REQUEST LETTER

04-008

NAME
ADDRESS
PHONE
FAX

Ruling Request: COMPANY 1

We are requesting a ruling on behalf of the COMPANY 1 and COMPANY 2 in relation to charges of software consulting services. COMPANY 1 has issued a Power of Attorney allowing me to represent them on sales tax matters.

Facts:

COMPANY licenses its principal information systems software from COMPANY 2, a software developer located outside the State. In accordance with the original contract, the Taxpayer pays an annual licensing/maintenance fee to COMPANY 2 for continued use of the "COMPANY 2 software." This fee entitles the Taxpayer to software upgrades, when available, and error corrections, and the use of the software. COMPANY 2 has historically treated its software as canned software, and continues to presume that this treatment is correct. Accordingly, COMPANY 2 has collected sales tax on all license fees from the Taxpayer.

In addition, the Taxpayer has entered into separate consultation agreements wherein employees of COMPANY 2 perform additional consultation services on behalf of the Taxpayer. The two separate consultation agreements for which the Taxpayer requests guidance are as followers:

1. COMPANY 2 employees are occasionally engaged to travel to the Taxpayer premises to assist in implementing and customizing the COMPANY 2 software on the servers of Bank of Utah, under terms that are separately negotiated from the original COMPANY 2 software licensing agreement.
2. The Taxpayer participates in a "best practices" group with other participating COMPANY 2 customers. Under this arrangement, all participants shared their results and best practices with COMPANY 2. Under the COMPANY 2 employees travel to the Taxpayer's premises to meet with Taxpayer employees, compare the Taxpayer's practices with the best practices of other participants, and assist the Taxpayer in implementing certain best practices. The essence of this service was education and consultation, and did not entail any modification, implementation or customization of the COMPANY 2 software resident on the Taxpayer's information systems.

Issue:

Are either of the two consultation charges summarized above subject to Utah sales tax?

Preliminary conclusion:

R865-19S-92 contains the Tax Commission's authoritative interpretation on determining when charges for computer software and related services are subject to sales tax. While consultation charges "in connection with a sale or lease" or "maintenance" are taxable, the two consultation services described above charges are not taxable [emphasis added]:

> B. The sale, rental or lease of canned or prewritten computer software constitutes a sale of tangible personal property and is subject to the sales or use tax regardless of the form in which the software is purchased or transferred. Payments under a license agreement are taxable as a lease or rental of the software package. Charges for software maintenance, consultation in connection with a sale or lease, enhancements, or upgrading of canned or prewritten software are taxable.
>
> D. Charges for services to modify or adapt canned computer software or pre-written computer software to a purchaser's needs or equipment are not taxable if the charges are separately stated and identified.

Many published Request letters and Tax Commission opinions have been in accord with this conclusion, but have failed to clearly explain the Tax Commission's interpretation. (Tax Commission Advisory Opinion, 96063, March 26, 1996; Private Letter Ruling, Opinion No 99-023, Private Letter Ruling 96-150, Private Letter Ruling 95-036, Private Letter Ruling 97-062) However, Private Letter Ruling 01-030 appears to be the most direct and recent guidance on this matter:

> As previously discussed, customizing software to a customer's working environment without altering its underlying functional operation does not change canned computer software into custom software. Nevertheless, any charges to perform such "customization" services are nontaxable if stated separately from taxable charges. Should such charges be combined with taxable charges, however, the entire charge is taxable. ****For consulting services involving the "design and development" of websites, we assume that such services relate only to an individual client; i.e., that the computer code written to design and develop a specific customer's website is unique. In this case, such design and development services would be considered the 'creation' of custom computer software, the sale of which under Rule 92 is nontaxable.

We respectfully request that the Tax Commission confirm this preliminary conclusion, or alternatively explain why this legal conclusion is incorrect or incomplete. Please do not hesitate to call me with any questions.

Sincerely,

NAME

RESPONSE LETTER

December 2, 2005

NAME
ADDRESS

Re: Private Letter Ruling Request for Consultation Charges related to Computer Software

Dear NAME,

We received your request regarding sales tax issues related to software sold and serviced by your client, the COMPANY 1. Your client licenses its principal information systems software from a software developer, COMPANY 2 You represented that there are separate agreements, two of which are the subject of your request. The original contract provides for an annual licensing/maintenance fee for continued use of the "COMPANY 2 software." It also allows for software upgrades and error corrections. You stated that you have historically treated this software as "canned software," and accordingly collected appropriate sales tax. Our analysis in this letter is based on the assumption that the facts as you describe are correct. That is, that agreement for software upgrades, error corrections, and the use of the software is taxable as a sale or lease of tangible personal property.

The other two contracts or "consultation agreements," which are the subject of the ruling are presented as follows:

Under the first consultation agreement, you said COMPANY 2 employees are engaged in travel to taxpayers' premises in order "to assist in implementing and customizing" your software under a separate agreement from the original COMPANY 2 licensing agreement.

