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State and Local Taxing Authorities Taking More Than Their Fair Share of the Electronic Information Age, 14 J. Marshall J. Computer & Info. L. 493 (1996)

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COMMENTS

STATE AND LOCAL TAXING AUTHORITIES: TAKING MORE THAN THEIR FAIR SHARE OF THE ELECTRONIC INFORMATION AGE

> [E]xpansive and erroneous interpretation[s] of tax law . . . ha[ve] subjected honest, law-abiding taxpayers to unwarranted assessments, endless notices of determinations, and years of litigation . . . all stemming from a policy in search of endless revenue streams from alleged taxes never authorized by the Legislature.[1]

I. INTRODUCTION

State and local departments of revenue are increasingly targeting the users and providers of computer and information services to expand the tax base. As this burgeoning field continues to grow, so does the state's appetite for much needed tax revenue.[2] Although some states and cities have enacted legislation to specifically tax today's technology,[3] most have not. Therein lies the problem.

The departments of revenue ("DORs") in jurisdictions that do not have specific state or local laws taxing electronic information are assessing unsuspecting users and providers of these services with tax liabili-

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1. *See* Governor George Pataki, Memorandum of Approval No. 46 (S. 691/Chapter 373), *excerpted in* 9 STATE TAX NOTES 512-13 (Aug. 21, 1995) (Removing meteorological services from New York's sales tax statute taxing information services).

2. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 12.05, at 12-17 (2d ed. 1994) (explaining that "[t]he continuing pressing needs of the States for new revenues, particularly in view of deep cuts in Federal grants . . . may accelerate the broadening of sales taxes to cover services . . . ."); *see also* ROBERT J. FIELDS, UNDERSTANDING AND MANAGING SALES AND USE TAX ¶ 401, at 54 (3d ed. 1994) (explaining "[i]n an attempt to broaden the tax base for purposes of revenue enhancement, states are now further defining their gross receipts to include the selling price of taxable services").

3. *See infra* notes 11-30 and accompanying text (discussing state taxes on data processing, computer and information services).

ties. DORs are creatively interpreting their statutes to tax a service without a specifically enumerated service tax.[4] In other words, DORs are generally recharacterizing the service of providing electronically transmitted information into a purchase or lease of tangible personal property so the transaction can be taxed.

Further compounding the problem is that most of the statutes principally relied upon by the DORs in assessing taxpayers predate modern technology. The legislatures therefore, could not have contemplated and subsequently intended to tax something that was not in existence at the time of drafting.[5] Finally, and most frustrating to the providers of the services, the state and local jurisdictions vary significantly in their sales[6]

4. Sales and use taxes generally tax the transfer of all tangible personal property unless specifically exempted; services however, are usually exempt from taxation unless specifically enumerated. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 12.03, at 12-8 to 12-9; *see also* 2 State and Local Taxes: All States Tax Guide (P-H) ¶ 5150, at 5029 (1994).

5. *See infra* notes 101-02 and accompanying text.

6. Forty-five states and the District of Columbia have a sales tax. FIELDS, *supra* note 2, ¶ 201, at 23. Alaska, Delaware, Montana, New Hampshire and Oregon do not have a "sales tax," but do have other taxes or fees. *See id.* ¶ 205, at 40-43. Furthermore, within these states, municipalities and other jurisdictions may impose a sales or use tax. *Id.*

There are four primary types of sales taxes: (1) a privilege tax; (2) a consumer's levy tax; (3) a transaction tax; and (4) a gross receipts tax. *Id.* ¶ 201, at 34.

In a privilege tax jurisdiction, the seller is liable for the tax, which is usually passed on to the purchaser at the time of the taxable transaction. *Id.* ¶ 202, at 35. The imposition section of a "privilege" tax statute typically is as follows: "There shall be imposed, upon each person for the privilege of engaging in the business of selling tangible personal property and taxable services at retail, a tax measured by the gross proceeds (receipts) therefrom." *Id.* The "seller privilege" tax states are: Alabama, Arizona, California, Connecticut, District of Columbia, Hawaii, Kentucky, Michigan, Missouri, Nevada, South Carolina, South Dakota, Tennessee, and Wisconsin. FIELDS, *supra* note 2, ¶ 205, at 40-43.

In a consumer levy jurisdiction, the purchaser is liable for the tax, however, the seller, acting as an agent or trustee for the state or municipality, is responsible for collecting and remitting the tax to the state or local jurisdiction. *Id.* ¶ 203, at 36. The imposition section of a consumer levy or excise statute is typically as follows: "There shall be imposed, upon each sale at retail at the rate of XX% of the sales price, a tax collected by the retailer from the consumer." *Id.* The "consumer levy" tax states are: Louisiana, Maine, Maryland, Mississippi, Nebraska, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, Washington, West Virginia and Wyoming. *Id.* ¶ 205, at 40-43.

In a transaction tax jurisdiction, "the payment responsibility of the privilege tax and the 'debt to the seller' liability of the consumer levy tax" are combined. *Id.* ¶ 204, at 37. A typical imposition section of a transaction tax statute is as follows: "A tax shall be imposed upon each transaction at retail at the rate of XX% of the sales price that shall be collected by the retailer from the purchaser." *Id.* The "transaction" tax states are: Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Massachusetts, Minnesota, New Jersey, Texas, and Virginia. FIELDS, *supra* note 2, ¶ 205, at 40-43.

While the difference between a consumer levy and the transaction tax is subtle, a company must consider three questions: "(1) Upon whom or what is the tax imposed? (2) Who and use[7] tax laws and application of their tax laws. Each jurisdiction taxes services differently. The definitions, exemptions, tax rates, classifications and threshold of taxability are generally unique to each jurisdiction. Moreover, there is usually limited, if any, case law for a provider to look to and rely upon.

An electronic information service provider by nature usually does business in several, if not all states. These providers therefore must look at potentially thousands of state and local jurisdictions[8] in order to de-

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is liable for the tax? [and] (3) After whom will the state come if the tax was not paid?" *Id.* ¶ 204, at 37-38.

In a true gross receipts jurisdiction, the liability for tax falls completely on the seller. *Id.* ¶ 205, at 38. A gross receipts tax is notably different than other taxes in that there are "minimal exemptions or exclusions from the taxable measure." *Id.* "Generally, tangible personal property and services are equally taxable." *Id.* The "gross receipts" tax states are: Arkansas and New Mexico. *Id.* at 40-42.

7. A *use tax* is a compliment to sales tax, rather than being in addition to a sales tax. 2 All States Tax Guide (P-H) ¶ 5003, at 5011. The purpose of a use tax, other than to produce revenue, is to prevent the evasion of sales tax by purchasing an item tax-free out of the state. *Id.* "Use taxes are imposed upon the privilege of ownership of possession, storage, use or other consumption" of tangible personal property not subject to a sales tax. *Id.* *See also* FIELDS, *supra* note 2, ¶ 302, at 48-49.

Storage is generally subject to use tax when property is purchased out of state without tax and brought into the state where the purchaser holds or controls the property and does not intend to resell or hold it for demonstration or display purposes. FIELDS, *supra* note 2, ¶302, at 50. *Use*, is when "property [is] brought in from out of state is used prior to being resold, and is not otherwise exempt from tax." *Id.*

Other consumption is an amorphous definition that generally includes, but is not limited to the following:

> (1) resale or exempt property self-consumed (e.g., . . . inventory items given away as samples to induce sales); (2) creation and use of self-constructed assets; (3) transfers or sale of property between divisions or subsidiaries of the same parent company . . . ; [and] (4) rental of property that does not qualify as a continuing sale, i.e., a true lease (sometimes viewed as a sales tax issue when property is rented from an in-state company) . . . .

Id. ¶ 303, at 50.

Use tax must generally be self-assessed by the user (i.e. since the tax will not be collected on the transaction by the vendor). The user must determine the value and voluntarily pay the tax to the state and/or local jurisdiction. *Id.* ¶ 501, at 65. A use tax however, should not generally be self assessed when sales tax is already paid to the state in which the property will reside, or, generally when sales tax was legally paid to another jurisdiction. *Id.* ¶ 502.

"The difference between a sales tax and a use tax is that generally a sales tax is imposed on items acquired within the state and a use tax is imposed on items acquired outside the state for use within the state." Gallacher v. Comm'r of Revenue Servs., 602 A.2d 996, 998 n.2. (Conn. 1992) (citing White Oak Corp. v. Dep't of Revenue Servs., 503 A.2d 582, 585 (Conn. 1986)); *see also* Hartford Parkview Assoc. Ltd. Partnership v. Groppo, 558 A.2d 993, 997 (Conn. 1989); 2 All States Tax Guide (P-H) ¶ 5003, at 5011.

8. "Virtually all the states and many municipalities, towns, school districts, counties, and other localities levy sales and use taxes." 2 All States Tax Guide (P-H) ¶ 5000, at 5011. "There are more than 39,000 individual taxing jurisdictions with almost unlimited author-

termine whether it is subject to a tax or a potential tax via creative DOR interpretation. The companies must then administer, collect and remit the appropriate taxes—leaving an enormous administrative burden, and worse, a potentially onerous liability on a company that otherwise would not have nexus[9] with that jurisdiction.

In general, jurisdictions use several classifications in attempting to tax electronic data transmissions via a remotely accessed database. These classifications include: (1) a statutory or regulatory computer/information service tax; (2) a sales or use tax on the rental or lease of the computer hardware necessary to receive the electronic information; and (3) a sales or use tax on the use of a remote database.

This Comment argues that users and providers of electronic information services should not be liable for a sales or use tax in a jurisdiction that lacks clear and specific statutory authority for a DOR to assess a tax on electronic information. Part II examines state statutes and regulations that impose a computer or information service tax, explains why having a statute (or lack thereof) is critical, and gives some examples of creative DOR interpretations that were overturned by the courts. Part III argues that state and local DORs should desist from assessing taxes upon users and providers of electronic information services in the absence of a specific and unambiguous statute, while also exploring arguments users and providers might make to defeat such an assessment.[10]

II. BACKGROUND

A. Statutes And Regulations

A minority of states statutorily incorporate computer, data processing, and information services in their list of specifically enumerated taxable services. These states include Connecticut,[11] the District of Columbia,[12] New York,[13] Ohio,[14] Pennsylvania[15] and Texas.[16] Florida

ity to impose taxes on business." Mary Jane Egr, *State and Local Tax Considerations for U.S. Investments*, JAPANESE INT'L TAX'N (forthcoming 1996, Vol. 15 No. 11). Of those jurisdictions however, more than 6,500 jurisdictions have actually imposed taxes. *Id.* The U.S. Supreme Court commented that there are over 6,000 state and local taxing jurisdictions. Quill Corp. v. North Dakota, 504 U.S. 298, 313 n.6 (1992). Moreover, the Court, almost three decades prior, determined that there were over 2,300 localities imposing local sales taxes. National Bellas Hess, Inc. v. Dep't of Revenue of Illinois, 386 U.S. 753, 759-60 n.12 (1965).

