**STATE BOARD OF EQUALIZATION**
(916) 445-5550

April 26, 1991

Mr. R--- S. B---
---, ---, --- & ---
Attorneys at Law
P. O. Box XXXX
---, Florida XXXXX

Re: C--- - J---, Inc.
SS -- XX-XXXXXX

Dear Mr. B---:

This is in response to your letter dated March 4, 1991 which we received on March 19, 1991. Your client, C--- - J---, Inc. (CJ), sells computer software to users in California. You ask how sales or use tax applies to this business.

Facts

CJ transfers the software to the customer on tangible media pursuant to a basic software license agreement. The license fee includes all charges for installation of this software, installation support services, training classes, and a negotiated warranty period which varies between three and twelve months. Out-of-pocket costs and expenses incurred by CJ when providing pre-installation support services, installation support services, or warranty work are separately billed to the purchaser, and would include transportation expenses, motel accommodations, meals, long-distance telephone charges, and mailing expenses.

By installation support services, you mean training the purchaser's employees and all other services necessary to make the software fully operational. The training included in the license fee includes tuition credits for training classes held by CJ in Florida. The warranty included in the license fee includes all standard updates, and it guarantees that the software will operate as designed for three months. The license fee is payable in two installments, the first upon the purchaser's execution of the agreement and the second upon the sooner of installation of the software or an agreed period which varies between six and twelve months from the date of execution.

The extended software maintenance agreement provides that CJ will provide the standard updates, ongoing consultation support services, and maintenance services. This agreement is currently incorporated into the licensing agreement, but my understanding is that the purchaser is not obligated to purchase the extended software maintenance agreement when contracting for the

licensing of the software. CJ also has a separate contract solely for the extended software maintenance.

CJ occasionally contracts to modify software according to a purchaser's specific requirements. CJ also occasionally contracts to provide outside computer consulting services. The consulting contracts may involve the modification of the customer's existing software (whether or not that software was purchased from CJ), or a systems analysis of the customer's overall computer requirements.

Discussion

You have asked for our advice regarding the application of tax to the transactions discussed above. Each of your conclusions regarding tax application is quoted below followed by our response.

> "(a) The entire charge stated in the License Agreement and the License and Support Agreement for the granting of a license to use the Company's computer software is subject to sale tax, unless the charge for pre-installation support, installation, installation support, training, and warranty services are separately stated in such contracts."

Generally, sales tax applies to a retailer's retail sale of tangible personal property in California measured by the retailer's gross receipts from the sale. (Rev. & Tax. Code § 6051.) Generally, when sales tax does not apply, use tax applies to the sales price of tangible personal property purchased from a retailer for use in California. (Rev. & Tax. Code § 6201.) You have not provided sufficient facts to ascertain whether the applicable tax is sales tax or use tax. This is discussed in Regulation 1620, a copy of which is enclosed. In either event, for purposes of your inquiry, the measure of tax is the same. (See Rev. & Tax. Code §§ 6011, 6012.)

We agree that the charge for the license agreement is subject to tax. We also agree that a charge for installation is not subject to tax. (Rev. & Tax. Code §§ 6011(c)(3), 6012(c)(3).) Although there is no requirement to separately state such charges, we strongly recommend that CJ does so. A charge for testing a prewritten program on the purchaser's computer to ensure that the program operates as required is the only charge regarded as an installation charge. (Reg. 1502(f)(1)(E).) Charges for services which are required as part of the sale of tangible personal property are subject to tax unless specifically excluded from the measure of tax by statute. Except for testing which constitutes installation, all the other services you list appear to be services part of the sale the charges for which are subject to tax regardless of whether they are separately stated or not. (Rev. & Tax. Code §§ 6011(a)(2), 6012(a)(2), Reg. 1502(f)(1)(B).)

> "(b) If the charges for pre-installation support, installation, installation support, training, and warranty services are separately stated in the License Agreement and the License and Support Agreement, such charges are exempt from sales tax."

As discussed above, charges for testing which constitute installation are excluded from the measure of tax. All other services that the purchaser is required to purchase in order to purchase the tangible personal property are services part of the sale the charges for which are subject to tax regardless of whether they are separately stated.

> "(c) The entire charge stated in the Maintenance Agreement and the License and Support Agreement for maintenance of the Company's computer software and consulting services are exempt from sales tax."

You cite subdivision (f)(1)(C) of Regulation 1502 for the proposition that if a software maintenance contract is optional for a separately stated price, the charges for the maintenance and consulting are not subject to sales tax. You have misread this provision. As explained in that provision, maintenance contracts sold in connection with software programs generally provide that the purchaser will receive storage media on which improvements have been recorded. This is a contract for the sale of tangible personal property, the charge for which is subject to tax whether optional or not. The language you have misread is as follows:

> "If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media. If, however, the purchaser may, at its option, contract for the consultation services for a separately stated price, it addition to the charges made for the storage media, then the charges for the consultation services are nontaxable."

