

Computer System Design and Software Modification Services Now Subject to the Massachusetts 6.25% Sales and Use Tax

Written by Nicola Lemay, Earl W. Mellott

August 1, 2013

Effective as of **July 31, 2013**, the Massachusetts 6.25% sales and use tax has been expanded to apply to certain types of computer system design and software modification services (“Computer/Software Services”).

Computer/Software Services that are provided pursuant to contracts entered into before July 31, 2013 are not subject to this tax, except to the extent that payment under such a contract is invoiced or billed on or after July 31, 2013 and only to the extent that the payment relates to services performed on or after July 31, 2013.

The expanded sales and use tax is one of the new taxes imposed by “An Act Relative to Transportation Finance” (the “Act”) to generate funding for the state’s public transportation system. The Massachusetts Department of Revenue (“DOR”) has issued Technical Information Release 13-10 (“TIR 13-10”) providing initial guidance regarding the application of the sales and use tax to Computer/Software Services (including guidance related to services provided to affiliated groups and guidance relating to applicable filing requirements), but many questions still remain about the specific circumstances in which the tax will apply. The DOR plans to release additional future guidance.

TIR 13-10 solicits input from affected taxpayers regarding the application of the tax to particular transactions or business practices. The DOR asks that comments or suggestions be sent to rulesandregs@dor.state.ma.us. The DOR also anticipates that there will be opportunity for public comment on a working draft of amended regulations before they are formally proposed.

Scope of the Expanded Sales and Use Tax

Prior to the Act, services (other than telecommunications services) were not subject to sales and use tax in Massachusetts. The Act subjects the following previously untaxed Computer/Software Services to the 6.25% sales and use tax umbrella:

- Computer system design services: The Act defines these services as “the planning, consulting or designing of computer systems that integrate computer hardware, software or communication technologies and are provided by a vendor or a third party”; and
- Software modification services: The Act describes these services as “the modification, integration, enhancement, installation or configuration of standardized software.”

In TIR 13-10, the DOR clarified that the software modification services covered by the Act are customization services with respect to prewritten software. In other words, software modification services that are now subject to sales and use tax are those services that modify, enable or adapt prewritten software to meet the business or technical requirements of a particular purchaser and to operate on the purchaser’s computer systems, regardless of how those services are described or billed to the purchaser.

By contrast, services provided in connection with the development of custom computer software that is not based on prewritten software remains exempt from sales and use tax. In addition, software services involving “data access, data processing or information management services” remain exempt. Thus, for example, cloud-based computing services such as remote data storage should not be subject to the sales and use tax, but assisting a client to design and implement a cloud-based computing system could be subject to the tax.

TIR 13-10 further clarifies that the tax under the Act will only apply to computer system design or software modification services that are directly related to a particular systems integration project involving the sale of computer hardware or software. Examples of non-taxable

services include (i) consulting and evaluation services with respect to existing computer systems to identify deficiencies and needs and (ii) training services to prepare a business to use modified software.

When are Computer/Software Services Subject to Sales or Use Tax in Massachusetts?

A sale of Computer/Software Services is subject to Massachusetts sales or use tax if it is “sourced” to a purchaser of the services in Massachusetts. TIR 13-10 states that sales of computer system design services and software modification services are not necessarily sourced in the same manner. TIR 13-10 goes on to note, however, that both sales of computer system design services and software modification services generally should be sourced to the location of the use of the computer system or modified software, as applicable.

Purchaser Obligation to Pay Use Tax

If a service provider does not collect sales tax on a Computer/Software Services transaction and such transaction is sourced to Massachusetts (e.g., because the purchaser will be using the computer system or modified software in Massachusetts), the purchaser must pay Massachusetts use tax on the transaction. TIR 13-10 includes guidance relating to the apportionment of the use by the purchaser of a computer system or modified software among multiple states.

