What's Up With New York Auditing Wall Street for Sales Tax?

by Timothy P. Noonan


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In Note to Self, Noonan contemplates why the New York State Department of Taxation and Finance would initiate sales tax audits against Wall Street firms given the lack of sales tax activity these firms engage in. Noonan's notations document these cases in hopes of being prepared when clients come to him with these issues.

Over the past few years, I have seen the New York State Department of Taxation and Finance initiate sales tax audits against Wall Street firms, which initially seemed unusual to me given the lack of sales of taxable stuff going on in those types of firms. I'm writing this memo to myself to document what's been happening in those cases, and to outline the types of things I should be looking out for when clients come to me with those issues.

First, some background: The department focuses its sales tax enforcement efforts both on a taxpayer's sales and on purchases. So while a firm such as a hedge fund or investment manager obviously wouldn't be in the business of selling anything taxable, it actually buys lots of things that are subject to sales tax. I think that the department figures that these "purchase audits" are a fruitful area of audit production given potential noncompliance on some issues.

In particular, the focus of those cases has been on information services. I've seen a push in recent years by the department to enforce and apply its tax on information services contained under Tax Law section 1105(c)(1). New York, along with a handful of other states, taxes the sale of information services, generally defined as a provision of reports that are not personal or individual in nature and in which the information presented isn't included in reports available to other customers. At some point, I'm guessing that someone in the department realized that the tax on information services could possibly apply to the types of research purchased by investment banks, hedge funds, and other Wall Street firms.

But what I've seen is that what is taxable and what is not is something that's subject to debate. In the audits I've been working on, the department takes the position that any information provided to a customer that isn't specific to that client or that is or *can be* provided to other customers is taxable. That has spawned what we refer to as the "common database" rule, in which the provision of information coming from a database that other customers or clients can access is deemed to be taxable. Custom reports — that is, reports provided to just one taxpayer or with information specific to that one taxpayer — are not subject to tax. Nor is the provision of oral information services, consulting services, or advisory services. There's also an exemption for periodicals, and sometimes reports fit into that category. But sometimes the line between those services is blurred, and that creates lots of "fun" in audits.

There's also a bundling problem that I'm always on the lookout for in those cases. Often, things such as consulting services, advisory services, etc. are bundled with reports that the department might believe are taxable. That can create a real problem. The department takes the position under its cheeseboard rule that when taxable and nontaxable items are bundled together and sold for a single price, the overall charge is taxable even though it is comprised of nontaxable elements. And from what I've seen, although many investment research firms provide a variety of different services in addition to reports, very few segregate the services into separate buckets on their invoice. So we run into a lot of cheeseboard problems on audit. Thankfully, I've had fairly good experience working with department auditors to "unbundle" on audit, at least for purposes of bringing a case to a resolution. But usually if the department is going to do that, it would like to see unbundling (or collection of 100 percent tax) on a going-forward basis.

I've experienced one really important exception to that rule, though. Some firms that offer investment research do it as part of trade execution services, in which clients don't separately pay for research but instead pay commissions on trading. As a policy matter, the department has taken the position that the provision of research to a trading client actually doesn't change the overall nontaxable status of the trade-execution services. Go figure.

One last issue that's been generating lots of headaches in audits concerns "soft dollars." Lots of hedge funds or investment managers "pay" for their research via soft-dollar accounts, or more specifically, they direct their broker to pay for that research. The position taken by the department

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varies sometimes from auditor to auditor, but the department as a policy matter seems to have settled on one approach. Under that approach, the entity that actually pays for the research (or, of course, the entity that sells it) is the entity that is being held responsible for the tax. So if an investment research provider issues an invoice to its client that is paid for by the broker, sales tax responsibility would fall either on the research provider or the broker, not on the ultimate client that used or consumed the taxable report.

In one case I had, the auditors vehemently argued that point. But the books and records didn't lie. The hedge fund client didn't reflect the purchase of research as an expense on its books, because it didn't purchase any research! So how could the department tax them on purchases that were not even on their books? Of course, in another audit I had with a soft-dollar broker, it was clear that all invoices were issued to the client, and the broker took the position that it did not have a legal responsibility to pay the invoice, and thus could not be responsible for the sales tax. That too is a good argument, though not one that the department seems to accept at this point.

Overall, what I've learned is that these investment research audits are like any other sales tax audit. It's like eating an elephant . . . one bite at a time. ✰

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