States Seek to Broaden Sales and Use Taxation of Computer Software

Possessing characteristics of both tangible and intangible property, as well as services, computer software is the subject of much litigation in the sales and use tax area. There have been many successful arguments for exemption, however.

By Nancy S. Rendleman and Charles B. Neely, Jr.

When IBM decided in 1969 to sell computer software separately from hardware, many state and local tax authorities faced a loss of revenue arising from their inability to impose a sales and use tax on the software. While the combined price of the software and hardware previously sold together was subject to tax, in most jurisdictions software was considered either intangible property or personal services and generally was exempt.

Shrinking Federal support for state and local programs and rising budgetary demands have forced local tax authorities to seek additional sources of revenue. In addition, the rapidly growing software industry was subject to a lesser tax burden than that carried by more traditional industries. These factors have prompted state and local tax authorities to attempt to include software under sales and use tax statutes.

Many states do not specifically identify computer software as either subject to or exempt from sales and use taxes. These states generally tax tangible personal property and exempt intangible property. Here, the tax practitioner must determine whether software is tangible or intangible personal property, or whether it is classified as services. As a service, software may be exempt from sales and use tax even in jurisdictions that tax both tangible and intangible property.

Some states have enacted statutes that expressly include or exclude certain types of computer software from sales and use taxation. Most of these states generally impose a sales and use tax on "canned" but not on "custom" software. Again, it is necessary to determine the qualifications for each category.

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SOFTWARE CLASSIFICATION SCHEMES

The taxation of software often depends on where it falls within a particular classification scheme. Computer software has generally been classified with reference to whether it is:

1. Canned or custom software.
2. Operational or applications software.
3. Tangible or intangible property or services.

The three classification schemes are not mutually exclusive. The canned/custom software class is the primary means used by legislatures to define software for inclusion or exclusion from sales and use taxation.

The method that distinguishes operational and applications software is used in a few states that already have classified software as either canned or custom. In these states, all operational software is subject to sales and use tax whether it is canned or custom, whereas sales of applications software are taxable only if the software is canned.

Tangibility or intangibility of software generally is a question of statutory construction that occurs when the statute (1) does not specifically address taxation of software, or (2) does not adequately

differentiate between canned and custom software and the state interprets the ambiguity in favor of taxing the software. If the taxpayer challenges the taxing authority's interpretation of a statute that exempts custom software, courts generally look at the tangible or intangible nature of the software.

Six states do not impose a sales and use tax on computer software, because either software is exempt or there is no state sales and use tax.[1]

Canned vs. Custom Software

In 28 states, computer software is classified as either canned ("off-the-shelf") or custom to determine taxability.[2] Generally, canned software is subject to sales and use tax and custom software is exempt.

Canned software. Canned software is more like tangible property that has always been included in the tax base. It generally is bought "off-the-shelf" from a retailer as a mass-manufactured product sold in a sealed box. Although various purchasers will use the same software for many different tasks, and the abilities of the purchasers are varied, the software sold to every customer is identical.

It is easy to determine the taxable value of canned software based on the sales price. Common examples of canned software include WordPerfect and IBM DOS, as well as the games designed for the Nintendo Entertainment System.

Custom software. Custom software is more like a service than it is tangible property. It usually is designed for one user. At the purchaser's request, an individual or a consulting team designs a unique program to meet the specific needs of that person. Whereas the purchaser of canned software buys a prepackaged product from a retailer, the custom software purchaser buys the knowledge and design services of the computer programmers. States commonly describe the purchase of knowledge and design services as either a service or an item of intangible personal property, neither of which generally is subject to sales and use tax.

It is not as easy to determine the taxable value of custom software. Although the purchase[3] of canned software gives the user the right to use the program in one computer, and the software manufacturer provides negligible additional support, the purchase of custom software generally includes much more. Research and development and administrative overhead costs are incurred in the design and manufacture of both canned and custom software. These costs are spread over every copy of a canned program and do not significantly affect the taxable value of each individual package. A custom program, however, is designed for one end-user. Should the taxable value of one custom software program include all the costs of research, development, and administration?

The purchase of custom software may also include on-site modifications by the consulting team, training of the purchaser's employees, and ongoing maintenance. These additional costs and features make valuing the product portion of custom software even more difficult.

Variations among the states. Of the 28 states that impose a tax on canned and exempt custom software, approximately half explicitly define those terms in their sales and use tax statutes.

