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What am I selling? Properly characterizing technology

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In this edition of Inside Deloitte, Csan, Gilfeather, Backer, and Ormonde discuss the application of sales and use taxes to emerging technology, arguing that proper characterization is important for vendors analyzing potential tax obligations and offering approaches for those characterizations.

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Technology companies that have developed new and unique products and services need to describe them in ways that customers can understand. Often, those companies describe their products using general terms and phrases, such as software as a service (SaaS), a cloud computing solution, or the Internet of things. While these terms and phrases may be more recognizable when marketing, they also may oversimplify the functionality of the electronically delivered products, resulting in many companies misunderstanding their underlying state or local sales and use tax obligations. Technology companies face the challenge of how to characterize their products using antiquated sales and use tax concepts adopted long before the digital revolution.

Sales taxes are generally transaction taxes imposed on the retail sale of tangible personal property and some services in 45 states and the District of Columbia. Use taxes complement sales taxes and generally are imposed on the storage or use of the same taxable products and services where the purchaser did not pay sales tax to the retailer or purchased from an out-of-state vendor while paying a lower rate of sales tax than the in-state rate. From a policy perspective, complementary use taxes are generally intended to prevent purchasers from avoiding sales tax when they have purchased products out of state — then brought the products into another state for use.

While sales and use taxes are generally levied on or passed on to consumers, collection and remittance generally falls on vendors. If a vendor has nexus with a state, it is often required to collect sales or use tax from the purchaser and report and remit that tax to a tax authority. When an out-of-state vendor lacks nexus with a state or has not otherwise collected tax, the customer is generally required to self-report and remit the applicable use tax directly to a tax authority, which may not occur.

In a typical sales and use tax transaction, a vendor is a passthrough conduit for tax otherwise due; that is, the vendor collects the tax from the customer and remits it to the tax authority for its customers. Accordingly, a vendor analyzing its sales and use tax collection obligations might consider using a three-step approach. First, the vendor must determine where it has nexus to require compliance with a jurisdiction's sales and use tax laws. Second, the vendor must determine whether its products and services are taxable in that tax jurisdiction. Finally, the vendor must estimate the sales and use tax exposure in jurisdictions of noncompliance where it has nexus, using historic taxable sales made during statute of limitations or lookback periods as defined by each state.

When sales and use taxes were first imposed in the 1930s, the second step was relatively easy because characterization of a product, which determines whether its sale or use is taxable, was fairly straightforward. That is, if the customer had purchased tangible personal property, the transaction was generally taxable unless an exemption applied. By contrast, if the customer had purchased a service, the transaction was generally not subject to or was exempt from sales and use tax in nearly all jurisdictions.

As the economy and technology have evolved, business transactions have become more sophisticated and complex. Distinguishing between what constitutes the sale of a tangible product versus a service has become increasingly difficult, and many tax jurisdictions have expanded their tax bases to services without considering an evolving technology landscape. Also, historically, treatment of sales tax transactions fell under the form-over-substance model in which tax jurisdictions did not typically look beyond a transaction's form to the underlying substance or objective, even if it resulted in a benefit to the taxpayer. However, in the

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current environment, application of a dated statutory framework to the digital and information technology marketplace can make determining taxability increasingly challenging — requiring companies to understand both the form and the substance of a transaction because a state or locality may look to either to characterize a product.

In today's technology-dominated market, proper characterization is one of the most important factors a vendor must consider when analyzing its potential sales and use tax obligations. However, many vendors fail to thoroughly analyze the nature of the product being sold when making a characterization determination. Relying solely on vague and often misused terms such as "SaaS" or "cloud computing" rather than performing a distinct characterization analysis may lead to unwarranted risk or missed opportunities. In this respect, vendors should arguably focus their taxability analysis on properly characterizing their products; this article focuses primarily on approaches to that characterization.

I. General Analytical Approach

A. Nexus: Step 1

In *Quill Corp. v. North Dakota*,[1] the U.S. Supreme Court held that an out-of-state company can be obligated to register and collect state use tax if it has "substantial nexus" with the taxing state. This substantial nexus standard derives from the commerce clause of the U.S. Constitution and requires some physical presence. In *Scripto v. Carson*,[2] the Court sanctioned the agency theory of nexus, finding that an out-of-state vendor that used independent contractors to solicit business could be required to collect the state's use tax. In *Tyler Pipe Industries Inc. v. Washington State Department of Revenue*,[3] the Court ruled that having representatives that perform activities for a vendor while physically present in a state may create sales tax nexus for a vendor if those activities are significantly associated with its ability to establish and maintain a marketplace in the state.

