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Department of Revenue
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SC PRIVATE LETTER RULING #14-4

SUBJECT: Cloud-Based Service for Processing and Routing Telephone Calls within a Customer's Telephone System and for Other Support Services (Sales and Use Tax)

REFERENCES: S.C. Code Ann. Section 12-36-910 (2014)
S.C. Code Ann. Section 12-36-1310 (2014)
S.C. Code Ann. Section 12-36-60 (2014)
S.C. Regulation 117-329.4 (2012)

AUTHORITY: S. C. Code Ann. Section 12-4-320 (2014)
S. C. Code Ann. Section 1-23-10(4) (2005)
SC Revenue Procedure #09-3

SCOPE: A Private Letter Ruling is an advisory opinion issued to a specific taxpayer by the Department to apply principles of law to a specific set of facts or a particular tax situation. It is the Department's opinion limited to the specific facts set forth, and is binding on agency personnel only with respect to the person to whom it was issued and only until superseded or modified by a change in statute, regulation, court decision, or another Departmental advisory opinion, providing the representations made in the request reflect an accurate statement of the material facts and the transaction was carried out as proposed.

Questions:

1. Are the hardware and software that XYZ, Inc. purchases, leases, or licenses from third parties, as described in the facts, purchased, leased or licensed for use and consumption or for resale?
2. Are the monthly charges by XYZ, Inc., to its customers for its 123 Service and supporting services, as described in the facts, subject to the sales and use tax?

Conclusions:

1. The hardware and software purchased, leased, or licensed from third parties by XYZ, Inc., as described in the facts, are purchased, leased or licensed by XYZ, Inc. for use and consumption, and not for resale.

2. The monthly charges by XYZ, Inc. to its customers for its 123 Service and supporting services, as described in the facts, are subject to the sales and use tax.

XYZ, Inc. is providing a service whereby calls are routed within the customer's own communications system and is providing other services, such as audio and video conferencing, which are subject to the tax under SC Regulation 117-329.4. The sales and use tax is a transaction tax and XYZ, Inc. has created and is selling a service transaction that is routing (i.e., sending) a voice or message. The services as described in the facts are subject to the tax under Code Sections 12-36-910(B)(3) and 12-36-1310(B)(3) and SC Regulation 117-329.

Facts:

XYZ, Inc. ("XYZ") offers a cloud-based service offering (the "123 Service" or the "Offering") to customers nationwide. The 123 Service Offering will provide certain cloud-based applications and related services (the "123 Services") that support a customer's telecommunication equipment, including its voice, video, messaging, presence, audio, web conferencing, and mobile capabilities.

BACKGROUND

Overview of the 123 Service Offering

Generally, a business's phone system, computers and other telecommunications equipment utilize various software applications and hardware in order to operate and function in the manner necessary for the business's needs. For instance, although a business may have a telecommunications provider that provides it with telephone lines to make outgoing and receive incoming calls, the business will need hardware and software that internally instructs the business's telecommunications equipment as to how to process and route those calls. Historically, customers have handled these functions internally. Through the 123 Service Offering, XYZ will be providing these functions as a service to its customers from an offsite location.

Specifically, the 123 Service Offering replaces certain customer-owned and maintained software applications and related computer hardware that support a customer's telecommunications equipment with a XYZ-hosted service. In this hosted service, XYZ owns (or is the lessee or licensee of) and maintains certain hardware and software. The benefit of the 123 Service Offering is that customers can utilize the hardware and software Cloud applications on an as-needed basis from XYZ, thereby reducing the customer's capital investment and on-going technology support and maintenance expenditures for such systems. The customer utilizes the hosted applications by means of the customer's existing telecommunications, Internet, or network connections, for which it pays its own third party telecommunications provider. In essence, in exchange for a monthly fee, XYZ will operate back-office equipment and software applications that provide a service for the necessary or enhanced functionality for a customer's phone systems and other telecommunication equipment. The customer will provide the telecommunications equipment.

XYZ will acquire, operate and maintain all the hardware and software necessary to provide the 123 Services and ensure optimal performance. The hardware and software required for providing the 123 Services will be installed on servers located in Anywhere, USA. XYZ employees based in Anywhere, USA will provide onsite professional services to maintain the hardware and software, and XYZ employees based in Nowhere, USA will remotely monitor performances, perform necessary adds, moves, changes, and deletions, and provide troubleshooting for issues that arise during performance.

The Manner in Which The 123 Services Are Provided

The 123 Services will be provided by XYZ on a remote basis through the use of XYZ-owned MNO Communications (“MNO”) clusters located at a XYZ data center. The MNO clusters will deploy a variety of available XYZ-owned, client software applications that are utilized by customer-owned phones and workstations located at customer sites. As described further below, the applications generally provide the customer’s telecommunication equipment with certain necessary or enhanced functionalities.

