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Taxation of Internet-Based Software Sales: Examining Recent Trends in New York

by Timothy P. Noonan and Joseph N. Endres

Well, it's that time of year again. Tax season is in full swing. And although income taxes are the focus, tax season always reminds us of some *sales tax* issues, too. Millions of New Yorkers will have their annual tax returns prepared by accountants. When a New Yorker hires an accountant to prepare a return, the transaction is not subject to sales tax because those services are not taxable under New York's tax law. Slightly more adventurous individuals will purchase one of those popular software programs that allow taxpayers to prepare their own tax returns. When New Yorkers buy those software programs from local stores, they pay sales tax on the transaction because the sale of prewritten computer software is taxable in New York state.[1]

But what about a combination of those two situations? For example, some accounting firms now allow taxpayers to prepare and file their taxes online through the firm's Web site or other online portal. The Web site allows taxpayers access to tax preparation software that is similar to the software sold in retail stores. However, the accounting firm may also provide live, online support to answer any questions the taxpayer may have when completing the forms. The firm essentially gives taxpayers access to accountants, who guide the taxpayers through the return preparation process. In this instance, is the taxpayer purchasing a nontaxable tax preparation service or a taxable license to use software?

Obviously that taxability issue extends beyond tax preparation services. It has lurked in New York sales tax audits for years, and has become increasingly prevalent as more and more vendors are providing services via the Internet. The New York Department of Taxation and Finance has begun to take an increasingly aggressive approach toward those online transactions. And in some cases, auditors appear to be adopting a presumption of taxability whenever services are transferred via the Internet. In those situations, the general thinking -- flawed as it may be -- is that because the Internet is powered by software, services transferred via the Internet must be sales of software.

Recently, the department has issued a slew of new advisory opinions addressing some of those thorny "software versus services" arguments. We'll review some of those arguments in this article and do our best to figure out where the department's current thinking is. As you'll see, we're not going to find any clear answers.

The Primary Function Test

But let's start with some background. How can taxpayers distinguish between a nontaxable service and a taxable sale of software? The New York Tax Appeals Tribunal has adopted the "primary purpose" test. The tribunal previously examined a taxpayer that provided a dating service to its members.[2] The taxpayer circulated member profiles (videotaped interviews, biographies, and so forth) in the hopes of facilitating dating among the members. The tax department attempted to characterize that as a taxable information service. However, the tribunal concluded that the taxpayer was providing a nontaxable dating service. In applying the primary purpose test, the tribunal focused on the service in its entirety, as opposed to reviewing the service by components or by the means in which the service is effectuated:

> We cannot accept the [tax department's] argument that the means by which a service is provided is the controlling factor in determining whether the subject service is taxable. To neglect the primary function of petitioners' business in order to dissect the service it provides into what appear to be taxable events stretches the application of [the sales tax] far beyond that contemplated by the Legislature.[3]

Based on that analysis, when a taxpayer uses proprietary software as the means to provide a service, the transaction is not automatically taxable as a sale of software. The tax department must look at the transaction as a whole.

Overview of Recent Rulings

In the last few years, the department has issued numerous advisory opinions touching on that primary function test in the software context. Several have come within the last couple of months. We've also seen some cases in which the issue has arisen. Here are some highlights:

Ernst & Young, LLP -- The taxpayer sold Internet filtering services that employers could purchase to restrict their employees' access to the Internet. The software-based service updated nightly to keep its list of acceptable and restricted Web sites current. The tax department determined that this was a taxable sale of prewritten computer software because the software was transferred to the customer. Moreover, the customer established policies that the software would use when controlling Internet access. Thus, the customer, rather than the seller, used the software in performing the Internet access services.[4]

Matter of Voicemate.com, Inc. -- In this administrative law judge opinion, the taxpayer used software to provide end-to-end services that helped businesses instantly publish, manage, and deliver branded, personalized information to their customers over mobile phone, PC, or hand-held devices. The ALJ determined that the taxpayer was using the software to provide a service rather than selling the software itself. A critical point in this case was that the customer could not access the software and it was not loaded onto the customer's servers or computers.[5]

Connected Corp. -- In this advisory opinion, the taxpayer sold software-based data storage and retrieval services. Customers would use the taxpayer's software to access and store their data on the taxpayer's servers. Software was transferred to the customers' computers, but the software could not be used by itself without a corresponding storage subscription. Using a primary function analysis, the tax department determined that the taxpayer was providing a nontaxable storage service. When the taxpayer sold a version of the software that would allow the customer to perform storage services on its own servers, the transaction constituted the taxable sale of prewritten computer software.[6] As you read through some of the advisory opinions that have come out more recently, ask yourself whether the department's analysis would still be the same today.