Taken together, those decisions appear to preclude a state from asserting sales or use tax collection duties on an out-of-state vendor unless the out-of-state vendor itself — or through an agent or representative soliciting on the out-of-state vendor's behalf — is physically present in the state.

However, because of consumers' general lack of use tax reporting compliance and the growth of the online marketplace, states have attempted to expand the instances through which an out-of-state vendor is deemed to have nexus with their tax jurisdictions, and to require out-of-state vendors to collect sales or use tax. In recent years, many states have enacted statutory nexus provisions that look to an agent's or representative's activities as they pertain to Internet sales solicitation and also through the shared activities of intercompany or affiliate entities (commonly referred to as click-through or affiliate nexus.) Louisiana recently enacted that type of statute.[4]

Creating additional uncertainty, Supreme Court Justice Anthony M. Kennedy recently questioned *Quill* in his concurring opinion in *Direct Marketing Association v. Brohl* (*DMA*).[5] In the future, if the Court agrees to reexamine its previous holdings in this area, its decision may have widespread implications regarding substantial nexus — not only for state sales and use taxation but also for state income, franchise, and gross receipts taxation.

In what appears to be a reaction to Kennedy's concurring opinion in *DMA*, the Alabama Department of Revenue has since promulgated an administrative regulation arguably requiring out-of-state sellers to collect state sales and use taxes if they have "a substantial economic presence in Alabama."[6] Substantial economic presence is defined as $250,000 or more in retail sales in Alabama annually.[7]

Similarly, recently enacted South Dakota legislation requires tax collection on sales into South Dakota if, in the previous or current calendar year, the seller's sales into South Dakota exceed $100,000 or the seller had 200 or more separate transactions into South Dakota.[8] Noting that "the inability to effectively collect the sales or use tax from remote sellers . . . is seriously eroding the sales tax base of [South Dakota], causing revenue losses and imminent harm to [South Dakota] through the loss of critical funding for state and local services," this new law also authorizes South Dakota to initiate a declaratory judgment action to provide the "most expeditious possible review of the constitutionality of this law."[9] It is unclear at this point whether such attempts by Alabama and South Dakota to impose sales and use tax economic nexus standards would withstand constitutional challenges.

Note that before a vendor can properly characterize its products, Step 2 below, it must understand how each jurisdiction where it may have nexus would source the receipts. Many states, including the 24 in compliance with the Streamlined Sales and Use Tax Agreement, source receipts based on a cascading series of sourcing rules wherein if the first sourcing rule does not apply, the vendor moves down a series of steps until one does. Generally, the first two sourcing rules assume that the product at issue is purchased at the vendor's location or that a place of receipt is known. However, for software and digital products, the vendor often does not know where the product is received. Therefore, the

[1] 504 U.S. 298 (1992).
[2] 362 U.S. 207 (1960).
[3] 483 U.S. 232 (1987).

[4] La. Rev. Stat. section 47:302.V.
[5] 135 S. Ct. 1124 (2015).
[6] Ala. Admin. Code r. 810-6-2-.90.03 (2015).
[7] *Id.* (requiring collection and remittance if "seller's retail sales of tangible personal property sold into the state exceed $250,000 per year based on the previous calendar year's sales").
[8] SB 106, 2016 Leg., Reg. Sess. (S.D. 2016).
[9] *Id.*

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vendor may rely on other information in its books and records, such as the place where the contract was signed, address in records held in the ordinary course of business, or address on the payment instrument. Generally, only if no other such information is available would the vendor be able to source receipts to its headquarters address.[10] Other states may follow a different sourcing approach, with some expecting the vendor to collect information on user location and others sourcing to the location of the server on which the digital product is held.

B. Product Characterization: Step 2

Product characterization is relatively simple if the vendor is selling tangible personal property. For example, a detailed characterization analysis is typically not necessary for a vendor when it is selling computer hardware, furniture, clothing, or prescription drugs. However, if a vendor sells technology-based products, the determination may often be much more difficult.

