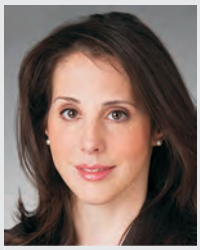
How to Defend a Remote Access To Software Sales Tax Audit, Part I

by Leah Robinson and Evan Hamme



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In Part I of a two-part article, Robinson and Hamme provide a roadmap for challenging a "remote access" audit by the New York State Department of Taxation and Finance, which has routinely taken the position that charges for application service provider services, software as a service, or other online services may be subject to New York sales tax as licenses of software, thus sales of tangible personal property.

Part II of this article will provide a comprehensive table describing every remote access advisory opinion published to date. The table may help taxpayers sort through the department's voluminous (and somewhat inconsistent) guidance.

Since late 2008, the New York State Department of Taxation and Finance has routinely taken the position that charges for application service provider (ASP) services, software as a service, or other online services may be subject to New York sales tax as licenses of software, which are taxable as sales of tangible personal property. Some sellers began collecting sales tax on this basis, and the department has audited and assessed many sellers who did not.

We have been critical of the department's position since its beginning, and we often advise companies to challenge the department's position, both as a matter of law and based on the seller's particular facts. Some taxpayer approaches have proven more successful than others.[1] Various items of published guidance and our own experiences together provide a roadmap for challenging a "remote access" audit.

This article takes a journey down that road.

I. The First of the Worst: *Adobe Systems Inc.*

The department published its first advisory opinion asserting that online services constitute software licenses in *Adobe Systems Inc.* (*Adobe*).[2] Adobe Systems Inc.'s service enabled customers to upload an image onto its servers (located outside New York) and to manipulate the image to show it from different angles and in different colors. Adobe's customers (some New York-based taxpayers) used login information to access the service over the Internet, but the customers neither took possession of anything tangible nor downloaded any software from Adobe.[3] Nonetheless, the department concluded that Adobe transferred software to its customers.[4] The department reasoned that Adobe's customers took "constructive possession" of the software and gained "the right to use, control or direct the use" of the software.[5] Further, and somewhat inconsistently,[6] the department sourced the sale to the customer's location rather than the location of Adobe's servers.[7]

The department's opinion in *Adobe* relies on several assumptions (some might call "mischaracterizations") regarding how online services are provided.[8] For example, a taxable transfer of tangible personal property requires there to be a transfer of an attribute of ownership from the licensor to the

[1] *See, e.g.*, TSB-A-09(33)S (Aug. 13, 2009); TSB-A-10(6)S (Feb. 17, 2010); TSB-A-10(14)S (Apr. 8, 2010); TSB-A-10(20)S (May 6, 2010); TSB-A-10(38)S (Aug. 20, 2010); TSB-A-10(40)S (Sept. 15, 2010); TSB-A-10(47)S (Sept. 29, 2010); TSB-A-10(59)S (Nov. 23, 2010); TSB-A-10(60)S (Nov. 24, 2010).

[2] TSB-A-08(62)S (Nov. 24, 2008).

[3] *Id.*

[4] *Id.*

[5] *Id.* (*citing* 20 N.Y. Comp. Codes R. & Regs. section 526.7(e)(4)).

[6] Sales of tangible personal property are normally assigned to where delivered, which would be the location of the server since nothing is downloaded. Sourcing based on where accessed is more akin to rules for sourcing receipts from services.

[7] TSB-A-08(62)S.

[8] Of course, the facts presented in an advisory opinion are only as good as the facts presented by the party requesting the opinion. Detailed, technical descriptions of facts should always be provided to and discussed with the department.

licensee.[9] This can be a transfer of "(i) custody or possession of the tangible personal property, actual or constructive; (ii) the right to custody or possession of the tangible personal property; or (iii) the right to use or control or direct the use of tangible personal property."[10] Even though the opinion acknowledges that Adobe's customers received no download of software, the opinion assumes that the "accessing of [Adobe's] software by [Adobe's] customers constitutes a transfer of possession of the software because the customer gains constructive possession of the software, and gains the 'right to use, control or direct the use' of software. [Adobe's] customers have the right to use the software to upload images of their products and to manipulate those images to display various colors and views of the products."[11]

This disregards the actual mechanics of online services. Customers do not "access" an ASP's *software*. Instead, ASPs use their proprietary software to provide services to their customers, often with no transfer of any attributes of ownership of the ASP's software.

In fact, more recent advisory opinions seem to recognize this distinction. The *Adobe* opinion is only a page and a half long, and the department did not provide exhaustive analysis. Later advisory opinions reiterate the department's position but also put some important limits on when such rationale would apply.

