STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions

of

CATALYST REPOSITORY SYSTEMS, INC.

for Revision of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Period January 1, 2008 through December 31, 2010.

DETERMINATION
DTA NO. 826545

Petitioner, Catalyst Repository Systems, Inc., filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the period January 1, 2008 through December 31, 2010.

A hearing was held before Herbert M. Friedman, Jr., Administrative Law Judge, in New York, New York, on April 28, 2016, with all briefs to be submitted by November 28, 2016, which date began the six-month period for the issuance of this determination. By letter dated May 17, 2017, this six-month period was extended for an additional three months (Tax Law § 2010[3]). Petitioner appeared by Hutton & Solomon, (Stephen L. Solomon, Esq., and Kenneth I. Moore, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Clifford M. Peterson, Esq., and Ellen K. Roach, Esq., of counsel). This matter was transferred to Kevin R. Law, Administrative Law Judge, pursuant to the authority of section 3000.15(f) of the Rules of Practice and Procedure of the Tax Appeals Tribunal.

ISSUES

I. Whether petitioner's receipts are properly classified as receipts derived from the performance of services, pursuant to Tax Law former § 210(3)(a)(2)(B), or as other business receipts, pursuant to Tax Law former § 210(3)(a)(2)(D).

II. Whether, upon determining the proper classification of petitioner's receipts, any portion thereof is properly allocable to New York.

FINDINGS OF FACT

1. Petitioner, Catalyst Repository Systems, Inc., is a Colorado based electronic data and document repository corporation that provides litigation support services to its clients. Its genesis began in the 1990's as a unit within a law firm and in 2000 it was spun off as a separate company.

2. Petitioner filed Form CT-3 (General Business Corporation Franchise Tax Return) and Form CT-3M/4M (General Business Corporation MTA Surcharge Return) for each of the tax years ending December 31, 2008, December 31, 2009 and December 31, 2010 (audit period) upon which it computed a business allocation percentage (BAP) in the amount of zero. In computing its BAP, petitioner treated its receipts as arising from services, and determined that such services were performed entirely in Colorado.

3. For each tax year, petitioner reported its highest tax base was the fixed dollar minimum tax base and, as such, it reported a tax liability of $25.00.

4. Petitioner subsequently filed amended Forms CT-3 and Forms CT-3M/4M to report changes to its federal taxable income for the tax years ending December 31, 2009 and December 31, 2010. The federal returns were amended to claim a deduction pursuant to section 199 of the Internal Revenue Code on the basis that its gross receipts from its customers' access to the companies software while connected to the internet are substantively similar to receipts from software which can be purchased or downloaded from a seller.

5. By a letter dated March 9, 2012, the Division informed petitioner that it was reviewing its corporation franchise tax filings for the audit period. This review included an examination of petitioner's BAP which became the focus of the audit.

6. Petitioner provides its clients with the use of its system, which includes its proprietary software and the use of its technical personnel in order to acquire, store, sort, filter, organize and ultimately find and retrieve the documents its clients require, typically in response to demands for discovery arising through litigation, governmental requests or regulatory inquires.

7. Petitioner licenses the use of its system and the services of its technical staff, located in Colorado. Each license is for a designated case, on a month-to-month basis, and may be terminated at will by either party. The license does not convey any ownership rights to any software or any of the storage or operating facilities being used. Petitioner does not sell any information or tangible personal property to its clients. Rather, the client provides data to be hosted by petitioner and uses petitioner's system for the purpose of searching, analyzing, reviewing and retrieving its own data.

8. The process begins when petitioner is provided with legal and other documents from its clients, which have been provided to petitioner for processing and loading into petitioner's platform. Petitioner then tags and organizes the data at its Colorado headquarters, where its computer servers and storage facilities are located. Clients from around the world utilize the Internet to access the Colorado system in order to process, search, sort, filter, organize and retrieve the data they require.

9. Petitioner does not sell or provide data to its clients, but rather its clients provide the data to be managed. Petitioner offers secure storage services, language translation, project

management, application support, network support, training, consulting, uploading, conversion, numbering, special formatting, exporting and delivery services all as part of its hosting services and all is performed by its facilities and personnel located in Colorado. During the course of the audit, petitioner was asked what its customers received when they made a purchase. Petitioner responded that when a client contracts petitioner it does not physically get anything, but rather the client licenses software that is hosted in Colorado and gets a login and password to access that software.

