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Bloomberg BNA regularly spotlights the insights of state and local tax attorneys at Alston & Bird LLP. In this installment, Zachry Gladney, Matthew Hedstrom, and Charles Wakefield discuss recent New York Department of Taxation and Finance advisory opinions and how they may or may not reflect the law.

Measuring the Worth of Advisory Opinions: A New York Cloud Computing Illustration



BY ZACHRY GLADNEY, MATTHEW HEDSTROM AND CHARLES WAKEFIELD

Guidance from state tax departments can be a useful resource for analyzing how a state's tax laws apply to a specific set of facts. But with increasing frequency, tax departments are releasing guidance that seems less concerned with analyzing the law as it exists than with establishing taxing principles that reflect a vision of what a tax department believes the law should be.

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Recent Advisory Opinions

Nowhere has this phenomenon been more apparent than in New York, where the Department of Taxation & Finance (the ''Department'') has in recent years issued a wave of guidance addressing the sales and use tax consequences of ''cloud computing'' transactions that consistently untether from the controlling tax statutes and decisional law the Department is charged with enforcing. To illustrate, consider two recently released advisory opinions, TSB-A-17(9)S (July 6, 2017) and TSB-A-17(21)S (August 9, 2017).

TSB-A-17(9)S concerns the taxability of a ''cloud collaboration service'' that allows the seller to remotely enhance the telecommunications systems of its customers with audio processing and routing communications using hardware and software located entirely outside of New York. The facts in TSB-A-17(9)S provide that the crux of Petitioner's service is to assist the customer's

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own telecommunication system in the processing and routing of communications.

TSB-A-17(21)S addresses the taxability of webinar and internet live stream products that offer customers the ability to make live and recorded events available to their clients through the taxpayers internet platform. As part of the service, the taxpayer also sold an optional evaluation and continuing education module that allowed viewers of the live streams and webinars to demonstrate their attentiveness, take tests, fill out evaluations and track their continuing education activities.

Defining Services as Software

In finding that sales of the cloud collaboration service and the education and continuing education module were subject to tax in New York, the Department made several legal conclusions that have little or no support under New York law.

As an initial matter, the Department concluded that the taxpayers in the advisory opinions sold taxable licenses to use pre-written computer software despite reciting facts that objectively demonstrate that the true object of the sales involved the provision of nontaxable services. The Department has, for the last decade, taken the position that any presence of pre-written computer software (defined by statute as tangible personal property) in an otherwise nontaxable service transaction will transform the transaction into a taxable sale of tangible personal property. *See* TSB-A-08(62)S (Nov. 24, 2008). However, the Department's position is quite often contrary to the only case in New York that addresses whether a nontaxable service that is delivered through the use of pre-written computer software. In *Matter of SunGard Securities Finance LLC*, DTA No. 824336 (Feb. 6, 2014), an administrative law judge concluded that even though pre-written computer software was an essential part of delivering the service, the ''primary purpose'' or ''true object'' of the transaction was for the sale of a service rather than for software. In light of *SunGard*, the Department's characterization of the products sold in TSB-A-17(9)S and TSB-A-17(21)S would appear to be improper because the facts demonstrate that the sellers are likely using software as a means for delivering their services and are not just selling prewritten software over the internet.

Inventing a ''Sale''

However, even if the Department correctly concluded in TSB-A-17(9)S and TSB-A-17(21)S that the primary purpose of the transactions was for pre-written computer software, its conclusion that the purchasers had the requisite control or possession over the software to constitute a taxable ''sale'' is contrary to settled New York law addressing analogous situations. The Department asserts that customers who purchase remote access to pre-written computer software take ''constructive possession'' of the software even though the software itself is stored on the seller's server and no copy is downloaded by the customer. This is in conflict with existing case law in New York. In *American Locker Co. v. New York City*, 308 N.Y. 264 (1955), New York's highest court held that ''the 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*.'' In its advisory opinions, the Department does not attempt to justify how constructive possession is sufficient to impose tax when cases such as *American Locker* require ''actual, exclusive possession.'' Rather, the Department seems to ignore the *American Locker* line of reasoning because its advisory opinions addressing cloud computing transactions make no mention of the ''actual, exclusive control'' requirement that has developed through case law.

Sourcing Software as a Service

Finally, even if it is assumed that the Department correctly determined that the cloud-based transactions in TSB-A-17(9)S and TSB-A-17(21)S primarily involved software, and that those transactions qualified as taxable ''sales,'' the Department also lacks any legal support for its conclusion that such sales are sourced to the location of the customer. Like most states, New York imposes sales and use tax on sales of tangible personal property at the location where the property is used or delivered. But for cloud transactions involving software, which is statutorily defined as tangible personal property, the ''property'' in virtually all circumstances remains on a server owned or rented by the vendor, and thus no property is ''delivered'' to the customer. Similarly, it stretches the imagination to conceive of a situation where property that physically resides in one state can be somehow be ''used'' in another. The Department avoids the issue altogether by concluding that 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. Thus, instead of using a tangible personal property sourcing approach—which is statutorily required since software is defined as tangible personal property—the Department uses a sourcing methodology that is normally associated with sales of services.

Practical Considerations

TSB-A-17(9)S and TSB-A-17(21)S demonstrate the inherent flaws with the Department's cloud computing guidance. By creating a fiction whereby cloud computing transactions (which fundamentally involve intangible property) are treated the same as physical goods, it then becomes necessary to create additional fictions to reconcile the real-life differences between intangible and tangible property for tax purposes. For example, the Department's position that cloud-computing transactions are sales of pre-written computer software gives rise to problems associated with the legal standards for possession and situs because, unlike computer software that is electronically delivered to the purchaser's computer via download, customers in cloud-based transactions do not take possession of the property. Thus, it became necessary to introduce new and unsupported legal concepts for ''constructive possession'' and sourcing based on customer location to account for the difference.

Taxpayers and tax professionals often rely on advisory opinions to analyze how the tax law works and to predict how the Department will apply the law under similar facts. However, advisory opinions have no legal effect in judicial proceedings, and reflect only the ''opinion'' of the Department. While advisory opinions

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can be useful to predict what the Department might assert in an audit, in the context of an administrative or judicial appeal an advisory opinion from the Department can be confidently discarded.