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The Software Sales Tax Recovery Guide: Do you really need to pay so much sales tax on your purchases of software?

Canned software is a commodity that virtually all businesses use. As its purchase usually entails a significant investment for a business, its taxability status should be considered. Certain software purchases may be exempt from sales tax depending on where, when, and how the purchases were made. If the software purchase is found to be nontaxable, it is the economic equivalent of a 6 to 10% discount on the transaction. Even if the software purchase were found to be tax exempt after the purchase had been made, the business may still obtain, with sufficient documentation, a tax refund from the software vendor or the state or local taxing jurisdiction—generally, whichever jurisdiction had initially collected the tax on the purchase. Thus, on purchases of \$1 million of software, savings or refunds of as much as \$100,000 can be obtained.

Illinois, for example, is unique among state and local taxing jurisdictions in exempting from state and local sales taxes canned software sold through a license agreement into which the software developer and its customer had entered. The software is tax-exempt provided that the license agreement contains five stipulations provided by statute. These stipulations are elements commonly found in most software license agreements. The Illinois sales tax exemption also extends to any post-sale maintenance agreements covering the exempt software, which the licensor purchases from the licensee. Thus, by examining software licenses and related maintenance agreements signed over the last few years, refunds of sales taxes can often be obtained.

Illinois, however, is not the only state that under certain common circumstances exempts software from sales tax. For instance, 14 states—including California, Virginia, Colorado, and Missouri—exempt software conveyed electronically to the customer, regardless of whether or not the software purchase is subsumed under a licensing agreement. Other states, like Wisconsin, exempt from tax software that a user may access remotely from a server residing in another state. A number of other states—such as Minnesota and Florida—treat software (and hardware) used predominantly in research and development or in manufacturing (which frequently includes the compilation of code used to create new software products for sale) as falling under their respective sales tax exemptions. Some taxpayers who purchase software for use in multiple locations may allocate on a pro rata basis sales tax due to various states where its employees have workstations. The sales tax due may be reduced or exempted to the extent that the sales tax is allocated to low tax-rate states, states with no sales tax altogether—such as

Delaware or New Hampshire—or states that would exempt the electronic conveyance of the software from the server to remote out-of-state workstations.

All of these strategies—and others not discussed herein—may be used to exempt or reduce the amount of sales tax due on software purchases. On a \$1 million purchase of software, savings can amount to as much as \$100,000 or 10%. True Partners Consulting can help businesses achieve these savings. We are highly proficient in obtaining from software vendors or taxing jurisdictions sales tax refunds for clients who erroneously paid tax on their software purchases. True Partners Consulting's sales tax refund software review engagement has been very well received by our clients because they often receive relatively quick cash refunds or credits on account from vendors or state taxing jurisdictions. These engagements are also low risk because: (1) our fees for the engagement are contingent, so, if we do not find any refunds, the client pays us nothing; (2) the tax-exempt status of the software is clearly demonstrable and noncontroversial; thus, the refund claims filed on behalf of clients are virtually always accepted as such by vendors or the State; (3) our fieldwork for the engagement is unobtrusive to the client, as it usually involves our presence at a client location for about two to three hours (pulling and copying purchase invoices and business agreements) with the remainder of the work, including monitoring refund claims, completed at our office; and (4) due to our substantial experience, we can often recognize the type of agreement and vendor that will result in a refund, which leads to an even quicker and more thorough execution of the engagement.

Are you paying too much sales tax on your purchases of software? Let True Partners Consulting help you determine the fair amount of tax due.

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