



# MULTISTATE TAX REPORT



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## Tax Base

If it looks like a service, walks like a service, and quacks like a service, but a state's department of revenue treats it as a taxable license to use pre-written computer software, then it is probably cloud computing, one of the fastest growing areas of electronic commerce, providing everything from financial services to online matchmaking. In this article, authors Arthur R. Rosen and Leah Robinson, of McDermott Will & Emery, dissect recent tax advisory opinions by the New York Department of Taxation and Finance to show the error of the state's approach to taxing online services—which some other states appear to be following—and to advocate for aggressive resistance by taxpayers.

## States' Extra-Statutory Attempts to Impose Sales Tax on Online Services Raise Questions of Fairness, Flouting of Legal Authority

BY ARTHUR R. ROSEN AND LEAH ROBINSON

**E**ven though it looks like a service, walks like a service, and quacks like a service, cloud computing is probably—in the eyes of some state tax administrators—a taxable license to use pre-written computer software. At least that is the disturbing multi-state trend that appears to have been initiated by a

steady stream of New York sales and use tax advisory opinions<sup>1</sup> released by the Department of Taxation and Finance starting in November 2008 and continuing since then on a constant basis. In each of the New York opinions, the department determined that “cloud computing” sales made by application service providers (ASPs)—sales that certainly appear to any reasonable observer to be services (that may or may not be

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<sup>1</sup> An advisory opinion is guidance provided by the Department of Taxation and Finance in response to a written request received from a member of the public. Advisory opinions are only binding on the specific facts presented but reflect the department's current policy at the time of issuance. Advisory opinions are available on the department's website.

taxable)—are actually licenses to remotely use pre-written software (that are nearly always taxable). Similar approaches are apparently being taken by a number of other states as well. Online financial services, games, business logistics service, dating forums, and educational courses are just a few examples of affected businesses.

For example, in the department's first ASP-as-licensor-of-software opinion, *Adobe Systems Inc.*,<sup>2</sup> Adobe charged fees to its customers for its service that allows retailers (its customers) to upload images of the goods they are selling onto Adobe's server (where they remain until removed by the retailer). The retailer is then able to display different angles and different color choices of a product. While the retailer does not receive any software or computer code as a download, in hard copy or in any other form, the department concluded that instead of providing a service, Adobe was actually licensing prewritten software to the retailers. The "license" is based upon the retailer's presumed ability to "use, direct, or control" Adobe's software on a remote basis.

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**ASPs and their customers should prepare themselves for the government's assertion of taxability on their services.**

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There have been numerous subsequent advisory opinions reflecting the same approach, many of them even more far-fetched than *Adobe Systems*. In each opinion, the department concludes that the ASP's receipts are derived from providing customers with access and control of software (i.e., a license to use tangible personal property) rather than the ASP itself using its own software to provide its services. In addition, and somewhat schizophrenically, the department also concludes that the receipts should be taxable wherever a customer, or a customer's customer, is located rather than where the software is actually being used (i.e., on the ASP's server).

There are a number of problems with this approach:

- First and absolutely foremost, even if one were to accept the government's assumption that a customer accessing an ASP's website is akin to the customer "using" the software that performs the sought services—a characterization that seems totally unsupported—such a use is not a taxable "license to use" under, for example, the relevant New York statutes and regulations because there is not a sufficient transfer of possession or control over the ASP's software. There is an enormous amount of case law supporting this conclusion. A legislative change—and not a series of administrative pronouncements—would be required to treat ASP services as taxable in all scenarios.<sup>3</sup>

<sup>2</sup> *Adobe Systems Inc.*, TSB-A-08(62)S (Nov. 24, 2008).

<sup>3</sup> The authors of this article recognize that some ASP services are properly subject to sales tax. When an ASP provides a service that is statutorily as taxable, and no exemptions or exclusions apply, then the ASP is providing a taxable service and must collect sales tax (assuming the ASP has substantial nexus with the state). The authors do not, however, accept the

- Second, the revenue department's position contradicts the judicially-developed "primary purpose," "true object," and similar tests that have evolved throughout the country and that would very likely result in ASPs being treated as service providers and not as licensors of pre-written software.

- Third, the revenue department (at least in New York) is using sourcing concepts relating to taxable services for determining where these transactions are taxable, but that directly contradicts treating the transactions as sales of *tangible personal property* (i.e., the licensing of prewritten software).

- Finally, some revenue departments may be claiming that this position reflects its historic position—as New York is doing—and, therefore, sales tax can be due for periods prior to the release of the first formal pronouncement of the new approach notwithstanding that there may be previous pronouncements—as there are in New York—that unambiguously conclude that the nature of the underlying ASP service controls taxability.

In New York, the department's position is, of course, not limited to the academic exercise of issuing advisory opinions. Department auditors are taking the same position in numerous sales tax audits of ASPs and in use tax audits of ASP customers. ASPs and their customers should prepare themselves for the government's assertion of taxability on their services. This article provides the analytical framework for responding to such an assertion; while the specific references are to New York, the issues and arguments should be applicable to a large extent in any state that is following New York's lead.

