

## Exemption for Computer System Hardware

On April 28, 1998, Governor George E. Pataki signed into law Chapter 56 of the Laws of 1998. Section 97 of Chapter 56 amended the New York State Tax Law to exempt from New York State and local sales and compensating use (use) taxes purchases, leases or rentals of computer system hardware that is used or consumed directly and predominantly in designing and developing computer software for sale. This exemption, which is provided for under Tax Law §1115(a)(35), is effective June 1, 1998.

For sales tax purposes, the term *sale* means 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 (monetary or otherwise), or any agreement therefor.

Only the purchase of those components of the computer system hardware and associated parts that are used directly and predominantly in the design and development of computer software for sale is exempt from sales and use taxes under section 1115(a)(35).

**Computer System Hardware.** *Computer system hardware* is any organized assembly of physical equipment that is united and regulated by interaction or interdependence to accomplish a set of specific computer system functions. The term includes any connected or directly related device or equipment which enables the computer to store, retrieve or communicate to or from a person, another computer or another device, the results of computer operations, computer programs or computer data.

Examples of computer system hardware are: microcomputers; minicomputers; main-frame computers; personal computers; external hard drives; portable disk drives; compact disc read only memory (CD-ROM) drives; external modems; printers; scanners; servers; monitors; keyboards; mice; network interfaces; network hubs; and network routers.

**Associated Parts.** A *part* is any component of, or attachment to, computer system hardware that is used in connection with, and is necessary to, the performance of the hardware's operation. By definition, a part cannot accomplish the work for which it is designed independent of the computer hardware for which it is intended to be a component.

Motherboards, daughterboards, central processing units, controller cards, internal hard drives, internal modems, network interface cards, sound cards, video cards, and network wiring and cables are examples of parts.

*Example 1.* A computer software program developer builds a computer system that consists of the following items: a case enclosure with an internal fan and power supply; a motherboard with a central processing unit (CPU); a 17" monitor; a keyboard; a 3

button mouse; an input/output controller card (to control disk drive functions, printer functions and modem functions); a CD-ROM drive; a 1.44mb floppy disk drive; a portable disk drive (for backing up and archiving the software development files); a video card (to control the monitor); an external voice fax/modem; a printer; a scanner; a 16-bit stereo sound card; and stereo speakers. All of the above items qualify as computer system hardware or associated parts. The purchase of the items is exempt if the items are purchased for use directly and predominantly in the design and development of computer software for sale.

**Directly and Predominantly.** The purchase of computer system hardware is eligible for the exemption only if the computer hardware meets the tests of direct and predominant use.

*Directly* means that the computer system hardware is actually used in designing and developing computer software for sale, or that the hardware has an active, causal relationship in the design and development of computer software for sale. For example, computer system hardware that is used to create, modify or store computer programs under the control of a developer is considered to be used directly in the design and development of computer software. Computer system hardware that is used to print the computer programs and documentation during the design and development stages is also considered to be used directly in the design and development of the computer software.

Computer system hardware used in activities that are collateral to the actual design and development process is not considered to be used directly in designing and developing computer software for sale. For example, use of computer system hardware in administration, production or distribution activities is not considered direct use for purposes of this exemption. *Administration* includes activities such as sales promotion, general office work, purchasing, maintenance, and clerical tasks (such as preparation of work, production and time records). *Production* includes those activities involved in the duplication of the finished software and packaging the software for sale. *Distribution* includes all operations subsequent to production, such as storing, displaying, selling, loading and shipping finished products.

*Predominantly* means that the computer system hardware must be used more than 50% of the time in the design and development of computer software for sale.

<p><b>Note.</b> Computer system hardware that is used directly and predominantly in the production of tangible personal property for sale may qualify for exemption as manufacturing machinery and equipment. See Publication 852, <i>Sales Tax Information For Manufacturers, Processors, Generators, Assemblers, Refiners, Miners and Extractors, Other Producers of Goods and Merchandise</i>.</p>
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**Designing and Developing.** The term *designing and developing* includes systems analysis, program design, coding, testing, debugging and documentation that are part of the design and development of computer software for sale. Thus, the term includes activities carried on from the conceptual stage, through the planning, evaluation and testing stages of development.

