

# OKLAHOMA TAX COMMISSION

TAX POLICY AND RESEARCH DIVISION  
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September 5, 2001

Re: Our file Number LR-01-132; Sales tax on a series of transactions involving the sale of software and related services.

Dear

This is in response to your inquiry on the subject referenced above. I have scanned into this letter your fact situations and questions under your headings. Each set of questions is followed by our response.

## **General Overview & Contract Language Fact Pattern:**

The software is canned software. Various modules are available to potential clients for purchase. All sales of software and services are contractually initiated for purposes of providing an internal audit trail. Billings/Invoices to clients are based upon signed contracts. The customer will receive separate invoicing for License fees and Continuing Support fees. A sale of software creates what is regarded as the master agreement. *Initial* support services are given to clients for a period of one year. *Initial* support will include use of reasonable diligence to confirm the existence of and correct errors in the system, provide reasonable telephone consulting support in the use of the system. Upgrades are primarily delivered to the client via, tangible media, but on occasion may be electronically transmitted and/or downloaded by the client, via an FTP site. In each case, support, customization and/or tailoring is only provided to customers that have purchased the standard software product of Company (X).

The master agreement will generally include standard language that discusses initial support services continuing support services and cost for an additional period of time, usually three years, after the initial support has expired.

## **Maintenance & Upgrade Questions:**

Does your state make a distinction between mandatory maintenance and optional maintenance?

How is mandatory maintenance defined? What is the taxability?

How is optional maintenance defined? What is the taxability?

Are the sales of canned software with "mandatory support services that includes upgrades on tangible media" taxable?

Are the sales of canned software with "optional support services that includes upgrades on tangible media" taxable?

Are the sales of canned software with "mandatory support services that includes upgrades electronically transmitted" taxable?

Are the sales of canned software with "optional support services that includes upgrades electronically transmitted" taxable?

What are general guidelines that may be followed in determining optional support services versus mandatory support services?

**Response:** The sales tax rules make a distinction as to when an additional service is part of the taxable gross receipts and when it is the additional purchase of an otherwise not taxable service. Please refer to Oklahoma Tax Commission Rules 710:65-1-9 and 710:65-19-158. However, since the line of business involved in this letter ruling request is the sale of computer software, and since a special rule applies to sales of software (see Oklahoma Tax Commission Rule 710:65-19-52), please refer to that rule which specifies that computer software maintenance agreements that provide for updates are subject to sales tax, regardless of whether they might be classified as being mandatory or optional. While the word "mandatory" is not used in the rule, the word "required" is, and since the common, everyday dictionary definitions of the words are, for these usages, synonymous, the rule applies to your fact situation. Based on Rule 710:65-19-52, all sales of computer maintenance agreements sold in accordance with the terms specified in your letter are subject to sales tax in Oklahoma. Therefore, it is not necessary to answer the individual questions posed in your letter concerning the taxability of sales of computer software maintenance agreements.

*Continuing Support Fact Pattern & Questions:*

When continuing support service is first optional to the client, and the client signs an agreement to accept additional support for a period of six months or more, does the fact that the customer signed a binding agreement with Company (X), change the status of continuing support services from optional to mandatory?

As related to the paragraph below, are "Continuing Support Services and Costs" mandatory or optional?

*Following the Initial Support period described in Paragraph 5, Company will continue to provide the Support Services described in paragraph 5 and exhibit X for a period of three years. As part of Continuing Support Services, Customer will be provided from time to time with new releases of the System containing updates or enhancements which, Company generally provides to its support service customers.*

As related to the paragraph below, are "Continuing Support Services and Costs" mandatory or optional?

*Upon the expiration of the initial (X) years of Continuing Support Services, the provisions of this Paragraph shall continue from year to year unless either Company or Customer shall cancel Continuing Support Services by providing the other party with at least (X) days of written notice prior to the anniversary date of the commence of Services. The annual charge for Continuing Support Services after the initial (X) year agreement may not increase more than (X) percent annually. The License grant will survive any termination of the Continuing Support Services.*

In cases when there is first a contract between Company (X) and its customer, and invoicing is based upon amounts detailed in the contract, does the state look to the contract for taxability or does the state look to invoicing for taxability determination?

**Response:** The last two sentences of the response given immediately above also apply to this series of questions.

*Substantial vs. Non-substantial Software Change Fact Pattern & Questions:*

Each module sold by Company X may consist of one million or more lines of code, customers may request for assistance in Tailoring the software for their specific organizational requirements. For instance, a certain data field may have a maximum length of thirty characters, but the client has the need to increase the field size to seventy-five characters. Company X has in-house utility programs that may be used to accommodate the client and will be provided at an additional fee initiated by a contract for Tailoring. While there is modification to the code through the use of an in-house utility program and possibly some maintenance changes to the program, there is not substantial change to the standard product.

**Question:**

Are less than substantial changes to the standard software product taxable when there is a separate contract and the customer is invoiced separately?

Are substantial changes to the standard software product taxable when there is a separate contract and the customer is invoiced separately?

Are charges for Tailoring the standard software product to customer specification considered as software customizations?

What is a general guideline that may be followed when determining if such services are substantial vs. less than substantial?

**Response:** You appear to have made the assumption that the taxability of a billed software service which results in a change to canned software is determined by whether the change is substantial or whether it is less than substantial. Rule 710:65-19-52, which was referenced above, also covers this subject and it states that any charges for changes to canned software are subject to sales tax.

