THE CITY OF SEATTLE
DIRECTOR'S RULE
IMPLEMENTING SEATTLE BUSINESS TAX ORDINANCE
RULE 5-500

Seattle Rule 5-500   Computer software.

(1)   Introduction. This rule explains the business license tax treatment of activities related to computer software, and computer software-related services. Such activities include, but are not limited to, selling, leasing, manufacturing, installing, repairing, and maintaining computer software, as well as developing, duplicating, configuring, licensing, downloading, and accessing computer software.

This rule contains examples that identify a number of facts and then state a conclusion. The examples should be used only as a general guide. The tax results in all situations must be determined after a review of all facts and circumstances.

(2)   Definitions.

(a)   <u>Automatic data processing equipment.</u> "Automatic data processing equipment" includes computers used for data processing purposes and their peripheral equipment.

(b)   <u>Computer software.</u> "Computer software" is a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task. All software is classified as either prewritten or custom. "Computer software" includes only those sets of coded instructions intended for use by an end user and specifically excludes retained rights in software and master copies of software. Computer software does not include data. Computer software may be delivered either electronically or by tangible storage media.

(c)   <u>Custom software.</u> "Custom software" is software created for a single person. The use of library files in software development does not preclude such software from being characterized as custom software, as long as the software is created for a single person. For purposes of this rule, "library files" are a collection of precompiled and frequently used routines that a software developer can use in developing the software. The nature of custom software does not change when ownership is transferred to a person with no rights retained by the transferor.

(d)   <u>Customizing prewritten computer software.</u> "Customization of prewritten computer software" is any alteration, modification, or development of applications using or incorporating prewritten computer software for a specific person. "Customization of prewritten computer software" includes individualized configuration of software to work with other software and computer hardware but does not include routine installation. Customization of prewritten computer software does not change the underlying character or taxability of the original prewritten computer software.

(e)   <u>Master copies of software.</u> "Master copies of software" means copies of software from which a software developer, author, inventor, publisher, licensor, sub-licensor, or distributor makes copies for sale or license. Development of a master copy of software by a software developer, or a third party hired by the software developer, that is used to produce copies of software for sale or commercial or industrial use, is not a manufacturing activity. A third party charge for development of a master copy of software is a charge for custom software development and is subject to taxation under the service and other business activities classification.

(f)   <u>Prewritten computer software.</u> "Prewritten computer software" is computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more

prewritten computer software programs or prewritten portions thereof does not result in custom software. However, configuration of prewritten computer software to work with other computer software does constitute customization of prewritten computer software. Prewritten computer software includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than such purchaser. Where a person, who is not the author or creator, modifies or enhances prewritten computer software, that person is deemed to be the author or creator only of the modifications or enhancements made. Prewritten computer software, or a portion thereof, that is modified or enhanced to any degree, remains prewritten computer software, even though the modification or enhancement is designed and developed to the specifications of a specific purchaser. Where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for the modification or enhancement, the modification or enhancement will not be considered prewritten computer software.

(g) Retained rights. "Retained rights" means any and all rights, including intellectual property rights such as those rights arising from copyrights, patents, and trade secret laws, that are owned or are held under contract or license by a software developer, author, inventor, publisher, licensor, sub-licensor, or distributor.

(h) Royalties. "Royalties" are compensation for the use of intangible property including but not limited to intellectual property, such as copyrights, patents, licenses, franchises, trademarks, trade names, and similar items. The true object of a transaction involving royalties is to grant an intangible right to reproduce and distribute copies of computer software for sale. It does not, however, include compensation for the licensing of prewritten computer software to the end user. The manner in which computer software is sold (e.g., volume of transactions, subscription license, term license, or perpetual license) or the manner in which payment amount is determined (e.g., fixed fee per copy, percentage of receipts, lump sum, etc.) does not alter the royalty nature of the transaction.

(i) Site license of prewritten computer software. "Site license of prewritten computer software" is a license which provides a consumer acquiring prewritten computer software with the right to duplicate prewritten computer software for use on its own computers, based on the number of computers, the number of workers using the computers, or some other criteria. A site license agreement may cover one site or multiple sites of a purchaser.

(3) **Taxation of custom software, software training, royalties, and customizing prewritten computer software.** The following activities are taxable under the service and other business activities classification:

(a) Creation of custom software. Gross income received for creating custom software in Seattle is subject to taxation under the service and other business activities classification.

