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The Nuts and Bolts of Sales Taxation Of Investment Research

by Timothy P. Noonan and Joshua K. Lawrence

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For roughly the last two decades, the New York Department of Taxation and Finance has been at the forefront in the enforcement of the state's sales tax on information services. During that time, the department has been vigorous in its pursuit of companies in the information services industry for sales tax, and correspondingly, there has been a constant flow of litigation regarding the nature and scope of New York's tax on information services. Just last year, we covered these issues in some detail in an article that addressed the tax department's most recent policy changes and enforcement efforts.[1]

In this column, we would like to focus on a more specific issue: developments in the taxation of investment research. Over the past few years, tax department auditors have turned their focus away from the typical information services provider and toward research providers and others in the financial services industry. This enforcement has come as a surprise to many, and taxpayers who historically never found themselves dealing with sales tax issues (such as broker-dealers) have found themselves mired in difficult and lengthy sales tax audits. As is often the case, once the department starts stepping up enforcement efforts in an area, we naturally are forced to face the complicated sorts of questions that result from those audits. In this article, we'll provide a nuts-and-bolts discussion of the tax on information services as applied to the investment research field, as well as some practical guidance on how to handle issues before or during an audit.

Sales Tax on Services, the Basics

First, though, let's provide some background on New York's information services tax. Generally, as most readers of this publication know, New York imposes sales taxes on all sales of tangible personal property, unless a special exemption applies.[2] Services, however, are treated differently. Only those services that are enumerated in the tax law are subject to tax.[3] Information services are one of the relatively few statutorily services enumerated in the tax law. Tax Law section 1105(c)(1) provides for a tax on the "furnishing of information by printed, mimeographed or multigraphed matter" or any other method of duplication "including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons."[4] The tax, however, is not imposed on the furnishing of information that is personal or individual in nature and that is not (or cannot be) substantially incorporated into reports furnished to other persons.[5] According to the tax department's regulations, "stock market advisory and analysis reports" are subject to tax as a form of information services.[6] And the regulations further provide a specific example confirming the taxable status of stock-based research reports:

> A company publishes and distributes weekly and daily reports on corporations, corporate

[1]Timothy P. Noonan and Mark S. Klein, "Information Services: Taxation by Administrative Fiat," *State Tax Notes*, Oct. 4, 2010, p. 63, *Doc 2010-20524*, or *2010 STT 191-7*.

[2]Tax Law section 1105(a).
[3]*See* Tax Law section 1105(c).
[4]Tax Law section 1105(c)(1).
[5]*Id.*
[6]20 NYCRR section 527.3(a)(3).

securities, and bonds. The publications . . . constitute a taxable information service.[7]

The tax department has confirmed that treatment in published rulings as well. In one advisory opinion, it ruled that a newsletter containing a combination of analysis and recommendations concerning the purchase or sale of specific stocks, as well as some limited financial news, constituted a taxable information service under Tax Law section 1105(c)(1).[8]

The Personal and Individual Test

As noted above, New York's tax on information services does not apply to reports that are personal or individual in nature.[9] What does that mean? For purposes of investment-related research reports, there are two important considerations. The first is fairly straightforward. If more than one person is getting the same report, the personal and individual test is not going to be met. That's the easy case. The more complicated situation arises in connection with New York's so-called common database rule. Under that rule — which has been developed through a long line of cases — the exclusion from tax regarding information that is personal and individual in nature will not apply if the information supplied to the customer includes information culled from a common database of information.[10] So, for instance, if a research client asks a research provider to check its database and provide information concerning the performance of a specific stock over the last three years, the research provider will be providing one report to one person in answer to a specific question. However, the tax department would still view this as falling outside the personal and individual exclusion because the report would be created from a common database of information — the same information pertinent to the stock performance would be capable of being "substantially incorporated into reports furnished to other persons" under Tax Law section 1105(c)(1) (for example, if another research client were to request a report on the same stock's performance).

