



# State & Local Tax **Alert**

Breaking state and local tax developments from Grant Thornton LLP

## Massachusetts Department of Revenue Rules Web-Based Services Are Taxable As Prewritten Software

On November 9, the Massachusetts Department of Revenue held that a taxpayer's sale of a Web-based portal and its components to Massachusetts customers was subject to the Massachusetts sales and use tax.<sup>1</sup> The Department reasoned that the portal and components were provided for a single subscription fee, and that the true object of the transaction was the sale of taxable prewritten software, despite the fact that the taxpayer may have provided some nontaxable services along with access to its Web-based solution.

### Background

The taxpayer (Company), an out-of-state Internet-based marketing and customer-communications solutions developer, had sales and use tax nexus in Massachusetts due to its employment of an individual in the state, and the physical presence of its traveling sales representatives within the state. The Company's product allowed service-industry businesses, such as medical offices and spas, to communicate with their patients or customers and track results via the Internet. Under the contract between the Company and a client, the Company provided a non-exclusive software license and other offerings chosen by the client for a one-time set-up fee and a monthly-based subscription fee.

The Company's Internet-based offerings included the following components, all of which were included in the subscription price:

1. **Platform:** Clients were provided with a non-exclusive right to access a Web-based portal (Platform) hosted on the Company's servers. The Platform permitted clients to communicate with their customers automatically via e-mail, text and postcard.<sup>2</sup> The Platform integrated with a client's customer management software via a plug-in application, which served as a portal through which the Company extracted the client's customer information.

A client had the option of modifying the parameters of the automated communications based on its personal preferences and could view customer

<sup>1</sup> *Letter Ruling 12-13*, Massachusetts Department of Revenue, Nov. 9, 2012.

<sup>2</sup> These automated communications consisted of appointment reminders, thank you notes, "customer-review" communications, "continuing care" communications for the scheduling of future appointments, and "promotional" communications (i.e. coupons).

#### Release date

November 30, 2012

#### States

Massachusetts

#### Issue/Topic

Sales and Use Tax

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reviews from the Platform. Moreover, if the client chose to utilize a service offering that allowed its customers to post reviews directly to public Web sites, then the client was entitled to support services at no extra charge. For example, the client could have requested the removal of certain customer reviews and depending on the circumstance and set protocols, the Company would have complied with such requests.

2. **Webfeed:** As an optional add-on component to the Platform, the Company would assist with the management and maintenance of a client's on-line business profile. The Company would regularly submit an up-to-date profile to third party "Profile Managers" (i.e. an Internet search engine) and pay a fee to enhance the client's visibility in the marketplace.
3. **"Connect for Websites":** This feature allowed clients to integrate portions of the Platform with their own Web sites. For instance, through Connect for Websites, a client could feature client reviews as well as promotional offers directly on its Web site or Facebook page, and permit customers to book appointments directly through its Web site.
4. **"Connect for Facebook":** This add-on allowed clients to link the Platform to their Facebook pages. Clients could allow customers to schedule appointments, post reviews or access promotional offers through their Facebook page.
5. **Mobile:** Through the Mobile offering, clients could access the Platform and component services from smartphone Web browsers. No applications were required to be downloaded onto a client's smartphone. Rather, the access was provided through the Company's Web site.

The Company requested a letter ruling, inquiring about the proper Massachusetts sales tax treatment of its Web-based services.

### **Taxable Transfer of Software**

The Department held that the Web services sold to Massachusetts subscribers were taxable, pursuant to the Department's regulations, as sales of "prewritten computer software, regardless of the method of delivery."<sup>3</sup>

In determining that the services were taxable, the Department discussed the general rules with respect to varying types of sales of prewritten software. First, when such software is accessed on the seller's server, it is generally taxable.<sup>4</sup> However, where the object of the transaction is the acquisition of a good or service and there is no separate charge for use of the software sold in conjunction with the good or service, tax on the software generally does not apply.<sup>5</sup> In addition, while it is possible that the object of a transaction where a

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<sup>3</sup> MASS. REGS. CODE tit. 830, § 64H.1.3.