10. Petitioner's system's "architecture" is a combination of petitioner's own computer codes and third party programs, stitched together and integrated into the system, which consists of hundreds of computer servers and storage devices all operating in tandem.

11. The third party programs are licensed to petitioner for its use as a hosted service for its clients. These licenses cannot be re-licensed by petitioner to its clients, but can be accessed and used through petitioner's system as part of the hosted program.

12. Petitioner's servers used to host the software and data being accessed by the end users are located in Colorado and the services related to its data hosting activities are performed by its Colorado employees. These employees facilitate petitioner's service by developing the technology, monitoring and maintaining it, supporting and training clients to use it, and performing other support services as may be requested.

13. Petitioner enters into a Master Hosting and Services Agreement (Agreement) with each of its clients. Petitioner's fees are listed in a standard price sheet or within each Agreement and these prices can vary from client to client, based generally on the volume of documents processed.

14. Petitioner's Agreements are standard and vary only between working with a direct end user client and an Alliance Partner Master Hosting and Service Agreement, which provides the same services to end users through a wholesale partner or reseller.

15. Petitioner's retail and wholesale customers paid, in part, fees for what the contracts identified as “Application Hosting.” The Agreements defined “Application Hosting” as making petitioner’s applications available to its customers over the Internet and the public telecommunication system.

16. The Agreements defined “Application” as one or more of petitioner’s software systems providing, among other things, document management, data sharing, collaboration, case, claim, deal and workflow facilities.

17. Petitioner charged its retail customers three types of “Hosting Fees,” to wit: a “Site Setup Fee,” a “Monthly User Access Fee,” and a monthly “Variable Hosting Fee.”

18. Site Setup Fees include provisioning the site on Petitioner servers, giving it a name and setting it up in the cases table and various databases. It also can include configuring the site for particulars about a case or matter by choosing certain fields, adding or deleting fields and other configurable options included in the software. All this work is performed by Colorado technicians and is technical in nature.

19. The Monthly User Access Fee is priced based upon the number of users, while the Variable Hosting Fee varies based on the client's cumulative storage volume per matter, i.e., the volume of documents that they have given petitioner and loaded onto its servers.

20. Petitioner's retail invoices billed the Variable Hosting Fee as a Variable License Fee and billed the Monthly User Access Fee as the Base Monthly License Fee.

21. Petitioner charged its wholesale clients a monthly “Base License Fee” as well as a Variable Hosting Fee, which was billed as a Variable License Fee.

22. Wholesale customers were required to execute contracts with their End Users that would be substantially similar to the terms of the agreement between petitioner and them.

23. Petitioner's retail and wholesale customers also paid fees for “Services,” which the Agreements defined as services other than Application Hosting and included document uploads, conversion, numbering, OCR or Optical Character Recognition, special formatting, export, delivery, or any consulting. Each of these services are performed by petitioner’s employees located in its Colorado offices.

24. Pricing is determined based on market conditions and on petitioner's published retail and wholesale price lists, subject to negotiation and change.

25. All data is maintained at co-location facilities rented by petitioner in the state of Colorado and all included and related services are provided in Colorado. Petitioner provides access to its servers to its clients, usually legal professionals from around the world, who use the Internet to access their documents on petitioner's system in order to review documents, perform electronic discovery, query information, and other tasks.

26. The system is very labor intensive, both in terms of making the system function, keeping the system operating and secure, and in assisting the clients in using the system and in optimizing their results. A large staff of employees perform a number of functions: system engineers, security people, code writers, account/project managers and, management and administrative staff. In addition, the system's architecture requires the building and maintenance of routers, servers, switches, hubs and other components required to make the system work.

27. During 2008, 2009 and 2010, petitioner's total payroll was $6,026,065.00, $7,505,532.00 and $6,786,682.00, respectively. Of the total, petitioner's Colorado payroll amounted to $4,904,919.71, $5,860,080.07 and 6,541,913.72 for the same years, respectively. Petitioner employed 84 employees in Colorado during 2008, 85 in 2009, and 103 in 2010. During 2008 and 2009, petitioner had one employee in New York. In 2010, petitioner had four employees in New York. The New York employees mostly performed sales work for petitioner, except for a research scientist who was hired in the later part of 2010.