(b) Duplication of custom software. Duplication of custom software for the same person, or by the same person for its own use, does not change the character of the custom software. Duplication of custom software for the same person, or by the same person for its own use, is not subject to taxation under the manufacturing classification, but is considered to be part of the sale of custom software and subject to taxation under the service and other business activities classification.

If a person duplicates custom software for sales to, or use by, another person other than the original purchaser, the software becomes prewritten computer software as defined in subsection (2)(f) of this section.

(c)   Computer software training. Gross income received for training on the use of *custom* software is subject to taxation under the service and other business activities classification. Gross income received for training on the use of *prewritten* computer software is subject to taxation under the service and other business activities classification, if the charge for such training is separately stated from the sale of prewritten computer software. If the charge for software training is not separately stated from the sale of prewritten computer software, the entire charge is considered to be a sale of prewritten computer software subject to taxation under the retailing classification.

(d)   Licensing computer software - royalties. Income received from charges in the nature of royalties for the licensing of computer software is taxable under the service and other business activities classification.

In determining royalties, the true object of the transaction is to grant an intangible right to reproduce and distribute copies of computer software for sale. In contrast, the true object of a site license is the sale to an end user of prewritten computer software for use on its computers. See subsections 2 (i), 4 (b)(ii) and 4 (c)(ii) of this rule for more information on site licenses.

For example, HG Computers, Inc., an original equipment manufacturer (OEM), acquires prewritten computer software from LL Software, Inc. for purposes of acquiring a license to reproduce and distribute the prewritten computer software, as part of a bundled computer hardware and software package to end users. LL retains all of its ownership rights to the software. Royalties received from granting intangible rights to reproduce and distribute prewritten computer software to HG are subject taxation under the service and other business activities classification.

(e)   Customizing prewritten computer software. Gross income received for customizing prewritten computer software is subject to the service and other business activities classification. When a charge for customization of prewritten computer software is separately stated on an invoice or contract given to the purchaser, such customization is subject to taxation under the service and other business activities classification. If a charge for customization of prewritten computer software is not separately stated from a sale of prewritten computer software, the entire charge is considered to be a sale of prewritten computer software.

Customization of prewritten computer software does not include routine installation. "Routine installation" means the process of loading program files and installation files onto a computer. Routine installation does not include installation of the customized elements of prewritten computer software. When an invoice or contract contains a separately stated charge for routine installation and customization of prewritten computer software, routine installation is subject to taxation under the retailing classification. If a charge for routine installation is not separately stated from customization of prewritten computer software, the predominant nature of the charge determines the business license tax treatment of the charge.

For example:

(i)   Golf Tee, Inc. needs financial modeling software that can tie into most of its existing computer systems. Golf Tee Inc. finds an industry-wide computer

software offered by PQR Computers, Inc. that, when modified, meets the requirements of Golf Tee Inc. PQR provides a separately stated charge to Golf Tee Inc. for customization of prewritten computer software performed. PQR is subject to taxation under the retailing classification for the sale of prewritten computer software. PQR, in addition, is subject to taxation under the service and other business activities classification for the customization of prewritten computer software.

(ii)   Same facts as (i), except that, in addition, PQR provides a separately stated charge to Golf Tee Inc. for routine installation of prewritten computer software. This charge represents installation of only the prewritten portion of the software. PQR is subject to taxation under the retailing classification for the routine installation of the prewritten software.

(4)   **Taxation of prewritten computer software.** The following explains the taxation of prewritten computer software:

(a)   Wholesale sales of prewritten computer software. Gross proceeds from sales of prewritten computer software to persons other than consumers (e.g., sales for resale without intervening use) are subject to taxation under the wholesaling classification, whether or not ownership or title passes to the buyer, and regardless of any express or implied restrictions upon the buyer. The method of delivery of prewritten computer software does not alter the wholesale nature of the transaction, whether it is through tangible storage media or any electronic means. Delivery of software manuals and backup copies of prewritten computer software does not alter the delivery of the actual copy of prewritten computer software to be used by the buyer in determining when and where the sale takes place.

