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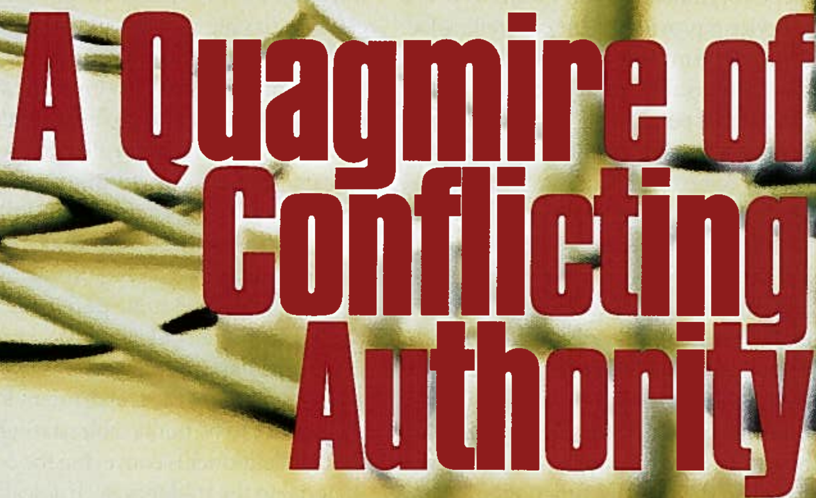
The Taxability of Software-Based Service Transactions



A Quagmire of Conflicting Authority

TIMOTHY P. NOONAN AND JOSEPH N. ENDRES

THE CONFUSING AND OFTEN CONFLICTING RULINGS BEING ISSUED BY CERTAIN STATES SEEM TO INVITE ADDITIONAL LITIGATION OR, AT THE VERY LEAST, LONG, CONTENTIOUS AUDITS.

Over the past several years, software has become increasingly complex, providing a wide variety of services previously performed manually by individuals. For example, software can now be used to maintain a company's financial books and records, track payroll and withholding obligations, monitor inventory levels, manage portfolios, provide instructional training, etc. Moreover, most of these services can be performed remotely via the Internet, where no software is downloaded or otherwise placed on a user's computer. In the majority of states, sales of software are taxable while sales of most services are not. Thus, when reviewing an Internet transaction that uses software to help perform a service, taxpayers and tax practitioners must determine whether the transaction represents the taxable sale of software or the nontaxable sale of a service. This can be a difficult proposition because the tax rules governing "software-as-service" transactions are in flux in many states.

Recent developments in New York State reflect this transition. For example, during the past year, New York State's Department of Taxation and Finance (the "Department") has issued administrative rulings and decisions clearly demonstrating an intent to take a more aggressive position with respect to such transactions. The following discussion reviews New York's policy shift, and also offers practical advice for practitioners and taxpayers dealing with software or Internet-related transactions. We don't have all the answers, of course, but at least we can identify the critical questions and issues, both in New York and elsewhere.

Background

In New York, as in most states, all sales of tangible personal property are subject to sales tax unless a specific exemption applies.[1] The term "tangible personal property" has been statutorily defined to include prewritten computer software.[2] Despite the fact that you cannot see, feel, or touch it, software has been deemed to be tangible personal property regardless of whether it is transferred via tangible format (i.e., disk) or electronically (i.e., downloaded or accessed via the Internet). Conversely, sales of services are not subject to sales tax unless the service is one of the few specifically designated as taxable.[3] This structure seems simple enough. But what happens when prewritten software is used to perform a service? Does the transaction constitute the taxable sale of software, or a nontaxable sale of a service? And most important, how are taxpayers and tax practitioners to differentiate between the two?

The primary function test. In New York, when examining a transaction that employs potentially taxable elements to perform a service, the Tax Appeals Tribunal, the Department's highest administrative court, has applied the "primary function test."[4] This test requires the Department to view a service transaction as a whole rather than breaking it into taxable and nontaxable parts. As the Tribunal stated: "In order to determine a service's taxability, the analysis employed by the New York courts and the Tax Appeals Tribunal focuses on the service in its entirety, as opposed to reviewing the service by components or by the means in which the service is effectuated."[5]

In past cases, the Tax Appeals Tribunal has admonished auditors for taking too narrow a view of service transactions, noting, "we cannot accept the [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."[6]

Thus, transactions that use software to perform a service are not automatically taxable. Rather, auditors must review the transaction as a whole to determine the transaction's primary function. In recent months, however, the Department has begun to move away from an analysis based on the primary function test. Now, it appears that the Department may be applying a general presumption that if a transaction includes the use of software, it is subject to sales tax. Several recent cases demonstrate this transition.

Recent Rulings and Decisions

Consider the following rulings issued by the Department with regard to the use of software in connection with the provision of online educational services, homecare patient monitoring systems, and online storage and marketing services.

Online educational services. During the past three years, the Department has issued three advisory opinions examining the taxability of online educational services. Despite the fact that the products are all remarkably similar, the Department arrives at very different conclusions.

Tower Innovative Learning Solutions. In this advisory opinion, which was issued to Tower Innovative Learning Solutions, Inc., in February 2006, the Department considered the taxability of the continuing and executive education certificate programs offered by this for-profit learning subsidiary of Cornell University.[7] The taxpayer provided software to its customers that helped teach the customer various professional development skills. Upon completion of the software course, the customer was awarded a certification that can be used to apply for continuing education units through a select group of universities, for relicensure or recertification with state agencies and professional organizations, or as proof to employers of their professional development activities. The taxpayer also provided academic support to customers enrolled in the certificate programs, including answering customers' e-mail inquiries and phone calls, hosting online discussions, coordinating group projects, and providing onsite support to corporate purchasers that had a large number of employees enrolled in a particular program.