9. For a discussion on income and sales and use tax nexus, see *infra* notes 66-72 and accompanying text.

10. Taxation of telecommunications, a related issue, is not specifically addressed in this comment.

11. CONN. GEN. STAT. § 12-407(2)(i)(A) (1958) (effective Jan. 1, 1994).

12. D.C. CODE ANN. § 47-2001(n)(1)(N) (1981) (effective July 1, 1989).

13. N.Y. TAX LAWS § 1105(c)(1) (McKinney 1987) (effective Sept. 1, 1995).

14. OHIO REV. CODE ANN. § 5739.01(B)(3)(e) (Anderson 1993) (effective July 1, 1993).

enacted a similar tax on information services, but repealed the tax six months later.[17]

Connecticut incorporates computer and data processing services in its definition of a taxable sale.[18] A regulation explains that "computer and data processing services" include "providing computer time, storing and filing of information, [and] retrieving or providing access to information."[19] Due to the negative impact on Connecticut's economic development,[20] this tax (currently at 6%) will be completely phased out, pro rata, over a six year period.[21]

The District of Columbia incorporates "the sale of or charges for data processing and information services" also in the definition of a taxable sale.[22] This statute specifically details a long list of services that are taxable as an information service.[23]

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15. PA. CONS. STAT. § 201(k)(16) (1971) (effective Jan. 1, 1992).

16. TEXAS TAX CODE ANN. § 151.0101(a) (West 1992) (effective October 1, 1991).

17. FLA. STAT. ANN. § 212.08(7)(v)(2) (West 1987) (providing that sales and use tax shall apply to information services other than professional services); *see also* Henley Holdings, Inc. v. Dep't of Revenue, [2 Fla.] Tax. Rep. (CCH) ¶ 202-317 (No. 89-4381) (Fla. Cir. Ct. July 22, 1991) *aff'd sub nom.*, 599 So. 2d 1282 (Fla. Dist. Ct. App. 1992) (explaining that FLA. ADMIN. CODE ANN. 12 AER 87-28 and 87-29 (1987) called for an information service tax to apply to "all remote database services accessed by telephone communications . . . [including] Westlaw, Lexis, Dow Jones Report, etc").

18. CONN. GEN. STAT. § 12-407(2)(i)(A). The statute in pertinent part provides: "'Sale' and 'selling' mean and include . . . the rendering of certain services for a consideration . . . (A) Computer and data processing services, including but not limited to time." *Id.*

19. CONN. AGENCIES REG. § 12-426-27(b)(1) (1980).

20. John R. Shaughnessy, Jr. & Richard W. Tomeo, *Survey of 1994 Connecticut Tax Developments*, 69 CONN. B.J. 85, 88 (1995).

21. 1994 Conn. Act 4 (1st Spec. Sess.) established the progressive reduction of one percentage point per year for sales and use tax on computer and data processing services from the current tax of 6% to 0%. This tax reduction however, is delayed by one year and will begin on or after July 1, 1997, instead of the originally scheduled July 1, 1996 reduction. [1 Conn.] Tax. Rep. (CCH) ¶ 60-310 (1995).

22. D.C. CODE ANN. § 47-2001(n)(1)(N).

23. *Id.* An information service is defined as:

> The furnishing of general or specialized news or current information, including financial information, by printed, mimeographed, electronic, or electrical transmission, or by wire, cable, radio waves, microwaves, satellite, fiber optics, or any other method in existence or which may be devised; electronic data retrieval or research, *including* financial newsletters, real estate listings, or financial investment, circulation, credit, stock market, or bond rating reports; mailing lists, abstracts of title; news clipping services; wire services; scouting reports; surveys; bad check lists; and broadcast rating services; *but does not include* information sold to a newspaper or a radio or television station . . . if the information is gathered or purchased for direct use in newspapers or radio or television broadcasts; charges to a person by a financial institution for account balance information . . . .

Id. (emphasis added) (as added by D.C. Law 8-119, Laws 1990, effective May 4, 1990, and applicable July 1, 1990).

A data processing service, on the other hand, is defined in pertinent part as: "[P]rocessing information for the compilation and production of records of transactions; the

The Texas law virtually mirrors the District of Columbia's law and defines "taxable services" to include electronic data retrieval or research and other information and data processing services.[24] A state regulation defining information services again mirrors many of the services enumerated in the District of Columbia statute and also provides examples.[25]

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maintenance, input, and retrieval of information; the provision of direct access to computer equipment to process, examine, or acquire information stored in or accessible to the computer equipment . . . and computerized data and information storage and manipulation." D.C. CODE ANN. § 47-2001(n)(1)(N)(A)(i); *see also* [1 D.C.] Tax. Rep. (CCH) ¶ 200-455, *Important Notice to Business* (June 1, 1989) (explaining that pertinent taxable services not specifically included in the law are computer time sharing, database management and library management services).

24. TEXAS TAX CODE ANN. § 151.0101(a). Another statute defines an "information service" to mean "(1) furnishing general or specialized news or other current information, including financial information, unless furnished to a newspaper or to a radio or television station . . . or (2) electronic data retrieval or research." *Id.* § 151.0038(a) (effective Sept. 1, 1991).

25. "Information services" are defined as: "Furnishing general or specialized news or other current information, including financial information, by . . . electronic, or electrical transmission, or by utilizing wires, cable, radio waves, microwaves, satellites, fiber optics, or any other method now in existence or which may be devised, and electrical data retrieval or research." TEXAS ADMIN. CODE tit. 34, § 3.342(a)(2) (1994). Examples of taxable information services include, but are not limited to the following: newsletters; scouting reports and surveys; mailing lists and bad check lists; real estate listings; financial, investment, stock market, bond rating, or financial reports, other than charges to a person by a financial institution for account balance information; news clipping services and wire services. *Id.* § 3.342(b)(1)-(6).

In *Reuters America, Inc. v. Sharp,* the Texas statutes and regulation were challenged and upheld as constitutional. 889 S.W.2d 646 (Tex. Ct. App. 1994). Reuters, an electronic news service, challenged Texas' tax scheme which taxed electronic information services, but exempted newspapers because it violated the free speech and equal protection clauses of the federal and state constitutions. *Id.* at 648. The court held that Reuters First Amendment right of freedom of speech was not infringed as the newspaper exemption's format requirements discriminate on the basis of *medium,* (*i.e.* how the message is conveyed), rather than the *content* of the message. *Id.* at 651.

Next, Reuters argued that Texas' tax scheme violated the equal protection clause as "there is no meaningful distinction between Reuters' product and a newspaper." *Id.* at 656. The court reasoned that since the Fourteenth Amendment was not violated, minimal scrutiny will apply and therefore, the tax will be upheld as long as it is rationally related to a legitimate state interest. *Id.* at 656-57. The court held that the state's interest in (1) encouraging the reading of newspapers to enhance the general knowledge and literacy of Texans, and (2) administrative ease were legitimate. *Reuters,* 889 S.W.2d at 657. Therefore the Fourteenth Amendment was not violated. *Id.*

But c.f., an Alabama revenue ruling held just the opposite of *Reuters*. Rev. Rul. 94-011, [2 Ala.] Tax. Rep. (CCH) ¶ 300-010 (1995). The revenue ruling held that a newspaper publisher's sale of subscriptions for its electronically transmitted newsletter was not subject to Alabama's sales and use tax, even though newspapers are subject to sales and use tax in Alabama. *Id.* The Alabama DOR reasoned that the electronically transmitted data does not constitute tangible personal property pursuant to ALA. CODE § 40-23-2(1). *Id.*

New York taxes the receipts from furnishing information in any manner unless it is "information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons."[26] A regulation explains that "any manner" includes "electronic readouts or displays."[27]

Ohio's applicable code provisions, a model for the nation, provide that sales of automatic data processing services, computer services, and electronic information services are subject to sales tax when the services are purchased for use in a business and when the true object is the service itself.[28]

Pennsylvania, the most recent addition to this list of states, imposes sales tax on computer processing, data preparation or processing services, information retrieval services, and other computer-related services.[29] However, certain banking and financial services are excluded

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26. N.Y. TAX LAWS § 1105(c)(1) (McKinney 1987) (eff. Sept. 1, 1995).

27. N.Y. COMP. CODES R. & REGS. tit. 20, § 527.3(a)(1) (amended Dec. 9, 1992). The regulation explains further that taxable information services include "credit reports, tax or stock market advisory and analysis reports and product and marketing surveys." *Id.* § 527.3(a)(3).

Two advisory opinions issued by the New York Commissioner of Taxation and Finance, which are only binding on the taxpayers who requested the information, explain that online financial news services are taxable information services. *Mark S. Klein*, TSB-A-91(53)S, [2 N.Y.] Tax. Rep. (CCH) ¶ 400-078 (July 29, 1991); *Market News Service, Inc.*, TSB-A-91(60)S, [2 N.Y.] Tax. Rep. (CCH) ¶ 400-141 (Aug. 20, 1991) (explaining that electronic readouts or displays are not tangible personal property and accordingly do not qualify for the newspaper or periodical exemption).

28. OHIO REV. CODE ANN. § 5739.01(B)(3)(e). The Code provides:

> 'Sale' and 'selling' include . . . [a]ll transactions by which . . . [a]utomatic data processing, computer services or electronic information services are or are to be provided for use in business when the true object of the transaction is the receipt by the consumer of automatic data processing, computer services or electronic information services, rather than the receipt of personal or professional services, to which automatic data processing, computer services or electronic information services are incidental or supplemental.

Id.

"Electronic information services" are defined as providing: "[A]ccess to computer equipment by means of telecommunications equipment for the purpose of either of the following: (i) [e]xamining or acquiring data stored in or accessible to the computer equipment; [or] (ii) [p]lacing data into the computer equipment to be retrieved by designated recipients with access to the computer equipment." *Id.* § 5739.01(Y)(1)(c).

