



Private Letter Rulings

"Private letter rulings" are written statements issued to a taxpayer by the department, that interpret Wisconsin tax laws based on the taxpayer's specific set of facts. Any taxpayer may rely upon the ruling to the extent the facts are the same as those set forth in the ruling.

The ruling number is interpreted as follows: The "W" is for "Wisconsin"; the first four digits are the year and week the ruling becomes available for publication (80 days after the ruling is issued to the taxpayer); and the last three digits are the number in the series of rulings issued that year. The date is the date the ruling was issued.

Certain information that could identify the taxpayer has been deleted. Additional information is available in Wisconsin Publication 111, "How to Get a Private Letter Ruling From the Wisconsin Department of Revenue."

The following private letter rulings are included:

Sales and Use Taxes

Computer software — tangible vs. intangible

Computer software — maintenance

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Exemptions — advertising materials for out-of-state use

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Exemptions — prosthetic devices

Exemptions — medicines

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Purchases for resale — promotional campaigns

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Use tax — subsequent shipment out-of-state

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W9452010, September 29, 1994

Type Tax: Sales and Use

Issue: Computer software — tangible vs. intangible; Computer software — maintenance

Statutes: Sections 77.51(20) and 77.52(1) and (2)(a)10, Wis. Stats. (1991-92)

Wis. Adm. Code: Section Tax 11.71, April 1993 Register

This letter responds to your request for a private letter ruling regarding the Wisconsin sales and use tax treatment of computer software licensing fees and support charges.

Facts

General

Company C sells computer systems, including computer hardware, and licenses various industry-specific computer software applications to automobile, truck, motorcycle, industrial, vehicle, and agricultural equipment dealers. The separate software applications range from back-office accounting and inventory control to front-office showroom traffic tracking and vehicle financing. The size of the dealer clients ranges from single brand dealers to "mega-dealers" who carry multiple brands.

Company C offers approximately 30 software applications. On average, large multi-franchise dealers ("mega-dealers") license 20 applica-

tions while single-franchise dealers license 9 applications.

Each of the 30 software applications represents standard software offered universally to all clients. Each standard application has several alternative "set-up" modification options, most of which are installed or "set up" by the client. In a few circumstances, the taxpayer will reprogram or "customize" a standard application to a limited extent for a client. Accordingly, the software licensed by each client is different only to the extent that "set-up" modifications may vary or, in limited situations, to the extent that the standard applications are customized.

Set-ups

Each of the 30 standard applications is tailored to meet the individual needs of each client through use of "set-ups." The client's requirements are generally defined by a series of "set-up" decisions that will control how the particular application (e.g., inventory, accounting) will function on a daily basis for that client.

A "set-up" is a feature within the software that tailors the standard application to the client's needs. It allows the dealer to choose options which alter the functionality of the software application without actually modifying the program.

Virtually all "set-ups" are installed by the client. Generally, client-installed "set-ups" are those that pertain to client preference options. Examples include defining how many days' supply for stock orders, the number of invoices to

print, the number of days to store information, what accounts are to be scheduled, or the different types of MIS information the user may want from the system.

A few "set-ups" are installed by Company C. Typically, Company C will install "set-ups" either because they are standard across the industry or because of their complexity. Examples include setting up the software application printers on specifically defined ports or helping the user to set up a daily operating chart.

User Programming Application

The User Programming Application is a separate application available to clients who wish to present or calculate their data in a manner different than what could be obtained from a standard application. This application allows clients the ability to retrieve data from standard application data files in order for the client to recalculate or present data in a different format or to store its data.

It is the client, not Company C, that reformats or recalculates the information by means of the standard User Programming Application. However, Company C conducts the requisite training to educate clients in the use of this application.

Custom Modifications of Standard Programs

In some instances, there is a need for Company C to modify the standard applications in order to meet the specific needs of a client. This is required when neither the standard "set-ups" nor the standard User Programming Application can meet the client's needs. When modifications are made by Company C, they range from small changes to an extensive change, usually ranging from 1% to 10% of the original program.