## Key Terminology

### What Do 'Application Service Provider' And 'Software as a Service' Mean?

Application service providers provide computer-based services to customers over a computer network, usually the internet. Their services are often referred to—in a somewhat sloppy manner—as "Software as a Service" (SaaS, usually pronounced "sass").<sup>4</sup> Generally speaking, SaaS involves an ASP's use of its own hardware infrastructure (computer servers, etc.) and its own proprietary software to provide some service to customers that access the ASP's front end portal (a webpage) using the customers' own computer hardware and software. Customers can access data or can request that the ASP, either solely using its own software or with minor or major involvement by ASP employees, perform various functions to produce the desired result. Some ASPs require customers to download some minor communications software onto the customer's computer to allow

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position that ASP services are taxable licenses of pre-written software.

<sup>4</sup> SaaS is a category within the realm of "cloud computing," but the term cloud computing encompasses more activities than just SaaS. "Infrastructure as a Service" (IaaS) and "Platform as a Service" (PaaS) are other categories of cloud computing. While SaaS is used on a daily basis by millions of businesses and individuals, only a limited set of businesses use IaaS, and PaaS is generally used by computer programmers and developers. Thus, IaaS and PaaS are not specifically addressed in this article.

receipt of the ASP's service, while other ASPs do not require or allow any downloads.

SaaS may be free for customers to use, others may charge a per-transaction fee, and still others may require a subscription or other long-term contractual arrangement.

Some ASPs provide remote access to web-based services that are similar to pre-written software that a customer could purchase in a shrink-wrapped box. For example, there are ASPs that provide remote access to word processing programs similar to Microsoft's Word software that can be purchased at an office supply store. In contrast, other ASPs provide web-based services that cannot be purchased "in a box," often because various constantly changing data points are required for the services (such as check verification services that access several third-party data sources in real time to determine whether a check is likely to be honored by a bank), or because customer data will be stored on the ASP's server and connection to that server is required, or because—as noted above—ASP employee involvement is required. Thus, while some SaaS is designed to replace traditional canned software, other types of SaaS could never be saved on CD-ROMs and sold off the shelf. Most of this article focuses on the latter type of ASP—those that provide functionality above and beyond what could be purchased in a shrink-wrapped box.

## How Do ASP Services Work?

While some aspects of ASP services are common sense, other aspects appear to require an advanced degree in computer science to understand fully. Still, the technical underpinnings of ASP services are highly relevant in determining whether a specific state's sales tax regime should apply.

Unless a person is a highly sophisticated computer hacker, he or she has absolutely no ability to access ASP software stored on the ASP's servers. Users can and do access the ASP's external portal in the form of a webpage, through the internet or a corporate network, that provides certain information and through which the user can submit certain data and certain requests to the ASP. Logging in with a password is usually required, although the user's computer can often be set to log in automatically so that the user does not need to enter it at each visit.

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Once a user name and password is input, a user sends a request to the ASP to verify that user information and to allow the user access to the subscription-only portions of the ASP's website. Once the log-in information is verified, the ASP will redirect the user to another webpage that often contains a variety of blank data fields in which the user can enter data to submit to the ASP. Alternatively, some ASP's software will auto-

matically pull data from the customer's databases so that the customer does not need to enter data manually.

Once a user enters data into the search fields, the user submits the data to the ASP by clicking "enter." Again, by clicking "enter," the user is merely requesting that the ASP use its software either to perform a search of the ASP's own databases for information that matches the customer's search criteria or to run whatever processes the ASP performs, or both. The ASP may or may not perform the requested search or processes. For example, if the ASP's server is experiencing too high a demand for services, it may inform the user that the work cannot be performed at that time.

Similarly, if the customer entered incorrect, incomplete, or incompatible data, or the ASP is experiencing technical difficulties or is undergoing system maintenance, it may similarly inform the user that the service cannot be performed at that time. Once the ASP does begin to perform the service, the user is usually unable to stop the service (in fact, even if the user logs off or even turns off his or her computer, an ASP will usually continue processing a user request until it requires additional information from the user and fails to receive a response). Similarly, if there is a glitch in the software's functionality, the user would be unable to access the software to correct the glitch. In sum, a user cannot access, alter, copy, or delete the software underlying the ASP's services. In fact, a user cannot force the software to function or to stop functioning; at best, a user can request that the software perform some task or tasks by, for example, clicking on "enter" on a webpage.

With this limited technical framework, we can now analyze New York's position.

