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# *Sales Tax Corner*

## *A Primer on the Taxation of Custom Software*

By Ilya A. Lipin

During the 1930s and 1940s, as states began implementing sales tax laws, one of the key components was the imposition of sales tax on all tangible personal property that did not qualify for an exemption. At the time, it was impossible to foresee that those concepts would become relevant to the expansion of the tax base to include computer software, regardless of its character and delivery method.

Over time, state legislatures became comfortable with treating prewritten or canned software as taxable tangible personal property, especially when delivered *via* physical means. States also recognized that there is a distinction between prewritten software, which is generally held for repeated sale or lease to the public, and custom software, which is made for one customer and, depending on the state, may have different or exempt tax treatment. The most common reason for exempting the sale of custom computer software is because states view it as a nontaxable professional service for one user,[1] rather than a retail sale of taxable tangible personal property to the public.

States often interpret the distinction between prewritten and custom software narrowly, leading to disputes among the government, custom software vendors, and purchasers. This column examines key risk areas when distinguishing between prewritten and custom software and highlights areas where taxpayers made costly mistakes. It also explains how modifications, method of delivery, and transfer of custom software in a transaction to a third party or between affiliated members of a group can affect the software's taxability.

## Taxability of Custom Software

Today, most states exempt from sales tax the sale or development of custom computer software except for states including Alabama,[2] Connecticut,[3] Hawaii,[4] Iowa,[5] Louisiana,[6] Mississippi,[7] Nebraska,[8] New Mexico,[9] South Carolina,[10] South Dakota,[11] Tennessee,[12] Texas,[13] and West Virginia,[14] as well as the District of Columbia.[15] In general, to be considered custom, software must be designed and developed to the specifications of an original purchaser.[16] While the definitions of canned and custom software vary by state and should be the first place

to look for determining proper taxability, a two-prong analysis is typically conducted during state tax audits or due diligence.

First, the reviewer would verify whether the software is genuinely custom and not just prewritten software with minor customization. While custom software may have some "preexisting routines, utilities or similar program components" and remain custom in states such as California, if substantial amounts of common software or basic code used for other programs are included in software customization, a product may lose its exempt status.[17]

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If a vendor incorporates past versions of custom software in sales to new customers, those sales can be deemed taxable as involving prewritten software, unless it can be proven which portion relates to new customization. For example, in *LumiData Inc. v. Comm'r of Rev.*, No. A14-0254 (Minn. 2014), the taxpayer licensed software that it customized to fit the requirements of each retailer, but it did not separately state customization charges on its invoices. The taxpayer presented evidence that the cost of customization often exceeded the cost of the software itself and that its customers refused to buy software without customization. The court found that each version of the customized software incorporated functionality of all existing versions and that there was a combination of prewritten and customized software. Because none of the taxpayer's evidence documented separate charges for customization work, the court concluded that the entire sales price was taxable as a sale of prewritten computer software.

Prewritten software can become custom if it undergoes significant transformation such that the final product may have little resemblance—aside from the most fundamental functionalities—to the original prewritten software on which it was built. Because determining whether software is custom is highly technical and factually driven, it is important for taxpayers to have detailed information such as statement of work, designs, build specifications and diagrams, coding sheets, and invoices separately showing how the software was specially designed and the hours of professional services incurred in customizing it.

Second, the reviewer would ensure that the custom software is sold only to a single purchaser and not resold to multiple parties. If custom software is sold to other purchasers, the subsequent sales or copies are considered sales of taxable prewritten software, unless a state-specific exemption applies (*see* New York example below).[18]

The sale of multiple copies of custom software to the same original purchaser generally does not change the preferential nontaxable treatment. For instance, Pennsylvania provides that "the sale at retail or use of multiple copies or licenses of custom software to the original purchaser is not subject to tax." Similarly, California defines a custom computer program to include a program that was initially developed on a custom basis or for in-house use. Thus, sharing custom software within divisions of a single legal entity generally does not make custom software taxable.

However, when custom software is transferred between legal entities of the same company or as a result of the sale of the company, some states may view such transfers as taxable. That is because the transfer is considered a sale to a different party than the original entity for which the custom software was developed.

For example, in *In re Xerox Corp. and XAC LLC f/k/a Amici Inc.*, No. 821914, New York Division of Tax Appeals Determination (2009), New York assessed sales tax on the bulk sale of assets, including custom software that the seller developed for its own use. Under New York law, "when a seller of business assets in bulk, as part of the bulk sale, sells software, such software is subject to tax even if it was deemed to be exempt software when purchased by the seller." In the context of a bulk sale, the Division said custom software "loses its identity as software originally designed and developed to the specifications of a specific purchaser" and becomes taxable prewritten computer software. Accordingly, the Division held that because there was no original purchaser as required by the relevant statute, the software at issue was considered prewritten software despite its customization and was therefore taxable.

