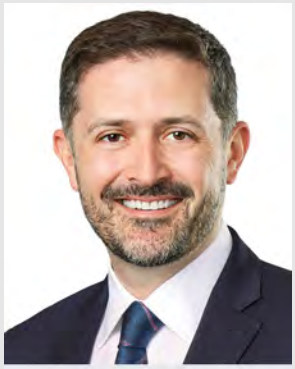
For Your Information: That Might Be a Taxable Service

by Christopher T. Lutz



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In this installment of Internally Consistent, Lutz examines state taxation of information services as more businesses grapple with economic nexus and multistate tax compliance.

In the five years since the Supreme Court held that the "physical presence rule of *Quill* is unsound and incorrect,"[1] many taxpayers have seen their sales tax footprint expand from a single state to dozens. While many sellers of tangible personal property were immediately thrust into a position of collecting tax and filing across the country, other sellers were left in an even less enviable position. Sellers of software, for instance, had to determine not only where they had nexus but also whether their products were taxable at all.

Against that backdrop, many sellers correctly concluded that they neither sold tangible property nor licensed or sold taxable software. Instead, they provided some form of professional service that might include a digital element. Concluding that they sold professional services, many of these businesses assumed they did not have any sales tax obligation in states where they had customers. This assumption, however, revealed a significant blind spot: State taxation of professional services is on the rise, and some industries have uniquely garnered states' interest.

At least 13 states and the District of Columbia tax information services to varying degrees. Other states tax data processing services, which might overlap with information services. Of the states that tax information services, less than half are full members of the Streamlined Sales and Use Tax Agreement. Not that it would make much of a difference if they were; the SSUTA does not define information services other than to note that they are not included in the definition of telecommunications service. States vary widely as to the types of information services they tax, with some limiting taxation to sales of credit bureau services or other specific types of information while others extend tax to information that is gathered, maintained, compiled, analyzed, furnished, delivered, provided access, collected, or retrieved.

The nature of the information matters, as well. Generally, the sale of information services to newspapers and the like will be treated as exempt from tax.[2] Information that is personal, proprietary, or of an individual nature, moreover, is typically not taxable, either. But a state might tax any subsequent sale of that proprietary information, as is the case in Texas.[3] As more businesses grapple with economic nexus and multistate tax compliance, the tax characterization of their services will only continue to generate controversy.

[1] *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

[2] *See, e.g.*, D.C. Code Ann. section 57-2001(n)(1)(N); Fla. Stat. section 212.08(7)(v); N.Y. Tax Law section 1105(c)(1); Tex. Tax Code Ann. section 151.0038(a)(1)(B).

[3] Tex. Admin. Code 3.324(a)(5)(A).

New York's Taxation of Information Services and The 'Primary Function' Test

Over the past few years, New York has been particularly active in examining whether businesses are selling taxable information services. There has been a noticeable uptick in audit activity on this question, and a significant amount of litigation. In 2022 there were at least four Division of Tax Appeals decisions and two Tax Appeals Tribunal decisions that examined whether a taxpayer was providing taxable information services — yet 2022 was not an outlier. Much of the activity in New York appears to have come on the heels of *Matter of Wegmans*,[4] in which the New York Court of Appeals upheld an appellate division decision that compiling pricing studies of a grocery store's competitors constituted a taxable information service.

But *Wegmans* stood for a fairly mild proposition. Both parties agreed that collecting competitive pricing information was an information service. The taxpayer contended, however, that the information was personal or individual in nature, so the service was excluded from tax under N.Y. Tax Law section 1105(c)(1). Holding that the information was "derived from a non-confidential and widely accessible source," the court determined that it was not personal or individual in nature and therefore was properly subject to tax.

The ongoing importance of *Wegmans* is evident. In *Dynamic Logic*,[5] the taxpayer provided services that measured the effectiveness of advertising strategies. The company would survey consumers and internet users and use this data to inform clients as to how they could improve advertising and marketing performance. The taxpayer contended that its primary function was to provide consulting services, not information. The Division of Tax Appeals disagreed, concluding that the taxpayer's "primary function is to collect information regarding the effectiveness of its clients' advertising by conducting surveys, analyze that information, and furnish that information and analysis to its clients via reports." However, the division went on to question whether that information was nonetheless personal or individual in nature.

Importantly, the division concluded that the information collected by the taxpayer in *Dynamic Logic* was individual or personal in nature and therefore might be exempt. The division explained that "unlike the publicly available source that information was derived from in *Matter of Wegmans*, the information gathered by petitioner for its clients in this matter was not publicly available or widely accessible." Nonetheless, the division next asked whether, under section 1105(c)(1), the information "is not or may not be substantially incorporated in reports furnished to other persons." Because the information collected by the taxpayer could be aggregated to provide more comprehensive services to all its clients, the services were taxable. Although the information collected was not publicly available, the taxpayer's ability to later incorporate and report that information to other clients prevented the taxpayer from claiming an exemption.

But that was not the end of the story. The taxpayer appealed to the New York Tax Appeals Tribunal. While the tribunal generally agreed with the division's analysis, it departed in one substantial way.[6] The tribunal examined the taxpayer's different product lines and determined that one such line was entitled to the exemption. The tribunal explained that although the collected information from this specific product line could in theory be aggregated, it was not. Because the information was not aggregated or resold, the exemption applied.

