

**New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit**

TSB-A-15(20)S
Sales Tax
May 26, 2015

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S120405A

The Department of Taxation and Finance received a Petition for Advisory Opinion from "Petitioner", [REDACTED] which asks whether Petitioner's drop shipment facilitation service ("DSM service") is subject to New York State sales and use tax. We conclude that the service is not subject to sales and use tax because its primary function is data processing, which is not a taxable service under the Tax Law.

Facts

Petitioner provides its Drop Ship Master ("DSM") service to major retailers in the Internet retail industry. Petitioner's DSM service combines advisory services, networking and data processing capabilities that connect e-commerce retailers ("Merchants") to third party manufacturers and distributors ("Suppliers") who can fulfill Merchants' customer orders. The drop shipment process allows web-based Merchants to offer products on their web sites without the costs and logistical issues of actually warehousing or stocking such products themselves; rather, orders can be shipped to customers directly from Suppliers' inventory warehouses. Petitioner also offers certain advisory and technical services to Merchants and Suppliers, including the formulation of a drop shipment strategy and operational procedures.

The technical aspects of Petitioner's DSM service involve connecting both Merchants and Suppliers to Petitioner's Internet-based universal "hub" and receiving, processing, translating and relaying order and inventory-related data between the parties. The DSM service receives order information provided by Merchants, converts it and translates it so that it may be processed by Suppliers' own internal order-processing systems. Likewise, the DSM service receives order information provided by Suppliers, converts it and translates it so that it can be read by Merchants' own internal order-processing systems.

Once a Merchant is set up for DSM service, Petitioner's employees individually contact all Suppliers with which the Merchant wishes to transact business through the service. Petitioner's employees work with the individual Suppliers to establish a proper connection and configuration for transacting with the Merchant. Suppliers have the option of interacting with Petitioner's service via a browser-based connection (which requires periodically logging into the system to retrieve orders and provide response data) or an "integrated connection" in which transactional information is exchanged via a batch-oriented data communications connection. Supplier training includes identifying the specific requirements that the Merchant dictates (i.e. timing of when products must be shipped and the Merchant specific business rules that must be adhered to by Suppliers). All Suppliers that become part of Petitioner's network must enter into

a separate agreement with Petitioner and pay for DSM service themselves in order to transact business with the Merchant using the service.

Petitioner uses its proprietary software applications to provide the technical aspects of its service, which does not require any software to be installed on its customers' computers. Once a Merchant and its Suppliers have configured connections to the DSM service, their order-management systems can exchange data with the service. Merchants provide order-related data to Petitioner through value-added telecommunications networks (VANs) or directly to Petitioner through the Internet. Additionally, Merchants and Suppliers can log on to the Internet and access a "dashboard view" of the drop ship order flow, such as whether orders were delivered on time or are pending. Merchants and Suppliers have no ability to control or constructively control the software providing this information: they can merely review the order flow, inventory, etc., and input information.

As part of its Service, Petitioner ensures that all of the business rules, processes and preferences specified by Merchants during the setup/implementation phase are followed. As an example of the type of rules that Merchants may require, a Merchant may require that a Supplier ship all in-stock orders within 12 hours and that all orders utilize the Merchant's own branded packing slip.

Once orders are received, Suppliers provide information, including acknowledgements, shipping status, fulfillment confirmations (i.e. completed shipments, cancellations), products in inventory, inventory levels and return notifications, through Petitioner. Merchants can then view and monitor the various aspects of its drop-shipment transactions in near-real-time throughout the supply chain.

Order information is received by the DSM service automatically from Merchants' own systems. In other words, Merchants do not need to log on to Petitioner's website in order to enter information each time a customer's order is to be placed with a Supplier. Rather, Petitioner's system retrieves or receives batches of transactional information sent through the Internet from Merchants' own order-processing systems that are then processed and supplied to the appropriate Supplier in the appropriate format for use by Suppliers' own order-processing system. Without Petitioner's solution, Merchants and Suppliers would exchange order information manually (for example, by sending information via fax or email). By using Petitioner's solution, the process is automated and information is automatically translated and converted by Petitioner's service across Merchant and Supplier order management systems. While Petitioner's service offers this automated translation and conversion process, it is important to note that Merchants and Suppliers must separately purchase their own telecommunications networks or Internet connections to access Petitioner's service.