Customization usually involves reformatting or calculation of data in a non-standard format. Examples of such custom modifications include invoice print formats, finance and insurance application calculations, and third party interface to Company C applications.

The number of clients to whom this type of customization has been provided ranges from less than 1% for some applications to 4% for others.

Generally, customization can be performed without changing the standard software code. In less than 1% of the modifications, the program code needs to be rewritten to some extent.

Customization is performed by the Company C Special Programming Group. Client requests are analyzed before a decision is made by Company C to accept the request. If accepted, a specification is created and an estimate of time and cost is provided to the client for approval. The client is billed by the hour for custom programming. This is a separate one-time charge and is in addition to the standard contractual licensing fee paid on the standard software.

Once the custom programming is completed, the custom software is installed on the client's computer by Company C. The client is either instructed via telephone, documentation, or both in the operation of the new software program.

Software License and Fees

The average term of a software licensing agreement is five to seven years. For each application, there is a one-time prepaid license fee and also a monthly license and support fee. The prepaid license fees vary, depending on the software application. For any single software application, the list price fee is the same

from client to client. Any difference in such fees is attributable to prices negotiated by the client and is not due to the number of "set-ups."

Presale Consultation and Analysis of User's Requirements

Each Company C sales representative spends a significant amount of time in solicitation, consultation, and configuration of the hardware (e.g., PCs, printers, modems) and software to be used at each prospective dealership client. Most of the presale consultation is devoted to software.

Each dealership has its own unique needs.

After consulting with each of the dealership's five major managers, the Company C sales representative first identifies the individual needs of that dealership and determines the configuration of hardware and software required to meet these needs. In presale consultation, the sales representative and the dealership personnel work together to determine whether the Company C standard software applications (with appropriate "set-up" options) can meet the user's specifications. In cases where they do not, Company C's Special Programming Group may supply more customized features or programs.

The average time spent dedicated to presale consultation and analysis of the user's needs is detailed as follows:

1. Detailed manager review

This represents a 2 to 3 hour meeting with each of the dealer's five main managers in order to determine the way the dealer's current system works and propose changes (Company C software applications) that would make the dealership more efficient. (15 estimated man hours)

2. Product demonstration

This involves a comprehensive hardware and software presentation with each of the dealer's department managers emphasizing those features of each software application, together with the appropriate "set-up" options, relevant to each manager. A demonstration can take from a minimum of 8 man hours to a maximum of 48 man hours. (Average 16 estimated man hours)

3. Custom report analysis

Where the standard software applications and available "set-ups" do not entirely meet the needs of an individual prospective client, the sales representative identifies the specific concern or request and confers with Company C's programmers and support people to determine whether Company C can program the desired change. If so, and if a contract is executed, the standard application would then be customized for the client. (Average 16 estimated man hours, when applicable)

Immediately after the client has agreed to license the software, account executives, conversion specialists, install coordinators, programmers, and trainers invest approximately 100 additional hours with each new client.

Post-Sale Activities

1. Installation and testing of program

When the computer system is shipped to the client, it has been pre-loaded with the Company C software applications requested by the client. The system at this

point does not have the specific tables and "set-ups" necessary to allow the software applications to execute in accordance with the client's business needs and requirements.

The computer hardware is installed by Company C at the client site after which the client is responsible for testing the application software and the custom "set-ups," whether those "set-ups" were installed by Company C or the client.

2. Training and documentation

Training is always provided to the client's management and staff. Much of the training is held at a Company C office location. In some instances, the training is done at the client's place of business. It would be difficult for a client to effectively operate the Company C software applications without preliminary training from Company C.

The number of days required for training varies depending on the application. For core applications, such as Accounting, Inventory, or Finance and Insurance, training classes average 5 days for each application and are provided to the client's managers. Other applications require 3 to 5 days training for each application.

