

**Draft Document Not For Publication But For Discussion Purposes Only** – Nothing contained herein represents a final position or opinion of the Streamlined Sales Tax Project, any of the participating or observing states, or any member of their staff. Readers should neither rely on any information herein nor make any inferences about final project positions or positions of participating or observing states or their members from the statements contained herein as this is a draft only and may change in response to comments and input from the public or private sector.

## **STREAMLINED SALES TAX PROJECT**

### **SOFTWARE ISSUE PAPER (1/2/02)**

#### **Issues:**

- How should “software” be defined?
- Should various sub-definitions of software be defined?

#### **Background:**

The tangible personal property subgroup was assigned the task of defining tangible personal property, digital property, and software. One of the definitions considered by the Project in 2002 would have included canned software and digital property in the definition of tangible personal property. The subgroup spent 2001 discussing if this approach was legally, politically, and logically correct. Discussing whether or not software or digital property should be defined as tangible personal property, a service, or something else, was complicated by the current diversity of treatment of these items.

To ease the discussion, this paper only addresses definitions relating to computer software. These definitions are designed to work in tandem with the definitions of “tangible personal property” and “digital property.”

In the course of its work, the tangible personal property subgroup met with persons from the private sector (purchasers and sellers of software and their representatives) who aided in developing the alternatives that were considered in arriving at recommended definitions.

States have been faced with a variety of issues related to applying or not applying sales tax to software, such as licenses, related services, rights, etc. At the present time, the tangible personal property subgroup has concentrated its efforts on defining only computer software and related terms necessary for imposing sales tax on, or exempting

from sales tax, computer software. The goal is to provide uniform definitions that will allow states to mirror, as closely as possible their existing tax treatment while providing retailers with common definitions that will ease their sales tax compliance burden.

How states define computer software today and how the tax is imposed is summarized in charts provided in Attachments 1 and 2 of this paper. The information in the attachments is based on a survey sent to all participating states. Twenty-eight states responded to the survey. This basic information can be summarized as:

A. 28 states impose tax on prewritten or canned computer software.

1. 13 states impose tax on prewritten or canned computer software regardless of the manner in which it is delivered.
2. 15 states do not impose tax on prewritten or canned computer software if the software is delivered electronically.

B. 8 states impose tax on custom computer software.

1. 5 states impose tax on custom computer software regardless of the manner in which it is delivered.
2. 3 states that impose tax on custom computer software do not impose tax if the software is delivered electronically.

## **Alternatives Considered**

### **Recommendation**

This paper contains the four alternatives studied by the subgroup. The tangible personal property subgroup recommends Alternative 4.

Alternative 1. Create a definition of computer software and custom computer software using words and phrases from various state sources or from UCITA. Attachment 3.

A state that wants to impose tax on all computer software could do so with the broad definition of computer software. For states that wished to tax only prewritten software, the state would impose tax on computer software and create an exemption for custom computer software.

The subgroup thought it was not necessary to define prewritten or canned software in addition to the above terms because a product could fall outside the definitions of both canned and custom and the tax treatment would be unclear.

The private sector and government participants had concerns with defining custom software as a subset of computer software because:

- There is very little custom computer software being created. Instead, it is common practice for computer software retailers to use prewritten modules and modify them to fit a customer's needs.
- Customizing software is a service. As such, it may not be advisable to use it as a subset of computer software, which may or may not be tangible personal property.

The concept of defining modified computer software was discussed briefly as a third category of software.

Alternative 2. Create a definition of computer software, custom computer software, modifications to computer software, configurations to computer software, and delivered electronically. Attachment 4.

Again, a state that wants to impose tax on all computer software could do so with the broad definition of computer software. For states that wished to tax only prewritten software, the state would impose tax on computer software, except custom computer software. The addition of definitions for modifications to computer software and configurations of computer software would allow states to impose tax on the prewritten modules of computer software while excluding the modifications to or configuration of software, as many states do today.

While this alternative addressed the fact that the more common scenario in the industry is the sale of prewritten programs with modifications to arrive at custom software, these definitions did not address the private sector's concern that custom software and modifications to prewritten software were in reality services.

Alternative 3. Use the terminology from 26 CFR 1.861-18, dealing with sourcing of income from software related transactions. Attachment 5. (*Only a portion of the regulation has been provided in the attachment.*)

The regulation categorized software transactions into 4 distinct categories:

- Transfer of a copyright right in the computer program
- Transfer of a copy of the computer program (a copyrighted article)
- Provision of services for the development or modification of the computer program
- Provision of know-how relating to computer programming techniques

The first category addressed a custom program and the second addressed what is currently taxed by most states today as tangible personal property.

There is benefit in using definitions that have already been developed by experts in the area of computer software. However, as with the prior approaches, the subgroup's problem wasn't in addressing software transactions that clearly fell into a defined category. The problem remains as to what to do when a transaction has aspects of

multiple categories (prewritten programs with customizations). The regulation stated that when there was a bundling of categories, classification was done based on “facts and circumstances” and de minimis standards. States were concerned with the subjective determinations that would be required to be made by industry and states.