(i)   *Wholesale sale versus royalty.* Sales of prewritten computer software constitute wholesale sales if the software is delivered to the reseller through tangible storage medium or any electronic means and the reseller, who has no right to reproduce the software for further sales, sells the same software to its customers. The true object of the wholesale sale is the sale of the software. On the other hand, income received for granting an intangible right to reproduce and distribute copies of prewritten computer software for sale constitutes royalties. The true object of the transaction that generates royalty income is the right to reproduce and re-license the software. See subsection (3)(d) of this rule for more information on royalties.

(b)   Retail sales of prewritten computer software. Gross proceeds of sales of prewritten computer software to consumers are subject to taxation under the retailing classification, whether or not ownership or title passes to the buyer, and regardless of any express or implied restrictions upon the buyer. The method of delivery of prewritten computer software does not alter the retail nature of the transaction, whether it is through tangible storage media or any electronic means. Delivery of software manuals and backup copies of prewritten computer software does not alter the delivery of the actual copy of prewritten computer software to be used by the buyer in determining when and where the sale takes place.

(i)   *Free prewritten software.* The use of prewritten computer software is not taxable, if it is provided free of charge, or if it is provided for temporary use in viewing information, or both. This exception from taxation is limited to prewritten computer software provided free of charge or for temporary use in viewing

information, such as free promotional software, donated software, free download of software, and software provided in beta testing to a third party free of charge.

(ii) *Retail sales of prewritten software under a site license.* Gross proceeds of sales of a site license to a consumer are subject to taxation under the retailing classification. Delivery or authorization of additional copies of prewritten computer software within Seattle will incur additional taxation under the retailing classification, regardless of the method of delivery. If the seller does not deliver any additional copies of the software to the buyer, then the sales occur when the sales agreements are made to purchase the additional copies, and the sales occur where the original copy or copies of prewritten computer software is delivered unless a better method of determining the delivery location can be made. Delivery of software manuals and backup copies of prewritten computer software does not alter the delivery of the actual copy of prewritten computer software to be used by the buyer in determining when and where the sale takes place.

For example:

(A) GH Computers, Inc. sells at retail a multiple site license of its prewritten computer software to Quick, Inc. GH is located outside Seattle, while Quick is located in Seattle and in other states and outside the U.S. The desktop software is licensed on an unlimited basis, which means that there are no restrictions of its use by Quick. The software is delivered to Quick outside Seattle. Quick then electronically duplicates the software and distributes the software to all of its 500 employees, of which 100 employees are located in Seattle. The software is electronically downloaded into the desktop computers of all employees and is immediately put into use. If GH has nexus with Seattle, business license tax is due under the retailing classification on the 100 copies of prewritten computer software used in Seattle.

(B) Same facts as (D), except that under the original site license agreement, Quick is entitled to reproduce, distribute, and use up to 500 copies of the desktop software. Then Quick merges with another company, and additional copies are needed for the use of its new employees. Quick, therefore, subsequently purchases 100 additional copies of the software from GH under the same site license agreement. No additional copies of the software are delivered to Quick in fulfilling this new agreement. Quick distributes additional copies of the software it electronically downloads to its 100 new employees, of which 50 employees are located in Seattle. If GH has nexus with Seattle, business license tax is due under the retailing classification on the 50 additional copies of prewritten computer software used in Seattle.

(c) Manufacturing of prewritten computer software. Persons engaged in manufacturing prewritten computer software in the city are subject to taxation under the manufacturing classification upon the value of the products. See Seattle Rule 5-044 (Value of products) and 5-111 (Manufacturing, processing for hire, fabricating). Manufacturers of prewritten computer software who sell their products at retail or wholesale in the city are also subject to taxation under either the retailing or wholesaling classification, as the case may be. In such cases the manufacturer must report under both the "production" (manufacturing) and "selling" (wholesaling or retailing) classifications and may claim a

multiple activities tax credit (MATC). See WAC 458-20-19301 (Multiple activities tax credits) for detailed information about the MATC. The mere development of the master software program is not a manufacturing activity.

(i) *Duplication of prewritten computer software.* Duplication of prewritten computer software in Seattle for sales to, or use by, more than one person is subject to taxation under the manufacturing classification upon the value of products. Duplication of prewritten computer software outside Seattle is not subject to taxation under the manufacturing classification regardless of where software development takes place.