**Computer Software.** This exemption is for computer system hardware only, and does not apply to computer software. However, *embedded software* (software that is actually an integral part of the computer, typically in the form of a memory chip) is treated as a part of the computer system hardware for purposes of this exemption. *Pre-written software*, on the other hand, is not considered part of the computer system hardware, even if pre-installed. Thus, costs attributable to *pre-written* (canned/off-the-shelf/standard) software are not eligible for this exemption. This applies to pre-written computer software programs of all classes, including operating systems, firmware, algorithms, data sets, compilers and translators, assembly routines, utility programs and application programs. The sale of *custom software* is not subject to sales or use tax. See TSB-M-93(3)S for a detailed discussion of the taxation of sales of computer software.

In cases where a computer software program developer purchases a computer system hardware package that includes pre-written software (such as pre-written operating system software, pre-written application software, or other pre-written software), the seller must reasonably allocate the sales price between the hardware and the software, and collect sales tax on the amount allocable to the pre-written software. If the sales price is not allocated between the hardware and the software, then the entire sales price will be subject to sales tax. The following two examples illustrate methods that may be used to allocate the selling price between hardware and software. The seller may use any method of allocation that results in a reasonable allocation of the selling price between hardware and software.

*Example 2.* A computer software program developer purchases, for \$5,000, a basic computer hardware system to be used in the design and development of computer software for sale. The basic system contains a monitor, hard drive, internal modem, keyboard, mouse, floppy drive, CD-ROM drive, and central processing unit (CPU), and includes pre-written operating system software, and several pre-written application software packages (including anti-virus and word processing software). The basic computer system will be used directly and predominantly in designing and developing computer software for sale. Thus, the hardware portion of the system may be purchased tax exempt. The pre-written operating system software and application software that were included with the computer hardware system are not eligible for this exemption. Therefore, the seller must allocate the sales price of the package between the software and the hardware. The seller paid \$1,000 for the software and \$2,500 for the hardware. Since the total cost of the hardware and software to the seller equals \$3,500, the seller may allocate \$1,428.57 of the \$5,000 selling price to the software ( $[\$1,000 \div \$3,500] \times \$5,000$ ) and charge sales tax on that amount.

*Example 3.* A computer software program developer purchases a new, all-in-one color printer/copier/scanner for \$399.99. The equipment will be used solely for producing copies of the program code for debugging purposes, and for printing the documentation related to the development of the computer software for sale. The printer/copier/scanner is considered to be used directly and predominantly in the design and development of computer software for sale. The printer/copier/scanner comes with pre-written creative application software. The seller does not sell the

components of the package separately, and has no breakdown of the cost of the hardware or software. The seller must still, however, allocate a reasonable amount of the sale price to the software and charge sales tax on that amount. If the seller uses the manufacturers' list prices for the hardware and the software to determine a percentage allocable to the taxable and non-taxable items, and establishes a value for each component based on such allocation, the allocation will be considered reasonable. If the seller does not allocate a reasonable amount of the selling price to the cost of the software, the entire selling price is subject to sales tax.

**Note.** Pre-written computer software may qualify for exemption from sales and use taxes if it is used directly and predominantly in the production of tangible personal property for sale, or directly and predominantly in research and development. See TSB-M-93(3)S for more information on this exemption.

**Exemption certificate.** To obtain this exemption when purchasing qualifying computer system hardware, the purchaser must present the seller with Form ST-121.3, *Exempt Use Certificate for Computer System Hardware*.

### **Purchases Not Eligible for This Exemption**

**Installation charges.** Charges for setting up computer system hardware are not eligible for this exemption.

**Maintenance charges.** Charges for maintaining, servicing or repairing computer system hardware, or charges for computer system hardware support packages or extended warranties are not eligible for this exemption.

**Supplies.** This exemption does not apply to consumable supplies such as toner, ink, printer paper, floppy diskettes, removable disk cartridges, high capacity disks, portable disk drive disks, writeable and erasable CD-ROM drive disks, mouse pads, wrist pads, and the like.

**Computer software.** The purchase of any stand alone pre-written computer software is not eligible for this exemption. This includes purchases of operating systems, firmware, algorithms, data sets, compilers and translators, assembly routines, utility programs and application programs. In cases where a computer system hardware package includes pre-written software, the seller must reasonably allocate the selling price between the hardware and the software, and collect sales tax on the amount allocated to the software. (See page 3 of this memorandum.)

**Tools.** This exemption does not apply to purchases of tools used in the operation, maintenance or repair of computer system hardware.