer software application as part of the taxpayer's SaaS did not create a transaction subject to Kentucky sales and use tax. KDOR specified that the SaaS remained available online and that the application did not transform the transaction into one involving tangible personal property. KDOR also found that providing the application along with the SaaS did not create a bundled transaction because the free software application was a de minimis part of the product the taxpayer provided to customers.

Because this guidance was issued in a private letter ruling, it is binding only to the specific taxpayer for which the ruling was issued. However, it may be instructive for similarly-situated taxpayers. It also illustrates the potential pitfalls to which such taxpayers may be exposed if they provide exempt SaaS products but offer additional ancillary products. For example, would the tangible product they offer also be considered de minimis? Or, would it be substantial enough to create a bundled transaction whereby the entire purchase price, including all SaaS products, was subject to sales tax? What if the application was provided via a physical medium, like a CD?

Taxpayers may consider seeking guidance or advice on their particular SaaS business model.

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