



SOFTWARE MAINTENANCE CONTRACTS

DISCUSSION OF ISSUES RAISED AT THE DES MOINES WORKING GROUP MEETING

At the Des Moines SLAC meeting held May 11, 2006, those attending the software maintenance contracts break out session raised several issues. In particular, how the industry's proposal for a definition of software maintenance contracts interacted with the bundling definition and the treatment of mandatory maintenance contracts seemed to dominate the discussion. This memorandum provides additional discussion of those issues and supplements the original discussion paper which accompanied the original proposal.

Interaction with the Bundling Definition:

The original premise of the industry's proposal is that software maintenance contracts that combine rights to future upgrades and updates with rights to future technical support services are not a bundled transaction because the companies that offer them do not separately market the individual elements of the contract. Because the upgrade/update and technical support elements are not separately marketed, they are not "products are otherwise distinct and identifiable." However, there does not appear to be universal agreement that software maintenance contracts that combine software and services elements are not bundled transactions.

The state survey on treatment of software maintenance contracts revealed that several states do not treat them as bundled transactions, several states do treatment them as bundled transactions and several states use an apportionment formula, similar to that set forth in the industry proposal, to separately treat the components of the transaction. We believe that, if in fact the components of a software maintenance contract are "products are otherwise distinct and identifiable" and therefore represent a bundled transaction, then those states that do not currently treat them as a bundle would have to change their treatment. Those states that use an apportionment formula to separately treat the components could be barred from continuing to do so unless Section 330(b) of the Agreement would permit them to do so (which is not clear).

The bundling definition eliminates some of the flexibility previously exhibited by the states in their treatment of software maintenance contracts. For this reason, the industry has modified its proposal so that it includes an amendment to the bundling definition that would exclude software maintenance contracts from its scope. States would then be free to continue to treat maintenance contracts in the same manner as before adoption of the SSUTA.

Assuming that separate marketing of the separate components is not necessary for products to be “otherwise distinct and identifiable,” adoption of this amendment would not prevent software maintenance from becoming part of a bundle with the underlying computer software license.

To give an example, consider a software vendor that provided its customer with a computer software license and included with the license the right to receive future software upgrades and updates and technical support. The invoice displayed a single price for this combined product with no separate statement for the update/ upgrade rights and the technical support. The vendor does not market its software separate and apart from the upgrade/update rights and technical support. Assuming that the three elements of this “product” actually are products that are otherwise distinct and identifiable (an interpretation with which the industry does not agree), because there were sold for one none itemized price, there would be a bundled transaction. The exclusion contained in the industry’s modified proposal would not prevent software maintenance from becoming part of a bundle with another putative product, such as software. The modification only makes it clear that software maintenance itself is not within the bundled transaction definition.

Mandatory Maintenance:

The survey discussed at the Des Moines breakout session revealed that several states consider mandatory maintenance to be part of the sales price of the underlying software. Analysis is required in order to determine whether states adopting the SSUTA may continue to treat mandatory software maintenance contracts as part of the sales price of underlying software.

Before discussing the sales price issue, another point bears discussion. In conversations with software industry participants, it became clear that several states treat as mandatory maintenance-contracts that are in fact optional. Some states find that an otherwise optional maintenance contract is mandatory if maintenance is not available from a third party and is only available from the software vendor. Because only the software vendor can provide the update/upgrade component of software maintenance, by definition, such a construction is unreasonable and obliterates the mandatory/optional distinction in those states that purport to use it. In order to further clarify the distinction between mandatory and optional maintenance, the industry has modified its proposed definition of mandatory maintenance so that it is clear that mandatory maintenance is maintenance that the purchaser is required “by contract” to purchase as a condition to acquiring the underlying computer software license.

The industry believes that treatment of mandatory software maintenance contracts as part of the purchase price of the underlying software is a practice that did not survive adoption of the SSUTA.

First, the effect of treating the price paid for mandatory maintenance as part of the price paid for the underlying software is to treat items separately stated on an invoice as a bundled transaction. However, the bundled transaction definition is clear that it does not apply where the components of the bundle are separately stated on the invoice, etc.

There is interaction between the definition of “sales price” and the bundling definition. The bundling definition provides that a retail sale may not be considered to be for “two or more distinct and identifiable products” if the items are included in the member states' definitions of “sales price.” This provision is an anti-abuse rule designed to prevent taxpayers from using the bundling rule to circumvent taxation of certain otherwise taxable items that should not be separated from another taxable item. Consider a situation in a state where services are not taxable but sales of tangible personal property are taxable. The state’s definition of sales price provides that installation charges are not to be deducted from the sales price of the tangible personal property that is installed. The provision is designed to prevent a taxpayer from “unbundling” the installation charge by separately stating it on the invoice.

We believe that there are two possible theories that those states that treat charges for mandatory maintenance as part of the purchase price of the software rely upon. First, it may be that they use the mandatory relationship between the maintenance and the software to conflate the charges for each into a single charge for a single product. Second, they may treat the charge for the maintenance as a “charge for services necessary to complete the sale” which is not to be deducted from the sales price for the software. We believe that neither theory can be proved.

Many of the states who responded to the survey that they treated mandatory maintenance as part of the purchase price also responded that they treated optional maintenance as a bundled transaction. It is inconsistent to treat optional maintenance as a bundled transaction and to treat mandatory maintenance as a part of the purchase price of the software. In order for a sale of an optional maintenance contract to be a bundled transaction, the separate upgrade/update and technical support components would have to be treated as distinct and identifiable products when the purchase of those components in combination is clearly mandatory. Yet, when a vendor mandates that a customer purchase maintenance along with the software, the claim is that the two are not distinct and identifiable products but are a single product sold for a single price. Both positions have the effect of imposing tax on services in several states where services are not subject to tax. The two positions are inconsistent with each other.

Treating charges for mandatory maintenance as part of the sales price of the underlying software cannot be supported from a factual standpoint. The commercial environment in which these transactions are consummated is such that there is negotiation between the parties over the separate prices to be paid for the software and for the maintenance; the invoice reflects this separate price negotiation.

The second theory, that charges for maintenance contracts are “charges for services necessary to complete the sale” does not apply as well. A sale of software is

considered complete when the copy of the software is delivered. The services that are contemplated under a software maintenance contract are to be performed in the future, after the software has been paid for, delivered and installed. None of the services required under a maintenance contract are to be performed before the sale of the software is considered complete. Charges for mandatory software maintenance contracts are not charges for services necessary to complete the sale.