Golden Gate University Law Review

Volume 19 | Issue 2 Article 1

January 1989

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ARTICLE

RECENT DEVELOPMENTS IN THE TAXATION OF COMPUTER SOFTWARE

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INTRODUCTION

Computer software has tax consequences both at the state and federal levels. At the state level, software might be subject to sales, use or property taxation if it is considered to be tangible personal property. On the federal level, software may qualify for the investment tax credit or research credit, also depending on tangibility. In the last few years, both state and federal courts and legislatures have rendered decisions and passed laws that have altered the taxability of computer software. This article summarizes those changes and attempts to spot a trend.

STATE TAXATION OF COMPUTER SOFTWARE

For more than a decade after the first software tax case was decided, computer software was uniformly classified as intangible for sales, use and personal property tax purposes, and therefore exempt from taxation.[1] Then, in 1983, the decisions began

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1. The first case to directly address the software tangibility issue was District of Columbia v. Universal Computer Assoc., 465 F.2d 615 (D.C. Cir. 1972). Other early cases also held software to be intangible for sales, use or property tax purposes. *See* State v. Central Computer Serv., Inc., 349 So. 2d 1160 (Ala. 1977); County of Sacramento v. Assessment Appeals Bd. No. 2, 32 Cal. App. 3d 654, 108 Cal. Rptr. 434 (1973); First Nat'l. Bank of Springfield v. Dep't. of Revenue, 85 Ill. 2d 84, 421 N.E.2d 175 (1981); Grey-

to go in the other direction, classifying software as tangible and therefore subject to taxation.[2]

In Comptroller of the Treasury v. Equitable Trust Co.,[3] the issue was whether the purchase of a "canned" or off-the-shelf program on magnetic tape constituted a transaction upon which sales tax could be assessed. Equitable entered into several license agreements whereby it obtained the nontransferable and nonexclusive right to use several programs in perpetuity.[4] Legal title, however, remained with the licensor.[5]

The Comptroller alleged that these transactions involved "tangible personal property, namely, magnetic tapes which had been enhanced in value by the copies of the programs coded thereon," and were subject to sales tax.[6] Equitable argued that "the predominant purpose or essence of the transaction governs classification of the sale as involving either tangible or intangible property. In the transfer of computer programs via magnetic tape, the purpose is to obtain the program, an intangible, and not the tangible tape."[7] The Data Processing Management Asso-

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hound Computer Corp. v. State Dep't of Assessments & Taxation, 271 Md. 674, 320 A.2d 52 (1974); James v. TRES Computer Service, Inc., 642 S.W.2d 347 (Mo. 1982); Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976); First Nat'l. Bank of Fort Worth v. Bullock, 584 S.W.2d 548 (Tex. Civ. App. 1979).

A number of cases involving data processing service bureaus also address the issue of computer software tangibility. *See, e.g.*, Miami Citizens Nat'l. Bank & Trust Co. v. Lindley, 50 Ohio St. 2d 249, 364 N.E.2d 25 (1977); Citizens Fin. Corp. v. Kosydar, 43 Ohio St. 2d 148, 331 N.E.2d 435 (1975); Accountants Computer Serv., Inc. v. Kosydar, 35 Ohio St. 2d 120, 298 N.E.2d 519 (1973); Bullock v. Statistical Tabulating Corp., 549 S.W.2d 166 (Tex. 1977).

2. For early cases holding software to be tangible, see Comptroller of the Treasury v. Equitable Trust Co., 296 Md. 459, 464 A.2d 248 (1983); Citizens & S. Sys., Inc. v. South Carolina Tax Comm'n, 280 S.C. 138, 311 S.E.2d 717 (1984); Chittenden Trust Co. v. King, 143 Vt. 271, 465 A.2d 1100 (1983). Software is sometimes considered tangible for Uniform Commercial Code purposes. See Chatlos Sys., Inc. v. National Cash Register Corp., 635 F.2d 1081 (3d Cir. 1980); RRX Indus. Inc. v. Lab-Con Inc., 772 F.2d 543 (9th Cir. 1985); Communications Groups, Inc. v. Warner Communications, Inc., 138 Misc. 2d 80, 527 N.Y.S.2d 341 (1988); Note, Computer Programs as Goods Under The UCC, 77 MICH. L. REV. 1149 (1979).

