New York State Department of Taxation and Finance

Office of Tax Policy Analysis

Technical Services Division

TSB-A-01(6)S
Sales Tax
January 12, 2001

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

<u>ADVISORY OPINION</u>   <u>PETITION NO. S000724B</u>

On July 24, 2000, the Department of Taxation and Finance received a Petition for Advisory Opinion from ITG Inc., 380 Madison Avenue, 4th Floor, New York, New York, 10017. Petitioner, ITG Inc., submitted additional information with respect to the Petition on September 13, 2000.

The issues raised by Petitioner are as follows:

1) Whether, prior to the proposed plan of reorganization described below, POSIT Software is exempt from sales and use tax.

2) Whether, prior to the proposed plan of reorganization, Petitioner's use of ITG Software is exempt from sales and use tax.

3) Whether, after the proposed plan of reorganization, ITG Software is exempt from sales and use tax.

4) If ITG Software is deemed to be pre-written software after the proposed plan of reorganization, whether the transfer of ITG Software from ITG to Solutions and the simultaneous license of ITG Software from Solutions to ITG is exempt from tax.

5) Whether future upgrades and enhancements of POSIT Software will be exempt from sales and use tax.

6) Whether future upgrades and enhancements of ITG Software will be exempt from sales and use tax.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner is a corporation organized under the laws of the State of Delaware, with its principal place of business located in the State of New York. Petitioner was formed as a wholly owned subsidiary of Investment Technology Group, Inc. (ITGI), which was a wholly owned subsidiary of Jeffries Group, Inc. In 1994, ITGI had its initial public offering and stock began trading on a public market. Petitioner is engaged in business as a registered securities broker-dealer and provides automated trade execution and analysis services to institutional investors. The automated nature of Petitioner's business requires Petitioner to continuously adapt to current and evolving technologies. Accordingly, a division of Petitioner is responsible for the development and

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maintenance of software and other technologically-driven products, as well as creating and protecting Petitioner's intellectual property rights (hereinafter these activities will collectively be referred to as "the Intellectual Property Operations.")

Integral to Petitioner's daily activities, Petitioner uses two different computer programs: (a) POSIT Software and (b) a number of internally developed software programs designed to perform functions such as the routing of orders, order management and decision support (such internally developed software being collectively referred to as the "ITG Software"). POSIT Software is an electronic stock crossing system based on an algorithm designed to effectuate the maximum number of trades based upon the orders submitted to the system by Petitioner's customers. Posit Software was designed and developed by a 50-50 joint venture (the "POSIT Joint Venture") between Jeffries & Company, Inc. ("JCI"), a wholly owned subsidiary of Jefferies Group, Inc., and Programmer, an independent third-party software programmer located in California. POSIT Software was initially designed to the specifications of JCI for use in conducting its business. From its inception, POSIT Software was licensed to JCI. JCI's POSIT Joint Venture interest, and JCI's interest as licensee of POSIT Software, were assigned to Petitioner during 1993. Petitioner and Programmer each own 50% of POSIT Joint Venture. Petitioner pays the POSIT Joint Venture a licensing fee for the right to use POSIT Software.

ITG Software was written and developed entirely by Petitioner's programmers. ITG Software includes internal architecture software as well as front-end software that is designed to act as an interface between Petitioner's customers and POSIT Software or other sources of liquidity (i.e., the NYSE or NASDAQ). The front-end software provides Petitioner's customers portfolio analysis capabilities, improved access to market liquidity and the ability to enhance their trading efficiencies. Petitioner's highly skilled programmers continually upgrade and enhance ITG Software to keep up-to-date as the technological needs of market leaders and financial markets evolve.

Petitioner provides its customers various equipment and/or software, but does not charge customers for the equipment and/or software. For tax and financial statement purposes, Petitioner owns the equipment and the software. Petitioner may "license" the right to use ITG Software to its customers, but does not charge customers for the licensing right. Instead, Petitioner charges customers for its trade execution services based on the number of shares traded. Thus, if a customer does not trade, Petitioner does not receive payment for the use of its ITG Software.