Some states provide an exemption to the general rule that custom software can be transferred only to the original purchaser. For instance, New York exempts from sales tax the transfer or sale of custom software to 1) a corporation that is a member of an affiliated group that includes the software's original purchaser, or 2) a partnership in which the software's original purchaser and other members of the affiliated group have at least a 50 percent interest in capital or profits.[19] That exemption does not apply if the

sale or transfer of the software is part of a plan meant to avoid or evade tax or if software is being sold is prewritten and readily available for sale to customers in the normal course of business.[20]

The New York Division of Tax Appeals Determination applied that exemption in *In re TheStreet.com Inc.*, No. 828467 (2021). There, a taxpayer obtained a refund of sales tax paid under an assessment related to the transfer of custom software between affiliated parties, *i.e.*, subsidiary to owner. The taxpayer acquired an interest in another entity that had internally developed software specifically designed to perform tailored functions for the company's business operations. The software provided added value to customers through enhanced data analysis. On audit, the auditor discovered that after the acquisition, the subsidiary transferred assets, including the software, to the owner and assessed tax on the transfer. However, the taxpayer used an exemption noted above to demonstrate that the transfer involved custom software previously developed by its subsidiary and was therefore exempt as a transfer between affiliates.

## Does Modification of Prewritten Software Make It Custom?

Modifying prewritten software to meet the customer's needs—for example, by creating a customized software solution based on existing software—is custom computer programming only to the extent of the modification. The mere act of combining prewritten software with custom code does not automatically transform it into custom software because the combination might not have been specifically intended for a particular purchaser's unique needs or requirements.

For instance, when a company installs prewritten software such as a tax engine, it often requires the creation of custom software to ensure compatibility with its existing ERP system. However, the development of that bridging software does not automatically classify the underlying prewritten software as custom. To maintain its exemption or be considered professional services, the custom software or the portion of the modification related to it must be invoiced separately from the standard software. Combining or bundling charges for the modification or creation of custom software with taxable prewritten software will typically result in the entire price being subject to tax.

Insufficient documentation showing which portion of the software is custom could lead to overpayment of sales tax. For instance, in Pennsylvania, "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."[21] Pennsylvania, as well as other states, often denies requests for refunds if taxpayers cannot prove through documentation such as invoices and statements of work that computer software was created for the original purchaser or which portion is custom.[22] Similarly, improperly expanding an exemption applicable only to the customized portion of software to a purchase that includes taxable prewritten software can lead to sales tax exposure.

## Delivery Method Matters

Taxability of custom software may depend on its method of delivery to the purchaser. In most states, such as Indiana and Nevada, custom software retains its exempt status regardless of whether it is delivered *via* tangible medium, load and leave, or electronically.[23]

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However, a minority of states allow for exempt status only if the custom software is delivered electronically. In South Carolina, for example, both custom and prewritten software are subject to sales and use tax if they are delivered *via* a tangible medium. However, if custom or prewritten software is delivered electronically, it is not subject to tax.[24]

## Services to Custom Software

Generally, the taxability of services provided to custom software follows the taxability rules of the underlying custom or prewritten software.

Some states that impose tax on the sale of custom software also impose tax on software maintenance, with variations on what tax is applied depending on

whether the contract is mandatory or optional. In Alabama, for example, if the maintenance contract is mandatory as a condition of a sale of software, the gross sales price is subject to tax whether the charge for the contract is stated separately from the charge for the software. The mandatory maintenance services subject to tax may include technical consultation (support) services, corrections of software errors or malfunctions (bugs), provisions for enhancements (upgrades) to the software, revisions to software operating manuals, and training services. However, if the sale of the maintenance contact is optional, then only the separately stated portion of the fee representing enhancements or upgrades and new operating manuals are taxable, and separately stated fees for consultation or support services, error corrections, and training services are not taxable.[25]

*Custom software taxation may look simple on the surface, but it is fairly complicated in practice. Businesses and their advisers are encouraged to be vigilant and inquire if any step in the development of software or in its contents, history, or sale could have changed the software's characterization from custom to prewritten, affecting its taxability.*

By way of another example, the District of Columbia also imposes sales tax on gross receipts from maintenance of any computer software, regardless of whether it is prewritten or customized, including system software, application software, computer programming, software modification, and updating.[26]

States that generally do not impose tax on custom software also tend to not impose tax on services. For instance, in Pennsylvania, "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."[27] Similarly, Massachusetts exempts from sales tax custom modifications and maintenance if they are separately stated.[28]

## Additional Nuances

Some states tax software programming services but not the subsequent possession or license to the custom software, and *vice versa*. That could affect when sales tax may be due based on the contract and payment terms.

