NY's Shocking Stance on Taxing Online Services

By Arthur R. Rosen, Leah Robinson and Jeffrey S. Reed

What is perhaps most disconcerting about New York's approach is that it is being done in the absence of a legislative mandate. In fact, the New York legislature previously considered -- but then declined to enact -- legislation that would have provided for sales taxation of "digital goods" -- items such as MP3s that are downloaded over the Internet.

In a startling development, the New York State Department of Taxation and Finance (the Department) is now taking the position that sales Free Report - Discover the Difference of Email Marketing 2.0! of online services are subject to sales tax -- believe it or not -- as sales of canned (i.e., noncustomized) software.

In other words, the Department is alleging that there is no meaningful difference between purchasing an online service and, for example, purchasing a shrink-wrapped version of Microsoft (Nasdaq: MSFT) Word at a local Staples (Nasdaq: SPLS) store. This new position results in the imposition of sales tax on purchases of services provided over the Internet that would not be subject to sales tax if provided in person by a human being. For example, the purchase of an educational course is not taxable if provided by a live speaker, but the same course may now be considered taxable by the Department if the course is given online.

The Department has painted with a broad brush to conclude in a number of advisory opinions that, among other things, the following services or forms of entertainment are really sales of software when provided over the Internet: 1) e-learning courses; 2) information technology courses; 3) mail-tracking services performed for airlines; 4) loan origination and processing services; 5) automobile insurance policy services; 6) payroll processing services; and 7) video games played on computers located at a business' facility.

Arguments and Responses

What is the legal basis for the position taken by the Department in these recent advisory opinions?

First, as a general rule, states impose sales taxes on items of tangible personal property -- items that can be perceived by the senses, such as a hammer, a desk or a car. Even though prewritten or canned software (software that is not custom-written for the purchaser) is really intellectual property that is usually licensed to users, during the 1970s the states decided -- through legislation or litigation -- that such software was, or was to be treated, in the same manner as tangible personal property and thus was subject to sales tax.

Second, the Department is asserting that a purchaser of an online service is controlling the software on the provider's server Manage and monitor your systems with Landscape for Ubuntu. Free 60 day Trial. by clicking various icons on his or her own computer screen, and thus the purchaser has control over the software; hence the software has effectively been "transferred" to the purchaser. Accordingly, the Department is taking the position that the purchase of an online service is really the purchase of a license to use software, even though the software is being used by the service provider on its own server. What is wrong with the Department's analysis?

First, the intent of the purchaser (often called the "true object" test), which is usually controlling in sales tax analysis, is to have a service performed, not to acquire software. For example, when a purchaser buys an online educational course, the true object is to obtain education in a particular area and not to receive software. The purchaser may not even think the service involves receiving any software at all, especially since the course is hosted on the seller's server and the customer is not able to download the course.

Additionally, and perhaps more crucially, software has not been transferred, because the purchaser does not really control the software. The purchaser has no ability to affect the seller's operating system Manage and monitor your sys-

tems with Landscape for Ubuntu. Free 60 day Trial. or hardware, both of which are necessary for the software to be used. Moreover, the customer cannot change the software, relicense it, alter its color scheme, or affect how the software is used by any other purchaser.

The Department, in a somewhat schizophrenic yet convenient manner, is saying on one hand that the purchaser is remotely using the software on the seller's server (often located outside New York) -- but on the other hand that the software is being used at the customer's location in New York and so tax is due (and must be collected by sellers) with respect to all sales made to New York purchasers.

Far-Reaching Implications

This is not only a New York issue. Several other states are closely monitoring what New York is doing and are considering taking the same approach (in no small part to increase sales tax revenues during a particularly challenging time). Of course, if a state's legislature wishes to tax such transactions, it can do so. But this should be done by a duly enacted law, as the State of Washington has done.

What is perhaps most disconcerting about New York's approach is that it is being done in the absence of a legislative mandate. In fact, the New York legislature previously considered -- but then declined to enact -- legislation that would have provided for sales taxation of "digital goods" -- items such as MP3s that are downloaded over the Internet. Accordingly, the Department is ignoring clear signals from the legislature with respect to taxing electronic commerce, and is attempting to tax electronic commerce based on its own highly aggressive and questionable interpretations of existing law.

Why should sellers of online services care?

The sales tax is a transfer tax, and sellers collect the tax from purchasers and remit the tax to the Department. However, when a seller fails to collect and remit any tax due, the seller itself becomes liable for the tax, interest and possibly penalties. The Department has not been content simply to apply its new position going forward, but rather has been seeking to apply its position retroactively on audit as well.

There have been instances of the Department auditing online service providers and assessing sales tax as far back as 2005, even though the Department's first clear administrative guidance with respect to its new position dates from November 2008 (and even though the Department issued administrative guidance in February 2006, that seems to conflict with its present position).

What will happen next?

It seems clear that some taxpayer -- an online service provider that did not foresee the Department's new position and understandably did not collect the tax for past periods, and now is being held responsible for several years worth of back taxes, or perhaps even a customer -- will challenge the Department's position in court. One can only hope that the court will review the situation in a fair-handed, careful way and conclude that New York's position is contrary to settled law. Stay tuned.

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