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DEPARTMENT OF REVENUE
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MAR 10 2000
OFFICE OF CHIEF COUNSEL

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March 10, 2000

Via Hand Delivery

Anita M. Doucette
Office of Chief Counsel
Pennsylvania Department of Revenue
10th Floor, Strawberry Square
Harrisburg, PA 17128-1061

Re: Proposed Regulation: Sales and Use Tax; Computer Software, Hardware and Related Transactions

Dear Ms. Doucette:

Following are comments which I am submitting with regard to the proposed regulation which is referenced above, published February 12, 2000 in the Pennsylvania Bulletin.

I write primarily to urge the Department to revise its treatment of sophisticated business software which may consist of elements or modules which have been prepared in advance and which may be sold to a number of different purchasers, but which is not generally sold until there has been a detailed analysis to determine the purchasing business' specific needs and which often requires adaptation, such as the setting of a number of switches which will ensure that the software will function in a manner which services the purchaser's needs. In addition, this type of software often requires custom integration with other business software systems. Unlike over-the-counter software, such as standard word processing, spreadsheet and presentation programs, this sophisticated business software cannot simply be placed in a computer's memory and run with effectiveness.

The Department's proposal to classify such sophisticated business software as "canned" software, subject to tax, poses both substantial legal and practical problems which would be better avoided by classifying this type of software as "intangible property" or "custom" software which is not subject to tax.

Before discussing the specific revisions which I would propose to address such software, I think it is useful to review the general issues involved in the treatment of computer software for sales and use tax purposes.

Software as Nontaxable, Intangible Property

First, under present Pennsylvania law, software can only be taxed if it qualifies as "tangible personal property." *See,* 72 P.S. §§7201(f),(k),(m),(o), 7202. With the removal of "computer programming" and other computer-related services from the definitions of "sale at retail" and "use" by Act 7 of 1997, there is no specific reference to computer programs or software in the statute. Whether computer programs or software constitute tangible personal property for sales and use tax purposes has not been addressed by Pennsylvania's courts and the answer is not a forgone conclusion.

While most other states tax at least some computer software in one form or another, not all have reached that result by classifying software as tangible personal property under common law property concepts. In fact, the courts of some other states have specifically held that all software is intangible and those states have subsequently amended their statutes to specifically tax certain types of software. *See, e.g. First National Bank v. Bullock,* 584 SW 2d 548 (Tex. Civ. App. 1979) (holding "canned" software to be intangible property); Tex. Tax Code Ann. §151.009 (including computer software in definition of tangible personal property for sales and use tax purposes); *University Computing v. Olsen,*677 SW 2d 445 (Tenn. 1984)(discussing how Tennessee amended its statute in reaction to the case of *Commerce Union Bank v. Tidwell,* 538 SW 2d 405 (Tenn. 1976), which held computer software was intangible property). Should Pennsylvania's courts be inclined to follow the lead of these states, the Department's proposed regulation would be inappropriate in taxing any form of software, absent action by the General Assembly to amend the statute.

While the Department could point to decisions in some other states holding certain types of software to be tangible personal property, recent changes in technology make it even more likely than it may have been in the past, that Pennsylvania's courts will treat all software as intangible personal property.

In fact, the Department has itself issued a letter ruling which highlights the problem with trying to treat some software as tangible personal property and other software as intangible property. In Ruling No. SUT-99-024, the Department has ruled that tax does not apply to "canned" software which is delivered electronically to the purchaser. The Department does not consider it taxable because it is not delivered on a tangible medium, such as a floppy disk or CD-ROM. Since nothing tangible is transferred in such a transaction, there can be no doubt that this

ruling is correct in concluding that tax does not apply to electronically-delivered software. Yet, a $2000 software program delivered electronically consists of exactly the same computer code as software delivered on a 50 cent disk or CD. It has precisely the same functionality. In fact, if a customer so desires, the customer may transfer nontaxable, electronically-delivered software to a disk after delivery, without incurring tax. Obviously, when software is delivered on a disk or CD, it is not the value of the medium which the Department attempts to tax, but the value of the computer code. To tax the code when delivered on a 50 cent disk, but not to tax it when delivered electronically, raises substantial questions of fundamental fairness, and possible constitutional issues.

In addition, any attempt to characterize "canned" software as tangible personal property, and "custom" software as a nontaxable service, rests on similarly questionable grounds. In taxing "canned" software delivered on disk but not taxing software delivered electronically, the Department has relied on the fact that the disk is a tangible medium, notwithstanding that the real value is in the otherwise nontaxable, intangible code. In exempting "custom" software, as narrowly defined in the proposed regulation, the Department apparently justifies the exemption of such software, notwithstanding that it may be delivered on disks or other tangible media, on the basis that the customer is paying for the nontaxable services evidenced by the code recorded on the medium. It makes no common sense that tax is imposed on "canned" software because of the existence of a 50 cent disk in conjunction with computer code which would otherwise be nontaxable, but tax is not imposed on "custom" software which also involves a 50 cent disk in conjunction with otherwise nontaxable code.

While it would obviously have some revenue impact, the simple solution would be to classify all software as nontaxable intangible personal property, unless and until the General Assembly enacts provisions specifically providing for such taxation.

Practical Problems Posed by the Department's Narrow Definition of Custom Software

In any event, the Department's proposed definition of "custom" software is unnecessarily narrow and will only create disruption in the business community.

The Department proposes to define nontaxable "custom" software as:

> Computer software designed, created and developed for and to the specifications of an original purchaser.

The Department has indicated that this definition will not include the type of sophisticated software which I am concerned with, because this class of software includes elements or modules which have been prepared in advance and which may be sold to a number of different purchasers.

The state of New Jersey, however, has taken a much more business-friendly approach by treating software as nontaxable intangible property, even when delivered on tangible media, if the design or selection of the software requires an analysis of the program for the customer's requirements by the vendor, or if the program requires adaptation, by the vendor, to be used in a specific environment. NJ Admin. Code §18:24-25.2 (the complete text of this regulation is enclosed). New Jersey's approach ensures that the sophisticated business software with which I am concerned will not be taxed.

Obviously, adoption of the Department's narrow definition of nontaxable "custom" software will result in potentially higher business costs for Pennsylvania-based business operations than for New Jersey operations. This will encourage businesses to (a) locate data processing operations in New Jersey; (b) have software on disks or CD's delivered to New Jersey in order to avoid tax; or (c) incur additional costs for equipment so that software may be delivered to the company electronically and then recorded on tangible media by the company.