Regarding the second agreement, you said COMPANY 2 employees travel to taxpayers' premises to share information from a "best practices" group, and assist taxpayers in implementing these practices. You characterized this as "education and consultation." You said it entailed no modification, implementation, or customization of the COMPANY 2 software

You asked if "consultation charges" for these activities would be subject to sales tax. You cited subsections B and D of R865-19S-92. You preliminarily concluded that charges for the "consultation services" would not be taxable.

Changes in the Law

Before beginning our analysis of the two agreements under consideration for this ruling we will review recent changes to the Administrative Rule you have cited as the basis for your position, as well as associated changes in the statute. Although these changes will not affect the outcome or our decision, we thought it might be helpful to clarify these. Administrative Rule R865-19S ("Rule 92"), which you cited, currently states in paragraph (B):

> The sale, rental or lease of prewritten computer software constitutes a sale of tangible personal property and is subject to the sales or use tax regardless of the form in which the software is purchased or transferred.

This change was effective on June 29, 2004. Paragraph(B) previously stated:

> The sale, rental or lease of canned or prewritten computer software constitutes a sale of tangible personal property and is subject to the sales or use tax regardless of the form in which the software is purchased or transferred. Payments under a license agreement are taxable as a lease or rental of the software package. Charges for software maintenance, consultation in connection with a sale or lease, enhancements, or upgrading of canned or prewritten software are taxable.

You also cited paragraph (D), which previously stated:

> Charges for services to modify or adapt canned computer software or prewritten computer software to a purchaser's needs or equipment are not taxable if the charges are separately stated and identified.

The current version now states:

> The sale of computer generated output is subject to the sales or use tax if the primary object of the sale is the output and not the services rendered in producing the output.

The earlier versions of the Rule apply only to transactions that took place prior to the change, effective DATE. They are no longer applicable with respect to modifications, enhancements, etc., to canned or prewritten software. The exemption for modifying or enhancing prewritten software to a purchaser's needs is now found in 59-12-102-54(c). It states that '"prewritten computer software" does not include a modification or enhancement … if the charges for the modification or enhancement are reasonable and separately stated on the invoice.'

The Agreements

To determine if the services provided pursuant to the other consultation agreements are taxable, we first look to see whether they are connected to the sale or lease in the first agreement. Second, we look to see if the separate agreements include any taxable activities.

If the first and second agreements are arms-length agreements negotiated separately from the original contract, and the services provided under them could be obtained from other providers, both could be viewed as not connected to the sale or lease. Other factors we would consider are the timing of the other contracts and the degree to which the services provided are interconnected with the original contract and sale of the software.

For example, if the agreements are negotiated at roughly the same time as the original contract, which is for the sale or lease of the software, it is possible that they may be connected to the sale or lease of the software. More specifically, if the purchaser signing the original contract would not do so without the services provided under the first and second consulting agreements, the services provided under those agreements would be taxable.

First Agreement

You indicate the first agreement is for implementing the software sold in the original contract as well as for customizing that software for your client. Given that understanding, it would seem that the first agreement is connected to sale of taxable tangible personal property under the original contract, and is therefore taxable with respect to any implementation of software. Sec. 59-12-102(54), which defines prewritten software, does not exclude "implementation," while "modifications and "enhancements" are excluded under certain conditions. In addition, it appears that unless any non-taxable customization work is separately stated from the implementation, the agreement would be taxable in full.

We assume that the original COMPANY 2 licensing contract and the subsequent agreement, under which assistance in implementing and customizing the software are provided, distinguish the nature and types of work to be done. It must be clear that the work done to assist in implementing and customizing the software is work done to solely to modify or adapt the software to the customer's needs and equipment. Neither modification nor adaptation to a customer's needs or equipment is subject to sales tax. This must be identified as separate from the purchase of the software. However, if what is done is "maintenance, consultation in connection with a sale or lease, enhancements, or upgrading of canned or prewritten software," charges for the "consultation" would be subject to sales tax.

Again, in the case of your client's contract, in the absence of additional information, it appears COMPANY 2 may be providing two separate and distinct services under the first agreement. The first is to "implement" the software, and appears to be a taxable transaction. The second service is for customizing the software. If this is in fact the case, these services are not taxable, if the specific customization services are separately stated and identified on the invoice. Otherwise, they would be subject to tax as part of the entire transaction.

Second Agreement

With respect to this question, consultation regarding best practices would not be subject to tax, provided what is done is educating customers on how to achieve the best use of the software, as you indicated in your letter. From your description, this appears to be a separate and distinct agreement from the original contract. However, if this service is included as part of the original sale, it is subject to sales tax.

Conclusion

In summary, the first consultation agreement appears to consist of two services. One, implementation of software, appears to be taxable; while the other, customizing the software, is not. However, the charges for the customization service must be reasonable, and separately stated and identified on an invoice or other statement of price. Otherwise, the entire contract is subject to sales tax.

The second agreement appears to be solely for educational and consulting services, and does not relate to installing, upgrading, or providing enhancements to pre-written software. As such, this contract is not subject to sales tax.

The conclusions stated in this letter ruling are based on facts and circumstances as you have described to us. Should actual facts and circumstances be different from those you have indicated, or should they change, the outcome of our ruling may change as well.

For the Commission,

Marc B. Johnson
Commissioner

MBJ/SR
04-008