STATE OF MICHIGAN

COURT OF CLAIMS

AUTO-OWNERS INSURANCE COMPANY, Plaintiff, v DEPARTMENT OF TREASURY, Defendant.	**OPINION AND ORDER** Case No. 12-000082-MT Hon. Michael J. Talbot

This case comes before the Court on plaintiff's motion for summary disposition pursuant to MCR 2.116(C)(10). The motion is GRANTED.

INTRODUCTION

This case presents a novel application of the Use Tax Act (UTA), MCL 205.91 *et seq.*, to an emerging, complex technology that involves a consumer's remote access to a third party's technology infrastructure, including its services as well as its networks, servers, data storage, and software applications not physically located on the user's computer.[1] Such access permits users

[1] This new model of computing, colloquially referred to as "cloud-computing," has resulted in a radical shift in the way that individuals use their computers. According to the U.S. Department of Commerce National Institute of Standards of Technology ("NIST"), cloud-computing is "a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., *networks, servers, storage, applications, and services*) that can be rapidly provisioned and released with minimal management effort or service provider interaction." (Emphasis added.) See report available at <http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf>. A broad term that does not apply to any particular transaction or application, cloud-computing "is not usually the equivalent of using software or hardware as most of us are accustomed to thinking about these terms."

to accomplish tasks that in the past required the in-house investment of computing resources such as software, hardware, and information technology (IT) support. These tasks include, for example, the retrieval of data, the processing of billing and payments, and the acquisition of information such as data reports, risk analyses, property valuations, and legal research. The present case concerns how such transactions should be treated under the UTA, and, specifically, whether accessing the computer systems of third-party providers involves either a taxable transfer of tangible personal property (e.g., "prewritten computer software") or a nontaxable sale of a service. Plaintiff Auto-Owners Insurance Company asserts that the transactions upon which the assessed taxes are based were services that are not subject to the UTA. It further claims that any tangible personal property involved in the transactions was either not "used" by Auto-Owners or was incidental to the transactions and, therefore, not subject to use tax. Defendant Department of Treasury ("the Department") argues that all transactions in question involved use of tangible personal property (specifically, "prewritten computer software"), and therefore, are properly subject to use tax under the UTA.

FACTS

Auto-Owners is a Michigan corporation headquartered in Lansing, Michigan. In the business of providing various types of insurance, it is represented by numerous independent agents in 26 states. During the tax years at issue (December 1, 2006 through December 31, 2010), Auto-Owners consisted of five property and casualty companies and one life/health/annuity insurer. Auto-Owners frequently engages in third-party provider transactions to accomplish tasks necessary to service its clients and independent agents. The nature of these

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Hellerstein & Sedon, *State Taxation of Cloud Computing: A Framework for Analysis*," 117 J Tax'n 11 (2012). See also, Melanson, *Sales Taxes and the Shadow of Cloud Computing: Searching the Horizon for A Workable, National Solution*, 65 Tax Law 871 (2012).

transactions often involves complex computing arrangements, some of which are at issue in this case. The transactions may be grouped into six categories:

- **Insurance industry providers**. Auto-Owners used various third-party providers to assess valuation of property on insurance applications and to analyze risk in connection with underwriting policies. For example, Auto-Owners electronically submitted over the internet to a third-party provider data relating to certain building factors such as location, construction, number of stories, occupancy, and square footage. The provider, using its own commuting system (software, hardware, computer infrastructure, and employees) processed the information and supplied Auto-Owners with a valuation on which to base insurance premiums. Other times, independent Auto-Owners agents accessed Auto-Owners' own computer intranet and input data that Auto-Owners transmitted to a third-party provider for analysis; the third-party provider then transmitted the processed data back to Auto-Owners. With respect to another non-profit provider, Auto-Owners paid a membership fee to obtain national insurance data standards for use in data submissions to other insurance companies and governmental entities. The data sent by the third-party providers were received by Auto-Owners at its Michigan offices. Licenses referenced in the third-party provider agreements typically involved licenses to access and use technology systems, subscription services, analytic results, or standards. The data processed or information delivered to Auto-Owners were unique to the specific insurance company customers and depended upon the information inputted or provided by Auto-Owners.