"Automatic data processing" means "processing of others' data . . . or providing access to computer equipment for the purpose of processing data." *Id.* § 5739.01(Y)(1)(a).

29. PA. CONS. STAT. § 201(k)(16). A Pennsylvania regulation supplies all pertinent definitions. PA. CODE § 60.13(a) (1993). "Information access" is defined as, "the ability to enter, store or retrieve data through a computer or other peripheral equipment." *Id.* "Information retrieval" is defined as, "providing data through a computer to either an online or remote computer or peripheral equipment upon request." *Id.* Taxable information retrieval service fees include "fees for connection, computer time, usage, transmission [and] . . . content of information." *Id.* § 60.13(f). Examples of taxable information retrieval serv-

from "computer-related services."[30]

Although a taxpayer may not agree with the aforementioned statutes, the issue addressed in this Comment is not whether the tax is fair, but rather, whether a DOR may fairly tax a user or provider of an electronic information service without such statutes.

B. Retroactive Versus Prospective Tax Treatment

Absent statutory and regulatory directives such as the ones enumerated above, taxpayers are left to guess what creative DORs and the courts will consider taxable. This creates tremendous exposure for users and providers of computer and information services to potential tax liabilities that will apply retroactively.

Retroactive tax treatment, as contrasted to a legislatively enacted statute, is an important distinction that underlies the entire premise of this Comment. A legislatively enacted statute or regulatory interpretation affords all parties involved an opportunity to comment on and to help shape the tax legislation. More importantly, when enacted, there is both notice to the world that a tax will be effective on a certain date,[31] as well as public accountability for the tax.[32]

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ices are: "(i) Bulletin board services obtained through a computer; [and](ii) Providing information through a computer upon the computer-aided request of the purchaser [where t]he purchaser performs various searches to obtain the necessary information," *i.e.* Westlaw/Dialog or Lexis/Nexis searches. *Id.* (Westlaw and Lexis example added by author for further explanation).

Stock quotation services and news reporting services are *not* examples of information retrieval services, *unless* the information is provided as the result of a direct inquiry. Pa. Code § 60.13(f)(2)(iii) (emphasis added).

Taxable computer processing, data preparation or processing service include, among other services, providing time-sharing or access to databases. *Id.* § 60.13(e)(1)(iv). Time-sharing is defined as "[a] system whereby two or more users can share access to a computer." *Id.* § 60.13(a).

Professional services such as the preparation of a will by an attorney who uses a computer; an accounting firm that prepares tax returns with a computer, when the computer service is incidental to the service; estate planning, retirement planning, actuarial certifications, even though prepared on a computer are examples of *non taxable* computer processing, data preparation or data processing services. *Id.* § 60.13(e)(2); *but see* CCH Computax, Inc. v. Dubno, 558 A.2d 270 (Conn. App. Ct. 1989) (holding that the preparation of an income tax return by a computer in Connecticut is taxable as a computer and data processing service).

30. Pa. Cons. Stat. § 201(k)(16). Exempt computer-related services include "at a minimum, . . . services that are part of electronic fund transfers, electronic financial transactions or services, banking or trust services; or management or administrative services . . . ." *Id.*

31. Unless clearly specified otherwise, tax statutes operate prospectively. 2 All States Tax Guide (P-H) ¶ 5045, at 5017.

32. *See, e.g., supra* notes 20-21 and accompanying text (discussing Connecticut's phase out of a computer and data processing service tax which hampered Connecticut's economic

A tax assessment, however, is not afforded prospective tax treatment. The assessment applies retroactively. Not only must a company pay the tax, but also penalties and interest. Moreover, a sales tax is usually passed on to the ultimate consumer.[33] Therefore, if a provider knows there is an applicable state or local tax, the provider may pass the tax on to the user of the electronic information. However, if a DOR assesses a tax on a provider of an information service, the company must pay the assessment. The company, in effect, gets hit twice: first, the company must pay a tax it could have rightfully passed on to the ultimate consumer; and second, the company must pay penalties[34] and interest[35] on the tax liability.

In the best scenario, the taxpayer prevails against the DOR, but the taxpayer generates sizable legal and accounting expenses from proving

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development). Similarly, in another jurisdiction, New York Governor George Pataki stated, in part:

> [T]he prior administration pursued avenues of taxation on the basis of an expansive — and erroneous — interpretation of the tax law. . . . The information services industry is an industry which New York should nurture, not overtax. I therefore will direct the Department of Taxation and Finance to re-evaluate all informal rulings issued publicly or internally regarding the taxation of information services by administrative edict under the sales and use tax and to develop a policy which encourages the information services industry to locate or remain in New York.

Governor George Pataki, Memorandum of Approval No. 46 (S. 691/Chapter 373), *excerpted in* 9 STATE TAX NOTES 512-13 (Aug. 21, 1995).

33. *See supra* note 6 (explaining the four major types of sales taxes and how they operate).

34. Although penalties vary widely depending on the jurisdiction, states generally impose at least three types of penalties: (1) failure to file a tax return; (2) failure to pay an applicable tax; and, (3) criminal penalties for intentionally evading a tax or filing a knowingly false tax return. *See generally* FIELDS, *supra* note 2, ¶ 704. The penalty for failure to file a tax return in many states is usually 5% of the tax due for the first month, and an additional 5% for each month thereafter, up to a maximum of usually either 25% or 35%. *Id.* Penalties for failure to pay a tax (including late payment penalties) are usually independent of late filing penalties and are generally between 5% and 15% depending on both the facts and the jurisdiction. *Id.* Criminal penalties, again depending on the specific facts and the jurisdiction, can be either a misdemeanor or a felony, including imprisonment, and generally range from 50% to 100% of the tax due. *Id.*

35. Interest rates, like penalties, also vary widely depending on the jurisdiction. *See generally id.* reproducing chart from the CCH MULTISTATE SALES TAX GUIDE (October 1994). Interest rates are generally determined in one of three ways: (1) a flat statutory rate (usually theses rates of interest are higher); (2) an interest rate that closely tracks the federal (IRS) rate of interest; and, (3) an interest rate that is based on some variation of the prime rate. FIELDS, *supra* note 2, ¶ 704.

Refunds in many states generally pay a lower rate of interest than does interest charged for tax deficiencies. *Id.* The rate of interest for a deficiency generally ranges between 7% and 20% with an average interest rate around 9% or 10%. *Id.* Average interest for a refund ranges between 3% and 7%. *Id.* Moreover, interest rates are adjusted as frequently as quarterly and as infrequently as when a statute is amended. *Id.*

its innocence. In some instances, wrongful assessments are paid because legal and accounting expenses do not justify protesting the assessment.

Therefore, a DOR that preys upon an electronic information service provider without a clear and specific statute or regulation must creatively interpret inapplicable tax codes that predate modern technology. This creative interpretation results in an assessment (retroactive taxation) when the user or provider, in essence, does not have a preexisting duty to remit a sales or use tax.

C. Creative Taxation — Case Law

If a statute is silent on whether an electronic transmission of data is taxable, the DORs must creatively interpret their own state or local statutes to tax a service without a specifically enumerated service tax. To be sure, DORs from around the country have attempted and continue to attempt numerous ways to turn a nontaxable service into taxable tangible personal property. Although a few creative interpretations are successful, most are not. Therefore, DORs should desist from strained interpretations and subsequent tax assessments on unsuspecting users and providers of electronic information services.

Three common creative interpretation attempts include: (1) computer images on a screen are tangible personal property;[36] (2) rental of the computer hardware necessary to receive the information subjects the entire transaction to a lease tax;[37] and (3) use of a remote database is taxable as the subscriber is leasing time on the database.[38]

1. *Computer Images Not Taxable as Tangible Personal Property*

Although several relevant cases exist around the country, two model decisions recently issued from Florida's courts. They are *Henley Holdings, Inc. v. Department of Revenue*[39] and *Department of Revenue v. Quotron Systems, Inc.*[40]

In *Henley Holdings*, the Florida DOR assessed the taxpayer[41] sales tax on the taxpayer's charges to its customers for the receipt of electronic

36. See *infra* Part II.C.1.

37. See *infra* Part II.C.2.

38. See *infra* Part II.C.3.

39. [2 Fla.] Tax. Rep. (CCH) ¶ 202-317 (No. 89-4381) (Fla. Cir. Ct. July 22, 1991) (unpublished in Fla. Supp. 2d), *aff'd sub nom*, 599 So. 2d 1282 (Fla. Dist. Ct. App. 1992).

40. 615 So. 2d 774 (Fla. Dist. Ct. App. 1993) (per curiam).

41. The taxpayer is a company named Bunker Ramo that provides its customers with: (1) real-time "stock, bond and commodity quotations (last sale, bid and ask, etc.)" in response to specific inquiries; (2) "watch buffer updates," whereby the customer selects specific securities which are updated as the trades occur; and (3) other financial news and information, all of which are received on CRT and video screens located at the customer's place of business. [2 Fla.] Tax. Rep. (CCH) ¶ 202-317.

financial news and information. The DOR alleged that the "transient images" on the screen were tangible personal property because a Florida statute defined tangible personal property to include that which may be "seen" or is in "any manor perceptible to the senses."[42] The court granted summary judgment in favor of the taxpayer.[43] The court reasoned that the images on the screen were not tangible personal property because the definition of tangible personal property cannot clearly and unambiguously extend to the transactions conducted by this taxpayer.[44] The court also acknowledged that "the [Florida] legislature could not have intended to tax a technology that postdates the enactment of the measure in question . . . [and that] all doubt would have to be resolved against the taxing authority and in favor of the taxpayer."[45]

The following year, the *Quotron* court adopted and specifically incorporated the holding of *Henley Holdings*.[46] The court held in part that Quotron's[47] transmission of electronic images appearing on display screens did not constitute tangible personal property.[48] The court explained that images were transient and had no enduring existence and that "[t]he plain and common meaning of 'tangible personal property' does not include 'images on a video screen.'"[49] Moreover, the court reaffirmed the notion that the legislature could not have intended to tax a technology that postdates the statute and all doubt must be resolved in favor of the taxpayer.[50]

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42. FLA. STAT. ANN. § 212.02(20) (1989). The statute provides, in pertinent part, that "tangible personal property means and includes personal property which may be *seen*, weighed, measured or touched or is in *any manner perceptible to the senses*, including electric power or energy . . . ." *Id.* (emphasis added).

