REQUEST LETTER

07-013

October 19, 2007

Utah State Tax Commission
Attn: Commissioner Marc B. Johnson, Private Letter Rulings
210 North 1950 West
Salt Lake City UT 84134

Re: Request for Private Letter Ruling

Dear Sir:

On behalf of our client, the Company, we respectfully request a letter ruling from the State of Utah as to the proper application of the state and local sales and use tax to the transactions identified below.

The Company has recently acquired a Utah-based company, Company A, which provides an online information backup and recovery service (the "Service") to residential and business customers throughout the world. The Company intends to continue to provide this service after this acquisition. The Company seeks a written determination as to whether the Service, as described below, is subject to the Utah sales and use tax. As shown by our analysis below of the applicable Utah law and precedents, the Company believes that the Service is not subject to tax.

STATEMENT OF FACTS

Company A provides to its customers a data protection service (the "Service") that automatically backs up their computer files and information in encrypted form over the Internet to remote servers owned and maintained by Company A, and similarly restores such information over the Internet to their respective computers upon request. The Service is offered under three plans: (1) a free-of-charge service to consumers, limited to 2 gigabytes ("GB") of backup capacity, (2) a service for a flat monthly (or yearly) charge per computer, allowing unlimited backup capacity and restores; and (3) a service for business customers for a flat monthly (or yearly charge per computer plus a small additional monthly charge for each GB of information to be protected.

Company A's customers are those individual and business computer users who wish to protect their data and other information kept on their computers from loss or destruction but do not want themselves to physically backup (or copy) their important data and other information from their computers on various external media (floppy disks, tapes, CDs, DVDs, external hard drives). Nor do they want to have responsibility for physically restoring such information to their computers in the event of a computer break-down caused by a hard drive crash or virus attack. Instead, they choose to have Company A

automatically handle their backups and restores, and to have their information protected and stored temporarily on remote servers maintained by Company A.

Once a customer signs up for the service at Company A's website, the customer receives an email with a link to download software, which the customer downloads and installs to enable the Service. The software is functionally the same whether provided as part of the free-or-charge or paid Service plans. The purpose of the software is to enable the customer or user to set the scope, frequency, and speed of the backups and restores, and help coordinate these activities over the Internet between the user's computer and Company A's online data center and back-end infrastructure. The software serves no function without the back-end service coordination of Company A's data center, and is rendered useless to the customer if the Service is cancelled.

After installing the software, the customer or user selects the files and other information to be backed up and determines certain parameters for the timing and scope of the backups. Once these parameters are set, the Service takes over to automatically back up the selected files on a set time schedule (usually a few hours apart). The Service works in the background of the computer, allowing the user to continue using other computer functions. The Service also encrypts (scrambles) the user's data to make it secure before it backs up or uploads the data files to Company A's server. The user's selected files are then transferred over the Internet to be temporarily stored on Company A's remote servers.[1] During this entire backup process, Company A employees are monitoring the progress of the backups, managing the customer's data, and fixing any problems that occur. Company A employees also determine on which of its 150-200 servers to initially store the user's information and from time to time whether such information needs to be moved to other servers due to its nature and size. In addition, for business customers, the Service includes 24/7 technical support and administrative assistance to facilitate the rollout and management of the Service to a company's employees.

While Company A's servers are currently located in Utah, because of their portability, they could be located anywhere in the United States. All versions of the selected backed-up files will remain in storage on these servers for only 30 days and then expire. In many cases, after the initial backup of the user's information, only incremental amounts of information may be subsequently backed up for that user. Consequently, no direct correlation necessarily exists between the amount of information the customer wishes to protect and the amount of server space actually used by Company A to temporarily store such information.

[1] In the case of some customers with large quantities of information, the initial backup may also involve loading the information on a DAS storage device shipped to the customer by Company A and then returned to Company A for the initial transfer ("seeding") of the information to its servers.

The Service also restores files to the user's computer upon request from the user by assembling the selected files in a single zip file and downloading the zip file over the Internet back to the user's computer. Before downloading the file, the user is notified by email that the restore is complete.[2] At the user's option, Company A will put the restored data on a DVD for a separate charge per GB included on the DVD plus a processing and shipping fee.