<sup>4</sup> The regulations state that the sales, "licenses and leases, transfers of rights to use [prewritten] software installed on a remote server" are taxable. MASS. REGS. CODE tit. 830, § 64H.1.3(a).

<sup>5</sup> MASS. REGS. CODE tit. 830, § 64H.1.3(14)(a); *Letter Ruling 10-1*, Massachusetts Department of Revenue, Feb. 22, 2010.

non-taxable service is bundled together with the use of software can be deemed the non-taxable service, and not the software,<sup>6</sup> in most cases, the sale of software, used for business management and operating “on an almost entirely automated basis,” is taxable.

The Department noted that the language of the regulations and the Company’s own service agreement showed that the Company’s Web-based platform and components were taxable. According to the regulations, the sale of a license or right to use software on a server hosted by the taxpayer such as the Company is generally taxable. The service agreement indicated that the customer received a non-exclusive right or license to use the Company’s software, and also indicated that such transactions are subject to Massachusetts sales tax. Nonetheless, the Department proceeded to analyze the taxability of each of the Company’s service offerings as described above.

First, the Department stated that it treats the Platform, when sold and operated via the default parameters on an automated basis, as a taxable sale of prewritten software. In addition, even when a client manipulated the Platform to accommodate personal preferences, the use of the software was taxable. Thus, in either scenario, the Platform was subject to sales tax.

The Department determined that the other components were also taxable. With respect to the Webfeed, the Department acknowledged that there may have been some exempt personal services provided in conjunction with the Webfeed (i.e. submitting profile information to third parties). Still, these personal services constituted an inconsequential part of the taxable sale of software. Moreover, the “Connect for Websites” and “Connect for Facebook” programs were taxable because they provided clients with access and control over the Company’s integrative software by integrating elements of the Platform directly to the client’s Web sites or Facebook pages. Finally, Mobile constituted a taxable transfer of a right to use software, as the Department recently ruled that software enabling access from a remote location or handheld device is taxable.<sup>7</sup>

Applying the true object test, the Department found that the facts supported its conclusion that the Company’s offerings, under one bundled subscription price, constituted the sale of taxable software, rather than non-taxable services. The Department gave weight to the fact that the solution’s automated functionality allowed clients to utilize the solution with very little need to tap into the services of the Company’s personnel, and the fact that the transaction was structured as the license to use software.

### **Commentary**

This ruling is consistent with the Department’s position with respect to other sales of software as a service (SaaS).<sup>8</sup> The Department applies the true object test to determine the essence of a bundled transaction. If the true object of the transaction is to obtain access

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<sup>6</sup> In *Letter Ruling 12-5*, Massachusetts Department of Revenue, May 2, 2012, the Department ruled that office management software used by physicians was inconsequential when bundled with substantial non-taxable services provided by the taxpayer.

<sup>7</sup> *Letter Ruling 12-11*, Massachusetts Department of Revenue, Sept. 25, 2012.

<sup>8</sup> *Letter Ruling 11-2*, Massachusetts Department of Revenue, March 4, 2011.

to and use the software, then the transaction is deemed a taxable sale of software, even if some services are provided to the customer along with the access to the software.

Massachusetts follows a trend of states extending their reach to Web-based services within the existing framework of their existing tax statutory schemes. Like Utah<sup>9</sup> and most recently, New Mexico,<sup>10</sup> Massachusetts has taken this stance via letter rulings and not through new legislation or an explicit change in current law. Merely classifying all of the above Web-based services as taxable “prewritten software,” as Massachusetts appears to have done in this letter ruling, sets the stage for the state to implement a one-size-fits-all approach with respect to the treatment of Web-based services, whether provided in isolation or as part of a larger software offering. This answer clearly is not desired by vendors that continue to grapple with varying treatments and approaches by states. The apparent broadening of the definition of prewritten software to these types of services is problematic, particularly when such result is not explicitly supported by the underlying sales tax statutes.

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<sup>9</sup> For more information, see [GT SALT Alert: Utah Tax Commission Rules Web-Based Services Constitute Taxable Tangible Property](#), April 6, 2012.

<sup>10</sup> For more information, see [GT SALT Alert: New Mexico Rules Web-Based Services Constitute Licensing Property Subject to Gross Receipts Tax](#), Nov. 15, 2012.