



## **DESCRIPTION OF PROPOSAL FOR SSTP PROVISION DEALING WITH SOFTWARE MAINTENANCE CONTRACTS**

The software industry proposes that the SSTP adopt a definition of “computer software maintenance contract.” The purpose of this paper is to describe the industry’s thinking behind each of the provisions of the proposal.

### **Overview of the Software Industry and Software Maintenance Contracts:**

Generally, a computer software maintenance contract is an agreement between a software vendor and its customer whereby the vendor agrees, for a period of time, to provide its customer with additional software and technical support services. The additional software typically will have two components: bug fixes and upgrades or enhancements. Bug fixes typically do not provide additional features or functionality; they merely make the software perform as initially warranted. Upgrades and enhancements add features and functionality to the software and cause it to do things that the software was not initially programmed to do. Technical support services could include employee training, troubleshooting, and merely helping the customer’s personnel operate the software on a case by case basis.

These software maintenance contracts are not a bundle of two separate products because the software vendors, as a matter of industry practice, typically do not sell rights to the additional software separate and apart from the rights to the services. As the separate discussion regarding bundling teaches, a bundled transaction is the sale of two separate and distinct products. In the context of computer software maintenance contracts, the contract is a single product with multiple components, some of which are subject to sales tax and some of which are not. The purpose of the industry’s proposal is to provide a uniform mechanism whereby the taxable and nontaxable components can be identified and separately treated for tax purposes.

One of the unique features of computer software that differentiates it from many other types of products is its extraordinarily low marginal cost of production. Once the software vendor’s research and development team has decided that a new computer program has reached “technological feasibility” and has been sufficiently “debugged,” the program is ready to be marketed. Unlike many other products, once a computer program is ready to be marketed, the marginal cost of producing copies of the software products for distribution to customer is about as close to zero as you can get it. Duplicating copies of the software onto disks or CD-ROM is a very inexpensive process and with the advent of the Internet, many companies forgo duplication onto physical media altogether and, instead, permit the customer to download copies of the product directly onto the customer’s computer.

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In order to remain competitive, software companies are constantly adding new features and functionality to their software. This enables them to create and market new versions of their software to new customers. These software systems require substantial investment by customers not only for the initial software license fee, which can run into the millions of dollars, but they must also make an investment in computer hardware systems, personnel training and, in many instances, they must revamp their business processes to capture business information in a form that can be utilized by the computer system. Many large and medium sized businesses are loath to make such investments unless they can be sure that they will have ready access to future versions of the software. Software maintenance contracts are the vehicle by which customers guarantee themselves access to the latest version of the software that they already have purchased. As discussed above, it costs the software company little if anything to supply an existing customer with a copy of the newest version of its software which it has developed for sale to new customers.

That having been said, these software maintenance contracts typically do not obligate the vendor to come up with enhanced or upgraded versions of its software. The maintenance contract only obligates the vendor to provide a copy of the upgraded software in the event that the vendor in fact releases a revised version of the software. Clearly, at the time the customer pays the initial license fee for the version of the software available at that time and obtains the maintenance contract, it is not relying on any future upgraded software to run its business, it is relying on the functionality currently available.

Training and technical support services, which are the other component of a computer software maintenance contract, have a very different cost structure. In order to provide such services, the software vendor has to employ a staff well trained in how its software works and in how to communicate with the customer's employees either during initial training, or in a future technical support/troubleshooting context. The salaries paid to such technical support staff represent a substantial cost to the vendor. Additionally, because the type of software which maintenance contracts typically accompany are extraordinarily complex, the customer necessarily relies on the vendor to show how the software works and to help with problems that crop up after the software is installed and the customer's employees are initially trained.

As can be seen, from a cost standpoint, it costs the software company next to nothing to provide its customers with copies of upgraded versions of its software while the costs associated with providing the training and technical support services are substantial. Also, from a value added standpoint from the customer's perspective, it is likely that the customer is entering into the maintenance contract primarily to gain access to the training and technical support services, not the right to gain access to future versions of the software which the vendor is not obligated to create. However, this is not to imply that the rights to the future upgrades and enhancements are de minimis. Providing a new customer with such rights might be crucial in a sales context where the

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market has already been made aware that a new version will be rolling out in the near future.

