

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-02(11)S
Sales Tax
June 4, 2002

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S000719A

On July 19, 2000, the Department of Taxation and Finance received a Petition for Advisory Opinion from Flextrade Systems Inc., 98 Cutter Mill Road, Great Neck, New York 11021. Petitioner, Flextrade Systems Inc., submitted additional information with respect to the Petition on June 6, 2001.

The issue raised by Petitioner is whether its software that is licensed to its customers, and related services provided by Petitioner to its customers, are exempt from sales and use tax.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner is organized under the laws of the state of New York, with its principle place of business located in the state of New York. Petitioner has developed comprehensive Equity Trading system software referred to as "FLEXTRADE." The features of the software are that it provides:

1. Direct link to a growing number of F.I.X. compliant execution systems.
2. Ability to send orders to crossing systems and track manual trades.
3. Real time trading with powerful analytics, order indications and real time market data.
4. Ability to trade multi-sided portfolios with real-time cash-balancing and allocations.
5. User defined system-wide and individual trading restrictions.
- 6 Ability to build personal trading strategies using fully customizable analytics, visual alarms and stock ranking techniques.

The software was designed and developed by Petitioner who is responsible for the maintenance of the software as well as creating and protecting intellectual property rights. It is designed to effectuate trades based upon orders submitted to the system by customers. Petitioner performs significant modifications, enhancements, and upgrades to the software, which are designed and developed to the specifications of each individual customer. Petitioner must continually upgrade and enhance the software to keep up-to-date as the technological needs of market leaders and financial markets evolve. The charges for these modifications, enhancements, and upgrades are separately stated on the invoice provided to customers. Petitioner also provides on-site training, repairs and maintenance, and customer support on a continual basis. Charges for these additional services are separately stated on customer invoices.

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Petitioner licenses the right to use FLEXTRADE to its customers. Petitioner charges customers based on the number of shares traded using FLEXTRADE, with a minimum monthly charge which is covered by volume based charges. Many of Petitioner's customers are brokers.

For tax and financial statement purposes, Petitioner maintains ownership of FLEXTRADE, which is never sold outright to its customers.

Petitioner submitted a sample copy of a "Flextrade Trading System Agreement" which is entered into by Petitioner and its client. Such agreement states, in part:

License

FLEXTRADE is granting CLIENT a non-exclusive, non-transferable license to use the FLEXTRADE software product(s) designated herein ("Licensed Software"). Under the terms of this license, CLIENT acknowledges that the access provided and information generated are intended solely for CLIENT's internal use, and may not be provided or licensed to any third party.

* * *

Term

The initial term of this Agreement ("Term") shall be for a period commencing on installation and continuing for twelve (12) calendar months thereafter. This Agreement shall automatically be renewed for periods of one (1) year each at the end of the initial term and/or any renewal period hereunder unless CLIENT terminates this Agreement upon thirty (30) days written notice in advance of the last day of the initial term or any renewal period hereunder. Service charges accrue as of the date of installation; if Service commences after the first of the month Customer will be charged for the remainder of the month on a prorated basis. Upon termination of this agreement, licensee must destroy all copies of the software in the licensees possession, and any related documentation and all copies thereof and provide Flextrade with written confirmation of having done so.

Price

The payment for the Licensed Software shall consist of those items specified on the FLEXTRADE Price List ("Price List") attached hereto (Exhibit A) and identified by CLIENT signature or initials. FLEXTRADE shall maintain the Licensed Software during the term of this Agreement. Unless specified in the Price List, all prices are "FOB" CLIENT's office. CLIENT shall be responsible for all

license fees, cable, communications, data feed, supplies, power, air conditioning and security related to CLIENT's use of the Licensed Software unless said condition is itemized in the Price List. FLEXTRADE shall not be responsible for any loss of CLIENT's data. At least once per day, CLIENT will provide FLEXTRADE with access to information concerning its trading volume to enable FLEXTRADE to bill CLIENT pursuant to the Price List.

Payment

CLIENT shall pay the charge(s) specified in the Price List, without discount, on the due date specified by FLEXTRADE. Installation charges in the amount of \$4,000 shall be paid upon installation of Licensed Software. A deposit of one (1) months charges shall be paid upon delivery of Licensed Software and shall be credited to the last month's required payment. Monthly charges shall be invoiced by FLEXTRADE one week in advance of the due date. Excepting charges for the installation and first month of service, the due date shall be the first date of each month. . . .

Applicable Law and Regulations

Section 1101(b) of the Tax Law provides, in part:

When used in this article for the purposes of the taxes imposed by subdivisions (a), (b), (c) and (d) of section eleven hundred five and by section eleven hundred ten, the following terms shall mean:

* * *

(5) Sale, selling or purchase. Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume (including, with respect to computer software, merely the right to reproduce), conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor.