The regulation also makes no distinction as to how the software is delivered to the customer (on a tangible medium vs. electronically or load and leave). In order to mirror current tax treatment, a definition allowing for such a distinction is necessary.

Alternative 4. Create a definition of computer software, prewritten or canned computer software, and delivered electronically. Attachment 6.

The majority of states either tax all computer software or prewritten or canned software and then some states make a distinction as to method of delivery (electronic vs. tangible).

A suggestion was made that the subgroup review New York’s laws and regulations on prewritten software. The subgroup felt that New York’s definition encompassed much of the current treatment by states. By defining prewritten computer software, it was not necessary to address custom software as a separate category. This addresses the major concern by the business community that services not be incorporated into the definitions relating to software.

In using New York’s definition of prewritten software, a modification was made, however, to remove the method of delivery in the definition. States are given a definition of delivered electronically which they may or may not use in their imposition of tax on computer software or prewritten computer software.

It is envisioned that a state whose courts have held that prewritten computer software is not tangible personal property can use the prewritten software definition to specifically impose tax on prewritten software. (Note: Such states currently tax prewritten computer software because they have deemed it by statute to be tangible personal property. However, by adopting the Project’s uniform definition of tangible personal property, these states may no longer be able to deem prewritten software to be tangible personal property). States who currently impose tax on all computer software could continue to do so using the uniform definition provided.

By using this alternative, it is not necessary to address whether the creation of computer software or customization or modification of prewritten computer software is a service, an intangible, or something else.

**Attachment 1**

| State  | Statutory Cite  | Canned: Taxable with Tpp? | Canned: Taxable w/out TPP? | Theory   | Custom: Taxable with TPP?                   | Custom: Taxable w/out TPP? | Theory  | A. Modification of Canned Software   |
|--|---|---------------------------|----------------------------|--|---|----------------------------|---|--|
| Alabama  |   |                           |                            |  |   |                            |   |  |
| Arizona  |   |                           |                            |  |   |                            |   |  |
| Arkansas   | Ark. Code Ann. §26-52-304(a)(1)                             | Yes                       | No                         | Gross receipts tax imposed on all sales of computer software, which are taxed as sales of tpp  | Yes   | No                         | Gross receipts tax imposed on all sales of computer software, which are taxed as sales of tpp         | ?  |
| California   | CA Code § 6010.9<br>CA Reg. 1502                            | Yes                       | No                         | Canned software transferred on storage media = taxable sale of tpp   | No; TPP incidental to true object (service) | No                         | Considered service transaction not subject to sales tax   | ?  |
| Colorado   |   |                           |                            |  |   |                            |   |  |
| Connecticut<br><i>See Andersen Consulting v. Gavin</i> , 255 Conn. 498 (2001)                | Conn. Gen. Stat. §12-407                                    | Yes                       | Yes (through 7-1-02)       | With tpp=sale of tpp<br>Electronically= taxable on-line access services  | Yes (through 7-1-02)                        | Yes (through 7-1-02)       | Process of designing, creating, developing custom software=taxable computer and data process. service | Considered a taxable computer and data processing service  |
| Florida  |   |                           |                            |  |   |                            |   |  |
| Georgia  | O.C.G. A. § 48-1-8  | Yes                       | No                         | Sales/Use tax applies to computer software held in a tangible medium ready for sale  | No  | No                         | Considered a Non-Taxable Service  | If separately stated, charges for modifications made at time of sale not taxed; if made after initial sale = nontax. service   |
| Hawaii   |   |                           |                            |  |   |                            |   |  |
| Idaho  | Idaho Code §63-3616   | Yes                       | Yes                        | "TPP" defined as any computer software that is not custom software; method by which title, possession, or right to use is transferred immaterial | No  | No                         | Considered a Non-Taxable Service  | If separately stated, charges for modification = nontaxable service<br><i>See Ryder v. Idaho State Tax Commission</i> , 939 P.2d 564 (1997) addressing bundling of service with TPP. |
| Illinois<br>§130.1935(a)(1) criteria excluding licenses of software from taxable retail sale | 35 ILCS 120/2-25<br>see also:<br>86 Ill. Adm. Code 130.1935 | Yes                       | Yes                        | Computer software = tpp, regardless of the form in which it is transferred or transmitted  | No  | No                         | Prepared to the special order of the customer and are not subject to the Occupation/Use Tax           | Considered custom software unless it is held for general or repeated sale (then =canned)   |
| Indiana  | Sales Tax Info. Bulletin No. 8, 2.9.90                      | Yes                       | Yes                        | Prewritten programs = tpp regardless of shipment to the buyer by electronic or physical means  | No  | No                         | Considered a Non-Taxable Service  | Modifications considered part of the sale of tpp   |