For instance, Alabama does not impose tax on software programming services, which includes the development and modification of software applications specific to a customer's needs but excludes any software sold or licensed to the customer as part of the development or modification. However, as mentioned above, Alabama imposes tax on the sale of custom software to the original purchaser.[29]

Conversely, Connecticut imposes a reduced tax rate of 1 percent on the data processing services, which includes the processes of designing, creating, and developing custom software, as well as on adapting or modifying existing software to the needs of a customer. However, Connecticut does not treat custom software as tangible personal property. Thus, any separate charges such as license fees for the mere use or possession of custom software are not subject to sales tax.[30]

Parties involved in the sale or purchase of custom software should also be aware of tax rates. In some states, like Connecticut, the development of custom software services is taxed at a favorable rate of 1 percent, instead of the standard 6.35 percent rate applicable to sales of software for nonbusiness use.[31]

## Purchaser's Taxability Considerations

In building custom software, vendors may themselves be consumers of other software or related products. In general, purchases of developmental code, libraries of software, media used to transfer custom software to customers, training manuals, and related materials are subject to sales tax because the vendor is viewed as the consumer, and not the reseller, of those products. As such, custom software vendors need to review their software purchases to ensure compliance with sales and use tax laws.

## Insights

Custom software taxation may look simple on the surface, but it is fairly complicated in practice. Businesses and their advisers are encouraged to be vigilant and inquire if any step in the development of software or in its contents, history, or sale could have changed the software's characterization from custom to prewritten, affecting its taxability. To be proactive in managing tax risk and

identifying potential opportunities, readers should consider the following insights:

- To validate that software is custom, auditors often test whether the software was originally designed to fit the needs of a purchaser and made for an original, not subsequent, purchaser. Because the burden of proof is on the taxpayer to show that the purchase is exempt from sales tax -- and, in this context, that the software was custom and developed for an original user -- taxpayers must collect accurate and contemporaneous documentation about what makes software, or any portion thereof, custom. Statements of work, purchase orders describing software to be developed, and invoices separately stating hourly professional services to be rendered often serve as helpful evidence in showing the costs of custom software development.
- One of the factors considered by auditors in determining if a company sells custom software is the company's NAICS code. Companies engaged in custom software development generally use Custom Computer Programming code 541511, which describes an industry's primary activities as including "writing, modifying, testing, and supporting software to meet the needs of a particular customer." If the majority of a company's revenue is derived from the sales of custom software development, it should confirm that it is properly classified and carries the correct NAICS code.
- As with prewritten software, method of delivery could affect the taxability of custom software. In states such as South Carolina, vendors and purchasers are encouraged to discuss among themselves how delivery method may impact taxability of custom software.
- If custom software is purchased in states that impose tax on it, potential savings opportunities may exist if it is used in states that do not tax it. However, sourcing could lead to exposure if the custom software is purchased in a state that does not tax it (*e.g.*, Massachusetts) but is used in a state that does (*e.g.*, Tennessee). To prevent overspend of tax or to mitigate potential exposures, it is important to track where the software may be used and whether it will be taxed there.

## ENDNOTES

1 *See* 61 Pa. Code §60.19(c)(2). For instance, in Pennsylvania, the sale at retail of custom software is not subject to tax because it constitutes the purchase of a nontaxable computer programming service.

2 Ala. Admin. Code r. 810-6-1-.37, as amended by Ala. Admin. Register, Vol. 38, No. 2 (Nov. 29, 2019), effective Jan. 13, 2020; *Russell Cty. Cmty. Hosp. LLC v. Alabama Dept. of Rev.*, 291 So. 3d 52 (Ala. 2019).

3 The act of creating custom software is taxed at a reduced rate of 1 percent because it is a "computer and data processing service." Conn. Gen. Stat. §12-407(a)(37)(A); Conn. Gen. Stat. §12-407(a)(13); *Andersen Consulting LLP v. Gavin*, 767 A2d 692, 255 Conn. 498 (Conn. 2001); Connecticut Policy Statement PS 2006(8).

4 *See* Haw. Rev. Stat. §237-13; Haw. Rev. Stat. §238-2.

5 Effective Jan. 1, 2019, Iowa imposes sales tax on custom computer software. Iowa Dept. of Rev., Taxation of Specified Digital Products, Software, and Related Services (Sept. 1, 2019).