## The Department Explains Why There Is a Taxable License

As previously described, the first in the line of ASP-as-licensor-of-software opinions was *Adobe Systems Inc.* For a fee, *Adobe's* service allows its customers to upload and display images of their goods for sale. *Adobe* and the retailers enter into a license agreement, but details of the agreement are not provided in the advisory opinion.<sup>5</sup> The retailer does not receive any soft-

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<sup>5</sup> In formal guidance, the department has expressly (and correctly) stated that the parties' characterization of an arrangement is not determinative of whether a taxable license exists: "Although the sample contract between XYZ and its subscribers provides that no license to use software is transferred to the purchaser, *this characterization is not controlling.*" *In re XYZ Corp.*, TSB-A-09(8)S (2/2/2009) (emphasis added). It is well established in New York tax jurisprudence that the substance of a transaction, and not its form, should control. *See, e.g., In re Burger King Inc.*, 435 N.Y.S.2d 689 (980) (holding that materials used to package fast food are excluded from taxation under the "sale for resale" exclusion, because "it would be exalting form over substance to hold that a resale does not take place merely because the chain does not list a separate price for the paper products."); *In re U-Need-A-Poll Off Corp. v. New York State Tax Comn.*, TSB-H-84(16.1)S (N.Y. App. Div., 3rd Dept. 1985) ("Insofar as this construction elevates form over substance, it is erroneous, for it is the substance of a transaction which controls rather than the form it takes . . . Respondent should have examined the evidence with a view towards determining whether a rental arrangement existed in substance.") (citing *Burger King*); *In re Cablevision of Queens*, DTA No. 814428 (DTA 1998) (determining that de-

ware or computer code as a download, in hard copy, or in any other form.

In the advisory opinion, the department does not discuss whether Adobe was providing, say, an advertising service. Instead, the department presumes that the transaction is the license of pre-written computer software, which is subject to sales tax as a sale of tangible personal property. However, as is discussed below, a license to use property requires that there either be constructive possession of the property or the “right to use, control or direct the use” of that property. The department concludes that the:

accessing of [Adobe’s] software by [Adobe’s] customers[] constitutes a transfer of possession of the software, because the customer gains constructive possession of the software, and gains the “right to use, control or direct the use” of the software. Petitioner’s customers have the right to use the software to upload images of their products and to manipulate those images to display various colors and views of the products. This is true even if no “copy” of the software is transferred to the customer.<sup>6</sup>

The advisory opinion does not address whether the ASP’s customers actually access the ASP’s software. In fact, the opinion appears to assume that use of an ASP’s service is the same thing as using or controlling the ASP’s software that performs various functions, the results of which are displayed on the user’s screen. The department also assumes that there is sufficient constructive possession of the software and sufficient control over the software for the transaction to be a license to use pre-written software. Numerous other advisory opinions since *Adobe* have reached the same conclusion.<sup>7</sup>

However, as is discussed in detail below, the department’s assumptions are wrong. In the vast majority of cases, ASPs’ customers do not receive a license to use the ASPs’ software (irrespective of the wording in any agreement between the ASP and its customer)<sup>8</sup> because they never have constructive possession of the software and because they never have control over the software.

spite certain contractual provisions providing for the removal of cable television distribution system “fixtures,” the record “clearly supported a conclusion that the installation of petitioner’s distribution system was intended to be a permanent installation, and that in reality, New York City would not request the removal of the distribution system” and therefore the expenses were for items that were sufficiently “permanent” to justify capital expenditure treatment). Accordingly, the department’s own position, as is stated in *XYZ Corp.*, is that contractual provisions do not control whether a true license exists; the parties’ actual arrangement determine the correct characterization.

<sup>6</sup> *Adobe Systems Inc.*, TSB-A-08(62)S at page 2

<sup>7</sup> TSB-A-08(62)S (Nov. 24, 2008); TSB-A-09(2)S (May 21, 2009); TSB-A-09(3)S (Jan. 29, 2009); TSB-A-09(6)S (Jan. 30, 2009); TSB-A-09(8)S (Feb. 02, 2009); TSB-A-09(15)S (April 15, 2009); TSB-A-09(19)S (May 21, 2009); TSB-A-09(25)S (June 18, 2009); TSB-A-09(33)S (Aug. 13, 2009); TSB-A-09(37)S (Aug. 25, 2009); TSB-A-09(41)S (September 22, 2009); TSB-A-09(44)S (Sept. 24, 2009); TSB-A-10(2)S (January 20, 2010); TSB-A-10(10)S (March 16, 2010); TSB-A-10(4)C; TSB-A-10(23)S (May 27, 2010); TSB-A-10(28)S (July 2, 2010); TSB-A-10(44)S (Sept. 22, 2010); TSB-A-10(47)S (September 29, 2010); TSB-A-10(50)S (Oct. 14, 2010).

<sup>8</sup> See footnote 5, above.