43. [2 Fla.] Tax. Rep. (CCH) ¶ 202-317.

44. *Id.*

45. *Id.*

46. *Quotron*, 615 So. 2d at 774. The DOR audited Quotron for a four year period (July 1, 1985 through May 31, 1989), and assessed $3,827,300.27, excluding penalties and interest. *Id.* The interest accrued at the rate of $812.31 per day. *Id.*

47. Quotron provides financial news and real time stock quotes via high speed electronic transmission to a subscriber's video display terminals. *Id.* at 775. Some of the subscribers use Quotron's equipment while others use their own equipment. *Id.*

48. *Id.* at 777. Notwithstanding the Florida DOR's defeat in *Henley Holdings*, at both the trial court and at the appellate level on virtually the same set of facts as the instant case, the DOR again asserted that the transmission of the electronic images on a screen constituted a sale of tangible personal property because they can be seen and are perceptible to the senses. *Quotron*, 615 So. 2d at 775.

49. *Id.*

50. *Id.* at 776-77.

2. *Rental or Leasing of Computer Hardware as Tangible Personal Property*

A second way DORs have tried to tax users and providers of electronic information without a statute is to reclassify or recast the transaction. Many DORs unsuccessfully argue that the subscriber/customer is really leasing the provider's equipment necessary to obtain the information, and that the service of receiving electronic information is merely incidental.

This was the second argument raised by the Florida DOR in *Quotron*.[51] The court rejected this argument and implicitly applied the "true object" test.[52] The court examined Quotron's activities and concluded that Quotron engaged in a non-taxable service of providing information because the subscriber's true object of the transaction was to receive information, not to lease equipment.[53] The Florida court, like other courts throughout the country, held the equipment was merely incidental to the service provided.[54] Accordingly, the assessment was set aside.[55]

In another case, the Wisconsin DOR assessed a sales tax liability on Dow Jones & Comapny which was also set aside.[56] The DOR argued that Dow Jones' charge for "teleprinters" was subject to Wisconsin sales tax as it constituted a rental.[57] The Wisconsin Court of Appeals, also applying the true object test, held that the true object of the transaction was not the transfer of tangible personal property, but the performance of a service.[58]

51. The DOR argued that the equipment which receives the "images constitutes a 'rental' of 'tangible personal property' and therefore, the entire transaction is subject to sales tax." *Id.* at 775.

52. *See infra* notes 103-106 and accompanying text (explaining that the True Object Test is a test that looks to the overall objective of the transaction when there is both a sale of tangible personal property and a service).

53. *Quotron*, 615 So. 2d at 778.

54. *Id. See also* Quotron Sys., Inc. v. Comptroller of the Treasury, 411 A.2d 439, 442 (Md. Ct. App. 1980) (holding that the "dominant purpose of the contract" was providing a service, not the rental or transfer of possession of hardware); Quotron Sys., Inc. v. Revenue Cabinet of Kentucky, [2 Ky.] Tax. Rep. (CCH) ¶ 202-174 (BTA 1990) (holding that the equipment provided to the subscribers was incidental to the information service received and therefore, the true object of the transaction was the receipt of a nontaxable service, not the receipt of tangible personal property).

55. *Id.* at 774.

56. Wisconsin Dep't of Revenue v. Dow Jones & Co., Inc., 436 N.W.2d 921 (Wis. Ct. App. 1989).

57. *Id.* at 923.

58. *Id.* at 921.

3. *Leasing Time On A Remote Database*

The leasing of a database on a remote computer, also known as "time-sharing" is a hot topic in Chicago and soon perhaps, in other jurisdictions as well. The City of Chicago is exploiting, in a socially responsible manner,[59] a 1989 Illinois appellate court decision.

In *Meites v. City of Chicago*, the court upheld the City's use tax assessment of a law firm's charges for online Lexis/Nexis database searches.[60] The City successfully argued that the law firm was essentially leasing a remote computer ("time-sharing"),[61] which is explicitly referred to in the City's ordinance as a taxable lease of tangible personal property,[62] even though the taxpayer was merely obtaining a service that is not specifically taxable.

To ameliorate the harsh result of this case as applied to all persons using online databases in the City of Chicago, the City instituted a settlement program.[63] In addition, the City reversed course somewhat. As

59. *See infra* note 63 (discussing Chicago's socially responsible settlement program).

60. Meites v. City of Chicago, 540 N.E.2d 973, 979 (Ill. App. Ct. 1989), *app. denied*, 545 N.E.2d 114 (Ill. 1989).

61. *Id.* at 975. Time sharing agreements which the court cited to, were defined as:

> A time-share computer network consists of a central computer, which stores programs and performs all calculations, and user terminals. Individual users access the central computer through telephone connections and terminals located in their own offices. Typically, users pay some monthly fee for access privileges plus an hourly rate for time actually spent utilizing the central computer.

Id. citing Flip Mortgage Corp. v. McElhone, 841 F.2d 531, 533 n.1. (4th Cir. 1988).

The second definition the court cited to as a time share agreement is where a user has a terminal that is connected to a remote central computer via a telephone line, and which enables the user access to that computer through the user's terminal. *Id.* at 976 (citing Greyhound Computer Corp. v. IBM Corp., 559 F.2d 488, 494 n.9 (9th Cir. 1977)).

62. The transaction tax ordinance § 200.1-2A provides in pertinent part:

> There is hereby imposed and shall immediately accrue and be collected a tax, . . . on . . . [t]ransactions consummated in the City of Chicago involving the lease or rental of any personal property . . . . The *ultimate incidence of and liability for payment of such tax shall be borne by lessee* . . . . [T]he lease or rental of any personal property shall include but not be limited to *leased time on equipment not otherwise rented*, such as, leased time for use of calculators, computers, computer software . . . . This includes but is not limited to the usage of a computer under a *time-share agreement.*

Id. at 974-75 (emphasis added).

63. *See* GUIDE TO CHICAGO LEASE TAX SETTLEMENT PROGRAMS, (City of Chicago 1995); *see also City of Chicago Offers Transaction Tax Settlement Package*, CCH ST. TAX. REVIEW, Sept. 11, 1995, at 20. The City's settlement guide explains:

> Many businesses have been unaware of the applicability of the lease tax to computer and database access leases and related party leases. To forgive these businesses from paying their tax obligations would be unfair to the taxpayers that have voluntarily paid or collected the lease tax or who have been audited by the City. However, to require full payment of all unpaid lease tax, plus interest and penalties, for all prior periods would impose a hardship on many businesses. The terms of the settlement programs are similar to those offered to businesses that have been audited for unpaid lease tax during recent years. These settlement pro-

of July 1, 1995, certain types of leases are exempt.[64] However, prior to July 1, 1995, all computer and database access leases are subject to the City's transaction tax.[65]

The *Meites* decision is the exception, rather than the rule. Most assessments do not survive in the courts when a DOR makes a strained interpretation. However, most taxpayers do not have the time or money to mount attacks to the appellate level courts. Most taxpayers end up paying or settling an assessment that perhaps was improper from the start.

Several plausible arguments are available to taxpayers who choose to fight an assessment. The arguments include: (1) the taxpayers do not have nexus with the taxing jurisdiction; (2) the DOR's interpretation of the statute is too broad and must be construed narrowly and in the taxpayer's favor; (3) the legislature did not intend to tax an activity that was non-existent at the time of drafting; and (4) the true object of the transaction was to receive a nontaxable service.

III. ANALYSIS

The DORs around this country are chasing dollars they simply are not entitled to receive while wasting the taxpayers' valuable time, effort and resources. The DORs are blatantly ignoring the rules of statutory construction, the intent of the legislatures and the true object of the transaction. Before these issues can be discussed, however, a taxpayer and DOR must realize that state and local jurisdictions can only assess a tax upon a taxpayer when the taxpayer has nexus with that taxing authority's jurisdiction.

> grams will bring in previously uncollected revenues while providing substantially equal treatment to all taxpayers.

GUIDE TO CHICAGO LEASE TAX SETTLEMENT PROGRAMS, (City of Chicago 1995).

The guide further explains, that if the taxpayer does not take advantage of the settlement program by its deadline (October 31, 1995 for lessor, providers of the services, or February 29, 1996, for lessee, users of the services) and the taxpayer is audited, the taxpayer is subject to back taxes, plus interest and penalties associated with the additional tax liability. *Id.*

64. *See* GUIDE TO CHICAGO LEASE TAX SETTLEMENT PROGRAMS, *supra* note 63 (indicating that the relevant exempt leases include stock and security price quotations services and news services as well as other non possessory uses of a computer by the banking and securities industry).

65. *Id.* The Guide to the City of Chicago settlement program explains that examples of taxable computer or database access leases include: legal or other database research services; credit reporting services; stock and security price quotation services; airline, hotel and other reservation services; payroll processing services; and using a computer program or data that is supplied by the customer. *Id.*

A. NEXUS: WHEN A TAXPAYER IS SUBJECT TO STATE AND LOCAL TAX LAWS

A taxpayer is subject to state and local tax laws when a taxpayer has nexus with a jurisdiction. Nexus, a nebulous concept, is generally created when a taxpayer has a presence and some minimum threshold level of activity within a jurisdiction.[66] Moreover, the activity within a jurisdiction will dictate which type of taxes are imposed. Sales and use tax nexus[67] generally has a lower threshold of taxability than income tax nexus.[68] Although there are no authoritative cases that specifically ad-

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66. *See* Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954) (holding the oft-repeated principle: "[T]he Due Process Clause requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax"). *See also* 2 All States Tax Guide (P-H) ¶ 3071, at 3034.

67. *See infra* notes 69-88 and accompanying text (discussing sales and use tax nexus).

68. 15 U.S.C. § 381 (effective Sept. 14, 1959). The federal government, via its preemption power, enacted Public law 86-272 to set out a minimum threshold of activity before a state or local jurisdiction can impose income taxes on a person or company engaged in interstate commerce. *Id.* If a person or company selling tangible personal property falls within the following elements, they will be exempt from state and local income taxes: (1) seller solicits sales only (does no other activity in the state); (2) the orders are approved outside the taxing jurisdiction; (3) shipment of the orders originates outside the taxing jurisdiction; and (4) seller maintains no office or other place of business in the taxing jurisdiction. *Id.* 2 All States Tax Guide (P-H) ¶ 3073, at 3036.

