STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 445-5550
FAX: (916) 323-3387

September 23, 1999

Mr. D--- R---
H--- E--- W--- & M---
XXX --- Street
--- ---, California XXXXX-XXXX

Re: I--- O---
SR -- XX-XXXXXX

Dear Mr. R---:

This is in response to your letter dated July 22, 1999 regarding the application of sales tax to sales by your client, --- O--- ("Taxpayer").

Taxpayer provides dental offices with office management systems, including proprietary software. Although not required in order to obtain the software, Taxpayer also often provides its customers computers with related accessories such as printers ("hardware"). When Taxpayer sells hardware to a customer, it purchases the hardware under a resale certificate and collects sales tax reimbursement on the sale price of the hardware. Taxpayer's customers obtain a nonexclusive license to the software purchased from Taxpayer, and pay a single license payment at inception. Taxpayer collects sales tax reimbursement on this charge too. Customers may obtain optional support services for a separately stated charge. Taxpayer does not charge sales tax reimbursement on charges for such optional support services.

For competitive reasons, Taxpayer is considering changing its price structure, other than for sales of hardware. Taxpayer plans to charge $395 per month, which would include $220 per month for the software license. You state that as part of this portion of the charge, the customer would be "eligible for free software upgrades and patches." In fact, Taxpayer provides the upgrades and patches on tangible storage media, and charges $25, adding sales tax reimbursement to the charge. The remaining $175 of the monthly charge would be for a "service

contract" consisting of technical support for the software and hardware maintenance. A customer who has more than one computer would pay an additional $30 per month per computer for the software license, and an additional $20 per month per computer for the service contract. You state that the service contract is optional. You have not indicated, however, whether the customer can obtain either of the two components of the service contract (i.e., the technical support for the software and the hardware maintenance) by itself.

You explain that Taxpayer will physically install the hardware and initial software at the customer's office, without leaving any software disks with the customer. It will also install a "dongle" on the customer's computer. This is a security key for the software, and the software will not function properly unless the dongle is physically attached to the computer. You state that the contract between Taxpayer and its customers will be on a month-to-month basis, and that the customer may cancel it at any time. If the contract is cancelled, the customer must return the dongle. If the customer pays the total $395 monthly charge for the license and for the service contract for 24 consecutive months, Taxpayer will upgrade the central processing unit of the customer's computer to the industry standard at no additional charge. Taxpayer will budget $1200 for the cost of this upgrade. I assume that the contract explicitly provides that, at the end of the 24-month period, the customer will have the right under the contract to the computer upgrade at no additional charge. You do not state what occurs if the customer has more than one computer under the plan and pays the additional charge for 24 consecutive months for the additional computer(s). For purposes of this opinion, I assume that *only one* computer is covered by the upgrade policy.

You state that after the 24 consecutive months of paying both the license fee and the service contract fee, Taxpayer "considers the customer to have purchased the software and charges them only for the Service Contract." You do not state, however, whether this is an explicit provision in the contract. I assume that the contract explicitly provides that at the end of the 24-month period, the customer then "owns" the software with all upgrades and patches provided up to that time. As part of this provision, I assume that the contract explicitly provides that at the end of the 24-month period, the customer owns the dongle which is required for use of the software, without any additional charge.

Since the customer owns the software and dongle after the first 24 months of consecutive payments, the customer would no longer make monthly payments for a license fee, meaning that the customer's monthly payments would be $175 for the service contract (for one computer). If the customer continues making these payments for an additional 24 consecutive months, Taxpayer will again upgrade the central processing unit of the customer's computer to industry standard at no additional charge, again budgeting $1200 for this cost. Again, I assume this is explicit in the contract.

You ask for our agreement with four statements regarding the application of tax. Each is quoted below followed by our response.

> "1. If [Taxpayer] sells a computer to a customer along with the License, then [Taxpayer] must pay California sales tax (or collect and pay over California use tax) on each monthly fee for the License that a customer pays during the first 24-month period, which tax is payable only as each monthly payment is made. If [Taxpayer] does not sell a computer to a customer along with the License, then [Taxpayer] has no obligation to pay California sales tax or collect California use tax on each monthly fee for the License."