Adoption of New Jersey's approach would promote the use of sophisticated software by Pennsylvania companies and would enable companies to simply do business without having to consider what special gyrations they must go through to minimize their software costs. I respectfully suggest that the Department redraft the regulation along the lines of the New Jersey regulation, so that sophisticated business software will not be subject to tax.

If the Department would like to discuss these comments, please contact me at the above address or direct dial phone number.

Very truly yours,

McNEES, WALLACE & NURICK

By
James L. Fritz

JLF:al
Enclosure

State & Local Regulations

Reg. § 18:24-25.2. Electronic data processing transactions.

(a) Rules concerning the taxable transactions include the following:

1. **The sale or lease of data processing equipment** is taxable, except where the equipment is leased or purchased with the intention of reselling or subleasing it. Equipment which is leased with the intention to sublease it is taxable to the sublessee on the charges made to such sublessee. Incidental use of the equipment made by the lessee is subject to the use tax, based upon the same rate charges as those charged to a sublessee.

2. **The sale or lease of a terminal device** has been and continues to be taxable. It is not essential for a transfer of possession to include the right to move the tangible personal property which is the subject of a rental, lease or license to use. The charges made to a customer for use of a computer (known as timesharing), which the customer has access to through a remote terminal device, are not deemed to be a taxable transfer of possession of the computer.

i.

Example 1:

Example 1: A corporation contracts with a computer center to use the computer on the center's premises for 10 hours weekly. The corporation provides its own operator and its own materials. During the 10 hour period, no one else may use the machine. This transaction, commonly known as the sale of raw time, constitutes a transfer of possession, pursuant to a rental, lease or license to use, which is a sale subject to tax.

Example 2:

Example 2: A corporation contracts with a computer center to use the computer on the center's premises for 10 hours weekly. The corporation provides its own materials and the computer center provides and directs the operator. During the 10 hour period, no one else may use the machine. In this case, there is no transfer of possession to the corporation as it has no control over the operation of the computer.

Example 3:

Example 3: A corporation contracts with a computer center for access time on the computer center's equipment through the use of a terminal located in the corporation's office. The terminal is connected to the computer by telephone. The corporation's access to the computer through the terminal is not deemed to be a transfer of possession of the computer subject to tax.

3. **Examples of taxable transactions:**

i. The charges for additional copies of records, reports, tabulations, and the like which are prepared by rerunning the original program;

ii Electronic data processing equipment manufacturers, service bureaus and data processing educational centers are deemed to be the consumers of tangible personal property which is used in training others. They are required to pay the tax on their purchases of such property; training aids which they purchase for resale, however, are taxable to the ultimate users.

(b) **Rules concerning nontaxable transactions** are as follows.

1. The processing of data by a service bureau constitutes a nontaxable service whether or not the customer supplies the medium. Data conversion services, whether by keyentry, keystroke verification or other entry procedure, are part of the processing of data, and whether or not forwarded to a customer, are nontaxable services. (11 NJR 474, 104 NJLJ 322, 9-28-79.)

2. Software which meets the criteria below is considered intangible personal property and not subject to sales tax; software applies to instructions and routines

(programs) which, after an analysis of the customer's specific data processing requirements, are determined necessary to program the customer's electronic data processing equipment to enable the customer to accomplish specific functions with his electronic data processing system. To be considered nontaxable "software" for purposes of this rule, one of the following elements must be present:

i. Preparation or selection of the customer's use requires an analysis of the program for the customer's requirements by the vendor; or

ii. The program requires adaptation, by the vendor, to be used in a specific environment that is, a particular make and model of computer utilizing a specified output device. For example, a software vendor offers for sale a prewritten sort program which can be used in several computer models. Prior to operation, instructions must be added by the vendor which specify the particular computer model in which the program will be utilized.

iii. The software may be in the form of:

(1) Systems programs (except for those instruction codes which are considered tangible personal property) – programs that control the hardware itself, and allow it to compile, assemble and process application programs. For purposes of this rule, instruction codes mean the internalized instruction code which controls the basic operations (that is, arithmetic and logical) of the computer causing it to execute instructions contained in application and system programs, and is an integral part of the computer. It is not normally accessible nor modifiable by the user. Such internal code system is considered part of the hardware and is taxable. The fact that the vendor does or does not charge separately for it is immaterial.

(2) Application programs – programs that are created to perform business functions or control or monitor processes.

(3) Pre-written programs (canned) – programs that are either systems programs or application programs and are not written specifically for one user.

(4) Custom programs – programs created specifically for one user.

iv. Software, whether placed on cards, tape, disc pack or other machine readable media, or entered into a computer directly, is considered intangible personal property for sales tax purposes, and as such its sale is not subject to New Jersey State sales and use tax. Software or programs which do not meet the criteria are subject to tax. The person selling nontaxable software is required to pay the applicable sales or use tax on any tangible personal property transferred to the customer in connection with the nontaxable service. In addition, the hardware and supplies used to develop the nontaxable software are not eligible for any sales tax exemptions.

(1) A nontaxable application program sold in machine readable form as keypunched cards, magnetic tape (with or without charts and instructions on its use) or discs is considered intangible personal property. As intangible personal property, its sale, including lease or license to use, is not subject to New Jersey State tax.

(2) A computer manufacturer sells or leases a computer containing nontaxable system programs. The sales invoice rendered to the purchaser separately states a reasonable charge for the system programs. The separately stated charge for such computer software is not subject to tax.

(3) A company leases a computer with nontaxable application programs. The monthly billing shows one charge. The entire monthly charge is subject to tax.

(4) A manufacturer sells or leases equipment which, in addition to recording transactions and issuing receipts, is capable of transmitting inventory and sales information by use of an application program to a central computer. The sale of such equipment is a sale of tangible personal property except to the extent of the nontaxable applications program option which may be purchased as a separate item and is separately billed to the customer as a software addition to the tangible property. If the customer does not have this option, the application program will be viewed as part of the hardware and taxed accordingly.

(5) A software supplier manufactures prepackaged programs for use with home television games or other personal computer equipment. The programs are marketed through retail stores, and the programs are fully usable by customers without modifications. In selecting or preparing the program, the supplier does not perform a detailed analysis of the customer's requirements. The program is viewed as

tangible personal property for sales tax purposes.

3. The following are deemed to be professional services and are, therefore, not subject to sales and/or use tax:

- **i.** Feasibility studies;
- **ii.** Consulting services;
- **iii.** Technical instruction;
- **iv.** Professional services, such as accounting services, where the service bureau initially receives the raw material and studies, alters, analyzes, interprets and adjusts such raw material which by the use of a data processing machine are sorted, classified and rearranged.