## What Is a Taxable License To Use Software?

No New York statutes or regulations explain when a license to use exists specifically with respect to software. The regulation defining “rentals, leases, and licenses to use” states that:

The terms “rental, lease and license to use” refer to all transactions in which there is a transfer for a consideration of possession of tangible personal property without a transfer of title to the property.<sup>9</sup>

This aligns perfectly with the property law concept of a possessory interest, such as a fee simple absolute or a leasehold. A transfer of possession with respect to a “license to use” has occurred when “one of the following attributes of ownership has been transferred: (i) custody or possession of the tangible personal property, actual or constructive; (ii) the right to custody or possession of the tangible personal property; [or] (iii) the right to use or control or direct the use of tangible personal property.”<sup>10</sup>

As the regulation makes clear, a transaction is not a taxable license to use unless one of the attributes of ownership is transferred to the user. This requirement will be met, and a “taxable” license to use will exist, when a customer receives constructive possession of an ASP’s software<sup>11</sup> or the “right to use or control or direct the use of” the software.

If possession or control is required for a transaction to be a taxable license to use, how much possession or control is needed? The department seems to have taken the position that virtually any possession or control is sufficient.<sup>12</sup> But, under controlling law, possession must

<sup>9</sup> N.Y. Comp. Codes R. & Regs. tit. 20 §526.7(c)(1).

<sup>10</sup> N.Y. Comp. Codes R. & Regs. tit. 20 §526.7(e)(4).

<sup>11</sup> The department acknowledges that a customer does not receive actual possession of an ASP’s software, *see, e.g.*, TSB-A-10(28)S (July 2, 2010), but instead asserts that a customer’s mere interactive use of an internet webpage constitutes a transfer of possession of the software because the customer gains “constructive possession” of the software, including the ability to “use, control or direct the use of the software.” The department first adopted this position in an advisory opinion issued to Adobe Systems in 2008. TSB-A-08(62)S (Nov. 24, 2008). The department claims that the position reflected in *Adobe (Systems)* reflects its historic position and not a change in position. Respectively, we disagree and believe that several slightly older advisory opinions reflect a different prior position. Compare, *e.g.*, *Tower Innovative Learning Solutions*, TSB-A-06(5)S (Feb. 2, 2006) (online educational courses a nontaxable service) with *MindLeaders Inc.*, TSB-A-09(2)S (Jan. 21, 2009) (online educational courses a taxable license of pre-written software); *Dataline, Inc.*, TSB-A-04(17)S (June 30, 2004) (staff monitoring services provided over internet a nontaxable service) with *Homecare Software Solutions LLC*, TSB-A-09(25)S (June 18, 2009) (staff monitoring services provided over internet a taxable license of pre-written software).

<sup>12</sup> The department’s conclusion that an actual copy of software source code does not need to be transferred to the customer for a taxable license to use to exist is erroneous as a matter of law. As a matter of statute and as a matter of sound tax policy, a transfer of an actual copy of the code is necessary to warrant the imposition of sales tax. When no copy is transferred and the software remains on the ASP’s server, there has been no constructive transfer for all of the reasons discussed in the text above. *See, generally In re DZ Bank*, DTA No. 821251 (N.Y. Tax App. Trib. 2008) (determining that the sale

be “exclusive” and must be for more than a fleeting moment and control must mean actual control.

For example, in *In re Darien Lake Fun Country Inc. v. New York State Tax Comn.*,<sup>13</sup> the department asserted that amusement park admission tickets were actually taxable licenses to use the amusement park rides because the park visitors had possession of the rides while they rode on or in them. But the New York Court of Appeals (New York’s highest court) rejected the department’s position, stating that “it has long been the rule that something more than temporary possession is required before there is, within the meaning of section 1105(b), a ‘license to use’ taxable as a retail sale.” Thus, park visitors lacked sufficient possession over the park rides for the sale of the admission ticket to constitute a taxable license to use the rides. Similarly, and in reliance on *Darien Lake Fun Country*, a New York state administrative law judge determined that providing access to luggage carts at airports for a fee was a taxable license of those carts because there was no time limitation on use and no use restrictions that interfered with the intended purpose of the carts (i.e., possession was more than merely fleeting).<sup>14</sup>

*Darien Lake Fun Country* and the decisions that follow it are very clear: temporary possession of property is not sufficient to constitute a license to use that property. In the ASP model, there is no actual, physical possession of the software. Indeed, the department concedes as much.<sup>15</sup> Instead, the department asserts that there is a “constructive possession” of the software because it assumes that the user can control the software. But the department confuses “control” over application software with mere receipt of a service from an ASP that itself uses the application software. Clearly, a customer “uses” an ASP’s service but that is a far cry from being able to “control” the ASP’s underlying application software.

The court of appeals recognized the distinction between “use” and “control” in *American Locker Co. v. New York City*.<sup>16</sup> The court was asked to determine whether New York City sales tax was due on rentals of coin-operated lockers that were available for public use for a period of up to 24 hours. The locker company argued that the rentals of the lockers did not constitute a “transfer of title or possession or both, exchange or barter, license to use, license to consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore.”

of three Windows-based software products was a taxable sale of pre-written software but that the sale of a substantially similar web-based product that involved no transfer of code was not subject to sales tax).