The Multistate Tax Commission, a quasi-governmental organization, developed recommended guidelines for it member states to follow regarding the interpretation of public law 86-272. 1 All States Tax Guide (P-H) ¶ 789, at 794-E. The activities that will create nexus with the taxing jurisdiction, if performed in that jurisdiction, are:

> (1) [m]aking repairs or providing maintenance . . . ; (2) [c]ollecting current or delinquent accounts . . . ; (3) [i]nvestigating credit worthiness; (4) [i]nstallation or supervision of installation . . . ; (5) [c]onducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation; (6) [p]roviding any kind of technical assistance or services . . . ; (7) [i]nvestigating, handling, or otherwise assisting in resolving customer complaints . . . ; (8) [a]pproving or accepting orders; (9) [r]epossessing property; (10) [s]ecuring deposits on sales; (11) [p]icking up or replacing damaged or returned property; (12) [h]iring, training, or supervising personnel, other than personnel involved only in solicitation . . . ; (13) [m]aintaining a sample or display room in excess of two weeks (14 days) . . . ; (14) [o]wning, leasing, using or maintaining . . . [real] property in-state; [and] (15) [m]aintaining, by an employee . . . , an office or place of business . . . .

Id. ¶ 789.40, at 794-F.

Activities protected by public law 86-272, that is, activities which will not create income tax nexus are the following:

> (1) [s]oliciting orders for sales by any type of advertising . . . ; (2) [c]arrying samples . . . for display or distribution without charge or other consideration; (3) [p]roviding automobiles to sales personnel . . . ; (4) [p]assing . . . inquiries . . . on to the home office; (5) [m]aintaining a . . . display . . . for two weeks (14 days) or less at any one location . . . during the tax year; (6) [r]ecruiting, training, or evaluating sales personnel . . . ; [and] (7) mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

dress what constitutes sales and use tax nexus for electronic transfers of information, the U.S. Supreme Court recently reaffirmed the traditional notions of nexus.[69]

In *Quill Corp. v. North Dakota*, the Court ruled that an out-of-state mail-order house did not have a "substantial nexus"[70] with the State of North Dakota because the company's only connection with North Dakota was solicitation of customers through the mail.[71] The company did not have a sales office, employees, equipment or inventory in North Dakota. The Court ruled that the State was precluded on commerce clause grounds from requiring Quill to collect and remit use tax on the company's sales in the State.[72]

The Court reaffirmed the "bright-line, physical presence requirement"[73] of a vendor as a prerequisite to state and local taxation of that vendor.[74] Accordingly, if a company does not have a presence in a specific jurisdiction, that jurisdiction cannot successfully assert its taxes upon the company. Therefore, under the traditional notions of nexus, an

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Id.

69. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

70. *See* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). The Supreme Court set forth a four part test to determine the validity of state taxes under the commerce clause. *Id.* A tax will survive a commerce clause challenge if the "tax [1] is applied to an activity with a *substantial nexus* to the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided to the State." *Id.* at 279.

The *Quill* court explained that the "substantial nexus" requirement is not merely a due process "minimum-contacts" requirement. 504 U.S. at 313. A company therefore may have minimum contacts with a taxing state as required by the Due Process Clause, and yet lack the substantial nexus with that State as required by the Commerce Clause. *Id.*

But see, Orvis Co. v. Tax Appeals Tribunal of State of N.Y., 86 N.Y.2d 165, 176 (1995), *cert. denied*, Vermont Info. Processing, Inc. v. Commissioner, New York State Dep't of Taxation, 116 S.Ct. 518 (Nov. 27, 1995) (explaining "Quill simply cannot be read as equating a substantial physical presence of the vendor in the taxing State with the substantial nexus prong of the Complete Auto test . . ."). The New York High Court further held that "[w]hile a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more than a 'slightest presence.'" *Id.*

Contra National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551 (1977). The Court in *National Geographic* disregarded the slightest presence test almost two decades ago by holding "[o]ur affirmance of the California Supreme Court is not to be understood as implying agreement with the court's 'slightest presence' standard of constitutional nexus." *Id.* at 556.

71. 504 U.S. at 301.

72. *Id.* at 313.

73. *Id.* at 314-15.

74. *Id.* The Court stated in a prior decision, that it affirmed the continuing vitality of the "sharp distinction . . . between mail-order sellers with a [physical presence in the taxing] State and those . . . who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business." *Id.* at 306-07 *quoting* National Bellas Hess, Inc. v. Dep't of Revenue of Illinois, 386 U.S. 753, 758 (1967).

information service provider will be subject to a jurisdiction's sales and use taxes if the information service provider has employees,[75] agents,[76] equipment[77] (whether leased to subscribers or otherwise), an office,[78] or inventory in that jurisdiction.

Applying traditional standards of nexus to electronic information services however, may be problematic. June Summers, Director of the Multistate Tax Commission's National Nexus Program explained, "defining nexus in the context of the electronic world and looking at the administrative issues of state taxation of these transactions is mind-boggling. Current nexus concepts are outmoded in the electronic marketplace."[79] Summers acknowledged however, that traditional standards of nexus may apply notwithstanding.[80]

Services such as CompuServe and Prodigy may create nexus for the vendors selling products through their respective services.[81] Products sold over the Internet however, may escape taxation as nexus might not be created.[82] The difference between these two services is a "centralized authority."[83] The Internet may be construed as nothing more than a modern day common carrier such as the U.S. mail which does not create nexus, as reaffirmed in *Quill*.[84] The online services however are distinguishable in that the services may be construed as "representatives" of the products sold via the service.[85] Jurisdictions that seek to tax these transactions, however, must be cognizant not to create duplicate taxation, as there are three potential business entities;[86] the content pro-

75. *See, e.g.*, Standard Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560 (1975) (holding that the maintenance of a single employee who worked out of his house in Washington and consulted with Washington customers created a sufficient nexus for Standard Pressed Steel).

76. *See, e.g.*, Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (holding that ten independent contractors who did no more than solicit business in Florida on a continual basis created a sufficient nexus for Scripto even though they were not regular employees devoting full time to Scripto).

77. *See, e.g.*, *Quotron*, 411 A.2d at 441 (explaining that Quotron had nexus with the State of Maryland because all of the equipment provided by Quotron to its subscribers was owned, installed, maintained, repaired, relocated, and insured by Quotron).

78. *See, e.g.*, *Nat'l Geographic*, 430 U.S. 551 (holding that the maintenance of two offices in California, unrelated to its mail order business, created a substantial nexus for the mail order business in California).

79. *MTC Examines Making (Tax) Money On the Internet*, 9 STATE TAX NOTES 408, 409 (August 7, 1995).

80. *Id.*

81. *Id.* at 408-09.

82. *Id.* at 408.

83. *Id.*

84. *See generally Quill*, 504 U.S. 298.

85. *Id.*

86. *MTC Dialogue Highlights Breakthrough in Taxation of Online Sales*, 9 STATE TAX NOTES 1397 (Nov. 13, 1995).

vider, the Internet access provider, and the online service provider.[87]

In any event, if the provider of the electronic service does not have nexus and therefore does not collect a tax, the *user* of the service will likely be required to self assess a "use tax" if information or data processing services are statutorily and unambiguously taxable in the user's jurisdiction.[88]

B. Statutes Must Be Construed Narrowly And In Favor Of The Taxpayer

DORs are conveniently ignoring the rules of statutory construction for revenue legislation. At the outset, there are two kinds of tax statutes, an imposition statute and an exemption statute. An imposition statute imposes or creates a tax liability whereas an exemption statute provides an exemption from a tax liability. The rules of statutory construction explain: "[I]t is a settled rule that tax laws that impose a tax liability are to be construed against the state and in favor of the taxpayer."[89] Indeed, this rule is a "fundamental precept"[90] supported by the U.S. Supreme

87. *Id.*

88. *See supra* note 7 (explaining what use tax is and how it is imposed); *see also, e.g.,* N.Y. Comp. Codes R. & Regs. tit. 20, § 531.1(b)(3) (1990) (effective July 10, 1991) (explaining that when a New York firm uses an out of state firm to provide information, and no tax was collected, "the New York firm is liable for a compensating use tax on the price paid for the information received"); 34 Texas Admin. Code tit. 34, § 3.342(j) (effective March 23, 1995) (explaining that if an information service provider is not doing business in Texas or in specific local taxing jurisdiction and is not required to collect Texas state or local tax, then the Texas customer/subscriber has the responsibility of reporting the state and local use tax directly to applicable DOR office(s)); *Meites*, 540 N.E.2d at 979 (holding a law firm liable for a 6% city lease tax assessment since Lexis/Nexis did not collect and remit the lease tax); Cummings & Lockwood v. Comm'r of Revenue Servs., 1994 WL 388558 at *2 (Conn. Super. Tax 1994) (holding a law firm's subscription of computer information services as a taxable service to the law firm under a "computer and data processing service" statute); 2 All States Tax Guide (P-H) ¶ 5610, at 5074 (explaining that statutes commonly require a buyer to pay a use tax directly to the state and local jurisdictions if the seller does not collect a use tax or charge a sales tax).

89. 3A Norman J. Singer, Sutherland Statutory Construction § 66.01 (5th ed. 1992). Singer compiles several theories advanced by the judiciary over the years to support the doctrine of strict statutory construction for tax legislation. *Id.* The theories are: (1) "strict construction is a way to assure that no taxes be exacted except by legislative authority;" (2) taxes "should not be extended by implication" as "tax laws are not founded on a permanent public policy;" (3) strict construction of tax laws "is for the protection of the citizen by informing him in unambiguous terms as to the amount and nature of his duty to pay taxes;" (4) "where tax statutes impose burdens upon long-established trades and occupations the balance of economic interest favors the taxpayer and not the state;" (5) "strict construction is desirable as a way to secure equality and uniformity in the imposition of tax burdens;" and (6) "it is presumed that no new tax is imposed by an act if notice is not given in the title." *Id.*

90. *Id.*

Court.[91]

If a statute's meaning is not ambiguous,[92] then a court need not apply the rules of statutory construction.[93] This is rarely the case. Where doubt exists regarding the meaning of an imposition statute, the doubt must be resolved in favor of the taxpayer.[94] Conversely, revenue statutes that provide tax exemptions, as a general rule, are given a strict interpretation against the taxpayer and in favor of the taxing authority.[95]

Based on the case law, it is conceivable that the DORs have the rule backwards. DORs are broadly interpreting imposition statutes in clear violation of the above established rules. DORs are attempting implausible leaps and must desist immediately. Without clear and unambiguous statutory authority and legislative intent, the state and local DORs simply cannot tax electronic transfers of information.[96] This rule is a *sine*

91. Gould v. Gould, 245 U.S. 151, 153 (1917). In *Gould*, the Court stated:

> In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt, they are construed most strongly against the government, and in favor of the citizen.