In its opinion, the Department found this service to be nontaxable, stating: "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,

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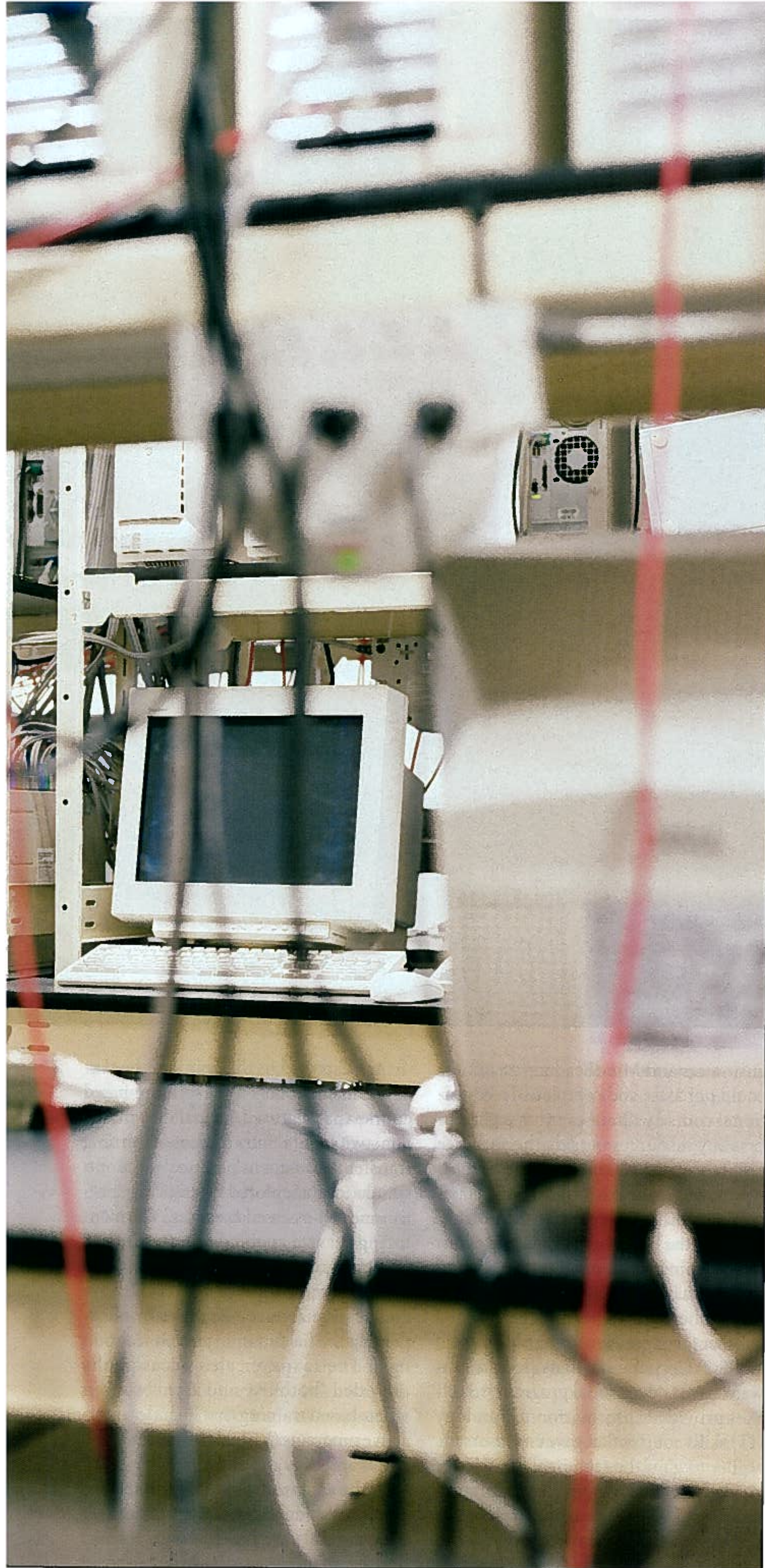


but rather paying Petitioner to attend a course of study. Petitioner is not selling software to students. Presumably, Petitioner's *primary function* is to provide its students with a course of study." (Emphasis added.)

One can see that the language employed by the Department in this advisory opinion is focused on the primary function test. The Department was 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. In contrast, an examination of the next two advisory opinions reveals a shift in the focus of the Department's language.

MindLeaders. In this advisory opinion, issued in January 2009 to MindLeaders, Inc., an Ohio-based for-profit corporation, the Department considered the taxability of the company's provision of "real-time, interactive, web-based training and educational services."[8] Customers who completed a course received a certification from the taxpayer that the customer could use: (1) to apply for continuing education credits through a select group of universities, (2) to obtain relicensure or recertification with state agencies and professional organizations, or (3) as proof to their employers of their professional development activities.