For example, New York exempts certain "[c]omputer software designed and developed by the author or creator to the specifications of a specific purchaser . . . but in no case including computer software which is pre-written."[4] This is fairly typical of the statutes that specifically address computer software. It defines custom software that is exempt from sales and use tax, and expressly states that pre-written, or canned, software does not qualify for the exemption.

Even when a state specifically defines software, a particular software program still may be difficult to classify. Many states, such as New York, define what might be called the "true" custom program and "true" canned program. The statutes do not, however, generally address the issue of modifications to canned software or the resale of a custom program to another user.

Many software programs are neither truly custom nor canned. Between the two ends of the spectrum lies "semi-custom" software. For example, a consulting team may find that instead of designing software from scratch for a purchaser, modifying a canned program that is already commercially available would be more effective and cheaper. With permission from the licensor of the canned software, the consultants modify the program to meet the specific needs of the purchaser. Here, the question is how much modification to the commercially available canned program is necessary before it will be classi-

[1] Alabama exempts software. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales and use tax. *Computer Law*, Vol. 1, ¶12,220 (CCH, 1992).

[2] Arizona, California, Colorado, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Rhode Island, Utah, Vermont, Virginia, Washington, and Wisconsin. *Id.*, at ¶12,200.

[3] Technically speaking, software is rarely "purchased," despite the common use of that term. Rather, software is licensed to the customer, allowing the customer the limited right to use the software on one computer and perhaps to make one backup copy in the event there is a problem with the original. These licenses usually run for an indefinite period. Nevertheless, courts have held these transactions to be sales. Furthermore, many state statutes broadly define "sale" to include licenses and, under the few statutes that do not, the software still is subject to a use tax. Thus, licenses for use subject to the terms of the licensor generally are sales for purposes of sales and use tax.

[4] N.Y. Tax Law §1115.

fied as custom. In some situations, the modifications necessary to meet the definition of custom computer software may be slight.[5]

California statutes, which also tax canned but exempt custom software, specifically address modifications to canned programs. Under California law, a custom computer program is one prepared in accordance with the customer's special order 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." It does not include a canned or pre-written program that "is held or existing for general or repeated sale or lease," even if the program was initially developed on a custom basis or for in-house use. In addition, a modification to an existing prewritten program to meet the customer's needs "is custom computer programming only to the extent of the modification."[6]

Most state statutes do not address modifications of canned software. Those states generally agree, however, that modifications of software are programming services and therefore not taxable.[7] The issue is whether the modification of a canned program creates an entirely new custom program exempt from taxation. The states that address the question limit the sales and use tax exemption to the extent of the modification.

Where a state statute addresses the resale of a custom software program, the intent is to ensure that the resale is subject to a sales and use tax. For example, California treats a resale of customized software as a taxable sale of a canned program.[8] The rationale is that the program was customized for the first buyer and not for the second. Thus, the second buyer purchased a canned program that is subject to sales and use tax.

Of the 16 states that impose a sales and use tax on both custom and canned computer software,[9] the statutes of most appear to explicitly define software to include both.

For instance, Texas defines a computer program as "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."[10]

Operational vs. Applications Software

In a few states, statutes and courts have distinguished between operational and applications programs. Operational programs are the basic instructions that tell a computer how to function. A familiar example is the DOS program used in IBM personal computers.

Applications programs are designed to solve specific problems or to make certain types of work easier. WordPerfect is an applications program that enables a computer to operate as a word processor. Lotus 1-2-3 and Microsoft Excel enable the computer operator to quickly and accurately create spreadsheets for financial calculations.

Distinctions between operational and applications programs are made for the purpose of taxing the operational programs, even if they are custom programs normally exempted by the state. Courts that differentiate software in this manner generally find operational software to be taxable as an integral part of the hardware, necessary to make the computer work properly. Applications software has been

5 One commentator noted that "[s]ituations like that found in Maccabees v. Treasury Dept., 122 Mich. App. 660, 332 N.W.2d 561 (1983), illustrate the folly of the judicial distinction between canned and custom software. It is too easy to avoid the taxable status of a transaction. The user could purchase a blank diskette and pay a fee for the right to transfer the program to the blank disk. Thus, the user can avoid purchasing a tangible asset that could be subject to tax, while still obtaining the desired program. Furthermore, the program in Maccabees was developed prior to the sale and then modified for the taxpayer. How much modification is needed to convert a canned program into a customized program? Clearly, this canned-or-custom distinction is unworkable in practice." Raabe, "Property, Sales and Use Taxation of Custom and 'Canned' Computer Software: Emerging Judicial Guidelines," 36 Tax Exec. 227 (1984).

