

## **New York State Tax Audit Issues for Electronic Service Providers – Part I: Reclassifying Service Receipts as 'Other Business Receipts' for Article 9-A Taxpayers**

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In December, the New York Department of Taxation and Finance (the "Department") issued an advisory opinion regarding the sourcing of debit card processing and debit card sale receipts. In this opinion, the Department characterized those receipts as "other business receipts" rather than as receipts generated from the rendition of services.<sup>1</sup> This type of reclassification of receipts from services has become increasingly common, as evidenced by the Department's publicly issued guidance and positions taken by the Department during audit. This reclassification is significant because it appears to be a tactic intended to limit the scope of service receipts that are sourced to New York based on cost-of-performance principles, while broadening the scope of other business receipts that are sourced to New York if "earned" in the state. This approach has, for the most part, been used in audits of corporations providing electronic and data processing services, remote access to databases, and the sale of digital products to customers located in New York. This issue is likely to become even more significant for audits of tax years beginning in 2007, when New York's single-receipts factor sourcing became effective.

### **New York Receipts Factor Sourcing**

For purposes of the corporate franchise tax imposed under New York Tax Law Article 9-A, the following business receipts are deemed to be New York receipts: (1) receipts from the sales of tangible personal property, if shipped to customers located in the New York;<sup>2</sup> (2) receipts from the rendition of services, if performed within New York; (3) receipts from rentals of property and the use of intangible property, if the property is located or used within New York; and (4) all other business receipts earned in New York.<sup>3</sup>

Business receipts categorized as receipts from services are generally sourced to New York using a proportional cost-of-performance methodology. Thus, as a general matter, receipts from the performance of services are sourced to New York only to the extent the service provider incurs the costs to provide the services in New York.<sup>4</sup> By contrast, business receipts categorized as "other business receipts" are sourced to New York if "earned" in New York. New York has issued a regulation providing specific examples of receipts that fall within the classification "other business receipts." These examples include receipts from the sale of real property, receipts from sales of intangible personal property by dealers for sale to customers in the regular course of business, receipts of securities and commodities brokers, and receipts from the sale of capital assets.<sup>5</sup> Other than this regulation, there is little guidance regarding the types of receipts that constitute "other business receipts." The regulation focuses on the receipts of broker/dealers and receipts from the sale of securities and commodities and, thus, it is reasonable to conclude that the "other business receipts" classification was intended to apply specifically to these types of receipts and was otherwise intended to be a narrow classification.

## **Department Policy Statements Regarding 'Other Business Receipts'**

The Department's move toward broadening the scope of "other business receipts" for Article 9-A purposes started in 1999 with an advisory opinion issued to the New York Mercantile Exchange ("NYMEX").<sup>6</sup> In this advisory opinion, the Department took the position that subscription fees that NYMEX charged vendors for access to a database of real-time market information constituted "other business receipts." The Department then sourced the fees to the location of the modem or other transmission equipment used by vendors to access the market data from NYMEX. In other words, the Department took the position that the location where the fees were earned was the customer location (i.e., a market-based approach).

The Department issued another advisory opinion shortly thereafter involving the sourcing of fees charged for access to a database of copyrighted information regarding the insurance industry.<sup>7</sup> The customers paid an annual subscription fee and/or a variable fee based on inquiries into the taxpayer's database. The Department concluded that these fees were "other business receipts" that should be sourced to the location of the modem or other transmission equipment used by the customers to access the data or, if that location could not be determined, to the customer mailing address. Once again, the Department took the position that the location where receipts were earned was the customer's location. It is important to note that the Department gave no

weight to facts regarding where the taxpayer's employees conducted research, revised information, formatted data, or otherwise provided support for the database that customers paid to access.