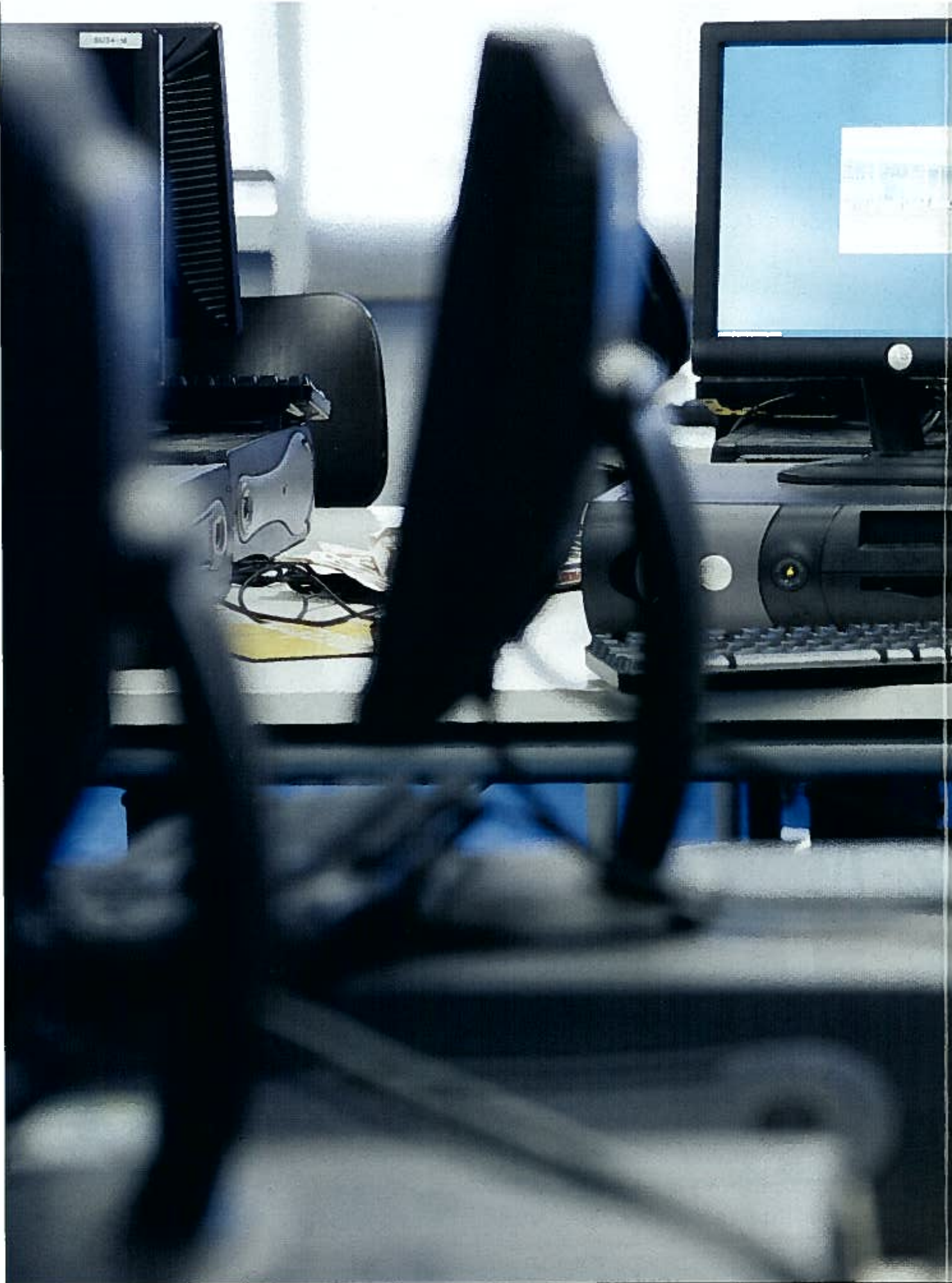
These facts sound a lot like the situation in the Tower Innovative Learning opinion, discussed above. The only significant difference between the MindLeaders' situation and that described in the Tower opinion is that, here, the taxpayer segregated the fees charged for the online course from the fees charged for its live, online mentoring (i.e., the "mentoring service [was] available only for a separate charge"). While finding that the charges for mentoring were nontaxable because it was not an enumerated taxable service, the Department nonetheless concluded that the charges to participate in the course were taxable because the transaction constituted the sale of prewritten computer software. Further, the Department distinguished this advisory opinion from the one issued to Tower, stating that "the on-line learning program found to be nontaxable in [Tower] ... included, at no extra charge, significant non-automated academic support."

Some questions remain, however. First, what about the primary function test? That

Practice Note: Software-Related Transactions: Practical Advice, in Brief

Keep the following factors in mind when examining software-based transactions to determine whether the transaction represents the sale of taxable software or a nontaxable service:

- **Does the customer receive a copy of or have access to the software? If not, the seller is probably using the software to perform a service.**
- **Who is using the software: (1) the seller, to provide a service, or (2) the purchaser, e.g., via a license, for the purchaser's own purposes?**
- **Although the language in the sales contract is not controlling, how the parties characterize the transaction is still important.**
- **Be careful in marketing the product/service; marketing or sales personnel may not be attuned to sales tax issues when explaining what the product is or how it functions.**
- **Can the purchaser use the software to complete the transaction with no additional activity by the seller, or does the seller bring expertise to the transaction apart from the software, and thus is likely selling a service.**
- **Always consider the "primary function" test, which often can help determine whether or not a sale is a nontaxable service.**