Matter of DZ Bank -- Here, the taxpayer provided four different software-based products that analyzed portfolio risk and provided financial analysis of various businesses to determine investment risk. Three of the services were governed by a license agreement, while one was not. Largely because of the language in the agreement, the three products were held to be taxable sales of prewritten computer software. Those products (software and databases) were installed on the customer's computers and updated monthly via CD-ROM. The product not governed by the agreement, though remarkably similar to one of the taxable products, was held to be a nontaxable financial consulting service. That product differed from the taxable products because it was accessed via the Web, updated daily, and required the user to input data that would be immediately analyzed by the seller's software.[7]

Icor Systems, LLC -- Now we're getting to the more recent rulings. You'll see the tide start to turn more toward taxability. This taxpayer created Internet cafes at which customers could buy time on a computer to access the Internet. For a basic fee, customers could surf the Web, access e-mail, and view documents in Microsoft Word, Excel, or PowerPoint viewers. Customers using the basic services could not edit documents using those programs. Customers who paid a premium in addition to the basic fee were allowed access to the Microsoft programs to edit documents. The tax department determined that the basic plan was a nontaxable Internet access service. However, the premium charge represented a taxable sale of prewritten computer software.[8]

Adobe Systems, Inc. -- The taxpayer sold a software-based marketing service. Customers were given access to a software product that allowed them to upload an image onto the taxpayer's servers and manipulate the image to show various colors and views of the item. When offering the item for sale on its Web site, the customer could then provide a link to that image. The tax department concluded that the taxpayer was selling taxable prewritten computer software even though the software was not transferred to the customer. The sales agreement specifically granted to the customer a license to use the taxpayer's software.[9] Can you square that with the *Connected Corp.* opinion above? The line is starting to get a little blurry.

KPMG LLP -- In this advisory opinion, the taxpayer sold automated voice messaging services. It used specialized software to make phone calls and deliver an automated voice message (for example, flight information to airline customers, bill pay notifications to credit card holders, telemarketing services, and so on). The tax department concluded that the taxpayer was selling a nontaxable service because the software was not transferred to the customer and the customer was not able to access the software. Thus, taxpayer used the software in performing its nontaxable service.[10]

XYZ Corp. -- In this case the taxpayer sold software that allowed financial institutions to edit and negotiate the terms of various financial instruments, such as bank loans. One product allowed the customers to negotiate and edit the terms of a loan. All information and edits, however, would be input by the taxpayer, who controlled the editing software at all times. A second product allowed the customers to enter information and edit the financial instruments themselves. The tax department held that the first product was a nontaxable service because the customer did not have access to or use of the software. The second product constituted a taxable sale of prewritten computer software, however, because the taxpayer had a right to use the software directly. Note that in both cases the sample contract between the taxpayer and its customers said the taxpayer was *not* transferring a license to use software. However, the tax department determined that language was not controlling in the face of the customer's use of the software.[11]

A Closer Look: Online Educational Services

As you can see, the line between what's taxable and what's not has been unclear in recent years. Nowhere is that more evident than in a review of recent department opinions in the field of online learning services. A close review of those rulings shows that, although the nature of some services remains the same, the department's view of them may be changing.