6 Cal. Rev. & Tax Code §6010.9.

7 Hoffman, "Software and State Sales/Use Taxes—A Current Look at 47 States and the District of Columbia," 3 Computer L. Rep. 703 (1985).

8 See note 6, *supra*.

9 Arkansas, Connecticut, Georgia, Hawaii, Maine, Mississippi, Nebraska, New Mexico, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, West Virginia, and Wyoming. The District of Columbia also imposes such a tax. *Computer Law*, *supra* note 1, at ¶12,220.

10 Tex. Tax Code Ann. §151.0031 (West Supp. 1992).

11 See, e.g., Compuserve, Inc. v. Lindley, 41 Ohio App. 3d 260, 535 N.E.2d 360 (1987); In re Protest of Strayer, 239 Kan. 136, 716 P.2d 588 (1986).

12 Cal. Rev. & Tax. Code §6010.9.

13 N.C. Gen. Stat. §105-164.3 (1989).

14 Mass. Gen. Laws Ann. Ch. 64H, §1 (West 1988 & Supp. 1991).

15 See Maccabees v. Treasury Dept., *supra* note 5; James v. Tres Computer System, Inc., 642 S.W.2d 347 (Mo., 1982); First Nat'l Bank of Springfield v. Dept. of Revenue, 85 Ill.2d 84, 421 N.E.2d 175 (1981); First Nat'l Bank of Fort Worth v. Bullock, 584 S.W.2d 548 (Tex. Civ. App., 1979); Honeywell Information System v. Maricopa County, 118 Ariz. 171, 575 P.2d 801 (1978); State v. Central Computer Services, Inc., 349 So.2d 1160 (Ala., 1977); Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn., 1976); Greyhound Computer Corp. v. State Dept. of Assessments and Tax'n, 271 Md. 674, 320 A.2d 52 (1974); District of Columbia v. Universal Computer Associates, Inc., 465 F.2d 615 (1972).

16 Texas and Tennessee statutes were amended to expressly tax both custom and canned software in response to early cases that held software to be intangible (First Nat'l Bank of Fort Worth v. Bullock and Commerce Union Bank v. Tidwell, *supra*). The Illinois statute was amended to expressly tax canned software following a similar decision in First Nat'l Bank of Springfield v. Dept. of Revenue, *supra*.

found not taxable because it is not necessary to the basic operations of the computer. Rather, it is an aid to help the operator use the computer more efficiently and effectively.[11]

The California statute, which as noted above generally taxes canned and exempts custom software, states that for sales and use tax purposes the sale and purchase of computer software does "not include the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program, *other than a basic operational program*" (emphasis added).[12]

Although North Carolina excludes most custom software from its definition of taxable tangible personal property, it explicitly retains operational programs in the definition. "The term [tangible personal property] does not include the design, development, writing, translation, fabrication, lease, license to use or consume, or transfer for a consideration of title or possession of a custom computer program, *other than a basic operational program*" (emphasis added).[13]

Tangible vs. Intangible Property vs. Services

Most states impose a sales and use tax only on sales of tangible personal property, exempting sales of intangible property. If software is not specifically addressed in the sales and use tax statute of such a state, the courts are left to determine its classification. This applies whether the state attempts to tax only canned software or both canned and custom programs.

The statutes that do not explicitly define computer software tend to rely on the general definition of tangible personal property. The Massachusetts statute is a typical example. Tangible personal property is "personal property of any nature consisting of any produce, goods, wares, merchandise and commodities whatsoever, brought into, produced, manufactured or being within the commonwealth, but shall not include rights and credits, insurance policies, bills of exchange, stocks and bonds and similar evidence of indebtedness or ownership."[14]

The effect of these general definitions, which do not specifically include or exclude computer software programs, is to defer the final determination of taxability to the courts. As noted below, court decisions in this area have been split.

LITIGATION

Until 1983, courts routinely held that both canned and custom software were intangible property.[15] As a result of these decisions, many states revised their sales and use tax statutes to expressly include computer software.[16] In 1983 and 1984, four cases reversed the trend, holding that software was tangible personal property subject to taxation.[17]

Since 1984, there has been no consistency in the holdings. Some courts continue to hold that computer software is intangible.[18] Others hold that software is tangible.[19] Still other courts hold that custom software is intangible but canned is tangible.[20] Finally, some courts hold that operational software is tangible and applications software is intangible.[21]

Courts have developed three tests for determining whether software is tangible or intangible.