Duplication of prewritten computer software in Seattle is subject to taxation under the manufacturing classification only if the prewritten computer software is delivered from the seller to the purchaser by means of tangible storage media which is retained by the purchaser. (Refer to SMC 5.30.035 H.)

When a software developer contracts with a third party to duplicate prewritten computer software, the parties must take into account the value of all tangible and intangible materials or ingredients, including the software code, when determining the relative value of all materials or ingredients furnished by each party. If the third party furnishes less than 20% of the total value of all materials or ingredients that become a part of the produced product, then the third party is presumed to be a processor for hire and the software developer is presumed to be a manufacturer. See Seattle Rule 5-111 (Manufacturing, processing for hire, fabricating) for more information.

(ii) *Duplication of prewritten computer software by a person under a site license.* The seller of a site license is subject to taxation under the manufacturing classification for its own duplication of prewritten computer software in Seattle. A purchaser of a site license, however, is not subject to taxation under the manufacturing classification for the duplication of prewritten computer software in Seattle for its own use, pursuant to a site license agreement with the seller.

5. **Key to activate computer software.** A key, or an enabling or activating code, may be required in some instances to activate computer software and put the software into use, and the key may be delivered to a purchaser after the software is already delivered and in possession by the same purchaser. In such instances, the entire sale of computer software occurs when both the key and the software are delivered to the purchaser. The sale takes place where the software is delivered to the purchaser. If the software delivery location is unavailable to the vendor because the software was delivered by a third party, then the sale takes place where the key is delivered. There is no separate sale of the key from the software, regardless of how such sale may be characterized by the vendor or by the purchaser.

For example:

JKL Computers, Inc., an in-state business, sells at retail prewritten computer software to Customer R. JKL delivers the software to R in Seattle. The prewritten computer software, however, cannot be activated without a key. JKL subsequently delivers the key in Seattle to R for a separate price. JKL is subject to taxation under the retailing classification on the entire sale of the software including the separate charge for the key. The entire sale takes place in Seattle (where the software is delivered) when both the software and the key are delivered to R. There is no separate sale of the key, regardless of the fact that JKL delivers the key to R for a separate charge. It also makes no difference if the key was delivered outside of Seattle.

6.   **Server license and client access license for the server software.** The server license, paid for at the time the server is purchased, grants the buyer the right to install the server software on the buyer's computer. The client access license (CAL) grants the buyer the right to access the server software. The client access license is not computer software and is not downloaded into the buyer's computer.

Sales of server licenses and client access licenses are treated as part of the sale of the server software, even if the charges are separately stated. The sales take place where the server software is delivered to the buyer.

For example:

(a)   ZZ Computers, Inc., a Seattle business, sells at retail server software to Customer Q. ZZ delivers the server software to Q in Seattle. ZZ also provides Q with client access licenses allowing Q the right to access the server software from its personal computers. Q's server is located in Seattle, but all of Q's personal computers are located outside of Seattle. The sale of server software to Q is subject to taxation under the retailing classification.

(b)   Same facts as (i), except that ZZ sells at retail two types of prewritten computer software to Customer Q. One is server software, and the other one is client software (which is different from client access licenses). ZZ delivers the server software to Q in Seattle where Q's server is located. ZZ delivers the client software to Q outside Seattle where all of Q's personal computers are located. Sales of client software and server software to Q are separately charged. Only the sale of server software to Q is subject to the retailing tax.

(7)   Other activities associated with computer software.

(a)   Installing or uninstalling computer software. Gross income received for installing or uninstalling custom software is subject to taxation under the service and other business activities classification.

Gross proceeds of sales for routine installation or the uninstalling of prewritten computer software are subject to taxation under the retailing classification. Routine installation of prewritten computer software includes charges for labor and services with respect to the installation, such as travel for the routine installation of the software.

(b)   Repairing, altering, or modifying computer software. Repair of prewritten computer software for more than one person may be distributed as a fix or patch by tangible storage media or electronically in the nature of software upgrades and updates. The sale of prewritten computer software upgrades and updates are a sale of prewritten computer software subject to taxation under the retailing classification.

Alteration or modification of prewritten computer software performed for a specific person is subject to taxation under the service and other business activities classification. Such alteration or modification of prewritten computer software for a specific person constitutes customization of prewritten computer software.

Alteration or modification of custom software is subject to taxation under the service and other business activities classification.

