

Ontario PST Software Audits

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Ontario PST on software and related services continues to be a frequently encountered audit issue, with significant assessments raised against IT service providers and their customers. The rules are complex and the Ontario ministry of revenue's evolving interpretation has generally seemed to narrow the few exemptions. However, most recently the minister released a new interpretation on the nature of custom software.

Custom software is defined as a software program designed and developed solely to meet the specific requirements of a particular person which is intended for their exclusive use. For several years ministry auditors considered that a purchaser who had not acquired ownership of the underlying software code did not have exclusive use and thus had not acquired a custom program.

However, in commercial practice a vendor develops the routine underpinnings of its programs by drawing on its library of codes and code licensed from third parties. Signing over the underlying intellectual property rights inherent in such strands of code would eviscerate the vendor's business, but not doing so has represented a hurdle to the Ontario PST exemption. Other provinces had similarly worded exemptions for custom software, but only Ontario took this commercially obstructive interpretation.

Whether as a result of representations made or because the ministry wished to enhance its audit simplicity and clarity, the new interpretation letter on custom software dated September 15, 2008 marks a shift in policy: " Provided the developer explicitly states (by way of contract or other legal documentation) that the program being developed for the customer will be for the exclusive use of that customer, then such a program may qualify as a 'custom computer program' despite intellectual property rights being retained by the developer".

This new interpretation suggests that if the program's transfer in final form is properly documented as being for the exclusive use of the purchaser, then the exemption criteria may be satisfied without the transfer of ownership of the program's building blocks represented by individual strands of code. This position raises the question of whether two separate programs that each contain substantial blocks of identical code, with only minor additional unique strands to distinguish them, should qualify as custom programs under the spirit and intent of the legislation. Arguably the requirement to document exclusive use, with its attendant legal implications, will temper any propensity to push the limits of this more lenient interpretation.

The protection afforded the ministry by the documentation requirement, combined with the need to achieve audit simplicity, suggests that the interpretive shift will benefit all interested parties. The change also bodes well for other areas of interpretive contention such as the non-taxable status of certain component services that form part of a larger software installation project, and the exemption for IT placement services. The latter are non-taxable "if the contract or arrangement between the placement agency and its client is for the supply of human resources and not for the provision of a taxable service," usually demonstrated by the fact that the IT consultant is not under the direction and control of the placement agency. This issue is raised with increasing frequency on audits, and taxpayers have experienced resistance from auditors in characterizing an arrangement as non-taxable IT placement services versus the outsourcing

of taxable IT functions. Arguably the former focuses on the secondment of qualified individuals to fill gaps within a customer's IT department, whereas the latter typically involves the service provider's assuming contractual responsibility for stipulated deliverables such as the development and/or implementation of software programs. The area is complex and the stakes are high, but it is hoped that the same productive spirit of reasoned compromise exhibited by the ministry in its resolution of the custom software issue will also be extended to other difficult interpretive issues as they arise.