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“Old School” Software / IT Issues

In the early 1980s …
- States increasingly grappled with whether software delivered in tangible form was taxable TPP.
- And whether custom software was a nontaxable service (and what did “custom” mean?).
- And what to do with modifications to prewritten software.

In the early-to-mid 1990s …
- Other issues began to take center stage.
- Like delivery of software through a digital download (roughly two-thirds of the states now tax).
- Or whether it was appropriate to tax information and data processing services – most states have chosen not to (Connecticut, DC, South Carolina, Texas, West Virginia, etc., are exceptions).

In the late 1990s …
- States began to see more activity surrounding load and leave software transactions.
- And more and more large-scale IT contracts where TPP and services were bundled together.
- And debate began to center around whether it was appropriate to tax internet access service (only 8 states currently tax – Hawaii, New Mexico, North Dakota, Ohio, Rhode Island, South Dakota, Texas, and Wisconsin; others like Connecticut, DC, and Iowa have ceased taxation).

Rules Now Well Established In Some Areas

Software:
- All SEATA states tax canned software delivered in tangible form.
- All but Arkansas, Mississippi, South Carolina, Tennessee, and West Virginia exempt custom software. Louisiana’s exemption for custom software was fully phased in beginning July 1.
- Most also exempt separately stated charges for customizing or modifying canned software.
- Half the SEATA states tax digital downloads of software. Kentucky was the most recent to do so, effective on January 1.
- And most tax load and leave transactions (the exceptions appear to be Arkansas, Georgia, North Carolina, and Virginia).

Information, data processing, and internet access services:
- Only South Carolina and West Virginia tax information services.
- No SEATA states tax data processing services.
- No SEATA states tax internet access services.
But Some Old Issues
Still Not Completely Settled

What does “custom” mean?
– Can any part of custom software originate from a canned product?

What does “modification” mean?
– For example, Virginia exempts by statute separately stated charges for the modification of prewritten software.
– Is modification limited to writing new software code?
– Or does it include up-front consulting on the modification/implementation gameplan, configuration activities aimed at unlocking the functionality of the software, and other integration/implementation activities?

How do you treat software masters?
– Is it a sale for resale when duplicates will be made from the master? See Massachusetts 830 CMR 64H.1.3.
– Or is the licensee the taxable user or consumer, notwithstanding subsequent resales? See various Virginia public documents.

Today’s Hot Issues

Large-scale software implementations / systems integration:
– Classical “sales price” issue
– Are services that would be nontaxable on a standalone basis – consulting, installation, programming, training, etc., become taxable when bundled with the sale of prewritten software?
– In states that exempt software modification labor, do these services fall into that nontaxable basket?

Related issues in the telecommunications industry:
– How does the bundling of a nontaxable product, like internet access or cable TV, with a taxable product like telephone service, affect the taxability of the overall product bundle?

Taxation of digitized products:
– While states increasingly know how to treat digital downloads of software, they by and large haven’t addressed sales of other digitized products – music, videos, books, ring tones, etc.
Today’s Hot Issues, continued

New media and communications technologies:
- Cable dates to the 1960s
- Satellite television came into vogue in the 1990s
- Satellite radio (XM and Sirius) arrived in 2001 and 2002

How do states encourage high tech industries in a digitized world?

Software-related Services

Frequently raised issues …
- Separate vendors license the software and provide integration/implementation services – services will generally be considered nontaxable (not rendered in connection with a sale of TPP).
- Same vendor licenses the software and provides the services but the parties execute separate agreements – will the services be deemed separately provided?
- Same as above, but all work performed under an umbrella agreement – can services be exempted if separately stated on customer invoices?

How are states dealing with these issues?
- 2003 exposure draft of Georgia software regulation recognized that “computer related services” would be nontaxable if separately stated.
  - Computer related services were defined as including “computer programming, installation, time-sharing, consulting, training, data processing, system testing, and information retrieval services.”
- Virginia PD 03-61 overturned previous precedent, allowing the Department to collapse separate license and services agreements that were executed contemporaneously.
  - However, the Tax Commissioner clarified that this didn’t mean that all implementation-related services were necessarily taxable.
  - Separately stated charges for software modification and installation (exempt under Virginia law) would still be excluded from the taxable sales price of the software transaction.
  - Appears to be some inclination to broadly interpret modification labor exemption to include a wide range of implementation, integration, and configuration services.
Software-related Services, continued

How are states dealing with these issues?