The common database rule has been applied over the years to bring numerous types of reports and research services into the information services fold — even when the research or information requested results in a report tailored to a client's needs. For example, in the often-cited *Rich Products Corp. v. Chu*,[11] the New York State Appellate Division upheld a sales tax assessment of a company that provided grocers with customized, comparative marketing reports analyzing sales of products competing with the grocers' own specified products during a particular period and in a specified geographical area. Despite acknowledging that it was unlikely that any two customers would ever receive the same report, the court nonetheless held that the provision of information from "a single data repository which itself is not confidential and is widely accessible" would prevent the information from being truly personal or individual in nature.[12]

> ***Companies in the information services industry should be aware that a wide range of research-related products and services would not be subject to New York sales tax.***

That should provide a pretty good indication of what is generally taxable and what is excluded in terms of research reports. Reports provided to a wide audience as well as individually tailored research reports that contain information gleaned from a common database will generally be subject to New York's tax on information services.

What Is Not Taxable?

Despite those guidelines, companies in the information services industry should be aware that a wide range of research-related products and services would not be subject to New York sales tax. Here are some examples:

Periodicals

In the past, many of our clients have successfully asserted that the reports they provide are not taxable because they qualify for the periodical exemption under Tax Law section 1115(a)(5).[13] To constitute a periodical under this exemption, a publication must conform to the following requirements:

- it must be published in printed or written form at stated intervals, at least as frequently as four times a year;
- it must not, either singly or when successive issues are put together, constitute a book;
- it must be available for circulation to the public;

[7]20 NYCRR section 528.6(c)(3)(ii), Example 7.

[8]*See Generic Stock Investment Service, Inc.*, TSB-A-88(44)S (Sept. 13, 1988).

[9]Tax Law section 1105(c)(1).

[10]*See Towne-Oller & Assocs. v. State Tax Com.*, 120 AD2d 873, 502 N.Y.S.2d 544 (3d Dept. 1986); *Westwood Pharms. v. Chu*, 164 AD2d 462, 564 N.Y.S.2d 1020 (3d Dept. 1990); *Rich Products Corp. v. Chu*, 132 A.D.2d 175, 521 N.Y.S.2d 865 (3d Dept. 1987).

[11]*Rich Products Corp. v. Chu*, *id*.

[12]*Id.* at 178.

[13]*See, e.g.*, *Value Line Publishing*, TSB-A-97(24)S (Apr. 11, 1997), *Economic Cycle Research Institute*, TSB-A-97(42)S (July 23, 1997).

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- it must have continuity as to title and general nature of content from issue to issue; and
- each issue must contain a variety of articles by different authors devoted to literature, the sciences or the arts, news, some special industry, profession, sport, or other field of endeavor.[14]

Of course, investment research providers can run into problems while seeking to conform to that exemption. Is the report available only electronically? If so, the first requirement is probably not met.[15] Can only some subscribers obtain the report? Here again, we would have an issue under the third requirement. And companies often struggle with the "articles" requirement, with auditors asserting that charts, graphs, and other data reports lack the necessary articles the regulation requires. Whatever the case, the presence of the periodical exemption does provide a planning opportunity for companies engaged in providing research reports.

Individualized Consulting

Consulting services are not one of the enumerated services in New York's tax law. Thus, investment research providers who perform individual consulting services for their clients won't be required to charge sales tax on the consulting aspects of their services, provided those services are separately billed and don't conflict with the "cheeseboard rule," discussed below. Nonetheless, the line between individualized consulting and taxable information services is often a blurry one — in large part because of aggressive auditors and improper interpretations of taxpayers' businesses.

> ***The tax department often lumps consultants and information service providers in the same category.* Nerac *shows that ALJs may take a different view.***

This played out just last year in an administrative law judge case involving a scientific research firm. In *Matter of Nerac, Inc.*,[16] the taxpayer specialized in providing technical, scientific, and engineering research to emerging technologies companies. Its staff contained 100 highly trained scientists, engineers, and other professional analysts from a variety of disciplines. In a typical project, a client would request assistance on a particular topic (for example, the client's attempt to invalidate a competitor's patent) and would be matched with an appropriate analyst who would consult with the client to determine the research needed. Although the analysts used a variety of databases (private and public) and other sources, they also used their own expertise to help solve the client's problem. The tax department's Audit Division argued that despite the customization of the research, the resulting reports contained information that could be included in reports to others. However, the ALJ looked to the "primary function" of the taxpayer's services and held that although the service undeniably involved the "furnishing of information," the taxpayer's principal function involved "giving guidance and advice, based on analysis."[17]