4. Where the output resulting from data processing services is received by an out-of-State client through the medium of a telephone or telegraph transmission device at an out-of-State location, the charges for such data processing services are not taxable to the out-of-State client.

5. The sales and/or use tax is not applicable to the fabrication of a program by a nonservice bureau company's employees for the exclusive use of their employer in connection with the employer's business.

6. The sales and/or use tax is not applicable when the tangible personal property involved is incidental to the professional or personal services and for which no separate charges are made.

7. The Sales and Use Tax Act is not applicable to charges for the sale or use of mailing lists.

(Revised at 15 NJR 1565(a); 16 NJR 148, eff. 1-17-96.)

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March 10, 2000

Hon. John R. McGinley, Jr., Esq., Chairman
Independent Regulatory Review Commission
333 Market Street, 14th Floor
Harrisburg, PA 17101

Re: Proposed Regulation: Sales and Use Tax; Computer Software, Hardware and Related Transactions

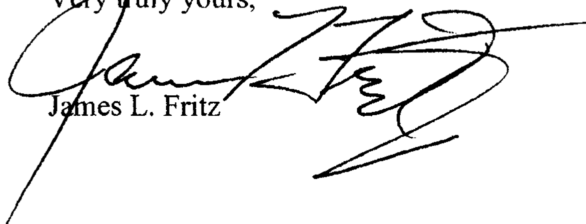
Dear Chairman McGinley:

Enclosed for your information is a copy of comments which I have submitted with regard to the Department of Revenue's proposed regulation published February 12, 2000, in the Pennsylvania Bulletin, dealing with imposition of Sales and Use Tax on Computer Software, etc.

I respectfully urge the Commission to consider these comments and to advise the Department of Revenue to revise its proposed regulation along the lines of New Jersey's regulation on the same subject, which exempts certain sophisticated software from tax. In the form proposed by our Department of Revenue, the regulation would make it more difficult and expensive than necessary for Pennsylvania businesses to enhance the efficiency of their companies through use of such technology.

If you have any questions concerning my comments on the regulation, or if I may be of assistance in any way to the Commission in reviewing this matter, please do not hesitate to contact me at the above number.

Very truly yours,



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ruling is correct in concluding that tax does not apply to electronically-delivered software. Yet, a $2000 software program delivered electronically consists of exactly the same computer code as software delivered on a 50 cent disk or CD. It has precisely the same functionality. In fact, if a customer so desires, the customer may transfer nontaxable, electronically-delivered software to a disk after delivery, without incurring tax. Obviously, when software is delivered on a disk or CD, it is not the value of the medium which the Department attempts to tax, but the value of the computer code. To tax the code when delivered on a 50 cent disk, but not to tax it when delivered electronically, raises substantial questions of fundamental fairness, and possible constitutional issues.

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Very truly yours,

MCNEES, WALLACE & NURICK

By

James L. Fritz

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Enclosure

State & Local Regulations

Reg. § 18:24-25.2. Electronic data processing transactions.

(a) Rules concerning the taxable transactions include the following:

1. The sale or lease of data processing equipment is taxable, except where the equipment is leased or purchased with the intention of reselling or subleasing it. Equipment which is leased with the intention to sublease it is taxable to the sublessee on the charges made to such sublessee. Incidental use of the equipment made by the lessee is subject to the use tax, based upon the same rate charges as those charged to a sublessee.

2. The sale or lease of a terminal device has been and continues to be taxable. It is not essential for a transfer of possession to include the right to move the tangible personal property which is the subject of a rental, lease or license to use. The charges made to a customer for use of a computer (known as timesharing), which the customer has access to through a remote terminal device, are not deemed to be a taxable transfer of possession of the computer.

i.

Example 1:

Example 1: A corporation contracts with a computer center to use the computer on the center's premises for 10 hours weekly. The corporation provides its own operator and its own materials. During the 10 hour period, no one else may use the machine. This transaction, commonly known as the sale of raw time, constitutes a transfer of possession, pursuant to a rental, lease or license to use, which is a sale subject to tax.

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Example 2:

Example 2: A corporation contracts with a computer center to use the computer on the center's premises for 10 hours weekly. The corporation provides its own materials and the computer center provides and directs the operator. During the 10 hour period, no one else may use the machine. In this case, there is no transfer of possession to the corporation as it has no control over the operation of the computer.

Example 3:

Example 3: A corporation contracts with a computer center for access time on the computer center's equipment through the use of a terminal located in the corporation's office. The terminal is connected to the computer by telephone. The corporation's access to the computer through the terminal is not deemed to be a transfer of possession of the computer subject to tax.

3. Examples of taxable transactions:

i. The charges for additional copies of records, reports, tabulations, and the like which are prepared by rerunning the original program;

ii Electronic data processing equipment manufacturers, service bureaus and data processing educational centers are deemed to be the consumers of tangible personal property which is used in training others. They are required to pay the tax on their purchases of such property; training aids which they purchase for resale, however, are taxable to the ultimate users.

(b) Rules concerning nontaxable transactions are as follows.

1. The processing of data by a service bureau constitutes a nontaxable service whether or not the customer supplies the medium. Data conversion services, whether by keyentry, keystroke verification or other entry procedure, are part of the processing of data, and whether or not forwarded to a customer, are nontaxable services. (11 NJR 474, 104 NJLJ 322, 9-28-79.)

2. Software which meets the criteria below is considered intangible personal property and not subject to sales tax; software applies to instructions and routines

(programs) which, after an analysis of the customer's specific data processing requirements, are determined necessary to program the customer's electronic data processing equipment to enable the customer to accomplish specific functions with his electronic data processing system. To be considered nontaxable "software" for purposes of this rule, one of the following elements must be present:

i. Preparation or selection of the customer's use requires an analysis of the program for the customer's requirements by the vendor; or

ii. The program requires adaptation, by the vendor, to be used in a specific environment that is, a particular make and model of computer utilizing a specified output device. For example, a software vendor offers for sale a prewritten sort program which can be used in several computer models. Prior to operation, instructions must be added by the vendor which specify the particular computer model in which the program will be utilized.

iii. The software may be in the form of:

(1) Systems programs (except for those instruction codes which are considered tangible personal property) – programs that control the hardware itself, and allow it to compile, assemble and process application programs. For purposes of this rule, instruction codes mean the internalized instruction code which controls the basic operations (that is, arithmetic and logical) of the computer causing it to execute instructions contained in application and system programs, and is an integral part of the computer. It is not normally accessible nor modifiable by the user. Such internal code system is considered part of the hardware and is taxable. The fact that the vendor does or does not charge separately for it is immaterial.

(2) Application programs – programs that are created to perform business functions or control or monitor processes.