– **Florida** TAA 05A-022 dealt with consulting services provided under an umbrella software license agreement where customers ordered services several months later and actually executed a separate contract and pricing terms at that time. Because the services were initially agreed to in the software licensing agreement, the DOR found them to be part of the sale of the software, notwithstanding the fact that a separate agreement and invoicing came later.
  
  ▪ However, would there have been a different result had the parties executed two separate agreements – a software license agreement and a software services agreement?

– Various **Texas** rulings have held that software-related services may be taxable if provided by the same legal entity that licensed the underlying software.
  
  ▪ But on the other hand, the services should be nontaxable if provided by a separate legal entity, even one that is affiliated with the licensor.

– **Massachusetts** regulation, 630 CMR 64H.1.3 exempts services so long as they are not a mandatory part of the licensing of the software.
  
  ▪ “If computer equipment cannot be purchased without services such as training, maintenance, developing custom software, and testing, charges for the services are considered part of the sales price and are generally taxable.”
  
  ▪ But “if the purchaser may purchase computer equipment without additional services, charges for the services are not considered part of the sales price for the equipment and are generally exempt.”

Another Emerging Software Issue

Application service providers (ASPs):

– Analogous to “old school” computer time shares, but here it’s the software that is shared.

– Customers execute a software license agreement, but typically they don’t physically receive software and they aren’t the sole licensee.

– Software is usually accessed electronically on an as-needed basis.

– Most likely should be classified as an information or data processing service, more so than a traditional software license.

Limited guidance on the ASP issue:

– Can probably assume that states that tax information and/or data processing services will tax ASP transactions.

– For example, **South Carolina** Revenue Ruling 04-15 specifically notes that ASP transactions are taxable communications services (the same rationale under which the state taxes information services). Various **Texas** rulings hold that ASP is a DP or info. service.

– But states that don’t tax digital downloads of software likely should not tax ASPs.

Telecommunications Bundling Issues

Increasing “convergence” in the media and communications industries:
- Telecommunications companies offer a wide range of services (internet access, satellite radio, etc.).
- Ditto for the cable TV industry (telecommunications, high-speed access, etc.).
- What happens when you bundle taxable and nontaxable services?

“Books and records” approach gaining momentum as a solution to the problem:
- SSTP recognizes this approach for dealing with certain bundled transactions, e.g., telecommunications and related services, internet access, audio or video programming services, etc.
- For such transactions, the portion of the price attributable to the nontaxable products may be subject to tax unless the provider can identify “by reasonable and verifiable standards” the nontaxable portion from its books and records kept in the regular course of business.
- Other states have adopted this approach previously and South Carolina did so legislatively in 2004.
  - Effective January 1, 2004, bundled transactions of communications services, if the charges are attributable to services that are taxable and to services that are nontaxable, are subject to tax unless the provider can reasonably identify the portion of the price attributable to the nontaxable services from its books and records kept in the regular course of business for other purposes.

Digitized Products

Still undefined for purposes of Streamlined Sales Tax:
- Original definition thought to be too broad – would have potentially allowed taxation of products states didn’t want to tax, e.g., programming tapes used by broadcasters
- Appears to be relative consensus to ultimately limit the definition to certain agreed digitized products – music, videos, books, ring tones, etc.
- Then, states can decide on their own whether or not to impose tax.

But some states are starting to jump the gun …
- Kentucky DOR interprets 2004 law change to KRS § 139.160 (definition of TPP) as imposing tax on any digital product, including music and books, effective July 1, 2004 (see Kentucky Sales Tax Facts, Vol. 6, No. 1, April 2004).
- Louisiana defines TPP as including “on demand” audio or video downloads (Reg § 4301).
- New Jersey budget bill passed by the Senate contains provision to tax digitized products (see SB 2628) – enactment is likely.
- Effective 10/1/01, the sale of a “taxable item” in electronic form is taxable in Texas.
- States that already tax information services may also have the right to tax downloads now.
- But on the other hand, a provision to tax digitized products was stripped from the Wisconsin budget bill.
States are increasingly imposing tax on pay TV (and sometimes pay radio):

- Cable and satellite TV increasingly are legislative targets for imposition of tax.
- But satellite TV is fighting back – lobbying, grass roots efforts & even litigation in FL, KY, and NC.
- Satellite radio (XM & Sirius) sometimes has to come along for the ride.

