

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-03(28)S
Sales Tax
June 24, 2003

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S020813A

On August 13, 2002, the Department of Taxation and Finance received a Petition for Advisory Opinion from Ernst & Young LLP, 18111 Von Karman Avenue, Suite 1000, Irvine, California 92612. Petitioner, Ernst & Young LLP, provided additional information with respect to the Petition on September 25, 2002.

The issue raised by Petitioner is whether the sale of subscription contracts to an Internet filtering program is subject to New York State sales and use taxes.

Petitioner submitted the following facts as the basis for this Advisory Opinion.

Company A, which is a C Corporation incorporated in Delaware with headquarters in California, offers Internet management solutions. The primary function of Company A is to provide its clients the ability to rapidly implement and configure Internet access policies in support of the clients' efforts to improve employee productivity through the use of Internet filtering capabilities.

Company A's Internet filtering service utilizes two components: application software and a master database. The application software is of no value in itself but is necessary to use the company's filtering services. The application software filters employee access to the Internet based on Internet policies set by Company A's clients. The application software (which is loaded on the client's server via the Internet) directs all employees' Internet Web site (URL) requests to Company A's master database which is downloaded to the client's server. The master database contains all known Internet Web sites, which are categorized by Company A in its California facility. The database is downloaded on a nightly basis to the client's server from one of Company A's three servers (two in California and one outside of the US). Similar to the application software, the database is of no value on a stand-alone basis. The client has the ability to implement and configure Internet access policies after the software and database have been downloaded onto its server. The employee's URL request is processed in the database to determine whether the Web site requested is approved for the particular user. Access to the Web site is either granted or denied based on the Internet policies set forth in the application software. Company A's clients access the application software free via the Internet.

Company A's revenue is generated by selling subscription contracts to clients for this Internet filtering program. Subscription contracts range from one to three years with full up-front cash payments made once a client accepts the contract. Upon acceptance of the contract terms, a key (similar to a password) is sent to the client via the Internet, which allows the client access to Company A's software and database.

Applicable Law and Regulations

Section 1101(b) of the Tax Law provides, in part:

When used in this article for the purposes of the taxes imposed by subdivisions (a), (b), (c) and (d) of section eleven hundred five and by section eleven hundred ten, the following terms shall mean:

* * *

(5) Sale, selling or purchase. Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume (including, with respect to computer software, merely the right to reproduce), conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor.

(6) Tangible personal property. Corporeal personal property of any nature. However, except for purposes of the tax imposed by subdivision (b) of section eleven hundred five, such term shall not include gas, electricity, refrigeration and steam. Such term shall also include pre-written computer software, whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to a purchaser. . . .

* * *

(14) Pre-written computer software. Computer software (including pre-written upgrades thereof) which is not software designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more pre-written computer software programs or pre-written portions thereof does not cause the combination to be other than pre-written computer software. Pre-written software also includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than such purchaser. Where a person modifies or enhances computer software of which such person is not the author or creator, such person shall be deemed to be the author or creator only of such person's modifications or enhancements. Pre-written software or a pre-written portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains pre-written software; provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute pre-written computer software.

Section 1105 of the Tax Law provides, in part:

On and after June first, nineteen hundred seventy-one, there is hereby imposed and there shall be paid a tax of four percent upon:

(a) The receipts from every retail sale of tangible personal property, except as otherwise provided in this article.

* * *

(c) The receipts from every sale, except for resale, of the following services:

(1) The furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons, but excluding the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity, and information services used by newspapers, radio broadcasters and television broadcasters in the collection and dissemination of news, and excluding meteorological services.

* * *

(9)(i) The furnishing or provision of an entertainment service or of an information service (but not an information service subject to tax under paragraph one of this subdivision), which is furnished, provided, or delivered by means of telephony or telegraphy or telephone or telegraph service (whether intrastate or interstate) of whatever nature, such as entertainment or information services provided through 800 or 900 numbers or mass announcement services or interactive information network services. Provided, however, that in no event (i) shall the furnishing or provision of an information service be taxed under this paragraph unless it would otherwise be subject to taxation under paragraph one of this subdivision if it were furnished by printed . . . matter or by duplicating written or printed matter in any other manner. . . .