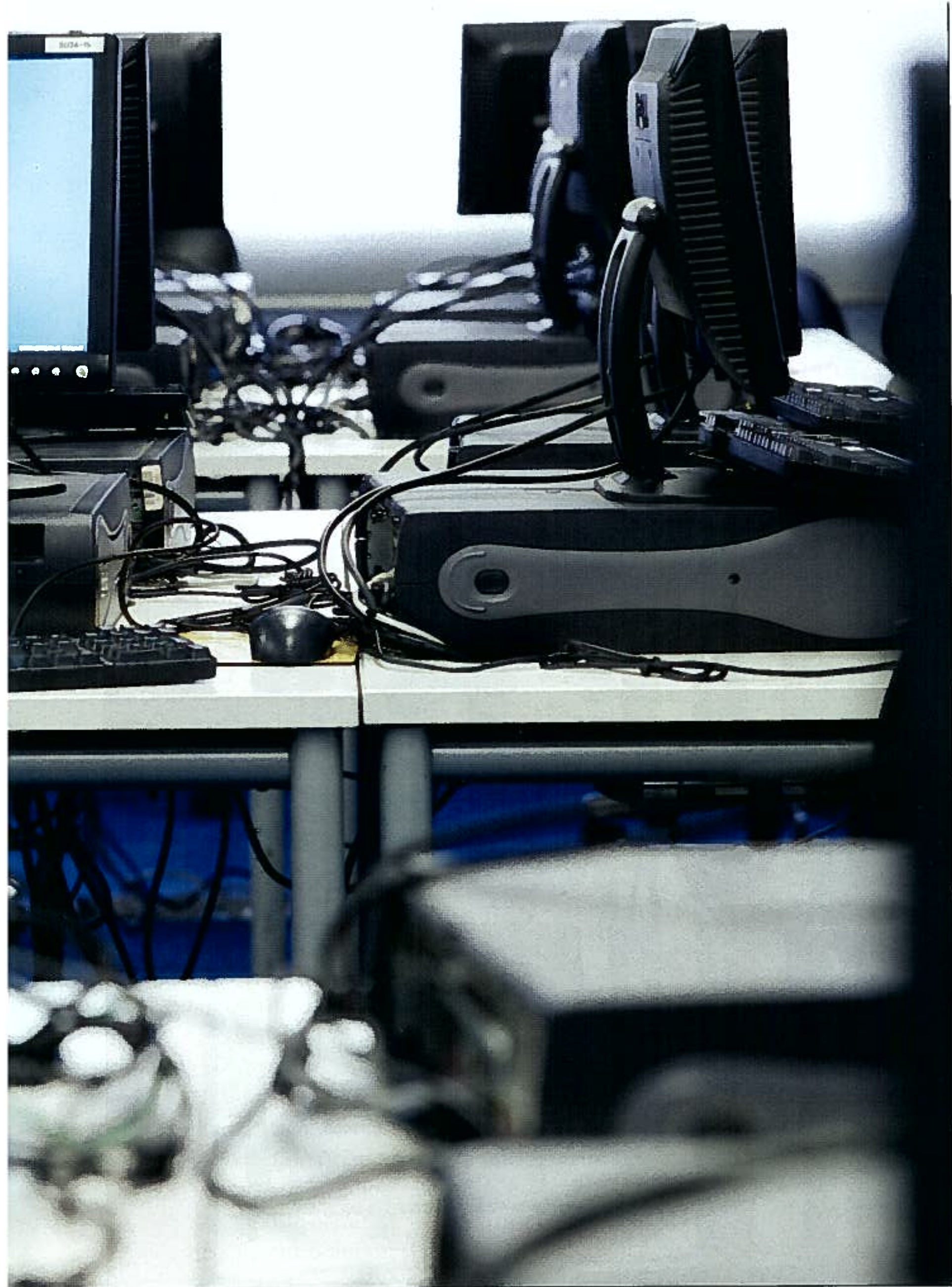


standard did not come up at all in the MindLeaders opinion, where, as in the Tower opinion, the primary function of the software was to teach the customer the necessary skills to advance professionally. The software was simply a means to achieving that objective. Thus, while the facts in the two opinions appear similar, the analysis seems noticeably different, at least as it relates to the primary function test. Moreover, the Tax Department distinguished Tower by pointing to the fact that Tower's customers did not have to purchase mentoring separately; it was included in the cost of the program. But does this mean that the taxpayers could avoid sales tax by simply bundling services? Normally, the opposite is true: i.e., when charges for taxable and nontaxable transactions are bundled, the entire charge is taxable.[9] Whatever the case, the bottom line is that both Tower's customers and MindLeaders' customers could purchase and complete the educational course without ever having to access any resources outside the software program. Thus, it is unclear whether this "mentoring" aspect is a viable distinction.

SkillSoft. The use of this "mentoring" aspect in the Department's analysis of online learning services is further blurred in its latest opinion, issued also in January 2009, where the Department examined another taxpayer, New Hampshire-based SkillSoft Corporation, that offered a software-based educational program.[10] SkillSoft provided information technology (IT) skills courses that gave end-users the ability to gain the technical knowledge needed to perform their jobs and prepare for IT professional certifications. Of the various services the taxpayer offered, two are relevant to this discussion.

As described in the opinion, the taxpayer's main product was a software-based course that featured "visual design, interactivity, and reinforcement of learning transfer via frequent practice questions, simulations, 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." The taxpayer also occasionally provided "both live and asynchronous video-based training that includes interactive programs (Virtual Classroom) with CEOs and thought leaders."

If the analysis from the MindLeaders opinion were applied to these facts, neither the main software-based service product nor the virtual classroom would appear



to be taxable because each contains mentoring aspects. The Department, however, reached a different conclusion, opining that the taxpayer's educational program was taxable as a sale of prewritten computer software, while the virtual classroom was a nontaxable educational service.

In arriving at this conclusion, the Department once again avoided any discussion of the transaction's primary purpose. Again, that test used to be the benchmark in the "software vs. 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 SkillSoft's main software-based product could seek additional guidance on *every assignment* completed through the software. Mentoring was built-in to the product. Nonetheless, the Department found that the customer's access to the mentoring services "does not appear sufficient to transform Petitioner's sale of software into the provision of a [nontaxable] educational service." But the Department does not explain why this 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 sufficient. This lack of a full analysis has made it virtually impossible to fashion a general rule that connects the Department's position in all three advisory opinions examined above. This situation does not bode well for taxpayers trying to proactively satisfy their obligations under the tax law.

Home healthcare employee monitoring. In the following two opinions, the Department looked at businesses that provided monitoring systems in connection with home healthcare services.

Dataline. In this advisory opinion, issued in 2004 to Dataline, Inc., the Tax Department considered the taxability of a staff monitoring system developed and implemented for the home healthcare industry.[11] The system was designed to keep track of employees who work in the field, away from a business's central office location. The monitoring system allows a business customer to track its employees on a real-time basis through access to Dataline's computer via the Internet. Further, the data gathered by the system may be integrated into the customer's scheduling, billing, and payroll systems and can be adapted for use with almost any time and billing bookkeeping function required by the customer.

As an example, the system can monitor the attendance, time spent, and services performed by employees sent by a healthcare business to work in a patient's home. Upon arriving at the home, the employee calls into the Dataline system via telephone using a toll-free number and, using the telephone key pad in response to prompts, enters his or her employee ID number, etc. Upon completion of the services performed, the employee again calls into the system and, via the telephone key pad, enters the codes relating to the services performed at that location. The monitoring system (i.e., the computer software that records and interprets the information keyed in via telephone), in addition to collecting the data entered by the employee, notes the time that the employee checked in (began work) and checked out (completed work) and, through a form of caller ID, verifies the location at which the employee claims to be present and performing services.

Thus, the system allows a home healthcare agency to have real-time access to pertinent information about each and every employee and patient appointment. This information provides the agency's staff coordinators and management team the ability to proactively and efficiently manage its employees in the field. The information gathered via the system may also be used by Dataline's customers to generate both billing information and payroll information. The data may be downloaded by the customer (electronically over the Internet, by disc, etc.), and may be directly incorporated for use in its payroll and billing systems.