6 La. Rev. Stat. Ann. §47:302(BB), as added by 2018 La. H.B. 10, Third Extraordinary Session, effective July 1, 2018; see La. Rev. Stat. Ann. §47:301(16)(h)(iv); Louisiana Publication R-1002 (Oct. 2021).

7 Miss. Code Ann. §27-65-23; Miss. Regs. §35.IV.005.06.101.

8 Neb. Rev. Stat. §77-2701.16(3)(a).

9 N.M. Stat. Ann. §7-9-3.5(A); N.M. Admin. Code tit. 3, §2.1.18(M), as renumbered by N.M. Reg. Vol. 32, No. 19 (Oct. 13, 2021), effective Oct. 13, 2021.

10 S.C. Code Ann. §12-36-60; S.C. Code Ann. §12-36-910; 117 S.C. Code Regs. §330; South Carolina Rev. Rul. 03-5 (Dec. 9, 2003), reinstated by South Carolina Rev. Rul. 11-2 (Sept. 1, 2011), and modified by South Carolina Rev. Rul. 12-1 (March 20, 2012).

11 S.D. Codified Laws Ann. §10-45-4; S.D. Admin. R. 64:06:02:79; South Dakota Tax Facts No. 267.

12 Tenn. Code Ann. §67-6-102(18); Tenn. Code Ann. §67-6-102(97)(A); Tenn. Code Ann. §67-6-702(a); Tennessee Sales and Use Tax Guide (October 2020).

13 Tex. Admin. Code tit. 34, §3.308(c)(1); Texas Comptroller's Letter No. 200812241L (Dec. 16, 2008); Texas Comptroller's Letter No. 200109497L (Sept. 25, 2001).

14 W. Va. Code §11-15-3(a).

15 D.C. Code Ann. §47-2002; D.C. Code Ann. §47-2202; D.C. Mun. Regs. tit. 9, §474.4.

16 61 Pa. Code §60.19(b)(iii); Ark. Regs. GR-25(H)(2).

17 Cal. Code Regs. tit. 18, §1502(b)(4); Cal. Code Regs. tit. 18, §1502(f)(2)(D),(E).

18 *See* N.Y. TB-ST-128 ("if the custom software is sold or otherwise transferred to someone other than the person for whom it was originally designed and developed, it becomes subject to tax"). *See also* R.I. Code Regs. tit. 280, §20-70-46.7 and R.I. Admin Hearing Decision 2012-10, 07/24/2012 ("a program written for a specific purchaser can be become prewritten if it sold to someone other than the specific purchaser").

19 *See* N.Y. Tax Law §1115(a)(28). New York State Department of Taxation and Finance, Tax Bulletin ST-128 (TB-ST-128).

20 *Id.*

21 61 Pa. Code §60.19(c)(2)(i)(B).

22 For example, in *In re SEI Investments*, BFR Dkt. No. 145047 (Dec. 12, 2016), the Pennsylvania Board of Finance and Revenue found that the taxpayer proved that purchased software was custom. The taxpayer submitted various documents, including appeal schedules, invoices, service and license agreements, and proof of tax payment, in support of its petition for a refund. However, the Board concluded that the evidence presented was insufficient to prove that the computer software was specifically designed, created, and developed according to the taxpayer's specifications as the original purchaser. It also clarified that modifying existing software to meet the specific needs of a particular customer does not transform canned software into custom software, as stated in 61 Pa. Code §60.19(c)(2)(i)(B). As a result, the Board denied the petitioner's claim for refund in its entirety.

23 Ind. Code Ann. §6-2.5-1-24; Indiana Tax Information Sales Tax Bulletin 8; Nev. Admin. Code ch. 372, §372.875(2).

24 S.C. Code Ann. §12-36-60; S.C. Code Ann. §12-36-910; 117 S.C. Code Regs. §330; South Carolina Rev. Rul. 03-5 (Dec. 9, 2003), reinstated by South Carolina Rev. Rul. 11-2 (Sept. 1, 2011), and modified by South Carolina Rev. Rul. 12-1 (March 20, 2012).

25 Ala. Admin. Code r. 810-6-1-.37(7).

26 D.C. Mun. Regs. tit. 9, §474.4.

27 61 Pa. Code §60.19(c)(2)(ii)(B).

28 Mass. Regs. Code tit. 830, §64H.1.3(3)(e).

29 Ala. Admin. Code r. 810-6-1-.37(5).

30 Conn. Gen. Stat. §12-407(a)(37)(A); Connecticut Policy Statement PS 2006(8).

31 *Id.*