II. The Evolution of Stance

During the year following *Adobe*, the department maintained a formalistic approach to the taxability of online services. If the taxpayer and customer used the word "license" in their agreement, the department found the transaction taxable.[12] In some opinions, the department would note additional facts surrounding the license. In one opinion, the department noted that the customer could make copies of the software and could elect to host the software internally.[13] Another opinion noted that, while parts of the agreement referred to the vendor's "services," an annex to the agreement granted a "license to use" the vendor's payroll software.[14] Thus, when licenses were explicitly involved, the department usually concluded the transaction was taxable.

The department concluded that some transactions were licenses without providing a meaningful description of the facts[15] and also treated some arrangements as licenses of software even when there was no explicit "license" language or terminology presented in the facts.[16] The theme clearly remained that online services resulted in the constructive possession of software.

However, in late 2009 the department published an advisory opinion foreshadowing a new, fact-specific approach to analyzing online services.[17] The department finally recognized that the seller itself used its own software to provide one of its services to customers.[18] Because the taxpayer's employees authored and used software on a customer's behalf, the customer was outsourcing logistics management rather than licensing software.[19]

This reasoning carried forward into 2010. The department began acknowledging more readily that software could be incidental to a seller's nontaxable service.[20] The department continued to find online services involving some type of "license" not taxable in some circumstances.[21] In these opinions, sellers were able to demonstrate that the nontaxable element of their service should control, even though the service was provided online. This included the services of providing information technology consulting and management;[22] matchmaking or dating services;[23] and litigation support.[24]

The department also clarified its treatment of specific services that often involve both some software element and a service traditionally taxable under the New York tax law. The most notable category was information services, which are taxable unless the information is personal or individual in nature.[25]

Thus, over several years, the sales tax landscape changed dramatically. Today, the department's conclusions are hard to predict, sometimes reflecting a formalistic approach and sometimes reflecting a functional approach.

III. Strategies for Defending a New York Remote Access Sales Tax Audit

There are three techniques taxpayers should consider when defending a remote access sales tax audit or requesting an advisory opinion. First, be very specific and technical

[9] *See, e.g. Bathrick Enterprises Inc. v. New York State Tax Comm'n.*, 27 A.D.2d 215 (N.Y. App. Div. 3d Dep't 1967); 20 N.Y. Comp. Codes R. & Regs. section 526.7(e)(5).

[10] 20 N.Y. Comp. Codes R. & Regs. section 526.7(e)(4).

[11] TSB-A-08(62)S.

[12] TSB-A-09(19)S (May 21, 2009); TSB-A-09(25)S (June 18, 2009); TSB-A-09(37)S (Aug. 25, 2009); TSB-A-09(41)S (Sept. 22, 2009).

[13] TSB-A-09(19)S.

[14] TSB-A-09(37)S.

[15] TSB-A-09(41)S.

[16] *See, e.g.*, TSB-A-09(44)S (Sept. 24, 2009).

[17] TSB-A-09(33)S (taxpayer received client data, and taxpayer's staff performed operational tasks for client on daily basis).

[18] *Id.*

[19] *Id.*

[20] TSB-A-10(6)S (data warehousing service); TSB-A-10(14)S (IT support service); TSB-A-10(20)S (litigation support service); TSB-A-10(40)S (dating service); TSB-A-10(59)S (e-discovery litigation support service); TSB-A-10(60)S ("data viewer" litigation support not taxable except when selling software used to capture, review, or manage data).

[21] *See, e.g.* TSB-A-10(6)S.

[22] TSB-A-10(14)S.

[23] TSB-A-10(40)S.

[24] TSB-A-10(20)S; TSB-A-10(59)S; TSB-A-10(60)S.

[25] *See, e.g.*, TSB-A-10(32)S (July 23, 2010) (taxable); TSB-A-10(38)S (not taxable); TSB-A-10(45)S (Sept. 24, 2010) (taxable); TSB-A-10(47)S (split).

when describing your services. Second, when appropriate, emphasize the aspects of your service that could not possibly come in a shrink-wrapped box — aspects like employee involvement in the client service process or the role that proprietary or third-party data or connectivity plays in your service. Finally, be prepared to demonstrate that the primary purpose of your service is something other than a software license and is nontaxable.

A. Let's Get Technical

A point perhaps obvious but worth stating is to accurately and completely describe how you provide your service and what your clients can — and cannot — do. The remainder of this section will assume that either a user accesses your website (with or without login credentials) via the Internet and enters some data that triggers some functionality by pressing an "enter"-type button with the mouse cursor or by typing some command, or, alternatively, after accessing your website, a user does not enter data but can select from a variety of reports or functions, again by selecting with the mouse cursor or by typing a command.

You should indicate whether your client downloaded anything and, if so, be sure to indicate whether there is a separate fee for the downloaded portion (or whether the downloaded portion is explicitly available for free).

