



The Taxman Cometh: Software Taxes and Who Pays Them

Computer software is usually considered by the law as “intangible personal property”. And most of the time, there is no sales tax on such property. And this wasn’t for lack of trying by state taxing authorities. They would take the position that software is tangible and try to tax its separate sale or licensure. Then the courts would overturn the rulings. Software developers were usually winning until state legislatures changed the tax codes. So, a bit of history is in order.

In pre-historic times (say, about thirty years ago), software was typically sold as part of a computer system and was never seen as separate from it. Then IBM began to unbundle software and sell it separately from the hardware. Then along came the PC revolution and unbundled software became the multi-billion dollar consumer industry it is today. As long as the software was viewed merely as part of the hardware, it didn’t really create a separate sales tax opportunity because it was deemed tangible.

But if there’s one thing that state legislators can’t overlook, it’s new sources of revenue. When the potential take is thought to be small, it usually doesn’t appear on legislative radar screens. When the PC came along, however, software became a mass-market, consumer-driven product and squarely in the tax collectors crosshairs. State – and even local - taxing authorities were literally itching to tax this revenue.

But what types of taxes do the revenuers try

to levy on software vendors. How big is your imagination? Here are a few.

The Sales Tax. Normally, a state imposes a sales tax on sales of *tangible* personal property sold at retail or on taxable services. The retailer or service provider is usually responsible for collecting and remitting the tax to the state or locality when the sale price changes hands. Usually, a seller in interstate commerce does not have to collect and remit sales tax though the buyer may have to pay a use tax. There are distinct *caveats* to this generally rule, however, so don’t rush this one.

The Use Tax. States impose a use tax on the users and consumers of tangible personal property. States collect the tax to cover their flanks: they want to make sure that purchasers of goods don’t avoid the sales tax by buying their goods in another state. Use taxes are assessed at the same rate as the sales tax – which is another indication of its purpose. In the case of use taxes, however, a buyer usually gets credit for taxes paid in another state. Note, however, that you may have to pay a use tax even in situations where there is no sales tax. A sale may be deemed “occasional” and therefore not subject to sales tax. The buyer, though, may have to pay a use tax on the items acquired. Message: the state usually collects one way or the other.

The Property Tax. Many – if not most – states impose a tax on tangible business property, including office equipment and inventory. When it comes to software, however, the issue is who pays the tax on licensed software. In

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theory at least, the licensor retains title of the licensed software and the contract must carefully specify who pays the property tax – the licensor or the licensee.

The Gross Receipts Tax. Here's a wide net. This tax is imposed on a business's gross income from business retail sales and leases. It's similar to sales and use taxes but with a GRT the state taxes everything – all business income – and not just certain transactions.

The Excise Tax. This is a particularly odious tax, based on a percentage of an item's value and imposed on the owner and possessor of specified property without regard to how the owner obtained the property. Most of us are acquainted with the excise tax through our cars and trucks. When it comes to software, it's similar in outcome to sales, use and gross receipts taxes.

But the most pernicious and pervasive of all these taxes are the sales and use taxes – and these are the ones that invariably trip up software vendors. How these taxes are assessed depends on a set of common (but not universal) definitions – but be advised that these definitions get applied in the first instance by the tax collectors themselves. And tax collectors have very creative minds *and there's no uniform, 50-state rule when it comes either to definitions or application.* But here are

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the main talking points:

“Software” typically means an application that can be obtained separately from hardware. Anything not obtained separately (like firmware, middleware and preinstalled applications) are not assessed in most jurisdictions. “Canned Software” is software generally obtained at retail. “Custom Software” is software specifically developed for a single customer. “Customization” relates to the taxation of programming and implementation services for software that would otherwise be considered “canned” software. “Support” relates generally to telephone help desk support. “Installation” refers to the taxation of separate charges for travel and installation.

“Downloads” relates to software obtained by download. This is very tricky because some states tax all software, however obtained, while others exempt downloads. Other states tax what comes through the Internet while others exempt telephone downloads (even though most telephone services utilize the Internet at least in part).

“Maintenance” relates to maintenance services – which can include software updates or debugging services. “Training” is sometimes taxed as a separate service. “ISP” services are usually taxed. “ASP” services are sometimes taxed.

As noted, there's no 50-state rule. It tends to be a matter of separate application – and negotiation.

And you thought that it was your job merely to run a business.