(3) Pre-written programs (canned) – programs that are either systems programs or application programs and are not written specifically for one user.

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iv. Software, whether placed on cards, tape, disc pack or other machine readable media, or entered into a computer directly, is considered intangible personal property for sales tax purposes, and as such its sale is not subject to New Jersey State sales and use tax. Software or programs which do not meet the criteria are subject to tax. The person selling nontaxable software is required to pay the applicable sales or use tax on any tangible personal property transferred to the customer in connection with the nontaxable service. In addition, the hardware and supplies used to develop the nontaxable software are not eligible for any sales tax exemptions.

(1) A nontaxable application program sold in machine readable form as keypunched cards, magnetic tape (with or without charts and instructions on its use) or discs is considered intangible personal property. As intangible personal property, its sale, including lease or license to use, is not subject to New Jersey State tax.

(2) A computer manufacturer sells or leases a computer containing nontaxable system programs. The sales invoice rendered to the purchaser separately states a reasonable charge for the system programs. The separately stated charge for such computer software is not subject to tax.

(3) A company leases a computer with nontaxable application programs. The monthly billing shows one charge. The entire monthly charge is subject to tax.

(4) A manufacturer sells or leases equipment which, in addition to recording transactions and issuing receipts, is capable of transmitting inventory and sales information by use of an application program to a central computer. The sale of such equipment is a sale of tangible personal property except to the extent of the nontaxable applications program option which may be purchased as a separate item and is separately billed to the customer as a software addition to the tangible property. If the customer does not have this option, the application program will be viewed as part of the hardware and taxed accordingly.

(5) A software supplier manufactures prepackaged programs for use with home television games or other personal computer equipment. The programs are marketed through retail stores, and the programs are fully usable by customers without modifications. In selecting or preparing the program, the supplier does not perform a detailed analysis of the customer's requirements. The program is viewed as

tangible personal property for sales tax purposes.

3. The following are deemed to be professional services and are, therefore, not subject to sales and/or use tax:

- **i.** Feasibility studies;
- **ii.** Consulting services;
- **iii.** Technical instruction;
- **iv.** Professional services, such as accounting services, where the service bureau initially receives the raw material and studies, alters, analyzes, interprets and adjusts such raw material which by the use of a data processing machine are sorted, classified and rearranged.

4. Where the output resulting from data processing services is received by an out-of-State client through the medium of a telephone or telegraph transmission device at an out-of-State location, the charges for such data processing services are not taxable to the out-of-State client.

5. The sales and/or use tax is not applicable to the fabrication of a program by a nonservice bureau company's employees for the exclusive use of their employer in connection with the employer's business.

6. The sales and/or use tax is not applicable when the tangible personal property involved is incidental to the professional or personal services and for which no separate charges are made.

7. The Sales and Use Tax Act is not applicable to charges for the sale or use of mailing lists.

(Revised at 15 NJR 1565(a); 16 NJR 148, eff. 1-17-96.)

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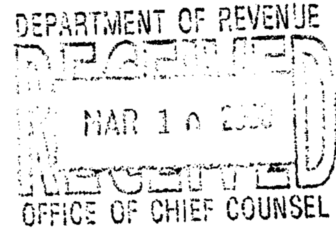
March 10, 2000



Ms. Anita M. Doucette
Office of Chief Counsel
PA Dept. of Revenue, 10th Fl. Strawberry Sq.
Harrisburg, PA

Re: **Department of Revenue Proposed Regulation**
61 Pa. Code §31.33 (Computer Software, Hardware & Related Transactions)

Dear Ms. Doucette:

As a follow-up to our telephone conversation on March 2, 2000, I am enclosing for your review an article which I have written that is currently under consideration for publication. In one section of this article, I discuss the above-referenced proposed regulation as it applies to the Department of Revenue's current sales and use tax treatment of computer software.

I am of the opinion that, to the extent that custom software and canned software are deemed to be within the "same class of subjects," the proposed regulation violates the Pennsylvania Constitution, and may very well violate the United States Constitution. Although my article does not address this particular issue directly, I do allude to this concern in footnotes 2 and 57.

The primary issue addressed in the article is the Department's disparate treatment between canned software delivered electronically and canned software delivered via a tangible medium. However, the article does highlight some of the inconsistencies between the Department's treatment of canned software and custom software outlined in its proposed regulation. Consideration, or reconsideration, of these inconsistencies by the Department may be beneficial to the Commonwealth, the business community, and the taxpaying public.

I welcome the opportunity to contribute to the debate over the proper sales and use tax treatment of computer software here in the Commonwealth of Pennsylvania.

Very truly yours,

Robert Freedenberg

RF:cd/880629.1

PENNSYLVANIA'S UNCONSTITUTIONAL SALES TAXATION OF COMPUTER SOFTWARE

By Robert Freedenberg, Esquire[1]
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INTRODUCTION

If you drive from your Pennsylvania home to the local computer software store, purchase your favorite personal income tax preparation software on disk, and download the software from the disk onto your personal computer, the Pennsylvania Department of Revenue (hereinafter, the "Department") currently asserts that the purchase is subject to Pennsylvania sales tax. However, if your neighbor, who does not leave her Pennsylvania home, purchases the identical personal income tax preparation software and downloads the software over the Internet onto her personal computer, the Department asserts that your neighbor's purchase of the identical computer program is not subject to Pennsylvania sales or use tax.

This disparate treatment by the Department of taxing you and not your neighbor exists despite the fact that you and your neighbor have the same "canned" computer program on your computers and have the same rights with respect to the use of the program. The only difference between you and your neighbor is that you took delivery of the program via a tangible medium, the disk, and your neighbor did not. However, the essence of what you and your neighbor purchased, the rights to use a computer software program, is identical.

This article reviews the statutory, decisional and constitutional authority under which the Department is taxing canned computer software at the time of the writing and publication of this article. This article further discusses the Department's interpretation of its authority to tax computer software, and provides recommendations to the Department and to consumers for the resolution of the Department's unconstitutional taxation of such software.[2]

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[1] Robert Freedenberg, a member of the Pennsylvania and Colorado bars, is an associate in the Harrisburg, Pennsylvania office of Barley, Snyder, Senft & Cohen, LLC. Mr. Freedenberg received his LL.M. degree in taxation from Villanova University School of Law and he is a member of the ABA Section of Taxation, the PBA Tax Law Section, and the Pennsylvania Chamber of Business and Industry Tax Committee. The views expressed in this article are not necessarily those of the organizations with which Mr. Freedenberg is associated.