The sale or license of many technology-based products is generally considered to be a mixed transaction, which contains both taxable and nontaxable elements that cannot be separately identified. For example, a contract ostensibly to license software may often include a provision for IT support services. When considering the potential taxability of a mixed transaction, many states may typically characterize the entire transaction as either taxable or nontaxable based on either the "true object" or the "true essence" of the transaction test.[11] Under this test, if the true object of the customer's purchase is the nontaxable component, the entire transaction would generally be exempt. However, if the true object is the taxable component, or more likely there is no true object, then the entire transaction would generally be taxable.

Unfortunately, the true object policies or rules in the states that employ them generally do not provide a clear path to taxability. In fact, these determinations are often subjective and require analysis and documentation to support conclusions. The vendor must often determine whether the receipt of the taxable attributes of the items sold are the overriding purpose or the true object of the transaction — as opposed to incidental to the receipt of a nontaxable product. These determinations require a careful review of books and records, including customer or vendor contracts, as well as discussions with a customer's internal operational personnel such as product managers. Under a true object or true essence of the transaction approach, if the taxable service is the true object of the overall transaction sold, the entire transaction is taxable. In contrast, if the true object of the transaction is the nontaxable service, the entire transaction is not taxable. When there is no true object of the transaction or its object is uncertain, it may be necessary to conclude that the entire transaction is taxable.

Today, many electronically delivered transactions have elements of software, data processing services, information services, telecommunications services, and general services — all for one non-itemized price. Each service may be treated differently by the states and jurisdictions from a sales and use tax perspective. For example, New York imposes sales and use tax on the sale of software, regardless of delivery method, and information services — but does not impose sales and use tax on the sale of some data processing services.[12] Alternatively, while Texas also imposes sales and use taxes on the sale of information services, it exempts from sales and use tax 20 percent of the gross receipts for those transactions — but does not provide a similar exemption for taxable sales of electronically delivered software.[13] New Jersey, on the other hand, does not impose sales and use tax on the sale of electronically delivered software sold for business use purposes but does impose sales and use tax on the sale of

[10]Streamlined Sales and Use Tax Agreement section 310 (amended Sept. 17, 2015).

[11]*See, e.g.*, *Albers v. State Bd. of Equal.*, 237 Cal. App. 2d 530 (1965), *cert. denied*, 383 U.S. 960 (1966); and Cal. Code Regs. tit. 18, section 1501:

> If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. For example, a firm which performs business advisory, record keeping, payroll and tax services for small businesses and furnishes forms, binders, and other property to its clients as an incident to the rendition of its services is the consumer and not the retailer of such tangible personal property. The true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property. Similarly, an idea may be expressed in the form of tangible personal property and that property may be transferred for a consideration from one person to another; however, the person transferring the property may still be regarded as the consumer of the property. Thus, the transfer to a publisher of an original manuscript by the author thereof for the purpose of publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of his creation. However, the tax would apply to the sale of mere copies of an author's works or the sale of manuscripts written by other authors where the manuscript itself is of particular value as an item of tangible personal property and the purchaser's primary interest is in the physical property. Tax would also apply to the sale of artistic expressions in the form of paintings and sculptures even though the work of art may express an original idea since the purchaser desires the tangible object itself; that is, since the true object of the contract is the work of art in its physical form.

(Footnote continued in next column.)

[12]N.Y. Tax Law section 1101(b)(6) (stating that prewritten computer software is included within the definition of tangible personal property, "regardless of the medium by means of which such software is conveyed to a purchaser"); and N.Y.S. Dep't of Tax'n & Fin., TSB-A-13(24)S (Sept. 9, 2013) (exempting data processing services).

[13]Tex. Tax Code sections 151.0101(a)(10) and 151.351; and 34 Tex. Admin. Code section 3.42(a)(2).

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information services.[14] This varying tax treatment highlights the importance of having a comprehensive yet focused understanding of the type and nature of what is being sold, as well as how to apply the true object test in the context of a specific jurisdiction's laws.

Once a vendor has thoroughly analyzed the characterization of its products, it may more accurately analyze their taxation. If all elements are either taxable or exempt, the analysis will be straightforward. However, if there is mixed taxability, the entire bundle will generally be deemed taxable, unless the true object of the transaction is the nontaxable component. Often, the entire transaction will be deemed taxable because there is no true object of the transaction.

