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June 29, 1994

B--- L. J---  
P.O. Box XXX  
---, TX XXXXX

**Re: Taxability of software products**

Dear Mr. J---:

This is in response to your letter dated April 27, 1994. You ask how tax applies to four scenarios with respect to a company with which you are associated that sells software products and data processing services to pharmacy industry customers.

Your first scenario is as follows:

"The company licenses pharmacy software to corporations with multiple locations throughout the United States. When a customer adds a location the customer is charged sales tax applicable to the new location and the tax is remitted to the appropriate taxing authority. Customers usually request the software be shipped to their headquarters location instead of the final destination. Most of the customers have a wide area network that connect each location to a system at their headquarters. In addition to licensing the software the company also enters into a software maintenance contract which is separate and apart from the sale of the software. This contract most often calls for a price per store per month for the maintenance. The maintenance contract provides the customer telephone support as well as upgrades and enhancements to the software. The[re] is no breakdown of the maintenance price as to what portion is for telephone support and what portion is for upgrades. The telephone support is only provided to the customer's headquarters location, not each individual store. When providing the customer with upgrades and enhancements, one tape containing the necessary changes is sent to the customer's headquarters location where the customer distributes the update to its various locations via modem, satellite, or by reproducing the tape themselves. The customer will be required to install the update within a specified period of time in order to continue to receive telephone support...."

Discussion

Sales of software maintenance agreements in California, to California consumers, are discussed in Regulation 1502(f)(1)(C) which explains that if a software maintenance contract must be purchased in order to purchase the prewritten software program, then all charges for the maintenance contract are taxable, including charges for consultation. If the software maintenance contract is optional, but in order to purchase it the customer must also purchase consultation services, then again all charges for the maintenance contract are taxable, including charges for consultation. If, however, the maintenance contract is optional, and if the maintenance contract may be purchased without also purchasing consultation services, then separately stated charges for the optional consultation services are not taxable, but the charges for the maintenance contract remain taxable. Under any scenario, the charges for the maintenance contract (updates and error corrections provided on storage media) are always taxable. That is, the maintenance contract to provide such updates is regarded as a contract for the sale of tangible personal property. As a sale of tangible personal property, the charge is taxable whether or not optional. You indicate that charges for consultation are not stated separately. Therefore, all charges for the maintenance contract are taxable.

The next question is whether there is a taxable event with respect to California. Sales tax is imposed on all retailers measured by their gross receipts from retail sales of tangible personal property in this state. (Rev. & Tax. Code § 6051.) When the sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for use, storage, or other consumption in California. (Rev. & Tax. Code §§ 6201, 6204.) "Use" includes the exercise of any right or power over the property incident to the ownership of that property. (Rev. & Tax. Code § 6009.)

In your first scenario, if the storage media with updates is shipped to the company in California and used in any way in California, which includes making copies to send to other locations or transmitting the program contained thereon via telecommunications, the entire charge is taxable. For example, the storage media is sent to California to a customer with 10 locations in California and 10 outside California. The customer is billed \$10,000 per location for a total of \$200,000. The customer receives the storage media in California and makes copies of it for all its locations. The entire \$200,000 is taxable because it is entirely from the sale of tangible personal property purchased for use in California.

Another scenario is when the storage media with updates is shipped to the company out of state and the out-of-state company sends a copy or transmits the information via telecommunications to its California locations. In this scenario the use of the property occurs out of state. The California locations receive only copies of the updates or electronic transmission of the program contained on the storage media sold to the customer. That is, the original storage media sent to the customer outside California never enters this state. As discussed above, the use occurs when the company makes copies of the storage media tapes or transfers the information on the storage media via telecommunications, which in this scenario is out of state. Since there

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is no use in this state, no California use tax applies.

You ask how tax applies if another jurisdiction assesses tax based on the final destination of the storage media. California has a credit provision which allows a credit against California use tax for tax imposed by another jurisdiction with respect to the same property. The credit is not available if the property is first used in California and the incidence of the other state's tax arises after that of the California tax. (Rev. & Tax. Code § 6406.) Since the California use (in the first scenario) is the first use, this credit provision would not be available.

Your second scenario states:

"The company also provides a database of drug information to [its] customers. The facts with regard to customers with multiple locations in many states are the same here as above. This service involves the company extracting from their comprehensive database a limited database for a customer based on a list of requirements provided by the customer. This database is structured in the same format for all customers, only the data differs. Each month the customer receives an update for drugs contained in their database. This update is transmitted electronically via modem and is only transmitted to the customer's headquarters location. The update would then be forwarded by the customer's headquarters personnel to the multiple locations via satellite or modem. The customer is billed monthly at a set fee per store for this service...."

Tax applies to sales of updates which are in the form of tangible personal property, i.e., tape, disk, or other tangible storage media, which are purchased for use in this state. Tax does not apply if (as is the case in your description of the transaction) the information is transferred by remote telecommunications and the purchaser does not obtain any tangible personal property, such as storage media. (cf. Reg. 1502(f)(1)(D).)

Your third scenario is as follows:

"Another service which the company is planning to provide involves customers having on-line access to a database the company maintains at the compan[y's] headquarters. This service enables a customer to electronically access the compan[y's] database of patient profiles and check for any drugs that the patient is currently taking so drug-interaction information can be given to the patient with the prescription. This service is billed to the customer on a per transaction basis...."

As discussed herein, tax does not apply to this transaction since the information is transferred by remote telecommunications and the purchaser does not obtain any tangible personal property, such as storage media.

Your fourth and last scenario states:

"The last group of services deal with the processing of third party claims (insurance, Medicare, Medicaid, etc.) for pharmacies. The company provides the services of submitting and reconciling third party claims. Almost all of the claims are transmitted to the company via modem or lease line. Some claims may have to be submitted to the company on paper. After claims are received from the customers, the company submits the claim to the third party by electronic tape, modem, or paper. Some customers only subscribe to submission services and some customers subscribe to both submission and reconciliation services. Customers that subscribe to reconciliation services in addition to the submission services send the company the remittance advice they receive with payments from third parties. The company then reconciles the claims from the remittance advice. The customer receives several paper reports in regards to the submissions and reconciliations and claim status information is also passed back to the customer's headquarters system electronically via modem or lease line. The customer's headquarters personnel would then transmit the applicable date to each locations. These services are billed on a per transaction basis...."

Remittance and reconciliation of billing by the company for its customer is regarded as a service and not a sale of tangible personal property. The company is the consumer of any materials it uses in California when providing such service. The use of any extax tangible personal property the company consumes in California while in the process of providing that service would be subject to tax. (Reg. 1501.) If the reports are sent from the company's out-of-state location by common carrier directly to the California customer, the company is consuming such property out of state and no California tax applies. If the company ships the reports from its California location to its customer, whether the customer is inside California or outside this state, it is regarded as consuming the property in this state, and would owe use tax on such California consumption.

Enclosed is a copy of Regulation 1502 to provide you further guidance on software issues. If we can be of further assistance please do not hesitate to write again.

Very truly yours,

Rachel M. Aragon  
Staff Counsel

RMA:es

Enc.: Reg. 1502

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cc: OH - District Administrator