As you know, a sale of software is not regarded as a sale of tangible personal property when the "load and leave" method of installation is used. This method involves the seller's installation of the software on the customer's computer, e.g., using the seller's CD ROMS or floppy discs, without allowing the customer to obtain any possession of those storage media (e.g., the seller maintains control of the customer's computer during the installation process), and then the seller provides no storage media to the customer whatsoever. The first part of your statement quoted above indicates your recognition that the load and leave analysis is irrelevant when the seller of the software is also selling the computer on which the software is loaded. Such a transaction is simply the sale of the computer with software. Provided the customer may truly cease paying the monthly fee for the software without any penalty and has no obligation to make any future payments, we agree that the monthly license fee is taxable on a monthly basis.[1]

The second sentence of your statement quoted above indicates your belief that the transaction in question is a load and leave installation. We cannot agree that this transaction is a load and leave installation that does not involve the transfer of tangible personal property. The software is designed to be effectively nonfunctional without the installation of the dongle. The dongle is a physical piece of tangible personal property. Taxpayer chose to design its software to require a physical piece of tangible personal property to function properly. Thus, because of this design, when the customer purchases the software, the customer must also obtain an important piece of tangible personal property that the customer will use to make the software functional. That Taxpayer could have obtained some lesser level of security without using a

---

[1] You argue the basis for this conclusion is that tax on leases is based on the monthly payment. If no dongle were provided (see discussion below), we would not agree that this is the basis for our conclusion. If no dongle were involved, the tax would apply here to the sale of the computer with the software loaded. This would not be treated as a lease of the software, but rather as an outright sale of the computer. The basis for not imposing tax up front on the future monthly charges would be that, since the customer may cancel at any time, only the itemized charge for the hardware and the first month's license fee (presumably paid as part of the initial contract payment) is certain. Beyond that, it would not be certain that the customer would owe any further amounts. This is similar to the payment of royalties which are based on a future event. Once that future event is certain and the amount is certain to be due, the tax is due on those amounts at that time. (See, e.g., BTLG Annot. 295.0570 (1/4/79).) These amounts would be the additional taxable sales price from the sale of computer with the loaded software.

dongle is irrelevant because it chose not to do so and instead required the purchase of the dongle in order for the software to function. (Cf. *Simplicity Pattern Company* v. *State Board of Equalization* (1980) 27 Cal.3d 900, 915.) Accordingly, the monthly charges for the software license that involves the transfer of the dongle is taxable without regard to the manner of transfer of the software.

> "2. [Taxpayer] has no obligation to pay any California sales tax upon the monthly fees for its Service Contract.
>
> "3. [Taxpayer] is the consumer of the computer components for Upgrade 1. [Taxpayer] must pay California sales tax reimbursement or use tax on the computer components for Upgrade 1 when it buys them from a third party.
>
> "4. [Taxpayer] is the consumer of the computer components for Upgrade 2. [Taxpayer] must pay California sales tax reimbursement or use tax on the computer components for Upgrade 2 when it buys them from a third party."

Prior to responding to these statements, I must explicitly caution you as to the extent of the opinion we render. You have not provided us an example of the actual contract. There also may be relevant information regarding marketing or other information relevant to our opinion. If we were to review the actual contract and had all information relevant to this transaction, we might disagree with your characterization that the service contract is optional and is not required as a condition to purchase either the hardware, or software, or both. If we concluded that the service contract was not optional, the opinion provided below would be inapplicable. I note further that this opinion is also based specifically on the dollar figures you have provided. As you understand, the relationship between the total of the monthly fees paid over the period of the contract compared to the value of the computer components provided to the customer at the end of that period is relevant to understanding the transaction. If the figures do not remain substantially the same (at least relative to each other) or if more than one computer per customer can be covered by this policy, then our opinion might be different. With these provisos in mind, we agree with your conclusions. Tax does not apply to Taxpayer's charges for the optional service contract. Taxpayer is the consumer of any property it provides as part of that service contract, including, for example, any repair parts it provides to maintain the hardware as well as the components for the upgrades.

I note that, although you have not provided us a copy of the contract, our opinion is necessarily dependent upon the actual provisions of that contract. Please be aware that upon our review of the actual contract, we might reach different conclusions than as set forth above based on a different, or simply better, understanding of the true facts. If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Supervising Tax Counsel

DHL/cmm

cc: --- --- District Administrator (--)