C. Exposure and Compliance Analysis: Step 3

The final step of analyzing potential sales and use tax exposure is determining the total receipts attributable to states or localities where the vendor has purportedly established nexus and the product sold is deemed taxable, and reviewing the underlying lookback period during which those sales have occurred. This analysis will assist in determining where the vendor is required to be registered for sales and use tax purposes, whether and how it should register, and whether a voluntary disclosure program should be entertained to reduce potential liabilities, penalties, and interest. Consideration should also be given to whether proper data management systems are in place that would allow the vendor to accurately collect sales and use tax from its customers in the future.

II. Characterization of Technology Products

In general, states have taken two broad approaches to applying sales and use tax to the sale of technology. The first, referred to as the statutory approach, exists when a state enacts sales and use tax amendments that address electronically delivered products. The second approach attempts to interpret historic sales and use tax statutes in the context of modern technology through the promulgation of administrative rules or regulations, published administrative ruling requests, or case law.

A. The Statutory Approach

A comprehensive example of the statutory approach is Washington's sales and use tax statute addressing digital products. In 2009 and 2010, Washington enacted a comprehensive statute and promulgated implementing administrative rules addressing the application of state sales and use tax to some products provided or furnished electronically.[15] This enacted legislation expanded Washington's sales and use tax base to include remote access software and digital products, with the latter organized into three categories: digital goods, digital automated services, and digital codes.[16] Both remote access software and digital products are generally subject to Washington sales and use tax.[17]

Products described under general terms, such as SaaS or cloud computing, must be characterized as remote access software or digital automated services in order to properly apply Washington's law.[18] While both would generally be subject to sales and use tax in Washington, proper characterization of the products is necessary because some exclusions or exemptions may apply to one category but not the other.[19]

Remote access software is defined as "software that is made remotely accessible from the vendor's server or other third-party server for a customer [and to] the extent that components similar to digital goods and/or additional services are supplied with the prewritten software, the sale may be the sale of a digital automated service."[20] Digital automated services are defined as "services transferred electronically that use one or more software applications."[21] This definition is arguably very broad and, in practice, appears to create a presumption that all current or future technology products would meet the definition of taxable digital automated services unless a statutory exclusion applies.

Because of the apparently broad definition of digital automated services, Washington's statute excludes items from the definition,[22] including: services that require primarily human effort by the seller; loaning or transferring money or the purchase, sale, or transfer of financial instruments; dispensing cash or other physical items from a machine; payment processing services; parimutuel wagering and handicapping contests; telecommunications services and ancillary services; the Internet and Internet access; remote access prewritten software; online education programs; live presentations; travel agent services; online marketplace-related activities; advertising services; storage, hosting, and backup; and data processing services.[23]

The exclusions provided under this Washington statute generally fall into four broad categories. First, some exclusions relate to services otherwise defined as retail sales, such

[14]N.J. Stat. sections 54:32B-3(b) and 54:32B-2(yy); N.J. Admin. Code section 18:24-35.3; and N.J. Division of Tax'n, Publication ANJ-29 (Aug. 20, 2013).

[15]*See* HR 2075, 61st Leg., Reg. Sess. (Wash. 2009).

[16]*Id.*

[17]*See id.*

[18]See Wash. Admin. Code section 458-20-15503.

[19]*Id.* at section 458-20-15503(301).

[20]*Id.* at section 458-20-15503(203)(a)(ii).

[21]*Id.* at section 458-20-15503(203).

[22]*Id.* at section 458-20-15503(302) and (303).

[23]*See* Wash. Rev. Code section 82.04.192(3)(b); and Wash. Admin. Code section 458-20-15503(203)(a)-(o). If a product is excluded from the definition of a digital automated service, it may nonetheless be subject to sales and use tax or Washington's business and occupation tax.

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as sales of remotely accessed software or telecommunications services. Second, some exclusions — such as the primarily human effort exclusion and live presentation exclusion — target electronically delivered services that involve significant amounts of services provided by a live person. Third, some exclusions preserve historic nontaxable treatment of some services such as data processing, advertising services, or payment processing services. Finally, some exclusions, such as the online marketplace-related activities, appear to be policy based.