For example:

(i)   STU Computers, Inc., a Seattle service provider, is hired by Customer B to perform fixes via remote access on its prewritten computer software in Seattle. STU is performing alteration or modification of prewritten computer software for a specific person in Seattle and is subject to taxation under the service and other business activities classification. Customer B may be located within Seattle or outside of Seattle and the alteration would still be taxable to STU Computers, Inc.

(ii)   VW Computers, Inc., a Bellevue service provider, is hired by Customer C to perform fixes via remote access on its prewritten computer software located in Seattle. VW's facility is located in Bellevue. VW is not subject to B&O tax, because the alteration or modification occurs outside of Seattle.

(c)   <u>Maintaining computer software.</u> Computer software maintenance agreements typically include, but are not limited to, support activities such as telephone consulting, help desk services, remote diagnostic services, and software upgrades and updates.

(i)   *Tax treatment of computer software maintenance agreement in general.* Stand alone computer software maintenance agreements that include telephone consulting, help desk services, remote diagnostic services, and other professional services sold in Seattle, are taxable under the service and other business activities classification. See Seattle Rule 5-133 (Warranties and maintenance agreements) for information about extended warranties.

Stand alone sales of updates or upgrades to prewritten computer software in Seattle are retail sales of tangible personal property subject to taxation under the retailing classification.

(ii)   *Prewritten computer software maintenance agreement with mixed elements.* The sale of a prewritten computer software maintenance agreement that includes professional service components such as telephone consulting and retail components such as upgrades and updates of prewritten computer software is a retail sale subject to taxation under the retailing classification.

In cases where the charges for the professional service component(s) and the retail component(s) are separately stated within a prewritten computer software maintenance agreement or invoice, then each activity is taxed according to the nature of the activity.

(iii)   *Maintenance agreement on custom software and customized elements of prewritten computer software.* Sales of maintenance or support services relating to custom software or the customized elements of prewritten computer software are subject to taxation under the service and other business activities classification. Such services, including upgrades and updates, are rendered with respect to the custom or customized software and take on the underlying character and taxability of the custom or customized software.

Effective: May 15, 2007.

THE CITY OF SEATTLE
DIRECTOR'S RULE
IMPLEMENTING SEATTLE BUSINESS TAX ORDINANCE
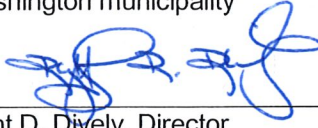#### RULE 5-500

DIRECTOR'S CERTIFICATION

I Dwight D. Dively, Director of the Department of Finance of the City of Seattle, do hereby certify under penalty of perjury of law, that the within and foregoing is a true and correct copy as adopted by the City of Seattle, Department of Finance.

DATED this __14TH__ day of May, 2007.

CITY OF SEATTLE,
a Washington municipality

By: _____

Dwight D. Dively, Director
Department of Finance

STATE OF WASHINGTON – KING COUNTY
--ss.

209880
CITY OF SEATTLE:REVENUE &

No. MAKING HEARING

Affidavit of Publication

The undersigned, on oath states that he is an authorized representative of The Daily Journal of Commerce, a daily newspaper, which newspaper is a legal newspaper of general circulation and it is now and has been for more than six months prior to the date of publication hereinafter referred to, published in the English language continuously as a daily newspaper in Seattle, King County, Washington, and it is now and during all of said time was printed in an office maintained at the aforesaid place of publication of this newspaper. The Daily Journal of Commerce was on the 12th day of June, 1941, approved as a legal newspaper by the Superior Court of King County.
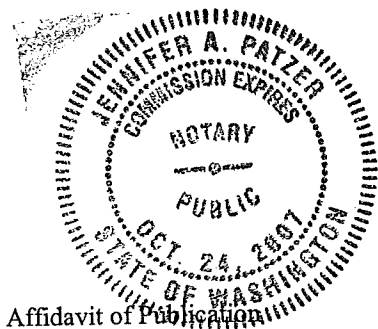
The notice in the exact form annexed, was published in regular issues of The Daily Journal of Commerce, which was regularly distributed to its subscribers during the below stated period. The annexed notice, a
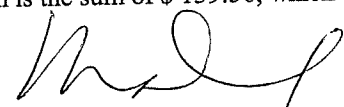
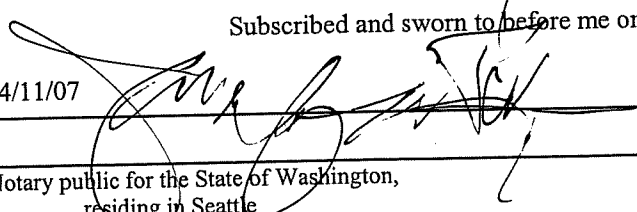CT:NOTICE PROPOSED RULE

was published on

04/11/07

The amount of the fee charged for the foregoing publication is the sum of $ 139.50, which amount has been paid in full.

