

**NEW JERSEY DIVISION OF TAXATION
REGULATORY SERVICES BRANCH
TECHNICAL ADVISORY MEMORANDUM**

TB-51R

ISSUED: 7-5-11

TAX: SALES AND USE TAX

TOPIC: SOFTWARE

Prewritten Computer Software Is “Tangible Personal Property”

Computer software means a set of coded instruction designed to cause a computer or automatic data processing equipment to perform a task. N.J.S.A. 54:32B-8.56.

The New Jersey Sales and Use Tax Act taxes retail sales of tangible personal property, unless a specific statutory exemption or exclusion applies. “Tangible personal property” includes prewritten computer software including prewritten computer software delivered electronically.

Change in the Law

Prior to October 1, 2006, software that was transmitted electronically was not treated as taxable tangible personal property, and therefore its sale was not subject to sales or use tax. P.L. 2006, c. 44, made the following changes regarding the taxability of software, effective October 1, 2006:

1. expanded the statutory definition of “tangible personal property,” *explicitly including “prewritten computer software delivered electronically”* N.J.S.A. 54:32B-2(g), and
2. limited the exemption for electronically delivered prewritten software, allowing an exemption for sales of electronically delivered prewritten software *only* when it is to be used directly and exclusively in the conduct of the purchaser’s business, trade, or occupation. N.J.S.A. 54:32B-8.56.

Taxability of Prewritten Software

Prewritten Computer Software

Prewritten computer software is any computer software, including prewritten upgrades and combinations or portions of two or more prewritten software programs, that is *not* designed and developed to meet the unique requirements of a specific purchaser and sold for that specific purchaser’s exclusive use. N.J.S.A. 54:32B-8.56. Prewritten software includes prewritten software delivered electronically. Prewritten software can be installed on the purchaser’s computer, either electronically or through the use of a tangible medium, without significant modification to the software. Prewritten software can also include prewritten software that has been modified for the customer as well as software initially designed as “custom” software for a specific purchaser, which is subsequently sold as is to anyone other than the original purchaser. N.J.S.A. 54:32B-8.56.

The retail sale of prewritten software is taxable. The sale of a license to use prewritten software is treated the same as the sale of outright title to the prewritten software. The use in New Jersey of prewritten

computer software purchased at retail without payment of sales or use tax is subject to use tax. N.J.S.A. 54:32B-6.

Custom Software

In the current market, it is rare for a software designer to create software solely for one specific purchaser. Most software is instead already prewritten, and can be sold as is, or with some modifications to adapt it to the customer's special technical or business needs. In those exceptional circumstances when software is created, written, and designed for the exclusive use of a specific customer, it is not considered prewritten computer software when sold to the specific customer for whom it was designed. N.J.S.A. 54:32B-8.56. That customer's purchase of this entirely custom-made software is treated as a nontaxable professional service transaction and is not subject to sales tax.

Modified Software

It has become commonplace for business customers to purchase prewritten computer software that has been modified somewhat to fit their technical or business requirements. The sale of prewritten computer software is taxable regardless of whether the prewritten software is sold in its original form, or combined with other prewritten software programs, or with modifications to meet the purchaser's special needs. However, the seller of modified software has an option to charge a separate fee for the customization service. A separately stated, commercially reasonable charge for the professional service of modifying the software for the customer is not treated as a charge for the sale of prewritten computer software and is therefore exempt from sales tax. N.J.S.A. 54:32B-8.56. If the seller of modified software instead chooses to charge a lump sum, without separately stating the fee for customization services, then the entire charge is subject to sales tax as part of the sale of tangible prewritten software.

Exemption for Sales of Electronically Delivered Software Used Exclusively and Directly in Conduct of Purchaser's Business, Trade, or Occupation

There is one exception to the taxability of prewritten software delivered electronically. Sales of prewritten software delivered electronically are exempt if the software is to be used directly and exclusively in the conduct of the purchaser's business, trade, or occupation. N.J.S.A. 54:32B-8.56.

This exception does not apply, however, if the software is being delivered by a "load-and-leave" method. Sellers sometimes send a service representative to a customer's New Jersey location to install prewritten or modified software. In some circumstances, once the installation is complete, the tangible storage medium (CD, disc) is not left with the customer. This type of installation is referred to as "load and leave." The transaction is not deemed to be the sale of tangible personal property delivered electronically, and therefore is not exempt, even if the software is to be used directly and exclusively in the conduct of the purchaser's business, trade, or occupation.

If the purchaser of software initially delivered electronically also receives tangible storage media containing the software, then the transaction is not deemed to be a sale of software delivered electronically and is not exempt, even when the software is to be used directly and exclusively in the purchaser's business.

Installation and Maintenance Services and Service Contracts

Fees for the service of installing software for the customer are subject to sales tax. They are treated as charges for the installation of tangible personal property. N.J.S.A. 54:32B-3(b)(2).