Id.

92. *See* 3A SINGER, *supra* note 89, § 66.03 (explaining that a statute is considered ambiguous if it is possible for reasonably well-informed people to construe the statute differently).

93. 3A SINGER, *supra* note 89, § 66.03.

94. *Id.* § 66.01; *see also, e.g.*, Winston-Salem Joint Venture v. City of Winston-Salem, 282 S.E.2d 509 (1981), *cert. denied*, 288 S.E.2d 803 (1982). *Winston-Salem* stated, "Where a taxing statute is susceptible of two constructions and the legislative intent is problematic, the uncertainty should be resolved in favor of the taxpayer." 282 S.E.2d at 511.

95. 3A SINGER, *supra* note 89, § 66.09; *see also, e.g.*, Teleprofits of Texas, Inc. v. Sharp, 875 S.W.2d 748, 750 (Tex. Ct. App. 1994) (holding that statutory exemptions from taxation are given strict construction and the taxpayer bears the burden of proving the exemption applies, however, all doubts are resolved in favor of the taxing authority); Educ. Computer Software, Inc. v. Baldwin, 8 N.J. Tax 253, 258 (N.J. Tax Ct. 1986) (citing Princeton Univ. Press v. Princeton, 172 A.2d. 420, 422 (N.J. 1961) (holding that it is a general principle that exemptions from taxation are to be strictly construed against the taxpayer, as exemptions represent a departure from the proposition that everyone should bear his just and equal share of the public burden of taxation).

96. *See, e.g.*, Morton Buildings, Inc. v. Bannon, 607 A.2d 424, 427 (Conn. 1992) (holding the oft-repeated principle, "[w]hen the issue is the imposition of a tax, rather than a claimed right to an exemption or a deduction, the governing authorities must be strictly construed against the commissioner and in favor of the taxpayer") (citing Hartford Parkview Assoc. Ltd. Partnership v. Groppo, 558 A.2d 993, 994 (Conn. 1989)); Quotron Sys., Inc. v. Gallman, 348 N.E.2d 604, 606 (N.Y. 1976) (holding in favor of the well-established rule of construction that ambiguities in tax statutes are to be construed most strongly in favor of the taxpayer and against the government); *Quotron*, 615 So. 2d at 776 (holding, "[a]s a matter of law, tax statutes are construed strictly against the taxing power, and any doubts are to be resolved in favor of the taxpayer"); *Dow Jones*, 436 N.W.2d at 924 (holding, "the general rule . . . [is] that a 'tax may be imposed only by clear and express lan-

qua non to preclude broad DOR interpretation of state and local statutes.

If a DOR passes an official regulation however, the courts will give deference to the interpretation[97] and generally will not overturn that regulation unless the construction is arbitrary or unreasonable.[98] The burden therefore shifts back to the taxpayer to prove the construction is unreasonable.[99]

Conversely, an informal or non-authoritative administrative regulation, such as a private letter ruling or DOR policy determination, is given less weight by the courts.[100] Therefore, absent a clear and unambiguous statute or formal, official regulation, a DOR cannot summarily give a statute a broad interpretation to assess an unsuspecting taxpayer.

C. Older Statutes Did Not Intend to Tax Modern Technology

The scope of a tax cannot exceed the intended purview of the drafters. When legislators drafted statutes to tax the sale or lease of tangible personal property, they could not have contemplated—and subsequently intended—to tax modern technology. Before the advent of personal computers, legislators drafting an imposition statute did not and could not intend to tax the high speed transfer of information via satellites or phone lines from a remotely accessed database. Indeed, courts cite the fact that the technology postdates the statute in question as a reason for setting aside a state tax assessment.[101]

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guage, and all ambiguities as to the applicability of a tax must be resolved in favor of the taxpayer'") *citing* Frisch, Dudek & Slattery v. Revenue Dep't., 396 N.W.2d 355, 358 (Wisc. Ct. App. 1986).

97. *See* 3A Singer, *supra* note 89, § 66.04; 2 All States Tax Guide (P-H) ¶ 5007, at 5013 (explaining that courts give weight to rules and regulations that are within the scope of the statute); *see also, e.g., Teleprofits*, 875 S.W.2d at 752 (stating, "Texas courts generally give weight to an administrative agency's interpretation of a statute as long as that interpretation is reasonable"); *Educ. Computer Software*, 8 N.J. Tax at 258 (ruling that administrative regulations are accorded a presumption of reasonableness) *citing* New Jersey Guild of Hearing Aid Dispensers v. Long, 384 A.2d 795, 803 (N.J. 1978).

98. *Educ. Computer Software*, 8 N.J. Tax at 258. The party contesting the presumption bears the burden of proving the regulation is arbitrary, capricious, unduly onerous or otherwise unreasonable. *Id. But see*, 3A Singer, *supra* note 89, § 49.04 (explaining "legislative history in the form of information as to how draftsman of a provision understood it and that their meaning was communicated to the Congress which enacted it has been held to be entitled to greater weight than subsequent administrative interpretation").

99. *Educ. Computer Software*, 8 N.J. Tax at 258.

100. Singer, *supra* note 89, § 66.04. Informal or non-authoritative administrative regulations should be given reduced weight as they are "made without the authority, care and deliberation with which ordinary interpretive regulations are [given when] promulgated." *Id.*

101. *See, e.g., Quotron*, 615 So. 2d at 776 (holding "[t]he Legislature cannot have intended to tax a technology that postdates the enactment of a measure in question").

A DOR may argue that technology is advancing so rapidly today that statutes will hardly ever keep up with the technology. This fact, however, is not really a problem as statutes or regulations may make reference to future technology.[102] The problem in the instant situation is that modern technology was never factored into the existing statutes.

DORs cannot tax what was never intended to be taxed. If the DORs insist that an electronic information service should be taxed, then a statute or interpretive regulation should be passed. Innocent taxpayers should no longer bear the physical and emotional burden of fighting a tax assessment under an outdated statute that never intended to tax the specific issue in question.

D. THE "TRUE OBJECT" TEST

DORs are also ignoring the firmly established principle of the "true object"[103] test. The courts are continually setting aside tax assessments where the true object of the transaction or the essence of the transaction was the receipt of a nontaxable service.

The true object test is an amorphous test with sometimes inconsistent results that is used both in the courts and in statutes[104] to determine if a transaction should be subject to a sales or use tax or if it should be exempt from taxation. Although this test varies from state to state, it has generally evolved into two distinct tests depending on how a state views electronically transmitted information. If a jurisdiction taxes computer services by statute, then the issue is whether the subscriber's true object is a computer service or some other service, such as an information service.[105] On the other hand, if a jurisdiction imposes a traditional

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102. *See, e.g.*, D.C. MUN. REG. § 475.1 (stating "'information services' includes furnishing . . . by printed, mimeographed, electronic, or electrical transmission, or by utilizing wires, cable, radio waves, microwaves, satellites, fiber optics, *or any other method now in existence or which may be devised*, and electronic data retrieval or research") (emphasis added).

103. "The test appears in different states under at least three different names: the real object test; the essence of the transaction test; and the essence of the relationship test." J. Elaine Bialczak, *Sales and Use Taxes: Information Services*, 1320 BNA TAX MANAGEMENT PORTFOLIO 1, 16 (1995).

104. *See, e.g.*, WISC. ADMIN. CODE § Tax 11.67(1) (1992), which explains:

> When a transaction involves the transfer of tangible personal property along with the performance of a service, the true object of the purchaser must be considered to determine whether such transaction is a sale of tangible personal property or the performance of a service with the transfer of property being merely incidental to the performance of a service. If the objective of the purchaser is to obtain the personal property, a taxable sale of that property is involved. However, if the objective of the purchaser is to obtain the service, a sale of a service is involved even though, as an incidence to the service, some tangible personal property may be transferred.

105. J. Elaine Bialczak, *The True Object Test Applied to States' Sales Test on Information Services*, 10 J. OF ST. TAX'N 46 (1991).

sales or use tax on the transfer of tangible personal property, then the issue is whether the subscriber's true object is the receipt of equipment or the receipt of an information service.[106]

1. *Computer Service or Information Service?*

Until recently, both Connecticut and Ohio statutorily taxed computer services, but not information services. The state judiciaries however, applied their unique statutes differently which resulted in opposite holdings. Ohio, as discussed *infra*, has since amended its statute to include electronic information services as a specifically enumerated taxable service.

i. Connecticut

The application of the Connecticut statute and regulation taxing computer and data processing services is confusing. However, when analyzing whether services are taxable as computer and data processing services, a determination must be made as to whether the "true object" of a transaction is for the service recipient to obtain computer and data processing services rather than some other service.[107] Moreover, the use of the computer equipment must be essential to the provision of the service and not merely incidental to it.[108]

A few years ago, the Supreme Court of Connecticut[109] decided the fate of a use tax liability by narrowly construing[110] Connecticut's statute[111] and regulation[112] that taxes computer and data processing serv-

106. *Id.*

107. [1 Conn.] Tax. Rep. (CCH) ¶ 60-310, Computers, Services, and Software. (September 1995).

108. *Id.* citing Cummings & Lockwood v. Comm'r of Revenue Servs., 1994 WL 388558 (Conn. Super. Tax July 20, 1994) and Priv. Ltr. Rul. 95-1, Dep't of Revenue Servs., (January 17, 1995)).

For a discussion of *Cummings*, see *infra* notes 131-133 and accompanying text. In Letter Ruling 95-1, the Department ruled that an auto parts locating service is not a provider of computer and data processing services. [2 Conn.] Tax. Rep. (CCH) ¶ 360-511 (January 17, 1995). The Department reasoned that, although a computer was utilized by the company, it was not essential to its ability to provide the service. *Id.* Moreover, the customers' intent was to make use of the company for the purpose of locating auto parts, rather than to obtain computer or data processing services. *Id.*

109. Hartford Parkview Ass'n Ltd. Partnership v. Groppo, 558 A.2d 993 (Conn. 1989).

110. The court reasoned that "a narrow view of the scope of the taxpayers liability for 'computer services' is entirely consistent with the proposition that, as presently drafted, the sales and use tax purports to tax only certain specifically enumerated services rather than commercial services generally." *Id.* at 995-96.