04/11/07

_____
Subscribed and sworn to before me on

_____
Notary public for the State of Washington,
residing in Seattle

Affidavit of Publication

City of Seattle

NOTICE OF PROPOSED RULE MAKING HEARING

AND OPPORTUNITY TO COMMENT

The Director of Finance, acting under the authority of Seattle Municipal Code Chapters 3.02 and 5.55, proposes to adopt new rules for implementing the Seattle Business License Tax Ordinance (Seattle Municipal Code, Chapter 5.45). Please note that although these rules are applicable to SMC 5.45, the individual rules may also apply to other chapters of the City's Tax Code, including, but not limited to, SMC 5.30 (Definitions), SMC 5.32 (Revenue Code), SMC 5.35 (Commercial Parking Tax), SMC 5.37 (Employee Hours Tax), SMC 5.40 (Admissions Tax), SMC 5.48 (Business Tax - Utilities), SMC 5.52 (Gambling Tax), and SMC 5.55 (General Administrative Provisions). The following rules are proposed for adoption and will become effective as of May 15, 2007:

Seattle Rule 5-000 Rules adopted.

Seattle Rule 5-002 Business license requirements.

Seattle Rule 5-007 Penalties.

Seattle Rule 5-008 Recordkeeping requirements.

Seattle Rule 5-009 Limitations on tax assessments.

Seattle Rule 5-033 When tax liability arises.

Seattle Rule 5-034 Finance charges, carrying charges, interest, and penalties.

Seattle Rule 5-037 Accounting methods.

Seattle Rule 5-039 Employees distinguished from persons engaging in business.

Seattle Rule 5-042 Successor liability.

Seattle Rule 5-044 Value of products.

Seattle Rule 5-064 Credit losses, bad debts, recoveries.

Seattle Rule 5-065 Taxes, deductible and nondeductible.

Seattle Rule 5-067 Accommodation sales.

Seattle Rule 5-068 Pool purchases.

Seattle Rule 5-125 Casual or isolated sales.

Seattle Rule 5-275 Installing, cleaning, repairing or otherwise altering or improving personal property of consumers.

Seattle Rule 5-276 Constructing and repairing of new or existing buildings or other structures upon real property.

Seattle Rule 5-500 Computer software.

Seattle Rule 5-501 Computer hardware.

Seattle Rule 5-502 Taxation of information services and computer related services.

Seattle Rule 5-804 Staffing businesses, staffing services.

Seattle Rule 5-921 Exemptions, deductions and credits available under the employee hours tax.

PUBLIC HEARING AND COMMENT: The Department of Executive Administration has scheduled a public hearing on the proposed rule changes for 1:00 p.m. to 3:00 p.m., on Monday, April 30, 2007. The hearing will be held in a conference room on the 40th floor of the Seattle Municipal Tower, Suite 4096, located at 700 Fifth Avenue. All interested persons are invited to present data, views, or arguments, with regard to the proposed rules, orally at the hearing, or in writing at or before the hearing.

Written comments should be mailed or delivered to:

Department of Executive Administration Attn.: Mel McDonald, Deputy Director Revenue and Consumer Affairs 700 Fifth Avenue – Suite 4250 P.O. Box 34214 Seattle, Washington 98124-4214

The public may inspect copies of the proposed rules at the Revenue and Consumer Affairs offices, 700 Fifth Avenue, Suite 4250. If you would like a copy of the proposed rules, please call (206) 233-0071, FAX (206) 684-5170, email: rca.bizlictx@seattle.gov, or submit a written request to the address above.

Dwight D. Dively, Director, Department of Finance

Date of publication in the Seattle Daily Journal of Commerce, April 11, 2007.

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