

Information Services: Taxation by Administrative Fiat in New York

by Timothy P. Noonan and Mark S. Klein



Timothy P. Noonan

Mark S. Klein

Over the past 15 years or so, a perfect storm of sorts has been brewing in New York state. As with any good storm — and being from Buffalo, we speak with some authority on this topic — a variety of factors arising at once causes a bad situation to turn ugly, and sometimes downright scary.

But even in Buffalo, it seems a bit too early in the year to talk about a storm like that, doesn't it? Unfortunately, for many New York state taxpayers, we're not referring to a blizzard. The perfect storm that has been brewing concerns sales taxes on information services in New York, and the threat it poses for some industry segments is much larger. In this article, we will discuss how we got in this position and what the prospects are for weathering the storm in the future.

The Issue

Three factors created this storm. First, we're dealing with an uncertain area of the tax law. Since 1965 New York has imposed a sales tax on the sale of information services, defined in the tax law as the service of "furnishing information by printed, mimeographed or multigraphed matter, or by duplicating

written or printed matter in any other manner."¹ So for companies that continue to provide information via mimeographed or multigraphed equipment, the law is fairly clear. But when was the last time you pulled out your mimeograph? One of us — the younger one — didn't even know what a mimeograph was. Since 1965 technology has developed just a little, and the information industry has undergone dramatic changes. Yet the law remains the same, with taxpayers and the Department of Taxation and Finance struggling to figure out how it applies.

And that leads us to our second factor. The information industry has grown by leaps and bounds since 1965, and because of the Internet, it is incredibly different from what it was even 10 years ago. So it's a much bigger issue now that we have all sorts of companies providing information online in one form or other.

The third factor is obvious to regular readers of this column. In New York we have an aggressive and sophisticated tax department. Auditors are hungry for revenue and smart enough to figure out creative ways to tax services within the confines of Tax Law section 1105(c)(1).

So those three factors work together to create, or together create a big problem. There's mass confusion in the industry. Different rules are applied across New York state, and even within the same district offices. And that creates an unlevel playing field, with many taxpayers getting hit for taxes that they never collected from customers. And things could get even worse, in light of a new policy memorandum issued by the tax department in July. But more on that later.

History

First, it's important to look at how we got here. As mentioned above, the tax on information services

¹N.Y. Tax Law section 1105(c)(1).

was put in place when the New York sales tax was created in 1965. Over the next few decades, several cases came out involving questions of interpretation.² One of the primary issues concerned whether information was “personal or individual” in nature and thus excluded from tax under the language of Tax Law section 1105(c)(1). So by the 1980s and early 1990s, a number of cases had been decided interpreting the “personal or individual” test and creating what is now known as the common database rule, whereby tax applied to information that was delivered from a common database even if the information was specific to a particular customer.³ Following that, aggressive New York state auditors were attempting to collect tax on all sorts of different services, with the last straw being an attempt by some auditors to tax meteorological services. In 1995 one of then-Gov. George Pataki’s first initiatives after taking office was to propose legislation to prohibit the tax department from treating meteorological services as information services subject to tax. More generally, in proposing that legislation, Pataki specifically targeted his own tax department’s actions against businesses, denouncing its efforts to create new taxes by “administrative fiat”:

This bill amends the Tax Law to exclude meteorological services from the sales and use taxation under section 1105, which was transformed by the prior administration into a catch-all tax for information services. While I am reluctant to approve a statutory exclusion to overturn an administrative fiat, I approve this bill today to clarify that meteorological services was never taxable under the sales and use tax. By administrative edict, the prior administration pursued avenues of taxation on the basis of an expansive — and erroneous — interpretation of tax law. This abusive practice has subjected honest, law-abiding taxpayers to unwarranted assessments, endless notices of determination, and years of litigation from tax auditors with marching orders from the top — all stemming from a policy in search of endless revenue streams from alleged taxes never authorized by the Legislature. *Taxation by administrative fiat must end.* It will end under my administration.⁴

²*Twin Coast Newspapers, Inc. v. State Tax Com.*, 101 AD2d 977, 477 NYS2d 718 (3d Dept. 1984); *Finserv Computer Corp. v. Tully*, 94 AD2d 197, 463 NYS2d 923 (3d Dept. 1983); *New York Life Ins. Co. v. State Tax Com.*, 80 AD2d 675, 436 NYS2d 380 (3d Dept. 1981).

³*Towne-Oller & Assocs. v. State Tax Com.*, 120 AD2d 873, 502 NYS2d 544 (3d Dept. 1986); *Westwood Pharms. v. Chu*, 164 AD2d 462, 564 NYS2d 1020 (3d Dept. 1990); *Rich Products Corp. v. Chu*, 132 AD2d 175, 521 NYS2d 865 (3d Dept. 1987).

⁴Governor’s message, L. 1995, c. 373 (Aug. 2, 1995) (emphasis added).