The Department has also supported its decision to classify certain receipts as "other business receipts" on the theory that certain receipts are, in reality, payment for an intangible right to redeem rather than payment for services. In 2002, the Department issued an advisory opinion that concluded that receipts from the sale of gift certificates, gift cards, and other digital and non-digital related products over the Internet constituted "other business receipts" on that basis. As a consequence, the Department held that the receipts from the sale of these products should be sourced to the location from which the customer accessed the vendor's website or, if that location could not be determined, to the customer's billing address.<sup>8</sup>

Most recently, the Department issued TSB-A-11(1)C.<sup>9</sup> In this advisory opinion, the Department reversed guidance that it had issued to Peach Tree Bancard Corporation ("PTBC") in 1995. Under the previous guidance, the Department had classified PTBC's credit card processing receipts as service receipts.<sup>10</sup> In reversing the previously issued guidance, the Department took the position that processing receipts and other receipts attributable to debit cards were all properly categorized as "other business receipts." This change in policy resulted in the sourcing of these receipts based on the location where the fees were earned, which the Department viewed as the location of the customer or based on customer activities (a market approach), as opposed to the location where the taxpayer's costs of performance were incurred. Specifically, the Department took the position that the fees at issue should be sourced as follows:

- Any fee for the sale of a prepaid debit card should be sourced to the location where the card was sold
- Any fee for the sale of an online debit card should be sourced to the location of the workstation from which the card vendor website was accessed to purchase the card<sup>11</sup>
- Any fee for the performance of processing activities<sup>12</sup> should be sourced to the location of the merchant accepting the card<sup>13</sup>
- Any fee attributable to card maintenance activities should be sourced to the location where the customer initiated the card transaction<sup>14</sup>

By categorizing these fees as "other business receipts," the Department was able to avoid sourcing any of the receipts based on the location in which taxpayer's costs of performance were incurred.

## **Audit Risks and Opportunities**

The proper categorization of receipts-either as receipts from the performance of services or as "other business receipts"-can often be a key audit issue. The primary risk is that a Department auditor will reclassify a taxpayer's service receipts as "other business receipts" and then source those receipts on a market basis rather than on a cost-of-performance basis.<sup>15</sup> Based on the Department policy guidance and our experience with Department auditors, the auditor could reclassify service receipts based on several different theories,<sup>16</sup> including characterizing the receipts as generated by an automated or passive activity;<sup>17</sup> characterizing the receipts as generated from the sale of an intangible right to redeem or a digital financial product (e.g., debit or gift cards);<sup>18</sup> or characterizing the receipts as generated from access to intangible property in the form of software, databases, or proprietary information.<sup>19</sup>

These types of receipt-reclassification issues are most likely to arise during audits of companies that provide electronic services<sup>20</sup> based outside of New York, and companies operating in, or providing support to, the financial services industry. However, receipt-reclassification issues can arise during the audit of any Article 9-A taxpayer that derives receipts that don't easily fall within the traditional categories.

A taxpayer can rebut the Department's reclassification of its receipts by establishing facts and evidence that people and capital are involved in rendering the taxpayer's service, that the taxpayer's services are not automated, and that the taxpayer is not merely providing an intangible right to redeem or passive access to intangible property.<sup>21</sup> In addition, taxpayers should establish that services do not lose their character as services merely because such services are delivered electronically. Finally, a taxpayer may be able to use accounting revenue recognition principles to establish that it accounts for its receipts as a service provider, and that pursuant to generally accepted accounting principles, it must account for its receipts in that manner.

Even if the Department is successful in categorizing a taxpayer's receipts as "other business receipts," the taxpayer may still be able to challenge the sourcing methodology adopted by an

auditor. The Department has scant authority to support its near universal conclusion that "other business receipts" are "earned" at the customer's location or based on the customer's activities. In our view, there is substantial tax law authority to support the position that it is the taxpayer's activities that generate, or earn, the receipts, and not the activities of the customer.<sup>22</sup> If receipts from "other business receipts" were to be sourced based on the location of the taxpayer's activities, then the reclassification of service receipts would likely not be a significant issue.<sup>23</sup>

Of course, some taxpayers may be able to turn the Department's readiness to reclassify service receipts as "other business receipts" to their own advantage. Depending on a taxpayer's particular facts and circumstances, there may be opportunities to reduce the receipts sourced to New York by recharacterizing certain receipts as "other business receipts," rather than as receipts from services. These opportunities may provide taxpayers with leverage on audit, and may even result in tax refunds.

