Cite as Det. No. 15-0034, 34 WTD 492 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of	)	D E T E R M I N A T I O N
Tax Ruling re:	)	
	)	No. 15-0034
	)	
. . .	)	Registration No. . . .
	)	

RULE 15502; RCW 82.04.215: BUSINESS AND OCCUPATION TAX – RETAIL SALES TAX – RETAILING – SALES OF PREWRITTEN COMPUTER SOFTWARE – SALES OF CUSTOM SOFTWARE – CUSTOMIZATION OF PREWRITTEN COMPUTER SOFTWARE – ROUTINE INSTALLATION OF COMPUTER SOFTWARE. The taxpayer appealed a letter ruling from the Department that the taxpayer's sales constitute sales of prewritten computer software subject to Retailing B&O tax and retail sales tax. The Department determined that, because the taxpayer customizes an already existing base software program for specific customers, but bills the customers for the framework, customizations, and installations in one charge, the sales are retail sales subject to Retailing B&O tax and retail sales tax. To be taxable under the Service & Other Activities B&O tax classification, the charges for customization must be separately stated from charges for sales of prewritten computer software.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Valentine, A.L.J. – A taxpayer appeals a letter ruling wherein the Department of Revenue (Department) instructed the taxpayer that its sales constitute sales of prewritten computer software subject to Retailing Business & Occupation (B&O) tax and retail sales tax. As set forth below, we conclude that the correct taxation classification of a particular sale is dependent on the elements of the transaction and how those elements are billed to the customer. The letter ruling issued to Taxpayer is modified accordingly.[1]

ISSUE

Pursuant to RCW 82.04.215 and WAC 458-20-15502 (Rule 15502), if a taxpayer customizes an already existing base, or framework, software application for a specific customer, and invoices the customer for the framework, customization, and installation as one charge, is that transaction

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[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

a sale of prewritten computer software, or is it a sale of the customization of prewritten computer software?

FINDINGS OF FACT

[Taxpayer] is a foreign corporation registered to do business in Washington. Taxpayer sells a variety of web-based systems applications to financial institutions for operations such as opening new accounts, running credit reports, and consumer lending. Taxpayer has a base application framework in place for each business area and then customizes the framework to meet each customer's individual needs. According to Taxpayer, its Washington customers are limited to federal credit unions.

Taxpayer's customers cannot purchase operational web-based software applications directly from Taxpayer's website. Rather, the website provides general information, and potential customers must contact a company sales representative to further explore a purchase. Taxpayer's base applications are neither operational nor sold without customization. Once a customer has made a purchase, Taxpayer, either in person or remotely, customizes the system for that particular customer. Taxpayer invoices the initial installation and customization as a single installation charge.

On January 31, 2014, Taxpayer submitted a letter ruling request about the taxability of its Washington income to the Department's Taxpayer Information & Education (TI&E) section, which is part of the Department's Taxpayer Services Division. Taxpayer's request reads as follows: "I need a tax ruling on the nature of my business. We consult and customize software for our clients."

In a letter ruling, dated February 13, 2014, TI&E notified Taxpayer that sales and installations of prewritten computer software are subject to retail sales tax and that gross income from these same sales is taxable under the Retailing B&O tax classification. TI&E wrote, in pertinent part:

> It appears that you have sold a [prewritten] computer software program called [Program X]. The billing description states: "[Program X] Installation Fee."

> Charges for the sale and installation of [prewritten] computer software are subject to retail sales tax and the gross income received from the sale is subject to business and occupation (B&O) tax under the *retailing* classification.

Taxpayer timely appealed. Taxpayer contends that it sells customization of prewritten computer software to customers, which Taxpayer asserts is not subject to retail sales tax or use tax.

ANALYSIS

In Washington, the term "sale at retail" or "retail sale" includes "the sale of prewritten computer software to a consumer, regardless of the method of delivery to the end user." RCW 82.04.050(6)(a). The term does not include the sales of or charges made for "custom software; or the customization of prewritten computer software." RCW 82.04.050(6)(a)(i)-(ii). Persons

making sales at retail must pay Retailing B&O tax on gross proceeds of sales and collect retail sales tax on the selling price. RCW 82.04.250 and RCW 82.08.020. Gross income obtained from the creation and sale of custom software or the customization of prewritten software is taxed under the Service & Other Activities B&O tax classification under RCW 82.04.290(2). RCW 82.04.29001(2); Rule 15502(2)(a) & (7)(a)(iii).

Washington law defines the term "computer software" as "a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task." RCW 82.04.215(2). *See also* Rule 15502(1). In Washington State, "all software is classified as either prewritten or custom." *Id.*

RCW 82.04.215(3) defines the term "custom software" as "software created for a single person." *See also* Rule 15502(2). RCW 82.04.215(6) defines the term "prewritten computer software" as "computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser."[2] *See also* Rule 15502(3).