3. 296 Md. 459, 464 A.2d 248 (1983)

4. *Id.* at 461, 464 A.2d at 248.

5. *Id.* at 400, 464 A.2d at 249.

6. *Id.*

7. *Id.* at 466, 464 A.2d at 251-52. Equitable's principal argument was that the Court should sever the program from the tangible tape. Thus, the transaction should be viewed from two levels, the delivery of a tangible tape and the delivery of intangible information. *Id.* at 468, 464 A.2d at 253. Courts that use the "essence of the transaction" test

ciation, in its amicus brief, contended that "the transaction is a license to use the program, and that such a license is a form of intangible property."[8]

The court held that Equitable acquired "tangible personal property, namely, magnetic tapes which had been enhanced in value by the copies of the program coded thereon,"[9] and that "the licenses. . .do not grant intangible rights from the proprietors to Equitable. . .[but] simply erect contractual limitations on the use which Equitable might otherwise make of the statutorily unprotected program copies it acquired."[10] The court in *Equitable* thus rejected the reasoning of a long line of cases that held taped copies to be intangible. The court saw misconceptions in the technological underpinnings of these decisions and departures in reasoning from that usually applied in sales tax cases. Furthermore, the court noted that a tape containing a copy of a canned program does not lose its tangible character because its content is a reproduction of the product of intellectual effort, just as a phonograph record does not become intangible because it is a reproduction of artistic effort.[11] The price paid for a copy of a canned program reflects the cost of developing the program as well as any profit that the proprietor hopes to recover. In the court's view, the fact that a canned software program on tape is much more expensive than the typical phonograph record does not render the program tape any less tangible than a phonograph record.[12]

The court did not find any legally significant distinction for sales tax purposes between the canned computer program on magnetic tape and music on a phonograph record:

> 'Both recorded music and computer programs are sets of information in a form which, when passed over a magnetic head, cause minute currents to

look at the substance of the transaction rather than the form it took. For example, if the value of a program is $50,000 and the value of the tape or disk upon which the program is stored has a separate value of $50, then the essence of the transaction is the purchase of a program, not the purchase of a tape or disk. The fact that a tape or disk is also acquired in the transaction is merely incidental.

8. *Id.* at 466, 464 A.2d at 251.

9. *Id.* at 460, 464 A.2d at 249.

10. *Id.* at 468, 464 A.2d at 252-53.

11. *Id.* at 484, 464 A.2d at 261.

12. *Id.*

> flow in such a way that desired physical work is accomplished.' In the case of the phonograph record, the sales tax statute in Maryland has never been viewed as conceptually severing the copy of the performance from the tangible carrier.[13]

The court concluded that "the statute does not sever copies of computer programs from the tangible carriers employed in the subject sales."[14]

The day after *Equitable* was decided in Maryland, in what appeared to be a one-two punch to the tax-free nature of computer software, the Vermont Supreme Court decided Chittenden Trust Company v. King.[15] This case also held software to be taxable, but this time it was a compensating use tax that was levied against canned software.[16] In holding that the computer tape was tangible personal property, the court noted that "the tape [could] be seen, weighed, measured and touched and [was] not a right or credit."[17] The court rejected Chittenden's contention that the "focus of the transaction" was the transfer of intangible knowledge and information, noting that the purchase of an off-the-shelf program does not involve the sale of personal services, but rather the sale of tangible personal property.[18]

The court also rejected the argument that a computer program tape was distinguishable from other taxable personal property such as films, videotapes, books, cassettes and records. In comparison to each of the latter items, the court found that computer software was similar since the "value lies in their respective abilities to store and later display or transmit their contents."[19]

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13. *Id.* at 485, 464 A.2d at 261 (citation omitted).

14. *Id.*

15. 143 Vt. 271, 465 A.2d 1100 (1983).

16. *Id.* A use tax is generally imposed on the sale or lease of property that is not subject to the sales tax.

