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To: Uniformity Sales and Use Tax Subcommittee
From: Roxanne Bland, Counsel
Date: November 20, 2009
Subject: Update of MTC Model Sales and Use Tax Recommendations

At its July meeting, the subcommittee continued its consideration of the MTC's 1988 model on the Applicability of Sales and/or Use Tax to Computer Software in light of the Streamlined Sales and Use Tax Agreement's (SST) definition of computer software. A second look at the 1988 MTC model indicates that conceptually, the definitional language is consistent with SST. For example, both definitions differentiate between pre-written and custom software, define a computer as a machine capable of acting upon information, and define "computer software" as a set of instructions that cause a computer to perform a task. The glaring inconsistency between the MTC 1988 model and the SST language is that the MTC model contains preliminary language stating a problem that has long been settled in the states. Therefore, the MTC model needs updating.

In general, the language used in the SST definition is much simpler than that used in the MTC recommendation. Structurally, the main difference between the two is that the MTC recommendation contains an explicit definition for "canned software" while the SST version defines the canned software by what it is not, for example, "[pre-written computer software] means computer software...which is not designed and developed by the author or other creator to the specifications of a specific purchaser." Aside from structure, the other difference between the MTC model definition and the SST definition is that the MTC model makes reference to specific programs, most of which are now obsolete.

Texas had adopted the MTC recommendation, but has repealed it. The state has adopted the SST definitions in its place.

It appears that the subcommittee has several choices regarding this recommendation. It can:

1. Leave it as is.
2. Initiate a project to amend the MTC recommendation by updating and offering it as an additional model for non-SST states to consider.

3. Recommend repeal the MTC recommendation as outdated and inconsistent with the SST version of the definitions. Do not initiate a project to draft alternative language. Do not substitute SST language.

4. Recommend repeal the MTC recommendation and adopt the SST version of the definitions.

Applicability of Sales and/or Use Tax to Sales of Computer Software

Adopted July 14, 1988

Policy Statement

This guideline sets forth the policy of each state which adopts it as to the manner in which that state applies its sales/use tax to computer software. Such states are designated herein as signatory states.

Objective

It is the purpose of this guideline to further the cause of uniformity and predictability in the manner in which states treat computer software for purposes of sales and use taxation.

The Problem

Many states subject sales of tangible personal property to sales and use tax but exempt from such taxes sales of intangible personal property and sales of services. Distinguishing between the two types of transactions, i.e. taxable and non-taxable, is often difficult. This is particularly true with respect to computer software; and the states have sometimes reached differing conclusions on the basis of the same facts.

Goal

This guideline seeks to establish a uniform standard by which the signatory states will distinguish between canned and custom sales of computer software. It is relevant for only those states which differentiate between the two for the purpose of distinguishing between taxable and non-taxable sales of computer software.

Definitions

Computer, as used here, means a programmable machine or device (including word processing equipment and testing equipment) having information processing capabilities and usually consisting of a central processing unit, internal memory and input and output peripherals. The term includes a programmable microprocessor and/or any other integrated circuit embedded in manufactured machinery or equipment.

Computer software, as used here, means and includes programming, i.e., a set of statements or instructions which, when incorporated into a machine-usable data processing storage or communication medium or device (such as printed material, cards, disks, tapes or modems), is capable of causing a computer to indicate, perform or achieve a particular function, task or result.

Custom software, as used here, means and includes programming which results when a user purchases the services of a person to create software which is specialized to meet the user's particular needs. The term includes those services that are represented by separately stated and identified charges for those modifications to an existing pre-written program which are made to the special order of the customer, even though the sale, lease or license to use the existing program remains taxable. The signatory states treat the sale of custom software as a sale of services on the basis: 1) that the user has purchased not tangible personal property but services; and 2) that the resulting software is simply the means by which those services are delivered to the user.

Canned software, as used here, means and includes programming that has general applicability and/or has not been prepared at the special request of the purchaser to meet his particular needs. It is sometimes known and/or described as "pre-written programming." Evidence of general applicability is to be found in the selling, licensing and/or leasing of the identical program more than once. A program may qualify as custom software for the original purchaser/lessee/licensee but become canned software with respect to all others. The signatory states treat the sale of canned software as either a taxable sale of, lease of or license to use tangible personal property. Examples of prominent canned programs are: Bank Street, Crossfire, D-Base III, DOS, Electric Desk, Fun Pack, Kings's Quest, Lisa, Lotus 1-2-3, MacEdge, MacPaint, MacPhone, MacVegas, MacWrite, MegaMerge, Soft Maker II, Solomon II, Ventura, Word Perfect, Word Proof, Wordstar, and Writing Assistant (IBM).

Licensing/Leasing Agreements

Whether a software licensing or leasing agreement is subject to tax depends, in some states, upon whether the software itself is custom or canned software.

Proposed Model Regulatory Definitions Regarding the Applicability of Sales and/or Use Tax to Sales of Computer Software*

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MTC Sales and Use Tax Subcommittee

Definitions

“Computer” means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions.

“Computer software” means a set of coded instructions designed to cause a “computer” or automatic data processing equipment to perform a task.

“Prewritten computer software” means “computer software,” including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more “prewritten computer software” programs or prewritten portions thereof does not cause the combination to be other than “prewritten computer software.” “Prewritten computer software” includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the specific purchaser. Where a person modifies or enhances “computer software” of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person’s modifications or enhancements. “Prewritten computer software” or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains “prewritten computer software;” provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute “prewritten computer software.” A member state may exempt “prewritten computer software” “delivered electronically” or by “load and leave.”

Custom software means computer software that is not prewritten.

*All definitions except for “custom software” were taken from the Streamlined Sales and Use Tax Agreement.