111. CONN GEN. STAT. § 12-407(2)(i)(A) (1995). The statute provides: "'Sale' and 'selling' mean and include . . . (i) the rendering of certain services for a consideration, exclusive of such services rendered by an employee for his employer, as follows: (A) Computer and data processing services, including but not limited to, time." *Id.*

ices. An unrelated, subsequent lower court decision[113] and Connecticut private letter rulings,[114] however, have clouded the Supreme Court of Connecticut's decision leaving a taxpayer the daunting task of attempting to draw lines in the gray area of the law.

The Connecticut Supreme Court, in *Hartford Parkview Ass'n Ltd. Partnership v. Groppo*,[115] determined that a computerized hotel reservation service was a nontaxable information service, not a taxable computer service.[116] The taxpayer operated the Parkview Hilton Hotel and regularly paid subscription fees for access to the Hilton Reservation Service ("HRS").[117] Parkview, via its computer, utilized HRS to inform it of room availability and rates, and to ascertain which reservations HRS had confirmed.[118]

Although the commissioner argued HRS constituted taxable computer services,[119] the Connecticut Supreme Court affirmed the trial court's holding that "the essence [or true object] of HRS services" is to obtain reservation services rather than computer and data processing services.[120] The court reasoned that the mere fact a computer was used in connection with this service could not be the basis of the tax, and would encompass too many transactions not contemplated by the legislature, stretching the language of the statute and the regulation too far.[121]

The Connecticut DOR has seemingly ignored the *Hartford Parkview*

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112. CONN. AGENCIES REGS. § 12-426-27(b)(1) (1995). The tax regulation provides:

> (b) Enumerated services. (1) Computer and data processing services. Such services mean and include providing computer time, storing and filing of information, retrieving or providing access to information, designing, implementing or converting systems providing consulting services, and conducting feasibility studies . . . .

Id.

113. *Cummings*, 1994 WL 388558, (Conn. Super. Tax July 20, 1994).

114. *See infra* notes 122 (explaining what a private letter ruling is, and discussing two specific Connecticut rulings).

115. 558 A.2d 993 (Conn. 1989).

116. *Id. See Cummings*, 1994 WL 388558 (explaining that *Hartford Parkview* was a seminal case which provided the proper scope for computer and data processing services and because the court set the appropriate standard [the true object test] to apply in determining whether a particular service relationship is subject to the sales and use tax).

117. *Hartford Parkview*, 558 A.2d. at 994.

118. *Id.*

119. *Id.* at 995. The Commissioner argued HRS "stores and files information" about reservations on its computer. *Id.* (wording was lifted directly out of Reg. § 12-426-27(b)(1)). The commissioner previously argued that HRS services were taxable as *management services*, under General Statutes § 12-407(2)(i)(I) and § 12-426-27(10) of the Regulations of Connecticut State Agencies, and subsequently argued HRS services were taxable as *telephone answering services* under General Statutes § 12-407(2)(i)(G) and § 12-426-27(8) of the Regulations of Connecticut State Agencies. *Id.* at 994 (emphasis added).

120. *Hartford Parkview*, 558 A,2d at 996.

121. *Id.* at 995-96.

decision in its rendering of private letter rulings to taxpayers.[122] Two letter rulings,[123] specifically, are nearly impossible to reconcile with *Hartford Parkview*.[124]

In both of these rulings, the Connecticut DOR determined that the activities were taxable computer and data processing services rather than a nontaxable service. In Ruling 95-2, the taxpayer provided a service which allowed their customers online access to the Department of Motor Vehicles ("DMV") computer instead of traveling to the DMV in person.[125] The Connecticut DOR determined that the *true object* of the taxpayer's customers is to gain the convenience, speed and accuracy possible only through immediate access to the DMV's computer.[126] This ability, the DOR concluded, was the very reason for choosing this service and therefore, the computer was not incidental.[127]

In Ruling 93-8, an out-of-state company provided farmers with market information via a one-way satellite link to data receiving equipment owned by the company.[128] Again, the Connecticut DOR ruled that the true object was also to gain convenience, accuracy, and immediate access which, rather than being "merely incidental" to the service, was the very reason the subscribers choose to avail themselves of the company's service.[129]

The DOR's reasoning is flawed and precarious. Applying the above enumerated reasoning to *Hartford Parkview*, that case would also be taxable. After all, the true object of the HRS service is to gain the convenience, speed and accuracy which is only possible through immediate access to the Hilton Reservation System database. Moreover, that is the

122. In a private letter ruling, a taxpayer writes to a DOR, explains its particular facts, and asks for a determination of taxability. 2 All States Tax Guide (P-H) ¶ 5007, at 5013. Given the specific nature of a private letter ruling, it is only binding on the commissioner as against the party who requested the ruling. *Id.* However, the rulings are helpful in that they give insight to a DOR's interpretation of existing laws, regulations and cases. *Id.* The commissioner may modify a letter ruling already issued; however, the change will operate prospectively only. *Id.*

123. Priv. Ltr. Rul. 95-2, [2 Conn.] Tax. Rep. (CCH) ¶ 360-512 (Jan. 31, 1995); Priv. Ltr. Rul. 93-8, [2 Conn.] Tax. Rep. (CCH) ¶ 360-474 (May 19, 1993).

124. *See* Bialczak, *supra* note 105.

125. Priv. Ltr. Rul. 95-2, [2 Conn.] Tax. Rep. (CCH) ¶ 360-512. After paying a one-time base fee, the customer can electronically apply for motor vehicles registration and make inquires regarding vehicle registration or property tax liabilities. *Id.*

126. *Id.*

127. *Id.*

128. Priv. Ltr. Rul. 93-8, [2 Conn.] Tax. Rep. (CCH) ¶ 360-474. The subscribers received, on a display monitor, around the clock open market calls on grain and livestock, future and option quotes from major exchanges, daily updates of livestock auctions, and radar weather maps plus forecasts. *Id.*

129. *Id.*

very reason subscribers chose to avail themselves of HRS's services.[130]

Recently, a Connecticut trial court determined that a law firm was liable for sales tax on its purchase of online services.[131] In *Cummings & Lockwood v. Commissioner*, the taxpayer-law firm argued that it did not purchase taxable computer services, rather, the law firm argued it was purchasing information which is not taxable pursuant to *Hartford Parkview*.[132] The court strained to distinguish *Cummings* from *Hartford Parkview* and concluded that the "true object" of the transactions between the law firm and the various services was to obtain computer and data processing information rather than the *unprocessed information* that HRS provided in *Parkview*. [133] This explanation is perplexing however, as the online services the law firm used, provided cases, articles, liens and the like which are also unprocessed information.

ii. Ohio

Ohio avoided Connecticut's quagmire by enacting an entirely different statute. First, Ohio now statutorily taxes information services in ad-

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130. The Connecticut Supreme Court stated that the mere use of a computer *cannot* alone be the basis to assert a computer service tax. Hartford Parkview Ass'n Ltd. Partnership v. Groppo, 558 A.2d 993, 995 (Conn. 1989).

131. Cummings & Lockwood v. Commissioner, 1994 WL 388558 (Conn. Super. Tax). The taxpayer subscribed to the following services: Dialog Information Services (permitting access to over 200 major data bases covering business, economic, demographic technological, scientific medical patents and trademarks, and government and news information), NewsNet (providing information relating to businesses, as well as credit reports from Dun & Bradstreet and TRW, Inc.), Information America (providing access to state and corporate filing data, such as liens, judgments, and asset ownership), ABANet (providing information relating to the developments in the legal profession), and Bechtel Information Services (providing information concerning filings with the SEC). *Id.* at *1. The audit period covered seven and one half years (January 1, 1983 to June 30, 1990). *Id.*

132. *Id.* at *2.

133. *Id.* at *3-4; *see also* [2 Conn.] Tax. Rep. (CCH) ¶ 60-310.26. The court went through a lengthy discussion of how to find the "true object." *Cummings*, 1994 WL 388558 at *2. First the court explained, the intention of the parties must be determined. *Id.* (citing Dine Out Tonight Club, Inc. v. Dep't. of Revenue Servs., 556 A.2d 580 (Conn. 1989)). Intention was defined in *United Aircraft Corp. v. O'Connor*, 107 A.2d 398, 401 (Conn. 1945) as "ascertained from the language used, interpreted in light of the situation of the parties and the circumstances surrounding them. *Cummings*, 1994 WL 388558 at *2. However, to determine the intention of the parties, computer and data processing must first be understood. *Id.* at *3.

The trial court then referred to GTE Service Corp. v. F.C.C., 474 F.2d 724, 727 (2d Cir. 1973) (holding "[c]omputer services may be generally categorized as (1) message-switching, (2) data processing, or (3) a combination of both"). *Message switching* is basically sending and receiving an unaltered message. *Id.* Whereas, *data processing* is using a computer to store, retrieve, sort, merge, and calculate data. *Id.* Therefore, the court reasoned that Cummings activities fell within the definition of data processing and were subject to the data processing service tax. *Id.*

dition to computer and data processing services.[134] Second, Ohio incorporates the true object test into its statute to distinguish between general computer services and personal or professional services, in which computer services are merely incidental.[135]

A year before a change in the law that subsequently taxed information services,[136] the Ohio Supreme Court affirmed the Board of Tax Appeals ("BTA") decision which supported a computer service tax assessment on *Quotron*, a provider of stock and commodity prices via modem to dumb terminals.[137] Interestingly, while the BTA agreed with the taxpayer that the true object of the transaction is instant access to financial price information, not the provision of access to computer equipment,[138] the BTA notwithstanding, affirmed the assessment.[139] The dissent in the Ohio Supreme Court opinion concluded that the BTA's reasons result in an unfair expansion of the statute and legislative intent, and that under the BTA's reasoning, an ATM transaction would be taxable.[140]

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134. OHIO REV. CODE ANN. § 5739.01(B)(3)(e). The Code provides in pertinent part:

> Automatic data processing computer services, or electronic information services are or are to be provided for use in business when the true object of the transaction is the receipt by the consumer of automatic data processing, computer services, or electronic information services rather than the receipt of personal or professional services to which automatic data processing, computer services, or electronic information services are incidental or supplemental.