17. *Id.* at 273, 465 A.2d at 1101. The Vermont statute defines tangible personal property as "personal property which may be seen, weighed, measured, felt, touched or in any other manner perceived by the senses and shall include fuel and electricity but shall not include rights and credits, insurance policies, bills of exchange, stocks and bonds and similar evidences of indebtedness or ownership." VT. STAT. ANN. tit. 32, § 9701(7) (1981).

18. *Chittenden*, 143 Vt. at 274, 465 A.2d at 1101-02.

19. *Id.* at 274, 465 A.2d at 1102.

In conclusion, the court stated:

> It may well be that the Bank could have procured, by way of telephone or personal service, the same programming information so as to avoid a use tax. To base the tax consequences of a transaction on how it could have been structured "would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred." This we will not do. The Bank must accept the consequences of its choice to purchase the program in the form of a tape.[20]

The following year, in Citizens & Southern Systems, Inc. v. South Carolina Tax Commission, the South Carolina Supreme Court also held canned software to be subject to the sales and use tax.[21] Here, the court compared the sale of magnetic tapes to a sale of books or phonograph records, observing that the conveyance of knowledge by a professor to students in a classroom would not be subject to tax, but publication in the form of a book or phonograph record would be taxable[22] In assessing the tax, the value of the books or records is based upon the value of what is contained in them, which is intangible.[23] The value of the paper, binding, ink or other material cost is not relevant.[24]

Appellants relied on the long line of cases that distinguished software from books, records and movies because of the separability of the computer program from the magnetic tape and the inherent inseparability of the matter contained in a book, on a record, or in a movie from a book.[25] The Court was not convinced and instead agreed with the idea that:

> [T]he taxability of a sale of a canned program copy should not turn on whether the buyer stores the program in memory. A tax system cannot be

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20. *Id.* at 274-75, 465 A.2d at 1102 (citation omitted).
21. 280 S.C. 138, 311 S.E.2d 717 (1984).
22. *Id.* at 141, 311 S.E.2d at 718.
23. *Id.*
24. *Id.*
25. *Id.* (citing First Nat'l. Bank of Springfield v. Department of Revenue, 85 Ill. 2d 84, 421 N.E.2d 175 (1981); *see* Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976)).

> administered dependent upon whether or not, at the time of the transaction, the buyer's intent is to store the program continuously in memory.[26]

Citizens asserted that the instructions could have been introduced into the computer through intangible means such as by telephone or personal programming, and that the fact that transmission was by magnetic tape should not make the transaction taxable.[27] On this point, the court indicated that Citizens had to accept the consequences of its choice to purchase the computer program in the form of a magnetic tape, finding that "[t]o base the tax consequences of a transaction on how it could have been structured would require rejection of the established tax principle that a transaction be given its tax effect in accord with what actually occurred and not in accord with what might have occurred."[28]

Another case that held software to be tangible is Hasbro Industries, Inc. v. Norberg.[29] In that case, Hasbro purchased a "canned" software program that could be put to immediate use without alteration or customization.[30] Hasbro argued that the software was not subject to the use tax because it constituted "(1) a nontaxable service, the transfer of the disk and punch cards bearing the written instructions being merely incidental to those services, and (2) intangible personal property."[31] The court found that contention to be without merit.[32] Being a "canned" program that could be used by any number of purchasers, the service element of the software was virtually nonexistent.[33] Although the software program was not perceptible to the senses, the disk and punch cards could be seen, weighed and measured, making the program tangible for use tax purposes.[34] Thus, the Rhode Island court adopted the position of the *Equi-*

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26. *Citizens & Southern*, 280 S.C. at 141, 311 S.E.2d at 718 (quoting Comptroller of the Treasury v. Equitable Trust Co., 296 Md. 459, 464 A.2d 248, 255 (1983)).

27. *Id.* at 141-42, 464 A.2d at 718-19.

28. *Id.* at 143, 464 A.2d at 719 (quoting Chittenden Trust Co. v. King, 405 A.2d 1100, 1102 (Vt. 1983)).

29. 487 A.2d 124 (R.I. 1985).

30. *Id.* at 126.

31. *Id.* at 128.

32. *Id.*

33. *Id.*

34. *Id.*

table and *Chittenden* courts.[35] Rhode Island joined a growing minority view that had gained much support in the previous 18 months as a result of the Vermont and Maryland decisions.