Recent examples in the Southeast:

- **North Carolina**: Imposed 5% sales tax on “direct-to-home satellite service” but not on cable TV.
  - Wake County Superior Court upheld equal protection and uniformity challenges from DirecTV and EchoStar in *DirecTV v. North Carolina* (one-page opinion).
  - Definition of direct-to-home service appears too narrow to include satellite radio (“programming transmitted or broadcast by satellite directly to the subscribers’ premises without the use of ground equipment or distribution equipment, except equipment at the subscribers’ premises or the uplink process to the satellite”).
- **Kentucky**: Imposed separate 3% tax on “multichannel video programming services” eff. 1/1/06
  - Defined as “cable service and satellite broadcast and wireless cable service,” but is the definition sufficiently broad to include satellite radio (not a video programming service)?
  - Satellite TV providers filed suit to invalidate the new statute in May 2005, claiming that cable providers have effectively been exempted from the tax as they will no longer pay local franchise fees.
- **Virginia**: Separate 5% communications tax rejected by the 2004 & 2005 legislative sessions.
  - Would have included telecommunications, paging, cable TV, satellite TV, and most any other one- or two-way communications service (broad definition along the lines of Texas and other states).

Encouraging the Growth of New Age Industries

Most thought has centered around

- whether digitized products will be taxed the same as their tangible equivalents

**But what about the production side of the issue?**

- Will states encourage the production of digitized products the same way they currently encourage the production of their tangible equivalents?
- Questions might include:
  - Where a manufacturing exemption is currently extended to a book publisher for printing presses and other production equipment, will the same exemption be extended to equipment dedicated to disseminating online books?
  - Dito for a newspaper publisher that publishes an online version of its daily newspaper?
  - Will exemptions designed to encourage filmmaking be extended to films or programming created specifically for dissemination over the internet?
  - If a state extends production-related exemptions to other forms of media, e.g., newspaper publishers, broadcasters, cable TV systems, etc., should it also extend an exemption for internet service providers and other “new media” outlets that may emerge?

**Food for thought …**

- States have long encouraged investment in certain industries through their tax codes
- Why not do the same with today’s emerging industries?
Some Best Practices

Internet service provider backbone equipment:
- Virginia has historically provided exemptions to cover the equipment costs of media and communications companies, including radio and television broadcasters, cable TV systems, newspaper publishers, and telecommunications companies (although the latter exemption was repealed in 2004).
- In 1999, Virginia went to the next step by providing an exemption to certain internet service providers to encourage the location of backbone facilities in the state.
- Connecticut and New York followed Virginia’s lead, but with exemptions that apply to any ISP.
- Ohio provides a refund of 25% of the tax paid on equipment used to provide “electronic information services.”

Software manufacturing:
- Massachusetts Gov. Mitt Romney’s budget would eliminate exemptions for digital software downloads and load and leave transactions.
- But at the same time, the legislation provides that the development and sale of software in any form constitutes a manufacturing activity, such that software companies will not lose any of the benefits afforded to manufacturers under Massachusetts law.

Computers used by high tech businesses:
- Georgia exemption for computer equipment used by high tech businesses; exemption applies if > $15 million in hardware/software is purchased or leased during the year.

And Some Other Findings …

Online newspapers:
- Virginia provides a manufacturing exemption to newspaper publishers, including publishers of free publications.
- But P.D. 00-33 denied the exemption for equipment used by a publisher of a daily newspaper to produce an online version of its traditional newsprint-based product.

Online films:
- Virginia provides an exemption for the production of all manner of audio or video works for commercial exhibition.
- But P.D. 03-2 denied the exemption for equipment and supplies used to produce audiovisual works for dissemination through the internet only.

Object lesson …
- Current statutes may constrain states from providing production-type exemptions for digital products.
- But to compete for economic development in the 21st Century, states must begin to think more about these issues and adapt their tax policies accordingly.
Questions and Answers

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