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Sales taxation of information services and data processing

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Introduction

The transfer or processing of information long has been difficult for state tax administrators to classify and tax properly, with technology creating an ever-changing paradigm for business operations. As a result, a taxpayer engaged in transferring information may incur a different sales tax treatment in each state in which it conducts business. The same transaction may be classified as an information service in one state and classified as data processing in another state. This article examines the current sales tax treatment for this activity in various states.

What You Should Know

What is an information service?

For sales tax purposes, an information service definition proves useful to determine which transactions can be classified accordingly. The term generally refers to services wherein the primary purpose is to obtain information that is accumulated, analyzed, or summarized for a client or customer from a base of information maintained by the service provider. Such information may or may not be provided according to criteria provided by the client or customer. An information service commonly is analyzed according to whether it occurs in a tangible or electronic form and whether the information is standardized or presented for a particular customer.



New York defines an information service as “the collection, compilation or analysis of any kind of information and the furnishing of reports to other persons.” New York further clarifies that information services include credit reports, tax or stock market advisory and analysis reports, and product and marketing surveys [20 NY ADC 527.3(a)(3)]. Washington State defines an information service as “every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, or procedures to a user through any tangible or intangible medium.” The term specifically excludes transfers of tangible personal property, such as computer hardware or standard prewritten software programs [[WA ADC 458-20-155](#)].

What does data processing mean?

Data processing can be defined simply as:

- The processing of information for the purpose of compiling or producing records of transaction;
- Maintaining information; and
- Entering and retrieving information.

Historically, the processing of data typically was thought of as a function similar to data entry. However, the term has evolved with technological advances. For instance, in Texas, data processing includes word processing, data entry, data retrieval, payroll and business accounting data production, data search, information compilation, and other computerized data and information storage or manipulation. The term also includes the use of a computer or computer time for data processing, whether the processing is performed by the provider of the computer or computer time or by the purchaser or other beneficiary of the services. Texas clarifies that the following services are considered data processing services: entry of inventory control data, maintenance of records of employee work time, filing payroll tax returns, preparing W-2 forms, and computing and preparing payroll checks [[V.T.C.A., Tax Code § 151.0035](#), [34 TX ADC § 3.330\(a\)](#)].

How are transactions classified?

As the preceding terms have demonstrated, there is considerable overlap between these two definitions. A transaction may involve data processing and information services concurrently or may involve a part of each activity. Herein lies the confusion for taxpayers, as well as state tax administrators: whether a transaction more closely resembles a data processing transaction or an information service transaction. The answer may be different in different jurisdictions according to whether the focus is on the action (processing) or the outcome (information).

For example, Connecticut defines computer and data processing services as “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.” However, information services are not included in the enumerated list of services subject to sales tax in Connecticut. An information service performed in Connecticut would most likely fall under the “computer and data processing” umbrella for classification purposes since the service most closely resembles retrieving or providing access to information

[\[CT ADC § 12-426-27\]](#). However, this example illustrates the confusion for a provider of information services when there is not clear direction as to how the service should be classified for sales tax purposes.

How are different states taxing information services/data processing?

In Ohio, taxable sales include transactions that involve the transfer, for consideration, of title or possession of books, manuals, bulletins, lists, or similar materials providing current information or data on a particular subject that are furnished and/or supplemented on a continuing basis pursuant to a contract. The statute also provides that taxable sales include the provision of automatic data processing, computer, and information services when the true object of the consumer is the receipt of the automatic data processing, computer, or information service rather than the receipt of a professional service [\[OH ADC 5703-9-43, 5703-9-46\]](#). Therefore, information services and data processing are clearly taxable unless the object of the transaction is a professional service.

California, on the other hand, does not tax data processing services or the transfer of information by electronic telecommunications from a remote location if there is no tangible personal property sent to the purchaser. However, the tangible transfer of information is subject to tax [18 CA ADC §1502(a), (c)(5), and (c)(8)].

New York taxes data processing and information services. However, the state differentiates whether the information services are of a business or personal nature. Specifically, if the information furnished is “personal and individual in nature and is not or may not be substantially incorporated in reports furnished to other persons, such information services are exempt from tax” [\[NY Law Sec. 1105\(c\)\(1\)\]](#).

What are some current examples of services considered information services/data processing?

Software as a Service (SaaS), a subset of cloud computing, is a service that currently is being scrutinized closely by the states. SaaS typically involves software applications that are available via an Internet web browser, such as e-mail accessed online, etc. As of the date of this article, the following states classify SaaS as an information or data processing service: Connecticut, D.C., Hawaii, Kansas, Minnesota, New Mexico, South Carolina, South Dakota, Tennessee, and Texas. However, the following states consider SaaS electronically delivered software: Arizona, Colorado (repealed effective July 2012), Idaho, Indiana, Louisiana (temporarily suspended), Massachusetts, Michigan, New York, Utah, Vermont, and Washington State.

To further illustrate, Texas determined that an out-of-state company providing an online business application to Texas customers that recorded and managed their business transactions was performing taxable data processing services for sales tax purposes. Customers accessed the taxpayer’s software through the Internet and transmitted data to the taxpayer’s out-of-state servers, which processed the data to prepare a tax return [Letter No. 200805095L, Texas Comptroller of Public Accounts (5/28/2008)]. Therefore, the state of Texas focused on the processing function for sales tax purposes, rather than whether software was purchased or information was provided.

Massachusetts takes a different position than Texas in a similar example. The Department of Revenue determined that a financial information provider's charges for access to an electronic database that allows users to obtain reports prepared by the seller were not subject to Massachusetts sales and use tax because the object of the transaction was to obtain information rather than to use the software itself. Charges for access to web-based tools that allow users to make credit decisions, manage risk exposure, and create credit applications, however, were taxable as sales of a right to use prewritten software because the object of the transaction was to use the seller's software to manipulate information [Letter Ruling 11-2, Massachusetts Department of Revenue (3/4/2011)]. In this example, the state looked to the object of the transaction to determine the taxability, regardless of whether the processing of information was involved.

What This Means in Practice

A provider or processor of information must evaluate carefully whether that process is classified as a data processing or information service transaction in the states in which it does business. Once the activity is properly classified, the taxability can be determined. Although this process of classifying and determining tax might seem a simple exercise, the reality is that the slightest technological upgrade can lead a taxpayer (and ultimately a state tax administrator) to disagree on the conclusions.

Many questions arise including: Are there other elements of the transaction involved, such as software? Are there other services included in the transaction (e.g., personal services) that could alter the true object of the transaction? Does the transaction involve an emerging technology that does not neatly fit into existing definitions? Does the classification of the transaction change depending on the states it is performed in? Are there sourcing issues as well to be aware of? Are there technological changes in the marketplace that can influence the classification or taxation of the transaction? Is the tax determined by whether tangible personal property is transferred? The answers to these questions can offer insight to make effective tax decisions.

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