Tower Innovative Learning Solutions -- In this advisory opinion, issued in 2006, the tax department examined a for-profit learning subsidiary of Cornell University.[12] The taxpayer provided software to its customers that helped teach the customer various professional development skills and, on completion of the software course, awarded a certificate of completion. It also provided academic support to customers enrolled in the certificate programs, including answering customer's e-mail, hosting online discussions, coordinating group projects, answering customer's phone calls, and providing on-site support to corporate purchasers with a large number of employees enrolled in a particular program. The department held that service to be nontaxable:

> Although Petitioner is conveying the course material to the students electronically via a software platform, the student's *primary objective* is to acquire credit toward a certificate for having completed and mastered the course material. Students are not purchasing software from Petitioner, but rather paying Petitioner to attend a course of study. Petitioner is not selling software to students. Presumably, Petitioner's *primary function* is to provide its students with a course of study. [Emphasis added.][13]

You can see that the language used by the tax department is focused on the primary function test. The tax department is concerned with determining the true objective of the transaction rather than simply focusing on the fact that the taxpayer used software to achieve that objective. As we examine the next two advisory opinions, we will see a shift in the focus of that language.

MindLeaders, Inc. -- In this advisory opinion, issued just last month, the tax department examined another company that provided "real-time, interactive, Web-based training and educational services."[14] Customers who completed the course received a certification from the taxpayer, later entitling them to: apply for continuing education credits through a select group of universities, obtain relicensure or recertification with state agencies and professional organizations, or provide to their employers as proof of their professional development activities. Sounds a lot like the *Tower* opinion, no? The only significant difference between this advisory opinion and *Tower* is that in *MindLeaders* the taxpayer segregated charges for the online course from charges for its live, online mentoring. Nonetheless, the tax department concluded that the charge to participate in the course was taxable because the transaction constituted the sale of prewritten computer software. And it distinguished this advisory opinion from *Tower* by saying: "This service is distinguishable from the on-line learning program found to be nontaxable in [*Tower*] because that service included, at no extra charge, significant non-automated academic support."[15]

But we're still left with some questions. First, what about the primary function test? It didn't come up at all in *MindLeaders*. Here, as in the *Tower* opinion, the primary function of the software is to teach the customer the necessary skills to advance professionally. The software is simply a means to achieving that objective. So while the facts in the two opinions appear similar, the analysis seems noticeably different, at least regarding the primary function test. Moreover, the tax department distinguished *Tower* by pointing to the fact that customers in *Tower* did not have to purchase mentoring separately; it was included in the cost of the program. But does that mean that the taxpayers could avoid sales tax by simply bundling services? Normally, the opposite is true: If you bundle taxable and nontaxable charges, it makes the entire charge taxable.[16] Whatever the case, the bottom line is that both the customer in *Tower* and the customer in *MindLeaders* could purchase and complete the educational course without ever having to access any resources outside the software program. So it's unclear whether that "mentoring" aspect is a viable distinction.

SkillSoft Corp. -- The use of that mentoring aspect in the department's analysis of online learning services is further blurred in its latest opinion, also issued last month, in which it examined another taxpayer that offered a software-based educational program.[17] Again, the taxpayer provided information technology (IT) skills courses that gave end-users the ability to gain the technical knowledge to perform their jobs and prepare for IT professional certifications. Of the different services the taxpayer offered, two are relevant to our discussion. The taxpayer's main product was a software-based course that featured "interactivity and reinforcement of learning transfer through frequent practice questions, simulations, and mentored (Mentoring Service) and self-assessed exercises." The Mentoring Service enabled the user "to ask questions relating to specific IT courses or the general subject matter of those courses and receive responses from experts in the field of information technology."[18] The taxpayer also occasionally provided both live and asynchronous video-based training that included interactive programs (Virtual Classroom).

The tax department concluded that the taxpayer's educational program was taxable as a sale of prewritten computer software while the Virtual Classroom was a nontaxable education service. In arriving at that conclusion, the tax department once again avoided any discussion of the transaction's primary purpose. Again, that used to be the benchmark in the software versus service analysis. Its absence in recent advisory opinions is noteworthy. But the department's application of the mentoring test raises more questions. For instance, customers using the SkillSoft product could seek additional guidance on *every assignment* completed through the software. But that wasn't enough for the department. It held that the customer's access to the mentoring services was simply "not sufficient" to transform the sale into a nontaxable service. But the department does not explain why that level of interaction is insufficient -- especially considering that a user could presumably obtain guidance on every assignment (or even every question) -- or exactly what level of interaction would be enough.