Customers will be responsible for providing connectivity of sufficient bandwidth between the customer’s location and XYZ’s data center. XYZ relies on the customer’s QoS-enabled, voice-grade Local Area Network and Wide Area Network over which it provides the 123 Services throughout a customer’s geographic locations. Connectivity to the Public Switched Telephone Network (“PSTN”) is not included in the 123 Service Offering. All connections between the customer and XYZ’s data center are through a customer’s existing or newly-ordered PSTN circuits, phone lines and Internet connections. The PSTN or other connections can reside throughout the customer locations, and are terminated into the XYZ data center through customer-owned, XYZ-managed gateways. Customers are always the “customer of record” for any PSTN, Internet or other service for the transportation or transmission of messages or information; the applications do not transport or transmit messages or information through any PSTN, Internet or other third party, external telecommunications service. All customer communications with third parties are through customer-contracted PSTN connections that are not provided by XYZ. XYZ’s customers continue to communicate with third parties over the PSTN, and continue to pay their telecommunications provider the same charges and taxes for such capabilities, both before and after signing up for the XYZ’s 123 Service Offering. PSTN communications with third parties are never physically routed through XYZ’s data center equipment.

XYZ may also host and deploy certain custom-owned software applications that provide enhanced functionalities for a customer’s phone system and other telecommunication equipment. Such hosted services are available as add-on services for additional fees (as described below), and are utilized by customers in the same manner as the XYZ-owned and hosted software applications.

Agreements and Monthly Charges

To purchase the 123 Service Offering, customers will enter into a contract with XYZ that includes a customer service order, a service description for the Offering, and detailed pricing invoice.

Under the contract with a customer, XYZ will charge the customer a monthly user license fee,¹ calculated based on the number of users. The monthly fee covers the charges for hardware, software, virtual server instance charges, required storage charges, rack space charges, power and cooling charges, as well as monitoring and management charges, most moves-adds-changes and major version upgrades. To the extent the customer purchases add-on services (including the hosting of customer-owned software applications), separate fees are charged for each such service. Charges for maintenance and management of any customer-owned software applications are also separately stated on the monthly invoice.

Description of the Services Provided by the Embedded Software Applications

As described above, the XYZ-owned software applications available through the Offering support a customer's own voice, video, messaging, presence, audio/web conferencing, and mobile capabilities. A brief description of the supporting services provided by the various applications is set forth below:

Voice. A XYZ server, utilizing the MNO, communicates with the customer's voice gateway device (*i.e.*, the customer-owned switch) to provide instructions to the customer's voice gateway device for the processing and routing of incoming and outgoing calls among the customer's phone extensions; the call is not routed through XYZ's server. No end-to-end communication is ever routed through XYZ's server. This MNO system also supports a customer's other forms of communication to its IP end-points, media-processing devices, VoIP gateways, mobile devices, and multimedia applications, as generally described below.

Video. Video is the technology of electronically capturing, recording, processing, storing, transmitting, and reconstructing a sequence of still images representing scenes in motion. Video utilizes components such as the ABC IP end-points, ABC Communication Application desktop clients, or purpose-built video endpoints such as the ABC System or larger units. The video support services will be provided by XYZ's server through a MNO cluster in the same manner as outlined above with respect to a customer's voice communication capabilities.

Messaging. When a customer phone extension does not answer an incoming call, the XYZ server, utilizing the MNO, instructs the customer's voice gateway device to send the call to voicemail. The voice messages are then stored on the XYZ servers and available for the user to access and manage at his or her convenience. The voice messaging support services provided by the 123 Service Offering will allow users to

¹ The fee is denominated as a "license" fee, but XYZ does not in fact license or lease any software or tangible personal property to the customer under the contract.

access and manage voice messages stored on XYZ-owned servers in a variety of ways, using an email inbox, web browser, ABC IP Phone, Smartphones, and ABC Communication Application, among other components.

Presence. Presence support services are provided by XYZ through a ABC presence application that provides users the ability to determine when colleagues are available. The ABC presence application offers the flexibility of rich, open interfaces that allow enablement of instant messaging and rich, network-based presence for a wide variety of business applications. As is the case with respect to the other services, the customer's own communications equipment accesses the ABC presence application hosted on XYZ's servers to utilize the presence capabilities.

Audio Conferencing. With respect to a customer's audio conferencing capabilities, XYZ supports a customer-owned ABC router and the phone devices through its hosted MNO, in a manner similar to that which is described above with respect to the voice support services.

Web Conferencing. ABC's QRS application is an optional, subscription-based component of the Offering. QRS is a cloud-based web conferencing application that permits desktop sharing through a web browser with phone conferencing and video. QRS operates through a user's computer or wireless device, an audio connection (either through the computer or through a phone), and a webcam (optional).

Mobility Services. XYZ supports a customer's mobile devices through use of the ABC Communication Application. Mobile clients utilizing ABC Communication Application can place and receive calls over their own corporate wireless local area network and telephony infrastructure, using XYZ's server to instruct the routing of calls, and essentially turns a mobile phone into another extension on the MNO. XYZ's server itself does not provide the routing for the call or otherwise function as a switch. No end-to-end communication is ever routed through XYZ's server.