In 1986, the Tennessee Supreme Court went a step further than other courts and taxed custom software, which, until that time, had usually been considered exempt from sales and use tax because it was the sale of a service rather than a product. In *Creasy Systems Consultants, Inc. v. Olsen*,[36] a consulting company designed or modified a client's software on a contract basis, using the client's own disk or tape rather than its own. The consulting company argued that there was no transfer of tangible personal property because the software was input directly into client-owned disks or tapes, and not by means of transferring the program from the consulting company's disk or tape.[37] Payment was on a contract basis, usually by the hour, which distinguished it from the usual software sale, which was by the package rather than time-based.[38]

The Tennessee statute at issue in *Creasy* defined sale to include the transfer of customized or packaged computer software.[39] The court rejected the argument that the sale could avoid tax by inputting the information directly into client-owned disks or tapes rather than by inputting the information into consulting company-owned materials, then transferring them to the client.[40] The court held that the law imposed a tax on the transfer or design of customized or packaged computer software regardless of how the transfer was accomplished.[41] This view differs somewhat from that of other courts, which hold that the actual means of transfer is determinative, not the means of transfer that could have been adopted.[42]

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35. *See* Comptroller of the Treasury v. Equitable Trust Co., 296 Md. 459, 464 A.2d 248 (1983); Chittenden Trust Co. v. King, 143 Vt. 271, 465 A.2d 1100 (1983).

36. Creasy Sys. Consultants, Inc. v. Olsen, 716 S.W.2d 35 (Tenn. 1986).

37. *Id.* at 36.

38. *Id.* at 37.

39. TENN. CODE ANN. § 67-6-102(14)(B).

40. *Creasy*, 716 S.W.2d at 36.

41. *Id.*

42. *See* University Computing Company v. Olsen, 677 S.W.2d 445 (Tenn. 1984) (holding that software developed for internal use was exempt from taxation, but software developed for sale was taxable). *See also* TENN. CODE ANN. §§ 67-6-101 et seq., 67-6-102(14)(B), 67-6-210. For an example of a case that held the actual means of transmission to be determinative, see Chittenden Trust Co. v. King, 143 Vt. 271, 275, 465 A.2d

The West Virginia Supreme Court recently agreed with the *Citizens & Southern Systems*, and *Equitable* decisions, both of which reject the "essence of the transaction" test.[43]

Other courts have made a distinction between canned and custom software. In Measurex Systems, Inc. v. State Tax Assessor, the Maine Supreme Court held that canned software is taxable but custom software is not.[44] It based its decision on the "relative value test," which it had previously relied upon in Community Telecasting Service v. Johnson.[45] In discussing the differences between canned and custom software the court noted as an important factor the value that the product has to non-buyers.

> [W]here the creation of property to be transferred requires high skill and the materials involved are of relatively little value and the principal value of the finished product lies in the services to be rendered, and the product is of little value to anyone other than the buyer, the transaction may be deemed a sale of services rather than goods. The relative dollar value of the service as against that of the product, sometimes expressed in percentages, has been held significant. "Canned" software has value apart from the programming services that create it because of its potential for resale and its value to more than one buyer.
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> "Custom" software, on the other hand, falls within the definition of services set forth in Community Telecasting. The creation of "custom" software requires high skill, although the materials (computer disks) are of little value. Moreover, the product is of little value to other buyers because the software is prepared specifically for the

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1100, 1102 (Vt. 1983), and *infra* notes 12-17 and accompanying text.

43. Pennsylvania and West Virginia Supply Corp. v. Rose, 368 S.E.2d 101 (W. Va. 1988). In this case, the previous statute classified off-the-shelf computer software as tangible and subject to the use tax even though information was the real product. *Id.* at 104-05. The rationale of the statute was that the disks upon which the information was stored had physical form and were capable of being touched, seen and possessed—the classic definition of tangible property. *Id.* at 104. *See* W. VA. CODE §§ 11-15A-2, 11-15A-2(a), 11-15A-1(5) (1969 and 1983 Replacement Vol.).

