

# Computer Software

Legislation passed in 1987 clarified the taxation of computer software in Michigan. Prior to 1987, the courts in Michigan have provided inconsistent applications of the sales tax and use tax to computer software. The following is a discussion of the taxation of computer software subsequent to the changes made in 1987. In 1999, the Department of Treasury issued Revenue Administrative Bulletin 1999-5. The 1999 RAB specifically addressed computer software issues relating to technological advances.

The Michigan Sales Tax is imposed on the sale of "tangible personal property" at retail. Section 1(p) of the Sales Tax Act and Section 2(k) of the Use Tax define "tangible personal property" to include "prewritten computer software" as follows:

"Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or that is in any other manner perceptible to the senses and includes electricity, water, gas, steam, and **prewritten computer software**. (Emphasis added) (MCL 205.51a((p))

"Prewritten computer software" means computer software, including prewritten upgrades, that is delivered by any means and that is not designed and developed by the author or other creator to the specifications of a specific purchaser.

Prewritten computer software includes the following:

- a. Any combination of 2 or more prewritten computer software programs or portions of prewritten computer software programs.
- b. Computer software designed and developed by the author or other creator to the specifications of a specific purchaser if it is sold to a person other than that specific purchaser.
- c. The modification or enhancement of prewritten computer software or portions of prewritten computer software where the modification or enhancement is designed and developed to the specifications of a specific purchaser unless there is a reasonable, separately stated charge or an invoice or other statement of the price is given to the purchaser for the modification or enhancement. If a person other than the original author or creator modifies or enhances prewritten computer software, that person is considered to be the author or creator of only that person's modifications or enhancements. (MCL 205.51a(n))

“Computer” means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions. (MCL 205.51a(b)) “Computer software” means a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task. (MCL 205.51a(c))

The statute quoted above defines “computer” and “computer software” and says “prewritten computer software” is “tangible personal property” and therefore subject to tax when sold at retail. Prewritten computer software, commonly referred to as canned software is any software not developed for a specific purchaser. It also includes any upgrades.

There are two exceptions to the above:

1. Computer software technical support or adaptation or modification of prewritten computer software programs are not subject to tax. The specific charges for technical support or for adapting or modifying prewritten computer software programs to a purchaser's needs or equipment are exempt if those charges are separately stated and identified. (MCL 205.54d(f))
2. Custom computer software is not subject to tax. The sale of computer software originally designed for the exclusive use and special needs of the purchaser is exempt. MCL 205.54d(g))

Also, any modifications or enhancement of prewritten computer software for a specific purchaser is not subject to tax if there is a reasonable, separately stated charge. The charge must be separately stated in the invoice to the customer.

### **Canned Software Transmitted By Electronic Media**

The definition of “prewritten computer software includes software “that is delivered by any means” and includes software “delivered electronically”. “Delivered electronically” means delivered from the seller to the purchaser by means other than tangible storage media. (MCL 205.51a(d)) “Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities. (MCL 205.51a(j))

## **Canned Software Transmitted By Electronic Media Where the State of Ultimate Use Is Unknown**

Section 20 of the Sales Tax Act provides a procedure for when a taxpayer obtains prewritten computer software which is taxable, but the software is transmitted by electronic media and the state of its ultimate use is not known. The statute directs the taxpayer to purchase the software tax exempt and pay tax to the appropriate state on a direct pay basis.

The purchase of prewritten computer software is exempt when a business purchaser other than a holder of a direct pay permit at the time of its purchase of electronically delivered computer software, knows that the electronically delivered computer software will be concurrently available for use in more than 1 taxing jurisdiction. The purchaser of the prewritten computer software shall deliver to the seller at the time of purchase an MPU exemption form. (MCL 205.60(1)) "MPU exemption form" means a multiple points of use exemption form. (MCL 205.60(1))

Upon receipt of the MPU exemption form, the seller is relieved of all obligation to collect, pay, or remit the applicable tax and the purchaser is then obligated to pay the applicable tax on a direct pay basis. (MCL 205.60(1))

A purchaser who delivers an MPU exemption form may use any reasonable, consistent, and uniform method of apportionment of the tax supported by the purchaser's business records as they exist at the time of consummation of the sale. (MCL 205.60(1))

The MPU exemption form remains in effect for all subsequent sales of electronically delivered computer software by the seller to the purchaser until revoked in writing. However, the apportionment may change based on the business records as they exist at the time of each subsequent sale. (MCL 205.60(1))

A business purchaser that is a holder of a direct pay permit is not required to deliver an MPU exemption form to the seller but shall apportion the tax on electronically delivered computer software using any reasonable, consistent, and uniform method supported by the purchaser's business records as they exist at the time of consummation of the sale. (MCL 205.60(1))

### ***Other Exemptions Available***

The transfer of otherwise taxable computer software may be exempt from tax under the provisions of other sections of both the sales tax act and the use tax act. The most common exemptions are computer software purchased by an industrial processor, agricultural producer, or computer software purchased by a non-profit organization.

In order to secure the exemption, the purchaser must submit to the seller a properly executed claim for exemption. The exemption claim must identify the name and address of the purchaser, describe the item sold, the amount of the purchase price, and the use to be made of the item sold. The Department of Treasury has made available an exemption claim form to be used for this purpose.

## Summary and Conclusions

The following are the conclusions on the taxation of computer software from Revenue Administrative Bulletin 1999-5 Sales And Use Taxation Of Computer Software:

1. Computer software that is offered for sale to the general public (canned software) is subject to Michigan sales or use tax. This includes license agreements for use of such software. Computer software offered for sale to the general public is taxable, regardless of whether the software has been modified for an individual customer. The seller's charge to modify canned software is subject to tax unless it is separately stated on the invoice. Computer software that is originally designed for the exclusive use and needs of a particular purchaser (custom software) is not subject to sales or use tax. A custom software program designed for a particular customer will become canned software if it is offered for sale.
2. Computer software is defined as "a set of statements or instructions that when incorporated in a machine usable medium is capable of causing a machine or device having information processing capabilities to indicate, perform, or achieve a particular function, task, or result." MCL 205.51(1)(f); MSA 7.521(f).
3. There are various types of software including operating software, application software, and system software. All types of software are subject to sales or use tax if the software is available to the general public as opposed to being custom software. The deciding factor for the taxability of computer software is whether it is canned or custom software.
4. Canned software, whether modified or not, is subject to the sales or use tax regardless of the method of delivery. A computer program transferred electronically by a network, intranet, the Internet or by any other electronic method is taxable if the software being transferred is within the definition of canned software.
5. Canned software is subject to sales tax when purchased in Michigan from a Michigan retailer. Canned software is subject to seller's use tax when purchased from an out-of-state seller registered for use tax. When purchased from a seller not registered for either sales tax or seller's use tax, the purchaser is subject to consumer's use tax. In this case, the consumer is liable for the tax and must file a use tax return. As in II, canned software is taxable regardless of the method used to deliver the software to the purchaser.

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