> Petitioner's role, as carried out by its Analysts, is clearly distinguishable from the admittedly taxable services of simply retrieving, collecting, compiling and furnishing information. Petitioner employs . . . highly skilled, educated and experienced "problem solvers" who function as consultants. Petitioner's clients subscribe to petitioner's service for the primary purpose of obtaining guidance, advice, input and direction to or toward solutions to resolve technically difficult problems.[18]

So research providers should take note of issues like this. The tax department often lumps consultants and information service providers in the same category. *Nerac* shows that ALJs may take a different view.

Out-of-State Sales

It goes without saying that sales of otherwise taxable information services to clients located outside New York wouldn't be subject to sales tax. Sometimes, however, questions arise concerning the allocation of taxable and nontaxable reports to out-of-state locations. That arises particularly in cases in which reports are accessed online or delivered electronically to multiple users spread across numerous states. Fear not, though: There are specific rules governing this situation as well. If the taxpayer is able to show that a certain number of users are located in another state, the sales tax burden can be reduced accordingly.[19] Based on the department's published guidance on this issue, however,

[14]20 NYCRR section 528.6(c)(1).

[15]Legislation is pending to extend the periodical exemption to include electronic news services and electronically delivered newspapers, journals, and magazines. However, the proposed legislation would limit the exemption to periodicals whose predominant purpose is to deliver news content. This would not include information relating to "compilations, databases and the like." S 5637, Sen., 2011 (N.Y. 2011); A 8223-A, Assem., 2011 (N.Y. 2011).

[16]*Matter of Nerac, Inc.*, DTA 822568, 822651 (July 15, 2010). For the decision, see *Doc 2010-16740* or *2010 STT 147-18*.

[17]*Id.*

[18]*Id.*

[19]*See, e.g.*, *KPMG LLP*, TSB-A-03(5)S (Jan. 31, 2003); *American Home Products Corp.*, TSB-A-91(6)S (Jan. 2, 1990); *Paul R. Comeau*, TSB-A-90(43)S (Aug. 20, 1990).

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taxpayers should make sure to clearly document the existence and location of out-of-state users via correspondence with their clients.[20] The research provider should acquire letters from its clients detailing all business locations where users will access the information or provide other details on the situs of the users. The weight given to that letter will depend on the amount of detail provided.[21] For example, if the research provider's customers will access reports electronically through use of passwords, the provider should request a breakdown from the client detailing each of its business locations and how many users at each will have a password.[22]

Commissions

The taxation — or lack thereof — of commissions also raises an interesting issue. There are many broker-dealers or other research providers who, in addition to providing their clients with investment research, also provide trading services. Normally the research isn't billed for separately. Instead, customers simply pay a commission for the trading services provided by the broker-dealer. Under current tax department policy, no sales tax is imposed on the commissions, even though the customer arguably could receive research as part of the service offered by the broker. Apparently, the view is that in this situation, the broker-dealer is consuming the research reports in connection with the provision of its nontaxable brokerage services. Currently, therefore, brokers' commissions are not taxable.

Mind the Cheeseboard Rule

The above examples demonstrate that some investment-related research and information can be provided without triggering sales tax obligations. However, research providers whose overall service consists of both taxable and nontaxable components (for example, generalized stock market research reports, along with personalized consulting) should be familiar with New York's cheeseboard rule. The premise of the rule is that when taxable and nontaxable items or services are sold as a single unit for a single charge, tax may be imposed on the entire amount of the receipt. The rule derives its name from a simple example in the tax department's regulations: "A vendor sells a package containing assorted cheeses, a cheese board and a knife for $15. He is required to collect tax on $15."[23]

In that example, normally nontaxable food becomes subject to tax merely because the vendor hasn't broken down the charges for the nontaxable and taxable elements of the sale on its invoice. Investment research providers should be careful to avoid similar bundling by separately stating the charges on its invoices for services that arguably fall outside the definition of information services under Tax Law section 1105(c)(1) (for example, personalized consulting).

