

SBT: SOFTWARE ROYALTIES

Senate Bill 1038 as enrolled
Public Act 539 of 1998
Second Analysis (2-18-99)

Sponsor: Sen. William Van Regenmorter
House Committee: Tax Policy
Senate Committee: Finance

THE APPARENT PROBLEM:

Under Michigan's single business tax (SBT), generally speaking, royalties paid out by a firm are added to a firm's tax base, and royalties received by a firm are deducted from a firm's tax base to the extent that they have been included in federal taxable income. (There are some specific exceptions in the act.) This is because the SBT is a value added tax that essentially uses for its tax base "a firm's costs in transforming the materials purchased into its products or service," and because federal taxable income is itself one of the components of the tax base. (The quotation is from a Department of Treasury booklet analyzing the SBT for years 1988-89.) In a 1996 case, Zenith Data Systems v Department of Treasury, the Michigan Court of Appeals determined that payments made by firms to companies providing them with specially modified computer software programs under licensing agreements restricting their use are royalties for the purpose of the SBT. This means the companies providing the software can deduct the royalties from their tax base but companies purchasing the rights to software must add these payments to their tax base. The effect, according to some interested parties, is a potential additional \$20 million in annual costs to the state's business consumers of application and operating software. Further, according to testimony, since these kinds of software are often obtained already combined with other technology, the calculation of the value of the software to the end user is a complicated one for companies and state tax officials. Moreover, representatives of manufacturers complain that firms must pay sales tax and single business tax on the products. Legislation has been introduced to address this issue in a manner that would exclude these royalties paid from the SBT tax base.

THE CONTENT OF THE BILL:

The bill would amend the Single Business Tax Act so that, for tax years beginning after December 31, 1993, royalties paid by a licensee of application computer software, operating system software, or system software under a license agreement would not have to

be included in (or added back to) the firm's single business tax base. Further, for tax years beginning after December 31, 1997, royalties received by a licensor, distributor, developer, marketer, or copyright holder of application computer software or operating system software under a license agreement could not be deducted from the tax base, but royalties from system software could be deducted.

The term "application computer software" would refer to a set of statements or instructions that when incorporated into a machine-usable medium is capable of causing a machine or device having information-processing capabilities to indicate, perform, or achieve a particular business function, task, or result for the non-technical end user. The term also includes any other computer software that does not qualify as operating system software or system software.

The term "operating system software" would refer to a set of statements or instructions that when incorporated into a machine or device having information-processing capabilities is an interface between the computer hardware and the application computer software or system software.

The term "system software" would refer to a set of statements or instructions that interacts with operating system software that is developed, licensed, and intended for the exclusive use of data processing professionals to build, test, manage, or maintain application computer software for which a license agreement is signed by the licensor and licensee at the time of the transfer of the software and that is not transferred to the licensee as part of or in conjunction with a sale or lease of computer hardware.

MCL 208.9

FISCAL IMPLICATIONS:

According to the Department of Treasury, the bill will result in \$1 million paid out in refunds, \$1.5 million in foregone revenue for fiscal year 2000, and \$32 million

in foregone revenue from the bill's retroactive application. (2-15-99)

ARGUMENTS:

For:

The bill's proponents say that it would exempt certain computer software-related royalties paid from the add-back requirement for royalties in the SBT and instead require the providers of application computer software or operating system software (but not system software) to add royalties received to their SBT tax base. The bill is said to represent an agreement acceptable to manufacturers, the state's largest provider of system software (Compuware), and the Department of Treasury.

Analyst: C. Couch

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.