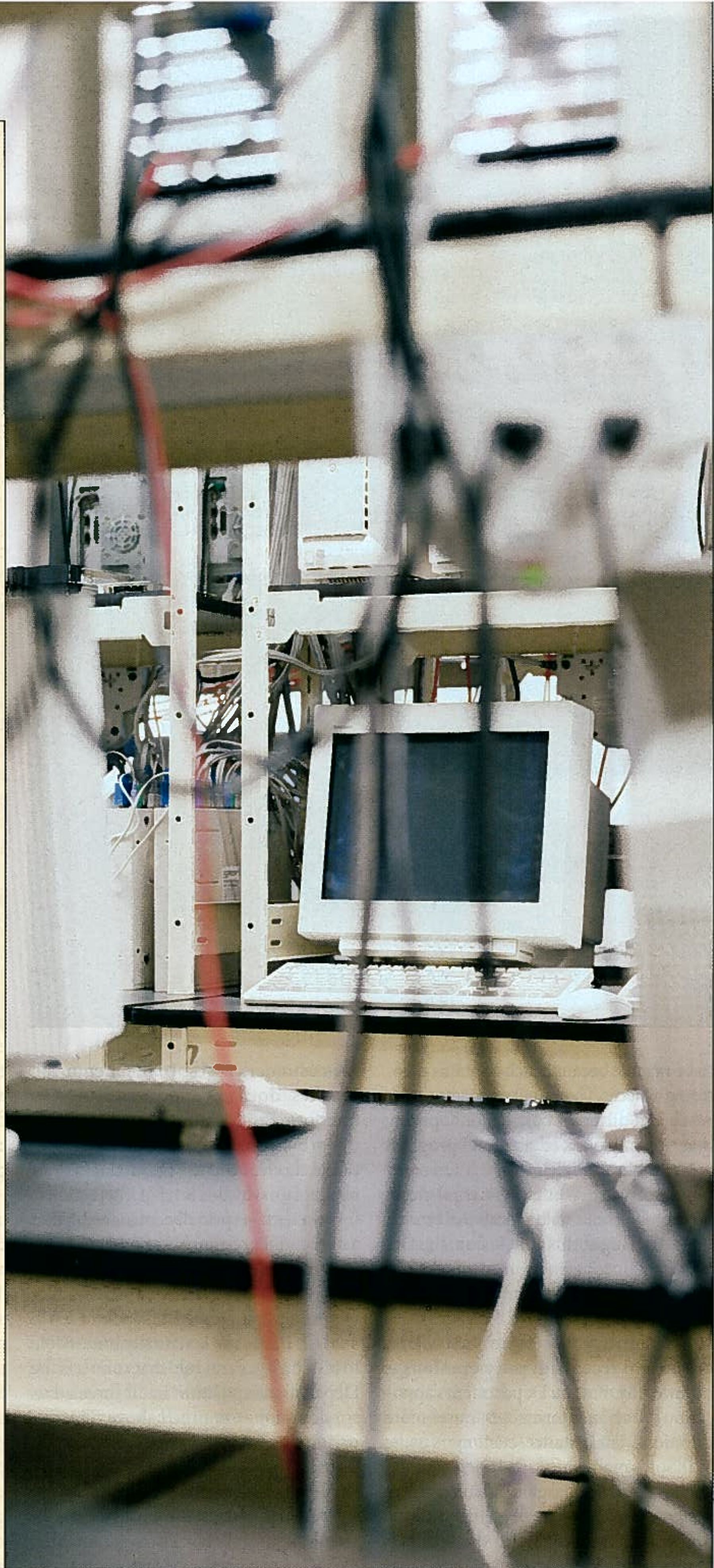


EXHIBIT 1
Taxability of Software Transferred or Accessed Electronically

Other than Alaska, Delaware, Montana, New Hampshire, and Oregon (none of which imposes a general state-wide sales tax), every state and the District of Columbia subject the sale of prewritten software to sales and use tax. The tax treatment may differ, however, if the software is transferred or accessed electronically, as indicated in the following chart:

Is software taxable if transferred or accessed electronically?

State	Taxable	Exempt
Alabama	Taxable	
Arizona	Taxable	
Arkansas		Exempt
California		Exempt
Colorado		Exempt
Connecticut	Taxable	
District of Columbia	Taxable	
Florida		Exempt
Georgia		Exempt
Hawaii	Taxable	
Idaho	Taxable	
Illinois	Taxable	
Indiana	Taxable	
Iowa		Exempt
Kansas	Taxable	
Kentucky	Taxable	
Louisiana	Taxable	
Maine	Taxable	
Maryland		Exempt
Massachusetts	Taxable	
Michigan	Taxable	
Minnesota	Taxable	
Mississippi	Taxable	
Missouri		Exempt
Nebraska	Taxable	
Nevada		Exempt
New Jersey	Taxable	
New Mexico	Taxable	
New York	Taxable	
North Carolina		Exempt
North Dakota	Taxable	
Ohio	Taxable	
Oklahoma		Exempt
Pennsylvania	Taxable	
Rhode Island		Exempt
South Carolina		Exempt
South Dakota	Taxable	
Tennessee	Taxable	
Texas	Taxable	
Utah	Taxable	
Vermont		Exempt
Virginia		Exempt
Washington	Taxable	
West Virginia	Taxable	
Wisconsin	Taxable	
Wyoming	Taxable	

In the Dataline opinion, the Department concluded that the fees the taxpayer charged its customers for the staff monitoring system were for a nontaxable service. Despite the fact that the customers used Dataline's computers and software and the Internet to access the system and both input and access data (schedules, tasks to be performed, etc.), the Department did not analyze the service from a software standpoint. Instead, it considered whether the transaction was the sale of a taxable telephone answering service. Applying a primary function analysis, the Department concluded that "[t]he essence of the transaction ... (attendance verification, tardiness alerts, etc.) goes beyond the mere answering of the customer's phone and forwarding of messages. Therefore, the services sold by [Dataline] are something other than a telephone answering service subject to the tax imposed pursuant to section 1105(b) of the Tax Law."

Homecare Software Solutions. In June 2009, the Department issued an advisory opinion to Homecare Software Solutions LLC the facts of which seem extremely similar to the fact pattern in the Dataline opinion discussed above. In this latter opinion, the taxpayer offered an Internet software application that allowed home healthcare providers to contact and communicate with other similar agencies in order to subcontract their obligations to provide in-home nursing, rehabilitation, or home health aide visits.[12] As with the Dataline system, the Homecare Software Solution system used information keyed in via telephone by the subcontractor's caregiver to allow both the primary healthcare provider and the subcontractor to access and track attendance, scheduling, changes in care, and services performed, as well as to verify billing.

Despite the remarkable similarity between this product and the product examined in Dataline, the Department concluded that the Homecare Software Solutions transactions constituted the taxable sale of prewritten computer software, stating: "The accessing of ... the time and attendance system by Petitioner's customers constitutes a transfer of possession of the software, because the customer gains constructive possession of the software." In reaching this conclusion, the Department does not even mention the primary function test. Had the Department applied that test, it is difficult to see how it would have arrived at this contrary position. Moreover, the Department does not provide much of an explanation for these conflicting conclusions. When addressing the Dataline opinion, the Department simply brushed it aside, stating: "These conclusions represent the current position of the Department. To the extent *Dataline, Inc.* ... or any other advice from the Department suggests a contrary conclusion, it does not represent current policy."

So there it is. The Department has, in an advisory opinion, announced its change in policy and a shift away from the primary function test. The tax law, of course, has not changed. Thus, whether the Department's initial policy or its new policy is the right one may end up being considered by the courts.

