STATE OF CALIFORNIA

120.0562

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2637
FAX: (916) 323-3387

September 24, 1996

Mr. J--- L. G---
C--- U--- B--- S---, Inc.
XXXXX --- ---
---, WA XXXXX

Re: Account No. SS -- XX-XXXXXX

Dear Mr. G---:

This is in response to your August 7, 1996 letter asking how tax applies on various computer hardware and software transactions undertaken by your company. For purposes of clarity, we have separately responded to each of your areas of interest below.

> "1) Licensing of pre-packaged computer software, sold without modification, to the customer."

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property inside this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) This tax is imposed on the retailer who may collect reimbursement from its customer if the contract of sale so provides. (Civ. Code § 1656.1; Reg. 1700.) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption of that property in California. (Rev. & Tax. Code §§ 6201, 6401.) This tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code § 6202.) A retailer engaged in business inside this state is required to collect this tax from its customers and remit it to this Board. (Rev. & Tax. Code §§ 6202, 6203.)

Subdivision (f)(1) of Regulation 1502 (copy enclosed) specifically addresses the application of tax on sales of prewritten (canned) software:

> "Prewritten programs may be transferred to the customer in the form of storage media or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax

> applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched."

Thus, tax applies to the entire gross receipts received by your company for the licensing of prewritten software to its customers.

> "2) Monthly fees associated with optional maintenance contracts for pre-packaged computer software. These are contracts for technical assistance only; software upgrades, which are also optional, are billed separately from the monthly fees."

Subdivision (f)(1)(C) of Regulation 1502 explains the application of tax to sales of optional software maintenance agreements:

> "Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.
>
> "....
>
> "If the purchase of the maintenance contract is optional with the purchase, 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, in addition to the charges made for the storage media, then the charges for the consultation services are nontaxable."

This means that an optional maintenance agreement that contemplates the providing of program updates on storage media is regarded as a contract for the sale of tangible personal property. As such, sales or use tax applies on the gross receipts from the sale of an optional computer software maintenance agreement if the sale or use of the agreement occurs in California. (Rev. & Tax. Code §§ 6051, 6201, 6401.)[1/] Tax also applies to charges for consultation services (i.e., technical support) unless the consultation is optional and such fees are separately stated. (Reg. 1502(f)(1)(C).)

We understand from your letter that C--- U---'s (hereafter "CU") optional maintenance contracts separately state amounts for consultation services and software updates. We further

---

[1/] Tax does not apply where an optional software maintenance agreement requires updates to be delivered to a customer outside this state and the updates are so delivered. (See Reg. 1620, a copy of which is enclosed.)

understand that CU's customers may contract for either consultation services (i.e., the "technical assistance"), software upgrades, or both. Under these facts, tax does not apply to the separately stated fees for consultation whether or not CU's customers also receive software upgrades. Tax does apply to CU's gross receipts from its sales of software upgrades in tangible form.

"3) Charges for technical assistance given on a non-contractual, per-call basis."

We assume that CU does not provide any tangible personal property to its customers when it provides this type of technical assistance. As such, tax does not apply to CU's charges for such assistance.

"4) Leases and rentals for computer hardware."

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases it in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by the lessor's purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).[1/]) When the lease is a continuing sale and purchase because either or both of the foregoing conditions are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) The lessee owes the tax and the lessor is required to collect it from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).)

You do not state whether CU leases its equipment in substantially the same form as acquired or whether CU paid tax or tax reimbursement on such equipment. We further note that CU may elect to pay tax on the purchase price of its equipment purchased outside California (rather than collecting tax on rentals) only if it purchased the equipment for use inside this state and made a timely election to report and pay tax to this Board measured by the equipment's purchase price. That is, CU may not exclude its leases from the definition of a taxable continuing sale and purchase by paying use tax if its use of the property is not subject to tax (i.e., if your Client did not purchase the equipment for use inside this state (see Rev. & Tax. Code § 6094.1)), or if it did not make a timely election to pay such tax. Property purchased outside this state from a retailer is regarded as purchased for use in California if the property is first functionally used inside this state or if the property is brought into California within 90 days of its purchase (exclusive of any time of shipment to California, or time of storage for shipment to California). (Reg. 1620(b)(3).) The self-reporting of use tax is "timely" if it is reported and paid with the return of the lessor for the period during which the property is first placed in rental service. (Reg. 1660(c)(2).)

[2/] A copy of Regulation 1660 is enclosed for your review.

"5) Leases and rentals for pre-packaged computer software."

Please see our response to item four above. You should also note that Regulation 1502(f)(2)(A) addresses this issue and, in pertinent part, states:

> "The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property."

"6) Customized computer programs written to the unique specification of one customer."

The application of tax to sales of custom software is set forth in Revenue and Taxation Code section 6010.9 and further explained in Regulation 1502(f)(2):

> "(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.
>
> "(B) However, 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 part of the sale of the prewritten program.
>
> "When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as 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 previously marketed, the new program will qualify as a custom program, if the charge made to the customer for custom programming services, as evidenced in the records of the seller, was more than 50 percent of the contract price to the customer.
>
> "...."

Thus, tax does not apply to CU's charges for custom software where the software meets the foregoing requirements.

"7) Charges for training customers to use the pre-packaged software; training is optional."

We regard CU's charges for optional training as the providing of a non-taxable service (see Reg. 1501) provided such training is not part of taxable software consultation as set forth above.

"8) Charges for installing the pre-packaged computer software; installation is optional."

We assume that CU does not modify or fabricate the prewritten software it installs at a customer's facility. Under these facts, CU's installation charges are not subject to tax. CU should separately state its charges for installation on its customers' invoices.

"9) Charges for converting a customer's computer data, which was generated by a third party, into a software format that is compatible with that customer's computer. Only service is provided in the transaction."

Regulation 1502(d)(1) provides that tax applies to the conversion of customer-furnished data from one physical form of recordation to another unless the contract is for the processing of customer-furnished information. "Processing of customer-furnished information" means the developing of original information from data furnished by the customer and generally includes such processes as summarizing, computing, extracting, sorting and sequencing. (Reg. 1502(d)(5)(A).)

We understand that CU only converts customer provided data from a physical form (e.g. a sheet of paper) to a form readable by its customer's computer without providing a summary, extraction, or sequencing of the data. Under these facts, tax applies to CU's charges for its data conversion.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Tax Counsel

WLA:rz

Enclosures - Regs. 1502; 1660

cc: Out-of-State District Administrator - (OH)