



**Software Finance & Tax Executives Council**  
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VIA EMAIL

June 13, 2005

Barton L. Graham  
Commissioner  
Georgia Department of Revenue  
Suite 15300  
1800 Century Boulevard  
Atlanta, Georgia 30345

**Re: Notice Number SUT-2005-1  
Proposed Rule 560-12-2-.111  
Computer Software and Computer-Related Services**

Dear Commissioner Graham:

I write on behalf of the Software Finance and Tax Executives Council (SoFTEC) to comment on your notice SUT-2005-1 which proposes new treatment for applying Georgia's sales and use tax laws to computer software and computer related services. Although we have some concerns, particularly with regard to the treatment of software maintenance agreements, SoFTEC generally is supportive of the proposed new rules as they will provide firm guidance and reduce uncertainty.

SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting. The proposed new rules would impact the sales and use tax compliance obligations of SoFTEC member companies with customers in Georgia; hence our desire to provide these comments.

**1. Treatment of Software Maintenance Agreements:**

**A. No Legislative Authority.**

As an initial matter, we point out that the longstanding rule in Georgia is that software maintenance agreements are not subject to its sales and use tax, regardless of the form of the transaction. The proposed new rules would impose the sales and use tax on maintenance contracts in certain circumstances. We believe that where an exemption from tax has been of such a longstanding nature, such as the exemption from sales and use taxes that software maintenance agreements have enjoyed, it would be inappropriate for the Commissioner to revoke the exemption without express authority from the state legislature.

## **B. Electronic Delivery and Load and Leave:**

The proposed new rules provide that software delivered electronically and through “load and leave” are not sales of tangible personal property and thus not subject to the sales or use tax. The proposed new rules also state that charges for software maintenance agreements that are bundled with prewritten software are only taxable if the underlying software is delivered using an intermediate storage medium. While we believe that this proposed rule is clear that there is no sales or use tax where both the underlying software and the maintenance are delivered electronically, it is unclear whether this implied exemption also extends to cases where the software is delivered using load and leave. We suggest that final rules include a clear statement that there is no sales or use tax on software maintenance agreements that are bundled with prewritten computer software delivered either electronically or by load and leave.

## **C. Fifty Percent Presumption:**

The proposed new rule provide that where the customer’s invoice separately states a charge for software maintenance in cases where any updates or upgrades to the underlying software are to be delivered using a storage medium, that fifty percent of the separate charge will be subject to the sales and use tax. Our assumption is that this arbitrary split is based on the presumption that a half of the charge will be for taxable tangible personal property and the other half will be for nontaxable services. Our problems with this 50/50 split proposal are twofold: (1) we believe that the economics of software maintenance agreements suggest that the portion of the price allocable to taxable tangible property should be no more than 20-percent and (2) if your final rule retains the 50 percent rule, the rule should also allow the taxpayer to rebut the presumption and come forward with evidence that a different allocation is appropriate.

### **(a) The economics of software maintenance agreements:**

One of the unique features of computer software that differentiates it from many other types of products is its extraordinarily low marginal cost of production. Once the software vendor’s research and development team has decided that a new computer program has reached “technological feasibility” and has been sufficiently “debugged,” the program is ready to be marketed. Unlike many other products, once a computer program is ready to be marketed, the marginal cost of producing copies of the software products for distribution to customers approaches zero. Duplicating copies of the software onto disks or CD-ROM is a very inexpensive process and with the advent of the Internet, many companies forgo duplication onto physical media altogether and, instead, permit the customer to download copies of the product directly onto the customer’s computer. Additionally, the load and leave delivery mechanism permits the vendor to deliver software to a number of customers using only a single physical copy, reducing number of physical copies needed to effectively distribute the product.

In order to remain competitive, software companies are constantly adding new features and functionality to their software. This enables them to create and market new

versions of their software to new customers. These software systems require substantial investment by customers not only for the initial software license fee, which can run into the millions of dollars, but they must also make an investment in computer hardware systems, personnel training and, in many instances, they must revamp their business processes to capture business information in a form that can be utilized by the computer system. Many large and medium sized businesses are loath to make such investments unless they can be sure that they will have ready access to future versions of the software. Software maintenance contracts are the vehicle by which customers guarantee themselves access to the latest version of the software that they already have purchased. As discussed above, it costs the software company little if anything to supply an existing customer with a copy of the newest version of its software which it has developed for sale to new customers.

That having been said, these software maintenance contracts typically do not obligate the vendor to come up with enhanced or upgraded versions of its software. The maintenance contract only obligates the vendor to provide a copy of the upgraded software in the event that the vendor in fact releases a revised version of the software. Clearly, at the time the customer pays the initial license fee for the version of the software available at that time and obtains the maintenance contract, it is not relying on any future upgraded software to run its business, it is relying on the functionality currently available.