Service Provider Obligation to Collect and Remit Sales Tax

A service provider is relieved of any obligation to collect sales tax on a Computer/Software Services transaction if the purchaser provides the service provider with a Multiple Points of Use Certificate, using Form ST-12, line 9 (“MPU Certificate”). A purchaser can (but is not required to) provide the service provider with an MPU Certificate if the computer system or modified software will be concurrently available for use by the purchaser in more than one state. Service providers may opt to shift the burden of the Computer/Software Services sales and use tax, when possible, by specifically requesting an MPU Certificate from purchasers that will be using the computer system or modified software in multiple states.

If a purchaser of Computer/Software Services does not provide an MPU Certificate to the service provider, then the service provider generally must apply a set of rules set forth in TIR 13-10 to determine whether it must collect and remit Massachusetts sales tax on the Computer/Software Services transaction. These rules refer to the location of the “receipt of services” and “delivery of services.” From the sourcing rules and examples provided in the TIR, these terms presumably should be interpreted to mean the location where a computer system or modified software is received or delivered (rather than the location where the service provider actually created the product).

The rules provided in TIR 13-10 relating to a service provider’s obligation to collect and remit Massachusetts sales on Computer/Software Services transactions can be summarized as follows, and generally must be applied in the order of priority listed below:

1. If the purchaser receives the service at a business location of the service provider, the service is sourced to that business location of the service provider.
2. If the service provider knows the location where the service is received by the purchaser based on instructions for delivery as provided by the purchaser, the service is sourced to that location, when use of this address does not constitute bad faith.
3. If the purchaser does not specify a location for the service to be delivered, the service is sourced based on the purchaser’s address that is known to the service provider as provided by the purchaser or based on information known to the service provider. For this purpose, address information from a payment instrument or credit card is acceptable, when use of this address does not constitute bad faith.
4. If neither the delivery location nor the purchaser’s address can be determined, then the service is sourced based on the address of the service provider from which the sale was made.

TIR 13-10 provides an example of these rules that assumes that a service provider makes a sale of Computer/Software Services to a purchaser located in Massachusetts and that the purchaser does not give the service provider an MPU Certificate. Under these facts, the services are sourced as follows:

- a. If the purchaser receives the software at the service provider’s location, the services are sourced to the service provider’s location.

b. If “a” does not apply and the service provider delivers the software (e.g., by disk or by load and leave) to the purchaser’s location, the services are sourced to the purchaser’s location.

c. If “a” and “b” do not apply, the service provider performs no services at the purchaser’s location, and the modified software is downloaded to the purchaser’s server, which may be in or outside of Massachusetts, the services are sourced to the purchaser’s address in the service provider’s books and records (assuming such information is available and the use of this address does not constitute bad faith).

Additional Observations

The scope of the computer system design services and software modification services that are subject to the new tax is vague and may be difficult to interpret in practice. This lack of clarity could lead to uneven compliance with, and enforcement of, the tax. For example, TIR 13-10 provides that consulting and evaluation services provided to identify deficiencies and needs with respect to existing computer systems are not subject to the sales and use tax. However, in practice, it may be difficult to separate consulting services that evaluate the deficiencies of a client’s existing computer systems from consulting services that assist a client with designing a system to address those problems. Further, while software training services are exempt from the expanded tax, determining the appropriate taxable amount may be problematic where training services are bundled with software services.

On a final note, service providers should approach their implementation of this expanded sales tax with care since purchasers may bring legal claims against service providers that improperly collect sales tax.

RELATED INDUSTRIES

- [Professional Services](#)
- [Technology](#)

RELATED PRACTICES

- [Business Counseling](#)
- [Taxation](#)

This communication is intended for general information purposes and as a service to clients and friends of Foley Hoag LLP. This communication should not be construed as legal advice or a legal opinion on any specific facts or circumstances, and does not create an attorney-client relationship.

United States Treasury Regulations require us to disclose the following: Any tax advice included in this document was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Attorney advertising. Prior results do not guarantee a similar outcome. © 2017 Foley Hoag LLP. All rights reserved.