STATE BOARD OF EQUALIZATION
(916) 445-6493

January 24, 1990

Mr. W--- L. G---, C.P.A.
---, ---, --- & Co.
XXX --- ---, Suite XXX
--- ---, CA XXXXX

Computer data base service – delivery of software

Dear Mr. G---s:

In your November 1, 1989 letter to the Board's legal staff, you write:

"An opinion is requested regarding an exemption from sales tax as follows:

"1. Client is engaged in the business of providing to customers a computer database service.

"2. Client contracts with a vendor who owns a computer main frame to store various computer databases owned by client.

"3. Client delivers to potential customers software that enables customer to connect with client database.

"4. Customer pays client for time usage, access fees and database utilized. Customer can download computer files from client database to customers computer.

An opinion is requested regarding:

"1. Is delivery of software to customers without charge a sales tax transaction?

"2. Are customer charges subject to sales tax?"

Opinion

Under the Sales and Use Tax Law, all retail sales of tangible personal property for a consideration are subject to tax, unless exempted or excluded by statute. (Rev. & Tax. Code §§ 6006, 6007, 6051). A lease of tangible property, including a license, is subject to tax if it is a continuing sale and purchase of the tangible property. (Reg. 1660(b)). Certain types of leases are excluded from the definition of a sale, including leases of tangible property which was acquired by the lessor in a transaction in which the lessor paid tax or tax reimbursement to the seller and then leased the tangible property in the same form as he acquired it. (Reg. 1660(c)(2)).

If a transaction is subject to tax, the tax applies to the gross receipts or sales price of the property, including services which are a part of the sale of the tangible property. (Rev. & Tax. Code §§ 6011(b)(1) and 6012(b)(1)). However, transactions which are for services only are not subject to tax. In order to determine whether a transaction is a sale or a service, the Board employs the true object of the contract test set out in Regulation 1501. In summary, that regulation provides that if the true object of the contract was for services only, then no tax applies to the charges, even though some tangible property was transferred incidental to the performance of the service. However, if the true object of the contract was to obtain the tangible property, then tax applies to the charges, including the charges for services performed as part of the contract.

Your letter does not indicate whether your client purchased or licensed prewritten software from sellers (including licensors), or developed the software on its own. Your letter also does not indicate whether your client transfers title to the software to its customers, or only licenses (or sublicenses) the customers to use the software in connection with your client's database service. We assume your client delivered the software in tangible form, such as on a disk.

If you client acquired prewritten software from a seller, in a transaction in which your client paid tax or tax reimbursement to the seller, and then licensed the software to its customers in the same form as acquired, (i.e., on the same disks), no tax would apply to your client's license of the software to its customers. (Reg. 1660(c)(2)). If your client purchased prewritten software from its vendors, and then transferred title to the software to its customers, we regard this as a sale of the software, notwithstanding that at the time your client delivered the software to its customers, there was no charge to the customer. In our view, your client did not make a gift of the software to its customers; rather, it transferred title in exchange for consideration in the form of the fees which the customers will pay to your client when they use the software to access your client's databases.

If your client purchased the software without paying tax or tax reimbursement to the seller and then licensed it to its customers, we believe the same result applies, except that the applicable tax is the sue tax, measured by the rental receipts from your client to its customers. (Reg. 1660(c)(1)). Again, we view the rental receipts as being included in the charges made by your client to its customers for the database access service. If your client developed the software itself, or copied the software onto its own blank disks, then it did not lease the property in the same form as acquired, and your client would have no option but to report and pay tax measured by the rental receipts for the software.

With respect to your client's charges for database access services, our opinion is that these are charges for services, rather than for the sale of tangible property, and no tax applies to these charges. However, if the sale or license of the software is subject to tax as described above, then your client must maintain records which will substantiate a fair and reasonable allocation of the charges which are subject to tax and the charges which are not subject to tax. If your client does not maintain sufficient records to substantiate a fair and reasonable allocation, then the Board may consider that all of the charges for your client's database service are subject to tax, since the access charges could be considered as services which are part of the sale or lease of the software.

I enclose Regulations 1501, 1502, and 1660 for your information. Please feel free to contact me if you have any further questions or comments about this letter.

Sincerely,

John Abbott
Senior Tax Counsel

JA:jb
Enclosures