

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-97(59)S
Sales Tax

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S970321C

On March 21, 1997, the Department of Taxation and Finance received a Petition for Advisory Opinion from TSI International Software Ltd., 45 Danbury Road, Wilton, Connecticut 06897-0840. Petitioner, TSI International Software Ltd., submitted additional information pertaining to the Petition on July 15, 1997.

The issue raised by Petitioner is whether sales tax should be imposed upon receipts from the sales of two of its software products.

Petitioner submitted the following facts as the basis for this Advisory Opinion. Petitioner also provided copies of its Registration Statement with the Securities and Exchange Commission, its prospectus and brochures on the software in question.

Petitioner develops and markets software and related services that enable organizations to facilitate the exchange of information among their own business applications, as well as with external business partners. The two software products at issue in this Opinion are "KEY/MASTER" and "Trading Partner."

"KEY/MASTER" is a data entry software product. With "KEY/MASTER," data may be input to production applications and databases from on-line terminals, off-line personal computers (PCs) and local area networks (LANs), and from non-keyed sources such as bar codes and scanners. "KEY/MASTER" uses simple screen painting and advanced validation and editing techniques. It operates in a wide range of IBM (or compatible) hardware and software configurations. "KEY/MASTER" allows the customer to analyze its requirements and resources, choose the best way to capture data for each of its applications, and to design a system that meets its requirements. Petitioner holds a copyright on "KEY/MASTER" and has been successful in defending this right in a lawsuit settled in 1995.

"Trading Partner" is electronic data interchange (EDI) software. EDI is the computer-to-computer exchange of business data among "partners" in a standardized format as a component of electronic commerce (EC). "Trading Partner" was designed to provide everything needed to implement, integrate and manage EDI processes and data in an IBM environment. "Trading Partner" allows the customer to tailor and manage integrated solutions from handling external trading specifications and internal application requirements to applying business rules and intelligence to EDI processes and data. (It is noted, Petitioner's "Trading Partner PC" and "Trading Partner Kits" are not at issue in this Opinion.)

Both "KEY/MASTER" and "Trading Partner" were created by Petitioner and are proprietary trade secrets. "KEY/MASTER" and "Trading Partner" are also registered trademarks.

Each of these computer software programs is a set of operating instructions that is uniquely programmed either by Petitioner's field engineers or the customer's management information systems (MIS) computer programming staff. The operating instructions are a library of prewritten functions or routines used in designing and developing a "custom software" program to the specifications of the customer. The customer's requirements and resources are analyzed and a system is designed to meet these requirements quickly and economically. The software cannot function unless program design and development takes place. After which, a software product takes form. The software product cannot and will not be sold in this exact form to any other customer. The software takes on a new form each time it is sold and will not perform unless it has been customized each and every time.

Petitioner categorizes "KEY/MASTER" and "Trading Partner" as *system software* or *system utility software*. Software of this nature interacts between operating system software (i.e., software designed to interact with computer hardware to guide the overall operations of the computer) and application software (i.e., software designed to run the business processes that are required in an electronic environment). *System software* or *system utility software* differs in that there is no defined standard output from its use, and it must be configured uniquely in each operating environment. Petitioner's software is configured by each user to be a link between the operating system that is storing data and managing its use and an application software layer that will actually process the data for a standard business outcome. When the customer runs its EDI translators, for example, there is no usable output other than a file of data that is uniquely configured to be passed on to its selected application program to process the data. (A "translator" converts programs written in one language into programs in another language.) The software serves as the conduit of data from an external partner, through the operating layer on its way to the processing application. Without Petitioner's software, the data would not be able to be processed; with just the software, there would be no desired result. This software acts as an aid or utility which is customized in each customer site to provide the link that is required for its application system.

"KEY/MASTER" and "Trading Partner," can be purchased outright or leased for a specified time. Petitioner charges customers for programming by separate invoice denoting professional service charges, plus any expenses incurred by its systems engineers. This programming may be done solely by Petitioner, by Petitioner and the customer, or by the customer alone.

These products are sold to a wide variety of industries throughout the United States and the world. They are not sold in any computer retail stores or via Petitioner's Web site. Sales are usually generated by word-of-mouth or by Petitioner's telesales group.

Applicable Law

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:

* * *

(4) Retail sale. (i) A sale of tangible personal property to any person for any purpose....

(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....

(6) Tangible personal property. Corporeal personal property of any nature.... 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 imposes sales tax on the "receipts from every retail sale of tangible personal property, except as otherwise provided in this article."

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.

Technical Services Bureau Memorandum, State and Local Sales and Compensating Use Taxes Imposed on Certain Sales of Computer Software, TSB-M-93(3)S, March 1, 1993, 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.... certain software previously considered "custom" may now be considered *prewritten computer software* and subject to such taxes.

* * *

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.

* * *

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.

The purchase of a development language or libraries of software routines is subject to sales or use tax if it is used in designing and developing custom software....

Opinion

Receipts from Petitioner's sales (including leases) of "KEY/MASTER" and "Trading Partner" in New York State are subject to State and local sales taxes. Both "KEY/MASTER" and "Trading Partner" constitute "pre-written computer software," as defined in Section 1101(b)(14) of the Tax Law, and as such, tangible personal property. However, receipts attributable to Petitioner's unique programming of these software products to meet the specifications of customers are not subject to tax. This is so, provided that these charges for programming are reasonable and continue to be separately stated on the invoices given to customers.

Technical Services Bureau Memorandum TSB-M-93(3)S, supra, provides guidance with respect to sales of computer software and related services. This memorandum explains the Department of Taxation and Finance's *de minimis* policy regarding the "incidental" use of development languages and libraries of prewritten functions and routines. Based on the information submitted, "KEY/MASTER" and "Trading Partner" as sets of operating instructions that are used in the design and development of custom software programs for customers are not "incidental" to these overall programs, but rather are the cores of these programs. Moreover, both "KEY/MASTER" and "Trading Partner" are sold separately by Petitioner, allowing customers to perform their own custom programming. As provided in such memorandum, the purchases of development languages and libraries of prewritten functions and routines are subject to sales tax if used in designing and developing custom software.

Whether these software products can be categorized as *system software* or *system utility software* is of no consequence. The tax imposed on "pre-written computer software" does not pertain exclusively to application software, nor are any such distinctions made in the statutory definition of "pre-written computer software."

DATED: September 30, 1997

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

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