Knowledge rationale test. Courts that applied the knowledge rationale test have determined that software is merely a means to pass data from the originator to the user.

In *Commerce Union Bank v. Tidwell*,[22] the Supreme Court of Tennessee held that computer software sold to a bank was not tangible property because what the bank actually purchased was the knowledge stored on tapes and cards.

When that case was decided, Tennessee did not expressly include or exclude computer software in its sales and use tax statute. The statute's definition of tangible personal property was identical to the definition still used in many states, *i.e.*, "personal property, which may be seen, weighed, measured, felt, or touched, or in any other manner perceptible to the senses."[23]

The court rejected the Commissioner of Revenue's argument that the purchase of the punch cards and tapes created a purchase of tangible property. The court noted that "[o]nce this information has been translated and introduced into the computer, and the tapes are returned or the punch cards destroyed, what actually remains in the computer is intangible knowledge; this is what was purchased, not the magnetic tapes or the punch cards." Accordingly, because information is intangible property, the sale was not subject to tax.[24]

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17 University Computing Co. v. Olsen, 677 S.W.2d 445 (Tenn., 1984); Citizens & Southern Systems, Inc. v. South Carolina Tax Comm'n, 280 S.Car. 138, 311 S.E.2d 717 (1984); Chittenden Trust Co. v. King, 143 Vt. 271, 465 A.2d 1100 (1983); Comptroller of the Treasury v. Equitable Trust Co., 464 A.2d 248 (Md., 1983).

18 Northeast Datacom v. City of Wallingford, 212 Conn. 639, 563 A.2d 688 (1989); Appeal of AT&T Technologies, Inc., 242 Kan. 554, 749 P.2d 1033 (1988); General Business Systems, Inc. v. State Tax Assessor, 162 Cal. App. 3d 50 (1984).

19 International Business Machines Corp. v. Dir. of Revenue, State of Missouri, 765 S.W.2d 611 (Mo., 1989); Pennsylvania and West Virginia Supply Corp. v. Rose, 179 W.Va. 317, 368 S.E.2d 101 (1988); Creasy Consultants, Inc. v. Olsen, 716 S.W.2d 35 (Tenn., 1986); Harbro Industries, Inc. v. Norberg, 487 A.2d 124 (R.I., 1985).

20 Bridge Data Co. v. Dir. of Revenue, 794 S.W.2d 204 (Mo., 1990); Measurex Systems, Inc. v. State Tax Assessor, 490 A.2d 1192 (Me., 1985).

21 See *supra*, note 11.

22 538 S.W.2d 405 (Tenn., 1976).

23 Tenn. Code. Ann. §67-3002(l).

24 See also District of Columbia v. Universal Computer Associates, Inc., 465 F.2d 615 (CA-D.C., 1972) (court found that "the material of the punched cards themselves is of insignificant value. It was for the intangible value of the information stored on the cards that Universal paid IBM.").

Essence of the transaction test. The essence of the transaction test also looks at what the buyer of information intended to purchase, without regard to the peripheral instruction manuals, tapes, or diskettes.

In *First National Bank of Fort Worth v. Bullock*,[25] the court held the sale of computer software was exempt from taxation because the object or essence of the transaction was "instructions which enabled [the bank's] computer to perform deposit and lending functions and process general accounting." The court rejected the state's contention that the service characteristics that made the software intangible apply only to custom software. The court stated "[t]he test in each case is not whether the product is 'customized' or 'canned,' but whether the object of the sale is tangible personal property. . . . We hold the essence of the transaction was not the four computer tapes, but, instead, the purchase of the computer process, an intangible."

The knowledge rationale and essence of the transaction tests do not depend on the type of software involved. If a court accepts these tests, a compelling argument may be made that the buyer of a WordPerfect software program is just as interested as the buyer of a custom program in purchasing the knowledge of the programmer.

Some courts have determined that software is intellectual services and not property.[26] If the consumer bought the programmer's help in solving a particular problem, and not a product, the computer software would not be subject to tax. Those cases where courts have found the essence of the transaction to be intellectual services,[27] however, involved custom software, based on the rationale that it is only with custom software that a personal service was performed. For canned software, courts are likely to hold that the purchase of a product, and not the purchase of intellectual services, was the essence of the transaction.[28]

Modes of transmission test. The tangible nature of the diskettes and instruction manuals accompanying a sale of software usually are not a factor used by the courts to determine whether computer software is tangible or intangible personal property.[29] A few courts, however, have decided that regardless of the way in which the software *could have* been transferred from the originator to the purchaser, the manner in which it *was* transferred does bear on the determination of intangibility.[30]

Analysis of Judicial Arguments

Analogies to other products. When the taxability of software is in dispute, the taxing authority may argue that a purchaser interested only in the information stored on a diskette is no different from the purchaser of a book, movie, or record who is interested only in the words on the pages, the pictures on the film, or the music in the record grooves. Since the sale of a book, movie, or record is taxable, the argument would continue, the sale or licensing of software also should be taxable as tangible personal property.