ITG Software and POSIT Software are virtually never sold to customers. However, Petitioner has transferred or sold the internal architecture component of ITG Software on two prior occasions. In 1994, the internal architecture component was provided to one of Petitioner's large institutional customers without a fee. In 1998, the internal architecture component was sold to one of Petitioner's floor runners for a fee. The fee charged represents less than one half percent of Petitioner's annual operating revenues.

Petitioner has made a business decision to segregate its Intellectual Property Operations into a new entity to facilitate technological development and for legal and management reporting purposes. Pursuant to a proposed plan of reorganization, Petitioner will contribute its Intellectual Property Operations to ITG Software Solutions, Inc. ("Solutions"), a newly created wholly-owned subsidiary, upon Solutions' organization in exchange for 100 % of the stock of Solutions, in a transaction intended to qualify for tax-free treatment under Internal Revenue Code ("IRC") § 351. The net result of the restructuring will be that Petitioner's broker-dealer activities will be conducted by Petitioner and its Intellectual Property Operations will be segregated into Solutions. Solutions, a Delaware Corporation, will maintain a regular place of business in California.

Included in the Intellectual Property Operations that will be contributed to Solutions in the exchange for stock described above are Petitioner's rights to the ITG Software. Subsequent to the reorganization, Petitioner will enter into a licensing arrangement with Solutions whereby Solutions will license ITG Software and other technology related products to Petitioner in return for a royalty rate based on arm's length rates, including the right for Petitioner to sublicense ITG Software to Petitioner's customers.

Petitioner submitted a sample copy of a "Hardware and ITG Software License Agreement" (the Agreement) which is entered into by Petitioner and the purchaser of its automated trade execution and analysis services. Such Agreement states, in part:

> Subject to the terms of this Agreement, Customer agrees to license from ITG, and ITG agrees to license to Customer (i) certain software which services a workstation-based analytics, information and routing system known as ITG Software and the user documentation describing the operation and use of such system (collectively, the "ITG Software") and (ii) a workstation, terminal, PC or other hardware and related modem (the "Hardware") for use with a phone line for communication with ITG.

> 1. Installation. ITG will, free of charge, deliver and install the Hardware and ITG Software (the "Installation") on Customer's premises. The Hardware and ITG Software shall remain the property of ITG.

> 2. License to Hardware and ITG Software. Subject to the terms of this Agreement, ITG hereby grants Customer a revocable, non-assignable, non-transferable, nonexclusive license to use the ITG Software in object code form but solely for use in direct connection with ITG's brokerage services on the Hardware. Customer will use the ITG Software only under the terms and conditions of this Agreement and all rights not expressly granted hereunder are reserved by ITG.

Customer shall use the ITG Software only on the Hardware provided by ITG, and shall not use the ITG Software on any other computer system or make the ITG Software available over a network or otherwise permit use of the ITG Software by more than one user at a time without the prior written consent of ITG. Customer shall grant ITG access to the Hardware during normal business hours.

3.   Prohibited Uses. **CUSTOMER SHALL NOT AND SHALL NOT PERMIT ANY OTHER PARTY** other than ITG to: (a) copy, modify, alter, print, list, decompile, disassemble or otherwise seek to reverse engineer the ITG Software whether in whole or in part or to attach or otherwise connect the ITG Software to any computer hardware other than the Hardware or other computer software without ITG's prior written consent given in its sole discretion; (b) allow anyone other than its employees to access or have access to the ITG Software or the Hardware; (c) sell, rent, lease, license, sublicense, transfer or assign the ITG Software or permit a timesharing, service bureau or similar arrangement using the ITG Software; (d) write or develop any derivative software or any other software program based on the ITG Software or any Proprietary Information (as defined in Section 9); (e) use the ITG Software or the analytical data derived from the ITG Software (the "Information") to execute securities trades of any kind, directly or indirectly, on any electronic trade execution system other than the ITG Software without the prior written consent of ITG, given in its sole discretion, or for any purposes other than in connection with its own trading via ITG's brokerage services; or (f) remove the ITG Software from the Hardware, central processing unit or any other location of original installation without the prior written consent of ITG in each instance; provided that Customer may move the ITG Software to other like hardware in the same location solely in the event of a Hardware failure....

