

DEPARTMENT OF TAXATION

2001 Fiscal Impact Statement

1. **Patron** Harris

3. **Committee** House Finance

4. **Title** Retail Sales and Use Tax: Extend
Industrial Exemptions to Computer
Software Production

2. **Bill Number** HB 2440

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would expand the current industrial manufacturing exemptions to include machinery, equipment, energy, or supplies used directly to produce any computer software for sale, resale or licensing.

This bill also defines "computer software" and "licensing" for purposes of the expanded exemption.

The proposed exemption would apply to the production of "custom" software and the production of computer software sold electronically, as current law exempts the manufacture of "off-the-shelf" software sold in tangible form.

The effective date of this bill is not specified.

6. **Fiscal Impact Estimates are:** Unknown. (See Line 8.)

7. **Budget amendment necessary:** No.

8. **Fiscal implications:**

This bill would result in minimal form revision and taxpayer education expenses for the department.

The exemption provided by this bill would have a negative impact on General Fund, Transportation Trust Fund, and local revenues. The full extent of this impact is not known because the amount spent on items that would be exempted by this bill by producers of computer software is not known. The number of businesses that produce computer software and would be affected by this bill is also not known, but may be large. It includes any business that produces computer software for sale, resale, or licensing.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: None.

11. Other comments:

This bill would expand the existing industrial manufacturing exemptions currently available to manufacturers of tangible personal property. Under this bill, the current exemptions would be available to the production of any computer software for sale, resale, or licensing.

This bill would also define “computer software” and “licensing” for purposes of the expanded exemption.

Current Industrial Manufacturing Exemption

Code of Virginia § 58.1-609.3(2) currently provides an exemption for equipment, machinery and supplies used in manufacturing or processing products for sale or resale. In order to qualify for the exemption, the equipment, machinery and supplies must be used directly and predominantly in an exempt manufacturing activity. Further, to qualify for the exemption, the manufacturing or processing must be industrial in nature. Code of Virginia § 58.1-602 defines “industrial in nature” to include, but not be limited to, those businesses classified in codes 20 through 39 published in the Standard Industrial Classification (“SIC”) Manual.

Manufacture of tangible software: Currently, the manufacture of computer software (i.e., the mass production or duplication of computer software in tangible form – such as tape, disk or CD) qualifies for the current exemption. Equipment, machinery and supplies used directly to manufacture this software may be purchased exempt of the tax. The subsequent sale of the software to the final consumer is generally taxable.

Production of custom computer software: Code of Virginia § 58.1-609.5(7) exempts from taxation the sale of custom computer software (which is defined as a computer program specifically designed and developed only for one customer). The sale of custom computer software is deemed to be the sale of an exempt service, and not the sale of tangible personal property. Because the industrial manufacturing exemption applies to the manufacture and sale of tangible personal property, it does not apply to the production of custom computer software.

Production of computer software that is provided electronically: TAX has consistently held that transactions involving information accessed via the Internet and other electronic means are nontaxable service transactions. Such transactions are

deemed to be nontaxable services precisely because there is no transfer of tangible personal property. In fact, TAX has consistently held that identical items may be taxable (as tangible personal property) or exempt (as a nontangible product) based solely on how such items are distributed to customers. The sale of computer software distributed electronically is exempt; the same software delivered in tangible form is taxable. The 1998 General Assembly codified this policy by amending Code of Virginia § 58.1-609.5(1) to specifically exempt:

Services not involving an exchange of tangible personal property which provides access to or use of the international network of computer systems commonly known as the Internet and any other related communication service.

Currently, the purchase of equipment, machinery and supplies used to produce computer software that is provided electronically is taxable because the subsequent sale of such computer software is not the sale of tangible personal property. Rather, the sale of such computer software is the sale of an exempt service.

Under this bill, the industrial manufacturing exemption would apply to the production of custom computer software and the production of computer software provided electronically. The subsequent sale of such custom software and electronic software would remain exempt of the tax. Accordingly, both the production and sale of custom and electronic software would be exempt from sales and use taxation.

These multiple exemptions may create an economic disadvantage for those businesses that manufacture and distribute computer software in tangible form. Although these businesses are currently exempt on items used to manufacture their products, the sale of the tangible product is generally taxable.

Research and Development

Currently, tangible personal property (including computer hardware and software) used directly and exclusively in research and development may be purchased exempt of the tax. The research and development exemption applies to the advancement of computer software technology, and the development and improvement of computer software products. This exemption applies to computer software regardless that the new or improved software is in tangible or intangible form.

cc: Secretary of Finance

Date: 1/22/01/tjh

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