Some software companies require that their customer purchase a maintenance contract as a condition to acquiring a license to the underlying software. Other companies do not impose such a requirement. Optional software maintenance would include renewal of a mandatory software maintenance contract.

The point of the foregoing is to provide a description of the framework upon which the industry's software maintenance contract definition is built.

### **Analysis of the Proposal:**

Most, if not all states apply their sales tax only to transactions involving tangible personal property, which, under the Agreement, includes prewritten computer software, and do not tax services. The object of the industry's proposal is to provide a convenient, easy to administer method of applying the sales tax in such a way as to make sure that only those parts of a computer software maintenance contract that obligate a vendor to provide software upgrades and enhancements are treated as prewritten computer software and to make sure that charges for services are not treated as charges for prewritten computer software.

The overarching thesis from which the industry proposal proceeds is that the precise terms of each software maintenance contract are likely to vary greatly from one software company to another and from one software company's customer to another. In short, not all software maintenance contracts will look exactly alike and a focus on their individual terms will be necessary in order to place them in the correct tax "pigeonhole." Some contracts may only obligate the vendor to provide software upgrades; others may only obligate the vendor to provide training and technical support. Many contracts will obligate the vendor to provide both software upgrades and technical support. Some software companies may invoice the customer separately for the software upgrades and the technical support services.

However, we believe that the vast majority of computer software maintenance contracts will obligate the software company to provide both software upgrades and technical support but will not provide any means to differentiate between the two in terms of price. Our belief is that most software companies selling software maintenance contracts do not separately market upgrade rights; such upgrade rights will only accompany a right to future technical support services. These contracts are each negotiated at the time the initial software license is acquired and frequently are renewable.

Section (a) of the proposal is a general definition section. The first section provides a basic definition of "computer software maintenance contract that recognizes the separate components of a maintenance contract. Subsections (1) and (2) provide definitions for mandatory and optional maintenance. These definition sections provide

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toggles that states can use to impose or not impose their sales/use taxes on these products. We believe that five states do not tax optional software maintenance. The separate definition of optional software maintenance provides these states with a mechanism for continuing their decision not to tax such contracts.

If a state should “toggle off” mandatory or optional software maintenance, the next sections would only apply to the type of contract that has been “toggled on.” We recognize that some states will treat all of the charges for the maintenance contract as payment for prewritten computer software if the maintenance agreement is mandatory. If all of a mandatory maintenance contract that includes a vendor obligation to provide services is treated as prewritten computer software, then the basic principle that the sales tax only applies to transactions in tangible personal property is violated. The aim of the proposal is to respect this basic principle unless the state makes a taxability distinction depending on whether the contract is optional.

Subsections (b) (1) and (2) of the proposal deal with two scenarios where the maintenance contract only has one component and state the obvious; namely, if the vendor is obligated to provide only technical support services or upgrades and enhancements, but not both, then all of the contract price will be for services or prewritten computer software, as the case may be. Very few tax questions will arise in connection with single-component software maintenance contracts.

The last section is modeled on the Minnesota rule which provides for an 80/20 split between services and prewritten software in those cases where there is no method for differentiating between the two. We believe that an 80/20 split is appropriate because, based on the discussion above regarding software industry cost structures, most of the cost and value of these contracts is to be found in the services component; the cost and value of the upgrade and enhancement component, while more than de minimis, is relatively much smaller.

Several states use this proportional split method. While the ratios of the split may vary among those states, we have proposed an 80/20 split because we believe that in most cases, it will approximate the economic reality of the transaction.

We considered including a section that dealt with contracts where the customer’s invoice displayed a breakdown between the charges for the service component and the charges for the prewritten software components. We eventually decided that such a rule would prove unsatisfactory in practice and could lead to manipulation. After all, the customer is the taxpayer and having an “invoice controls” type rule in this context could lead customers to demand an invoice with a breakdown that did not comport with the economic realities of the transaction. Vendors, because they are tax indifferent with regard to the transaction, would have little reason to resist such a demand from a customer. In the end, we decided that having a single 80/20 rule for multiple element arrangements would be the easiest from both compliance and enforcement standpoints. Such a rule would approximate the economic realities of most all of these transactions regardless whether the invoice or other sales related documentation suggested otherwise.

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