STATE OF CALIFORNIA **120.3080**

STATE BOARD OF EQUALIZATION

APPEALS REVIEW SECTION (MIC:85)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

August 27, 1993

C--- B---
E--- S--- G---, Inc.
XXXX --- --- Drive #XXX
--- ---, -- XXXXX

Dear Mr. B---

Re: SS – XX-XXXXXX-010

Enclosed is a copy of the Decision and Recommendation pertaining to the above-referenced petition for redetermination. I have recommended that the petition be granted in part and denied in part.

Please read the Decision and Recommendation carefully. If you accept the decision, no further action is necessary. If you disagree with the decision, you have the following two options:

REQUEST FOR RECONSIDERATION. If you have new evidence and/or contentions not previously considered, you should file a Request for Reconsideration. Any such request must be sent to me within 30 days from the date of this letter, at the post office box listed above, with a copy to the Principal Tax Auditor at the same box number. No special form is required, but the request must clearly set forth any new contentions; and any new evidence must be attached.

BOARD HEARING. If you have no new evidence and/or contentions, but wish to have an oral hearing before the Board, a written request must be filed within 30 days from the date of this letter with Mrs. Mary Ann Stumpf, Business Tax Appeals Analyst, Board Proceedings Division, at the above post office box.

The above options are also available to the Sales and Use Tax Department. If the Department requests reconsideration or an oral hearing before the Board, you will be notified and given a chance to respond.

If neither a request for a Board hearing nor a Request for Reconsideration is received within 30 days from the date of this letter, the Decision and Recommendation will be presented to the Board for final consideration and action. Official notice of the Board's action will then be mailed to you.

Sincerely,

David H. Levine
Senior Staff Counsel

DHL:jlh
Enclosure

cc: Mr. J--- M. G---
J---, F---, M--- & J---
XXXX --- --- Drive, Suite XXX
---, CA XXXXX (w/enclosure)

Mrs. Mary Ann Stumpf (MIC:81)
Business Tax Appeals Analyst
Board Proceedings Division (w/enclosure)

Mr. Glenn Bystrom (MIC:49)
Principal Tax Auditor (file attached)

--- – District Administrator (w/enclosure)

STATE OF CALIFORNIA

120.3080

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
E--- S--- G---, INC. C---, INC.	)	No. SS – XX-XXXXXX-010
Petitioner	)	

The Appeals Conference in the above-referenced matter was held by Senior Staff Counsel David H. Levine on March 10, 1993 in Sacramento, California.

Appearing for Petitioner:	J--- M. G--- Representative
Appearing for the Sales and Use Tax Department	Jack E. Warner District Principal Auditor

Protested Item

The protested tax liability for the period October 1, 1986 through March 31, 1991 is measured by:

Item	State, Local and County
Unreported sales of computer hardware and software	$ 920,766

Petitioner's Contentions

Petitioner contends that its charges were for custom computer software.

Summary

As relevant here, during the audit period petitioner leased software programs to six television stations: XETV, KTVU, KTTV, KMPH, KNBC, and KCAL. It did not collect use tax on the license fees paid by the stations and did not report or pay use tax to the Board with respect to these leases.

At the Appeals conference, petitioner submitted documents which it believes would convince the Sales and Use Tax Department (Department) that its lessees had either self-reported use tax or that the tax had been picked up by the Department during audits. The Department has reviewed the documents and has conducted further investigation.

The Department noted that the total measure of tax for the second quarter 1989 as reflected on page 5 of Schedule 12b is $60,647, but only $40,936 was carried forward to the summary Schedule 12. The Department also noted that the transactions (district) tax assessed for San Diego must be deleted because the California Supreme Court has concluded that the tax was unconstitutional. After making the correction for failure to carry the correct amount from Schedule 12b to the summary and making the deletions that the Department concluded were appropriate the Department concludes that, prior to further adjustments, the correct measure of tax is $930,977. A copy of that calculation is attached as Exhibit A. Petitioner has not indicated any disagreement with the Department's calculation.