**Attachment 1**

| State  | Statutory Cite   | Canned: Taxable with Tpp? | Canned: Taxable w/out TPP? | Theory   | Custom: Taxable with TPP? | Custom: Taxable w/out TPP? | Theory  | A. Modification of Canned Software   |
|--|--|---------------------------|----------------------------|--|---------------------------|----------------------------|---|--|
| Missouri<br><i>IBM Corp. v. Director</i> , 765 S.W.2d. 611 (Mo. 1989) and <i>Director v. TRES Computer Systems, Inc.</i> 642 S.W.2d 347 (Mo. 1982) | 12 CSR 10-109.050  | Yes                       | No                         | Sale of canned computer software is taxable as the sale of tpp; tax applies to the sale of canned programs delivered in a tangible medium        | No                        | No                         | The real object sought by the purchaser of customized programs is the service of the seller and not the property produced by the service of the seller. | Programming changes to canned program are in the nature of fabrication or production labor that are part of the sale and taxable |
| Nebraska   | NE Reg. 1-088.05   | Yes                       | Yes                        | The gross receipts from furnishing software regardless of the manner in which it is conveyed is taxable  | Yes                       | Yes                        | The gross receipts from furnishing software regardless of the manner in which it is conveyed is taxable   | ?  |
| Nevada   | NAC 372.865<br>NAC 372.870<br>NAC 372.855<br>NAC 372.860 | Yes                       | Yes                        | Standard prewritten program means software which is not originally developed and produced for the user and are tpp.                              | No                        | No                         | The tax does not apply to the sale, lease, rental, or licensing for use of custom software, regardless of the form in which the program is transferred  | Modifications are exempt if separately stated  |
| New Jersey   | N.J.A.C. 18:24-25.2(b)(2)                                | Yes                       | No                         | Canned software is taxable as tpp; canned software transferred electronically is treated as intangible property                                  | No                        | No                         | Custom software is exempt as intangible property  | ?  |
| New Mexico   |  |                           |                            |  |                           |                            |   |  |
| New York   |  |                           |                            |  |                           |                            |   |  |
| North Carolina   | N.C.G.S. 105-164.13 (43)                                 | Yes                       | No                         | Canned software delivered on a storage medium, such as a CD-Rom, disk, or tape specifically included in tpp                                      | No                        | No                         | Custom Computer Software defined as tpp but is specifically exempted from the sales tax imposed by this Article.  |  |
| North Dakota   |  |                           |                            |  |                           |                            |   |  |
| Ohio   |  |                           |                            |  |                           |                            |   |  |
| Oklahoma   |  |                           |                            |  |                           |                            |   |  |
| Pennsylvania   | Pronouncement 61 Pa. Code §60.19 (c)                     | Yes                       | No                         | Sale at retail or use of canned software not subject to tax if the entire canned software program is transferred by remote telecommunications... | No                        | No                         | Sale at retail or use of custom software is a purchase of a nontaxable computer programming service   | ?  |



**Attachment 1**

| State     | Statutory Cite  | Canned:<br>Taxable<br>with<br>Tpp? | Canned:<br>Taxable<br>w/out<br>TPP? | Theory   | Custom:<br>Taxable<br>with<br>TPP? | Custom:<br>Taxable<br>w/out<br>TPP? | Theory                          | A. Modification of Canned<br>Software |
|-----------|---|------------------------------------|-------------------------------------|--|------------------------------------|-------------------------------------|---------------------------------|---------------------------------------|
| Wisconsin | Section 77.51(20), Wis.<br>Stats.<br>Section Tax 11.71(1)<br>Wis. Adm. Code | Yes                                | Yes                                 | TPP includes computer<br>programs, regardless of<br>medium of delivery | No                                 | No                                  | TPP excludes custom<br>software | ?                                     |
| Wyoming   |   |                                    |                                     |  |                                    |                                     |                                 |                                       |

| State       | Statutory Cite                   | Definition   |
|-------------|----------------------------------|--|
| Alabama     |                                  |  |
| Arizona     |                                  |  |
| Arkansas    | Ark. Code Ann. §26-52-304(a)(1)  | Software shall include tapes, disks, cards, or other devices or materials which contain instructions for a computer and dictate different operations or functions to be performed by computer.   |
| California  | CA Code § 6010.9<br>CA Reg. 1502 | (c) "Computer program" means the complete plan for the solution of a problem, such as the complete sequence of automatic data-processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs.<br><br>(d) "Custom computer program" means a computer program prepared to the special order of the customer and includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer. The term does not include a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the prewritten or "canned" program was initially developed on a custom basis or for in-house use. Modification to an existing prewritten program to meet the customer's needs is custom computer programming only to the extent of the modification.<br><br>(rule) (f) "Canned" Programs = Prewritten programs.                                  |
| Colorado    |                                  |  |
| Connecticut | Conn. Gen. Stat. §12-407         | (35) "Canned or prewritten software" means all software, other than custom software, that is held or existing for general or repeated sale, license or lease. Software initially developed as custom software for in-house use and subsequently sold, licensed or leased to unrelated third parties shall be considered canned or prewritten software.<br><br>(36) "Custom software" means a computer program prepared to the special order of a single customer.  |
| Florida     |                                  |  |
| Georgia     | O.C.G. A. § 48-1-8               | (a) As used in this Code section, the term "computer software" means any program or routine, or any set of one or more programs or routines, which are used or intended for use to cause one or more computers or pieces of computer related peripheral equipment, or any combination thereof, to perform a task or set of tasks. Without limiting the generality of the foregoing, the term "computer software" shall include operating and application programs and all related documentation.<br><br>(b) Except as otherwise provided in subsection (c) of this Code section, for the purposes of Chapters 5 and 6 of this title, computer software shall constitute personal property only to the extent of the value of the unmounted or uninstalled medium on or in which it is stored or transmitted.<br><br>(c) Nothing herein shall be deemed to affect the taxation under Chapter 5 or Chapter 8 of this title of copies of computer software held as inventory in a tangible medium ready for sale at retail by one who is a dealer with respect to such property and the sale of which is subject to sales and use taxation. |
| Hawaii      |                                  |  |