Online data storage; marketing services. In the following two opinions, the Department pondered the provision of online data storage and retrieval services and software that facilitated the marketing of a users' products.

Connected Corp. In this 2005 advisory opinion, the taxpayer, Connected Corporation, sold two types of software-based data storage and retrieval services.[13] In the first instance, customers subscribed to the taxpayer's data protection service in order to ensure the safe storage of data in the event that the customer's original data was lost or stolen. All the backed-up data was stored on the taxpayer's servers at data centers located in Massachusetts. The taxpayer's software was placed on the customers' computers to allow customers to connect their computers to the servers at the taxpayer's Massachusetts data centers. The software had no other function and could not be used by itself without a corresponding storage subscription.

Using a "primary function" analysis, the Department determined that the taxpayer was providing a nontaxable storage service. Specifically, the Department stated: "The primary function of Petitioner's subscription service is to provide its subscribers with a backup of their data," and "Petitioner's use of ... software to provide data backup and storage service does not constitute a sale of such software for purposes of section 1105(a)."

In contrast, in the second scenario the taxpayer sold a version of the software that "allows customers to backup, secure, store and recover data from the customer's own data backup servers, and contains software facilitating the customer's transfer of data from its computers to the servers where the customer will backup and store the data." In that situation, the Department said, the transaction constituted the taxable sale of prewritten computer software. Thus, in the Connected Corp. opinion, the Department provided a clear, rational distinction between the taxable and nontaxable transactions.

Adobe Systems. In a 2008 opinion issued to Adobe Systems Inc., the taxpayer sold a marketing service using software that resided on the taxpayer's servers located outside New York.[14] Using an e-mail address and password provided by the taxpayer, customers could access the software, which allowed them to upload an image of a product onto the taxpayer's servers and to manipulate the image to show various colors and views (e.g., front, back, zoom) of the item. The customer could then provide a link to this image when offering the item for sale on its own website. The uploaded images remain on the taxpayer's servers and the customers did not receive a copy of the software in tangible or other form.

The Department concluded that the taxpayer was selling taxable prewritten computer software even though the software was not transferred to the customer. The sales agreement did, however, specifically grant the customer a license to use the taxpayer's software. But does this seem like a sound basis for the determination? Remember, in the Connected Corp. opinion, software was actually transferred to the customers, but the transaction was not taxable so long as the seller performed the storage service on its own servers. Here, the seller transfers *no* software to the customer and keeps the product image on its own servers. Still, the Department concluded that the Adobe Systems transaction constituted the taxable sale of software. Again, the contradictions suggest a subtle—but potentially unjustifiable—change in policy.

Other rulings. In just the past year, several other New York opinions and decisions dealing with taxable software transactions have also been issued. These determinations highlight the Department's aggressive new stance with respect to software-based products.

Portfolio management services. In *Matter of DZ Bank*,[15] the bank protested the sales tax it paid on the purchase of a web-based portfolio management product, "Credit Edge," that enabled it to access certain databases and software that allowed businesses to better manage market and credit

exposures. In an earlier proceeding, an administrative law judge (ALJ) with the New York Division of Tax Appeals had concluded that the bank's subscription to three other portfolio management products constituted the purchase of taxable prewritten computer software, but found that the Credit Edge product was a nontaxable electronic financial consulting service. On appeal, the Tax Appeals Tribunal overruled the ALJ with regard to Credit Edge, finding that it too was taxable, but as an information service.

Insurance services. An international software company sold a software-based platform to insurance companies that used the system to provide rate quotes, insurance contracts, and other insurance documents to insureds and prospective insureds. An insurance company purchasing the system could log into the software residing on a third-party's server using a URL address provided to the company by the taxpayer. The software also could be installed on the taxpayer's servers or on an insurance company's own servers. The Department determined that, regardless of where the software was located or how the system was accessed, the transactions were sales of taxable prewritten computer software.[16]

Payroll processing services. The National Football League sought an opinion as to the taxability of its purchase of software-based payroll processing and payroll data management services. A portion of the service-provider's charges was for "the Application Programs as run on the [service provider's] hardware." The Application Programs (which were hosted on the service provider's computers in Michigan) included various software products used for human resource and payroll administration functions that the League was to use "to process its own internal data and only in connection with its receipt of [the service provider's] Payroll Services." The Department found that the charges for the Application Programs were taxable as sales of prewritten computer software.[17]

Logistics management support. The taxpayer sold its "On-Demand TMS System," a web-based logistics management platform, consisting of software that resides on the taxpayer's servers, which its customers access via the Internet. The TMS System provided customers with daily planning, execution, and settlement functions related to the management of their transportation and delivery operations, and also enabled customers to view their complete supply chain and private transportation systems via the Internet. The Department determined that the taxpayer's charges for use of the system were receipts from the sale of taxable prewritten computer software.[18]

Retail management services. The taxpayer developed a software-based platform that provides each of its customers with weekly markdown recommendations based upon weekly sales data supplied by the customer. The system assists each customer in managing its clearance of merchandise.

The information being processed is provided by the customer, is confidential in nature, and is for the exclusive use of the customer. The software and customer-related data are stored on the taxpayer's server. The system collects, analyzes, and compiles each customer's data according to the customer's specifications. The data is assembled into reports accessible by the customer via an Internet connection. The customers cannot access or use the software to manipulate their data stored on the taxpayer's server, nor can they generate ad hoc reports, test marketing hypotheses, or request additional analysis.

The Department found that the taxpayer was selling taxable prewritten computer software.[19]

Mortgage-related services. The taxpayer, Electronic Mortgage Affiliates, Inc., sells a software-based platform that assists subscribers in providing loan origination and processing services. The subscribers, who are mostly mortgage brokers, access the taxpayer's product via the Internet, allowing subscribers to do business with online mortgage lenders. The taxpayer's system consists of software hosted on the taxpayer's own out-of-state servers. The "hosting" function performed by the tax-

1 N.Y. Tax Law § § 1105(a) (imposition of tax), 1115 (exemptions).

2 N.Y. Tax Law § 1101(b)(6). Software that is custom-designed to the specifications of a particular purchaser is not subject to sales tax. Most states follow this construction.