28. Petitioner's marketing brochure from 2010 provided, in pertinent part, that:

> "[Its] secure, web-based systems help corporations and counsel manage electronic discovery and other complex matters. Our e-discovery platform helps clients save on e-discovery costs by reducing document populations and making reviewers more efficient. Our collaboration systems offer a central place to coordinate complex litigation or to connect counsel and clients. Both are delivered as web-based, hosted services via the Internet cloud. There is no hardware to purchase, no software to maintain and no technical staff to hire."

29. This same brochure also provided the following:

> "We design our products with you in mind. You run our ediscovery systems from start to finish-from processing, through search, analysis, review and production. Administrators can set up users, identify and batch document populations, manage and track review teams and direct productions. Whenever you need additional support, our project managers and expert consultants are there to help."

30. The Division focused its audit on the "Monthly User Access Fees" and "Variable License Fees" from the retail price list and the "Base License Fees" and "Variable License Fees" from the wholesale price schedule. These fees are the receipts at issue.

31. Petitioner provided documents with revenue information for its New York customers for each of the tax years comprising the audit period. Using this information, the Division computed a receipts factor for each of the tax years at issue based upon the location of the

customer.

32. On August 14, 2013, the Division issued to petitioner a Notice of Deficiency (L-039990114-3) asserting tax due of $182,844.00, plus interest. Penalties were not asserted nor did the Division assert the MTA surcharge under Tax Law § 209-B.

33. Following a conciliation conference with the Division's Bureau of Conciliation and Mediation Services, a conciliation order sustaining the notice of deficiency was issued on July 11, 2014.

34. Petitioner timely filed a petition with the Division of Tax Appeals and this proceeding ensued. Thereafter the Division filed an answer to the petition and an amended answer. The amended answer asserted an additional deficiency pursuant to Tax Law § 1089(b) on the premise that the Division incorrectly computed petitioner's receipts factor for the 2010 tax year and asserted the MTA surcharge for all of the years that was not previously asserted.

35. The parties have stipulated that the notice of deficiency, exclusive of interest should be modified as follows:

Tax Year Ending	December 31, 2008	December 31, 2009	December 31, 2010	TOTAL
Amount Previously Asserted	$72,666.00	$65,854.00	$44,324.00	$182,844.00
Reduction in tax	$0.00	$15,292.00	$0.00	$15,292.00
Total tax due	$72,666.00	$50,562.00	$44,324.00	$167,552.00
MTA Surcharge	$15,660.00	$10,897.00	$9,553.00	$36,110.00
Revised Deficiency				$203,662.00

36. Petitioner contends that its receipts were properly classified as "service receipts" under Tax Law former § 210(3)(a)(2)(B), and that as such, the receipts must be sourced to the location

where the services were performed, which, in this case, was outside of New York State. Alternatively, petitioner argues that if it is determined that its receipts should be classified as "other business receipts," per Tax Law former § 210(3)(a)(2)(D), they should be sourced to Colorado because the activities and work that generated the receipts were performed there and not in New York.

37. The Division argues that petitioner's receipts should be classified as other business receipts, as opposed to receipts derived from the performance of services, since there allegedly was no human involvement (i.e., performance of services by persons) in the transactions that generated the receipts. The Division maintains petitioner's receipts were earned as the result of petitioner allowing access to and use of its software and should be allocated based upon the location of the customer. Alternatively, the Division argues that even if the receipts in issue are properly classified as service receipts, they are nonetheless allocable to New York based upon the location of the customer.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law former § 209[1]).[1]

B. In New York, corporate taxpayers report their tax liability based on their computation of the highest of four income bases, one of which is their entire net income base (Tax Law former § 210[1][a-d]). A corporation's entire net income base is computed by calculating its

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[1] An additional surcharge tax is imposed, per Tax Law former § 209-B, upon corporations located or doing business within the Metropolitan Commuter Transportation District (MCTD).

entire net income (ENI), generally consisting of its investment income (Tax Law former § 208[6]), and its business income (Tax Law former § 208[8]; ***see*** Tax Law former §§ 210[1][a]; [3]; 208[9]; 209[1]). In turn, the corporation's investment income and business income are allocated to New York pursuant to the corporation's investment allocation percentage (IAC) (Tax Law former § 210[3][b]) and its BAP (Tax Law former § 210[3][a]), with the resulting amounts totaled to arrive at the corporation's entire net income base. The BAP consists entirely of the receipts factor (Tax Law § 210.3 [a][10][A][ii]), the computation of which is at issue herein.