| State    | Statutory Cite  | Definition   |
|----------|---|--|
| Idaho    | Idaho Code §63-3616   | <p>(i) As used in this subsection, the term “computer software” means any computer program, part of a program or any sequence of instructions for automatic data processing equipment or information stored in an electronic medium. Computer software is deemed to be tangible personal property for purposes of this chapter regardless of the method by which the title, possession or right to use the software is transferred to the user.</p> <p>(ii) As used in this subsection, the term “custom computer program” means any computer software (as defined in this subsection) which is written or prepared exclusively for a customer and includes those services represented by separately stated charges for the modification of existing prewritten programs when the modifications are written or prepared exclusively for a customer. The term does not include a “canned” or prewritten program which is held or existing for general or repeated sale, lease or license, even if the program was initially developed on a custom basis or for in-house use. Modification to an existing prewritten program to meet the customer’s needs is custom computer programming only to the extent of the modification, and only to the extent that the actual amount charged for the modification is separately stated on invoices, statements, and other billing documents supplied to the purchaser.</p> |
| Illinois | 35 ILCS 120/2-25<br>See also:<br>86 Ill. Adm. Code 130.1935 | <p>§ 2-25. Computer software. For the purposes of this Act, “computer software” means a set of statements, data, or instructions to be used directly or indirectly in a computer in order to bring about a certain result in any form in which those statements, data, or instructions may be embodied, transmitted, or fixed, by any method now known or hereafter developed, regardless of whether the statements, data, or instructions are capable of being perceived by or communicated to humans, and includes prewritten or canned software that is held for repeated sale or lease, and all associated documentation and materials, if any, whether contained on magnetic tapes, discs, cards, or other devices or media, but does not include software that is adapted to specific individualized requirements of a purchaser, custom-made and modified software designed for a particular or limited use by a purchaser, or software used to operate exempt machinery and equipment used in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease.</p> <p>For the purposes of this Act, computer software shall be considered to be tangible personal property.</p>  |
| Indiana  | Sales Tax Info. Bulletin No. 8, 2.9.90                      | <p>B. Computer Software:</p> <p>A software program is one in which instructions and routines (programs) are determined necessary to program the customer’s electronic data processing equipment to enable the customer to accomplish specific functions.</p> <p>The software may be in the form of:</p> <ol style="list-style-type: none"> <li>1. System programs (except for the instruction codes which are considered tangible personal property in paragraph 2 above) - programs that control the hardware itself and allow it to compile, assemble, and process application programs.</li> <li>2. Application programs - programs that are created to perform business functions or control or monitor processes.</li> <li>3. Pre-written programs (canned) - programs that are either system programs or application programs and are not written specifically for the user.</li> <li>4. Custom programs - programs created specifically for the user.</li> </ol>  |

| State  | Statutory Cite         | Definition  |
|--------|------------------------|---|
| Iowa   | IAC 701—18.34(422,423) | <p>(1) "Computer" means a programmed or programmable machine or device having information processing capabilities and includes word processing equipment, testing equipment, and programmed or programmable microprocessors and any other integrated circuit embedded in manufactured machinery or equipment.</p> <p>(3) "Canned software" is prewritten computer software which is offered for general or repeated sale or rental to customers with little or no modification at the time of the transaction beyond specifying the parameters needed to make the program run. Canned software is tangible personal property. The term also includes programs offered for general or repeated sale or rental which were initially developed as custom software. Evidence of canned software includes the selling or renting of the software more than once. Software may qualify as custom software for the original purchaser or lessor but is canned software with respect to all others. Canned software includes program modules which are pre-written and later used as needed for integral parts of a complete program.</p> <p>(4) "Custom software" is specified, designed, and created by a vendor at the specific request of a customer to meet a particular need and is considered to be a sale of a service rather than a sale of tangible personal property. It includes those services represented by separately stated charges for the modification of existing prewritten software when the modifications are written or prepared exclusively for a customer. Modification to existing prewritten software to meet the customer's needs is custom computer programming only to the extent of the modification and only to the extent that the actual amount charged for the modification is separately stated. Examples of services that do not result in custom software include loading parameters to initialize program settings and arranging preprogrammed modules to form a complete program.</p> <p>When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program before modification was previously marketed, the new program will qualify as a custom program if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced by the records of the seller, was more than 50 percent of the contract price to the customer.</p> <p>The department will consider the following records in determining the extent of modification to prewritten software when there is not a separate charge for the modification: logbooks, timesheets, dated documents, source codes, specifications of work to be done, design of the system, performance requirements, diagrams of programs, flow diagrams, coding sheets, error printouts, translation printouts, correction notes, and invoices or billing notices to the client.</p> |
| Kansas | KSA § 79-3603(s)       | <p>"Computer software" means information and directions loaded into a computer which dictate different functions to be performed by the computer. Computer software includes any canned or prewritten program which is held or existing for general or repeated sale, even if the program was originally developed for a single end user as custom computer software. The sale of computer software or services does not include:</p> <p>(1) The initial sale of any custom computer program which is originally developed for the exclusive use of a single end user; or</p> <p>(2) Those services rendered in the modification of computer software when the modification is developed exclusively for a single end user only to the extent of the modification and only to the extent that the actual amount charged for the modification is separately stated on invoices, statements and other billing documents provided to the end user. The services of modification, alteration, updating and maintenance of computer software shall only include the modification, alteration, updating and maintenance of computer software taxable under this subsection whether or not the services are actually provided...</p>   |