44. Measurex Sys., Inc. v. State Tax Assessor, 490 A.2d 1192 (Me. 1985).

45. *Id.* at 1195-96. *See also* Community Telecasting Serv. v. Johnson, 220 A.2d 500 (Me. 1966).

> needs of the particular user. The principal value lies in the services of the programmer.[46]

However, the trend in case law since 1983 has not been uniformly in favor of taxing software as tangible personal property. In Ohio, an appellate court in Compuserve v. Lindley, found software to be intangible, and not subject to sales, use or property taxation.[47] Although the software was stored on tangible tapes, and, as operational software, was indispensable to the operation of the computer, the true purpose of the software purchase was to obtain intangible information, and the purchase of the tapes was merely incidental to the purchase of intangible information.[48] In effect, the court held that Ohio was attempting to tax personal service transactions, which were exempt from taxation because of their intangible nature.[49] It also specifically disagreed with the holdings in *Chittenden, Equitable, Citizens and Southern Systems* and *Hasbro* because these cases held that the real purpose of the transaction was to obtain the medium upon which the software was stored (tape, etc.) rather than the information itself.[50]

Courts in Michigan and California also have recently held software to be intangible and not subject to taxation.[51] In *Maccabees*,[52] the Michigan Appellate Court, relying on decisions in the District of Columbia and Tennessee, held custom software to

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46. *Measurex*, 490 A.2d at 1195-96 (citations omitted).

47. 41 Ohio App. 3d 260, 535 N.E.2d 360 (1987); *but see* Ohio Farmers Insurance Co. v. Lindley, No. 79-B-43 (Ohio Board of Tax Appeals July 15, 1981) (court found the purchase of software to be taxable on the grounds that the tangible tapes were the true object of the transaction); Statistical Tabulating Corp. v. Lindley, 3 Ohio St. 3d 23, 445 N.E.2d 1104 (1983) (where the true object of the transaction was a computer printout rather than a software program, the sale was held to be the sale of tangible personal property, and therefore subject to the sales tax).

For other Ohio cases, see Interactive Information Sys., Inc. v. Limbach, 18 Ohio St. 3d 309, 480 N.E.2d 1124 (1985); Union Central Life Ins. Co. v. Lindley, 12 Ohio St. 3d 80, 465 N.E.2d 440 (1984); Aedes Associates v. Lindley, No. C-830969, (Ohio Ct. App. 1986).

48. *Compuserve*, 41 Ohio App. 3d at 265-66, 535 N.E.2d at 365.

49. *Id.* at 269-70, 535 N.E.2d at 369.

50. *Id.* at 265, 535 N.E.2d at 365.

51. General Business Sys. v. State Board of Equalization, 162 Cal. App. 3d 50, 56-57, 208 Cal. Rptr. 374, 378 (1984), *hearing den.*; Maccabees Mutual Life Ins. Co. v. State Dep't of Treasury, 122 Mich. App. 660, 332 N.W.2d 561 (1983).

52. Maccabees Mutual Life Ins. Co. v. State Dep't. of Treasury, 122 Mich. App. 660, 332 N.W.2d 561 (1983).

be intangible because it more closely resembled a service than a product.[53] The court also noted that custom programs should be distinguished from canned programs.[54]

In *General Business Systems*, a California appellate court held custom application software to be exempt from tax, since the true object of the transaction was rendition of services.[55] Although the software was delivered in the form of punch cards, delivery could have been by any number of other methods, including transmittal through the computer's keyboard, over telephone lines or via terminal. Delivery by cards was chosen because of convenience and cost.[56]

Another distinction being made in types of computer software focuses on whether the program is application or operational software. The Kansas Supreme Court has determined that application software is intangible and operational software is tangible.[57] This distinction in treatment is based on the differing natures of the two types of software. Operational software is needed to make the hardware work, and so has some attributes of hardware, which is tangible. Application software, on the other hand, is not needed to make the hardware work.

While the majority of states still classify software as intangible and thus non-taxable, some courts, employing different standards and tests, are finding software to be tangible.[58] As a

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53. District of Columbia v. Universal Computer Associates, Inc., 465 F.2d 615 (1972); Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976).

54. *Maccabees*, 122 Mich. App. at 664, 332 N.W.2d at 564 (citing *Universal Computer Assoc.*, 465 F.2d at 615.)