UTAH SALES TAX ANALYSIS

Only services enumerated as a taxable service at Utah Code Ann. § 59-12-103 are subject to Utah sales and use tax. The Service described above is not one of those enumerated services. That should be the end of the analysis whether the sales tax is applicable to the Service. Tax is not applicable based on the controlling statute.

However, the Company is concerned that the State Tax Commission (the "Commission") has asserted in two previous private letter rulings (Priv. Ltr. Rul. 06-004 and Advisory Opinion 01-030) that the Commission considers the provision of data and information storage on a server located in Utah to be a taxable "lease" of disk space and server equipment and hardware. While these private letter rulings adhere to the peculiar facts presented and, by the Commission's admission, are "not intended as a statement of broad tax commission policy," the Company seeks determination that the data storage aspect of the Service does not constitute a taxable lease of tangible personal property under Utah law. As explained below, the Company believes that the Commission's conclusion in these private letter rulings, both specifically as to the Service and generally, is contrary to and inconsistent with the controlling tax statues, judicial decisions and the Commission's own rulings regarding the taxability of "lease" transactions. The below analysis also addresses why the Company believes the software downloaded by subscribers to use the Service similarly does not make the Service subject to the Utah sales tax.

Taxability of Company A's Information Storage as a "Lease"

Leases are taxable pursuant to Utah Code Ann. 59-12-103(1)(k). Under this statute, a tax is imposed on "amounts paid or charged for leases or rentals of tangible personal property if within this state the tangible personal property is (i) stored; (ii) used; or (iii) otherwise consumed." A "lease or rental" is defined at Utah Code Ann. §59-12-102(43) (a) to mean "a *transfer of possession or control* of tangible personal property for: (i) (A) a fixed term; or (B) an indeterminate term; and (ii) consideration" (emphasis added). The Commission's regulation is not inconsistent with the statute. Utah Admin. Code r. 865-19S-32(2) states that "[w] hen a lessee *has the right to possession, operation or use* of tangible personal property, the tax applies to the amount paid pursuant to the lease agreement, regardless of the duration of the agreement" (emphasis added). Indeed, the Utah courts have held consistently that the express statutory requirement that the "lessee" have *possession or control* of the property at issue is determinative of a taxable lease.

[2] The Service permits users to alternatively select individual backed-up files to restore. Other options available to subscribers of the Service include setting their own private encryption format and varying the speed at which the files are backed up by the Service.

The Utah Supreme Court addressed the issue of what constitutes a taxable lease in *South Central Utah Telephone Ass'n, Inc. v. Auditing Division of the Utah State Tax Commission,* 951 P.2d 218 (1997). The court held in this case that the purchase by a telecommunications service provider of the equipment used by it to provide telephone service was not an exempt sale for resale. In doing so, the court rejected South Central's argument that its monthly dial tone charge was actually a fee for the "use/rental" of the telephone equipment and system to its subscribers because once the subscribers accessed the system, after obtaining a dial tone, the company had no control over the manner in which that equipment was used. Instead, the court ruled that the finding by the Commission that at all times the telephone transmission equipment remained in the possession of and under the control of South Central was dispositive of this issue because, as the end-user, the telephone company was liable for sales tax as the retail purchaser. The court found:

> The equipment remained on South Central's premises and in its possession. *Although its customers exercised some "control" over the way they individually used the equipment, South Central controlled the actual equipment, its operation, and the availability* of the equipment to its telephone service subscribers. Furthermore, *the subscribers had no contractual right to the equipment but only to the services that South Central provided* through South Central's use of the equipment.

Id. At 226 (emphasis added). The court's decision was also influenced by the absence of any formal indication that a rental agreement existed, as the telephone company's tariff or customer bills made no mention of a lease or rental agreement between it and its subscribers and there was no evidence of any formal recognition by either party that a rental relationship existed. Based upon the above facts, the court concluded that "[c]haracterizing this relationship as a rental arrangement ignores both the form and the substance of that relationship." *Id.*

The Utah Court of Appeals employed a similar analysis to deny a company that sold music and video conferencing services over its satellite network to qualify for a sale-for-resale exemption with respect to its purchase of equipment used in the delivery of its services, including equipment installed on customer premises. *Broadcast Int'l v. Utah State Tax Comm'n,* 882 P.2d 691 (Utah Ct. App. 1994). The service company argued that it purchased the equipment for resale because it transferred the "right to possession, operation, [and] use" of its equipment by contract to its subscribers and such transfer of possession would have been taxable had actual transfer of title occurred. Employing a two-part analysis, the court first determined that the essence of the transaction was the sale of services, because the subscribers paid Broadcast for access to the satellite network and related services, not to buy equipment or the right to possess or use that equipment.