3 N.Y. Tax Law § 1105(c).

4 See, e.g., Matter of SSOV '81 Ltd., N.Y. Tax App. Trib., DTA Nos. 810966 and 810967, 1/19/95.

5 *Id.* See also Matter of Telecheck Services, Inc., N.Y. Div. of Tax App., ALJ Determination, DTA No. 822275, 11/5/09.

6 Matter of SSOV '81 Ltd., *supra* note 4.

7 TSB-A-06(5)S, 2/2/06. In reviewing advisory opinions, keep in mind that, as generally stated in each opinion, it is issued at the request of a person or entity. The opinion is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An advisory opinion is based on the law, regulations, and Department policies in effect as of the date the opinion is issued or for the specific time period at issue in the opinion.

8 TSB-A-09(2)S, 1/21/09.

9 20 N.Y. Codes, Rules & Regs. § 527.1(b) (also referred to as the "cheeseboard rule," from the example in the regulation that states: "A vendor sells a package containing assorted cheeses, a cheese board and a knife for $15. He is required to collect tax on $15.").

10 TSB-A-09(3)S, 1/29/09.

11 TSB-A-04(17)S, 6/30/04.

12 TSB-A-09(25)S, 6/18/09.

13 TSB-A-05(40)S, 10/26/05.

14 TSB-A-08(62)S, 11/24/08.

15 N.Y. Tax App. Trib., DTA No. 821251, 5/11/09.

16 TSB-A-09(41)S, 9/22/09.

17 TSB-A-09(37)S, 8/25/09.

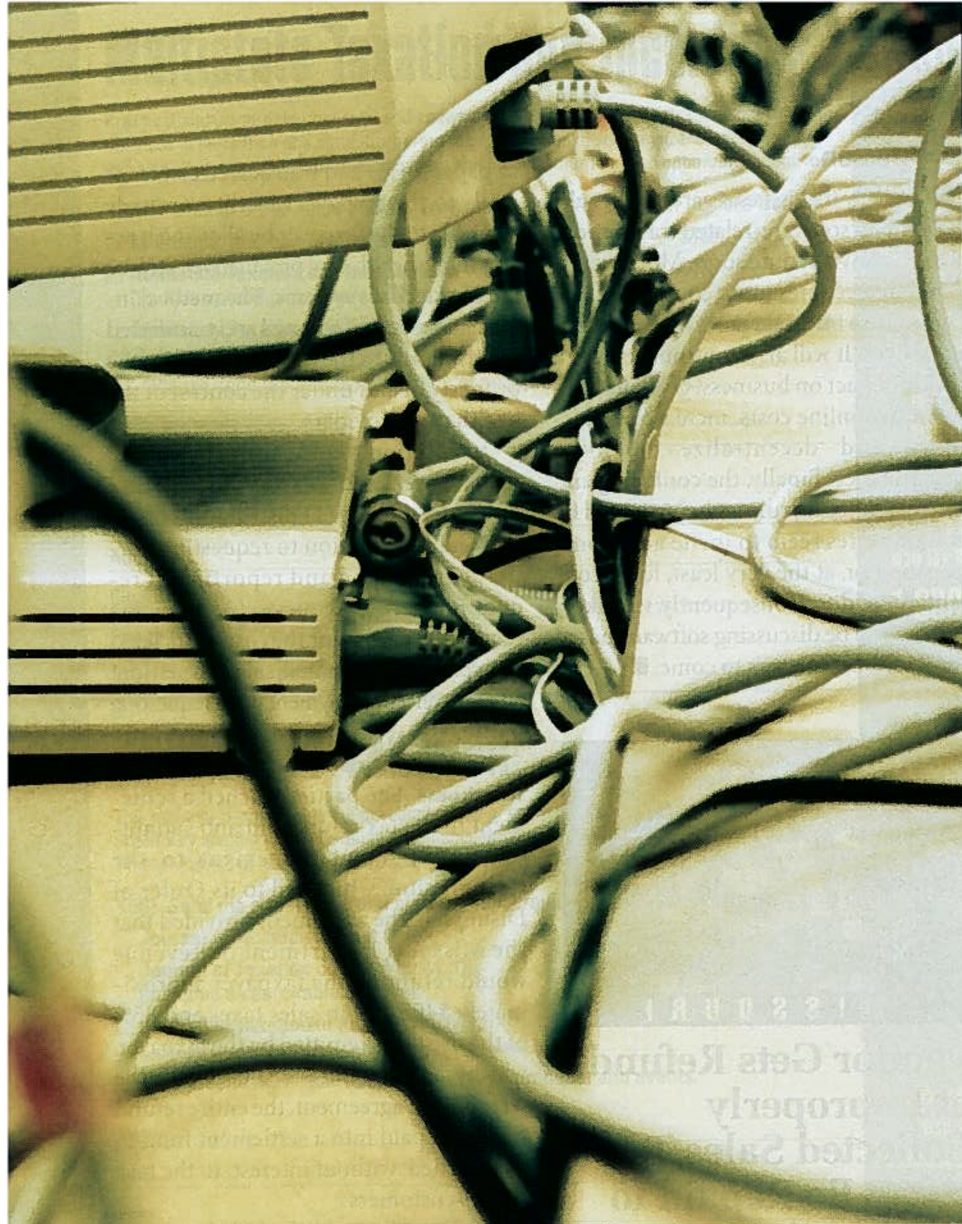
18 TSB-A-09(33)S, 8/13/09.

19 TSB-A-09(19)S, 5/21/09.

20 TSB-A-09(15)S, 4/15/09.

21 TSB-A-09(52)S, 11/13/09.

22 See *supra* note 7.



payer includes loading and maintaining the software on its own servers, storage of subscriber data, data backup, security, and software updates.

A subscriber obtains from an unrelated third party freely downloadable software that enables the subscriber to access the taxpayer's system on the host server. The system incorporates certain data into the software, such as certain Federal Housing Administration (FHA) county dollar limits, and mortgage insurance pricing. The data helps the subscriber to search for loans for which a borrower qualifies and for the applicable insurance costs. Loan data (e.g., a credit rating score) are analyzed against data provided by third parties, who contract with the taxpayer, to find the various loan products and pricing available to a specific borrower.