Based on the facts outlined above, and the statutes and rules cited above, we conclude that Taxpayer's base software applications do not constitute custom software because these applications are not created for a single person or for a specific purchaser. Taxpayer's customers start with the same base applications and have them customized for their specific business needs. Thus, Taxpayer's base applications constitute prewritten computer software rather than custom software.

RCW 82.04.215(4) defines the term "customization of prewritten [computer] software" as "any alteration, modification, or development of applications using or incorporating prewritten computer software for a specific person." *See also* Rule 15502(7)(a)(i). Customization of prewritten [computer] software includes "individualized configuration of software to work with other software and computer hardware but does not include routine installation." RCW 82.04.215(4).

Rule 15502(7)(a)(iv) describes the customization of prewritten computer software versus routine installation as follows:

> Customization of prewritten computer software includes custom installations but does not include routine installation. "Routine installation" means the process of loading program files and installation files onto a computer. Routine installation includes the process of "clicking through" dialog boxes to install prewritten software. Routine installation does not require any specialized knowledge or skills. Custom installation generally requires programming by a programmer to integrate customized elements of prewritten computer software.

"Customization of prewritten [computer] software does not change the underlying character or taxability of the original prewritten computer software." RCW 82.04.215(4); Rule 15502(7)(a)(i). However, if there is a reasonable, separately stated charge on an invoice or other

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[2] Video games played with video consoles are examples of "prewritten computer software" because the gaming software is not designed to the specifications of specific purchasers. Det. No. 13-0263, 33 WTD 562 (2014).

sales document given to the purchaser by the seller of the modification or enhancement of the prewritten software, the modification or enhancement element does not constitute prewritten computer software. RCW 82.04.215(6).

Taxpayer does not invoice for the base applications and initial customizations separately. Taxpayer charges one line-item price and labels the charge an installation fee. Thus, these sales constitute sales of prewritten computer software and are taxable under the Retailing B&O tax classification and are subject to retail sales tax. Rule 15502(3)(a). Rule 15502(7)(a)(ii).

Taxpayer contends its Washington customers are federal credit unions. We note, therefore, that federally-chartered credit unions are not subject to state retail sales tax. *See* 12 U.S.C. § 1768 (2013); WAC 458-20-190(2) and (3). Thus, if Taxpayer sells prewritten computer software to federally-chartered credit unions located in Washington, those sales are not subject to retail sales tax.[3]

In summary, charges for customization of prewritten software must be separately stated on invoices or other sales documents to be taxable under the Service & Other Activities B&O tax classification. If charges for customization are not separately stated from sales of prewritten computer software, "the entire charge is considered a retail sale subject to retail sales tax." Rule 15502(7)(a)(iii).

Following is an example, provided by Rule 15502(7)(vi), of the taxation of separately stated charges for the sale of prewritten computer software and the customization of prewritten computer software issued by a seller to the same customer:

> (A) **Example 20**. Tee, Inc. needs financial modeling software that can tie into its existing computer systems. Because of the unique business, however, Tee needs the industry-wide computer software offered by PQR Computers, Inc., to be modified to meet the needs of Tee. Both Tee and PQR are in-state corporations, and the software is delivered in this state. PQR provides a separately stated charge to Tee for customization of prewritten computer software performed in this state that is supported by the terms of the sales agreement. PQR is subject to retailing B&O tax, and it must collect retail sales tax from Tee for the sale of prewritten computer software in Washington. PQR, in addition, is subject to service and other activities B&O tax for the customization of prewritten computer software in Washington.

We note that customization of prewritten software does not include routine installation. Rule 15502(7)(a)(v). If a routine installation is billed separately from a customization of prewritten software, the charges for routine installation are subject to Retailing B&O tax and retail sales tax. *Id.* De minimis routine installation charges, however, if not separately stated from the

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[3] We are not making a determination about whether Taxpayer's credit union customers in Washington are federal credit unions. Many state-chartered credit unions are federally insured. We are merely instructing that federally-chartered credit unions are not subject to state retail sales tax. *See* Det. No. 03-0097E, 24 WTD 156 (2005). It is Taxpayer's responsibility to know its tax reporting obligations and to ensure the accuracy of the information entered on its Washington excise tax returns. RCW 82.32A.030. Thus, it is Taxpayer's responsibility to know which, if any, of its credit union customers located in Washington are federally-chartered credit unions rather than state-chartered credit unions that are federally insured.

customization of prewritten computer software, are subject to Service & Other Activities B&O tax. *Id.*

Accordingly, the ruling at issue is modified based on the additional information provided above. These instructions constitute "specific written instructions" within the meaning of RCW 82.32.090.

DECISION AND DISPOSITION

Taxpayer's petition is denied relative to its assertion that all of its Washington sales constitute the customization of prewritten computer software. The letter ruling issued to Taxpayer, dated February 13, 2014, is modified as set forth above.

Dated this 13th day of February, 2015.