

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

TSB-A-98(20)S  
Sales Tax

STATE OF NEW YORK  
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO.S970812A

On August 12, 1997, the Department of Taxation and Finance received a Petition for Advisory Opinion from SAP America, Inc., 701 Lee Road, Wayne, PA 19087.

The issue raised by Petitioner, SAP America, Inc., is whether the licensing of its software and related, separately stated charges for customization, maintenance, support, updates and training services are subject to New York State sales and compensating use taxes.

Petitioner submitted the following facts as the basis for this Advisory Opinion and provided a sample of the software agreement in question.

Petitioner, a Delaware corporation headquartered in Wayne, Pennsylvania, engages in the business of licensing computer software throughout the United States. Petitioner's software contains three main modules from which customers may choose; the modules are virtually identical for every customer. The modules assist customers in managing their accounting, human resources and logistics functions. Within each of these main modules, customers may choose among various applications according to their specific needs. For example, within the accounting module, customers can choose from the following applications: accounts receivable, accounts payable, fixed assets, general ledgers and others. The modules are inoperable for any specific customer's business needs until customized as discussed below. Petitioner's pre-sale technical representatives meet with potential customers to assist them in determining which of the modules or applications will best suit each customer's particular business needs. The pre-sale technical representatives typically spend several months with a particular customer reviewing the customer's operations and system requirements. Based on this review, the pre-sale technical representatives develop a Systems Requirements Analysis which the customer uses in deciding which modules or applications to license and how the customer's chosen configuration should be customized.

The software licensed by Petitioner resides on one or more designated computers whose physical location is determined by the customer. The customer will connect to each computer one or more application servers where Petitioner's software will also reside. The customer will have a number of users attached to the application server accessing the applications. For example, a particular customer may have individuals from its production, sales, engineering, purchasing, human resources and accounting departments use the software to generate reports designed specifically for each department's use.

Each customer is responsible for the installation of the software it chooses. The various departments within a customer's organization that use the software may utilize different hardware platforms on which they run their specific software applications. To accommodate the uniqueness of each customer, the software licensed by Petitioner has the capability to run on a number of

different operating systems, such as UNIX, OS/2 and Microsoft Windows. This flexibility enables various operating units within a customer's organization to utilize the software to generate reports to meet their specific needs regardless of the operating system or hardware platform used by each unit.

With the wide array of options available to customers, there is a need to configure or modify the operation of the software to accommodate different operating environments. Petitioner is not responsible, pursuant to Section 9.2 of the sample agreement, for "the modification or improvement of the Software to fit the particular requirements of Licensee; or . . . for preparation or conversion of data into the form required for use with the Software." Either Petitioner or an independent consultant or an independent consultant with the assistance of Petitioner generally enters into a separate contract with the customer for customization of the software. The time necessary to customize the base software can range from six to eighteen months depending upon the complexity and scope of the customization. Typically, the separately stated total charge for customizing the software can range from two to three times the cost of purchasing the software license. However, in some cases, the cost of customization can be ten times the cost of the software license. The cost for purchasing Petitioner's license of software is generally in excess of \$1,000,000 per customer.

The activities involved in customizing the software are much more complicated and lengthy than what would commonly be considered installation. One of the more time consuming processes in the customization procedure is establishing the new databases. This is accomplished by evaluating the customer's business processes and customizing Petitioner's software to accommodate the new required processes. Another time consuming process is moving the data from the old system to the new system. The migration of the data is performed by a specialized program. The alternative would be to key the data into the new system which would be cost prohibitive. The customization of the software also involves either the elimination or simplification of existing routines. Often the customization requires that Petitioner re-engineer the customer's business processes. Again using the accounting function as an illustration, the charts of accounts are always adjusted in the customization process. Tables are adjusted, screens are customized and parameters are set up. Another aspect of the customization involves creating interface logic which allows the various modules to "talk" to one another.

After the software is customized, Petitioner performs extensive testing to ensure that the customized software satisfies the customer's requirements set forth in the Systems Requirements Analysis. The testing process normally lasts several weeks. Petitioner's charges for testing are stated separately from other charges relating to purchase and customization of the software. In addition, the customer's employees using the software will generally enroll in an extensive training program, conducted by Petitioner or an independent consultant. The training program consists of a multitude of application and system instructional courses, with each course normally lasting from two to five days. As part of the training courses, trainees receive extensive documentation dealing with the operation of the specific software modules and applications purchased. Petitioner separately states the charges for training from other charges relating to purchase and customization of the software.

Included as part of the license of software is a six-month maintenance agreement. Upon expiration of this initial agreement, customers may purchase an extended maintenance agreement. Pursuant to Section 7.4 of the agreement, the fee for this extended maintenance agreement is paid annually in advance in an amount calculated as a percentage of the net license fee for the software. To date, all of Petitioner's customers have purchased this optional extended maintenance agreement. As part of the agreement, the customers are entitled to receive the following:

- new releases and updates of the software ("updates");
- "hot-line" telephone support provided by Petitioner; and
- on-line support of the software product.

Both maintenance and updates are provided under one agreement. As noted above, maintenance is provided in the form of "hot line" telephone support and on-line support of the software licensed to customers.

Updates for the software contain product modifications that modify and/or enhance the existing software. These product modifications may include new features or fixes for problems which were identified in the current or previous version of the software. As a result, customers are able to enhance the usefulness of the software product licensed from Petitioner through the purchase of an extended maintenance agreement. Furthermore, through these updates Petitioner is continually enhancing and modifying the software it licenses to its customers. Updates normally require integrated application of the customer's specific needs. The amount and complexity of modifications contained in Petitioner's updates vary from one update to another. Based on the content of an update, varying degrees of consultation and/or modification are required for the proper installation and utilization of an update. As a result of Petitioner's research, development and a customer's feedback, updates are generated containing corrections to flaws in the existing system, enhancement for existing functionality and possibly new system functionality.