Taxpayers have argued that computer software is not analogous

25 *584 S.W.2d 548 (Tex. Cir. App.*, 1979).

26 See, e.g., Greyhound Computer Corp. v. State Dept. of Assessments & Tax'n, 271 Md. 674, 320 A.2d 52 (Md., 1974) ("[s]o much of the software as consists of services to be rendered after the purchase is not only intangible in nature, but is beyond the reach of Code (1957, 1969 Repl. Vol.) Art. 81, §11(c), dealing primarily with taxation of intangibles."). See also Touche Ross & Co. v. State Bd. of Equalization, 203 Cal. App. 3d 1057, 250 Cal. Rptr. 408 (1988) ("the Legislature has recognized that the design, development or creation of a custom computer program to the special order of a customer is primarily a service transaction and, for that reason, not subject to sales tax. However, once the program has been completed and in the possession of the original customer, the design or development service has been completed, and the program itself has become a tangible personal asset of the customer. A subsequent sale of that program by the initial customer can no longer be characterized as a 'service' transaction, but rather is a transfer of a tangible personal asset produced by the original programmer's services.").

27 See, e.g., note 24, *supra*.

28 See *Comptroller of the Treasury* v. Equitable Trust Co. and Chittenden Trust Co. v. King, note 17 *supra*.

29 Commerce Union Bank v. Tidwell, *supra* note 16 ("magnetic tape is only one method whereby information may be transmitted from the originator to the computer of the user. That same information may be transmitted from the originator to the user by way of telephone lines, or it may be fed into the user's computer directly by the originator of the program."). James v. Tres Computer Systems, Inc., *supra* note 15 ("[f]irst, the tapes themselves were not the ultimate object of the sale. The customer purchased them because they contained the data and programs which it desired for its computer. The tapes are merely a medium to convey the data and programs to the customer's computer. After they are used to program the computer they can be discarded. . . . Second, it was not necessary that the information be put on tape. It could have been sent to the customer through electronic communications and fed directly into the computer.").

30 Comptroller of the Treasury v. Equitable Trust Co., *supra* note 17 ("[t]he millions of magnetic impulses which in their precise order have meaning were conveyed to the computer, in the transactions as carried out, by tapes. A meaningful sequence of magnetic impulses cannot float in space. . . . [B]ecause a taxable transaction might have been structured in a nontaxable form, it does not thereby become nontaxable."). Chittenden Trust Co. v. King, *supra* note 17 ("[i]t may well be that the Bank could have procured, by way of telephone or personal service, the same programming information so as to avoid a use tax. To base the tax consequences of a transaction on how it could have been structured 'would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred.' Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148 (1974). This we will not do. The Bank must accept the consequences of its choice to purchase the program in the form of a tape.").

31 See note 29, *supra*.

32 E.g., California exempts the service components of a software purchase, including maintenance. Cal. Rev. & Tax Code §6010.9.

33 See note 5, *supra*.

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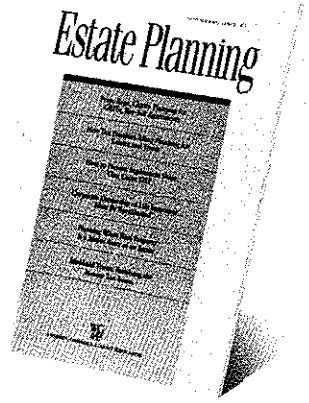

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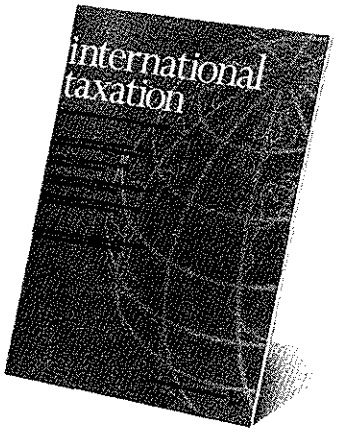

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to a book, movie, or record because, unlike those media, diskettes are not necessary to convey the information (software) stored on them.[31] In fact, once the software is copied onto the computer, the diskettes can be discarded. On occasion, this argument has been successful, and taxpayers may continue to assert it to show the intangible nature of software.