The court then determined that Broadcast was the ultimate "user or consumer" of the equipment based on the facts in the record. For example, Broadcast only transferred the use or possession of the equipment incident to providing a service to the subscribers, and only for the length of the service. Broadcast's own representatives testified that it never sold or even leased its equipment to its subscribers. Further, Broadcast listed the equipment as an asset on its corporate balance sheet, and took depreciation deductions on it. Finally, Broadcast made no attempt to collect sales tax from its subscribers on the equipment it claimed it "resold" to its subscribers.

Several of the commission's rulings regarding what constitutes a taxable lease further support that the mere use of equipment or storage by a customer of a service provider does not transform the transaction into a taxable lease. For example, in Private Letter Ruling 03-015 (February 18, 2004), the Commission determined that the charge for the electronic storage of information by a company that provided record processing services, including the scanning and storage of certain information using computer laptops or scanners, was not subject to sales tax. Contrary to its apparent position on server storage, the Commission concluded:

> *We assume that the customer does not have possession and control of the equipment on which the information is stored. Under such circumstances, the fee for the storage transaction would not be considered the lease of tangible personal property and, accordingly, would not be taxable under Section 59-12-104(1)(k).*

Priv. Ltr. Rul. 03-015 (emphasis added). In another private letter ruling, Rul. 00-025 (August 23, 2000), the Commission determined that screen phones supplied to customers to access the vendor company's automated hiring services did not transform an otherwise nontaxable service into a taxable lease. Instead, the Commission concluded:

> In addition, *even though the customer receives physical possession of a screen phone from COMPANY, COMPANY retains ownership of the screen phone and the customer's only benefit from the phone is to receive the services and information provided by COMPANY. Accordingly, COMPANY's charges would not be characterized as the taxable rental or sale of the screen phone to its customers.* Instead, COMPANY is considered to "consume" the screen phone while providing its nontaxable services.

Priv. Ltr. Rul. 00-025 (emphasis added). Finally, the Commission's apparent position on server storage is also inconsistent with the position it has taken regarding delivery of software to an external server not in the possession or control of the user of the software. Priv. Ltr. Rul. 01-027 (October 31, 2001). In that ruling, the Commission stated:

> If canned computer software is downloaded, not to a customer's computer, but to a server dedicated to the customer, the transaction may still be taxable because the customer is considered to be renting or leasing the server as part of the contract price for the software. Any software delivered to such a server is in possession by the customer and is taxable, if the server is located in Utah. If the server is located outside of Utah, the sale is not taxable. *On the other hand, if the server is not dedicated to one particular customer, we consider the server to be in the possession or control of the host provider or the Taxpayer. In this case, the sale of access to the computer software is not taxable, because the customer has not received possession of the software.*

Priv. Ltr. Rul. 01-027 (emphasis added). As described above, under Utah law, the Company believes that the Service plainly is not a taxable lease of tangible personal property. Company A's customers simply do not have the requisite possession of or control over Company's A's remote Utah servers used by Company A to temporarily store the customers' backed up computer files. Company A's customers are purchasing the Service, similarly to the subscribers' purchase of telephone service in *South Central* and their purchase of satellite service in *Broadcast.* As in those cases, Company A at all times controls the operation and availability of its servers to its subscribers upon which their computer files are stored, determining which servers to use both initially and throughout the information backup and storage process. The customer has no control over or even knowledge of what servers are being used or where they are located. Subscribers to the Service have no contractual right to possess or control the servers but only to acquire the

backup and restore services that Company A provides using its servers as well as other equipment. In addition, Company A lists the servers as assets on its corporate balance sheet, and takes the appropriate depreciation deductions on them. Finally, consistent with the holdings in both *South Central* and *Broadcast,* Company A *has* not collected sales tax from its subscribers for the Service, but it has paid Utah use tax on and filed returns reporting the charges paid for its purchases of equipment used in providing the Service, including its purchases of the servers used to store its customers' backed-up computer files.