Training and technical support services, which are the other component of a computer software maintenance contract, have a very different cost structure. In order to provide such services, the software vendor has to employ a staff well trained in how its software works and in how to communicate with the customer's employees either during initial training, or in a future technical support/troubleshooting context. The salaries paid to such technical support staff represent a substantial cost to the vendor. Additionally, because the type of software which maintenance contracts typically accompany are extraordinarily complex, the customer necessarily relies on the vendor to show how the software works and to help with problems that crop up after the software is installed and the customer's employees are initially trained.

As can be seen, from a cost standpoint, it costs the software company next to nothing to provide its customers with copies of upgraded versions of its software while the costs associated with providing the training and technical support services are substantial. Also, from a value added standpoint from the customer's perspective, it is likely that the customer is entering into the maintenance contract primarily to gain access to the training and technical support services, not the right to gain access to future versions of the software which the vendor is not obligated to create. However, this is not to imply that the rights to the future upgrades and enhancements are de minimis. Providing a new customer with such rights might be crucial in a sales context where the market has already been made aware that a new version will be rolling out in the near future.

We believe that allocating 20 percent of the price of a maintenance agreement to taxable tangible property is appropriate because, based on the discussion above regarding

software industry cost structures, most of the cost and value of these contracts is to be found in the services component; the cost and value of the upgrade and enhancement component, while more than de minimis, is relatively much smaller. We know of at least one other state that has adopted such a 20 percent rule: Minnesota.

#### **B. Definitions of “License Agreement” and “Software License Agreement:**

The proposed new rules contain separate definitions for the terms “license agreement” and “software license agreement.” As near as we can tell, the only difference between the two is that a “license agreement” confers upon the licensee the right to make copies of the software while the term “software license agreement” does not confer such a right. If this is the intent, we suggest that the definition of “software license agreement” be amended to make clear that it is limited to contracts that do not allow reproduction of the software except to the extent necessary to operate the software on a computer.

If the intent, with respect to the definition of “software license agreement” is not to exclude reproduction licenses, then we question the need for a separate definition. Many license agreements give customers the right to make a limited number of copies for internal use by the customer. For example, a customer needing 500 copies of a particular program may take possession of a single copy of the software and obtain, through the license agreement, the right to make an additional 499 copies for internal use. Such a license will prohibit distribution or sale of any of those copies to the public. It may be that the distinction you are looking for is whether the license not only permits the making of copies but further grants the right to sell those copies to others. Either way, we think clarification is in order.

#### **C. Bundled Products:**

The proposed new rules provide instances where an entire transaction will be considered taxable even if the transaction clearly includes taxable and nontaxable components. For instance, the proposed new rules provide that if otherwise nontaxable computer services are bundled with taxable prewritten computer software, the entire transaction is subject to tax. Similarly, if otherwise nontaxable custom software is bundled with a taxable sale of computer hardware, then the custom software will be subject to tax. We believe that there may be some conflict between these proposed bundling rules and the bundling rule recently adopted by the Streamline Sales Tax Implementing States at its April 2005 meeting. We believe that before the proposed rules are finalized, that their bundling provisions should be harmonized with the SSTIS bundling rule. Having inconsistent bundling rules could cause Georgia’s sales tax laws to be noncompliant with the Streamlined Sales and Use Tax Agreement.

#### **D. Custom Software:**

The proposed rules generally define custom software and software developed by the author to the specifications of a specific purchaser. Custom software is considered nontaxable as a service. The proposed rules go on to find that “the combining of two or

more prewritten computer programs or prewritten portions thereof does not cause the combination to be other than prewritten computer software.” We believe that this second rule so narrows the definition of custom software as to make the universe of custom software very nearly a null set.

The combination of the definition with the rule regarding the combination of two or more prewritten programs represents an unrealistic view of the process of developing custom software and seems to presuppose that a developer of custom software starts with a “clean sheet of paper.” The reality is that a custom software developer will have a “toolkit” of prewritten portions of computer software that will be used over and over again in developing software for various customers. Consider how inefficient and expensive it would be if a custom software developer had to write a new algorithm that causes a computer to print a document. The reality is that the developer wrote that print algorithm early in his or her career and pulls it out of the “toolkit” anytime there is a need to insert it in a program. That “print” algorithm very likely constitutes “prewritten computer software” within the meaning of the proposed new rules and combining it with other similar algorithms from the “toolkit” in the design of a customer computer program would cause the final product to be “prewritten computer software” in nearly every instance. The failure to recognize the reality of how custom computer software is created makes any tax exemption for custom software illusory.

We think that what is intended by the rule regarding combining prewritten computer software has to do with combining what are called in the industry “modules” and is not intended to apply to the algorithms contained in a custom software developer’s “toolkit.” Because SoFTEC does not represent the interests of customer software developers, we do not feel it is our place to offer advice on how to craft a proper definition of custom software. Suffice to say that we believe more work is needed in this area.

**Conclusion:**

We thank you for the opportunity to present these comments and hope you find them useful as you move forward in finalizing your proposed software rules. Please feel free to contact me if you have any questions.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Mark E. Nebergall". The signature is fluid and cursive, with the first name being the most prominent.

Mark E. Nebergall  
President  
Software Finance and Tax Executives Council