Company C also supplies documentation and user guides to its clients. The documentation varies by the software application. In general, each application might have a User Guide (defining daily functions), a Maintenance Guide (defining "set-ups"), and a Manager's Guide. However, due to the number of software applications offered and the various

"set-ups" for each client, the documentation and user guides alone would not provide a complete understanding of the system without personal training.

3. Enhancements and maintenance support

a. Software maintenance and updates

Company C systems require that clients be able to interact with Company C via modem. This is referred to as "on-line access." This access provides for both electronic and manual updates of the system software. "Updates" refer to database changes, such as changes in auto parts prices by manufacturers. These updates can be delivered electronically or by magnetic tape. The software is not useful without current data.

Corrections to software can also be made by Company C on-line. Corrections involve solving problems that clients encounter when using the software.

The on-line access also provides for a quick and easy method for Company C to respond to specific regulation changes imposed by local, state, and federal agencies. Also, auto manufacturers make changes that require Company C to modify standard software. Such changes occur on a frequent basis.

Company C releases an average of 20 to 30 upgrades per client per year or 2 to 4 upgrades per application. All clients of a particular application receive the same updates.

b. Telephone support

Company C also provides telephone support to its clients. The average client calls approximately 12 to 14 times per month. Approximately 40% to 50% of these calls raise questions on how to use the applications. The remaining calls are either technical in nature or request assistance implementing a "set-up."

The software telephone consultation support is not optional to the client.

Request

You ask the following:

1. Is the prepaid license fee for Company C's software applications subject to Wisconsin sales or use tax?
2. Is the monthly charge for "software license and support" subject to Wisconsin sales or use tax?

Ruling

1. The prepaid license fee for Company C's standard software applications, including User Programming Applications, is subject to Wisconsin sales or use tax, except those standard applications where Company C customizes the software by rewriting program codes.
2. The monthly charge for "software license and support" relating to the standard applications subject to tax in #1 above is subject to Wisconsin sales or use tax. The monthly charge for "software license and support" relating to standard applications where Company C customizes the software by rewriting program codes is not subject to Wisconsin sales or use tax.

Analysis*Prepaid License Fee*

Section 77.52(1), Wis. Stats. (1991-92), imposes a Wisconsin sales tax on sales of tangible personal property and taxable services at retail in Wisconsin.

"Tangible personal property" for purposes of imposing Wisconsin sales tax is defined in sec. 77.51(20), Wis. Stats. (1991-92), to include computer programs, except custom computer programs.

Section Tax 11.71(1)(e), Wis. Adm. Code (April 1993 Register), defines "custom programs" to mean utility and application software which accommodate the special processing needs of the customer. The determination of whether a program is a custom program shall be based upon the facts and circumstances, including the following:

1. The extent to which the vendor or independent consultant engages in significant presale consultation and analysis of the user's requirements and system.
2. Whether the program is loaded into the customer's computer by the vendor and the extent to which the installed program must be tested against the program's specifications.
3. The extent to which the use of the software requires substantial training of the customer's personnel and substantial written documentation.
4. The extent to which the enhancement and maintenance support by the vendor is needed for continued usefulness.
5. There is a rebuttable presumption that any program with a cost of

\$10,000 or less is not a custom program.

6. Custom programs do not include basic operational programs or prewritten programs.
7. If an existing program is selected for modification, there must be a significant modification to the program by the vendor so that it may be used in the customer's specific hardware and software environment.

The standard software applications and user programming applications sold by Company C which do not require customization by Company C are tangible personal property as defined in sec. 77.51(20), Wis. Stats. (1991-92).

Such applications do include significant presale consultation, enhancement and maintenance support by the vendor, preloading of software by Company C prior to obtaining the hardware purchased from Company C, and some training and documentation by Company C. However, the standard software applications exist at the time ordered by the client. In addition, the standard applications are not tested by Company C against program specifications nor are they modified in any way by Company C so that they may be used by the client. The standard applications sold by Company C are usually under \$10,000 per year per application.

