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Pennsylvania: Canned Computer Software Taxable Regardless Of Delivery Method

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The Pennsylvania Commonwealth Court (the "Court") recently surprised the Board of Finance and Revenue and taxpayers alike by holding that license renewals for canned software were subject to the Pennsylvania sales tax regardless of the means of delivery.[1]

Factual Background

In 1991, Graham Packaging Company, L.P. ("Graham"), a manufacturer of customized blow-molded plastic containers, paid Dell approximately $395,000 for a two-year license renewal fee to use certain software programs, such as Windows NT and Office Pro 2000, that it had previously purchased from Dell. In connection with the license renewals, Graham paid sales tax in the amount of $22,379.40. Graham later filed a refund claim for the sales tax paid, which was denied by both the Board of Appeals and the Board of Finance and Revenue.

Is Canned Software Taxable? Yes. Yes. It Depends. Yes.

Pennsylvania imposes a six-percent tax on "each separate sale at retail of tangible personal property." 72 P.S. § 7202(a). A "sale at retail" includes "[a]ny transfer, for a consideration, of the ownership, custody or possession of tangible personal property, including the grant of a license to use or consume whether such transfer be absolute or conditional and by whatever means the same shall have been effected." 72 P.S. § 7201(k)(1). "Tangible personal property" is defined, in part, as "[c]orporeal personal property including, but not limited to, goods, wares, merchandise, steam and natural and manufactured and bottled gas for non-residential use, electricity for non-residential use, prepaid telecommunications, premium cable or premium video programming service, spirituous or vinous liquor. . . ." 72 P.S. § 7201(m).

Prior to July 1, 1997, the definition of "sale at retail" expressly included programming services. 72 P.S. § 7201(k)(16) [repealed by the Act of May 7, 1997, P.L. 85 (the "1997

[1] *See Graham Packaging Co. v. Commonwealth*, 882 A.2d 1076. (Pa. Commw. Ct. 2005).

Act")]. Although the statutory definition of "computer programming services" did not include canned software, canned software was considered tangible personal property.[2]

The Department of Revenue (the "Department") statement of Policy in effect until June 30, 1997, provided that the performance of computer services resulted in either a taxable service or a taxable transfer of tangible personal property. 61 Pa. Code § 60.13(b)(1)(i). Moreover, the statement of policy also provided: "(1) The following are examples of taxable computer programming services: . . . (iii) [t]he sale of a license to use canned or custom software applications. Canned software is tangible personal property. Custom software is a computer service." *Id.* at (c)(iii).

Following the 1997 Act, in which custom computer programming services were deleted from the definition of "sale at retail," the Department issued a new policy statement, effective July 1, 1997, which reiterated that the sale of canned software remained a taxable transaction. Although the Department did not rescind its statement of policy, in February of 2000, the Department issued a revenue ruling that indicated that the purchase of canned software that is transmitted electronically is not subject to tax, but the purchase of the same software delivered on tangible media is subject to tax because it has a "physical material body." Sales and Use Tax Ruling, No. SUT-99-024.

Transactional Essence: Property or Service?

Summarily dispensing both the Department's and Graham's analysis of the taxability of canned software, the Court examined the Department's statements of policy which categorized canned computer software as taxable tangible personal property and its seemingly inconsistent ruling which excluded from tax sales of electronically delivered canned software. Not satisfied with the Departments' policies and rulings, the Court turned to other jurisdictions' decisions seeking to distinguish between tangible personal property and intangible property or a service. Some decisions employ an approach that adheres to traditional notions of the terms “tangible” and “corporeal” and concludes that some physical matter must be involved in the sale.[3] Other jurisdictions adopted the "essence of the transaction" test or the "true object" test[4] in order to determine whether

[2] "Canned software" is defined as "[c]omputer software that does not qualify as custom software." 61 Pa. Code § 60.19(b). "Custom software" is "[c]omputer software designed, created and developed for and to the specifications of an original purchaser." *Id.*

[3] *See Citizens & S. Sys., Inc. v. S.Carolina Tax Comm’n,* 311 S.E.2d 717 (S.C. 1984); *Chittenden Trust Co. v. King*, 465 A.2d 1100 (Vt. 1983). *See also Mark O. Haroldson, Inc. v. State Tax Comm’n*, 805 P.2d 176 (Utah 1990).

[4] The "essence of the transaction" test or the "true object" test applies when a transaction appears to involve both tangible and intangible property or tangible property and a service. In order to determine whether a taxable sale of tangible personal property has occurred, the test focuses on whether the essence or true object of the sale is tangible personal property or intangible property or a service with tangible property serving only as the medium of transmission. If the essence of the transaction or true object of the transaction is the intangible property of service, the intangible object/service does not assume the taxable character of the tangible property serving as the medium of transfer. *See generally* 68 Am. Jur. 2d Sales and Use Taxes § 6.2.

the license of canned software was the sale of a service or intangible property or the sale of tangible personal property.[5]

Applying the essence of the transaction test, the Court determined that the mode of transfer of the software is irrelevant since the essence of the sale is the computer program. The Court stated that "the essence of the transaction test is the most logical and practical . . . test" since it . . . "does not exalt form over substance . . . and it avoids the potential for parties to structure their transactions to avoid tax liability." As such, the Court noted, it is the nature of the software itself which must determine whether the software and accompanying license is tangible personal property.

Okay, Its Property. But is it Tangible?

Finally, the Court determined that since a computer program "is stored on a computer's hardware, takes up space on the hard drive and can be physically perceived by checking the Computer's files," the computer program and its accompanying license are tangible personal property. Moreover, the Court concluded that legislative history and the Department's statement of policy support the determination that, regardless of whether transmitted electronically or on a physical medium, the sale of all canned software is taxable as the sale of tangible personal property.

Conclusion

As of November 1, 2005, all canned software sold in Pennsylvania is subject to the sales and use tax regardless of whether the software was delivered in physical form or downloaded electronically. If a vendor collected sales tax on electronically downloaded canned software prior to November 1, 2005, the vendor may refund the sales tax to the purchaser or remit the sales tax to the Department.■

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[5] *See Dallas Central Appraisal District v. Tech Data Corp.,* 930 S.W.2d 119 (Tex. App. 1996). *See also Northeast Datacom, Inc. v. City of Wallingford,* 563 A.2d 688 (Conn. 1989) (concluding that both canned and custom software were intangible property and rejecting view that if one has intangible property that is temporarily fixed in a tangible medium, the tax authority may tax as tangible personal property the value of the tangible medium plus the value of the intangible personal property).