

## New Jersey Adopts Sales Tax Rules for Software and Related Services

December 15, 2014

### Overview

The New Jersey Division of Taxation (“Division”) recently released new regulations<sup>1</sup> that address the imposition of sales and use taxes on sales of software and software-related services. The new regulations, which are effective December 1, 2014 through October 28, 2015, address the following:

- Modification of the definitions of custom software and installation services
- Addition or clarification of the definitions of customer support service, modified software, servicing of software and certain software maintenance contracts

In this Tax Alert we summarize the new regulations, which in some instances codify or clarify the Division’s informal policies and practices. Accordingly, taxpayers may wish to revisit their historical New Jersey sales and use tax practices and discuss the new regulations with their vendors.

### Background

New Jersey law defines tangible personal property, which is generally subject to sales tax, to include prewritten software regardless of method of delivery.<sup>2</sup> Cloud computing, which in most instances is not taxable, is distinguished from the purchase of downloaded or otherwise electronically delivered software, which is taxable as a sale of tangible personal property unless the business use exemption applies.<sup>3</sup> Software as a Service (“SaaS”) is not considered to be tangible personal property and is thus not taxable.<sup>4</sup>

### Expanded Definition of Custom Software

The purchase of custom software is treated as the purchase of a nontaxable software design service.<sup>5</sup> Previously, custom software was defined to mean software created, written and designed exclusively for a specific customer. The new regulations expand the definition to include the modification of prewritten software to the specification of a customer.<sup>6</sup>

### Modified Definition of Software Installation Services

Previously, services that involved enabling or configuring new software were considered installation services subject to New Jersey sales and use tax. Under the new regulations, taxable installation services are now restricted to loading executable files containing a prewritten computer software application or program onto a device or equipment, and such services do not include the mere act of electronic delivery of software.<sup>7</sup>

### New Definition of Modifying Software

Charges for modifying prewritten software are not subject to New Jersey sales and use tax.<sup>8</sup> The new regulations define modifying software as any action, other than installing or servicing software, performed to enhance, improve or customize software regardless of whether the computer code is changed.<sup>9</sup>

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<sup>1</sup> N.J. Admin. Code 18 §§ 18:24-25.1A; 25.6; 25.7; 25.8 (Dec. 1, 2014).

<sup>2</sup> N.J. Rev. Stat. § 54:32B-2(g).

<sup>3</sup> New Jersey Division of Taxation Regulatory Services Branch Technical Bulletin TB – 72 (Jul. 3, 2013).

<sup>4</sup> *Id.*

<sup>5</sup> N.J. Admin. Code 18 § 18:24-25.3(b).

<sup>6</sup> N.J. Admin. Code 18 § 18:24-25.1A.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

## Added Definition of Servicing Software

The servicing of software is subject to New Jersey sales and use tax.<sup>10</sup> Under the new regulations, servicing of software means any action to maintain the compatibility of software with other hardware/software and other corrective services without changing the underlying software code.<sup>11</sup>

## Treatment of Non-taxable Items in a Bundled Software Maintenance Contract

Under the new regulations, a software maintenance contract is any contract that provides future upgrades and/or updates to computer software and/or customer support services.<sup>12</sup> A software maintenance contract that only provides upgrades and updates is treated as a sale of prewritten computer software and is subject to New Jersey sales and use tax regardless of whether the software is delivered on tangible storage media (i.e., disk or CD-ROM) or electronically.<sup>13</sup> Under the new regulations, customer support services are defined as verbal and written software advice or guidance.<sup>14</sup> The new regulations provide (as examples) that such services may be furnished over the Internet or telephone.<sup>15</sup>

Non-taxable components bundled with taxable components in a software maintenance contract are not subject to New Jersey sales and use tax if the seller of the contract can reasonably substantiate, based on books and records, the non-taxable components in the software maintenance contract.<sup>16</sup> Customer support services, including verbal and written software advice or guidance, are not subject to New Jersey sales and use tax.<sup>17</sup>

## Considerations

The Division worked closely with the business community in its consideration of these new sales and use tax regulations. Since the majority of these new regulations clarify existing policies, taxpayers may wish to review their historical and current software and software-related transactions and respective contractual arrangements to determine the applicable sales and use tax treatment.

## Contacts

If you have questions regarding the New Jersey sales and use tax regulations applicable to software and related services or other New Jersey tax matters, please contact any of the following Deloitte Tax professionals.

Stephanie Csan  
Director  
Deloitte Tax LLP, Parsippany  
[scsan@deloitte.com](mailto:scsan@deloitte.com)  
(973) 602-6435

Jim Nason  
Partner  
Deloitte Tax LLP, Parsippany  
[jnason@deloitte.com](mailto:jnason@deloitte.com)  
(973) 602-6529

Rick Heller  
Director  
Deloitte Tax LLP, Parsippany  
[rickheller@deloitte.com](mailto:rickheller@deloitte.com)  
(973) 602-6529

Phil Lee  
Senior Manager  
Deloitte Tax LLP, New York  
[philee@deloitte.com](mailto:philee@deloitte.com)  
(516) 918-7809

Becca Thompson  
Senior Manager  
Deloitte Tax LLP, New York  
[becthompson@deloitte.com](mailto:becthompson@deloitte.com)  
(212) 436-3091

Dareck Stringfield  
Manager  
Deloitte Tax LLP, Stamford  
[dstringfield@deloitte.com](mailto:dstringfield@deloitte.com)  
(203) 708-4236

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<sup>10</sup> N.J. Admin. Code 18 § 18:24-25.6.

<sup>11</sup> N.J. Admin. Code 18 § 18:24-25.1A.

<sup>12</sup> *Id.*

<sup>13</sup> N.J. Admin. Code 18 § 18:24-25.7.

<sup>14</sup> N.J. Admin. Code 18 § 18:24-25.1A.

<sup>15</sup> *Id.*

<sup>16</sup> N.J. Admin. Code 18 § 18:24-25.7.

<sup>17</sup> N.J. Admin. Code 18 § 18:24-25.6.

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