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Appellate Tax Board adds to body of law on remotely accessed software

Cambridge company found to be a seller, not a service provider

By Kris Olsen January 6, 2022

A business qualified as a manufacturer and should receive a corporate excise abatement because it was engaged in the sale of remotely accessed software rather than the provision of a service, the Appellate Tax Board ruled recently, building on a body of law that is evolving as technology advances.

The taxpayer in the case is a Cambridge corporation whose products allow its customers to improve the delivery of content and applications over the internet.

The company and the commissioner of revenue agreed that if that substantial aspect of the taxpayer's business constituted the sale of standardized, remotely accessed computer software, the company would qualify for "manufacturer" status, entitling it to state corporate excise and local personal property tax benefits.

To resolve the issue, the ATB looked at several factors, including that the company's products were, in fact, "standardized" and not designed and developed to the specifications of a specific purchaser. Rather, customers could and did set their own desired configurations within the software to meet their objectives.

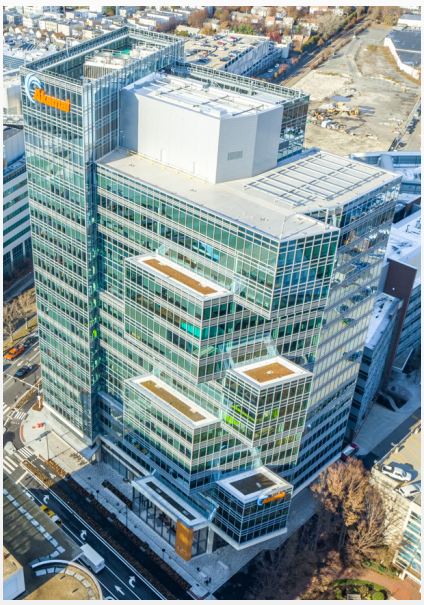
The company also presented credible evidence that its software performed the same functions found in standardized software products sold by other vendors, whether disseminated in tangible format, downloaded from the internet, or similarly accessed remotely.

Still, the commissioner argued that the taxpayer used its software and its worldwide network of servers "for the purpose of providing services to its customers."

However, the commissioner's own factors to distinguishing a taxable sale of pre-written software from a non-taxable sale of services — as articulated in a 2013 draft directive that the commissioner never finalized and in several letter rulings — "provide little support for his conclusion," the ATB noted.

Among other things, those letter rulings discounted the importance of the wording of a software provider's contractual arrangements with its customers and its marketing descriptions. Instead, the board prioritized the fact that the taxpayer's software products "operated almost automatically without the interaction of [the company's] employees."

The 59-page decision in Akamai Technologies, Inc. v. Commissioner of Revenue, et al. is Lawyers Weekly No. 20-025-21.



The taxpayer in the case is Cambridge corporation Akamai Technologies.

FEEDING A NEED FOR GUIDANCE

Given the significant state and local tax implications hinging on whether a company is in the business of selling software, there has been a crying need for guidance on where to draw the lines, said Richard L. Jones and Caroline A. Kupiec, co-counsel for the taxpayer in Akamai.

Until now, the "hodgepodge of letter rulings" and the draft directive listed factors that cut in both directions, making little cohesive sense, they added.

The Akamai decision stands as "one of the clearest guide marks we have right now," Kupiec said.

From a lawyer's perspective, Akamai was a challenging case, given the technical nature of the software involved, Jones said.


Caroline A. Kupiec

At trial, the taxpayer's team began by laying a foundation of "how the internet works" and then showed how Akamai's products function within that framework, Jones said.

Kupiec led a demonstration by the taxpayer's software programming executives, which showed what customers see and can do when they log into the software.

"They're actually impacting the underlying code that directs the functionalities that customers want and are purchasing," Kupiec said.

Boston attorney Matthew A. Morris said the most striking aspect of the Akamai decision is the ATB's sophisticated analysis of the practical aspects of modern, enterprise-level software transactions, which eschewed formalistic distinctions like the marketing label the company used or how customers access the software.

Akamai may not establish any kind of "bright line" that will resolve the current ambiguity over whether a business is service provider rather than a manufacturer, Morris noted.

"That said, this case is certainly helpful in that it sets out the types of facts that the board — and the Department [of Revenue] — will consider in making these kinds of determinations," he said.

Like the 2020 Supreme Judicial Court case Citrix Systems, Inc., et al. v. Commissioner of Revenue, Akamai illustrates the fact-intensive nature of software cases, he said.

"It is pretty clear at this point that there is no one determinative factor that will dictate whether it is software rather than a service being sold but rather the whole fabric of the arrangement between the vendor and its customers," Morris said, adding that Akamai likely will not be the last case the board hears on the issue.

Boston tax attorney Philip S. Olsen agreed that the ATB's decision in Akamai "is not a great surprise" considering Citrix, though in Citrix the revenue commissioner had been the one to aggressively and successfully argue that the sales of the online products were sales of tangible personal property, and that remote access of the software was an acceptable form of delivery.

Olsen noted that the ATB's expansive view of manufacturing, especially with respect to the technology and pharmaceutical industries, has a more meaningful tax impact on cities and towns, given the significant property tax exemptions for machinery and equipment used in manufacturing.