<sup>13</sup> *In re Darien Lake Fun Country Inc. v. New York State Tax Comn.*, 68 N.Y. 2d 630 (N.Y. Ct. App. 1985).

<sup>14</sup> *In re Smarte Carte Inc.*, Dkt No. 812942 (N.Y. Tax App. Trib. 1996).

<sup>15</sup> See, e.g., TSB-A-10(28)S (July 2, 2010).

<sup>16</sup> *American Locker Co. v. New York City*, 308 N.Y. 264 (1955). *American Locker* involved a sales tax imposed by New York City pursuant to N.Y.C. Admin. Code §N41-1.0(5) and §N41-2.0. The tax was very similar to the current sales tax and was imposed “upon the amount of the receipts from every sale of tangible personal property sold at retail” and defined a sale as “[a]ny transfer of title or possession or both, exchange or barter, license to use, license to consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore.”

The court agreed, stating “[t]he purpose of the sales tax law is not to impose a tax on all transactions, but only on transactions which involve the passage of title . . . or transactions in which the actual, exclusive possession is transferred.”<sup>17</sup> After indicating that it was clear that title to the lockers does not pass to the customers, the court stated “[n]either can there be said to be a transfer of actual physical possession of the lockers to the patrons. The lockers are physically and permanently attached to each other, having been manufactured so as to comprise a cabinet unit. The patron has no right to move any of the lockers.” Still, the city argued that customers were in *constructive possession* of the lockers and that constructive possession was sufficient to render the transaction taxable. The court did not agree because the customers, while able to use the lockers, did not have *control* over them:

It is true, of course, that the patron may keep his baggage on the locker for a period up to twenty-four hours and that during such period he may exclude all others from use of the locker. However, this is, at best, a limited type of constructive possession. The patron has the right only to lock and unlock the locker once during a period not in excess of twenty-four hours. After the door has been locked the patron may not open the locker without ending his right to its further use. If the transaction were one in which real, exclusive possession were transferred, it seems to us that the patron would have the right or privilege of opening and closing the door as many times as he wished during the twenty-four hour period.<sup>18</sup>

Thus, mere “use” without “control,” and the ability to exclude others does not constitute a constructive possession sufficient to become a license to use.<sup>19</sup> *Smarte Carte*, described above, provides a good example of a transaction in which a customer enjoyed both use of and control over property (airport luggage carts) and that was determined to be a taxable rental, lease, or license.

The department certainly recognizes—or, at least, used to recognize—the use/control distinction as well. For example, in *McKelvey (Advisory Opinion)*,<sup>20</sup> the department addressed a transaction in which a customer hired a truck to move asphalt. The customer could instruct the truck driver when and where to load and unload the asphalt but could not instruct the truck driver how to do so or what routes to take from one location to another. The advisory opinion concluded that the trucking company (and not the customer) had “exclusive possession of the trucks and a sufficient degree of

<sup>17</sup> *Id.* (emphasis added).

<sup>18</sup> *Id.* at 267-68.

<sup>19</sup> See, e.g., *Shanty Hollow Corp. v. New York State Tax Comn.*, 111 A.D.2d 968 (N.Y. App. Div. 1985) (relying on *American Locker* for “the firmly established principle that only transactions involving passage of title or of actual exclusive possession constitute sales”); *Bathrick Enterprises Inc. v. New York State Tax Comn.*, 27 A.D.2d 215 (N.Y. App. Div. 3d Dept. 1967) (ability to make jukebox play music was not the result of a license to use the jukebox because “it was never intended that there be (nor was there) any passage or transfer of title nor were they such that actual, exclusive possession was transferred. . . . No title ever passed nor was any possession ever transferred.”).

<sup>20</sup> *McKelvey (Advisory Opinion)*, TSB-A-97(1)S (Jan. 23, 1997).

control over them while performing the service paid for by the customer so as to be furnishing a transportation service and not renting, leasing, or licensing trucks.”

Thus, while the customer clearly “used” the trucks to move its asphalt, it did not “control” them and therefore did not rent, lease, or license them. In fact, in TSB-M-86(3)S<sup>21</sup> the department determined that a storage unit customer only has “control” over the storage unit when the “lessor [has] relinquish[ed] all control of the space rented. The lessee’s possession and control of the space must be to the complete exclusion of the lessor” to be taxable.

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### **ASP users have absolutely no control over the application software itself.**

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While ASP users can submit data through an ASP’s website and request that the ASP’s application software perform certain tasks, ASP users have absolutely no control over the application software itself. First, the software cannot function at all—not even to the slightest degree—unless the underlying operating system and computer server hardware are turned on and being operated and monitored by the ASP’s employees. The users cannot force the application software to perform, cannot stop the software once it has begun performing, cannot copy or alter the software, and cannot correct a flaw or a virus in the software. Simply pushing a few keys on a keyboard or clicking a mouse, at best causes a request to be sent to an ASP’s server, which may or may not be honored. Control would necessitate that the user have access to the underlying computer code itself, be able to force the software to perform or to stop its performance, be able to alter the way the software functions, correct a flaw or virus in the software, or add to or delete parts of the software. An ASP user can do none of these things.

