



The Custom Software Sales Tax Exemption: Sensible Tax Policy

Background

Revenue and Taxation Code Section 6010.9, the sales tax exemption for custom software, was enacted in 1982 as a clarification to existing law regarding the application of sales and use tax to the sales of custom programs. A custom computer program is defined by Section 6010.9 as "a computer program prepared to the special order of the customer and includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer."

In enacting section 6010.9, the Legislature declared : "Sales and service of custom computer programs, as defined in section 6010.9 of the Revenue and Taxation Code, other than basic operational programs, are service transactions not subject to sales or use taxes under any existing law. The use of any storage media in the transfer of custom computer programs is only incidental to the true object of the transaction, which is the performance of a service. Therefore the Legislature, consistent with the statement of intent in Chapter 165 of the Statutes 1972, declares that [section 6010.9] is declaratory of, and not a change in, the existing law."

In contrast to custom software, "canned" or prewritten software programs are subject to tax, unless they are electronically delivered.

Custom Software Is a Service That Should Remain Exempt from Sales Tax

Under existing law, the state of California does not tax services. Thus, it makes sense to exempt custom software, primarily a service, from the sales tax. There has been much discussion, however, regarding whether California should depart from its existing policy of declining to tax services and instead broaden the sales tax base to include some services. The custom software exemption is sensible tax policy, consistent with existing law, and should remain in place for a variety of reasons.

- ✓ **Double-Taxation/Pyramiding.** The sale of custom software is primarily a business-to-business service transaction, a business input that should not be taxed. The retail sales tax is intended to be a one-stage exaction on consumer expenditures. Although businesses usually are deemed to be the

ultimate purchaser of custom software, the cost of custom software is likely to be incorporated into the purchase price of the product or service produced by the business for consumers. If sales tax were imposed on the sales price of custom software, the custom software would be taxed again, as its cost, along with the price of the final product forms the basis for taxing the final product. This phenomenon results in double-taxation.

- ✓ ***Situs/Nexus Issues.*** The design of custom software can be achieved and delivered without regard to geographic boundaries. Moreover, under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), out-of-state businesses must have a "physical presence" in the state for there to be "substantial nexus" sufficient to impose a sales or use tax collection duty. Thus, imposing sales tax on the sale of custom software based on the physical location of the seller would lead sellers to locate in a non-taxing state with no physical ties to California. Because the software can be delivered electronically, the location of the seller out of state would have little, if no impact on in-state marketing and sales. Conversely, if the situs of the sale is based on the billing address of the purchaser in the taxing jurisdiction and the seller has no physical connection to California, compliance issues arise with respect to use tax, which is imposed on the ultimate in-state consumer of the product. In addition to compliance issues, there are administrative issues with a destination-based sales tax on custom software. How should the state apportion the tax when a company uses the same software in multiple states? What if the billing address is fraudulent? What if the billing address bears no relationship to the use of the software?
- ✓ ***Business Climate.*** Taxing custom software would lead in-state businesses to purchase software outside the state, and accordingly, would harm California-based custom software sellers. Because the software can be purchased and delivered electronically, the potential to push California-based custom software sellers out of state is relatively high, with little or no adverse impact on the seller. The imposition of tax would then shift to the California consumer, who would be liable for use tax. Due to previously stated compliance issues and the dynamic revenue loss associated with the migration of custom software sellers to other states, the revenue gains from the taxation of custom software likely will be far less than projected with a static revenue estimate.

Conclusion

The decision to exempt custom computer software from sales tax is based on sound tax policy: declining to extend the sales tax to a business input that consists mainly of a service. While it may be tempting to impose the sales tax on sellers of custom software, based on static estimates of potential revenue gain, to do so would be short-sighted. California boasts a thriving technology sector that should be nurtured and encouraged. Imposing sales tax on custom software would have the opposite

effect by encouraging technology companies to consider moving to another state or country that does not tax custom software. The result would be a loss in property, income and sales tax revenue previously attributed to these companies. Moreover, the administrative difficulties associated with taxing services and the potential for double-taxation lead to the conclusion that the custom software exemption should remain in place.