Petitioner did not submit additional documentation with respect to XETV. The Department understood petitioner's comments at the conference to mean that petitioner agreed that its leases to this station were taxable and should be included in the audit of petitioner, and the Department apparently did not conduct further investigation for this reason. (I note that the comments that the Department refers to would have been related only to the question of whether tax had been self-reported or assessed by the Department and were not necessarily a concession by petitioner that the programs were subject to tax.)

With respect to KTVU, petitioner submitted an XYZ letter in which the station asserted that it had paid the tax as the result of an audit. The Department responds that the person conducting that audit specifically stated that the software license fees were not assessed against the station in the audit.

With respect to KTTV, the Department states that tax had not been assessed against the station for the software license fees nor had the station self-reported the tax. The Department concluded that documentation submitted by petitioner establishes that some of the invoice amounts were erroneously listed on the audit schedules. The Department therefore agrees that the measure of tax assessed for petitioner's leases to this station should be reduced by $13,300.

With respect to KMPH, petitioner submitted an XYZ letter that indicated that tax on the entire measure assessed against petitioner for its leases to this station were self-reported by the station. The Department therefore agrees that such amounts should be deleted from the assessment.

With respect to KNBC, petitioner submitted an XYZ letter which indicated that a portion of the tax was included in an audit of this station. The Department reviewed its audit workpapers and concluded that the tax had not been assessed against this station during the audit.

With respect to KCAL, the station had indicated in an XYZ letter that it should be billed for the tax.

In light of the failure of petitioner to convince the Department on the issues summarized above, petitioner has submitted a brief in which it argues that the programs provided to NBC[1] were custom computer programs, the fees paid by Fox TV (KTTV) and Bay City TV (XETV) were nontaxable maintenance fees, and the true object of the transactions in question was for the transfer of intangible information and the performance of maintenance services. The specific arguments and facts asserted in support of them will be discussed below in my analysis.

Analysis and Conclusions

In petitioner's brief, it does not contest the Department's conclusions with respect to whether tax had been paid by the stations nor dies it contest the adjustments asserted by the Department. In any event, if the transactions are subject to tax, then petitioner was required to collect that tax from the lessees and pay it to the Board. (Rev. & Tax. Code §§ 6201, 6203, Reg. 1660.) The amount of tax required to be collected and paid to the Board by a retailer constitutes a debt of that retailer to the state unless and until the retailer establishes that the tax was actually paid to the state. (Rev. & Tax. Code § 6204.) Except as set forth above, petitioner has failed to establish that its lessees paid the tax. Therefore, unless it establishes that the leases were not subject to tax, it is liable for the tax that is due.

[1] The relevant contract is one between petitioner and the network NBC. One of the locations covered by that contract was NBC's Burbank, California station, KNBC, and the tax at issue was assessed on the license fees attributable to the lease of the program for that station.

Petitioner argues that the true object of the contracts in question was the intangible information contained in the programs and not the tangible personal property on which the property was transferred.[2] It cites in support of its assertions the case of *General Business Systems, Inc. v. State Board of Equalization* (1984) 162 Cal.App.3d 50 and the Board's Intel decision.

The *General Business Systems* case covered a transaction that the court concluded was a custom computer program. It has no application to the circumstances of a transfer of a computer program that is not a custom computer program. I note that petitioner failed to cite *Touche Ross & Co.* v. *State Board of Equalization* (1988) 203 Cal.App.3d 1057. That case involved computer programs that had originally developed as custom computer programs. The court concluded that even if a program had once been written as a custom computer program, a later sale of that program does not qualify as the transfer of a custom computer program since it is not developed to the special order of that purchaser. That is, even if the first transfer of the program had qualified as the transfer of a custom computer program, later transfers of that same program do not so qualify.