Taxability of Company A's downloaded Software

The Company recognizes that "canned" software sold and downloaded to a purchaser's computer is generally considered a taxable sale in Utah. Utah Admin. Code R865-19S-92.B. However, the Company does not believe that this rule applies to the software downloaded for company A's Service. First, the facts demonstrate that substantially the same software is provided and downloaded to customers acquiring the Service free of charge as to those that purchase the plan for a fee. Thus, the lack of any consideration either paid for or attributed to this downloaded software results in no taxable sale having occurred. Moreover, the Commission has ruled that software included in the price of an otherwise nontaxable service or product is not taxable. For example, in Private Letter ruling 02-029 (January 14, 2003), the Commission determined that a downloaded start-up CD required to access a nontaxable prepaid Internet service – which CD sold separately is considered taxable canned computer software under Utah Admin. Code r. 865-19S-92 – was included in the price of and considered incidental to the nontaxable prepaid Internet service. Here, the downloaded software to Company A's Service customers is incidental to the primary function of the Service as an information protection and backup service. While the software allows the user to access and coordinate with Company A's back-end operations, it otherwise has no utility aside from complementing and connecting with Company A's Service activities, which utility ends when the Service ends. The software provided as part of the Service is not materially different from the CD used to access the prepaid Internet service.

RULING REQUEST

Based upon the above facts and analysis, the Company respectfully requests that the Commission determine and confirm that the monthly or yearly charges paid by Company A's Customers for the Service, including the monthly per-GB charges paid by business customers, are not subject to Utah sale or use tax.

Thank you for your assistance with this request. We would appreciate your prompt attention to this matter. Should you have any questions or wish to discuss the content of this request, please contact me at the above address or by email at EMAIL, or NAME PHONE), EMAIL

Cc: Commissioner R. Bruce Johnson

RESPONSE

December 21, 2007

2ND NAME
NAME

PLR REQUESTING COMPANY
ADDRESS

Re: PLR 07-013—Data backup services

Gentlemen:

You have asked whether Company A is required under Utah law to collect sales tax on certain activities. You have described those activities as follows:

Description of Company A's Activities

Company A provides to its customers a data protection service (the "Backup Service") that automatically backs up their computer files and information in encrypted form over the Internet to remote servers owned and maintained by Company A, and similarly restores such information over the Internet to their respective computers upon request. The Backup Service is offered under three plans: (1) a free-of-charge service to consumers, limited to 2 gigabytes ("GB") of backup capacity; (2) a service for a flat monthly (or yearly) charge per computer, allowing unlimited backup capacity and restores; and (3) a service for business customers for a flat monthly (or yearly) charge per computer plus a small additional monthly charge for each GB of information to be protected.

Company A's customers are those individual and business computer users who wish to protect their data and other information kept on their computers from loss or destruction but do not want themselves to physically backup (or copy) their important data and other information from their computers on various external media (floppy disks, tapes, CDs, DVDs, external hard drives). Nor do they want to have responsibility for physically restoring such information to their computers in the event of a computer break-down caused by a hard drive crash or virus attack. Instead, they choose to have Company A automatically handle their backups and restores, and to have their information protected and stored temporarily on remote servers maintained by Company A.

Once a customer signs up for the service at Company A's website, the customer receives an email with a link to download software, which the customer downloads and installs to enable the Backup Service. The software is functionally the same whether provided as part of the free-of-charge or paid Backup Service plans. The purpose of the software is to enable the customer or user to set the scope, frequency, and speed of the backups and restores, and help coordinate these activities over the Internet between the user's computer and Company A's online data center and back-end infrastructure. The software serves no function without the back-end service coordination of Company A's data center, and is rendered useless to the customer if the Backup Service is canceled.