[2] This article does not specifically address the potentially unconstitutional distinction that the Department draws between canned software and custom software. Arguably, to the extent that canned software and custom software are within the "same class of subjects," the Department's taxation of some, but not all, software violates the Pennsylvania Constitution.

INTERNET TAX FREEDOM ACT

The sales tax implications of the purchase and delivery of computer software via the Internet cannot be discussed fully without first acknowledging the existence of the Federal Internet Tax Freedom Act.[3] Signed into law on October 21, 1998, the Internet Tax Freedom Act contains a three-year moratorium on the imposition by any state or political subdivision of new taxes on Internet access and on multiple or discriminatory taxes on electronic commerce.[4] Under the law, states that did not tax Internet access prior to October 1, 1998 are prohibited from doing so from October 1, 1998 through October 20, 2001.[5] During the same time period, states are also precluded from imposing any multiple tax or discriminatory tax on electronic commerce.[6]

Under the Internet Tax Freedom Act, "Internet access" is defined, in part, as "a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users."[7] Therefore, to the extent that a computer software program that is provided to a user is one that is unrelated to "accessing" the Internet, and is not sold as part of a package of access services offered to users, states are not precluded from imposing a sales and use tax on the purchase of such software delivered via the Internet.

"Electronic commerce" is defined in the law as "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access."[8] States are free to impose a sales and use tax on transactions conducted over the Internet, including those involving the delivery of property, services or information via the Internet, as long as the tax does not result in, or act as, a multiple or discriminatory tax on electronic commerce.[9]

Therefore, states are free to impose a sales and use tax on property purchased and delivered over the Internet (other than that purchased as part of a package of Internet access services), as long as the tax does not act as a multiple or discriminatory tax. The Internet Tax Freedom Act confirms this interpretation of the law by providing that

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[3] Omnibus Appropriations Act of 1998, Pub. L. No. 105-277, Title XI, §§1100-1206.
[4] *Id.* §1101(a).
[5] *Id.* §1101(a)(1).
[6] *Id.* §1101(a)(2). Pub. L. No. 105-277, Title XI, §1104(6) defines "multiple tax" and §1104(2) defines "discriminatory tax" for purposes of the Internet Tax Freedom Act.
[7] *Id.* §1104(5) (emphasis added).
[8] *Id.* §1104(3).
[9] *Id.* §1101(a)(2).

"nothing in this title shall be construed to modify, impair, or supersede or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act."[10] Accordingly, the Internet Tax Freedom Act does not limit Pennsylvania's ability to impose a sales and use tax on the purchase of computer software, canned or custom, purchased and delivered via the Internet.

STATUTORY AUTHORITY TO TAX

The Pennsylvania Tax Reform Code of 1971 (hereinafter, the "TRC") imposes "upon each separate sale at retail of tangible personal property or services . . . within this Commonwealth a [sales] tax of six percent of the purchase price, which tax shall be collected by the vendor[.]"[11] In an instance where a vendor does not collect the tax, a use tax of six percent is "imposed upon the use . . . within this Commonwealth of tangible personal property . . . and on those services described herein . . . which tax shall be paid to the Commonwealth by the person who makes such use as herein provided[.]"[12] The use tax taxes those transactions that might otherwise escape taxation as a result of a vendor not collecting Pennsylvania sales tax. The compensatory nature of the use tax endeavors to treat similarly situated taxpayers similarly by not allowing a purchase or use of taxable personal property or services to go untaxed simply because the vendor did not collect sales tax.

The TRC defines "sale at retail" as "[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 whatsoever means the same shall have been effected."[13] "Tangible personal property" is defined in the TRC as "[c]orporeal personal property" and includes a nonexclusive list of examples that does not include any reference to computer hardware or computer software.[14] Excluded from the definition of sale at retail are purchases for the purpose of

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[10] *Id.* §1101(b).
[11] Pa. Stat. Ann. tit. 72, §7202(a) (Purdon 1990 & Supp. 1999).
[12] Pa. Stat. Ann. tit. 72, §7202(b) (Purdon 1990 & Supp. 1999).
[13] Pa. Stat. Ann. tit. 72, §7201(k)(1) (Purdon 1990 & Supp. 1999).
[14] Pennsylvania Sales and Use Tax Regulation §31.1(3), 61 Pa. Code §31.1(3) (1972), provides a nonexclusive list of specific items encompassed within the definition of tangible personal property, but does not otherwise attempt to define or elaborate on the definition of tangible personal property provided by the Tax Reform Code of 1971. The list does not include any reference to computer hardware or computer software.

resale and purchases used directly in enumerated activities such as manufacturing, farming, and processing.[15]

The TRC does not specifically provide for the taxation of computer software or computer programming services.[16] Since the TRC does not explicitly provide for the taxation of computer software or the programming services rendered to produce computer software, the Department is taxing canned software that is transferred by a tangible medium under the construct that the purchase or use of such software is a transfer of the ownership, custody or possession of tangible personal property. This practice by the Department ignores the true object of the software purchaser's acquisition, and results in a sales tax on intangible personal property simply because it is transferred by a tangible medium. The essence of the transaction is a purchase of intangible property, the software content itself.

TRUE OBJECT OR ESSENCE OF THE TRANSACTION TEST

Pennsylvania has not yet addressed, either statutorily or by court decision, the applicability of either the "true object of the transaction" test or the "essence of the transaction" test, although other states have done so.[17] These tests are designed to determine what a consumer is (really interested in) purchasing when a mixed-purchase transaction involves taxable, tangible personal property, and nontaxable, intangible personal property or service-related, components. Some states simply provide that the "inconsequential" transfer of tangible personal property in conjunction with the rendering of a nontaxable service is exempt from sales tax.[18] Other states provide quantitative thresholds in determining whether or not the tangible personal property component is inconsequential to what is being purchased.[19]

The Commonwealth Court of Pennsylvania has addressed a related issue of whether the passage of tangible personal property is "incidental" or "critical" to a purchase transaction in determining whether the vendor is entitled to the resale exclusion

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[15] Pa. Stat. Ann. tit. 72, §7201(k)(8) (Purdon 1990 & Supp. 1999).
[16] Prior to Act No. 7 of May 7, 1997 (P.L. 85, No.7), Pennsylvania did impose a sales tax on computer programming services and other computer-related services. This tax was repealed effective July 1, 1997.
[17] *See Emery Industries v. Limbach*, 539 N.E.2d 608 (Ohio 1989); *see Culligan Water Conditioning of Bellflower, Inc. v. State Bd. of Equalization*, 550 P.2d 593, 17 Cal.3d 86 (Cal. 1976).
[18] *See, e.g.*, N.J. Rev. Stat. §54:32B-2(e)(4)(A) (which excludes from the definition of retail sales "[p]rofessional, insurance, or personal service transactions which involve the transfer of tangible personal property as an inconsequential element, for which no separate charges are made.").
[19] *See, e.g.*, Mass. Regs. Code tit. 64H §1.1(1) (providing that "[a]s a general guideline, the term 'inconsequential' . . . means a value of less than ten percent of the total charge[.]").