- **Marketing and Advertising Providers**. Auto-Owners engaged in various marketing and advertising companies to obtain such things as logo designs, marketing strategies, and standards to use for advertisements. Another third-party provider produced commercials for Auto-Owners, after which a subsequent third-party vendor was paid by Auto-Owners to enable local agencies to customize the commercials for their particular local markets. A website was created by Auto-Owners that allowed local agencies to "click" on the type of commercial they wanted and order that commercial from Auto-Owners. As another example, Auto-Owners engaged a third-party provider to create search engine optimization queries so that the Auto-Owners agents' websites would rank in the top three for Google and Bing searches. These engagements also included hosting the websites and implementing an internet pilot program that included pop-up advertisements.

- **Technology and Communications Providers**. In order to maintain confidentiality of insured parties' information, Auto-Owners used a third-party provider to manage information exchanges among thousands of insurance carriers, agents, and brokers via a single communication infrastructure of electronic communication. The third-party providers enabled data translation between carrier and agent systems so that both could communicate while using their own technology infrastructures. Through such systems, Auto-Owners and its independent agencies were able to request quotes, process policy transactions, and retrieve account status information directly from their own agency systems. The third-party provider managed the data exchange among insurance carriers,

agents, and brokers via a managed data network that used a secured data telecommunications line between the parties. The communication infrastructure, in these particular transactions, was built and maintained by the third-party provider, and no software was transferred to or downloaded by Auto-Owners. The third-party providers also allowed for Auto-Owners and its agents to access motor vehicle records, and send electronic notices to secured, interested parties regarding Auto-Owners insurance coverage or cancellation of coverage. These transactions involved data exchange and did not provide Auto-Owners or its independent agents the ability to search any database. Rather, the transactions allowed an independent agent to input certain information over the internet by using an Auto-Owners application form. Auto-Owners also utilized web-conferencing services from a third-party provider that offered internet conferencing. The third-party provider combined desktop video sharing through a web browser with phone conferencing and video so that all participants could see a presenter talk. At no time during the tax years in question, did Auto-Owners have any of the third-party provider's software on its system. All web-conferencing was provided over the internet, and no software was downloaded or transferred from the third-party provider. Finally, as part of its insurance business, Auto-Owners' corporate personnel utilized remote personal computer ("PC") access and virtual private network ("VPN") connectivity from another third-party provider. This permitted Auto-Owners' employees to work remotely from any location. Auto-Owners' users gained access to the third-party network by accessing computer systems through an online internet based password system using a website or portal hosted and fully supported by the third-party provider. Auto-Owners accessed the third-party provider's system without downloading software from the third-party provider.

- **Information Providers**. As part of its business during 2008 through 2010, Auto-Owners purchased a subscription to obtain access to a third-party provider's online information database through the internet. Auto-Owners did so to conduct legal research. During 2008 through 2010, Auto-Owners did not receive any computer discs or software from the third-party provider. No software was purchased or downloaded by Auto-Owners in connection with these transactions. Auto-Owners also purchased an online subscription to a third-party provider's database, which included state-specific insurance laws, insurance filing guides, attorneys general opinions, and bulletins. As part of a unique agreement, the third-party provider supplied a small portion of the materials to Auto-Owners through books and print materials. The third-party provider's databases were electronically housed and stored by the third-party provider.

- **Payment Remittance and Processing Support Providers**. As part of its insurance business and to outsource its payment processing services, Auto-Owners employed a third-party provider that used scanners and software to streamline remittance processing, reconciliation, and research. Using scanners, the third-party provider's system captured images of both checks and stubs. The third-party provider provided custom-designed recognition software for Auto-Owners using Auto-Owners internal codes. Auto-Owners separately paid a fee for additional upgrades to this customized software. Auto-Owners also separately paid a fee for support and maintenance of the scanners that included two preventative maintenance visits per year plus training and customer support. The invoice

included in the audit exceptions was part of the annual support fee paid for equipment maintenance.

- **Information and Technology Providers of Equipment Maintenance Support**. Auto-Owners separately purchased certain optional equipment maintenance and customer support services from various information and technology service providers. The purpose of engaging in the equipment maintenance and customer support transactions was to provide technical "troubleshooting" support to ensure that software and hardware systems separately purchased continued to operate smoothly.