With respect to each of the support services described above, a customer utilizes the XYZ-owned and hosted software with its own equipment and through its own telecommunication, Internet or other network connection. At no time does the customer download or otherwise possess the software that is hosted by XYZ. In addition, XYZ does not provide the telecommunication, Internet or network connections necessary for the customer to utilize the 123 Services.

Discussion:

Code Section 12-36-910(A) states:

A sales tax, equal to [six]² percent of the gross proceeds of sales, is imposed upon every person engaged or continuing within this State in the business of selling tangible personal property at retail. (Emphasis added.)

² Code Section 12-36-1110 increased the sales and use tax rate by 1% beginning June 1, 2007.

Code Section 12-36-1310(A) reads:

A use tax is imposed on the storage, use, or other consumption in this State of tangible personal property purchased at retail for storage, use, or other consumption in this State, at the rate of [six]³ percent of the sales price of the property, regardless of whether the retailer is or is not engaged in business in this State. (Emphasis added.)

Code Section 12-36-60 defines the term "tangible personal property" to mean:

... personal property which may be seen, weighed, measured, felt, touched, or which is in any other manner perceptible to the senses. It also includes services and intangibles, including communications, laundry and related services, furnishing of accommodations and sales of electricity, the sale or use of which is subject to tax under this chapter and does not include stocks, notes, bonds, mortgages, or other evidences of debt. ... (Emphasis added).

Therefore, the term tangible personal property includes the sale or use of intangibles, including communications, that are subject to South Carolina sales or use taxes under Chapter 36 of Title 12.

Communications are subject to sales and use taxes under Chapter 36 of Title 12 pursuant to Code Sections 12-36-910(B)(3) and 12-36-1310(B)(3)⁴, which impose the tax on the:

gross proceeds accruing or proceeding from the charges for the ways or means for the transmission of the voice or messages, including the charges for use of equipment furnished by the seller or supplier of the ways or means for the transmission of the voice or messages (Emphasis added.)

The Department has long held that Code Sections 12-36-910(B)(3) and 12-36-1310(B)(3) impose the sales and use tax on the total amount of money derived, exclusive of deductions, from a commercial venture and accruing or proceeding from charges for the manner, method or instruments for sending a signal of the voice or of messages. See SC Revenue Ruling #89-14, SC Revenue Ruling #04-15 and SC Revenue Ruling #06-8.

Furthermore, the definition of tangible personal property, as defined in Code Section 12-36-60, includes services and intangibles "the sale or use of which is subject to tax under [Chapter 36]," such as "communications." The Second College Edition of the American Heritage Dictionary defines "communication," in part, as "[t]he exchange of thoughts, messages or information, as by speech, signals or writing." "Communications" is defined, in part, as, "a means of communicating esp.: a system of sending and receiving messages, such as mail, telephone and television." The Department has long used the definition found in the Second College Edition of the American Heritage Dictionary for the term "communications."

³ See footnote #2.

⁴ See SC Revenue Ruling #06-8 for other statutes concerning communications subject to the sales and use tax. These other communications statutes are not relevant to this discussion.

Based on the above discussion, it is the Department's position that charges for the ways or means of communication include charges for access to, or use of, a communication system (the manner, method or instruments for sending or receiving a signal of the voice or of messages), whether this charge is based on a fee per a specific time period or per transmission. This is further supported by the definition of the terms "sale" and "purchase," which are defined in Code Section 12-36-100 to include "a license to use or consume." See SC Revenue Ruling #89-14, SC Revenue Ruling #04-15 and SC Revenue Ruling #06-8.

In addition, SC Regulation 117-329.4 provides examples of communication services that are subject to the tax, including but not limited to telephone services, teleconferencing services, paging services, fax transmission services, e-mail services, and voice mail messaging services.

Based on the above, XYZ is providing a service and is, therefore, the user or consumer of the hardware and software it purchases, leases, or licenses from third parties in providing its service.

The service provided by XYZ does not transmit telephone calls through land-based telephone lines, the Internet or similar outside telecommunication services. However, the service does process and route incoming and outgoing telephone calls through the customer's own telephone system within its business. The support services route voice, video, and voicemail messages. The support services also support audio conferencing, video conferencing and mobility services. These services constitute the ways or means for the transmission of the voice or messages.

While a customer could purchase the necessary hardware and software to provide these services for its own purposes, XYZ has created a service through the cloud to provide these same services. XYZ is providing a service whereby calls are routed within the customer's own communications system and is providing other services, such as audio and video conferencing, which are subject to the tax under SC Regulation 117-329.4. The sales and use tax is a transaction tax and XYZ has created and is selling a service transaction that is routing (i.e., sending) a voice or message. The service as described in the facts are subject to the tax under Code Sections 12-36-910(B)(3) and 12-36-1310(B)(3) and SC Regulation 117-329.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Rick Reames III
Rick Reames III, Director

November 4, 2014
Columbia, South Carolina