

# Does the Internet Vendor Sell Items or Engage in Activity That is Subject to the Destination State's Sales and Use Tax?

Prepared by:  
Pat Derdenger and Karen Jurichko Lowell  
*Steptoe & Johnson LLP*



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## **DOES THE INTERNET VENDOR SELL ITEMS OR ENGAGE IN ACTIVITY THAT IS SUBJECT TO THE DESTINATION STATE'S SALES AND USE TAX?**

Sales and use taxes arise from state law and vary from state to state. A few states – such as New Hampshire and Oregon – have chosen not to impose a general sales or use tax at all. Other states have elected to tax not only sales or rentals of tangible personal property, but also virtually every type of business transaction, including services. Other states fall somewhere in the middle.

States that do impose a sales tax fairly universally apply the tax to retail sales of tangible personal property. See *e.g.* Ariz. Rev. Stat. (“ARS”) § 42-5061 (imposing a tax on “the business of selling tangible personal property at retail”); Cal. Rev. and Taxation Code (“CRTC”) § 6051 (imposing tax on “the privilege of selling tangible personal property at retail”); Fla. Stat. § 212.05; N.Y. Tax Law § 1105(a). Many states, however, go beyond mere sales of tangible personal property and apply their tax to a myriad of different transactions and activities. These other areas might include rentals of tangible personal property, licenses for use, amusements, lodging (hotel/motel), and transportation.

State sales and use tax classifications also come with many different exemptions, deductions and exclusions. One common and almost universal exemption is a sale for resale. See *e.g.* ARS § 42-5061(V)(3) (explicitly excluding sales for resale); CRTC § 6051 (limiting tax to sales at retail, which excludes resales); Fl. Stat § 212.02(14)(a) (excluding sales for resale from the definition of a retail

sale); N.Y. Tax Law § 1105 (excluding sales for resale from definitions of taxable transactions). As a result internet wholesalers, for example, will generally not be subject to sales or use tax in most states.

In addition, some states have addressed electronic commerce by establishing additional rules that can create problem areas for internet vendors. These include the following:

**Software**: Many states treat computer software differently depending on the nature of the software. For example, sales tax generally applies to sales, license, or rentals of “canned” software (i.e. prewritten software designed for general use and not tailored to the specific needs of a particular client), and the tax base usually includes any licensing fee or royalty paid for the software license. See e.g. CRTC § 6010.9; Ariz. Admin. Code Reg. R15-5-154; N.Y Tax Law § 1101(b)(6). At the same time, many states treat “custom” software (i.e. software originally created or written for the specific use of a particular client) as a non-taxable service, rather than a taxable sale, rental or license.

States also come out differently on the proper tax treatment of software downloaded from the internet. Some states, such as California, do not impose their sales tax on software downloads, because the property sold was not tangible personal property. Internet vendors must be careful, however, as this rule generally only applies so long as *no transfer whatsoever* of tangible personal property occurs as part of the transaction. For example, states such as California take the position that downloaded software would be taxable if the customer receives backup disks or physical manuals as part of the sale.



Other states, like New York, Kansas, and Rhode Island, tax software sales “regardless of the medium by means of which such software is conveyed to a purchaser” be it through a tangible medium such as a disk or downloaded from the internet. N.Y. Tax Law § 1101(b)(6); Kan. Info. Guide EDU-71R (July 23, 2010); R. I. Gen. Laws § 44-18-23.

**Information Services:** Some states, such as New York, also tax information services. New York defines an information service as “[t]he furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons.” N.Y. Tax Law § 1105(c)(1).<sup>1</sup>

New York regulations interpreting this section state that the information may be duplicated in any manner, including through “tapes, discs, [and] *electronic readouts or displays*.” N.Y. Reg. 527.3(a) (emphasis added). In short, New York taxes any activity involving “collecting, compiling or analyzing information of any kind or nature and the furnishing reports thereof to other persons.” N.Y. Reg. 527.3(b). A few examples of taxable information services include credit reports, tax or stock market advisory reports, and product or marketing surveys. N.Y. Reg. 527.3(c). New York administrative and judicial decisions have frequently applied the sales tax on information services to activity engaged in over the internet.

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<sup>1</sup> New York excludes from its definition of information services, “the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity.” N.Y. Tax Laws § 1105(c)(1).

The rules discussed in this section are meant as a guideline to alert you to the general structure of state sales and use taxes and areas that might affect internet vendors. It is not intended to be all-inclusive, as each of the fifty states has adopted tax laws that differ from the laws of every other state. Thus, when you start engaging in transactions in a state (such as making sales into a state) you will need to determine if that state's sales and use tax applies and if you engage in any taxable transactions.

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