This is in stark contrast to, for example, renting a movie on videotape. By renting a videotape, the video rental store truly has give control over the property to the renter. Even though it would surely run afoul of the rental agreement, the renter could—because of his or her exclusive possession of the videotape—illegally copy it, open it up and remove the tape, lend it to a friend to use, copy over the content, splice in some new material, submerge it in water, etc. The same is true with pre-written software purchased on a CD-ROM in a computer store. Once the purchaser is home with his or her purchase, the purchaser could make illegal copies of the underlying code and distribute those copies to others. Under no circumstances, however, could the same be said with respect to ASP software stored on the ASP’s servers—users simply are powerless to affect the software because they have no access to it whatsoever.

Moreover, an ASP user cannot prevent the ASP from doing any of these activities even if the user does not like the results. There is simply an insufficient amount of “control” over the software to for a user to be treated as constructively possessing it.

This is quite comparable to a music jukebox. A customer can insert coins and request a set number of

songs to be played by the jukebox. However, the customer cannot control the jukebox’s software or hardware to, for example, cause the machine to play a song backwards and cannot delete a song from the jukebox’s library. Because the customer’s control and possession over a jukebox is so limited, a New York appellate court concluded, such use of a jukebox is clearly not a license to use tangible personal property.<sup>22</sup>

New York regulations provide further support that an ASP does not transfer control of its software to users. Specifically, the regulations provide the following example of a situation where there has not been a transfer of possession:

Example 13: A corporation contracts with a computer center to use the computer on the center’s premises for 10 hours weekly. The corporation provides its own materials and the computer center provides and directs the operator. During the 10 hour period, no one else may use the machine. In this case, there is no transfer of possession to the corporation as it has no control over the operation of the computer. However, the transaction may be taxable [as an information service].<sup>23</sup>

The situation presented in this example is quite analogous to an ASP scenario. An ASP’s customers remain an ASP, for example, to provide them with certain electronic banking services. The ASP, like the computer center in the example, “provides and directs” the operation of its electronic services, because the operating systems and the hardware on which the software operates are not under the constructive possession or control of the ASP’s customers. Unlike in the *Smarte Carte* decision, the ASP’s customers cannot do whatever they wish within the software’s “parameters” (as could the luggage cart patrons within the airport’s “perimeter”). Rather, the ASP’s customers can do absolutely nothing without the active coordination and essential concurrent activities contributed by the ASP’s employees in operating the software, operating systems, and hardware. The ASP’s customers have no control over the underlying operations of the ASP’s business. Compare N.Y. Regs. §526.7(e)(5) (example 12) (where the corporation—not the computer center as in example 13 above—provides its own operator, then a taxable sale is deemed to have occurred).

Similarly, the regulations provide a second example of a situation where there has not been a transfer of possession:

Example 14: A corporation contracts with a computer center for access time on the computer center’s equipment through the use of a terminal located in the corporation’s office. The terminal is connected to the computer by telephone. *The corporation’s access to the computer through the terminal is not deemed to be a transfer of possession of the computer sub-*

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<sup>22</sup> See *Bathrick Enterprises Inc. v. New York State Tax Comn.*, 27 A.D.2d 215 (App. Div. 3d Dept. 1967) (ability to make jukebox play music was not the result of a license to use the jukebox because “it was never intended that there be (nor was there) any passage or transfer of title nor were they such that actual, exclusive possession was transferred. . . . No title ever passed nor was any possession ever transferred.”).

<sup>23</sup> N.Y. Comp. Codes R. & Regs. tit. 20 §526.7(e)(5).

<sup>21</sup> TSB-M-86(3)S (Jan. 16, 1986).

ject to tax. However, the transaction may be taxable [as an information service].<sup>24</sup>

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### **Use of another entity's computer systems, without more, is not sufficient to constitute a taxable sale.**

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This example further demonstrates that use of another entity's computer systems, without more, is not sufficient to constitute a taxable sale. Remote use of the computer was simply insufficient to constitute a transfer of possession. Clearly, the corporation had no right to control or operate the underlying computer systems. That is exactly the case with respect to an ASP.

Even federal income tax authority relies on a similar approach and comes to the same conclusion. This issue—sale of service versus rental of property—was at the very heart of an important federal tax decision. In *Xerox Corp. v. United States*,<sup>25</sup> the court looked to the degree of control customers had over “leased” photocopiers and concluded that the lack of control customers had and the nature of the “lessor's” obligations meant that Xerox was providing a service, not renting equipment.