from tax for such property. In *Covenco, Inc. v. Commonwealth of Pennsylvania,*[20] the court sustained a use tax assessment on disposable eating utensils, napkins and straws purchased by Covenco and subsequently provided by Covenco to its customers who purchased food products at cafeterias and vending machines operated by Covenco. Covenco argued unsuccessfully that it was entitled to claim a resale exclusion on its purchase of such items, under the theory that Covenco was reselling these items to its customers. In its decision, the court postulated that if the accessory items were part of the food products, then Covenco's purchase of such items would be for resale. However, if the accessory items were not part of the food products provided by Covenco to its customers, then the purchase of such items was for Covenco's own use to enhance its ability to sell its food products.

In addressing the issue of whether an accessory item is part of a primary product or used merely to enhance the sale of the primary product, the *Covenco* Court analyzed the "incidental" test and "critical element" test developed by the Massachusetts and New York courts, respectively. Under the incidental test, transfers of tangible personal property are not for resale when they are not necessary to the consummation of the principal transaction. For example, the Supreme Judicial Court of Massachusetts has found that napkins, stirrers and straws purchased by a fast-food franchisee are to facilitate the consummation of the sale of food and beverages, the principal transaction, and that such accessory items are "used as an incidental means of facilitating that goal."[21] The Court of Appeals of New York has found that similar items provided in conjunction with the sale of food products prepared by restaurants or sold in vending machines are not exempt from tax because such accessory items are not "critical elements" and are "more akin to items of overhead, enhancing the comfort of customers consuming the food products[.]"[22]

In determining that the incidental test and the critical element test are the same test, the Commonwealth Court concluded that the analysis focuses on the "relationship between the accessory items and the primary product with which they are provided."[23] The court went on to find that "Covenco is in the business of selling food products and food management services and not in the business of selling accessory items. Covenco provides accessory items to its customers for the purpose of enhancing its customers' convenience and enabling them to consume the food products which they purchase[.]"[24]

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[20] *Covenco, Inc. v. Commonwealth of Pennsylvania,* 134 Pa. Commw. 314, 579 A.2d 434 (1990), *aff'd per curiam,* 530 Pa. 206, 607 A.2d 1077 (1992).
[21] *Id.* at 320, 579 A.2d at 437 (citing *Jan Co. Central, Inc. v. Commissioner of Revenue,* 405 Mass. 686, 544 N.E.2d 586 (1989)).
[22] *Id.* at 321, 579 A.2d at 437 (citing *Celestial Food of Massapequa Corp. v. N.Y. State Tax Commission,* 63 N.Y.2d 1020, 473 N.E.2d 737, 484 N.Y.S.2d 509 (1984)).
[23] *Id.* at 321-322, 579 A.2d at 438.
[24] *Id.* at 323, 579 A.2d at 438.

Hence, Covenco could not claim the resale exclusion from tax on its purchase of the accessory items.

This same analysis applies to the sale of computer software (the primary product) delivered via a tangible storage medium (the accessory item). The software manufacturer is in the business of selling software and is not in the business of selling the tangible storage media through which the software is sometimes transferred to the consumer. The consumer is interested in purchasing the rights to use the software and not the tangible storage media through which it may be transferred. The essence of the software-purchase transaction is the purchase of intangible personal property.

CONSTITUTIONAL CONCERNS

The Pennsylvania Constitution requires that "[a]ll taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws."[25] This provision of the Pennsylvania Constitution is referred to as the "uniformity clause" and the Pennsylvania Supreme Court has opined that its "language is as broad and comprehensive as it could possibly be and must necessarily be construed to include all kinds of taxes[.]"[26]

In *Amidon, v. Kane*, the Supreme Court of Pennsylvania interpreted the uniformity clause as requiring "that the classification [of subjects for taxation] by the legislative body must be reasonable and the tax must be applied with uniformity upon similar kinds of business or property and with substantial equality of the tax burden to all members of the same class[.]"[27] "While taxation is not a matter of exact science and perfect uniformity and absolute equality in taxation can rarely ever be attained, the imposition of taxes which are to a substantial degree unequal in their operation or effect upon similar kinds of business or property, or upon persons in the same classification, is prohibited. Moreover while reasonable and practical classifications are justifiable, where a method or formula of computing a tax will, in its operation or effect, produce arbitrary or unjust or unreasonably discriminatory results, the constitutional provision relating to uniformity is violated."[28]

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[25] Pa. Const., art. VIII, §1.
[26] *Amidon v. Kane*, 444 Pa. 38, 47, 279 A.2d 53, 58 (1971) (citing *Saulsbury v. Bethlehem Steel Co.*, 413 Pa. 316, 196 A.2d 664 (1964)).
[27] *Id.* at 48, 279 A.2d at 59 (citing *Allentown School District Mercantile Tax Case,* 370 Pa. 161, 87 A.2d 480 (1952)).
[28] *Id.* at 48-49, 279 A.2d at 59 (internal citations omitted).

The Department's disparate sales tax treatment between canned computer software delivered electronically over the Internet and canned computer software delivered via a tangible medium violates Pennsylvania's uniformity clause as interpreted by the Pennsylvania Supreme Court. Quite simply, the Department is not applying the sales tax law uniformly to purchases of similar property. When you and your neighbor purchase the personal income tax preparation software, each of you is interested in acquiring the rights to use a computer program which will compile and produce a personal income tax return. Absent the administrative formalities of downloading the software program onto your computer, neither of you is concerned about the medium through which the program is delivered.[29] The essence of the transaction is the purchase of intangible personal property, and the Department's imposition of sales tax on your purchase of the software and not on your neighbor's purchase is unconstitutional.[30]

THE DEPARTMENT'S POSITION

The Pennsylvania Department's taxation of the sale or use of computer software can be summarized as follows: 1) custom software delivered via the Internet is not taxable,[31] 2) custom software delivered via a tangible storage medium is not taxable,[32] 3) canned software delivered via the Internet is not taxable,[33] and 4) canned software delivered via a tangible storage medium is taxable.[34] In maintaining this position, the Department seems to concede that the electrons comprising a computer software program do not fall within the definition of tangible personal property pursuant to the TRC

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[29] Arguably, the disks containing the computer program may have nominal value as additional storage media provided that the income tax preparation software program can be erased from the disks.