LAW GOVERNING THE MOTION

The issues come before the Court in the context of the motion for summary disposition filed by Auto-Owners pursuant to MCR 2.116(C)(10). A motion for summary disposition, under MCR 2.116(C)(10), is properly granted if no genuine factual dispute exists, and the moving party is entitled to judgment as a matter of law. *Rice v Auto Club Ins Ass'n*, 252 Mich App 25, 31; 651 NW2d 188 (2002). In this case, the parties' disagreement concerns a matter of interpreting the provisions of the UTA. When interpreting a statute, the primary goal "is to give effect to the Legislature's intent, focusing first on the statute's plain language." *Malpass v Dep't of Treasury*, 494 Mich 237, 247-248; 833 NW2d 272 (2013). When the words of a statute are unambiguous, the provisions must be enforced as written, and no further judicial construction is permitted. *Id.* at 249.

ISSUES AND ANALYSIS

Under the UTA, a 6% tax is levied "for the privilege of using, storing, or consuming tangible personal property in this state . . . ." MCL 205.93(1). Resolution of the motion for summary disposition requires consideration whether the transactions in question involved "tangible personal property" as defined under the UTA. If so, this Court must consider whether the tangible personal property was "used" by Auto-Owners within the meaning of the UTA. Finally, if the evidence shows that Auto-Owners both "used" tangible personal property as well

as purchased services in connection with the transactions at issue, the Court must apply the "incidental to services" test set forth by the Michigan Supreme Court in *Catalina Mkg Sales Corp v Dep't of Treasury*, 470 Mich 13; 678 NW2d 619 (2004).

I. WAS THE SOFTWARE INVOLVED IN THE TRANSACTIONS "TANGIBLE PERSONAL PROPERTY" WITHIN THE MEANING OF THE UTA?

"Tangible personal property" includes "prewritten computer software," which is defined as "computer software, including prewritten upgrades, that is delivered by any means and that is not designed and developed by the author or other creator to the specifications of a specific purchaser." MCL 205.92b(o). Thus, for computer software to constitute tangible personal property, it must be "delivered by any means."

"[D]elivered by any means" is not defined in the statute. Unless defined in the statute, every word or phrase of a statute should be accorded its plain and ordinary meaning, considering the context in which the words are used. MCL 8.3a; *Krohn v Home-Owners Ins Co,* 490 Mich 145, 156; 802 NW2d 281 (2011). Dictionary definitions may be consulted to give words their common and ordinary meaning. *Id.* The most relevant, conventional meaning of the word "deliver," given the context of MCL 205.92b(o), is "to take and handover to or leave to another: CONVEY; to hand over, surrender." *Merriam-Webster's Collegiate Dictionary* (2003). Similarly, Black's Law Dictionary (9th ed) defines "delivery" as: "[t]he formal act of transferring something; the giving or yielding possession or control of something to another."

The definition of "prewritten computer software" indicates that the UTA applies only to those transactions in which the person takes "delivery" of prewritten computer software. When Auto-Owners engaged in its various transactions with third-party providers, there is scant evidence in the record that it took "delivery" of the prewritten computer software within the

common and approved meaning of the word. The software used to produce the results that Auto-Owners obtained was not handed over, left, or transferred. The third-party providers did not surrender possession and control of the software to Auto-Owners or actually transfer the software needed to process and produce the outcomes for which the parties contracted. What was transferred was information and data that had been processed using the third-party purchasers' software, hardware, and infrastructure. But the software itself was not "delivered" to Auto-Owners, as that word is commonly used.

Further, when evaluating the context of the words that are used by the Legislature to discern intent, it is relevant to consider the time period during which the definition of tangible personal property was amended to include "prewritten computer software . . . delivered by any means." On September 1, 2004, the effective date of the relevant amendment,[2] it is unlikely that the Legislature could have contemplated the nature of most of the transactions involved in this case because such methods of remotely accessing the entire technological infrastructures of third parties were not commonly used by consumers.[3] The commonly used methods involved electronic and physical delivery of software, and given the temporal context of the statute's

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[2] 2004 PA 172.

[3] This same point was made by the Michigan Senate Fiscal Agency in its analysis of two bills (SB 335 and 336) that were introduced in 2011 in the Senate to amend the UTA and to clarify that "cloud-computing" transactions are non-taxable services that do not fall within the definition of prewritten computer software: "When the definition of 'prewritten computer software' was added to the statutes in 2004, cloud computing was unheard of, and the purchase or sale of software involved the delivery of material goods. Since then, technology and practices have evolved, and what formerly was a product has migrated to a service." See Senate Bill Analysis, SB 335 and 336, August 24, 2011, p 2. Both bills stated that the amendments were "curative" and "intended to express the original intent of the Legislature concerning the taxation of prewritten computer software" under the UTA. The bills passed in the Senate and made it to a second reading in the House, but were never enacted. They have since been reintroduced and are pending in the Legislature.

