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 450 N STREET, SACRAMENTO, CALIFORNIA  
 (P. O. BOX 942879, SACRAMENTO, CA 94279-0082)  
 TELEPHONE: (916) 322-2976  
 FAX: (916) 323-3387

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November 3, 1995

Ms. D--- C---  
 A--- M--- I--- Services, Inc.  
 XXX --- Avenue  
 ---, -- XXXXX-XXXX

**Re: A--- M--- I--- Services, Inc.**  
**SC - XX-XXXXXX**

Dear Ms. C---:

This is in response to your letter dated July 31, 1995 regarding the application of tax to your sales of computer software products and related services. You state:

“A--- M--- I--- Services, Inc. is headquartered in ---, ---. The company provides data processing and consulting services to banks, mortgage companies and credit unions in the origination, secondary marketing and servicing of single family mortgage loans. The company also sells software licenses to clients who prefer to do their own processing. The company licenses two major products. One is known as the MSP package (mortgage service processing); the other is known as the RLIC package (residential loan inventory control). The MSP package covers all areas of loan servicing including customer service, escrow management, payment processing, default management, investor reporting, and management reporting. The RLIC package is used to help the clients monitor their unsold loans. The company internally developed both of these packages. The packages are modified to fit each client’s needs. The process of converting to our software varies from several months to several years.

“The company has clients located in California who have purchased our modified software. The client has the choice of receiving the programs on tapes or to have them transferred by remote telecommunications. Hard copy instruction manuals are included in the price of the software and are shipped to the client.

“Clients also have the option of receiving updates of the software and telephone support under a separate enhancements and systems support agreement. A copy of the agreement is enclosed. Please note that this agreement shows our name as C--- P---, Inc.; this was our trade name. Earlier in 1995 we changed our legal name from CPI A---, Inc. to A--- M--- I--- Services, Inc. These updates are

necessary to keep the software up to date with the latest industry changes, program corrections, program modifications and client request changes. The clients are sent a tape with the changes each month. This tape contains a program activity report that lists the modules that are being changed that particular month. The client also receives a memorandum (on paper) which highlights some of the changes for the month. For most of our clients these fees are combined (referred to as bundled billing) into one amount and billed monthly. Some of our old contracts allow the separate billing of enhancements and telephone support; all of our clients will eventually be under the bundled billing method (when their enhancements and systems support agreements are up for renewal). The enhancements/telephone support billing is a totally separate fee from the license fee. The enhancements/telephone support billing is calculated based on the number of loans the client processes. The company is looking into transferring these monthly updates and memorandums by remote telecommunications to its clients.”

## **DISCUSSION**

Retail sales of tangible personal property in California are subject to sales tax, measured by gross receipts, unless specifically exempt by statute. (Rev. & Tax. Code § 6051.) When sales tax does not apply, such as when sales take place outside of California, the use tax, measured by the sales price of the property sold, applies to the use of property purchased from a retailer for storage, use, or other consumption in California. (Rev. & Tax. Code §§ 6201, 6401; Reg. 1620.)

It is not clear whether your sales take place inside or outside of California. For your retail sales occurring inside California, the applicable tax is generally sales tax (see Reg. 1620(a)(2)), for which you may collect reimbursement from your customers if your contracts of sale provide for such reimbursement (Civil Code § 1656.1). For your sales taking place outside of California in which tangible personal property is purchased for use in California, the purchasers owe the use tax, but you are required to collect the applicable use tax from all of your California purchasers and to pay that tax to this state. (Rev. & Tax. Code §§ 6202, 6203.)

The measure of the sales or use tax includes charges for any services that are part of the sale of tangible personal property. (Rev. & Tax. Code §§ 6011, 6012.) If services are not part of the sale of tangible personal property, then neither the sales tax nor the use tax applies to charges for the services if they do not themselves constitute sales of tangible personal property. (Reg. 1501; see Rev. & Tax. Code §§ 6006(b), 6010(b).)

Regulation 1502, a copy of which is enclosed, explains the application of tax to sales involving computers, programs, and data processing. We assume that the MSP and RLIC programs you transfer to your customers are prewritten (canned) programs. The sale of a prewritten computer program furnished on storage media constitutes a sale of tangible personal

property. (Reg. 1502(f)(1).) The measure of tax includes all amounts charged by the vendor for the sale of the software, including all license and other end user fees. (Reg. 1502(f)(1)(B).)

The sale of a software maintenance contract (updates and error corrections provided on storage media, such as tapes) is also a sale of tangible personal property, and it is therefore subject to tax. (Reg. 1502(f)(1)(C).) You state that clients “have the option of receiving updates of the software and telephone support under a separate enhancements and systems support agreement.” Charges for services such as telephone support are taxable as part of the sale of the maintenance agreement unless the services are optional and the customer may contract for the services for a separately stated price. (Reg. 1502(f)(1)(C).) The services are optional only if the customer may purchase the maintenance agreement without also purchasing the service. Based on the facts you have provided, our understanding is that when your customers purchase maintenance agreements from you, they do not have the option of purchasing the tangible personal property (i.e., updates and error corrections on storage media) without also purchasing support services; therefore, it appears that your charges for support services are taxable as part of the sale of that tangible personal property.

You state that in some cases, you transfer software to your customers by remote telecommunications. Tax does not apply where your only transfers to your customer are by remote telecommunications from your computer to your customer’s computer and your customer does not obtain possession of any tangible personal property in the transaction. (See Reg. 1502(f)(1)(D).) If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

If you have further questions, please feel free to write again.

Sincerely,

Kelly W. Ching  
Staff Counsel

KWC:cl