Applicable Law and Regulations

Section 1101(b) of the Tax Law provides, in part:

When used in this article for the purposes of the taxes imposed by subdivisions (a), (b), (c) and (d) of section eleven hundred five and by section eleven hundred ten, the following terms shall mean:

*   *   *

(4) Retail sale. (i) A sale of tangible personal property to any person for any purpose, other than (A) for resale as such or as a physical component part of tangible personal property...

*   *   *

(iv) The term retail sale does not include:

*   *   *

(D) The transfer of property to a corporation upon its organization in consideration for the issuance of its stock.

*   *   *

(5) Sale, selling or purchase. Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume (including, with respect to computer software, merely the right to reproduce), conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor.

(6) Tangible personal property. Corporeal personal property of any nature. However, except for purposes of the tax imposed by subdivision (b) of section eleven hundred five, such term shall not include gas, electricity, refrigeration and steam. Such term shall also include pre-written computer software, whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to a purchaser....

(7) Use. The exercise of any right or power over tangible personal property or over any of the services which are subject to tax under section eleven hundred ten of this article or pursuant to the authority of article twenty-nine of this chapter, by the purchaser thereof, and includes, but is not limited to, the receiving, storage or any keeping or retention for any length of time, withdrawal from storage, any installation, any affixation to real or personal property, or any consumption of such property or of any such service subject to tax under such section eleven hundred ten or pursuant to the authority of such article twenty-nine....

* * *

(14) Pre-written computer software. Computer software (including pre-written upgrades thereof) which is not software designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more pre-written computer software programs or pre-written portions thereof does not cause the combination to be other than pre-written computer software. Pre-written software also includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than such purchaser. Where a person modifies or enhances computer software of which such person is not the author or creator, such person shall be deemed to be the author or creator only of such person's modifications or enhancements. Pre-written software or a pre-written portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains pre-written software; provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute pre-written computer software.

Section 1105(a) of the Tax Law provides for the imposition of sales tax on the receipts for every retail sale of tangible personal property, except as otherwise provided in Article 28 of the Tax Law.

Section 1110 of the Tax Law provides, in part:

(a) Except to the extent that property or services have already been or will be subject to the sales tax under this article, there is hereby imposed on every person a use tax for the use within this state on and after June first, nineteen hundred seventy-one except as otherwise exempted under this article, (A) of any tangible personal property purchased at retail, (B) of any tangible personal property (other than computer software used by the author or other creator) manufactured, processed or assembled by the user, (i) if items of the same kind of tangible personal property are offered for sale by him in the regular course of business...(F) of any computer software written or otherwise created by the user if the user offers software of a similar kind for sale as such or as a component part of other property in the regular course of business.

* * *

(g) For purposes of clause (F) of subdivision (a) of this section, the tax shall be at the rate of four percent of the consideration given or contracted to be given for the tangible personal property which constitutes the blank medium, such as disks or tapes, used in conjunction with the software, or for the use of such property, and the mere storage, keeping, retention or withdrawal from storage of computer software described in such clause (F) by its author or other creator shall not be deemed a taxable use by such person.

Section 1115(a) of the Tax Law provides, in part:

Receipts from the following shall be exempt from the tax on retail sales imposed under subdivision (a) of section eleven hundred five and the compensating use tax imposed under section eleven hundred ten:

*   *   *

(28) Computer software designed and developed by the author or creator to the specifications of a specific purchaser which is transferred directly or indirectly to a corporation which is a member of an affiliated group of corporations within the meaning of subparagraph six of paragraph (b) of subdivision seventeen of section two hundred eight of this chapter except for clauses (ii) and (iii) of such subparagraph that includes such purchaser, or to a partnership in which such purchaser and other members of such affiliated group have at least a fifty percent capital or profits interest (but only if the transfer is not in pursuance of a plan having as its principal purpose the avoidance or evasion of tax under this article), but in no case including computer software which is pre-written, as defined in paragraph six of subdivision (b) of section eleven hundred one of this article and available to be sold to customers in the ordinary course of the seller's business.