enactment, it is clear that the Legislature meant to include these particular methods of delivery in its definition. Because remote access of third-party provider's technology infrastructure as a mainstream business model was essentially unheard of at the time the statute was enacted, the only way that this Court could determine that the Legislature intended "delivery" to include transactions such as those described in the record would be to extend in scope or forced construction the term "delivered by any means." However, this approach would be contrary to the principle that tax laws generally will not be extended in scope by implication or forced construction. *Sharper Image Corp v Dep't of Treasury,* 216 Mich App 698, 702; 550 NW2d 596 (1996).

In summary, the transactions did not involve "computer software . . . that is delivered by any means . . . ," as is necessary to meet the definition of "prewritten computer software," which is "tangible personal property" for the UTA.

II. DID AUTO-OWNERS "USE" THE PREWRITTEN COMPUTER SOFTWARE WITHIN THE MEANING OF THE UTA?

Even if the Court determined that prewritten computer software was "delivered" to Auto-Owners, the requisite "use" of the software was not made in this case under any of the facts stated in the record.

The UTA defines "use" as "the exercise of a right or power over tangible personal property incident to the ownership of that property including transfer of the property in a transaction where possession is given." MCL 205.92(b). For purposes of the UTA, "use" does not require the transfer of actual possession, but it necessitates the exercise of a right or power over the property "incident to ownership." *NACG Leasing v Dep't of Treasury*, ___ Mich ___; ___ NW2d ___ (Docket No. 146234, issued February 6, 2014).

The definition of the term "incident to ownership of tangible personal property" is not found in the UTA, nor is there any controlling Michigan case directly on point. However, most courts in this state that have considered the issue have required a certain level of control by the taxpayer before there is deemed to be an incident of ownership for use tax purposes. For example, in *WPGP1, Inc v Dep't of Treasury*, 240 Mich App 414; 612 NW2d 432 (2000), the Court of Appeals considered the many indicators of control over an airplane that the taxpayer leased to a third party. In concluding that the taxpayer did not engage in a taxable use of the airplane in Michigan because it had ceded control of the airplane to the third party, the Court focused on the fact that the third party—and not the taxpayer—completely controlled the flight schedules and the routine maintenance of the airplanes and that the third party was responsible for ensuring that the aircraft remained duly registered with the Federal Aviation Administration. See also *Fisher & Co, Inc v Dep't of Treasury*, 282 Mich App 207, 212; 769 NW2d 740 (2009) ("The right to control what happens—in layman's terms—to one's property is one of the most fundamental rights incident to ownership," citing *Twichel v MIC Gen Ins Corp*, 469 Mich 524, 534-535; 676 NW2d 616 (2004)). While the facts in these cases are distinguishable from those in this case, it is clear that "right or power" under the definition of "use" requires that the taxpayer have some level of control over the tangible personal property before use tax can be properly applied. The record is devoid of any evidence that Auto-Owners had such control. The only evidence of control by Auto-Owners was the ability to control outcomes by inputting certain data to be analyzed.

The Department's argument that mere "access" to property equates with "use" is not persuasive. Although computer software was involved in most of the transactions in question, there is no evidence in the record that Auto-Owners exercised a right or power incident to

ownership in the underlying software. At the most, Auto-Owners accessed the computer power of the third-party providers and controlled the output of information by entering data. But Auto-Owners had no control over the underlying software that may have been used by the third-party provider to complete the necessary tasks.

In summary, the transactions did not involve "using" tangible personal property under the UTA.

III. WAS USE OF TANGIBLE PERSONAL PROPERTY BY AUTO-OWNERS INCIDENTAL TO THE SERVICES PROVIDED?

Finally, even if prewritten computer software was delivered and used by Auto-Owners under the meaning of the UTA, any such use was merely incidental to the services rendered by the third-party providers and would not subject the overall transactions to use tax.

In *Catalina Mktg Sales Corp,* 470 Mich 13, the Supreme Court adopted the "incidental to services" test articulated in *Univ of Mich Bd of Regents v Dep't of Treasury,* 217 Mich App 665, 553 NW2d 349 (1996), to determine whether a business transaction that involves both the provision of services and the transfer of tangible personal property is a service or a tangible property transaction. Under the "incidental to services" test, a court must look objectively "at the entire transaction to determine whether the transaction is principally a transfer of tangible personal property or a provision of a service." *Catalina,* 470 Mich at 24. The *Catalina* Court identified six factors to consider when making this determination.