Pataki also called for a wide-ranging study on the taxation of information services and directed the department to develop a new policy to address the issue:

The information services industry is an industry which New York should nurture, not over-tax. I therefore will direct the Department of Taxation and Finance to re-evaluate all informal rulings issued publicly or internally regarding the taxation of information services by administrative edict under the sales and use tax and to develop a policy which encourages the information services industry to locate or remain in New York.⁵

So now is when we should tell you about the report issued by the tax department in the mid- to late 1990s that addressed the problem of information services and the new policy for addressing it.

[Cue the sound of crickets chirping.]

That’s right — there was no report. The 1990s came and went without a study. The project died, and no report or study was ever issued. Instead, after years of relative inactivity, the issue started arising again in sales tax audits. And for the last 10 years or so, we again had to deal with taxation by administrative fiat. Creative auditors turned to Tax Law section 1105(c)(1), claiming that tax was designed to cover all kinds of services and products, such as the following:

- dating services⁶;
- check verification services⁷;
- credit analysis services⁸; and
- scientific engineering reports.⁹

And that’s just from reported cases. In audits, we’ve seen auditors attempt to tax a variety of other services as information services simply because some “information” was transferred to the purchaser:

- valuation studies;
- consulting services involving the delivery of a report;
- personalized risk management studies; and
- court reporting services.

The New Technical Services Bureau Memo

But enough history. Let’s fast-forward to July 2010, when the tax department issued a new technical services bureau memorandum (TSB-M-10(7)S) intending to “clarify the tax treatment of certain information services.” But really all that memo does

⁵*Id.*

⁶*Matter of SSOV '81 Ltd. d/b/a People Resources*, Tax Appeals Tribunal (Jan. 19, 1995).

⁷*Matter of Telecheck Services, Inc.*, administrative law judge (Nov. 5, 2009).

⁸*Matter of DZ Bank*, Tax Appeals Tribunal (May 11, 2009).

⁹*Matter of Nerac, Inc.*, administrative law judge (July 15, 2010).

is clarify that the tax department's continued aggressive enforcement in the information services area will continue. Essentially, the new technical services bureau memo does three things.

First, it provides a listing of the types of information services that it deems taxable, including many loosely defined categories that will undoubtedly be difficult for auditors to implement and will create the possibility for more taxation by administrative fiat. Categories such as "investment reports and services," "Internet-based data services," "matching or networking services" (which seemingly had been held nontaxable by the Tax Appeals Tribunal in the *People Resources* case), and "survey results" all raise questions and could be interpreted in numerous ways.

Second, the memorandum attempts to limit the scope of the "primary function" test — a test used by the tribunal in past cases that, to some extent, has curbed the department's efforts to impose tax in the information services context. As noted in a *State Tax Notes* article a few weeks ago, this new interpretation of the primary function test appears to be inconsistent with the tribunal's reasoning in *People Resources*, and it is also undermined by the decision of an administrative law judge in a case issued just a few weeks before the technical services bureau memo came out.¹⁰

The memorandum declares (can anyone say 'administrative fiat?') that some services previously held nontaxable now would be taxed under Tax Law section 1105(c)(1).

Finally, the memorandum declares (can anyone say "administrative fiat"?) that some services previously held nontaxable now would be taxed under Tax Law section 1105(c)(1). One is the service of providing copies of public documents. The tax department said in the memorandum that because of confusion in the industry about whether the tax applied here (go figure), it was clarifying that tax should be collected on those services effective September 1, 2010.

But two other services also were addressed. First, the tax department declared in the memo that the provision of title abstract services by search companies, lawyers, or others in the business of providing abstracts of title would constitute the sale of taxable information services — even though the department

had publicly stated in guidance previously issued to the industry that those services were nontaxable.¹¹ The other change concerned the taxation of risk management analysis services. There are already numerous advisory opinions holding that the provision of risk management analysis services is nontaxable.¹² In the new technical services bureau memorandum, however, the tax department has switched course and declared that those services are taxable. Thus, effective September 1, 2010, tax must be collected on those services, too.

Analyzing the New Rules

The department's declaration in the memorandum of the types of services it deems taxable is bound to create confusion, and its attempt to limit the scope of the primary function test is questionable. But these last two "policy changes" are particularly troubling.

For instance, in the abstracts of title context, it's highly questionable whether tax applies to the provision of this type of "information." An abstract of title is a document that is prepared as a result of an extensive title examination process, a process that is performed by a skilled professional whose job it is to examine whether title to a piece of real property is clear. It's not a data dump or the mere provision of an information service. Indeed, the primary function of the provision of title abstract in the context of a real estate closing is to provide evidence of good title, and the creation of the abstract is a time-intensive process that is undertaken by trained professionals with the appropriate knowledge in various legal areas, including real estate, bankruptcy, estates, and so on. And those overall interpretive issues aside, other problems arise in the application of the new rule/policy. For instance, in Erie County, an abstract is treated as an insurance product under the insurance law, and we understand that the department has already informally concluded that the sale of abstracts in *Erie County* is not subject to the tax! But you'll see no mention of that in the new technical services bureau memorandum — again confirming why it is inappropriate to reverse course in an area like this without going through appropriate legislative or administrative channels.