The comprehensive approach of the Washington statute and accompanying administrative rules consider technological advances and define taxable digital automated services intended to cover the majority of computer services.

In that respect, potential benefits to Washington's statutory approach may exist. First, it provides a structured framework for analyzing products. Second, its approach does not use overly general and vague terms such as cloud computing or SaaS to define taxability, as varying types of services could be labeled SaaS depending on the industry. In fact, items commonly referred to as SaaS may be deemed remotely accessed software under Washington's definitions — or could be deemed a digital automated service.[24] If classified as the former, the transaction may be subject to Washington sales and use tax unless another exemption applies.[25] If it is the latter, the same exemptions may apply, but the vendor may also be able to claim a statutory exclusion to help argue that the transaction is *not* a digital automated service and therefore not subject to sales and use tax.[26]

B. Applying Historical Statutes to Modern Technology: The Constructive Possession Approach

Unlike Washington, many states have merely issued administrative guidance in the form of promulgated bulletins or rulings that have deemed some technology products as taxable (typically SaaS), thus attempting to interpret dated statutory provisions to apply sales and use tax to the sale of modern technology. In those instances, the concept of constructive possession is often generally applied to conclude that obtaining a service from the cloud equates to obtaining constructive possession of prewritten software that resides on the service provider's server. Constructive possession generally describes a situation in which a party exerts control over property without physically possessing it.

Because prewritten software is statutorily defined as tangible personal property in many states, the central question of characterization in those states becomes whether the purchaser or licensee has access to and a degree of control over the software as to constitute constructive possession for sales and use tax purposes. For example, in New York, a transfer of possession is inferred when some attributes of property ownership are transferred, including "the right to use, or control or direct the use of tangible personal property."[27] Applying this concept to a technology product, a New York administrative advisory bulletin explains that:

> The access of the company software by the customer constitutes a transfer of the possession of the software as the customer gains the constructive possession of the software and the "right to use, control or direct the use" of the software. This is true even if no "copy" of the software is transferred to the customer. Thus, the sale of a license to use the software to a customer in New York is taxable.[28]

Under that administrative guidance, electronically delivered software, regardless of whether resident on a server inside or outside the state, is generally deemed taxable in New York.[29] In most instances, customers or their users have access to the technology, so the requisite analysis in New York focuses on the degree of control the purchaser or licensee has over the technology. The more control a user has over the software components of the electronically delivered items or services, the more challenging it becomes for the vendor to argue that the true object of the transaction is something other than software in New York.

Similar to Washington's statutory approach, the application of constructive possession rules in New York essentially yields that all electronically delivered services where the customer has access and control over software are generally deemed taxable. However, unlike Washington, the constructive possession approach in New York does not generally provide any exclusions to this presumption. Instead, the vendor must analyze all of New York's published guidance on specific technology products and services — such as data processing, data storage, or online advertising services — to determine whether its products are considered taxable versus nontaxable.

In 2014, New York promulgated guidance seeking to address uncertainty relative to the taxability of electronically delivered advertising services.[30] New York's guidance determined that portions of an advertising service offering that were sales of a license to use software were subject to state sales and use tax.[31] However, the portions of the advertising service that were electronically delivered were deemed exempt advertising services.[32] The guidance excludes from taxation "any advertising materials created by an advertising

[24] *See* Wash. Admin. Code section 458-20-15503(203).

[25] *Id.* at section 458-20-15503. Digital Products. ("The sale or use of digital products and digital codes is generally subject to retail sales or use tax unless purchased for resale or some other exemption applies.")

[26] *Id.* at section 458-20-15503(203).

[27] N.Y. Tax Law section 526.7(e)(4).

[28] N.Y.S. Dep't of Tax'n & Fin., TSB-A-08(62)S (Nov. 24, 2008).

[29] *Id.*

[30] N.Y.S. Dep't of Tax'n & Fin., Advertising Services, TB-ST-10, (Feb. 3, 2014).