This is the first of two articles from the Reed Smith State Tax Group highlighting New York audit issues that impact electronic service providers. For more information on the rules governing the classification and sourcing of receipts for New York Article 9-A franchise tax purposes, contact the authors of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's New York tax practice, visit [www.reedsmith.com/nytax](http://www.reedsmith.com/nytax).

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1. TSB-A-11(1)C (December 28, 2010).
  2. New York looks to the ultimate destination in determining the location to which tangible personal property is shipped. 20 NYCRR § 4-4.2.
  3. N.Y. Tax Law § 210.3(a)(2)(A)-(D).
  4. Service receipts are wholly allocated to New York if the services are performed in New York. Where a lump sum is received by the taxpayer in payment of services performed within and out of New York State, the portion of the sum attributable to services performed within New York State is determined on the basis of the relative values of, or

amounts of time spent in performance of, such services within and out of New York State, or by some other reasonable method. 20 NYCRR § 4-4.3(d).

5. 20 NYCRR § 4-4.6.

6. TSB-A-99(16)C (April 7, 1999).

7. TSB-A-00(15)C (September 6, 2000).

8. TSB-A-02(3)C (April 18, 2002).

9. TSB-A-11(1)C (December 28, 2010).

10. TSB-A-95(13)C (August 4, 1995).

11. In situations in which the taxpayer could not determine the physical location from which the customer was physically accessing the taxpayer's databases, the taxpayer was advised to source the receipts to the customer's mailing address.

12. The taxpayer's processing activities included set-up, activation, maintenance of the card and maintenance of the cardholder funds, clearing and settlement, and system and regulatory compliance.

13. In situations in which the taxpayer could not determine if the transaction occurred with a New York merchant, the taxpayer was advised to source the receipts to the customer's mailing address.

14. In situations in which the taxpayer could not determine the physical location from which the customer initiated the card transaction, the taxpayer was advised to source the receipts to the customer's mailing address.

15. This risk also applies to taxpayers subject to New York City General Corporation Tax, which has receipts-factor sourcing rules similar to those applicable under the Article 9-A franchise tax.

16. The strength of the auditor's position for market-based sourcing will vary depending on which theory the auditor pursues. For example, there is guidance to support the position that receipts generated from the use of intangible property should be sourced to the location where the intangible property is used.

17. Based on the position that the receipts in question are generated through electronic means or through the limited use of employees or capital. The auditor would likely source the receipts under this theory to the customer workstation.

18. Tax Law Article 32, which imposes a franchise tax on banking corporations, has specific guidance regarding the sourcing of receipts from certain banking and financial activities. The Article 32 rules for sourcing receipts often differ from the Article 9-A

receipts sourcing rules.

19. The auditor would likely source the receipts under this theory to the customer workstation.

20. Such as providers of data processing services, information services, database access services, remote communication services, digital product services, and companies that render their services through an application service provider (ASP) environment.

21. The taxpayer may find it helpful to arrange interviews between the auditor and its various service personnel to establish the scope of the employees and capital used to render its services.

22. In analyzing the issue of sourcing interest receipts received by a New York taxpayer, the New York Court of Appeals differentiated between the term "earned" for Article 9-A franchise tax purposes and the term "sourced" for Article 9 section 184 tax purposes. *Matter of Siemens Corp. v Tax Appeals Trib.*, 89 NY2d 1020 (1997).

23. However, the sourcing methodology used to determine the location of a taxpayer's activities to earn "other business receipts" could differ somewhat from the cost-of-performance methodology generally applied to source service receipts.

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