The standard Software License Agreement ("Agreement") grants the customer a perpetual license for the use of the software. The Agreement contains provisions which restrict the customer's duplication and use of the software, and prohibit the customer from licensing, sublicensing, or transferring the software to third parties with the exception of affiliated entities. Further, the Agreement requires that upon termination of the license, the customer will irretrievably delete the software and documentation from its computer system. In addition, the customer is required to deliver to Petitioner, or at Petitioner's request delete, all copies of the software and documentation from any storage media. Finally, it is Petitioner's policy to replace damaged, malfunctioning or lost software at no cost to the customer.

#### Applicable Law and Authority

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, other than (A) for resale as such or as a physical component part of tangible personal property . . .

(5) Sale, selling or purchase. Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore . . .

(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 of the Tax Law imposes sales tax on "[t]he receipts from every retail sale of tangible personal property, except as otherwise provided in this article."

Section 1105(c) of the Tax Law imposes tax on the receipts from every sale, except for resale, of certain enumerated services.

Section 1110 of the Tax Law imposes a use tax "for the use within this state . . . of any tangible personal property purchased at retail."

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, TSB-M-93(3)S, March 1, 1993, pertaining to the taxability of computer software and certain related services 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 . . . . 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. (Emphasis added)

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.

\* \* \*

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 a prewritten program 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. (Emphasis added) 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.

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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.

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Customer Support and Related Services

. . . 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. . . .

\* \* \*

Software Maintenance Agreements

If a software maintenance agreement provides for the sale of both taxable elements (e.g., prewritten software upgrades) and nontaxable elements (e.g., training, consulting, diagnostic and troubleshooting support, etc.), the charge for the entire maintenance agreement is subject to tax unless the charge for the nontaxable elements is reasonable and separately stated in the maintenance agreement and separately billed on the invoice or other document of sale given to the purchaser . . . .

Opinion

Petitioner develops and markets software and related services. Petitioner's customers are able to choose from certain pre-written modules and applications in such areas as human resources, financial accounting and production planning, in order to create systems tailored to their own requirements. The modules are virtually identical for every customer; they are sold separately by Petitioner and each customer is responsible for the installation of the software it chooses. These modules are sold under an agreement, separate and apart from Petitioner's customization services. Even though the modules may later be modified to the specific requirements of the customer's business, the modules constitute pre-written software since they are not designed and developed to the specifications of a specific customer. Accordingly, the receipts from the licensing fees Petitioner charges its customers for the use of its software and for pre-written updates to the software are sales of tangible personal property in the form of pre-written software that are subject to the taxes imposed by Sections 1105 and 1110 of the Tax Law (see Software Dynamics, Inc., Adv Op Comm T&F, July 23, 1997, TSB-A-97(45)S; TSB-M-93(3)S, supra).

To accommodate different operating environments, each customer generally enters into a separate contract for customization of the software. The customer may choose either Petitioner, or an independent consultant, or both an independent consultant with the assistance of Petitioner to customize the base software. Customization, in this regard, consists of configuring and/or modifying Petitioner's software to meet the computer application needs and information processing requirements of the customer. Customization also may include re-engineering the customer's business processes. Such re-engineering appears to be in the nature of consulting, which is not an enumerated tax service. Customization is followed by testing of the software to ensure that the customer's requirements are fulfilled, and by extensive training of the customer's employees in the use of the software. Petitioner separately states the charges for testing and training from other charges relating to the purchase and customization of the software. Petitioner's separately stated charges to customize the modules and the updates it licenses to its customers, designed and developed to the specifications of a specific customer, as well as charges for business processes re-engineering, testing and/or training, are not subject to tax provided these charges are reasonable and continue to be separately stated in a fee statement given to customers (see Astrogamma Inc., Adv Op Comm T&F, June 22, 1992, TSB-A-92(50)S; State Tax Resources Group, Adv Op Comm T&F, July 11, 1996, TSB-A-96(44)S). However, any charge for interface logic which allows the modules to talk to each other may be subject to tax, since the modules are virtually identical and presumably the interface logic software for such virtually identical modules would itself likely be pre-written, and therefore taxable.

The sample software agreement provided by Petitioner includes a six-month warranty by which Petitioner warrants that the software will substantially conform to functional specifications. Petitioner's customers may also purchase an extended maintenance agreement that includes software updates and new releases, correction of defects and both on-line and telephone maintenance support. Pursuant to Section 7.4 of the agreement, the maintenance fee is paid

annually in advance in an amount calculated as a percentage of the net license fee for the software. Since the software maintenance agreement offered by Petitioner provides for the sale of both taxable elements (e.g., pre-written software upgrades and new releases, to the extent that the new releases are pre-written) and nontaxable elements (e.g., diagnostic and troubleshooting support), the receipt from the charge for the entire maintenance agreement is subject to tax (see Garpac Corporation, Adv Op Comm T&F, February 6, 1992, TSB-A-92(8)S; Moore Business Forms, Inc., Adv Op Comm T&F, February 15, 1995, TSB-A-95(6)S; ALLTEL Financial Information Services, Inc., Adv Op Comm T&F, May 2, 1996, TSB-A-96(27)S). If Petitioner were to state the charges for such taxable and non-taxable elements separately, and the charges were reasonable, Petitioner would be required to collect tax only on the taxable elements.

DATED: March 24, 1998

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

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