Soft-Dollar Sales

A growing question in these sales tax audits concerns the taxation of soft-dollar arrangements. Here is how they generally work: In exchange for using the broker for trade executions services, the broker agrees to use some of the commission dollars as "soft dollars" to pay some expenses associated with the transaction. That often includes the customer's usage of investment research. Instead of directly paying for the investment research, the customer directs its soft-dollar broker to purchase research out of the commissions accrued to its account.

Although this has raised numerous questions over the years in the financial services industry, it seems that the sales tax answer here is pretty straightforward. Although there could be an argument that the soft-dollar broker is purchasing that investment research for resale to the client, the normal approach in sales tax audits is to treat the soft-dollar broker as the user of that investment research. Thus, sales tax is due on sales to the soft-dollar broker even though the ultimate customer could be classified as the user of that research. All that means from a sales tax perspective is that the research provider should be collecting sales taxes from whoever is paying its bill. If the customer pays it, sales tax is due from the customer. If a soft-dollar broker pays the bill, tax should be charged to the soft-dollar broker.

Audit Issues

So with all these issues, how do you handle a sales tax audit in this area? It reminds me of another question: How do you eat an elephant?

The answer to both is the same: one bite at a time. Investment research providers need to take a step-by-step approach to address and deal with all the different issues that can arise on audit. There can be lots of different ways to cut down the tax bill.

Here are some ideas:

Periodical Exemption. Sometimes it pays to be creative. Arguments can be made to classify a report as qualifying for the periodical exemption. Be sure to take that into account.

Unbundling. As noted above, the cheeseboard rule creates a lot of problems in this area. But those problems aren't unsolvable. And I will give credit here where credit is due. In most of the audits of investment research providers we've handled, the tax department has been incredibly reasonable in allowing for a sensible allocation between taxable

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[20] *See KPMG LLP*, *id*.
[21] *Id.*
[22] *Id.*
[23] 20 NYCRR section 527.1(b), ex.1.

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and nontaxable services, despite the strictures of the cheeseboard rule. So long as a rational method exists to differentiate between charges for taxable and nontaxable services, most auditors permit a "reverse-cheeseboard" allocation, provided the taxpayer fixes the issue going forward. In most cases, that seems only fair. Indeed, for many research providers, 80 to 90 percent of what they do falls outside the scope of information services subject to tax. Subjecting 100 percent of an invoice to sales tax when such a small percentage is in fact taxable is unfair and unreasonable, particularly for sales tax vendors who often lose the practicable ability to pass the tax along to their customers years after the transactions have occurred.

Consulting Services vs. Information Services. As noted above, be mindful of the consulting services issue. Too many times, we've seen sales tax auditors attempt to tax services when "information" is being provided by a consultant or other professional. Sometimes auditors need to be reminded that the tax is on information *services*, not on information. Indeed, if there was a tax on simply the furnishing of information, we lawyers better go get registered for sales taxes, as we are giving out information to clients all the time.

Overlapping-Audit Issues. Don't forget about the overlapping-audit rule. Because the tax department has been doing so much auditing in this area, many investment research advisers, broker-dealers, institutional investors, and others in the financial services industry are subject to repeated audits. What that means is that some investment research providers may have clients who were already audited and who already paid the tax. Make sure to check that out. And make sure to insist that auditors help you do that.

Out-of-State Sales. Make sure to pay close attention to this issue as well, particularly for research providers selling to soft-dollar brokers. In those cases, the paying broker often isn't the user. So if the paying broker is located in New York and the user is located in California, there shouldn't be a New York sales tax obligation. The burden again, though, is on the vendor to show that the user is located out of state. But this is often a way to whittle down the list of taxable items.

Conclusion

Companies in the financial services industry are often surprised to find that the eyes of the sales tax man are directed toward them. The good news is that there are arguments out there to allow companies to reduce their exposure and defend themselves on audit. As this article illustrates, there are many nuts and bolts that have to be taken into account. Practitioners that have a thorough understanding of these issues will be more than able to serve their clients effectively. ✰

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