The sale of a maintenance contract for prewritten software is generally subject to tax. Software maintenance contracts usually include the provision of updated, supplemental, and corrected software. Contracts covering delivery of such updated, supplemental, and corrected software via tangible storage media are taxable. Contracts for the delivery of such updated, supplemental, and corrected software entirely electronically, with no tangible storage media, are also taxable *unless* these electronically delivered updates

are to be used directly and exclusively in the conduct of the purchaser's business, trade, or occupation. A maintenance contract covering only entirely custom-made updates of custom software, for the exclusive use of the original purchaser, is also nontaxable, regardless of whether delivered electronically or through tangible storage media. If a software maintenance contract covers *only* the provision of training, consultation, or advice, help and customer support via telephone or online, but no software, then the contract is not taxable.

Sourcing of Receipts from Sales of Prewritten Computer Software

Effective October 1, 2005, the Streamlined Sales and Use Tax Agreement (SSUTA) has been incorporated into the New Jersey Sales and Use Tax Act. P.L. 2005, c.126. The SSUTA sourcing provisions aid a seller by identifying which state's law should be applied to a sale, e.g., the sourcing rules are used to specify which state has the first right to tax tangible personal property or services sourced to that state. Sourcing a sale to a particular state does not mean that the transaction is taxable. The sale may in fact not be taxable under the law of the state to which the sale was sourced.

Sourcing of receipts from sales of prewritten computer software is governed by the following principles:

1. If prewritten computer software is received by the purchaser at a business location of the seller, the retail sale is sourced to that business location. N.J.A.C. 18:24-25.7(a)(1).
2. If prewritten computer software is not received by the purchaser at a business location of the seller, the retail sale is sourced to the location(s) where receipt by the purchaser occurs. Receipt may occur at multiple locations if the seller delivers the software to multiple locations. The transaction is sourced to those locations if the seller receives delivery information from the purchaser by the time of the invoice. N.J.A.C. 18:24-25.7(a)(2).

Example: Seller ships multiple hard copies of prewritten computer software to multiple locations of the Purchaser. The retail sale is sourced to those locations indicated by the instructions for delivery to each jurisdiction in which the Purchaser receives the prewritten computer software.

Example: Seller electronically delivers copies of the prewritten computer software to multiple locations of the Purchaser. The Seller has the information identifying the multiple locations for the electronic delivery of the prewritten computer software. The Seller sources the retail sale to each jurisdiction where the Purchaser receives the prewritten computer software.

Example: Seller electronically delivers prewritten computer software to the Purchaser's server in State A. The Seller has information identifying the location of the server in State A. Purchaser subsequently downloads copies of the prewritten computer software to its multiple locations. The Seller sources the retail sale to the jurisdiction where the Purchaser receives the prewritten computer software, at the location of the server in State A. Seller has no responsibility to source the retail sale to any other state.

Example: Purchaser headquartered in State A also has locations in States B and C. The Seller electronically delivers prewritten computer software to the Purchaser's server located in State B. The Seller has information identifying all of these locations. The Purchaser's prewritten computer software will be accessed by its employees in all three states. The Seller sources the retail sale to the jurisdiction where the Purchaser receives the prewritten computer software, at the location of the server in State B. Seller has no responsibility to source the retail sale to any other state.

3. If 1. and 2. above do not apply, the retail sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller, that are maintained in the ordinary course of business when use of this address does not constitute bad faith. N.J.A.C. 18:24-25.7(a)(3).

Example: Seller electronically delivers prewritten computer software to an unknown location(s) of the Purchaser. The Seller has information identifying an address that is maintained in the Seller's files for

business purposes. The Seller sources the retail sale to the jurisdiction for the address of the business location of the Purchaser available in the Seller's business records.

4. If 1. 2. and 3. above do not apply, the retail sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the retail sale, including the address of a purchaser's payment instrument if no other address is available when this address does not constitute bad faith. N.J.A.C. 18:24-25.7(a)(4).

Example: The Seller makes retail sales of prewritten computer software by allowing Purchasers to electronically download the prewritten computer software from Seller's website. In connection with the retail sale, the Purchaser discloses an address associated with the credit card used to pay for the prewritten computer software. This is the only location information the Seller receives from the Purchaser in connection with the retail sale. The Seller sources the retail sale to the jurisdiction of the address for the Purchaser associated with the credit card payment.

5. If 1. 2. 3. or 4. above do not apply, including circumstances in which the seller is without sufficient information to apply 1. 2. 3. or 4 above, then the retail sale is sourced to the jurisdiction for the address of the location from which the prewritten computer software was shipped or, if delivered electronically, was first available for transmission by the seller. N.J.A.C. 18:24-25.7(a)(5). "First available for transmission" means the location from which the software originated. N.J.A.C. 18:24-25.7(a)(5)(i).

Sourcing of Receipts from Sales of Services to Prewritten Software

Sourcing of receipts from sales of services to prewritten software is governed by the following principles:

A retail sale of a computer-related service is sourced where the purchaser makes first use of the service. The purchaser may make first use of a service in more than one location. N.J.A.C. 18:24-25.7(b)(1).

Example: A Purchaser drops off two of its computers at a Seller's location for the purpose of having data recovered from one computer and transferred to the second computer. Upon the completion of the service, the Purchaser picks up the computers at the Seller's location. The retail sale of the service is sourced to the Seller's location.