[30] In addition to violating the uniformity clause of the Pennsylvania Constitution, this disparate imposition of tax may also violate the Equal Protection Clause of the United State Constitution. U.S. Const., amend. XIV, §1.

[31] 61 Pa. Code §31.33(b)(2)(ii) (2000) (Department of Revenue Sales and Use Tax Proposed Regulation), 30 Pa. Bull. 784 (February 12, 2000). Pursuant to this proposed regulation, custom software is not taxable regardless of the delivery medium. This treatment is inconsistent with the treatment of custom software as prescribed in the "list" discussed at footnote 34 below.

[32] *Id.*

[33] Pennsylvania Institute of Certified Public Accountants Annual Question and Answer Session with the Pennsylvania Department of Revenue, PICPA Legislative Alert, Vol. XI, Issue 4, September 1, 1999; CCH Internet/Electronic Commerce Survey, Pennsylvania Department of Revenue, October 6, 1999; Pennsylvania Sales and Use Tax Ruling No. SUT-99-024 (published at www.revenue.state.pa.us/legal/letrulings/sut99024.htm). This treatment is inconsistent with the treatment of canned software as prescribed in the "list" discussed at footnote 34 below and with 61 Pa. Code §31.33(b)(2)(i).

[34] 61 Pa. Code §31.33(b)(2)(i); Pennsylvania Sales and Use Tax Ruling No. SUT-99-024. Pursuant to 61 Pa. Code §58.1 (1990), the Department is required to compile and publish every three years a list of taxable and exempt property to be used by vendors as a general guide for sales tax purposes. The current list provides that computer software, canned or customized, is taxable. 28 Pa. Bull. 2731 (June 13, 1998). Apparently, the Department has not updated this list to reflect its current treatment of computer software.

(whether they do or not is a discussion better left to a physics class).[35] The Department bases its authority to impose a sales tax on the purchase of canned computer software solely on the transfer of such software through tangible storage media.[36]

THE DEPARTMENT'S PROPOSED REGULATION

The Department recently issued a proposed regulation addressing the sales and use tax treatment of computer software, hardware and related transactions.[37] This proposed regulation defines canned software, computer hardware, custom software, original purchaser, and storage media, provides for the imposition of sales and use tax on computer hardware and canned software, and provides for exemptions from the tax for certain enumerated purchasers (e.g., charitable organizations and religious organizations) and certain identified operations (e.g., manufacturing, research, and processing).[38]

The proposed regulation defines computer hardware, in part, as "[a]ny assembly of physical equipment that is united and regulated by interaction or interdependence to accomplish a set of specific computer system functions[,]" and provides examples such as main-frame computers, personal computers, compact disc read only memory (CD-Rom) drives, printers, network interfaces, and network wiring.[39] The proposed regulation defines storage media via a list of examples which includes "hard disks, compact disks, floppy disks, magnetic tape, cards and another [sic] tangible medium used for the storage of computer readable information."[40] Canned software is defined as "[a]ll computer software that does not qualify as custom software."[41] Custom software is defined as "[c]omputer software designed, created and developed for and to the specifications of an original purchaser."[42] Original purchaser is defined as "[t]he first person for whom the

[35] Pennsylvania Sales and Use Tax Ruling No. SUT-99-024.
[36] *Id.*
[37] 61 Pa. Code §31.33 (2000) (Department of Revenue Sales and Use Tax Proposed Regulation), 30 Pa. Bull. 784 (February 12, 2000). This proposed regulation was preceded by a statement of policy containing almost identical language. 61 Pa. Code §60.19 (2000) (Department of Revenue Sales and Use Pronouncements – Statements of Policy), 30 Pa. Bull. 233 (January 8, 2000). The proposed regulation and statement of policy come 2½ years after the July 1, 1997 effective repeal date of the sales and use tax on computer services. The statement of policy provides that "[t]he sale at retail or use of computer hardware and canned software, as well as services thereto, remains subject to Sales and Use Tax as the sale at retail or use of tangible personal property and is not affected by the repeal of section 201(dd) – (ii) of the TRC." 61 Pa. Code §60.19(a).
[38] 61 Pa. Code §31.33.
[39] 61 Pa. Code §31.33(a).
[40] *Id.*
[41] *Id.*
[42] *Id.*

custom software was designed, created and developed, and to whom it was transferred in a sale at retail."[43]

The proposed regulation provides that "[t]he sale at retail or use of canned software, including updates, enhancements and upgrades is subject to tax."[44] "Canned software includes custom software that is transferred pursuant to a sale at retail to any person other than the original purchaser."[45] Under the proposed regulation, only the initial transfer of custom software to an original purchaser is not subject to tax. Therefore, software designed, created and developed for and to the specifications of an original purchaser is no longer custom software upon the sale of the software by the original purchaser to a subsequent purchaser. An analogy can be made to the sales tax treatment accompanying the publication of a book manuscript. The transfer of a book manuscript by the author to a publisher is not subject to sales tax under the theory that the publisher is not interested in the tangible quality of the manuscript but rather in the intangible value of the ideas and concepts contained within the manuscript and the associated economic rights of publication. The subsequent sale of copies of the book by the publisher is subject to sales tax under the supposed theory that the reader of the book has more interest in the tangible quality of the book than the ideas expressed therein!

Pursuant to the proposed regulation, the sale at retail or use of custom software is not subject to tax as the sale at retail or use constitutes a purchase of a nontaxable computer programming service.[46] This appears to be the case even when the custom software program is transferred to the customer by means of a tangible storage medium such as a floppy disk or magnetic tape. According to the proposed regulation, it is the custom software vendor's purchase of the storage medium, presumably a blank disk or tape, that is subject to sales tax.[47] The subsequent transfer for a consideration of such medium containing a custom computer program to an original purchaser is not subject to sales tax.

In summary, the proposed regulation provides that the sale at retail or use of custom software is not subject to tax but that the sale at retail or use of canned software is subject to tax. The proposed regulation adopts an "incidental test"-type approach to excluding custom software from taxation but abandons this approach for canned software.[48] It should be noted that the proposed regulation itself, despite the

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[43] *Id.*
[44] 61 Pa. Code §31.33(b)(2)(i).
[45] 61 Pa. Code §31.33(b)(2)(i)(A).
[46] 61 Pa. Code §31.33(b)(2)(ii).
[47] 61 Pa. Code §31.33(b)(2)(ii)(C).
[48] In its proposed regulation, the Department acknowledges that the purchase of a custom software program constitutes the purchase of a computer programming service and that any storage media used to transfer the program from the custom software vendor to its customer is incidental to the purchase transaction.

