

**STATE BOARD OF EQUALIZATION**

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November 13, 1991

Mr. J--- A. T---, CPA
I--- M--- S---, Inc.
XXX K--- Street, Suite XXX
--- ---, CA XXXXX

SR – XX-XXXXXX

Dear Mr. T---:

This is reply to your August 20, 1991 letter regarding the application of sales and use tax to your charges for software programs.

You explained that the main business of I--- M--- S---, Inc. (I---), is the development, design, and production of custom computer software programs. Your letter goes on to state:

“I---’s main activity is the creation of custom software programs which are written to the special order of the customer. Each computer program is unique to each customer and, thus, can not suit the specific needs of other customers. The process begins by taking the customer’s marketing, advertising, training, or educational concepts and developing alternative methods of program design. The design phase requires research and creativity on the art of I---. Once the program design has been finalized with the customer, I--- writes and produces the customized program. On some customer contracts, I--- will utilize a purchased software program as a tool to help produce the finished custom program.”

You did not describe the program which I--- transfers to its customer or the use I--- makes of the purchased software.

Charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as services that are part of the sale of the prewritten program. (Sales and Use Tax Reg. 1502, Computers, Programs, and data Processing, subd. (f) (2).)

If I--- modifies prewritten programs to become the program which is transferred to the client, the transferred program is a custom program if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not marketed, the new program is a custom program if the charge for the custom modification was more than 50 percent of the contract price to the client. We will assume that the program transferred to the client is a custom program.

You note that I---'s interpretation of Sales and Use Tax Regulation 1502 is that the sale of the custom software is exempt from tax subject to any use of a prewritten program. We agree that I---'s transfer of a custom computer program is not subject to tax. The sale is not exempt from tax. Rather, the transfer is not a "sale" or "purchase" for purposes of the Sales and Use Tax Law. (Rev. & Tax. Code § 6010.9.) The sales tax consequence is that I--- is the consumer of, and tax applies to the sale to I--- of, the tangible personal property which I--- consumes in developing the program and the tangible personal property which I--- transfers in the form of a custom program. For example, when I--- uses a purchased software program as a manufacturing aid to produce the finished custom program, tax applies to the sale to I--- of the software program. Tax also applies to the sale to I--- of the software which it transfers to its client.

Given the nature of I--- programs, it appears that you would provide additional copies to the client. If you provide additional copies, tax applies to your sale of the additional copies. They are not custom computer programs.

We agree with your conclusion that your charge to a client for a manual to facilitate the use of a custom program is nontaxable. You are the consumer of such manuals.

You note that I--- designs and creates packaging for the storage media used to transfer the custom computer program to the customer. The process involves I---'s preparation of artwork, drawings, illustrations, and other graphic material. The packing generally includes disk labels, disk sleeves, and disk packaging. We agree with your interpretation that I---'s charge to the customer for such packaging is subject to tax. (See Reg. 1502, subd. (d) (5) (F).)

You note that I--- usually duplicates the customer computer program, the packaging, and the documentation and manuals that accompany the program. The customer generally needs duplicate copies for distribution as advertising, sales force training, and other purposes. We agree with your conclusion that I---'s charge for the duplicate programs, packaging, and manuals is subject to tax.

You note that I--- will provide training services to the customer to teach the customer's employees how to use the customer computer program. We agree that tax does not apply to your charge for training the employees how to use the custom program. Tax applies to separately stated charges for training materials supplied to the trainees.

You note that I--- also provides feasibility studies to determine what marketing, training, or other benefits customers may derive from using I---'s products. If the feasibility studies are

performed as part of the sale of tangible personal property, the charge for the studies is subject to tax. On the other hand, if I--- separately contracts to provide a feasibility study for a customer and contracts to sell tangible personal property, the charge for the study is not subject to tax.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

Ronald L. Dick
Senior Tax Counsel

RLD:sr

bc: --- --- District Administrator