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SFA BILL ANALYSIS

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Senate Bill 1038 (as enrolled) **PUBLIC ACT 539 of 1998**
Sponsor: William Van Regenmorter
Senate Committee: Finance
House Committee: Tax Policy

Date Completed: 1-21-99

RATIONALE

Under the Single Business Tax (SBT) Act, a taxpayer must add to its tax base royalties paid, to the extent that they were deducted in arriving at Federal taxable income, except those royalties specifically excluded. A taxpayer may deduct from the tax base royalties received, to the extent they were included in arriving at Federal taxable income, except those royalties specified. Payments made or received for the sale or purchase of computer software were not specifically excluded under the provisions that address royalties; however, "royalties" is not defined in the Act, which has sometimes led to disputes between the Department of Treasury and taxpayers.

In one such dispute, Zenith Data Systems and a Zenith affiliate determined that payments received from customers for computer software, modified by Zenith and distributed pursuant to licensing agreements, were royalties. Zenith and the affiliate included those payments as taxable income in their Federal income tax returns, and therefore deducted the payments from their SBT base. The Department disagreed with this treatment of the payments, and assessed Zenith for tax deficiencies. After the Michigan Tax Tribunal ruled in favor of Zenith, the Court of Appeals agreed, stating that both Michigan case law and Federal income tax law supported the conclusion that payments received by Zenith for the license of its computer software were royalties (*Zenith Data Systems and Heath Company, Inc.* v *Department of Treasury*, 218 Mich App 742 (1996)) . Reportedly, after the decision, the Department indicated that since payments received for software had been determined to be royalties (and therefore deductible), then payments made for software must also be royalties, meaning that the licensees who paid for the software would have to include those payments in their SBT base. This, in effect, shifted the tax burden from the software distributor or licensor to the licensee. It was suggested that the Act be amended to clarify what is, and what is not, considered a royalty regarding software.

CONTENT

The bill amended the Single Business Tax Act to provide that for tax years beginning after 1993, royalties paid by a licensee of application computer software, operating system software, or system software under a licensing agreement do not have to be included in the licensee's tax base. Further, for tax years beginning after 1997, royalties received by a licensor, distributor, developer, marketer, or copyright holder of application computer software or operating system software under a license agreement may not be deducted from the tax base; however, royalties received for system software may be deducted.

The bill defines "application computer software" as 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 nontechnical end user. The term also includes any other computer software that does not qualify as operating system software or system software. "Operating system software" means 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" means 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

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The Department of Treasury's response to the Court of Appeals decision in *Zenith Data Systems* would have had the unwanted effect of suddenly taxing companies for software purchases, and would have sent a negative signal to the business community. Since computer software expenditures are a constantly increasing part of business costs, denying a deduction for these vital purchases would discourage business expansion or location in Michigan. The bill addresses this situation by declaring royalties paid for software to be excluded from the tax base, while declaring royalties received by the licensor or distributor (except for system software) to be nondeductible.

Legislative Analyst: G. Towne

FISCAL IMPACT

The impact of this bill is very difficult to estimate due to the very limited availability of relevant data. Based on the information that is available, it is estimated that this bill probably will have little or no net fiscal impact because the provisions in the bill shift the tax burden on computer software royalties from businesses that purchase software to businesses that sell software.

Fiscal Analyst: J. Wortley

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