C. The BAP is computed by dividing the corporation's New York business receipts by its total business receipts. In general, a corporation's New York business receipts are defined as: (i) sales of tangible personal property shipped to points within the state; (ii) services performed within the state; (iii) rentals from properties situated, and royalties from the use of patents or copyrights, within the state; and (iv) all other business receipts earned within the state (Tax Law former § 210[3][a][2][A-D]). Petitioner has taken the position that the receipts at issue were from the provision of services which were earned in Colorado, whereas the Division has taken the position that petitioner's receipts in question were other business receipts and are therefore sourced according to the customer's location.

D. First, relying upon ***Matter of Xerox Corp. v New York State Tax Appeals Trib.*** (110 AD3d 1262 [3rd Dept 2013]), the Division asserts that petitioner must prove its interpretation of the law and facts is the only reasonable interpretation. In making this argument, the Division implies that the standard of review appropriate to a court is the standard of review to be employed by the Division of Tax Appeals. This argument is rejected as the Division is misreading the cases upon which it relies. This same argument was squarely rejected by the Tax Appeals Tribunal in ***Matter of 300 East 74th Owners Corp.*** (Tax Appeals Tribunal, July 25, 1996) and ***Matter of OK Petroleum Products Corp.*** (Tax Appeals Tribunal, November 1, 1990), wherein the Tribunal held "the proper standard of review to be applied by the Administrative Law Judge is a de novo review" (***id.)***. Likewise, the Division's reliance upon ***Matter of Zanetti*** (Tax Appeals Tribunal, February 13, 2014) for the same proposition is similarly misplaced, as the petitioner therein was attempting to invalidate a regulation. Since this matter involves statutory interpretation, the standard of review is de novo.

E. Having addressed the standard of review to be applied, it must be determined whether petitioner's receipts were from "services performed within the state" versus "other business receipts." According to the Division, petitioner's receipts are not receipts from services as no employees, agents, subcontractors or other persons on behalf of petitioner were involved in performing the transactions in question and, therefore, fall into the catchall of "other business receipts" under Tax Law former § 210(3)(a)(2)(D). This argument is rejected as the statute in question, Tax Law former § 210[3][a][2][A-D], does not limit the type of services provided to only those performed by humans. The Division's interpretation acts to remove automated services such as petitioner's from the statute. In cases of statutory interpretation, the prerogative of the adjudicatory body is to ascertain and give effect to the intent of the Legislature (***see Patrolmen's Benevolent Assn. v. City of New York***, 41 NY2d 205 [1976] citing ***Matter of Petterson v. Daystrom Corp.***, 17 NY2d 32 [1966]). The language of the statute is the clearest evidence of such intent (McKinney's Cons Laws of NY, Book 1, Statutes § 51[d]). Where no ambiguity exists, "the court should construe it so as to give effect to the plain meaning of the words used" (***Patrolmen's Benevolent Assn. v. City of New York*** at 208). Generally, words of ordinary import are to be given their ordinary and usual meaning (McKinney's Cons Laws of NY, Book 1, Statutes § 232) and a tax law should be interpreted as the ordinary person reading it would interpret it (***Saltser & Weinsier v. McGoldrick***, 295 NY 499, 508 [1946]). The term "services" may be properly defined in the present context as "useful labor that does not produce a tangible commodity" (Webster's Ninth New Collegiate Dictionary, 1076) or "performance of labor for benefit of another, or at another's command" (Black's Law Dictionary 1227 [5th ed 1979]). In this case, petitioner is performing a litigation support service and, as such, its receipts are from services. The Division's contention that the term "services" must be defined as it was understood when the Legislature enacted the law is rejected as "the statute was drafted with broad generalized language that fits squarely into today's digital world" (***People v Aleynikov*** 148 AD3d 77 [1st Dept 2017] ***lv granted*** 29 NY3d 995 [2017]).

F. As further support for its interpretation, the Division asserts that 20 NYCRR 4-4.3(a) specifies that receipts from services must have a human element. Specifically, 20 NYCRR 4-4.3[a] provides as follows:

> "The receipts from services performed in New York State are allocable to New York State. All receipts from such services are allocated to New York State, whether the services were performed by employees, agents or subcontractors of the taxpayer, or by any other persons."