(6) Tangible personal property. Corporeal personal property of any nature. However, except for purposes of the tax imposed by subdivision (b) of section eleven hundred five, such term shall not include gas, electricity, refrigeration and steam. Such term shall also include pre-written computer software, whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to a purchaser. . . .

* * *

(14) Pre-written computer software. Computer software (including pre-written upgrades thereof) which is not software designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more pre-written computer software programs or pre-written portions thereof does not cause the combination to be other than pre-written computer software. Pre-written software also includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than such purchaser. Where a person modifies or enhances computer software of which such person is not the author or creator, such person shall be deemed to be the author or creator only of such person's modifications or enhancements. Pre-written software or a pre-written portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains pre-written software; provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute pre-written computer software.

Section 1105(a) of the Tax Law provides for the imposition of sales tax on the receipts for every retail sale of tangible personal property, except as otherwise provided in Article 28 of the Tax Law.

Section 1110(a) of the Tax Law provides, in part:

Except to the extent that property or services have already been or will be subject to the sales tax under this article, there is hereby imposed on every person a use tax for the use within this state on and after June first, nineteen hundred seventy-one except as otherwise exempted under this article, (A) of any tangible personal property purchased at retail, (B) of any tangible personal property (other than computer software used by the author or other creator) manufactured, processed or assembled by the user, (i) if items of the same kind of tangible personal property are offered for sale by him in the regular course of business. . . (F) of any computer software written or otherwise created by the user if the user offers software of a similar kind for sale as such or as a component part of other property in the regular course of business.

* * *

(g) For purposes of clause (F) of subdivision (a) of this section, the tax shall be at the rate or four percent of the consideration given or contracted to be given for

the tangible personal property which constitutes the blank medium, such as disks or tapes, used in conjunction with the software, or for the use of such property, and the mere storage, keeping, retention or withdrawal from storage of computer software described in such clause (F) by its author or other creator shall not be deemed a taxable use by such person.

Section 1115(o) of the Tax Law provides:

Services otherwise taxable under subdivision (c) of section eleven hundred five or under section eleven hundred ten shall be exempt from tax under this article where performed on computer software of any nature; provided, however, that where such services are provided to a customer in conjunction with the sale of tangible personal property any charge for such services shall be exempt only when such charge is reasonable and separately stated on an invoice or other statement of the price given to the purchaser.

Section 526.7 of the Sales and Use Tax Regulations provides, in part:

(a) Definition. (1) The words sale, selling or purchase mean any transaction in which there is a transfer of title or possession, or both, of tangible personal property for a consideration.

(2) Among the transactions included in the words sale, selling or purchase are exchanges, barter, rentals, leases or licenses to use or consume tangible personal property.

* * *

(b) Consideration. The term consideration includes monetary consideration, exchange, barter, the rendering of any service, or any agreement therefor. Monetary consideration includes assumption of liabilities, fees, rentals, royalties or any other charge that a purchaser, lessee or licensee is required to pay.

Technical Services Bureau Memorandum TSB-M-93(3)S, dated March 1, 1993, entitled State and Local Sales and Compensating Use Taxes Imposed on Certain Sales of Computer Software provides, in part:

Effective September 1, 1991, State and local sales and compensating use taxes are imposed on the sale or use of prewritten computer software and certain related services.

The effect of this change in the Tax Law is to broaden the types of computer software that are subject to sales and use taxes. Prior to September 1, 1991, “custom” software was exempt from tax as described in Technical Services Bulletin 1978-1(S). However, certain software previously considered “custom” may now be considered prewritten computer software and subject to such taxes. References in the 1978 bulletin to exempt software are largely obsolete and should be disregarded. The only software that is exempt from sales and use taxes under the new law is software designed and developed to the specifications of a specific purchaser.

Prewritten computer software is any computer software that is not designed and developed by the author or other creator to the specifications of a specific purchaser.

The sale of prewritten software includes any transfer of title or possession, any exchange, barter, rental, lease or license to use, including merely the right to reproduce, for consideration. Thus, a payment made by a customer on or after September 1, 1991, for a license to use, or for the rental or lease of prewritten software is subject to sales or use tax . . .

Software that was originally designed and developed to the specifications of a specific purchaser (i.e., “custom” software) loses its identity as such and becomes prewritten software, subject to tax, if and when it is sold to someone other than the person for whom it was specifically designed and developed. (See section “Exemptions from Tax” for certain exceptions.)

Prewritten software is subject to tax whether sold as part of a package or separately. Software created by combining two or more prewritten programs or portions of prewritten programs is still prewritten software subject to tax. The medium by which the software is transferred to the purchaser has no effect on the software’s taxability. Thus, prewritten software is taxable whether sold, for example, on a disk, tape or by electronic transmission over telephone lines.

Prewritten software, even though modified or enhanced to the specifications of a specific purchaser, remains prewritten software subject to tax. However, if a charge for the custom modification or enhancement is reasonable and separately stated on the invoice or billing statement, then the separately stated charge for the custom modification or enhancement is not subject to tax.