Taxing authorities may respond that movies and records can be copied onto tape and the original can be discarded just as easily as the software diskette. Moreover, movies can be delivered via satellites or through cable lines, yet they remain taxable under most sales and use tax statutes (although the tax may be on the overall cable or satellite *service* rather than on the specific cost of one movie).

Where software is delivered over telephone lines, the purchaser could claim that since there is no tangible media, no tax should apply. The argument that software is intangible should not depend solely on the nature of the carrier, however. Software has characteristics of both tangible and intangible property. The comparison of software to books, movies, and records may appear stronger now that all are available on CDs (compact discs). A more persuasive argument for nontaxability should also rely on the extent of the service delivered to the buyer.

Extent of service. A book, movie, or record is not tailor-made for an individual buyer, but a custom software program is designed to meet the purchaser's specific needs. Therefore, software is more comparable to a will drafted by an attorney or a tax return prepared by an accountant for a client. It does not matter that the paper the documents are written on is tangible. It also does not matter that the attorney began with a draft format taken from a book of standard forms, or that the accountant began with tax forms provided by the Federal, state, or local government. The tangible property is only a by-product of the service provided by the attorney or accountant. Similarly, taxpayers may argue that it does not matter that the diskette containing software is tangible. The diskette is more a by-product of the service provided by the software programmer, whether the programmer started from scratch or modified an already existing program.

Modification of a canned program can create an entirely new custom program exempt from tax.

The downside of this argument is that it appears to concede that canned software is tangible property subject to sales and use tax. This may be acceptable, however, since many states specifically make the sale of canned software taxable. Moreover, in most of the states that do not, the taxing agencies routinely interpret the statutes to include canned software. Therefore, this may be a concession of a point that has already been lost. In addition, the sales tax on canned software is not as significant as that on the custom product, because generally canned software is relatively inexpensive.

This concession on the taxability of canned software may strengthen the argument that custom software (including software that has been modified for an individual customer) is different. The service element should make custom software exempt from taxation. Arguably, few wills drafted by an attorney are written from scratch; most incorporate modifications of clauses used in previously drafted wills. Nevertheless, preparing a will is a professional service provided by the attorney. Likewise, not every software program is written from scratch. The type or number of modifications may differ from one program to the next, but if the revision is to meet an individual customer's needs, a service is involved to the same extent as that rendered by the attorney drafting a will.

PLANNING

The fundamental problem with the classification of computer software is that, unlike most property, software has characteristics of tangible and intangible property and services. Generally, the state tax authorities simply have not found a workable basis for classifying software.

The courts also have not consistently determined the classification of computer software, and there is no apparent trend in the decisions. Thus, it is impossible to determine whether the sale of any particular software would be taxable without recourse to the statutes and case law of each jurisdiction. If a statute specifically provides that the sale of *all* software is taxable, there is little that can be done to avoid sales tax. Where *canned* software is defined by statute as taxable property, mass-produced software not modified for the user surely will be taxed.

There are steps one can take, however, to minimize the taxability of computer software when statutes do not specifically address the issue, or when a state taxes canned but exempts custom software.

1. Sales of computer software and hardware should be separately invoiced, or at least individually itemized on the bill. Similarly, all software should be separately identified to distinguish between custom and canned programs.
2. Whenever possible, software should be delivered to the buyer through intangible media, such as over telephone lines or direct keyboard entry, rather than on diskettes or tapes.

3. For custom software, the sales documents should clearly identify the services provided by the seller in designing the computer program for the buyer's particular use.
4. For purchases of existing software, any charge for modifications should be billed separately as for services.
5. Where appropriate, a portion of the purchase price should be allocated to a maintenance contract.[32]
6. The applicable state's statutory or regulatory definition of custom software should be reviewed, along with related case law. On occasion, the modification necessary to transform canned software into a custom program is minor. In a few instances, a modification simply to adapt the software to the particular user's computer hardware will suffice.[33]

CONCLUSION

As states become more aggressive in interpreting their statutes to include computer software in the sales tax base, the tax practitioner must be aware of the steps that can be taken to structure transactions involving software so as to minimize the potential tax burden. Planning must be tailored to the specific taxing jurisdiction, of course, but following the recommendations discussed above will increase the likelihood that software—particularly the more valuable customized software—will be exempt from sales and use taxation improved by the various state and local taxing jurisdictions. ■