**Attachment 2**

| State         | Statutory Cite  | Definition   |
|---------------|---|--|
| Kentucky      | Revenue Policy 51P170<br>Revenue Policy 51P171                            | <p>Computer software is defined as written or printed data, such as programs, routines, and symbolic language essential to the operation of the computers and can be produced in the form of punched cards, data on magnetic tape or by listing the program instructions on coding sheets, magnetic disks, diskettes, etc.</p> <p>"Canned" or packaged computer programs are prewritten application or operational programs sold off the shelf to more than one customer. This includes software that was originally custom-designed or written for one specific customer but that is now available to others, including software updates or enhancements to canned programs and standardized options available for customers' needs.</p> <p>"Custom software" is a program tailored solely to the needs of an individual customer.</p>  |
| Louisiana     | <i>South Central Bell v. Barthelemy</i> , 643 So.2d 1240, 1249 (La. 1994) | <p>"Canned" software is software which has been pre-written to be used by more than one customer, or mass marketed; "custom" software is specially designed for exclusive use by one particular customer.</p> <p>(Page 1246) "Software" encompasses all parts of the computer system other than the hardware, i.e., the machine; and the primary non-hardware component of a computer system is the program. In its narrowest scope, software is synonymous with program, which, in turn, is defined as "a complete set of instructions that tells a computer how to do something." Another definition is "a set of instructions" or "a body of information."</p>  |
| Maine         |   |  |
| Maryland      |   |  |
| Massachusetts |   |  |
| Michigan      | MCL 205.51(e)   | <p>"Computer software" means a set of statements or instructions that when incorporated in a machine usable medium is capable of causing a machine or device having information processing capabilities to indicate, perform or achieve a particular function, task, or result.</p>  |
| Minnesota     | M.S. 297A.01<br>Minnesota Rule 8130.9910                                  | <p>Subd. 18. Custom computer program.</p> <p>"Custom computer program" means a computer program prepared to the special order of the customer, either in the form of written procedures or in the form of storage media on which, or in which, the program is recorded, or any required documentation or manuals designed to facilitate the use of the custom computer program transferred. It includes those services represented by separately stated charges for modifications to an existing prewritten program that are prepared to the special order of the customer. It does not include a "canned" or prewritten computer program that is held or existing for general or repeated sale or lease, even if the prewritten or "canned" program was initially developed on a custom basis or for in-house use. Modification to an existing prewritten program to meet the customer's needs is custom computer programming only to the extent of the modification. For purposes of this subdivision:</p> <p>(1) "Storage media" includes punched cards, tapes, discs, diskettes, or drums on which computer programs may be embodied or stored;</p> <p>(2) "Computer" does not include tape-controlled automatic drilling, milling, or other manufacturing machinery or equipment; and</p> <p>(3) "Computer program" means the complete plan for the solution of a problem, such as the complete sequence of automatic data processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs.</p> |
| Mississippi   |   |  |