On the risk management issue, the tax department's conclusion that a service that relies on statistical models and historical data to generate a

¹⁰Michael W. McLoughlin and A. Sonali Carlson, "New York Issues Questionable Guidance on Taxation of Information Services," *State Tax Notes*, Aug. 2, 2010, p. 323, *Doc 2010-16228*, or *2010 STT 147-3*; *Matter of Nerac, Inc.*, administrative law judge (July 15, 2010).

¹¹In one of the letters in which guidance had been issued, a high-level department representative said that "abstracts of title and title searches were not subject to sales tax either now or in the future." Letter from Steven U. Teitelbaum to Mark S. Klein, May 22, 1995 (on file with authors).

¹²*The RiskMetrics Group, LLC*, TSB-A-00(2)S (Jan. 21, 2000); *Measurisk, LLC*, TSB-A-00(9)S (Feb. 10, 2000); *Deloitte & Touche LLP*, TSB-A-99(58)S (Dec. 3, 1999).

report analyzing the specific risks associated with a client's business is taxable is also suspect. It seems this is anything but the provision of a taxable information service. It is a personalized consulting-type service, one in which the vendor has used its own statistical models to generate analysis and advice for the needs of a client. For the tax department to declare administratively that such services are taxable — especially in the face of its previous declarations that they were nontaxable — is unsettling. The State Legislature has not changed the law. The tax department has not changed the regulations. Instead, just like in the early 1990s, it seems we are seeing taxation by administrative fiat.

To be fair, the department clearly doesn't believe it is sidestepping legislative channels or the state's Administrative Procedure Act by issuing this technical services bureau memo. Rather, state policymakers believe that changes in the case law over the past couple decades have expanded the scope of information services subject to tax, justifying the issuance of a memo like this. They also believe that previous proclamations on issues like title abstracts and risk management services were simply wrong and that there is nothing illegal or improper about fixing old mistakes.

And you know what? Maybe they have a point. Maybe there is a way to interpret the provisions of Tax Law section 1105(c)(1) in such a way as to tax things like title abstracts, risk management services, and many of the other services listed in the memo. Then again, you could just as easily come to the opposite conclusion on many of these areas — as previous tax department administrations (and courts) have done. This is an incredibly confusing area, and one that can't be fixed with a four-page memo and some changes in policy. It's a much bigger problem, and one that was supposed to be fixed 15 years ago. Ultimately, it may take litigation to sort out many of these issues. But in the meantime, taxpayers will bear the burden of uncertainty and the risk of running into problems on an audit if they interpret the rules the wrong way.

Next Steps

So where do we go from here? It's hard to say. The tax department has drawn a line in the sand. It has declared some types of services taxable under Tax Law section 1105(c)(1), and now those creative tax auditors will be even more emboldened to take aggressive positions and to tax a wide variety of previously exempt services under the scope of the information services tax. But it's important to point out that just because the tax department's clarification is embodied in a publicly issued technical services bu-

reau memorandum does not mean it'll end up being the right or final answer. Indeed, we've handled several litigated cases in which a previously issued position set forth by the tax department in a publicly issued memorandum or publication was rejected in whole or in part.¹³ But it does mean that taxpayers may be forced to press cases toward litigation or deal with continued uncertainty in their business.

That's probably what's most frustrating about this development. Businesses performing services within New York are deemed agents of the state for sales tax purposes. They collect and remit sales taxes on behalf of the tax department. Given that, it's important that the state's agents be given clear direction on how the tax applies, when to apply it, and so on. And that direction should come primarily in the form of sales tax laws and regulations issued under the normal legislative or administrative processes.

The memo does anything but clarify the issue. It just makes things more confusing.

We understand that the tax department isn't trying to confuse the issue or make things more difficult for vendors. It appears it is trying to provide clarification. But the memo does anything but clarify the issue. It just makes things more confusing. And it might mean that once again the department will be viewed as seeking to extend the scope of the tax law by administrative fiat. So until the department's position is vetted through the normal regulatory or administrative channels, or until efforts are made to actually change the law and make things crystal clear for sales tax vendors, the perfect storm will continue for years to come.

And you thought the weather was bad in Buffalo. ☆

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner in the Buffalo and New York City offices of Hodgson Russ LLP. This column was coauthored by Mark S. Klein, who is also a partner with Hodgson Russ LLP.

¹³*Matter of Frederick R. and Anne M. Clark*, Tax Appeals Tribunal (Sept. 14, 1992); *Matter of Lawrence G. Rawl*, Tax Appeals Tribunal (Dec. 10, 1998); *Matter of Laura Kaltenbacher-Ross*, administrative law judge (May 29, 2003); *Matter of Gregg and Stephanie Falberg*, administrative law judge (Oct. 9, 2003); *Matter of E. Randall Stuckless*, Tax Appeals Tribunal (May 12, 2005); *Matter of Marriott International, Inc.*, Tax Appeals Tribunal (Jan. 14, 2010).