55. *General Business Sys.*, 162 Cal. App. 3d at 56-57, 208 Cal. Rptr. at 378 (1984), *hearing den.*; *see* CAL. REV. & TAX CODE §§ 6006(f), 6010.9, 6010.9(a), 6016, 6051.

56. *General Business Sys.*, 162 Cal. App. 3d at 53, 208 Cal. Rptr. at 375.

57. In re Protest of Strayer, 239 Kan. 136, 716 P.2d 588 (1986); Appeal of AT&T Technologies, Inc., 242 Kan. 554, 749 P.2d 1033 (1988).

58. The issue of computer software tangibility is relevant in other areas of the law besides tax. *See* Hancock v. State of Texas, 402 S.W.2d 906 (Tex. Crim. App. 1966). In *Hancock*, an employee was accused of stealing several computer programs from his employer. *Id.* at 907-08. The employee maintained that he had committed petty theft rather than grand larceny because the only tangible property he stole was the paper on which the programs were printed and these tapes had a value of less than fifty dollars. *Id.* at 908. The court disagreed, holding that the programs had a value in excess of the value of the paper upon which they were printed and that the programs, as well as the paper they were printed on, were tangible personal property for purposes of the criminal statute. *Id.* at 911.

result a software is classified as tangible and taxable in one state and intangible and tax exempt in another state. It does not appear that a uniform classification of software will emerge. The inconsistent treatment of software is not limited to the states but exists on the federal level as well.

FEDERAL TAXATION OF COMPUTER SOFTWARE

Whether computer software is classified as tangible or intangible determines whether it qualifies for federal tax credits. The Internal Revenue Code and regulations do not specifically state whether computer software is eligible for the investment tax credit ("ITC").[59] The Code merely states that tangible personal property qualifies for the investment tax credit, without mentioning whether computer software is tangible or intangible.[60] The only guidance is found in a few IRS pronouncements and court cases. Although the investment tax credit was repealed by the 1986 Tax Reform Act,[61] the old rules still apply to many cases still pending before the various courts. Furthermore, the investment tax credit rules have been repealed or changed many times before, and are subject to possible re-enactment. Therefore, it is useful to examine the treatment of software as it relates to the investment tax credit.

The Internal Revenue Service developed a two-prong test to determine whether or not an investment in computer software qualifies for the ITC.[62] If the software exists independently of the hardware, it is treated as intangible property and therefore ineligible for the ITC.[63] But if the software costs are included in

59. I.R.C. §§ 38, 43 (1982). The investment tax credit reduces the tax liability, dollar for dollar, for purchases of certain tangible, depreciable property. *Id.* at § 38. For example, if a business taxpayer purchases Section 38 property costing $100,000 and the investment tax credit percentage is 10%, then the tax liability is reduced by $10,000—10% of $100,000. Tax credits are better than deductions because of this dollar for dollar offset. If the income tax rate is 40%, each dollar deducted reduces the tax liability by only 40 cents, whereas each dollar of tax credit reduces the tax liability by one dollar. Furthermore, depreciation deductions can also be taken, so taxpayers can both deduct the cost of the asset over a number of years and claim an investment tax credit for the same asset.

60. *Id.*

61. Pub. L. No. 99-514, § 211, *codified* at 26 U.S.C. § 49 (1986) ("Tax Reform Act of 1986").

62. Rev. Proc. 69-21, 1969-2 C.B. 303.

63. *Id.*

the price of hardware and are not separately stated, an investment credit may be taken for the entire system, not just the portion attributable to hardware.[64] In other words, if the software is "bundled" with the hardware, it qualifies for the investment tax credit. Otherwise, it does not.