**Attachment 2**

| State      | Statutory Cite  | Definition   |
|------------|---|--|
| Missouri   | 12 CSR 10-109.050   | <p>(A) Canned programs-Canned programs are standardized programs purchased "off the shelf" or are programs of general application developed for sale to and use by many different customers with little or no modifications. These may include programs developed for in-house use and subsequently held or offered for sale or lease. A program may be a canned program even if it requires some modification, adaptation or testing to meet the customer's particular needs.</p> <p>(B) Customized programs-Customized programs are programs developed to the special order of a customer. The real object sought by a purchaser of customized programs is the service of the seller and not the property produced by the service of the seller.</p>   |
| Nebraska   | NE Reg. 1-088.05  | Computer software is a sequence of instructions which directs the computer to process either digital or analog data. Software does not include data, such as mailing lists, even when in machine-readable form, or charges for converting data into machine-usable form.   |
| Nevada     | <p>NAC 372.865</p> <p>NAC 372.870</p> <p>NAC 372.855</p> <p>NAC 372.860</p> | <p>NAC 372.865 "Software" defined. "Software" means programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system.</p> <p>NAC 372.870 "Standard prewritten program" defined. "Standard prewritten program," sometimes referred to as "canned" or "off-the-shelf" software, means software which is not originally developed and produced for the user.</p> <p>NAC 372.855 "Custom program" defined. "Custom program" means software which is:</p> <ol style="list-style-type: none"> <li>1. Developed pursuant to the special order of a customer;</li> <li>2. Produced by a provider exclusively for a specific user; and</li> <li>3. Of an original, one-of-a-kind nature.</li> </ol> <p>The term includes preexisting routines or prewritten components of a program created specifically to be integrated into a larger custom program.</p> <p>NAC 372.860 "Preexisting routines" and "prewritten components of a program" defined. "Preexisting routines" and "prewritten components of a program" mean those portions of a custom program which cannot function separately as "stand-alone" software.</p>   |
| New Jersey | N.J.A.C. 18:24-25.2(b)(2)   | <p>iii. The software may be in the form of:</p> <p>(1) Systems programs (except for those instruction codes which are considered tangible personal property)--programs that control the hardware itself, and allow it to compile, assemble and process application programs. For purposes of this rule, instruction codes mean the internalized instruction code which controls the basic operations (that is, arithmetic and logical) of the computer causing it to execute instructions contained in application and system programs, and is an integral part of the computer. It is not normally accessible nor modifiable by the user. Such internal code system is considered part of the hardware and is taxable. The fact that the vendor does not charge separately for it is immaterial.</p> <p>(2) Application programs--programs that are created to perform business functions or control or monitor processes.</p> <p>(3) Pre-written programs (canned)--programs that are either systems programs or application programs and are not written specifically for one user.</p> <p>(4) Custom programs--programs created specifically for one user.</p> |
| New Mexico |   |  |
| New York   |   |  |

| State          | Statutory Cite                       | Definition   |
|----------------|--------------------------------------|--|
| North Carolina | N.C.G.S. 105-164.13 (43)             | "Custom computer software" is software written in accordance with the specifications of a specific customer. The term includes a user manual or other documentation that accompanies the sale of the software. The term does not include prewritten software that can be installed and executed with no changes to the software's source code other than changes made to configure hardware or software.   |
| North Dakota   |                                      |  |
| Ohio           |                                      |  |
| Oklahoma       |                                      |  |
| Pennsylvania   | Pronouncement 61 Pa. Code §60.19 (c) | <p>(i) Canned software. The sale at retail or use of canned software, including updates, enhancements and upgrades is subject to tax.</p> <p>(A) Canned software includes custom software that is transferred pursuant to a sale at retail to a person other than the original purchaser.</p> <p>(B) Computer software designed, created and developed to adapt or modify canned software to the specific needs of a particular customer does not convert the canned software to custom software. Any charge for the custom software or modifications shall be reasonable and be separately stated on the sales invoice or statement to the customer to be exempt from tax.</p> <p>(C) A vendor's transfer for consideration to a purchaser of the temporary ownership, possession or custody of a storage medium containing canned software for the purpose of being used or recorded by either the purchaser or vendor on the purchaser's computer hardware is subject to tax.</p> <p>(D) The sale at retail or use of a canned software maintenance contract constitutes a prepayment for services to tangible personal property and is subject to tax. If a canned software maintenance agreement provides that the purchaser is entitled to receive both taxable components, such as canned software updates, enhancements, upgrades or error corrections, and nontaxable components, such as consultation, support or training services, the charge for the nontaxable component is not subject to tax if that charge is separately stated on the sales invoice.</p> <p>(ii) Custom software. The sale at retail or use of custom software is not subject to tax. The sale at retail or use of custom software constitutes a purchase of a nontaxable computer programming service.</p> <p>(A) The sale at retail or use of multiple copies or licenses of custom software to the original purchaser is not subject to tax.</p> <p>(B) The sale at retail or use of custom software installation, custom software repair and maintenance, custom software updates, enhancements and upgrades that constitute custom software is not subject to tax.</p> <p>(C) A custom software vendor's purchase of storage media used to transfer custom software to its customer, and the vendor's purchase of any related materials, including documentation and training manuals that are transferred to the customer as part of the sale at retail of custom software, are subject to tax when purchased by the custom software vendor.</p> |