Technical Services Bureau Memorandum, entitled State and Local Sales and Compensating Use Taxes Imposed on Certain Sales of Computer Software, March 1, 1993, TSB-M-93(3)S, provides in part:

Effective September 1, 1991, State and local sales and compensating use taxes are imposed on the sale or use of prewritten computer software and certain related services.

* * *

Prewritten computer software is any computer software that is not designed and developed by the author or other creator to the specifications of a specific purchaser.

The sale of prewritten software includes any transfer of title or possession, any exchange, barter, rental, lease or license to use, including merely the right to reproduce, for consideration. Thus, a payment made by a customer on or after September 1, 1991, for a license to use, or for the rental or lease of prewritten software is subject to sales or use tax. The transfer of public domain software without any charge is not taxable because there is no consideration.

* * *

Prewritten software is subject to tax whether sold as part of a package or separately. Software created by combining two or more prewritten programs or portions of prewritten programs is still prewritten software subject to tax. The medium by which the software is transferred to the purchaser has no effect on the software's taxability. Thus, prewritten software is taxable whether sold, for example, on a disk, tape or by electronic transmission over telephone lines.

Prewritten software, even though modified or enhanced to the specifications of a specific purchaser, remains prewritten software subject to tax. However, if a charge for the custom modification or enhancement is reasonable and separately stated on the invoice or billing statement, then the separately stated charge for the custom modification or enhancement is not subject to tax.

* * *

Programming and systems analysis are also exempt services. However, where these services are rendered in conjunction with the sale of *prewritten* software, the charge for the service is exempt from tax only when the charge for the service is reasonable and separately stated on the invoice or billing statement given to the customer.

Opinion

Company A's Internet filtering program utilizes two components: application software and a master database which contains all known Internet Web sites, which are categorized by Company A. The primary function of Company A's program is to provide its client with the ability to rapidly implement and configure Internet access policies.

The application software is loaded on the client's server via the Internet. The software directs Internet Web site (URL) requests of the client's employees to Company A's database which also resides on the client's server. The database "updates" are downloaded to the client's server nightly. Prior to accessing Company A's software and database via the Internet, the client is required to agree to the terms of a subscription contract and make an up-front payment. The client has the ability to implement and configure Internet access policies after the software and database have been downloaded onto its server. The software and database provided by Company A direct and filter the client's employees' Web site requests based on the client's established policies, and either grant or deny the employees access to the Web site requested.

While Petitioner describes Company A's operation as a service, all tasks related to the "filtering services" provided by Company A are performed by the software and master database. The software and database provided by Company A direct and filter the client's employees' Web site requests. The client establishes its policies and, through the use of Company A's filtering software, its employees are granted or denied access to certain Web sites. The software and database are transferred to the client's server. Therefore, the consideration received by Company A is for providing the client with the use of its software application which controls Internet use by the client's employees. The fee paid for the lease or license to use or consume prewritten computer software, regardless of the medium by means of which such software is conveyed to the purchaser, is subject to New York State sales tax as provided in section 1105(a) of the Tax Law. See section 1101(b)(6) of the Tax Law. Were the database sold separately from the application software, the fees paid for the database (and its updates) would be subject to the tax imposed on information services under section 1105(c)(1) or section 1105(c)(9) of the Tax Law since the information in the database is not personal and individual in nature and is provided to multiple customers. See Matter of Towne-Oller & Assocs. v. State Tax Commission, 120 A.D.2d 873 (3d Dep't 1986); Matter of Twin Coast Newspapers Inc. v. State Tax Commission, 101A.D.2d 977 (3d Dep't 1984). Accordingly, the payment received by Company A from the sale of subscription contracts for Internet filtering services are subject to New York State and local sales and compensating use taxes.

To the extent that Company A performs nontaxable services such as software maintenance, or provides custom software programming for the client, no tax is required to be collected with respect to such services. See section 1115(o) of the Tax Law. If the customer is billed for both taxable and nontaxable services, the total charge is subject to tax unless the charge for the nontaxable service is reasonable and separately stated. See sections 1101(b)(14) and 1115(o) of the

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Tax Law, and OMR Systems Corporation, Adv Op Comm T&F, September 9, 1998, TSB-A-98(59)S. For additional information on the taxability of sales of computer software and related services, Petitioner should refer to TSB-M-93(3)S, supra.

DATED: June 24, 2003

/s/
Jonathan Pessen
Tax Regulations Specialist IV
Technical Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.