Example: A Purchaser receives computer services at the Purchaser's location. The retail sale of computer services is sourced to the Purchaser's location.

Example: Seller sends computer repair personnel to two of Purchaser's locations to perform data recovery services in States A and B. Seller bills Purchaser at an hourly rate for the work performed by its employee. The Seller's employee tracks its time based on the work performed at each location. The Seller shall source the retail sale to States A and B in accordance with the time spent at each location.

A retail sale of a post-sale support agreement, sold by the seller of software at the same time as the sale of the software itself, is sourced to the same address(es) as the retail sale of the underlying software. N.J.A.C. 18:24-25.7(b)(2).

Sourcing of Payments Made in Connection with a Software Term License or Subscription

Pursuant to Rule 309.5(1) of the SSUTA Rules and Procedures, "software subscription" means a transaction requiring additional payments for updates to prewritten computer software and "software term license" means a transaction where the purchaser's right to continue to use prewritten software is dependent on periodic payment.

Sourcing of payments made in connection with a software term license or subscription is governed by the following principals:

Initial payments are sourced in the same manner as the sale of the software. N.J.A.C. 18:24-25.7(c)(1). (See “Sourcing of receipts from sales of prewritten computer software” above).

If the initial payment is sourced based on the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery known to the seller, then one of the following applies:

If the seller receives information from the purchaser indicating that the location of the underlying software has changed, a subsequent payment made in connection with a software term license or renewal of a software subscription is sourced to such new location; or

If the seller has not received information from the purchaser indicating a change in the location of the underlying software, sourcing a subsequent license payment made in connection with a software term license or the renewal of a software subscription to the same location where the initial payment was sourced will not constitute bad faith. N.J.A.C. 18:24-25.7(c)(2).

Example 1: Seller electronically delivers to Purchaser a copy of prewritten computer software on a subscription basis. The software is a product designed to detect online threats. In order to remain effective, the software must be constantly updated with new threat definitions. The subscription provides the Purchaser with electronically delivered updates for a one year period. The Purchaser may renew the subscription annually. The Seller does not have information as to the location where the software was electronically delivered. However, the purchase order discloses a “ship to” address. Seller sources the sale to the “ship to” address shown on the purchase order as such address constitutes a “location indicated by instructions for delivery to the purchaser”.

Example 2: Same facts as in Example 1, except the Purchaser is a consumer who downloads the software from the Internet and uses a credit card to pay for the software and the subscription to the updates. During the consummation of the sale, seller does not receive any information regarding the location to which the software and the subscription will be delivered, but does receive the Purchaser’s credit card billing address. The Seller does not have delivery or other address information in its business records, thus, Seller sources the transaction to the Purchaser’s credit card billing address because it is a location indicated by an address for the purchaser obtained during the consummation of the sale.

Example 3: Seller delivers to Purchaser a copy of prewritten computer software. The license is for a 1-year period and requires the Purchaser to make payments to renew the license. If the Purchaser does not make an annual payment, the Purchaser must terminate use of the software and the software may cease to function. Seller ships the software on a disk to purchaser in State A. Seller sources the initial license payment to State A, the location to which it shipped the software.

Example 4: Same facts as in Example 1, above, except the Purchaser renews the software subscription for a second year. The purchase order for the renewal discloses a different “ship to” address than the purchase order for the initial sale of the subscription. The different “ship to” location on the renewal purchase order constitutes the receipt by the Seller of information indicating that the location of the underlying software has changed. Seller sources the renewal to the new address.

Example 5: Same facts as in Example 4, above, except that the purchase order for the renewal discloses a different “bill to” address than the purchase order for the initial sale of the subscription. The “ship to” address on the Purchase order remains the same. A change in the “bill to” address on the purchase order does not constitute the receipt of information from the purchaser indicating that the location of the underlying software has changed. The Seller sources the renewal payment to the same location as the initial payment.

Example 6: Same facts as in Example 2, above, except that the Purchaser has moved and has a new credit card billing address. The Purchaser uses the credit card and the new address when renewing the software subscription for a second year. In the interim, Seller has not received information concerning the location of the software. Because the initial payment was not sourced to the location where receipt by the

purchaser occurs, Seller's use of the new credit card address for sourcing the renewal payment would not constitute bad faith.

Example 7: Same facts as in Example 3, above, except that after the software copy was delivered to Purchaser in State A, the Purchaser installs the software on a computer located in State B. Seller never receives any information that the software is located in any state other than the one to which it originally shipped it. Purchaser renews the license at the end of the first year and seller sources the renewal payment to State A. Because seller has not received any information indicating that the location of the software has changed, Seller's sourcing of the license renewal payment to State A does not constitute bad faith.

Example 8: Seller sells to Purchaser prewritten computer software under a perpetual license for \$3 million. Seller agrees to finance the license fee over a 3-year period under which the Purchaser will make three equal annual payments. Seller sends Purchaser an invoice that includes the first annual payment plus 100 percent of the sales tax due on the transaction. Seller thus collects and remits all of the tax due with respect to the transaction at the time of the sale. The subsequent payments are not made in connection with a software term license or subscription and sourcing is therefore not necessary.

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