Department's disparate tax treatment of canned software based on the medium of delivery, makes no distinction between the tax treatment of canned software purchased on disk and canned software downloaded over the Internet.

THE DEPARTMENT'S DELIBERATIONS

On two separate occasions, the Department has informally advanced the position that the sale of electronically transmitted canned computer software delivered to a Pennsylvania purchaser is not subject to sales and use tax.[49] The Department also maintains this position in Pennsylvania Sales and Use Tax Ruling No. SUT-99-024.[50] The Department maintains the position that the electronic transmission of digitized products (computer software, electronic greeting cards, etc.) is not subject to sales and use tax because such products do not possess any tangible quality. The Department distinguishes software delivered electronically over the Internet from software delivered via a tangible medium, such as a disk or magnetic tape, subjecting the latter to Pennsylvania sales and use tax merely because the latter is delivered via a tangible medium.[51] It is this disparate treatment, based solely on the delivery medium of an identical product, which violates the uniformity of taxation clause of the Pennsylvania Constitution.

It is noteworthy that the Department recently released a "white paper" on the impact of electronic commerce on Pennsylvania sales and use tax in which the Department addresses some of the sales tax implications of "digitized goods and services."[52] This white paper acknowledges that the Internet Tax Freedom Act does not appear to preclude a sales tax on goods when electronically downloaded from the Internet. The paper wrestles with the issue of the sales taxation of computer software and the delivery of such software to a consumer over the Internet.

Consistent with the Commonwealth Court's reasoning in *Covenco, Inc. v. Commonwealth of Pennsylvania*, 134 Pa. Commw. 314, 579 A.2d 434 (1990), the Department deems the custom software vendor the consumer of the storage medium and thereafter treats the medium as incidental to what is truly being purchased from the custom software vendor, a custom software program.

[49] Pennsylvania Institute of Certified Public Accountants Annual Question and Answer Session with the Pennsylvania Department of Revenue, PICPA Legislative Alert, Vol. XI, Issue 4, September 1, 1999; CCH Internet/Electronic Commerce Survey, Pennsylvania Department of Revenue, October 6, 1999.

[50] Pennsylvania Sales and Use Tax Ruling No. SUT-99-024 (published at www.revenue.state.pa.us/legal/letrulings/sut99024.htm).

[51] *Id.*

[52] Pennsylvania Department of Revenue Release, The Impact of Electronic Commerce on Pennsylvania Sales and Use Tax, September 22, 1999.

In the paper, the Department adopts the incidental-test analysis and concludes that "a *custom* software program would be exempt [from sales tax] even if it is on a tangible medium, such as a disk. In such an instance, the tangible medium is incidental in determining taxation and the item is exempt [from sales tax] based on the nature of what is contained on the disk."[53] The Department fails to make any cogent argument as to why the same analysis does not apply to the purchase of a canned software program on a tangible medium. The Department also fails to cite any authority to support its imposition of a sales tax on the value of the computer-software-program component of a software purchase transaction. On the contrary, the Department concedes that an "argument can be made that it is the tangible medium, and not the 'information' included on that medium, that is subject to tax. For example, the value, or purchase price, of a book is not based on the information contained in the book, but rather the tangible medium."[54]

Interestingly enough, the white paper released by the Department seems to endorse an "essence of the transaction" analysis and acknowledges the TRC's statutory shortcomings in light of advancing technology "because it does not consider the true nature of many transactions. For example, a compact disk purchased in a store is subject to sales tax; however, the contents of that same disk can be downloaded over the Internet. The intention of, and outcome to, the purchaser is the same. When considered from this point-of-view, taxing similar items differently when one is represented by tangible personal property and the other is not, places vendors selling the items in tangible form at a competitive disadvantage, and violating [sic] the principal of equitable treatment for similarly situated taxpayers."[55] The Department concedes that the essence of what the purchasers are buying is the same, but the Department asserts that there is a taxable event in one instance and not the other based solely on the delivery medium. This inequitable treatment results in bad tax policy.[56] This inequitable treatment is also unconstitutional.

The Department's only logical argument to refute the constitutional challenge to its disparate tax treatment of canned software is that canned software delivered via a tangible medium is somehow in a different class of subjects than that delivered via the

[53] *Id.* at 12 (underlined emphasis added).

[54] *Id.*

[55] *Id.*

[56] "[S]tates and local governments [should] retain the authority to tax or exempt digitized goods in a manner consistent with tangible goods and taxable services. The conversion of tangible personal property into digitized goods does not change the essence of what is being sold and therefore does not provide an overriding policy reason for allowing them tax-favored treatment." Report Drafting Subcommittee, Advisory Commission on Electronic Commerce, Issues and Policy Options Paper (final draft) at 15 (December 3, 1999). The Internet Tax Freedom Act established the Advisory Commission on Electronic Commerce to address issues related to Internet taxation.

Internet.[57] This argument requires a strained reading of our Constitution to uphold such a distinction, and it results in a complete departure from the statutory policy of imposing sales tax based on the type of property or service transferred to a consumer and not on the medium through which the property or service is transferred.

The Department has the statutory authority to tax the value of the tangible medium used to transfer a computer software program. Arguably, the Department does not have the statutory authority to tax the value of the computer software program transferred via the tangible medium. Regardless of whether or not the Department has the statutory authority to tax the value of a computer software program transferred via a tangible medium, the Department's taxation of canned computer software only in instances when the software is transferred via a tangible medium is unconstitutional.

CONCLUSION

The Department's disparate sales tax treatment of canned computer software violates the Pennsylvania Constitution. This unconstitutional treatment may stem from the fact that the Department probably does not have the statutory authority to impose a sales tax on any computer software. Assuming, arguendo, that the Department does have the statutory authority to tax computer software, it may do so only in a manner which does not violate the Pennsylvania Constitution. Taxation of computer software must be uniform, and should not be contingent upon the medium by which it is delivered to the consumer.

The Department should cease enforcement of the collection of sales tax on the value of canned computer software delivered via a tangible medium. The Department should treat as taxable the purchase of the blank tangible storage media by the vendor who copies the canned software program onto the tangible storage media for subsequent sale consistent with the current treatment for custom software vendors.

Business and individual consumers who intend to purchase canned software should take delivery of such software via an intangible medium, such as downloading the program over the Internet. Businesses and individual consumers who have already paid sales tax on the purchase of canned software and who have the patience for state tax litigation may want to file a claim for refund.

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[57] As mentioned in footnote 2 above, it also may be difficult to argue that canned software and custom software are not within the "same class of subjects" as provided by the Pennsylvania Constitution.