This argument is likewise rejected. First, the regulation does not define the term "services" or "services within the state." Instead, the regulation makes clear that all services performed in New York are allocated to New York whether the services are performed by employees or not. The Division's interpretation of the regulation represents an impermissible expansion of Tax Law former § 210(3)(a)(2)(B). "A tax statute may not be extended by implication beyond the clear import of the language used" (***Yonkers Racing Corp. v. State***, 131 AD2d 565, 567 [2d Dept 1987]). Tax Law former § 210(3)(a)(2)(B) does not require human involvement at the moment of sale in order for services to have been performed, and the regulation must not be interpreted to improperly restrict the meaning of the word "services" by adding such a requirement.

G. The Division also alleges that for the receipts from the two types of fees the Division has focused on, i.e., the Monthly User Access Fees and Variable License Fees from the retail price list and the Base License Fees and Variable License Fees from the wholesale price schedule, petitioner is merely providing access to and use of its system, such that the receipts at issue resulted from the licensing of intangible assets and, as such, constituted other business receipts. This argument is rejected. First, a determination of what petitioner's business activities must be made from the perspective of the petitioner's clients (***see Matter of Capitol Cablevision Systems, Inc.***,Tax Appeals Tribunal, June 9, 1988). Petitioner's clients do not pay petitioner to simply host their documents on petitioner's servers or pay a fee to access petitioner's software. Petitioner's clients pay petitioner to use its system, which includes its proprietary software and the use of its technical personnel in order to acquire, store, sort, filter, organize and ultimately find and retrieve the documents the clients require. As petitioner's marketing brochure advertises, petitioner's system helps corporations and counsel manage electronic discovery and other complex matters. In sum, petitioner is a service provider.

H. Having found that petitioner's receipts are properly classified as services, it must be determined whether such receipts were earned in New York. Tax Law former § 210(3)(a)(2)(B) provides that receipts from the performance of services must be allocated to the location where they are performed (***see also*** 20 NYCRR 4-4.3[a]). In this case, the services are performed in Colorado where petitioner's servers and computer infrastructure as well as the majority of petitioner's employees are located. Petitioner's receipts are therefore not properly allocated to New York (***see Matter of Siemens Corp. v Tax Appeals Tribunal***, 89 NY2d 1020 [1997]). Nonetheless, even if the receipts in issue are properly classified as "other business receipts," the fees are not earned in New York simply because the client is in New York. As stated, the activities that generate the fees are not earned in New York, but rather in Colorado (***id.***).

I. Finally, it is noted that the New York Legislature amended the Tax Law to change the allocation of service receipts to a customer sourcing approach beginning with 2015 (Tax Law § 210-A; L 2014, ch 59 eff January 1, 2015).[2] Such a change would be unnecessary if former section 210 was interpreted as the Division suggests. It is a well founded that "[w]hen the Legislature amends a statute, it is presumed that the amendment was made to effect some purpose and make some change in the existing law" and that "[b]y enacting an amendment of a statute and changing the language thereof, the Legislature is deemed to have intended a material change in the law" (***Matter of Stein***, 131 AD2d 68, 72 [2d Dept 1987], citing McKinney's Cons Laws of NY, Book 1, Statutes §§ 191, 193). By allocating petitioner's receipts based on its

[2] The memorandum in support of the amendment states that:
"New York's current sourcing rules fail to acknowledge the shift to a service-based economy. Companies that generate significant receipts from services can incur greater tax liability if they increase their activity in New York. This reform proposal would source a business's receipts to the location of its customers. This assigns income to various states based on where the customers are located and eliminates factors that would increase tax if a company increased its activity in New York. This removes a previous disincentive to locating in New York" (2014-2015 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, Part A).

customers' addresses, the Division has applied a customer sourcing approach that was not effective until January 1, 2015, and runs contrary to the statutory scheme in place during the years at issue. The Division's claims to the contrary are simply meritless and deserve no further discussion.

J. Accordingly, the petition of Catalyst Repository Systems, Inc., is granted and the August 14, 2013 Notice of Deficiency is cancelled.

DATED: Albany, New York
August 24, 2017

/s/ Kevin R. Law
ADMINISTRATIVE LAW JUDGE