Section 1115(o) of the Tax Law provides:

Services otherwise taxable under subdivision (c) of section eleven hundred five or under section eleven hundred ten shall be exempt from tax under this article where performed on computer software of any nature; provided, however, that where such services are provided to a customer in conjunction with the sale of tangible personal property any charge for such services shall be exempt only when such charge is reasonable and separately stated on an invoice or other statement of the price given to the purchaser.

Section 526.7 of the Sales and Use Tax Regulations provides, in part:

(a) Definition. (1) The words sale, selling or purchase mean any transaction in which there is a transfer of title or possession, or both, of tangible personal property for a consideration.

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(b) Consideration. The term consideration includes monetary consideration, exchange, barter, the rendering of any service, or any agreement therefor. Monetary consideration includes assumption of liabilities, fees, rentals, royalties or any other charge that a purchaser, lessee or licensee is required to pay.

Opinion

Technical Services Bureau Memorandum TSB-M-93(3)S, dated March 1, 1993, entitled <u>State and Local Sales and Compensating Use Taxes Imposed on Certain Sales of Computer Software</u> provides, in part:

Effective September 1, 1991, State and local sales and compensating use taxes are imposed on the sale or use of prewritten computer software and certain related services.

The effect of this change in the Tax Law is to broaden the types of computer software that are subject to sales and use taxes. Prior to September 1, 1991, "custom" software was exempt from tax as described in Technical Services Bulletin 1978-1(S). However, certain software previously considered "custom" may now be considered prewritten computer software and subject to such taxes. References in the 1978 bulletin to exempt software are largely obsolete and should be disregarded. The only software that is exempt from sales and use taxes under the new law is software designed and developed to the specifications of a specific purchaser.

Prewritten computer software is any computer software that is not designed and developed by the author or other creator to the specifications of a specific purchaser.

The sale of prewritten software includes any transfer of title or possession, any exchange, barter, rental, lease or license to use, including merely the right to reproduce, for consideration. Thus, a payment made by a customer on or after September 1, 1991, for a license to use, or for the rental or lease of prewritten software is subject to sales or use tax...

Software that was originally designed and developed to the specifications of a specific purchaser (i.e., "custom" software) loses its identity as such and becomes prewritten software, subject to tax, if and when it is sold to someone other than the person for whom it was specifically designed and developed. (See section "Exemptions from Tax" for certain exceptions.)

Prewritten software is subject to tax whether sold as part of a package or separately. Software created by combining two or more prewritten programs or portions of prewritten programs is still prewritten software subject to tax....

*   *   *

Sale of Software Upgrades

Generally, the sale of a revision or upgrade of prewritten software is subject to tax as the sale of prewritten software. If, however, the software upgrade is designed and developed to the specifications of a specific purchaser, its sale to that specific purchaser would be exempt as custom software.

*   *   *

Use Tax Exemption

Use tax generally applies to taxable uses of prewritten computer software in the same manner that the use tax applies to uses of other tangible personal property, except that: (1) no use tax is imposed on software used by its author if the author does not offer similar software for sale in the regular course of business, and (2) where software is used by its author and the author does sell the same or similar software in the regular course of business, use tax applies and is computed on the cost of the medium (floppy disk, magnetic tape, etc.) that contains or is used in conjunction with the program.

Transfers of Software To Certain Corporations and Partnerships

Computer software designed and developed by the author or other creator to the specifications of a specific purchaser is exempt from tax under section 1115(a)(28) of the Tax Law when subsequently sold or transferred, directly or indirectly, by the purchaser of the software either

- to a corporation that is a member of an affiliated group of corporations which includes the original purchaser of the software; or

- to a partnership in which the original purchaser of the software and other members of such an affiliated group have at least a 50 percent capital or profits interest.

However, the exemption does not apply if the sale or transfer of the software is part of a plan to avoid or evade the tax. The intragroup transfer exemption also does not apply to prewritten software that is available to be sold to customers in the ordinary course of the seller's business. The term "affiliated group" has the same meaning as it has in section 1504 of the Internal Revenue Code except that references to "at least 80 percent" shall be read as "more than 50 percent" for purposes of this sales tax exemption.