Example 1. A software developer creates an accounting system using prewritten software modules for general ledger, accounts receivable, accounts payable, payroll, inventory management, etc. The developer may also sell the modules separately or

bundled in other packages. Even though the modules may be modified to the specific requirements of the client's business, the sale of the modules is subject to sales or use tax as prewritten software. An additional charge for modification or "custom" programming by the developer would not be subject to sales or use tax if the developer's charge for the modification is reasonable and is separately stated on the billing statement.

The incidental use of a development language (e.g., COBOL, BASIC, C, etc.) or of libraries of "prewritten" functions or routines in designing and developing a "custom" software program to the specifications of a specific purchaser will not, in and of itself, make the sale of an otherwise custom program taxable. The "custom" program must be examined as a whole to determine whether it is exempt from tax. If the prewritten components of a custom program are sold separately, their sale is subject to tax.

* * *

Sale of Software Upgrades

Generally, the sale of a revision or upgrade of prewritten software is subject to tax as the sale of prewritten software. If, however, the software upgrade is designed and developed to the specifications of a specific purchaser, its sale to that specific purchaser would be exempt as custom software.

* * *

Customer Support and Related Services

Services taxable under section 1105(c) of the Tax Law are exempt from tax under section 1115(o) of the Tax Law where performed on any computer software. However, where such services to be performed on software are sold in conjunction with the sale of tangible personal property, such as prewritten software, the charge for such services is exempt only if it is reasonable and separately stated on the invoice or billing statement given to the customer.

Thus, charges for customer (user) support or for information services provided by a vendor to a customer, either in person or by some type of telecommunications arrangement (e.g., telephone, modem, facsimile machine, etc.), in the nature of training, consulting, instructing or other diagnostic or troubleshooting services related to prewritten software are exempt from sales and use

taxes where the charges are reasonable and separately stated. Charges for the service of installing, repairing, maintaining or servicing prewritten software are also exempt from sales and use taxes where the charges are reasonable and separately stated on the invoice. Of course, any charges for the above described services sold in connection with custom software are exempt from tax.

* * *

Use Tax Exemption

Use tax generally applies to taxable uses of prewritten computer software in the same manner that the use tax applies to uses of other tangible personal property, except that: (1) no use tax is imposed on software used by its author if the author does not offer similar software for sale in the regular course of business, and (2) where software is used by its author and the author does sell the same or similar software in the regular course of business, use tax applies and is computed on the cost of the medium (floppy disk, magnetic tape, etc.) that contains or is used in conjunction with the program.

Opinion

Based on the sample contract and other information submitted by Petitioner, it appears that Petitioner licenses the FLEXTRADE software to its customers for a consideration, based on the number of shares traded with the software. Petitioner, therefore, is selling software to its customers for purposes of Article 28 of the Tax Law. See Section 1101(b)(5) of the Tax Law. Petitioner's license of FLEXTRADE will constitute a sale of tangible personal property subject to tax under Section 1105(a) of the Tax Law if FLEXTRADE constitutes pre-written software. See Section 1101(b)(6) of the Tax Law. Software designed and developed to the specifications of a specific customer is "custom" software not subject to sales tax. See TSB-M-93(3)S, *supra*. If FLEXTRADE, or components of FLEXTRADE, are not designed and developed by Petitioner to the specifications of a specific purchaser, then FLEXTRADE is pre-written software subject to tax. See Section 1101(b)(14) of the Tax Law. The license of FLEXTRADE updates constituting pre-written software will also be subject to tax.

Pre-written software or a pre-written portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains pre-written software. Section 1101(b)(14) of the Tax Law. Accordingly, if FLEXTRADE or FLEXTRADE updates constitute pre-written software, this software remains pre-written software although Petitioner performs modifications and enhancements which are designed and developed to the specifications of a specific customer. Such modifications and enhancements, however, shall not constitute pre-written software, where there is a reasonable and separately stated charge on the customer invoice or billing statement for such modifications and

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enhancements. See Section 1101(b)(14) of the Tax Law. Petitioner's charge to a customer for modifications and enhancements in such case is not subject to tax. See TSB-M-93(3)S, supra.

Petitioner's charges for the service of installing, repairing, maintaining, or servicing FLEXTRADE, or for providing customer support and training for the use of FLEXTRADE, may be exempt under Section 1115(o) of the Tax Law. In order for this exemption to apply, the charges for such services must be reasonable and separately stated on the customer invoice or billing statement, where such services are provided in conjunction with the sale of pre-written software or other tangible personal property. See TSB-M-93(3)S, supra.

Although it appears that FLEXTRADE may constitute pre-written software that is modified and enhanced to the specifications of particular customers, it is not within the scope of this Advisory Opinion, based on the information submitted, to determine questions of fact such as whether FLEXTRADE constitutes pre-written software or is custom software designed and developed by Petitioner to the specifications of a specific purchaser.

DATED: June 4, 2002

/s/
Jonathan Pessen
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.