Petitioner has the ability to exchange order and inventory data with customers either directly through the Internet, through a VAN service provider, or through a direct connection protocol such as AS2, which is an electronic data interchange [EDI] specification intended to ensure the proper level of security for data transmitted over the Internet. The customer selects which protocol it wishes to use based on its own technological capacities. If a customer has a VAN EDI mailbox, it may request that messages to it be sent over VAN EDI. If a customer chooses that option, Petitioner will use the services of a third-party VAN EDI service provider to transfer messages to the customer. Petitioner does not provide any VAN EDI capacity or service

to its customer; rather, Petitioner's VAN EDI charge is to recoup its expense in using a VAN EDI service to facilitate the transfer of data to the customer. In no case is Petitioner installing a protocol for the customer or providing a protocol service to a customer. In all cases, the customer is selecting the protocol based on its own technological capacities and is independently acquiring the protocol from an unrelated, third-party service provider. In other words, the customer's engagement of a third-party VAN service provider and selection of this protocol requires Petitioner to engage a separate VAN EDI service provider to enable Petitioner to receive EDI messages through this protocol method.

Petitioner bills a per order charge for the DSM service, as well as a monthly base fee for the DSM service. In addition, it bills customers an implementation and training fee for setting up the service, along with separate fees for the conversion and transfer of inventory files (for the use of the customer's trading partners) and an additional fee if Petitioner is required to obtain the services of a VAN EDI or AS2 provider to communicate with the customer.

Analysis

The Tax Law imposes sales and use tax on the retail sale of tangible personal property, including prewritten computer software, and the sale, except for resale, of certain enumerated services. *See* Tax Law §§ 1101(b)(6); 1105(a), (b), and (c). Among the taxable services is the sale of "telephony and telegraphy and telephone and telegraph service of whatever nature." The words "of whatever nature" indicate that a broad construction is to be given the terms describing the items taxed. Sales and Use Tax Regulation § 527.2(a)(2). The terms "telephony and telegraphy" include the "use or operation of any apparatus for transmission of sound, sound reproduction or coded or other signals." Sales and Use Tax Regulation § 527.2(d)(2). Included in the definition of telegraphy are "[m]essage switching services," which transmit messages to computers over lines leased from communications carriers, fax services and teletypewriter services. 20 NYCRR § 527.2(d)(2). On the other hand, a service is not considered telegraphy where it "is merely an incidental element of a different or other service purchased by the customer." 20 NYCRR § 527.2(d)(4).

Petitioner's DSM service has multiple components, including transferring of messages between Merchants and their Suppliers, providing Merchants with a means of monitoring on a near real-time basis the data surrounding their drop shipment program, and consulting with Merchants to allow them to optimize their drop shipping programs. Integrated services are to be taxed according to their primary function. *See Matter of SSOV '81 Ltd.*, Tax Appeals Tribunal, January 19, 1995. Here, the most important part of the DSM service appears to be its service of allowing Merchants and suppliers to exchange information pertinent to their drop shipment relationship. This "exchange" component of Petitioner's DSM service has two aspects: the transfer of information and the processing of that information to allow the recipient's computers to use the information without any manual input. Petitioner's DSM service acts as a central data messaging hub that routes business messages or data from one party to another. Given that Petitioner here does not own the telecommunication lines through which the messages pass, it is not clear that its DSM service is equivalent to the message-switching service found taxable in Example 3 of Sales Tax Reg. § 527.2(d)(2).

It is not necessary to resolve that issue here, however, because of the significant data processing services Petitioner engages in as part of the DSM service. Specifically, Petitioner must translate the messages between the subscribers to the service in order to permit straight through processing of the messages by the recipient's computers. Inasmuch as there exists a myriad of ways to get the messages to other subscribers other than through Petitioner's technology (e.g., fax or mail), it appears that the most valuable part of Petitioner's service is this processing of the messages. Accordingly, in this matter it appears that the data processing aspect of the service is the primary function of the service, not the transmission element.

This case is distinguishable from *Matter of Easylink Intl., Inc. v. New York State Tax Appeals Trib.* (101 AD3d 1180 [3d Dep't 2012]), in which the Third Department upheld the Tax Appeals Tribunal's decision that the taxpayer's electronic messaging services, which included fax, telex, e-mail and EDI, were "telephony services" subject to sales tax. In that case, the taxpayer's service provider was responsible for the whole transmission pathway, whereas here Petitioner is only providing the switching aspect. *Id.* at 1182-1183. Moreover, while Petitioner processes the messages to make them machine readable for the recipient's system so that the messages can be processed without human intervention, the service provider in *Easylink* engaged in much less significant processing involving translating messages between standard formats (e.g., from email to fax) and the preparation of messages using templates. *See Id.* at 1182. In short, while transmission of messages was the primary function of the service at issue in *Easylink*, that is not the case here. Accordingly, Petitioner's fees for performing the DSM service and its associated charges are not subject to sales tax.

DATED: May 26, 2015

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NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.