Issue #1

POSIT Software was designed and developed by POSIT Joint Venture, a 50-50 joint venture between JCI, which is a wholly owned subsidiary of Jeffries Group, Inc., and Programmer, an independent third-party software programmer located in California. Petitioner is a wholly owned subsidiary of ITGI, which, like JCI, is a wholly owned subsidiary of Jeffries Group, Inc. POSIT Software was designed and developed to the specifications of a specific purchaser, JCI. JCI was the original licensee of POSIT Software and paid POSIT Joint Venture a licensing fee for the right to use POSIT Software. JCI has since assigned its interest in POSIT Joint Venture, and its interest as licensee of POSIT Software, to Petitioner. The assignment by JCI to Petitioner in 1993 of JCI's interest as licensee of POSIT Software and the fees paid for the POSIT Software by Petitioner under the license between Petitioner and POSIT Joint Venture are exempt under Section 1115(a)(28) of the Tax Law. Therefore, prior to the proposed plan of reorganization, the sale of the POSIT Software to Petitioner under the licensing agreement is not subject to sales and compensating use taxes. It should be noted that a transfer of software will only be exempt under Section 1115(a)(28) if the transfer is not in pursuance of a plan having as its principal purpose the avoidance or evasion of sales and compensating use tax.

Issue #2

ITG Software constitutes computer software which is manufactured, processed and developed by Petitioner and used by Petitioner in providing its customers with its trade execution services from which it receives a per share commission. Although Petitioner may license ITG Software to its customers, as indicated in the sample Agreement, the ITG Software appears to be incidental to the trade execution services provided by Petitioner, and there is no consideration

attributable to such license. Therefore, the licensing of ITG Software by Petitioner to its customers does not constitute a "sale, selling or purchase" within the meaning and intent of Section 1101(b)(5) of the Tax Law and Section 526.7 of the Sales and Use Tax Regulations.

Also, the two isolated instances where the internal architecture component of ITG Software was sold or transferred do not result in the conclusion that such software is offered for sale in the regular course of business by Petitioner. Therefore, Petitioner's use of ITG Software is not subject to the use tax imposed under Section 1110(a) of the Tax Law. See the Use Tax Exemption section as found in TSB-M-93(3)S. It should be noted that the previous sales of ITG Software may be subject to sales tax. See Section 1101(b)(14) of the Tax Law.

Issue #3

Subsequent to the reorganization, ITG Software is software designed and developed to the specifications of a specific purchaser, Petitioner. Therefore, the licensing of ITG Software by Solutions to Petitioner is not subject to sales and compensating use taxes.

Issue #4

The transfer of ITG Software to Solutions upon its organization in exchange for 100% of its stock would not be subject to sales and compensating use taxes as it would not constitute a "retail sale" in accordance with the exception provided in Section 1101(b)(4)(iv)(D) of the Tax Law.

Issue #5

Future upgrades and enhancements of POSIT Software by POSIT Joint Venture to the specifications of Solutions as the sole purchaser would be exempt as custom software in accordance with TSB-M-93(3)S. Also, the subsequent sublicensing of such upgrades and enhancements from Solutions to Petitioner would be exempt under Section 1115(a)(28) of the Tax Law, provided that Petitioner does not resell such upgrades and enhancements to any other person. If Petitioner does resell any such upgrades and enhancements to a third party, the upgrade or enhancement would lose its character as custom software and become pre-written software, the sale (including licensing) of which would be a retail sale. It should be noted that a transfer of software will only be exempt under Section 1115(a)(28) if the transfer is not in pursuance of a plan having as its principal purpose the avoidance or evasion of sales and compensating use tax.

Issue #6

Future upgrades and enhancements of ITG Software by Solutions to the specifications of Petitioner as the sole purchaser would be exempt as custom software in accordance with

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TSB-M-93(3)S. If Petitioner subsequently sells such upgrades or enhancements to third parties, the upgrade or enhancement would lose its character as custom software and become pre-written software.

DATED: January 12, 2001   /s/
                                                           Jonathan Pessen
                                                           Tax Regulations Specialist III
                                                           Technical Services Division

        NOTE: The opinions expressed in Advisory Opinions are
                        limited to the facts set forth therein.