

Memorandum

120.0009

To : Mr. Steve Adams
Supervising Tax Auditor, Petitions Section

Date: July 15, 1996

From : David H. Levine
Supervising Tax Counsel

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Subject: C--- C--- A---, Inc.
Account No. SR -- XX-XXXXXX-010

This is in response to your memorandum dated June 5, 1996 regarding the Decision and Recommendation in the above matter involving a mixed contract for the providing of hardware maintenance and software maintenance. The hardware maintenance was not sold as a condition of purchasing the hardware. Thus, the charge for the hardware maintenance would not be taxable unless it is regarded as part of the sale of the taxable software maintenance contract. You are holding the reaudit in abeyance until we review this matter.

A contract for optional hardware maintenance is not a contract for the sale of tangible personal property, and no sales or use tax applies to the charge. (See Regs. 1546, 1655.) On the other hand, a contract for software maintenance under which the customer will receive updates or error corrections on tangible media is a contract for the sale of tangible personal property. Furthermore, if a software maintenance contract includes a mandatory charge for consultation, that charge is included in the measure of tax from the sale of the software maintenance contract. (Reg. 1502(f)(1)(C).)

When a bundled contract includes a software maintenance portion and a hardware maintenance portion, the question arises whether the entire charge for the contract is taxable as from the sale of taxable software maintenance, or if instead the contract should be prorated into taxable and nontaxable portions. Proposed annotation 120.0450 concluded that the entire contract is taxable, while the D&R concluded that a proration is appropriate. Regulations 1546 and 1655 cover hardware maintenance, and Regulation 1502 covers software maintenance. Upon further review, we believe that harmonizing these provisions require prorating between the taxable software maintenance portion of the contract and the nontaxable optional hardware maintenance portion of the contract. Thus, we conclude that the D&R is correct on this point;

proposed annotation 120.0450 will be deleted. (This conclusion applies only to this scenario. When a software maintenance contract is bundled with consultation, the explicit provisions of Regulation 1502 apply.)

If the hardware maintenance portion of the contracts considered by the D&R were taxable, then petitioner would be regarded as having purchased for resale the parts provided to customers to fulfill its obligations under those contracts. However, in light of its conclusion that the charges for the hardware maintenance portion of the contracts were not taxable, the D&R correctly concluded that petitioner was the consumer of any parts it purchased to fulfill its obligations under the contracts.

There were three basic scenarios considered when the parts were purchased from and installed by an out-of-state contractor: the contractor sent the repaired items directly to petitioner's customers outside California; the contractor sent the repaired items directly to petitioner's customers in California; and the contractor sent the repaired items to petitioner, who then sent them to its customers. The D&R concluded that petitioner did not owe tax with respect to the first scenario, but did owe use tax with respect to the second and third scenarios.

Since petitioner was the consumer of these parts, it owes use tax if that consumption occurred in California. In the first scenario, the property never enters California. As such, petitioner could not be regarded as consuming the property in California, and the D&R correctly concludes that petitioner does not owe use tax with respect to such property. The question of where petitioner's consumption occurs, however, is squarely presented in scenarios two and three.

We have consistently regarded a person who transfers property in a transaction other than a sale as consuming the property no later than when he or she transfers title to the property to the recipient. The same analysis applies whether the transfer is parts pursuant to an optional maintenance contract (which is treated for sales and use tax purposes the same as a contract for the providing of insurance services), or the transfer is a gift, or the transfer is property incidental to the providing of a service, or the transfer is marketing aids where the transferor sells the marketing aids for less than 50 percent of cost (see Reg. 1670). When such a transferor places the property in the mail in one state for shipment to a recipient in another state, the transferor's use must occur either in the state where the recipient receives the property, or in the state where the transferor completes its duties with respect to physical delivery of the property, that is, where he or she deposits the property in the mail. For over 45 years, we have regarded the use as occurring in the state where the transferor delivers the property to a common carrier for shipment to the recipient, and not in the state of receipt by that recipient. (See, e.g., BTLG Annots. 280.0360 (7/18/50), 280.0080 (11/22/55), 280.0640 (3/15/60), 280.0940 (4/15/65), 280.1140 (3/21/67), 280.0390 (1/8/92).)

When the contractor outside California shipped the property directly to petitioner's customers, the contractor made a retail sale of property to petitioner. That sale occurred when

the contractor delivered the property to a common carrier for shipment to California per petitioner's instructions. Petitioner thereafter transferred title to that property to its customer. Under these facts, it did so at the same time it gained title, that is, when the contractor delivered the property to the common carrier for shipment to California. Since petitioner never owned the property in California, it cannot be regarded as using the property in this state and thus does not owe use tax. Although the customer does use the property in this state, it did not purchase the property and thus also does not owe use tax.

When the property was shipped to petitioner and petitioner then sent the property to its customers, petitioner used the property no later than when it transferred title to its customers, that is, when it delivered the property to a common carrier for shipment to its customers. This is true regardless of whether the customer is inside or outside California. Thus, petitioner owes use tax on its purchase price of any property sent to it which it thereafter shipped to its customers to fulfill its maintenance contract obligations, whether the customers were inside or outside California.

In summary, we agree that the contract should be prorated between the taxable software maintenance portion and the nontaxable hardware maintenance portion. We also agree that the contractor's sales of parts to petitioner were retail sales, and that petitioner owes use tax with respect to the property it used in California which it purchased from an out-of-state contractor. Thus, it owes use tax on its purchase price of all such property which the contractor delivered to petitioner and petitioner thereafter delivered to its customers, whether those customers were inside or outside California. However, when the parts sold to petitioner were sent from outside California directly to petitioner's customers (whether inside or outside California) to fulfill petitioner's obligations under optional maintenance contracts, petitioner is regarded as having used the property at the out-of-state point of shipment, and California use tax does not apply. I therefore recommend that the reaudit delete any such amounts from the measure of tax.

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