[31] *Id.*

[32] *Id.*

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agency that are conveyed to its customer by intangible means (for example, by digital or other electronic media)."[33]

New York administrative guidance generally indicates that advertising services consist of consultation, development of advertising campaigns, and the placement of advertisements with the media.[34] In an advisory opinion, TSB A-15(1)S,[35] the vendor at issue sold various Internet marketing products, including its core offering that collected, managed, and displayed customer feedback using software developed by the vendor and embedded into websites. The sale of those products qualified for New York's advertising exemption.[36] It thus appears that New York is applying the advertising services exemption broadly, since customer feedback generally is not considered the direct consultation or development of advertising campaigns, nor is it a placement of an advertisement in the media.

New York's approach, as evidenced in this instance, appears to try and balance its historic nontaxable treatment of some services with adaptation of its taxing model to fit the digital world. Similar examples in New York exist regarding the taxability of some training services[37] and data processing services.[38]

III. Suggested Framework for Analyzing the Taxability of Electronically Delivered Products

While there are various ways to approach digital product characterization, the following is a suggested framework for the analysis.

A. Determine What Attributes of Electronically Delivered Services Are Present in the Product

State sales and use tax laws often use antiquated technology terms and apply them to modern technology. The first step is to determine the possible ways a state could tax the product. Common categories are downloaded or electronically delivered or accessed software, SaaS, infrastructure as a service, platform as a service, data processing, information services, online searchable databases, data storage, streaming audio or audio-visual services, and Web hosting services. Any individual product may have attributes of other general services, including advertising services, training services, or account processing services. This process may include determining which states may tax the product or service.

B. Determine How an Individual State Would Tax Each Attribute of the Electronically Delivered Service

If all are taxable, the entire transaction would be deemed taxable. If all are nontaxable, the entire transaction would be deemed nontaxable. If the electronically delivered service has some attributes that are taxable and others that are nontaxable, a true object analysis may be performed.

C. Determine the Proper Characterization of the Product by Determining the 'True Object' of the Transaction

If there is no true object or the true object is the taxable component, the entire transaction would be deemed taxable. However, if the true object of the transaction is the nontaxable component, the entire transaction would be deemed nontaxable. Any true object analysis is inherently subjective based on facts and circumstances. Therefore, the vendor may consider whether to collect tax based on the presumption that a mixed transaction is taxable; take a position that the true object of the transaction is the nontaxable service; or consider requesting an administrative ruling from the tax jurisdiction to make the determination. Vendors may consider taking a nontaxable position or requesting an administrative ruling in circumstances in which the electronically delivered services involve human interaction; are applied to services that would be treated as nontaxable but for the fact that the services are transferred electronically; or when a state has treated similar services as nontaxable for other policy reasons.

IV. Conclusion

The changing marketplace has led to a fundamental change in the analysis of tax consequences concerning sales and use taxation, particularly in the realm of digital products that do not fit neatly into historical sales and use tax statutes. While many states have directly addressed the taxability of remotely accessed software (that is, software hosted by the vendor on its own or a third-party server), most have not outlined a framework to analyze electronically delivered services that use software in the provision of those services. Washington has developed a proactive statutory approach that generally taxes remotely accessed software and electronically delivered services, which the state defines as a digital automated service. By proactively adopting such a statute, Washington lawmakers had the opportunity to exclude some electronically delivered services from taxation.

Other states, such as New York, have published administrative rulings to help clarify whether a product for sale is considered taxable software or another electronically delivered service. Because these administrative rulings are specific to some delineated facts, those states do not have a comprehensive framework that vendors may employ to properly characterize the sale of their own unique products. In such instances, vendors may wish to consider their position on whether or not to charge and collect sales tax to their customers when the sale requires significant human effort by the seller; the services would be deemed nontaxable but for the fact that they are electronically delivered; or the specific state has deemed other similar services as nontaxable for policy-related reasons. ✰

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[33] *Id.*

[34] N.Y. Comp. Codes R. & Regs. tit. 20, section 527.3(b)(5); *see also* N.Y.S. Dep't of Tax'n & Fin., TSB-A-15(1)S (Jan. 15, 2015).

[35] N.Y.S. Dep't of Tax'n & Fin., TSB-A-15(1)S (Jan. 15, 2015).

[36] *Id.*

[37] N.Y.S. Dep't of Tax'n & Fin., TSB-A-13(1)S (Jan. 8, 2013).

[38] N.Y.S. Dep't of Tax'n & Fin., TSB-A-10(52)S (Oct. 18, 2010).

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