

ADVISORY

SULLIVAN & WORCESTER TAX ADVISORY

Massachusetts Sales/Use Tax is Expanded to Tax Electronic Transfers of Standardized Computer Software

The Massachusetts sales tax generally imposes a tax of 5% of the retail sales price of tangible personal property sold at retail in Massachusetts. The use tax imposes a parallel 5% tax for the storage, use, or other consumption of tangible personal property in Massachusetts, regardless of where the taxpayer acquired it, to the extent the taxpayer has not paid sales tax in Massachusetts or another state. Historically, the purchase of prewritten or standardized software, sometimes referred to as "canned" software, on a tangible medium, such as a CD-ROM, has been subject to sales and use taxes, but an electronic download of the same software has not. Effective April 1, 2006, the definition of "tangible personal property" for purposes of these taxes will include transfers of standardized computer software, regardless of whether the transfer is by tangible or intangible means, such as electronic, telephonic, or similar transfers. If a taxpayer acquires software for use in more than one state, the Massachusetts Department of Revenue ("DOR") has the task of providing guidance on how to limit the tax to the proportion of the use of the property in Massachusetts.

In contrast to standardized software, the development of customized software for a specific customer is generally considered a service transaction, and the cost of such software will continue to be generally exempt from sales and use tax.

The pervasive scope of the sales and use taxes will cause the acquisition of standardized software to be subject to tax if it will be used at least in part in Massachusetts. If the seller of the software otherwise has connections with Massachusetts (*e.g.*, property or employees in the commonwealth), the seller may be obligated to collect sales tax, but otherwise the user of the software is required to pay use tax.

At this time there are no regulations on how to apportion use of prewritten software among jurisdictions, but the DOR's Technical Information Release 05-15 provides some guidance. The TIR indicates that in order for a business purchaser of prewritten software to be able to limit the tax by the proportion of use in Massachusetts, the purchaser must issue a certificate (a "multiple points of use certificate") to the seller which will relieve the seller of any obligation to collect sales tax, because the purchaser certifies

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that it will report and pay the proper amount of use tax. A purchaser can then apportion the cost by a reasonable, consistent, and uniform method based on the locations of the use of the software by the business. The DOR expects a purchaser to maintain records and documentation for DOR audit that would justify the purchaser's apportionment. The DOR emphasizes as the basis for apportionment the location of the actual use of the software, without regard to the location of a server from which users get access to the software or any other factor.

Under an existing DOR sales and use tax compliance regime, some business purchasers are eligible to issue a so-called direct payment certificate to sellers, by which the purchaser undertakes responsibility for calculating and paying tax, relieving the seller of the responsibility. According to the DOR, the provision of a direct payment certificate to a seller entitles the purchaser to apportion use in the same manner as a multiple points of use certificate.

The DOR provides that neither certificate would be effective for standardized software that is loaded on computer hardware prior to sale of the hardware. Also, a certificate would not be effective for software that the purchaser receives in person at a business location of the seller, like a retail store.

Because the DOR requires the presentation of a certificate before a purchase price for software can be apportioned by use in and out of Massachusetts, if a purchaser fails to present a certificate, then it appears the DOR would assert that the entire purchase price would be subject to tax regardless of the extent to which it is used in Massachusetts.

Strategies to Minimize Tax. Those who are currently considering the purchase of standardized computer software should consider acquiring it by electronic transfer prior to April 1 to avoid the effect of the change in law.

Business users of standardized computer software with locations within and outside of Massachusetts have a few options that might minimize sales and use tax exposure, but they should be careful. If a software vendor charges a per user license fee, the acquisition of licenses for an office outside of Massachusetts might not be subject to tax,

because a purchase that is shipped or used outside of Massachusetts is generally not subject to sales or use tax. For this strategy to be successful it might be necessary to reflect the purchase on the books of the business as a purchase by the remote office. That office could also take delivery of the software in physical form outside of Massachusetts, if possible. Similarly, Massachusetts sales and use tax might be avoided by having a remote office purchase on its own account, or at least receive directly, computer hardware with preloaded standardized software that is to be used in that office. There is as yet little guidance on how to apply these taxes, and it remains to be seen how the DOR would react to any of these strategies, so taxpayers seeking to minimize their exposure ought to consult with a tax advisor before making any attempt.

March 2006