Let's Talk About SaaS, Baby: Kentucky's Recent Taxing of Software as a Service Compared With Its Neighbor States

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Recent Kentucky tax legislation continued to expand the landscape of services subject to sales and use tax in the Bluegrass, including for "prewritten computer software access" – aka software as a service, or "SaaS." More specifically, 2022 House Bill 8 (HB 8) introduced more than 30 new services subject to Kentucky sales/use tax, beginning January 1, 2023. While such legislation is in line with Kentucky's recent focus to move from a production-based economy to a more consumption-based economy,[1] this legislation puts Kentucky into a minority, but growing, group of states that now tax SaaS and other internet/cloud-based services.

Is this good tax policy, or is it a diSaaSter waiting to happen? This article summarizes the evolution of Kentucky's taxation of SaaS and similar products/services, while comparing same to regional neighbors that Kentucky competes with through differing tax policies to retain and attract more businesses.

Kentucky Gets SaaSy – Its History and New Taxation of Cloud-Based Software

From a more technical perspective, SaaS is a user-accessing software supplied by a third-party service provider which serves as the host of the software over an internet service. But more simply put: SaaS is software that is accessed over the internet for use, rather than by being transferred or downloaded. Examples of SaaS can be something as simple and common as almost every app on your phone for emails, calendars, music, streaming, etc. SaaS can also include more complex examples like customer relationship management (CRM) software such as Salesforce, collaboration tools like Google Workspace, project management tools like Asana, and many other web-based applications used in various professions

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and industries.

Prior to HB 8, SaaS was not taxable in Kentucky as it only taxed the sale or lease of *prewritten* (i.e., "canned") computer software as a *transfer* of tangible personal property regardless of delivery (e.g., electronic, load and leave, physical transfer), as compared with *custom* software (i.e., software created for a specific user), which was exempt regardless of form of delivery. In that regard, the Kentucky Department of Revenue (the "Department") previously issued guidance that if "software is accessed exclusively via the 'cloud' or online exclusively via the selling entity's server [rather than transferred or downloaded], the software access is not subject to Kentucky sales and use tax. Software accessed via servers and in no way downloaded to the customer is not a retail sale of tangible personal property subject to Kentucky sales and use tax."[2]

But, effective January 1, 2023, Kentucky began subjecting prewritten computer software access *services* to its 6% sales and use tax. This is statutorily defined as "the right of access to prewritten computer software where the object of the transaction is to use the prewritten computer software while possession of the prewritten computer software is maintained by the seller or a third party, wherever located, regardless of whether the charge for the access or use is on a per use, per user, per license, subscription, or some other basis...."[3] Therefore, Kentucky has essentially reversed its longstanding treatment of SaaS. But how far? No one knows yet.

What this all means and how it will be applied to a variety of products and services is still up in the air, as there has been no promulgated regulation providing guidance on any of the new taxable services enacted by HB 8, including SaaS. The Department's most recent internal sales/use tax training manual likewise does not provide additional insight, other than to make clear that: (i) exceptions do apply in sale-for-resale situations, and (ii) use tax does not apply in "temporary storage/use" situations (i.e., when such service is purchased for use outside the state and transferred electronically outside the state for use thereafter solely outside the state).[4] Also noteworthy is that the statute looks to the "object" of the transaction, which may add more uncertainty and complexity to determine its taxability based on old Kentucky case law and limited

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statutory guidance regarding what constitutes the object of a transaction.

The sourcing of prewritten computer software access services is also another issue that has yet to be addressed by statute or by the Department other than generally directing taxpayers to KRS 139.105 and 103 KAR 30:190, which traditionally looks to where the customer receives a service.

By the Kentucky General Assembly listing "prewritten computer software access services" as the very last of the 35 newly enumerated taxable services in HB 8, with nothing more than a general definition of the term, there is growing concern over how broadly it will be applied and enforced by the Department given the dearth of guidance, the complexity of current and future cloud-based services and products, as well as the Commonwealth's need to increase revenue through the taxation of services to help fund its legislative push to continue reducing personal income taxes.

The same goes for other internet-related services that are now also subject to Kentucky sales/use tax after HB 8, including website design, development, and hosting services[5] – none of which have any guidance whatsoever from the Department after HB 8's enactment in April 2022, and its effective date in January 2023.

No one knows for certain how broadly or aggressively the Department will interpret or enforce these new laws until it promulgates a regulation (which is subject to notice and comment), issues other formal guidance, or begins auditing taxpayers. Not exactly what you're looking for when trying to retain and attract new businesses to your state, especially when nearby states, such as Indiana, take a different approach and provide guidance on same.

Indiana Clears the Clouds on SaaS Taxation

While Kentucky now sits on one side of the issue, one of its fiercest competitor states, Indiana, has taken the exact opposite approach. Indiana has cleared up any past confusion/uncertainty regarding taxation of SaaS (previously taxed as the constructive possession of software), and it clarified that such services are *not* subject to sales/use tax through its initial guidance issued in 2018 via Indiana

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Bulletin #8, along with subsequent updates to such guidance.

As a result, effective July 1, 2018, SaaS became generally *exempt* from sales and use tax in Indiana, as the right to access prewritten software is not considered a retail transaction if the end user accesses the software via the internet, public or private networks, or wireless media, and the exemption applies regardless of whether access is a purchase, rental, lease, or license.[6] According to this guidance, custom SaaS is not taxable, and prewritten SaaS is not considered an "electronic transfer of software" or a "retail transaction" subject to tax in Indiana, unlike the transfer of specified digital products, prewritten computer software or telecommunication services, which generally are taxable in Indiana. [7]

However, not everything is exempt in the Hoosier State. Indiana Bulletin #8 also provides that software stored on the computer of a user in Indiana, instead of being accessed through a third-party's platform, *is* subject to tax due to the storage use. This also applies in situations where there are multiple software licenses stored on an Indiana server, that are sourced in Indiana, regardless of whether there is access occurring outside of Indiana. Indiana does offer credits, however, only when software is accessed outside of Indiana, if there is already a sales or use tax being paid to another state for the same service.