Id.

"Electronic information services" were added to § 5739.01(B)(3)(e) and became effective on July 1, 1993. OHIO REV. CODE ANN. § 5739.01(Y)(1)(c); *see also* [2 Ohio] Tax. Rep. (CCH) ¶ 293-060.02 (providing sales and use tax changes made by Omnibus Tax Bill).

135. *Id. See also* Bialczak, *supra* note 105.

136. *See supra* note 134 for an explanation of the change.

137. Quotron Sys., Inc. v. Limbach, 584 N.E.2d 658 (Ohio 1992). Quotron was assessed $648,622.20 for use tax it should have collected from subscriber billings. *Id.*

138. Quotron Sys., Inc. v. Limbach, BTA Decision and Order, 1990 Ohio Tax LEXIS 970 at *9 (Nov. 23, 1990).

139. The BTA concluded:

> (1) it does not fall within the personal or professional services exemptions because the transaction does not involve 'cognitive thought,' (2) the customer's true object is 'singularly met and satisfied by and through a taxable service,' (3) the customer's true object could not be realized or attained without the examination and acquisition by Quotron's computer, and (4) the statutory definition of data processing and computer services in R.C. 5739.01(Y)(1) is a 'mirror perfect' description of Quotron's services.

Quotron, 584 N.E.2d at 661 (Wright, J., dissenting) (summarizing the BTA holding).

140. *Id.* at 660-61. An ATM transaction would be taxable as automatic data processing and computer services under the BTA's reasoning and would implicitly be accepted by the majority because:

> [1] the transaction is entirely performed by computer; [2] there is no cognitive thought and thus would not fall within the personal or professional service exemptions; [3] the true object, instant access to account data, is singularly met and satisfied by a taxable service that can be accomplished only through the examina-

While there is no way to reconcile the high court decisions of Connecticut and Ohio, these cases do illustrate the point that each jurisdiction is unique and must be evaluated individually.

2. *Is the True Object a Service or Tangible Personal Property?*

Jurisdictions without a specifically enumerated tax on information services, data processing or computer services must try to recast the taxpayer's transaction into an activity that a state statute will tax if they are to try to "backdoor" a tax on a service. Often this is accomplished through a DOR assessing tax on either the entire transaction or the leasing of equipment dedicated to receive the provider's signal.

Although the determination of the "true object test" is fact specific, a provider of information services generally will prevail if it can prove the equipment used in providing an information service is merely incidental to the service. To do this, information providers must prove that their activity is a nontaxable service, rather than a taxable transfer of a tangible personal property. Jurisdictions generally consider the true object of a transaction a service if the provider retains ownership of the equipment, the equipment has no utility in and of itself, and where, although subscribers have some control and discretion over the equipment, it can only be used to receive the information subscribed.

In Maryland, a taxpayer prevailed against a DOR assessment on all monthly charges to its subscribers for providing them with financial information via leased telephone lines to equipment owned by the provider.[141] Although the DOR argued the taxpayer was leasing their equipment to its subscribers, the court held that the "dominant purpose" intended by the parties was to render a service, and not to lease the equipment dedicated to receive the service.[142]

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tion of data in a bank computer; [and 4] REV. CODE § 5739.01(Y)(1) . . . is a mirror-image description of an ATM transaction.

Id. at 661.

The dissent used the ATM example to illustrate the point that the legislature intended to tax the sale of access to a computer, not the taxation of a service which allows access to data through the use of computer technology as a communication devise. *Id.*

141. Quotron Sys., Inc. v. Comptroller of Treasury, 411 A.2d 439 (1980).

142. *Id.* at 444. The court first started out with a two-step analysis on how to determine if sales tax can be imposed on a company that provides both a service and related equipment. *Id.* at 184. First, based on the facts, the "overall function" must be characterized as either a rental or transfer of possession, or a service. *Id.* The critical factor in determining whether any type of transfer of possession, including a lease, has occurred is to look at which party has control. *Id.* at 443. Second, it must be determined whether sales tax is applicable to that function. *Quotron*, 411 A.2d at 443.

The court reasoned that although the subscribers had some control of the equipment, "on the balance," Quotron retained overall control as they owned the equipment, installed, maintained, repaired, relocated and insured the hardware almost exclusively at its own expense. *Id.* at 444. The court also found noteworthy the fact that the equipment had no

Similarly, ten years later in Kentucky, the same taxpayer, Quotron, prevailed on essentially the same facts.[143] The Board of Tax Appeals ruled that Quotron was providing a non-taxable information service because the "essence of the transaction" was the service itself and not the incidental leasing of equipment.[144]

Quotron also prevailed in Florida, a few years after the Kentucky decision, from a DOR assessment asserting sales tax on alleged leasing of Quotron's equipment.[145] The court held that the true object was the receipt of a service that was assisted by equipment rather than the leasing of equipment in which a service was only incidental.[146]

In Wisconsin, Dow Jones & Company also prevailed against a DOR sales tax assessment for allegedly leased equipment.[147] The issue in *Dow Jones* involved Dow Jones' separate charge for teleprinters.[148] The

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utility in and of itself to the subscribers, the equipment could only be used to receive Quotron's information service, and most importantly, that Quotron paid use tax on the value of the equipment at the time it was placed in service in Maryland because that indicated Quotron is intending to use the equipment themselves rather than intending to resell or lease the equipment which would have been purchased tax free. *Id.*

143. Quotron Sys., Inc. v. Revenue Cabinet, [2 Ky.] Tax. Rep. (CCH) ¶ 202-174 (BTA 1990).

144. *Id.* The assessment was set aside since the financial information was not tangible personal property. *Id.*

145. *Quotron*, 615 So. 2d 774 (1993). The DOR assessed $3,827,300.27 for sales tax, plus penalties and interest. The DOR alleged that equipment used by some (not all) of the Florida subscribers, to receive the information service, constituted a rental of property which therefore subjected the entire transaction to a sales tax. *Id.* at 775.

146. *Id.* at 778. In coming to this conclusion, the court referred to Rule 12A-1.071(10), Rentals, Leases, or Licenses to Use Tangible Personal Property which states:

> When the owner of equipment furnished the operator and all operating supplies and contracts for their use to perform certain work under his direction and according to the customer's specifications and the *customer does not take possession or have any direction or control over the physical operation*, the contract *constitutes a service transaction* and not the rental of tangible personal property, and *no* tax is due on the transaction.

Id. at 778 (emphasis added).

The court ruled that the subscribers only had access to a "dumb video terminal," and the subscribers did not have possession or control over the physical operation of the central processing unit (CPU) or related equipment essential to providing the information service. *Quotron*, 615 So. 2d at 775. The facts to support this assertion are that the CPU was kept in locked rooms usually not located on the subscribers premises, Quotron reserved the right to remove or replace the CPU, Quotron insured and maintained all of the equipment, and immediately removed the equipment upon termination of a subscriber's service. *Id.*

147. Wisconsin Dep't of Rev. v. Dow Jones & Co., 436 N.W.2d 921 (1989).

148. *Id.* at 922. Dow Jones publishes the Dow Jones News Service which subscribers received exclusively from teleprinters that work automatically and not in an interactive format. *Id.* However, with the advent of computers, some subscribers preferred to use video display screens instead of a teleprinter which is the only way to receive a hard copy of the news service. *Id.* Therefore, Dow Jones began to itemize a separate charge for teleprinters. *Id.*

Wisconsin DOR concluded that the taxpayer's provision of teleprinters constituted a rental because of the separate charge for the teleprinters in the subscriber's possession, and because the subscribers had an option whether or not to use the teleprinters. Accordingly, the DOR determined that the transaction was subject to Wisconsin's sales tax.[149] Both the Wisconsin Court of Appeals and the Tax Appeals Commission rejected these arguments because the true object of the transaction was for customers to receive a service and not to lease equipment.[150] The courts reasoned that Dow Jones' purpose for itemizing was not to make a profit,[151] and that the subscribers really did not have an option as whether or not to use the teleprinters because the only way to receive a hard copy was to have a Dow Jones teleprinter.[152] If a subscriber was found using "unauthorized equipment," Dow Jones would terminate the news service.[153]

When a transaction involves both a non-taxable service and a taxable transfer of tangible personal property, the true object of the transaction must be considered to determine what, if anything, should be taxed. If the true object of the transaction is for the recipient to receive a service, while the equipment utilized is incidental, then the transaction should be exempt from taxation. On the other hand, should the service be incidental to the use of equipment, then the true object of the transaction is the equipment itself. In that case, the transaction should be taxed.

When an individual receives information via computer equipment, the true object of the transaction is generally to receive information, and not to lease the equipment necessary to receive the signal. Therefore, absent a clear and unambiguous tax on electronic information services, the transaction should escape taxation because the user's true object is to receive a non-taxable service.

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149. *Id.* at 923.

150. *Id.* at 924. The provision of teleprinters were incidental to the information service provided to the subscribers pursuant to WIS. ADMIN. CODE § TAX 11.67(1), which provides in pertinent part:

> When a transaction involves the transfer of tangible personal property along with the performance of a service, the true objective of the purchaser must be considered to determine whether such a transaction is a sale of tangible personal property or the performance of a service with the transfer of property merely incidental to the performance of the service. If the objective of the purchaser is to obtain the personal property, a taxable sale of that property is involved. However, if the objective of the purchaser is to obtain the service, a sale of such a service is involved even though as an incidence to the service, some tangible personal property may be transferred.

Id. at 922.

151. *Dow Jones*, 436 N.W.2d at 923-24.

152. *Id.* at 923.

153. *Id.* at 922.

IV. CONCLUSION

State and local departments of revenue must exercise social responsibility and avoid creative tax interpretations of outdated, inapplicable and ambiguous statutes. While DORs are entitled to interpret their statutes to expand the tax base, they must stay within strict rules of statutory interpretation. They should not be allowed to continue practicing predatory gamesmanship on users and providers of electronic information services. Absent a clear and unambiguous statute and a full consideration of the true object of the transaction, DORs should be precluded from any attempt to tax electronic transfers of information. The departments of revenue need to focus on fair administration, not just enforcement because countless dollars are wasted on transactions never intended to be taxed.

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