After installing the software, the customer or user selects the files and other information to be backed up and determines certain parameters for the timing and scope of the backups. Once these parameters are set, the Backup Service takes over to automatically

back up the selected files on a set time schedule (usually a few hours apart). The Backup Service works in the background of the computer, allowing the user to continue using other computer functions. The Backup Service also encrypts (scrambles) the user's data to make it secure before it backs up or uploads the data files to Company A's server. The user's selected files are then transferred over the Internet to be temporarily stored on Company A's remote servers.[1] During this entire backup process, Company A employees are monitoring the progress of the backups, managing the customer's data, and fixing any problems that occur. Company A employees also determine on which of its 150-200 servers to initially store the user's information and from time to time whether such information needs to be moved to other servers due to its nature and size. In addition, for business customers, the Backup Service includes 24/7 technical support and administrative assistance to facilitate the rollout and management of the Backup Service to a company's employees.

While Company A's servers are currently located in Utah, because of their portability, they could be located anywhere in the United States. All versions of the selected backed-up files will remain in storage on these servers for only 30 days and then expire. In many cases, after the initial backup of the user's information, only incremental amounts of information may be subsequently backed up for that user. Consequently, no direct correlation necessarily exists between the amount of information the customer wishes to protect and the amount of server space actually used by Company A to temporarily store such information.

The Backup Service also restores files to the user's computer upon request from the user by assembling the selected files in a single zip file and downloading the zip file over the Internet back to the user's computer. Before downloading the file, the user is notified by email that the restore is complete.[2] At the user's option, Company A will put the restored data on a DVD for a separate charge per GB included on the DVD plus a processing and shipping fee.

Analysis

Introduction. Utah law imposes a sales tax on sales of tangible personal property and certain enumerated services, unless a specific exemption applies. See generally, Utah Code Ann. §§ 59-12-103 and 104.[3] One of the enumerated taxable services is the "repair or renovation" of tangible personal property. Section 59-12-103(1)(g). The tax is

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[1] In the case of some customers with large quantities of information, the initial backup may also involve loading the information on a DAS storage device shipped to the customer by Company A and then returned to Company A for the initial transfer ("seeding") of the information to its servers.

[2] The Service permits users to alternatively select individual backed-up files to restore. Other options available to subscribers of the Service include setting their own private encryption format and varying the speed at which the files are backed up by the Service.

also imposed on the lease or rental of tangible personal property. Section 59-12-103(1)(k).

In *South Central Utah Tel. Ass'n v. Auditing Division* , 951 P.2d 218 (Utah 1997), the Utah Supreme Court determined that the electronic signals that comprise computer software are tangible. Therefore, computer software or computer stored information is tangible personal property. Thus, if Company A is deemed to be "selling" computer stored data to its customers, it would be subject to tax under Section 29-12-103(1). Similarly, if it is deemed to be "repairing or renovating" the customers' data, it would be subject to tax under Section 59-12-103(1)(g).

Primary object test. In determining taxability, the Utah Supreme Court has applied a "primary object" or "essence of the transaction" test. See *Eaton Kenway, Inc. v. Auditing Division*, 906 P.2d 882 (1995) and the cases cited therein. Applying this test, we do not believe Company A is selling tangible personal property to its customers. In *Eaton Kenway*, the company created engineering drawings as a part of its production process. To store these drawings on its computer system, Eaton sent the drawings to a third party, Auto-Scan, that electronically scanned the drawings and placed them on computer readable disks. The Court noted that Auto-Scan did not manipulate the drawings in any way, other than to change their form to floppy disk. Thc Court reversed the Commission's finding that Auto-Scan's services were subject to sales or use tax holding:

> The disks here were simply a method of returning to Eaton the data, documents, and information which Eaton had supplied and the ownership of which it had not relinquished. The transaction was primarily a service, not a new taxable purchase of "tangible personal property" that the customer did not previously own. We conclude that Eaton's purchase of the computer disks is not taxable because the primary object of the sale was the services rendered in producing the disks, not the disks themselves.

The Backup Services you have described are, analytically, similar to the Auto-Scan services. Company A's customers do not relinquish ownership of their information. Nor is their primary object to obtain duplicate sets of data. Indeed, the data stored by Company A remains on its servers for only 30 days and then "expires." The primary object of the transaction is to preserve and protect the customers' existing data. Company A downloads that data to its own servers and restores and refreshes its customer's computers according to a pre-determined schedule. In doing so it is providing a service to its customers, not selling them tangible personal property. This service is not one of the enumerated services that is taxable under the Utah statutes.