Conclusion

All of this leaves us with open questions. Indeed, it seems pretty clear that the customers in all three of the online learning opinions were making their purchases for the exact same purpose. To treat the purchases differently from a tax standpoint is going to create problems. Still, though we cannot provide a definitive test for determining whether an Internet-based service will be subject to New York state sales tax, it does appear we can find some guidelines in the above rulings and cases. Here are some things to look out for:

- Does the customer receive a copy of or have access to the software? If so, the transaction is not automatically taxable, but it will be more difficult to prove that the transaction is a nontaxable service. If the customer does not have access to or "touch" the software, it is unlikely that a taxable sale of software has occurred and the seller is probably using the software to perform a service.

- Although this may be another way of asking the same question, it's always important to figure out who exactly is *using* the software. Is the seller using the software to provide a nontaxable service? Or is the seller licensing the software to the purchaser for the purchaser's own use?

- Pay attention to the language in the sales contract. Though this language is not controlling, how the parties characterize the transaction is still an important aspect of the tax department's analysis. When no software is transferred to the purchaser, the seller should avoid characterizing the transaction as a sale or license to use

software. We've seen some sloppiness in sales contracts create problems in audits.

- Also be careful how the product/service is marketed. Marketing or business development people describing what the product is all about may not be tuned in to sales tax issues. Like problems caused by contractual language, we've seen sloppy wording on client Web sites that hurt them in a sales tax audit.

- Once a contract is executed, ask yourself whether the purchaser can use the software to complete the transaction without any additional activity by the seller. If so, the software appears to be the focus of the transaction. If the seller brings expertise to the transaction apart from the software, or otherwise is required to perform further services to satisfy its contractual obligation to the purchaser, the transaction looks more like a sale of a service.

- And while the department seems to have at least temporarily forgotten about the primary function test, the taxpayer should not. The taxpayer should be sure to ask herself what the primary purpose of the transaction is. For example, the goal of an Internet dating service is not to upload your picture and bio to the Web, or even to review other members' information. The purpose of the transaction is to facilitate dating among the members. Questions like those will help determine whether a sale is a nontaxable service or the taxable sale of software.

There is no doubt that this will remain a hot topic in sales tax, especially as software becomes more complex and handles more activities traditionally done by people. That the rules, at least for now, seem to be in flux may also help keep this issue alive. We can only hope that our careers end long before a software program can provide legal advice or write pithy articles for *State Tax Notes*.

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Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y. This column was cowritten by Joseph N. Endres, an associate with Hodgson Russ LLP.

FOOTNOTES

[1] Sales of customized software in New York are not subject to the state's sales tax. *See* N.Y. Tax Law sections 1101(b)(6), (14). *See also Aviation Software, Inc.*, TSB-A-09(6)S (Jan. 30, 2009).
[2] *Matter of SSOV '81 Ltd.*, Tax App. Trib. (Jan. 19, 1995).
[3] *Id.*
[4] *Ernst & Young, LLP*, TSB-A-03(28)S (June 24, 2003).
[5] *Matter of Voicemate.com, Inc.*, ALJ (June 2, 2005).
[6] *Connected Corp.*, TSB-A-05(40)S (Oct. 26, 2005).
[7] *Matter of DZ Bank*, ALJ, (May 1, 2008).
[8] *Icor Systems, LLC*, TSB-A-08(47)S (Oct. 16, 2008).
[9] *Adobe Systems, Inc.*, TSB-A-08(62)S (Nov. 24, 2008).
[10] *KPMG LLP*, TSB-A-09(5)S (Jan. 29, 2009).
[11] *XYZ Corp.*, TSB-A-09(8)S (Feb 2, 2009).
[12] *Tower Innovative Learning Solutions*, TSB-A-06(5)S (Feb. 2, 2006).
[13] *Id.*
[14] *MindLeaders, Inc.*, TSB-A-09(2)S (Jan. 21, 2009).
[15] *Id.*
[16] 20 NYCRR 527.1(b) (also referred to as the "cheeseboard rule").
[17] *SkillSoft Corp.*, TSB-A-09(3)S (Jan. 29, 2009).
[18] *Id.*