*Custom Modification Fact Pattern & Questions;*

Company (X) agrees to grant customer the right to use Company's Software Custom Modifications, consisting of the computer programs and documentation. Company agrees to provide services relative to the design, programming, testing, documentation and training at negotiated billing rates. Customer will be invoiced separately based on amounts detailed in the contract agreement.

Additional software modules that did not previously exist prior to the contract with a client may be written from scratch to work in conjunction with the standard software module. These custom programs are written at the customers request and may include maintenance services. Company (X) retains ownership of license agreements.

***Questions:***

Are customized programs/modules created at the customers' request considered as new customized programs "from scratch" even though it will be integrated with a base software product?

Are customized programs/modules created "from scratch" taxable when Company (X) retains ownership of the license agreement?

Are customized programs/modules created "from scratch" taxable when Company (X) does not retain ownership of the license agreement?

When there is an existing software product and customized programs are written that cause a substantial change to the standard software product, what is the taxability of the customized portion of the contract when separately invoiced?

When a customized agreement is being negotiated and it concludes with an associated maintenance agreement that extends support for a period of one year or more, is maintenance considered to mandatory or optional?

When there is a single contract, but separately stated invoicing for customized programming and mandatory maintenance, is the mandatory maintenance taxable? Will separate contracts change taxability?

When there is a single contract, but separately stated invoicing for optional maintenance, is the optional maintenance taxable? Will separate contracts change taxability?

Are the sales of customized software with "mandatory support services that includes upgrades on tangible media" taxable?

Are the sales of customized software with "optional support services that includes upgrades on tangible media" taxable?

**Response:** As stated in the sales tax rule on software previously referenced, the sale of custom programs in Oklahoma is not subject to sales tax. Whether the sale of a program is or is not the sale of a custom program or instead is the taxable sale of customization services related to the sale of canned software is a question of fact that cannot be answered in a letter failing a complete analysis of the terms of each individual transaction. However, in those instances where Company X retains title to the software program written, it is by definition not a custom program sold to Company X's customer and is therefore a canned program that is subject to sales tax. The taxability of the maintenance programs in this case would follow from the rule. If the sale is the sale of custom programming, which is exempt from sales tax, any charges for software maintenance for the custom programs would also be exempt from sales tax.

*Additional Custom Modification Fact Pattern:*

Special contract circumstances may arise where both a Master Contract for canned software and a Custom Modification software license agreement may both be signed on the same day. Each contract will be separately invoiced. The custom software contract, however, will consist of special language referencing the master contract.

The custom software license will include a paragraph that gives the customer the right to return all software, including the standard software product that was sold under a different contract, but the same related project scope, if requirements have not been met by a predetermined date. The customer shall receive a full refund for software and services as full and liquidated damages.

**Paragraph Example:**

*The foregoing notwithstanding however, in the specific event that Company fails to deliver by <date> the enhancements described as <description of customization> under <contract number(s)> (functioning as per the specification documents provided herein unless changes are mutually agreed to by both parties) then at Customer option, Customer may terminate this agreement and return all software delivered and shall be entitled to a payment equal to the*

amount of the sum paid to Company for software and services for the <project> Project as full and liquidated damages.

*Questions:*

Will the above referenced contracts be treated as separate contracts or as one single project for taxability purposes? Again, two separate contracts as well as separate invoicing, signed on the same day, same project scope. Per paragraph example above, found only in the Customized contract, does the reference to the Master contract regarding damages and refunds change the taxability from separate contracts to lump sum contracts?

**Response:** Your classification of the contracts as being two, one for the sale of canned software and the other as being the sale of custom modification, involving the sale of "enhancements" indicates that the second contract is for the taxable modification of canned software, not the provision of non-taxable custom programming services.

*Nexus Fact Pattern:*

Company (X) has various salespersons working throughout the country from their home offices. Salespeople may accept customer orders from their home office. No inventory is maintained in the home office of the salesperson. Orders are forwarded to headquarters, which is located out of state, for acceptance.

*Question:*

In determining whether to collect a local sales tax or possible use tax in your state, will the salesperson's home office be considered a "Point-of-Order-Acceptance" and should a local sales tax be collected instead of a sellers use tax?

**Response:** It is unclear from your fact pattern whether the correct tax to apply to taxable sales is sales tax or use tax. If this pattern is one that matches the pattern set out in sub-section (c) of Rule 710:65-15-1, sales tax would apply. If not, then use tax would apply as set out in Rule 710:65-21-4. The term "Point-of-Order-Acceptance" is not defined in the Oklahoma sales tax and use tax statutes or rules.

*Local Tax Allocation:*

Question: How are taxes allocated on the local level for report purposes when making sales from city to city, county to county, and so forth as a retail outlet with delivery trucks? Are taxes collected based on the "Ship-From" a origination based tax or the "Ship To" a destination based tax.

**Response:** Since it appears that the orders are received by the salespersons at a location other than location of the company's business office, it would appear that any transactions subject to sales tax would be taxable for local tax purposes at the delivery location, pursuant to Rule 710:65-17-1. For sales subject to use tax, the

**local taxes to be charged are the tax rates in effect at the location at which the purchase is to be used in accordance with 68 O.S. Section 1411.**

This response applies only to the circumstances set out in your request which was received August 22, 2001. Pursuant to Commission Rule 710:1-3-73(e), this Letter Ruling may be generally relied upon **only** by the entity to whom it is issued, assuming that all pertinent facts have been accurately and completely stated, and that there has been no change in applicable law.

If I can be of further assistance, please feel free to contact me.

Sincerely,  
OKLAHOMA TAX COMMISSION

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