In addition, standard applications which are customized for purposes of reformatting or calculation of data, but which do not involve rewriting program codes, are tangible personal property. Such applications are not custom programs because the modifications are not considered significant.

Customization of standard applications by Company C which involves rewriting program codes is consid-

ered to be a significant modification. Therefore, the resulting application after the customization is a custom program, and the charge for the standard application and customization is not subject to Wisconsin sales or use tax.

Software License and Support Fees

Section 77.52(2)(a)10, Wis. Stats. (1991-92), provides that the service or maintenance to tangible personal property is subject to Wisconsin sales or use tax. Company C, in providing telephone support, is providing a service to software. If the software is tangible personal property, the service is subject to Wisconsin sales or use tax.

Section Tax 11.71(3)(c), Wis. Adm. Code (April 1993 Register), provides that gross receipts from providing program technical support, error correction services, and maintenance and enhancement to **custom programs** are not subject to Wisconsin sales or use tax. Therefore, services performed by Company C to the nontaxable customized software are not subject to tax. □

✻ **W9438008**, June 24, 1994

Type Tax: Sales and Use

Issue: Exemptions — advertising materials for out-of-state use

Statutes: Section 77.54(25), Wis. Stats. (1991-92)

Wis. Adm. Code: Section Tax 11.19, March 1991 Register

This letter responds to your request for a private letter ruling.

Facts

XYZ Funds ("The Funds") are organized as a Massachusetts Business

Trust registered for sale in all 50 states and the District of Columbia. Its shares are sold only to members of a certain religion or to parties affiliated with that religion. Federal law and regulations, as well as state laws and regulations, require that it provide prospectuses and periodic financial statements to its shareholders.

Company A, a subsidiary of Company B, is the distributor for shares of The Funds. It uses the Company B national sales force of licensed Registered Representatives to sell The Funds and it splits the sales charge or "load" with the Registered Representatives.

Securities laws require that most sales and promotional material be preceded or accompanied by a current prospectus. In order to encourage sales of The Funds, Company A pays for the printing of additional prospectuses. It provides these prospectuses, free of any charge, to its Registered Representatives who use them both alone and in conjunction with Company A's sales literature.

Company A is a member of the National Association of Securities Dealers ("NASD"). As a member, it files the sales and promotional materials that are given to the public with the NASD for review. Because Company A is legally obligated to supervise its Registered Representatives' activities, it only permits its Registered Representatives to use these pre-approved sales and promotional materials. Because of the promotional nature of its use of the periodic financial reports, Company A files text and graphics it proposes to use in the financial reports with the NASD and pays for the printing of additional financial reports. Company A provides these periodic financial reports free of charge to its Registered Representatives to use for sales and promotional activities.

The Funds mailed about 123,000 prospectuses and annual reports dated June 30, 1993, to shareholders (no claim for sales tax exemption is made for these pieces). Company A anticipates using 450,000 prospectuses and 160,000 annual reports for sales and promotional purposes. The estimated cost per prospectus and annual report ranges from about \$0.12 to \$0.15 per prospectus or report.

Because of state securities registration requirements or "Blue Sky" laws, Company A must maintain detailed records concerning the nature and number of shares and accounts sold in each state. State laws also require that Registered Representatives be licensed and supervised. Company A maintains detailed records concerning the number and location of a Registered Representative's sales.

The prospectuses and financial reports used to satisfy legal requirements regarding existing shareholders, are sent from the printer to a mail house for transmittal. The prospectuses and financial reports used by Company A for sales and promotional purposes are shipped to a central warehouse from which their distribution is monitored. Neither The Funds nor Company A has previously made any claim for exemption from sales tax.

Request

You have requested a ruling that the prospectuses and financial reports that are actually used to fulfill legal requirements or are used in Wisconsin for any reason would be subject to Wisconsin sales or use tax. You propose that sec. 77.54(25), Wis. Stats. (1991-92) and sec. Tax 11.19(4) Wis. Adm. Code, March 1991 Register, be interpreted to require sales tax on those prospectuses and financial reports sent to existing shareholders.