Further, Indiana Bulletins #8 and #96 provide other taxable situations, such as for: (i) purchased apps and canned software transferred on a tangible medium, electronically or by load and leave, and (ii) downloaded "specific digital products," such as songs, spoken word recordings, ring tones, digital audiovisual works, and digital books. Nevertheless, Indiana has chosen to broadly exempt most SaaS and related services as a matter of tax policy.

Kentucky and Indiana also appear to differ regarding the *method* for determining the taxability of such services. Indiana places the onus more on how a user is accessing SaaS, while Kentucky has shifted policy to focus on the object of the transaction involving SaaS, with less respect to the type of user access.

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Indiana has also been very proactive in issuing substantial guidance and revenue rulings applying its current interpretation of Indiana Bulletin #8 to a multitude of products and services.[8] This is an important factor when viewing each state's business tax climate for retaining and attracting new businesses, where Indiana continues to be ranked in the top 10 nationally, with Kentucky trailing at 18th after making headway from its prior ranking of 33rd before it enacted its first round of state tax reform back in 2018.[9]

Cloudy at Best: A Regional Round-Up

While Kentucky and Indiana now stand on different sides of the spectrum for treatment and taxation of SaaS, and while states that tax SaaS in some form or fashion are still in the minority nationally (approximately 20 states), neighboring states fall more closely to Kentucky than Indiana, such as Tennessee, Ohio and West Virginia.

For example, Tennessee generally taxes SaaS as the "retail sale, lease, licensing or use of computer software," including "the access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer";[10] however, it does recognize the difference between nontaxable advertising and data processing/information services and taxable software use/access, which can be a very close call.[11]

Another approach to taxing SaaS can be seen by Ohio, which does generally tax SaaS or cloud-based services if the customer is using the service for business purposes (with personal users being generally exempt). Ohio also taxes digital products delivered electronically and prewritten software regardless of delivery method.

In West Virginia, while there is no specific statute or guidance on the taxation of SaaS or internet and cloud-based services, West Virginia law provides that consumer and service taxes apply to the furnishing of *all* services, unless specifically exempted, and since there is no exemption for cloud computing, SaaS or similar services, such services are likely to be taxable.[12]

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What does this all mean? Simply put, it is a mess out there! Each state takes a different approach, not only to whether it taxes SaaS but how it classifies cloud and internet-based products, services and transactions (e.g., a taxable/exempt sale/lease of personal property vs. an enumerated service vs. licensing). States also vary in how they differentiate between many similar and bundled services, such as advertising, data processing, information services, communication services, etc., that must be considered by businesses in a variety of industries. Adding to this complexity is that many states that reportedly tax SaaS and similar services/products do not do so through clear or explicit statutes or regulations, but instead through administrative policy and other forms of guidance. Thus, businesses must also analyze what states have these "unwritten rules" and/or whether these states' policies violate applicable statutes/laws.

Accordingly, it is critical for businesses to closely monitor, analyze, and plan for these continually changing developments in the taxation of SaaS on the front end. This includes *before* launching a new product or service, when reviewing a contract, or in preparation for a future sales/use tax audit, which will soon be coming in Kentucky and many other states that recently enacted laws and began taxing these services – the kind of analysis we are often asked to comduct for our clients.

So, considering all of the above, in the immortal words of Salt-N-Pepa, one should always be thinking: "Let's talk about all the good things, and the bad things that may be, let's talk about [SaaS]!"

For more information, please contact the author, Daniel Mudd, or another attorney in Frost Brown Todd's Tax practice group. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state and local tax planning and tax administration.

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[1] *See e.g.*, 2018 House Bill 487 (subjecting several new services to sales tax, effective July 1, 2018).

[2] *See* Kentucky Department of Revenue, Sales Tax Facts (Dec. 2020) ([ ] added). *See also* KY-PLR-21- 01.

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[3] KRS 139.010(34).

[4] *See also* KRS 139.260 (also amended by HB 8 to allow the sale for resale exception to services) & Kentucky Department of Revenue Sales Tax Facts (Jun. 2022).

[5] Note that Kentucky did attempt to also subject marketing and advertising services to sales and use tax, but both were removed from legislation or statutes prior to being enforced.

[6] *See* the most recently available version of Indiana Bulletin #8 (Jan. 1, 2023) at https://www.in.gov/dor/files/reference/sib08.pdf.

[7] *See also*, Indiana Bulletin #93 (Apr. 2023) (regarding the taxability of products transferred electronically), *available at* https://www.in.gov/dor/files/reference/sib93.pdf.

[8] *See e.g.*, IN Revenue Rulings ST 18-07 (7/22/19) & ST 20-14 (7/22/21).

[9] *See* Tax Foundation's 2024 State Business Tax Climate Index (Oct. 24, 2023), *available at* https://taxfoundation.org/research/all/state/2024-state-business-tax-climate-index/.

[10] *See* e.g., TDOR Letter Ruling 20-03 (May 2020); TDOR Letter Ruling 21-10 (Oct. 21, 2021).

[11] Compare 2022 TDOR Letter Ruling Nos. 22-7, 21-08 and 21-04, with 2019 TDOR Letter Ruling Nos. 19-04 & 21-01.

[12] *See* e.g., W. Va. Code §11-15-8 ; W. Va. Code §11-15A-2; Code of State Rules §110-15-33.1.

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