You should indicate what happens — from a technical perspective — when a client takes some action (such as entering data) and then triggers functionality. Specifically, is a client actually altering software (that is, rewriting source code) or merely causing some data file to change? For example, when a user purchases a non-downloaded digital item, the user has probably not altered the seller's source code but has caused a change in the data file associated with that user's account. New York guidance clearly dictates that a flat file (for example, database content) "itself is not software and does not contain code."[26] Therefore, downloading such files is not subject to sales tax, and should not be subject to sales tax when client's access the altered data.[27] Preparing a full statement of facts may require coordinating with your IT team, but it is worthwhile in the long run.

Keep in mind that regardless of what you tell the audit team, it will usually (and appropriately) give substantial credence to the language in your contracts and user agreements, as well as the descriptions contained on your company's website and other marketing materials. So even the most artfully written discussion of the true mechanics of your online service will go by the wayside if your website expressly states that you license software for your customers to use. We know your business operations and internal legal team will balk at the idea of removing all references to a user license agreement from your website or other materials, so we will not even make the suggestion. Still, if you have the ability to minimize contractual references to a "software license" and instead have contracts focus on the provision of a service (that may include some element of a license to access the results of your own use of software), you will be better poised to defend against a remote access to software assertion.

B. Think Outside the Shrink-Wrapped Box

In our experience, the single most influential factor in reaching a nontaxable conclusion is to focus on the aspects of your online service that could not possibly be a part of shrink-wrapped software. After all, if your online service functions identically to a software product that could be purchased in a shrink-wrapped box, except that instead of running from a diskette, the software runs from your server, it is very likely the department will conclude your online service is taxable as software.[28] On the other hand, if your service involves human involvement or is fully functional only if the service incorporates proprietary or third-party data points that are constantly being updated or changed — in other words, no matter how big the shrink-wrapped box, your service simply would not fit inside it — then your service looks a lot more like something other than mere access to software.

The "human touch" comes into play at several levels. Of course, humans are creating the initial programming that underpins an online service. But other human involvement is often required. This includes the efforts of your IT team to update and monitor the functionality of your software, as well as non-IT efforts. For example, if your online service requires you to onboard third parties that contract with your client or will provide benefits to your clients through your service, those efforts should be detailed.

Similarly, the role of proprietary and third-party data (which we will refer to together as "external data points") ought to be described. For clarity, we mean elements of functionality that change regularly, especially when the constantly changing nature of the data is critical to the functionality of the online service. For example, an online identity verification service will fully function only if it constantly accesses various external data points, such as data from the Social Security Administration, federal and state crime watch lists, and other sources. Even if a snapshot of all available external data points at a single moment could be captured and stored on a diskette, that diskette would become obsolete the minute it was created. The functionality of the service depends on access to the external data points. In this scenario, it should be easier to demonstrate that the seller itself uses its software to cull the various external data points to provide identity verification to the customer.

[26] *See* TSB-A-11(14)S (May 3, 2011).

[27] *Id.*

[28] Of course, we still believe that insufficient possession is transferred in this scenario, as the user cannot actually (or even "constructively") use, control, or direct the software source code itself. *See* Arthur R. Rosen, Robinson, and Hayes R. Holderness, "Cloud Computing: The Answer Is 'No,'" *State Tax Notes*, Oct. 8, 2012, p. 101.

Similar examples of services that require external data points are social gaming services (where the draw is social interaction with other users, as opposed to merely playing against one's self or "against the computer") and various logistics outsourcing services that assist retailers with their supply chain or distribution management by connecting suppliers and retailers. The value of these services rests on external data points that constantly change and are separate from the software the seller uses to process and deliver content or results. This type of service — even if provided entirely online with no direct human-to-human interaction between seller and customer — should not be treated as a license of software. The service simply would not fit in a box.

C. Characterize Your Online Service as Traditional

To avoid being mischaracterized as remote access to software, consider describing the primary purpose of your service as akin to another service the department has previously considered to be excluded from the list of taxable services.[29] Obvious categories include data processing,[30] logistics management,[31] and information services (that are personal in nature and are not contained in reports provided to others). A less obvious category is "computing power."[32]

It's important to note that some services are subject to sales tax in New York even if no software is involved (for example, some information services or telegraphy services). So be sure to fully understand the implications of your primary purpose position.

IV. Conclusion

While the department continues to assert that many online services are taxable as licenses to use software, sellers should not simply roll over and collect. Engaging in meaningful discussions with the audit team or the department's office of counsel often reveals an approach with which the department can conclude that a particular online service should not be taxable as a license of software. ☆

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[29]Services are to be taxed according to their primary function. *See Matter of SSOV '81 Ltd.*, Tax Appeals Tribunal (Jan. 19, 1995).

[30]TSB-A-15(20)S (May 26, 2015).

[31]TSB-A-10(14)S; TSB-A-13(12)S (Apr. 23, 2013).

[32]TSB-A-15(2)S (Apr. 14, 2015) (petitioner used advertising and marketing material to demonstrate that its clients' primary motivation was to acquire additional computing power, a function traditionally associated with hardware).