An ASP's customers enter data into a web-based application form and click “enter.” The customers' actions stop there. Once the ASP receives the data file submitted by the customer, the ASP begins performing many tasks, some of which are predominantly electronic, some others of which may require substantial human interaction, but all of which require processes the customer is generally not even aware of and certainly not in control of. (How can a customer be treated as controlling a process that the customer does not even know is occurring?) For example, the customer cannot choose which database an ASP uses (in fact, the customer will likely not even know this is occurring) and cannot control what the ASP does with the results of its database search. Most significant, the customer has absolutely no contact with the ASP's operating systems or computer hardware that—just like the truck drivers in *McKelvey*, above—are really operating the “tangible personal property.” Pushing a few keys on a keyboard or clicking a mouse is simply insufficient action to constitute control over a third-party's software.

### **‘Primary Purpose’ Test**

Instead of demonstrating that ASP services do not fit within the statutory and regulatory definitions of a taxable license to use, one could simply argue that the “primary purpose” or “true object” of the transaction is to receive services and not to receive tangible personal property (i.e., the software). This is the test the New York Tax Appeals Tribunal has traditionally used when there is some uncertainty as to what has been purchased.<sup>26</sup> Thus, if the customer's primary purpose or

true object for making the purchase is to receive a service, then the purchase is a purchase of services (which may or may not be taxable) and not a purchase of tangible personal property.<sup>27</sup>

This test certainly has appeal here, particularly since, we suspect, ASP customers would likely view their purchases as purchases of services and most would be shocked to learn that the department believes they are actually leasing tangible personal property when they use an ASP's website. After all, “the proper focus should be on the primary function itself and not upon whether the service might, as an incident thereof, involve the provision of [some taxable service] . . . [t]o neglect the primary function of petitioner's business in order to dissect the service it provides into what appears to be taxable events stretches the application of Article 28 far beyond that contemplated by the Legislature.”<sup>28</sup> However, because the primary purpose was created judicially and is not contained in statute, the test should be asserted in conjunction with the statutory and regulatory arguments presented above.

### **Sourcing: Yet Another Problem With the Department's Position**

Treating ASP services as sales of prewritten software is not the only troubling element of the Department's new position. The department's approach to determining where the “sale of software” is taxable (i.e., the department's approach to sourcing) is somewhat schizophrenic. On the one hand, the department takes the position that a customer is “using” software that resides on the ASP's server—which very well may be located outside of New York; but on the other hand, the department is taking the position that the software is being used by the customer at the customer's location in New York. But this makes no sense.

According to the department:

The location of the code embodying the software is irrelevant, because the software can be used just as effectively by the customer, even though the customer never receives the code on a tangible medium or by download. The accessing of [and ASP's] software by [its customer] constitutes a transfer of possession of the software, because [the customer] gains constructive possession of the software and gains the “right to use, or control or direct the use of” the software. Therefore, [the ASP] should collect tax from [its customer] where the software is being used.<sup>29</sup>

In other words, even though no tangible personal property is transferred to the customer or is received at the customer's location, the sale should be sourced to that location because the customer has gained constructive possession of software residing on an ASP's server somewhere (perhaps outside of New York).

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<sup>24</sup> N.Y. Comp. Codes R. & Regs. tit. 20 §526.7(e)(5) (emphasis added).

<sup>25</sup> *Xerox Corp. v. United States*, 656 F.2d 659.

<sup>26</sup> See, e.g., *SSOV '81 Ltd. d/b/a People Resources*, DTA No. 810966 (N.Y. Tax. App. Trib. 1995); *In re Principal Connections, Ltd.*, DTA No. 818212 (N.Y. Tax App. Trib. 2004).

<sup>27</sup> See *Marriott Internat'l. Inc.* DTA No. 821078, etc. (N.Y. Tax App. Trib. 2010) (“for tax to apply, there has to be a separate transaction that has as its primary purpose the furnishing of something that is taxable.”).

<sup>28</sup> *In re Telecheck Svcs. Inc.*, DTA No. 822275 (N.Y. Tax App. Trib. 2009) (citing *SSOV '81 Ltd. d/b/a People Resources*, DTA No. 810966 (N.Y. Tax App. Trib. 1995)).

<sup>29</sup> TSB-A-10(28)S (July 2, 2010).

If, however, an ASP's services are properly considered to be taxable licensing of tangible personal property, that property is delivered at, and remains at, the ASP's server where it is used in conjunction with the ASP's operating systems and hardware. This does not occur, as the department asserts, at the location of the client's *remote access* to the software over the internet. The actual activity takes place, plainly, at the location of the server. The department seems to be taking the position that correct "sourcing" for the transaction is where the benefit is received. However, that is a concept applicable to sales of services, not sales to tangible personal property.