Once again, the Department opined that the taxpayer was selling taxable prewritten computer software.[20]

On-line auctions. Finally, not all of the new advisory opinions that examined software-based transactions have concluded that the product is taxable. In this opinion, the taxpayer, an auctioneer engaged in live and on-line auctions, was developing a new multi-seller website where individual sellers could list personal merchandise that they want to sell and where buyers could submit bids to purchase the listed merchandise. Each seller would be charged a $20 registration fee that would entitle the individual to participate on the website as both a seller and a buyer. The taxpayer would also charge sellers a flat rate of $5, or $2 per listing (depending on the type/quantity of items listed). Buyers would be charged a $10 registration fee that would allow them to submit bids for the purchase of the listed merchandise.[21]

Here, the Department found that the registration charges for participation as a buyer or seller in the online auction website (which included the website's providing descriptions and photographs of the items offered for sale, the terms of the sale, the bids, etc.) were not subject to tax—neither as a purchase of prewritten software nor as taxable information services.

Other States' Views on Software-Based Transactions

As demonstrated above, New York has begun taking a more aggressive stance with respect to software-based transactions, especially those conducted over the Internet. But this trend is not exclusive to New York. Most states have begun taking more aggressive positions with respect to software sales. In fact, in every state that currently imposes a sales tax, the sale of prewritten software is deemed a taxable transaction. Various exemptions can apply, however.

For example, when the software is transferred electronically, several states take the position that the transaction is no longer taxable, although here too, certain exclusions can apply. Exhibit 1 illustrates how the states (and the District of Columbia) generally tax software transactions if the software is transferred electronically.

Practical Tips When Examining Software-Based Transactions

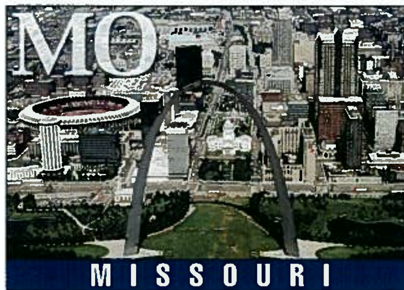
As illustrated by the New York opinions and decisions detailed above, in many states the sales and use tax rules regarding software are in flux. This can lead to a confusing quagmire of conflicting rulings and irreconcilable conclusions. Nevertheless, taxpayers and tax practitioners should keep the following factors in mind when examining software-based transactions. In most states, these factors will help determine whether a transaction represents the sale of taxable software or a nontaxable service.

- 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 is always important to understand exactly who 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. Although this language is not controlling, how the parties characterize the transaction is still an important aspect of the analysis. If no software is transferred to the purchaser, the seller should avoid characterizing the transaction as a sale of or license to use software. Based on our experience, carelessness in preparing sales contracts likely will create problems in audits.
- Also be careful regarding how the product/service is marketed. Marketing or business development people may not be attuned to sales tax issues when they prepare descriptions for potential customers explaining what the product is all about or how it functions. As with problematic contractual language, we have seen sloppy wording on client websites 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 seems more like the sale of a service.
- Most states apply some form of the primary function test. And although New York appears to be avoiding this analysis, taxpayers and tax practitioners should ask "what is the primary purpose of the transaction." Such questions will help determine whether a sale is a nontaxable service or the taxable sale of software.
- In New York (and perhaps other states), taxpayers may not be able to rely on previous advisory-type opinions as an indication of how the taxing authorities will treat a similar product or service.[22] Thus, taxpayers may need to submit their own guidance requests to be certain that they are satisfying their tax obligations.

Conclusion

It is unlikely that issues regarding the sales taxation of software-related transactions will go away anytime soon. Moreover, as software becomes more complex, it will continue to infiltrate more aspects of our daily lives. It will also continue to have a major impact on business, given its ability to streamline costs, increase productivity, and decentralize employee performance. Finally, the confusing and often conflicting rulings being issued by certain states seem to invite additional litigation or, at the very least, long, contentious audits. Consequently, it is likely that we will be discussing software-based transactions for years to come. ■



Vendor Gets Refund of Improperly Collected Sales Tax but to Be Repaid to Vendor's Customers

In a decision handed down by the Missouri Administrative Hearing Commission, which is a trial court in the state, the Commission dismissed the complaint filed by a taxpayer seeking a refund of sales taxes paid in connection with obtaining copies of medical records of patients at Missouri hospitals. The Order of Dismissal in *Smart Document Solutions, LLC v. Director of Revenue*, Mo. Admin. Hearing Comm'n, No. 07-0011 RS, 4/25/08, is short and does not tell the complete behind-the-scenes story.

The basic facts. The taxpayer received requests for copies of health and medical records from hospitals and other health care providers, which initially received the requests from attorneys, insurance companies, governmental entities, patients, physicians, and other hospitals. To facilitate the copying process, all of the medical record information held by the health care providers is either scanned (if in paper form) and transferred electronically to the taxpayer's facility, or made available to the taxpayer by allowing it access to the health care providers' electronic medical records systems. The medical information, even if scanned and transferred electronically to the taxpayer, remains the property of and under the control of the health care providers.

In addition to providing the copies, the taxpayer's services to the health care providers include (1) distribution of the medical information to requesting parties, (2) tracking and reporting of requesting parties' requests, (3) invoicing requesting parties for the costs associated with providing the medical information, and (4) collecting payment from requesting parties.

Settlement calls for refunds ... but to whom? The parties reached a settlement in the tax refund suit and submitted a settlement agreement to the Commission, which led to its Order of Dismissal. The agreement provided that the Missouri Department of Revenue would refund to the taxpayer approximately $403,000 in sales taxes and 85% of the use taxes remitted by the taxpayer, which came to about $428,000. Under the terms of the agreement, the entire refund was to be paid into a settlement fund to be returned, without interest, to the taxpayer's customers.

Under well-established Missouri law, sales or use taxes returned to a taxpayer who has filed a refund claim are not required or mandated to be paid or reimbursed to that taxpayer's customers. See Mo. Rev Stat. § § 144.190 (which generally states that sales or use tax overpayments "shall be refunded to the person legally obligated to remit the tax") and 144.696. This "loophole" in Missouri law has been recognized by the courts, which have pointed out that it is up to the legislature to change the law. See, e.g., *American East Explosives, Inc. v. Director of Revenue*, Mo. Admin. Hearing Comm'n, No. 04-0422 RS, 5/30/06.

The parties in *Smart Document Solutions* agreed in the settlement that the taxpayer would seek a letter ruling from the Department of Revenue with respect to the sales and use tax treatment of the reproduction of medical records. The parties also agreed that the taxpayer would cease collecting and remitting sales and use taxes on transactions relating to the