As this explains, charges for the software updates are always subject to tax. This is because this portion is always regarded as the sale of tangible personal property. The only portion of the maintenance contract arrangement which may be regarded as not taxable is the charge for the consultation services. Two conditions are required in order for such charges to be excluded from the measure of tax: the purchaser must be able to obtain the software update portion without obtaining the consultation portion; and the charge for the consultation must be separately stated. My understanding is that software updates may not be obtained without also obtaining the consultation services nor are the charges for those services separately stated. Therefore, we conclude that the entire charge for the maintenance agreements are subject to tax.

> "(d) The additional charges for out-of-pocket costs and expenses incurred by the Company in connection with pre-installation support, installation and warranty services and which are separately billed to purchasers are exempt from sales tax."

When the additional charge relates to a nontaxable service, then that additional charge would also not be subject to tax. Based on your description of the transaction, only testing constituting installation would be nontaxable. Additional charges related to all other services, which appear to be taxable as part of the sale of tangible personal property, would also be subject to tax. When the additional charges relate to both taxable and nontaxable services, the additional

charges should be prorated between taxable and nontaxable in the same percentage as the services to which they relate.

> "(e) The charge for modifying and adapting the Company's computer software to the specific requirements of a purchaser is exempt from sales tax if such charge is separately stated in the License Agreement or the License and Support Agreement. The separately stated charge for the granting of a license to use the modified computer software is generally subject to sales tax. However, if the price for the computer software prior to modification is 50% or less of the total charge for the modified computer software, the modified computer software will qualify as custom computer programming and will be entirely exempt from sales tax."

Initially, I note that exclusion from the definition of sale for custom computer programs does not apply to basic operational programs. (Rev. & Tax. Code § 6010.9, Reg. 1502(f)(2)(A).) For purposes of this opinion, I assume that the programs about which you inquire are not basic operational programs. I also assume that the modifications about which you inquire constitute custom computer programming as defined in section 6010.9(d) and Regulation 1502(b).

We agree that the charge for the modification of CJ's software to the specific requirements of a purchaser is not subject to tax if that charge is separately stated in the contract of sale. We disagree that the separately stated charge for the granting of a license to use the modified software is generally subject to tax. The charge for the granting of a license is part of the sales price for the modification as is the charge for the actual modification itself. If the modification qualifies as nontaxable custom computer programming, the separately stated charge for the granting of the license to use is also not subject to tax. On the other hand, if for some reason the modification does not qualify as nontaxable custom computer programming, the charge for the right to use that modification as well as the charge for the actual modification would be subject to tax.

If CJ creates a complete custom computer programming, the charge for that program is not subject to tax, including the charge for the right to use. If CJ performs custom modification of a prewritten program and separately states the charge for that modification, the charge for that modification would not be taxable. If CJ makes a separate charge for the right to use, the charge for the right to use the modification will not be subject to tax if it is stated separately from the right to use the prewritten portion of the program. Otherwise, the charge for the right to use the modification will be subject to tax unless meeting the following requirements.

When the charges for modification of the prewritten program are not separately stated (which would include a bundled charge for the right to use the modified prewritten program), tax applies to the entire charge (or, if appropriate, the entire charge for the right to use) unless the price of the prewritten program (including the right to use) was 50 percent or less of the total price of the modified prewritten program. (Reg. 1501(f)(2)(B).) I note also that the charge for a modified prewritten program is entirely exempt from tax only if the price of the prewritten program was 50 percent or less of the total price and there is lump sum billing (no separate statement of charges). If the charge for the modification is stated separately, the charge for that modification is not taxable

and the charge for the prewritten program is taxable, regardless of the percentage of the modification.

> "(f) The charge for providing outside computer consulting services constitutes a service transaction and is exempt from sales tax."

My understanding is that CJ provides no tangible personal property when performing these consultations and performs no fabrication of tangible personal property except fabrication qualifying as nontaxable custom computer programming. Based on these understandings, no tax applies to the charges for providing these services.

> "(g) The entire lump sum charge stated in the License Agreement and the License and Support Agreement for the license to use the Company's unmodified computer software is subject to sales tax at the time the executed agreement is accepted by the Company, so that there is no deferral of a portion of the sales tax until the final installment of the purchase price is paid upon the installation of the computer software."

The applicable tax in these transactions is incurred at the time of the sale of the tangible personal property. That sale occurs when title to or possession of the property is transferred to the purchaser. (Rev. & Tax. Code § 6006, UCC § 2401.) My understanding is that CJ's contracts do not pass title to the software to the customer prior to the installation. Based on this understanding, tax is not incurred upon the signing of the contract, nor is it incurred by virtue of payment of the second installment. Rather, the tax is incurred at the time CJ transfers title to or possession of the property to the customer, that is, at the time of installation. CJ must therefore report the applicable tax with its timely return for the quarter in which that installation occurs regardless of whether it had received the entire payment in a previous quarter or whether it receives the entire payment in a quarter following the quarter in which the sale occurs.

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

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl
Enclosure