"It effectively removes valuable personal property from the tax rolls," he explained. "In cities like Cambridge, where there are heavy concentrations of these industries, the loss of revenue can be significant."

The Department of Revenue and Anthony M. Ambriano, attorney for the Cambridge Board of Assessors, had not responded to Lawyers Weekly's request for comment as of press time.

BUILDING A BETTER WEB

Founded in 1998, Cambridge-based Akamai has become a leading provider of software-based solutions for accelerating, managing and improving the delivery of content over the internet.

At issue in the ATB appeal were Akamai's "CDN business units," which comprised most of its revenues in the relevant tax years.

Akamai pairs its software components and systems with an extensive worldwide network of servers, enabling customers to choose software solutions based on their individual business needs and strategies.

One segment of Akamai's customer base, which included Staples and Vitamin Shoppe, used Akamai's products to ensure that their e-commerce websites were fast and dependable.

Another segment of Akamai's clientele, served by its "Media" business unit, wanted to ensure that customers did not experience lags or interruptions when they streamed live and on-demand high-definition video, or downloaded software.

Unlike providers of infrastructure as a service, Akamai does not offer access to its computer hardware, where customers could run their own software applications or store their content.

Akamai's software is also pre-written and standardized and operates with little or no interaction with company staff. While customers access the software online, it offers functions such as software available in tangible form or via download to a customer's server.

Purchasers of Akamai's CDN software products usually paid a monthly fee based on anticipated usage, which the company would

then adjust once their actual usage was determined.

The commissioner of revenue initially granted Akamai status as a manufacturing corporation under state law in a letter dated Nov. 20, 2014.

But the commissioner's audit division soon began to reassess that determination and revoked Akamai's manufacturer status by email on Dec. 19, 2016, retroactive to Jan. 1, 2015.

On Jan. 18, 2017, Akamai filed abatement applications appealing the revocation of its classification as a manufacturing corporation.

The commissioner issued a letter of determination dated May 11, 2018, finding that the revocation of Akamai's manufacturing classification had been proper.

But the Appellate Tax Board has now ruled that Akamai had been engaged in "substantial" manufacturing activities during all relevant periods, granting abatements totaling almost $7.5 million for the 2010, 2011 and 2012 tax years.

The board also ruled that the Department of Revenue should have classified Akamai as a manufacturing corporation in 2017 and 2018.

'OBJECT' TEST PASSED

The commissioner also argued that Akamai's software and services were "so inextricably intertwined that the focus should be on what customers sought," referring to the "object of the transaction test" established by the SJC in the 1977 case Houghton Mifflin Co. v. State Tax Commission.

While the commissioner conceded that a transfer of software was involved in how customers accessed Akamai's products, he argued that "such access was incidental to the faster and more reliable content delivery that Akamai's customers sought and that Akamai provided."

As an initial matter, the board expressed doubt that the "object of the transaction test" even applied.

But even assuming the test applied, the board found that "the evidence clearly establishes that purchasers of Akamai's CDN Software Products bought and intended to buy standardized computer software, rather than a service."

Akamai may have used a "layperson's term" — the word "services" — when describing its software products, but that was not determinative of the nature of the transactions between the company and its customers, the board added.

Rather, the "relevant question" was "the substance of what Akamai sold to its customers."

The board also found support for its conclusion in Citrix, in which the SJC upheld the board's conclusion that purchases of subscriptions to software products accessed remotely were subject to sales tax.

The commissioner cited differences between Citrix's products and Akamai's, but none were significant enough to tip the scales to a conclusion that Akamai was offering a service, according to the board.

"Akamai's approach to billing, the details of access procedures, and whether or not customers identified a particular product by name are not alone determinative of the substance of the transactions entered into between Akamai and its customers," the board wrote.

The ATB similarly found significant differences between Akamai's product and that of the corporation in the 1976 SJC case First Data Corp. v. State Tax Commission, whose main product was reports created by manipulating customer-supplied information.

"First Data simply provided the results to its customers for a charge, unlike Akamai which sold software to customers that they could configure for their own particular purposes," the board wrote.

Finally, the board refused to construe Akamai's decision to forego collecting sales tax on its product as a concession that it was a service provider. The board noted that the company had made that decision because the DOR had challenged its classification as a manufacturing corporation within four days, and, if it had lost that challenge, it would have needed to refund the sales tax it had collected.

AKAMAI TECHNOLOGIES, INC. V. COMMISSIONER OF REVENUE, ET AL.

THE ISSUE: Should a company whose product allows customers to improve the delivery of content and applications over the internet qualify as a manufacturer and receive a corporate excise abatement?

DECISION: Yes, because it is engaged in the sale of remotely accessed software rather than the provision of a service (Appellate Tax Board)

LAWYERS: Richard L. Jones, Nicholas M. O'Donnell and Caroline A. Kupiec, of Sullivan & Worcester, Boston; Joseph X. Donovan of Fauver Co., Elyria, Ohio *(appellant)*. Celine E. de la Foscade-Condon and Brett M. Goldberg, of Boston *(appellee commissioner of revenue)*. Anthony M. Ambriano of Hingham *(appellee Cambridge Board of Assessors)*