Federal courts have been inconsistent in their treatment of the tangibility of computer software. In Texas Instruments, Inc. v. United States, the Fifth Circuit held software to be tangible for investment tax credit and depreciation purposes.[65] The court stated that it could not accurately separate the value of the information recorded on the tapes from the value of the tapes because the value of the data was wholly dependent upon the existence of the tapes.[66] If the tapes were destroyed, nothing would remain. An investment in the data would have no value apart from an investment in the tapes. Thus, the software was tangible and eligible for the tax credit.[67]

In Ronnen v. Commissioner,[68] the Tax Court came to the opposite conclusion, holding that software is intangible and ineligible for the investment tax credit. In *Ronnen*, the court applied the intrinsic value test of Texas Instruments and concluded that, based on different facts, the intrinsic value of the software was attributable to its intangible rather than tangible embodiments, and was therefore not eligible for the investment tax credit.[69]

A federal District Court has also distinguished *Texas Instruments* in holding software to be intangible, and therefore not eligible for the investment tax credit. In Bank of Vermont v. United States,[70] the court found that the computer tape and the information contained in the tape could be separated and exist apart from each other. This was not the case in *Texas Instruments*.

The inconsistency resulting from different state and federal

64. Rev. Rul. 71-177, 1971-1 C.B. 5.
65. 551 F.2d 599, 611 (5th Cir. 1977).
66. *Id.*
67. *Id.*
68. 90 T.C. No. 7, Tax Ct. Rep. (CCH) 2639 (1988).
69. *Id.* at 2650.
70. 61 A.F.T.R.2d (P-H) 88-788 (1988).

treatment of software tangibility was manifest in this case. The Vermont Supreme Court in *Chittenden*,[71] had held computer software to be tangible and subject to the use tax. The District Court in *Bank of Vermont*, however, rejected *Chittenden* as not binding on the federal courts. This put the Bank in the unenviable position of having the same software treated as tangible for state use tax purposes and intangible for federal investment credit purposes.

In another context, the Tax Court has held that software is intangible for collapsible corporation purposes.[72] A collapsible corporation is formed to convert ordinary income into capital gains to effectuate tax savings.[73] The Internal Revenue Code prohibits the prearranged use of a corporation for these purposes.[74] In Computer Sciences Corp. v. Commissioner,[75] Computax, a wholly owned subsidiary of Computer Sciences Corporation, developed a software program for the computer preparation of income tax returns. The corporation took the position that its software program for the preparation of tax returns was intangible property and that the term "property" as used in IRC section 341 only applied to tangible property.[76] The Tax Court held that the computer software programs were intangible property developed by the corporation and that intangible property should be considered property within the meaning of section 341.[77]

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71. Chittenden Trust Co. v. King, 143 Vt. 271, 465 A.2d 1100 (1983).

72. Computer Sciences Corp. v. Commissioner, 63 T.C. 327 (1974).

73. A collapsible corporation is defined as

> A corporation formed or availed of principally for the manufacture, construction, or production of property. . .with a view to the sale or exchange of [corporate] stock by its shareholders. . .before the realization by the corporation of a substantial part of the taxable income to be derived from such property, and the realization by such shareholder of gain attributable to such property.

BLACK'S LAW DICTIONARY 237 (5th ed. 1979).

74. *See* I.R.C. § 341(b)(1) (1982). If the IRS classifies the corporation as collapsible, the gain that otherwise would be capital is taxed as ordinary gain, which means more taxes are paid. Collapsible corporations are used to reduce the tax bite. IRS realizes this fact, so it treats capital transactions of such corporations as if they were ordinary transactions.

75. 63 T.C. 327.

76. *Id.* at 346.

77. *Id.* at 346-47.

CONCLUSION

It appears that the weight of authority, while no longer unanimous, still classifies computer software as intangible and non-taxable. There appears, however, to be a trend among the states to characterize computer software as tangible for state sales, use and property tax purposes. State courts are distinguishing types of software and the means by which the software is delivered. "Canned" software is more likely to be classified as tangible than is custom software, although at least one court has classified custom software as tangible. Also, if the software is delivered in the form of disk or tape, some courts may be more likely to find that the software is tangible as compared to software transmitted via telephone lines.

Although federal courts generally hold that software is intangible and not eligible for the investment tax credit, at least one court held software to be tangible property that qualified for the investment tax credit. In states that are classifying software as tangible, there is the potential for inconsistent state and federal treatment of software.

With the rapid development in computer technology and changing nature of computer software, however, it appears that courts will continue to confront the issue of whether software is tangible or intangible with differing results. Inconsistent treatment of software among the states and federal jurisdictions undoubtedly will continue.