| State          | Statutory Cite  | Definition  |
|----------------|---|---|
| Rhode Island   | STATE-REG, RI-TAXRPT<br>§64-579, Reg. SU 94-25.               | <p>¶1. Computer "hardware" is defined as the machine and all of its components. Computer "software" is the programming needed to make computers operate.</p> <p>4. Canned programs are programs prepared, held, or existing for general or repeated use, including programs developed for in-house use and subsequently held or offered for sale or lease.</p> <p>Canned programs which include such items as instructional material, prepunched cards or programmed tapes are tangible personal property and the entire charge is taxable, including the services of a technician to assist the customer in the use of the package whether or not his services are separately stated on the billing.</p> <p>The licensing of canned software is a lease or rental and is subject to tax along with any services pertaining thereto. (Cross Reference Regulation SU 92-62)</p> <p>5. Custom programs are programs created specifically for one user and prepared to the special order of that user. Such programs are exempt including any services incidental thereto and any modifications made to said programs for a particular user. Custom programs are not subject to tax regardless of the manner or mode of transfer to the customer since the charge for the custom program is a charge for professional services and the manner or mode of transfer is considered incidental to the sale of the service.</p> |
| South Carolina | SC Regulation 117-174.262                                     | <p>A computer program is the complete sequence of automatic data processing instructions necessary to enable automatic data processing equipment to function in resolving a particular problem. These instructions, commonly referred to as software, may be recorded on or in paper or magnetic tape, cards, disc or drum or may consist of written procedures such as program instructions listed on coding sheets. Programs are, in essence, the parts, attachments or instructions necessary to enable personnel to produce the results desired from the automatic data processing system.</p> <p>Such programs may be prewritten (canned) or custom designed for a particular installation.</p> <p>Custom programs are programs prepared to the special order of a customer, the gross proceeds therefrom being subject to the tax. Also considered to be custom programs are sales of programs developed through modification of existing prewritten programs to meet a customer's specific needs. Charges to modify and adapt these programs to a customer's equipment (including testing) or translating a program to a language compatible with a customer's equipment are services that are a part of the sale price of tangible personal property and likewise subject to the tax.</p>   |
| South Dakota   | SDCL 10-45-2  | (No specific definition of canned/custom provided)  |
| Tennessee      | T.C.A. § 67-6-102   | (25)(B) "Sale" also means such transfer of customized or packaged computer software, which is defined to mean information and directions loaded into a computer which dictate different functions to be performed by the computer, whether contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property; however, the fabrication of software by a person for such person's own use or consumption shall not be considered a taxable "use" under subdivision (30) or any other section of this chapter;  |
| Texas          | V.T.C.A., Tax Code § 151.0031<br>V.T.C.A., Tax Code § 151.009 | <p>"Computer program" means a series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, punched cards, printed instructions, or other tangible or electronic media.</p> <p>"Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner, and, for the purposes of this chapter, the term includes a computer program and a telephone prepaid calling card.</p>  |

| State         | Statutory Cite  | Definition  |
|---------------|---|---|
| Utah          | Utah Adm. Rule R865-19S-92(A)   | <p>1. "Canned computer software" or "prewritten computer software" means a program or set of programs that can be purchased and used without modification and has not been prepared at the special request of the purchaser to meet their particular needs.</p> <p>2. "Custom computer software" means a program or set of programs designed and written specifically for a particular user. The program must be customer ordered and can incorporate preexisting routines, utilities or similar program components. The addition of a customer name or account titles or codes will not constitute a custom program.</p>   |
| Vermont       | <i>Chittenden Trust Co. v. King</i> , 143 VT 271, 465 A 2d 1100, (1983) | <p>"Computer software" is a set of logical instructions designed to enable a computer to perform the computations, comparisons and sequential steps necessary to process and produce a certain desired output.</p> <p>... Computer software tape purchased by the Bank constitutes "tangible personal property" for purposes of the state use tax. In so doing, we reject the Bank's attempts to distinguish a computer program tape from other taxable personal property such as films, videotapes, books, cassettes and records. In each, their value lies in their respective abilities to store and later display or transmit their contents. A computer software tape is no different....</p>  |
| Virginia      |   |   |
| Washington    | RCW 82.04.215   | <p>(6) "Software" means any information, program, or routine, or any set of one or more programs, routines, or collections of information used, or intended for use, to convey information that causes one or more computers or pieces of computer-related peripheral equipment, or any combination thereof, to perform a task or set of tasks. "Software" includes only those copies of such information, programs, or routines intended for use by an end user and specifically excludes retained rights in software and master copies of software. "Software" includes the associated documentation that describes the code and its use, operation, and maintenance and typically is delivered with the code to the consumer. All software is classified as either canned or custom.</p> <p>(1) "Canned software" means software that is created for sale to more than one person.</p> <p>(2) "Custom software" means software created for a single person.</p> <p>(3) "Customization of canned software" means any alteration, modification, or development of applications using or incorporating canned computer software for a specific person. "Customization of canned software" includes individualized configuration of software to work with other software and computer hardware but does not include routine installation. Customization of canned software does not change the underlying character or taxability of the original canned software.</p> |
| West Virginia |   |   |

| State     | Statutory Cite                        | Definition   |
|-----------|---------------------------------------|--|
| Wisconsin | Section Tax 11.71(1) Wis. Admin. Code | <p>(e) "Custom Programs" mean utility and application software, which accommodate the special processing needs of the customer. The determination of whether a program is a custom program is based upon all the facts and circumstances including the following:</p> <ol style="list-style-type: none"> <li>1. The extent to which the vendor or independent consultant engages in significant presale consultation and analysis of the user's requirements and system.</li> <li>2. Whether the program is loaded into the customer's computer by the vendor and the extent to which the installed program must be tested against the program's specifications.</li> <li>3. The extent to which the use of the software requires substantial training of the customer's personnel and substantial written documentation.</li> <li>4. The extent to which the enhancement and maintenance support by the vendor is needed for continued usefulness.</li> <li>5. There is a rebuttable presumption that any program with a cost of \$ 10,000 or less is not a custom program.</li> <li>6. Custom programs do not include basic operational programs or prewritten programs.</li> <li>7. If an existing program is selected for modification, there must be a significant modification of that program by the vendor so that it may be used in the customer's specific hardware and software environment.</li> </ol> <p>(k) "Prewritten Programs" often referred to as "canned programs," means programs repaired, held, or existing for general use normally for more than one customer, including programs developed for in-house use or custom program use which are subsequently held or offered for sale or lease.</p> <p>(m) "Program" means the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a specific problem. It includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs. For purposes of this section a program is either a prewritten or custom program.</p> |
| Wyoming   |                                       |  |