It would be a mistake to construe New York's definition of information services too broadly. Several decisions have recently held that the "primary function" of a particular taxpayer is the underlying service, not an information service. For instance, in *Matter of Breakdown Services Ltd.*,[7] the taxpayer provided an "internet-based casting facilitation service that connects casting directors

[4] *Matter of Wegmans Food Markets Inc. v. Tax Appeals Tribunal*, 131 N.E.3d 876 (N.Y. Ct. App. 2019).

[5] *Matter of Dynamic Logic Inc.*, DTA No. 828619 (N.Y. Div. Tax App. Jan. 14, 2021).

[6] *Matter of Dynamic Logic Inc.*, DTA No. 828619 (N.Y. Tax App. Trib. Jan. 20, 2022).

[7] *Matter of Breakdown Services Ltd.*, DTA No. 829396 (N.Y. Div. Tax App. Jan. 27, 2022).

seeking actors for available roles in productions such as feature films." After a thorough analysis of all the components of the taxpayer's services, the division determined that the taxpayer was essential to the casting of actors in acting roles, and any information service it provided was merely in support of that primary function.

The division reached similar conclusions in *LendingTree*[8] and *Lender Consulting Services*.[9] In the former, the taxpayer's primary function was to provide an online loan marketplace. In the latter, the taxpayer's primary function was to analyze real estate's potential environmental liabilities. While information was conveyed in both cases, this information was merely a component of the taxpayers' broader services.

With the amount of activity in the state, New York provides a useful template for how taxpayers should think about the taxability of their products. Even with ample authority, it can still be difficult to determine where on the spectrum a taxpayer may fall in determining what their primary function is. Indeed, one would think the taxpayers in *Wegmans* and *Dynamic Logic* would argue that their primary function was advertising consulting, despite the outcomes in those cases.

Texas's Spectrum of Taxation From Information Services to Data Processing Services

Texas adds another complex angle to this analysis because it taxes data processing services in addition to information services. In New York, we need only ask whether the primary function of a service is to provide information services, and then whether that information is individual and proprietary. However, in *Instill Corp.*,[10] we see the complexity of connecting this analysis to the taxation of data processing services.

In *Instill*, the taxpayer obtained "raw data from customers and each customer's vendors and then use[d] its own algorithms to process and present these data in a user-friendly manner intended to 'help Instill's customers run their businesses.' Instill's customers would then access the solution via a secure website." The taxpayer contended that this constituted information that was proprietary in nature and therefore should be exempt from Texas sales tax. The court of appeals disagreed. Although the information may have been proprietary, the court explained, the taxpayer did more than merely convey the information. Instead, the value of the taxpayer's services was in its "reformatting, standardization, and aggregation of the Customer's raw data into an accessible, usable format." While an exemption for proprietary information does exist for the taxation of information services, Texas provides no such exemption for data processing. Thus, the processing of proprietary information was taxable.

Other State Attempts to Reach Historically Nontaxable Services

While New York and Texas, the two largest states to tax information services, provide some framework for examining whether a particular service is taxable, other states prove more amorphous. For instance, Wisconsin does not tax information services. However, in 2021 the Wisconsin Department of Revenue purported to "clarify" that its taxation of "additional digital goods" included "charges for access to an online database or website of information that allows the user to perform searches of the database and view and/or download the information."[11] The DOR's bulletin provides examples such as job listings, construction plans, price or valuation information, and personal information such as addresses, ages, or phone numbers.

Wisconsin's bulletin highlights how taxpayers should be wary of state attempts to expand their tax base to services that historically have not been subject to tax. Indeed, Wisconsin's bulletin likely runs afoul of the Internet Tax Freedom Act,[12] which prohibits state taxes from discriminating against electronic commerce. How far might Wisconsin, or some other state, go in converting a

[8] *Matter of the Petition of Lending Tree Inc.*, DTA No. 829714 (N.Y. Div. Tax App. Dec. 9, 2021).

[9] *Matter of Lender Consulting Services Inc.*, DTA No. 829198 (N.Y. Div. Tax App. Dec. 2, 2021).

[10] *Instill Corp. v. Hegar*, No. 03-18-00374-CV (Tex. Ct. App., May 31, 2019).

[11] Wisconsin Department of Revenue, Tax Publication No. 240 (Nov. 1, 2021).

[12] 47 U.S.C. section 151 note.

historically nontaxable service into a taxable service merely because that service is now accessible via a digital database?[13] Certainly a state such as Washington, which imposes tax on "digital automated services," has shown a willingness to tax "any service transferred electronically that uses one or more software applications."[14]

Yet another wrinkle in a post-*Wayfair* world. Once only the concern of sellers of tangible property, service providers now must think comprehensively about the taxability of their services in states they may never enter. The answer to the question of taxability, too, will evolve in the coming years as states continue to reinterpret old rules to reach digital transactions. Hopefully states will become better information providers themselves and make it easier on these businesses going forward. ■

[13] Tennessee recently came close to explicitly rejecting Wisconsin's approach in Tenn. Letter Ruling No. 22-08. The department explained that "building a proprietary database from various sources of information and providing customers access to that database is a type of information service." The "incidental use" of an online portal or API to access information service offerings did not convert those otherwise-nontaxable offerings to taxable ones.

[14] Wash. Rev. Code section 82.04.192(3). *But see Landis+GYR Midwest Inc. v. Department of Revenue*, 526 P.3d 867 (Wash. Ct. App. 2023) (holding that a taxpayer that provided an automated meter reading service qualified as an exempt data processor whose primary purpose was extracting data from raw data points and therefore was exempt from sales tax).