### **Does one remotely use tangible personal property**

**... where the remote control device is used or where the actual tangible personal property is located?**

Does one remotely use tangible personal property (which, by statute, includes prewritten software) where the remote control device is used or where the actual tangible personal property is located? Consider the Pentagon's drone Predator aircraft flying in Afghanistan. The unmanned aircraft is operated remotely—assume from the military base in Rome, N.Y.—while the tangible personal property at issue—the drone—is in Afghanistan. Where is the drone being used? The department's position would lead to the conclusion that the drone is being used in New York because that is where the operator is located (and where the benefit—protection of Americans—is received). But this conclusion makes no sense as it is undeniable that the drone is being used in Afghanistan. The department is apparently focusing on where the benefit of the use of the remotely controlled tangible personal property is enjoyed. This, however, is a test for certain taxable services but never for the sale or license of tangible personal property. The department's approach to sourcing reveals the reality of the situation—an ASP provides a service.

Accordingly, if the department continues to insist that ASPs are in the business of licensing pre-written software, then the department—if it is forced to use proper, consistent sourcing rules—seems to be inadvertently laying the ground work for unsound tax policy for New York. If the use of software to deliver a service is deemed a taxable sale of tangible personal property, then savvy taxpayers can simply defeat the tax by moving their servers outside of New York.

It would seem that the department almost has to take this schizophrenic approach to sourcing or else its new ASP position would lose its teeth. After all, there is no question that absolutely no software is delivered to ASP customers in the normal ASP scenario (the department concedes this point) and if an ASP's servers are located outside of New York, none of the software would be "used" by the customer in the state. Thus, no sales tax would be due from ASPs whose servers are outside of New York. Only by disregarding that reality and conflating tangible personal property sourcing with services sourcing does the department actually raise a meaningful amount of revenue from its new position.

**If the use of software to deliver a service is deemed a taxable sale of tangible personal property, then savvy taxpayers can simply defeat the tax by moving their servers outside of New York.**

In other words, if it is appropriate to treat a customer's use of an ASP's software as a license to use, then the department should acknowledge that the software is being used on the ASP's server and the receipts from the sale should be sourced to wherever the server is located (even if outside of New York).

### **A Change in Audit Position May Only Be Applied Prospectively**

Finally, the department's recently adopted position that the provision of online services constitutes a taxable sale of tangible personal property (particularly where there has not been a transfer of a copy of the software itself) is not only contrary to the statute and controlling case law as explained above, but also represents a clear change in its audit position, including the wholesale abandonment of the underlying soundness of the "primary purpose" test discussed above.<sup>30</sup>

Under these circumstances where the department has clearly reversed course, such a change, if legitimate, can be applied only prospectively and may not be applied retroactively. This is particularly true in light of the department's reversal of long-standing policy with respect to the nontaxability of electronic banking services.<sup>31</sup>

### **The Right Way to Tax ASP Services: The Washington State Model**

Effective July 26, 2009, the Washington Legislature expanded Washington's sales tax base to include services provided by ASPs.<sup>32</sup> Specifically, sales tax is now imposed on "digital automated service" which describes "any service transferred electronically that uses one or more software applications." This would likely include the services at issue in *Adobe Systems* and most

<sup>30</sup> Compare, e.g., *Tower Innovative Learning Solutions*, TSB-A-06(5)S (Feb. 2, 2006) (online educational courses a nontaxable service) with *MindLeaders, Inc.*, TSB-A-09(2)S (Jan. 21, 2009) (online educational courses a taxable license of pre-written software); *Dataline, Inc.*, TSB-A-04(17)S (June 30, 2004) (staff monitoring services provided over internet a nontaxable service) with *Homecare Software Solutions LLC*, TSB-A-09(25)S (June 18, 2009) (staff monitoring services provided over internet a taxable license of pre-written software).

<sup>31</sup> See *In re NYCE Corp.*, TSB-A-97(86)S (Dec. 29, 1997); see also *In re New York Cable Television Assn.*, 397 N.Y.S.2d 205 (N.Y. App. Div., 3rd Dept. 1977).

<sup>32</sup> 2010 Wash. Laws, ch. 111 (HB 2620); See also, Wash. Admin. Code 458-20-15501(401)(G).

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of the other ASP opinions. Interestingly, Washington already imposed sales tax on sales of prewritten software but the Legislature apparently did not believe that provision would apply to ASP services.

Changing tax legislation is never easy. But it is the *only* way a sales tax base can legitimately be expanded. Washington state chose the right way to tax ASP services—by acknowledging that a legislative change was required; New York's Department of Taxation and Finance instead is attempting to make end-run around the law.

## Where to Go From Here

New York and states that are following New York's lead—or are considering doing so—should re-evaluate the underlying assumptions regarding possession and control in light of controlling legal authority. Reality simply does not support its conclusion that ASPs are licensing software to their customers.

Because this revenue-raising position is so seriously flawed, ASPs have a very good chance of successfully litigating this issue. ASPs who have large enough potential sales tax deficiencies as a result of this position should consider doing so.