Pre-written software. Company A also provides pre-written software to its customers that allows them to access and utilize the Backup Service. There is no separate charge for that software. We believe the provision of that software is merely incidental to the provision of the service. Accordingly, that software is deemed to be consumed by

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[3] Hereafter, any section references will be to the Utah Code Annotated as in effect January 1, 2008.

Company A in providing its service, rather than being "resold" to Company A's customers in a taxable transaction. See Rule R865-19S-70.

Repair of tangible property. Nor is Company A "repairing or renovating" its customers' data. The object of the transaction is to preserve and protect that data in its existing form, not to alter it in any way.

"Hard copies." In some cases, Company A does put the restored data on a DVD for a separate charge per gigabyte. Although functionally closer to the sale of traditional tangible personal property, this transaction appears indistinguishable from the provision of floppy disks held to be nontaxable in *Eaton Kenway.* Accordingly, we hold that the sale of the DVD's is also nontaxable as part of the larger nontaxable service.

Prior rulings. You have correctly noted that the Commission has ruled in other cases that leasing of disk space for storage of electronic information is the lease of tangible personal property and, if that disk space is in Utah, is subject to Utah sales tax.

In PLR 01-030, the Taxpayer "hosted" its customers' websites and automated certain of its customers' business functions. Among the options available to the customer were single dedicated servers, dual dedicated servers, or specified amounts of storage space on shared servers, along with canned or custom software to effectively utilize those servers or the allocated space. The Commission ruled that those transactions would not be subject to tax, in part, because the servers, whether dedicated or shared, were not located in Utah. If the true object of the transaction was the acquisition of storage space, or the acquisition of specific servers, those transactions presumably would have been subject to tax if the servers had been located in Utah.

In PLR 03-015, the Commission addressed the taxability of "Docustore fees" for the electronic storage of medical records. The Commission ruled that, because the customer "does not have possession and control of the equipment on which the information is stored . . . . the fee for the storage transaction would not be considered the lease of tangible personal property" and would not be subject to Utah sales tax. It appears that the records may have been stored at the Taxpayer's facility in Georgia, but that did not appear to be necessary to the ruling. The ruling did not refer to PLR 01-030.

In PLR 06-004, the Taxpayer provided "remote administrative/monitoring hosting services", ""information/data hosting services", and "remote administrative/ monitoring hosting services. . . [with] computer equipment/hardware." The Commission held that the remote management service was not a taxable service under the Utah Code. The "information/data hosting services" were comprised of the "storage and backup of data and the tools to support the customer's information systems infrastructure." The Commission held that the "information/data hosting services" would be viewed as the lease of tangible personal property because the Taxpayer's servers were located in Utah.

The facts in PLR 06-004 are somewhat sketchy. It is not clear what services, if any, are provided by the Taxpayer above and beyond the mere storage of data. Nor is it clear

exactly what services were provided under "remote administrative/monitoring hosting services" that differentiated those services from the "information/data hosting services." (Indeed, the ruling itself noted that "[w]ithout a more detailed description of the hosting services" it was necessary to make certain assumptions.) It is clear, however, that the "information/ data hosting services" were performed on Taxpayer's Utah servers, while the "remote" services were performed in connection with equipment owned by the customer and located at the customer's office. Thus, the Taxpayer's customers apparently could not conduct their normal business operations without access to Taxpayer's servers and storage capacity. The paucity of information in PLR 06-004 describing the actual services performed by the Taxpayer, demonstrates exactly why a private letter ruling is limited in application to the taxpayer requesting it. There is simply not enough information available to reliably apply it as precedent to a different taxpayer. In the present case, however, Company A's customers can conduct all their normal business operations without access to any property or storage capacity of Company A. Company A merely provides a backup system to protect its customer's information if its customers existing systems break down or become infected. Company A's customers are not contracting for servers or other storage equipment or space. They are contracting for the continual back-up, encryption, temporary storage and refreshing of their data.

Conclusion

We conclude that the Backup Services described above are not subject to Utah sales tax. Our conclusion is based on the facts as described. Should the facts be different, a different conclusion may be warranted. If you feel we have misunderstood the facts as you have presented them, if you have additional facts that may be relevant, or if you have any other questions, please contact us.

For the Commission,

R. Bruce Johnson
Commissioner