The first *Catalina* factor concerns what the buyer sought as the object of the transactions. The various agreements with third-party providers in the record, along with affidavits provided by Auto-Owners, show that the primary objective for entering into the transactions was to access

the technology services of third-party providers. The Department has presented no evidence indicating that Auto-Owners wanted to own or otherwise have responsibility for prewritten computer software. Auto-Owners did not hire teams of IT employees to maintain its own IT infrastructure and staff. Instead, Auto-Owners assigned these duties to third-party providers specializing in such services.

Second, *Catalina* directs the Court to consider what the third-party providers were in the business of doing. Except with respect to third-party providers with which Auto-Owners had separate maintenance and support agreements, none of the third-party providers were in the business of selling prewritten computer software. What they were offering was much broader and involved the provision of the services that rendered results in the form of, for example, reports and analyses.

Third, *Catalina* requires the Court to consider whether the goods were provided as a retail enterprise with a profit-making motive. The third-party providers' motives were not to make money by selling prewritten computer software; the majority of the companies were service providers that provided much more than simply software. Any prewritten computer software was a very small part of the overall transaction to provide services. The evidence shows that third-party providers' motives were not to profit from the sale of prewritten computer software, but to profit from providing services. The Department has not provided any evidence to the contrary.

Fourth, the Court, under *Catalina*, must consider whether the tangible goods (namely, the prewritten computer software involved in these transactions) were available for sale without the associated services. Auto-Owners wanted to purchase the technology of third-party providers in

order to obtain certain results. To receive the computing services from the various third-party providers, it was sometimes required to enter an agreement that included the licensing of software. The record is devoid of any evidence that any of the transactions in question involved third-party providers that were in the business of selling software apart from services. The third-party providers, at the most, provided licenses to access software as part of a larger access to entire computer infrastructures.

The fifth *Catalina* factor requires the Court to consider the extent to which the intangible services offered by the third-party providers contributed to the value of the tangible item (the interest in prewritten computer software) that Auto-Owners may have received in the transactions. The prewritten computer software here held no value to Auto-Owners without the associated services. The few times that any reference is made in the agreements to software downloaded to Auto-Owners' computers, the software was clearly a conduit to the acquisition of what Auto-Owners really wanted and contracted for: results that flowed from the third-party providers' computer power capabilities.

Finally, *Catalina* permits consideration of any other factors relevant to this transaction. The Department's characterization of the transactions in question fails to recognize not only the complexity of the agreements and their multiple elements, but the complexity associated with the computer environment within which Auto-Owners and businesses around the country are now operating. With the evolution of "on-demand" access to third-party providers' networks, servers, and application software, businesses no longer need to install, download, or transfer software—or or much of anything—to a computer. Simply put, the technology, as it stands today, allows for access to another's *computer power* with little to no transfer of tangible personal property, including software. The transactions in question are illustrations of the changing nature of

computer-based technology and business models that are in essence services with incidental transfers of tangible personal property, or no transfers of tangible personal property at all.

These factors, considered together, lead to the conclusion that the prewritten computer software was simply an incidental component of the principal transactions for the various services that Auto-Owners and its third-party providers entered into. In the transactions at issue, Auto-Owners sought out a service, not software. Further, the third-party providers in question were in the business of providing services, not selling or licensing software. The underlying software used to provide the services were generally not available to customers without the service, and the value of that software was incidental to the services offered alongside it. Any prewritten computer software used in these transactions was incidental to the transactions as a whole.

CONCLUSION

The transactions are not subject to Michigan use tax. The transactions here are properly characterized as non-taxable services rendered to Auto-Owners by third-party providers. Whether such transactions *should* be subject to the state's use tax is a determination for the Legislature. Unless and until the Legislature expresses an intent to specifically tax transactions involving the remote access to a third-party provider's technology infrastructure, transactions such as those described in this case do not fit under the plain meaning of the UTA and are not properly subject to the tax. In light of this ruling, there is no need to address other arguments raised by Auto-Owners, including those relating to the Department's audit methodologies.

IT IS HEREBY ORDERED that summary disposition in favor of Auto-Owners is GRANTED.

Dated: MAR 20 2014

Hon. Michael J. Talbot
Court of Claims Judge