## Alternative 1

The first proposed definition of software is:

**“Software” means a set of coded instructions designed to cause a computer, another electronic device, or automatic data processing equipment to perform a task.**

A second definition of software, not found in the UCITA but designed to work with UCITA definitions, is:

**“Software” means an organized and interrelated set of one or more computer programs, which may include documentation and examples that describe how the software may be tailored and used for specific applications.**

UCITA definitions that would accompany this definition of software include:

**“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 program” means a set of statements or instructions to be used directly or indirectly in a computer to bring about a certain result. The term does not include separately identifiable informational content.**

**“Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.**

Several definitions were proposed:

**“Custom software” means software that has been designed and produced exclusively for a specific identifiable customer.**

**“Custom software” means software that is designed for a specific user where the cost of prewritten software is no more than ten percent [or other appropriate figure] of the sales price.**

**“Modified software” means software that has been changed for a specific user to the extent the charges for the changes are separately stated.**

## Alternative 2

### Computer Software

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

“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.

“Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

### Custom Computer Software

“Custom computer software” means computer software that has been designed and created exclusively for a specific identifiable customer. Custom software does not include computer software modules that existed prior to entering into a contract or agreement for the sale, lease or license of custom software.

A “computer software module” is a set of coded instructions designed to handle a specific task within larger software that can be programmed and tested independent of the larger software.

### Modifications to Computer Software

“Modifications to computer software” mean changes or additions to a set of coded instructions. “Modifications to computer software” do not include selecting or changing preferences or defaults.

### Configuration of Computer Software

\*

“Configuration of computer software” means selecting or changing computer software preferences or defaults.

An assumption is made that some states treat configurations as modifications. That is the only reason the definition is provided. States then have a means of exempting such services.

**Note:** States that exempt custom software today treat pre-written software that is customized by a vendor in one of two ways:

1. Treat the entire charge by the vendor for the prewritten program and modifications as exempt from sales or use tax.

## **Attachment 4**

Note: There will be situations where the prewritten software is not purchased by a vendor. Instead, it has been developed in-house by the vendor. In this case, there is no transaction to tax in the modification and sale, lease, or license of the computer software.

2. Treat the charge for the prewritten program as subject to sales tax, but do not tax the modifications.

**§1.861-18. Classification of transactions involving computer programs**

(a) *General--(1) Scope.* This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions.* This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions--(1) General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following--

- (i) A transfer of a copyright right in the computer program;
- (ii) A transfer of a copy of the computer program (a copyrighted article);
- (iii) The provision of services for the development or modification of the computer program; or
- (iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving copyright rights and copyrighted articles--(1) Classification--(i) Transfers treated as transfers of copyright rights.* A transfer of a computer program is

classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. Whether the transaction is treated as being solely the transfer of a copyright right or is treated as separate transactions is determined pursuant to paragraph (b)(1) and (b)(2) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (or only acquires a de minimis grant of such rights), and the transaction does not involve, or involves only a de minimis, provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section, the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows--

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is--

- (1) Information relating to computer programming techniques;
- (2) Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and
- (3) Considered property subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles--(1) Transfers of copyright rights.* The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation--(1) Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account.* The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

(3) *To the public--(i) In general.* For purposes of paragraph (c)(2)(i) of this section, a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For purposes of this subparagraph, a related person is a person who bears a relationship to the transferee specified in section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). In applying section 267(b), 267(f), 707(b)(1)(B), or 1563(a), "10 percent" shall be substituted for "50 percent."

(ii) *Use by individuals.* The number of employees of a transferee of a computer program who are permitted to use the program in connection with their employment is not relevant for purposes of this paragraph (g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of a computer program who are permitted to use the program in connection with the performance of those services is not relevant for purposes of this paragraph (g)(3).

## Alternative 4

### Computer Software

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

“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.

“Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

### Prewritten Software

“Prewritten software” means computer software, including pre-written 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 pre-written computer software programs or pre-written portions thereof does not cause the combination to be other than pre-written computer software. Pre-written 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 such purchaser. Where a person modifies or enhances computer software of which such person is not the author or creator, such person shall be deemed to be the author or creator only of such person's modifications or enhancements. Pre-written software or a pre-written 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 pre-written 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 pre-written computer software.

### Delivered Electronically

“Delivered electronically” means delivered from the seller to the purchaser by means other than tangible storage media. Delivered electronically also includes the delivery by use of a tangible storage media where the tangible storage media is not physically transferred to the purchaser.