The Intel decision related to certain transfers of technology that are not specifically addressed by the Board's regulations. The transfer here is not such a technology transfer, but rather a transfer of software programs. The taxability of transfers of software programs is covered by Regulation 1502, and it is that regulation to which we must look to resolve this case.

Petitioner contends that subdivision (f)(1)(C) of Regulation 1502 states that maintenance charges are not subject to tax if two conditions are satisfied: the maintenance is optional and the charges are separately stated. That is incorrect. That provision states 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, 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 charges 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.[3]

---

[2] Petitioner indicated that the programs may have been transferred without the use of storage media and that it is reviewing its records to ascertain the manner of the transfer. If the programs had been transferred by remote telecommunications from petitioner's place of business to its customer's computers and those customers had received no tangible personal property such as storage media, then the provisions of subdivision (f)(1)(d) of Regulation 1502 would apply. As of this time, petitioner has not established that such was the case.

[3] Although it is possible for a maintenance contract to qualify as a custom computer program, petitioner does not contend that the maintenance contracts in question were modified to that extent (or to any extent).

Thus, as relates to charges for a maintenance contract, only separately stated charges for *consultation* services might be deductible from the measure of tax. The documents submitted by petitioner do not establish that any of its charges were for optional and separately stated charges for consultation services. There is therefore no basis for adjustment on this theory.

Petitioner contends that its contract with NBC was to provide a custom computer program. Revenue and Taxation Code section 6010.9 excludes the transfer of custom computer programs from the definition of "sale" and "purchase" for purposes of the Sales and Use Tax Law. This statute is applied by subdivision (f)(2) of Regulation 1502, which states that when the charge for customization is not separately stated, as is the case here, the program qualifies as a custom program only if 50 percent or more of the seller's charge attributable to the program is for the customization. If so, then the entire charge attributable to the program is not taxable. If less than 50 percent of the charge attributable to the program is for customization, then the entire charge attributable to the program is taxable.

When a seller provides a modified computer program along with something other than the program and makes a lump sum charge for the entire package, the first step of the analysis is to ascertain the portion of the charge attributable to the program. The next step is to ascertain what portion of that charge attributable to the modified program is attributable to the modifications, and what portion is attributable to the prewritten portion. Only if the charge attributable to the modifications is equal to or greater than the charge attributable to the prewritten portion will the program qualify as a nontaxable custom computer program.

I note that the analysis discussed above is the same whether the seller is selling tangible personal property in addition to the modified software or the seller is providing service in addition to the modified software. If the seller bills in lump sum, the charge attributable to the sale of any tangible personal property other than the modified program, and the charge attributable to any service other than the modification of the particular program in question, must be subtracted from the seller's lump sum charge prior to performing the final analysis of whether the program qualifies as a custom computer program. Furthermore, I note that the analysis of whether a program qualifies as a custom program is done on a program by program basis. Thus, if the services which were not part of the modification process of the program in question are instead modifications to another unrelated program, the charge for that service would nevertheless not factor into the calculation of whether the program in question was custom or not.

Petitioner has provided some explanations with respect to the amount of hours of work that it spent on the NBC contract. However, petitioner does not distinguish between time spent modifying the prewritten program and all other time spent on the project. Petitioner does not address the fact that its contract with NBC also included the sale of equipment and that some of its charge was attributable to that equipment, either as part of the sales price or for services related to that equipment. Petitioner also fails to address the fact that part of its services related to installation site preparation.

Notwithstanding the discussion above, it appears that it is unnecessary in this case to separate out from the asserted $XX,XXX charge per month the charges attributable to each individual activity in order to ascertain the amount attributable to the software alone. Section 10.3 of the contract provides that NBC would pay petitioner license fees for the software as specified in Exhibit 5 to the contract. That exhibit specifies that the monthly license fee for petitioner's software was $X,XXX for the KNBC site at Burbank, California. This amount was payable in advance and was to remain fixed through March 31, 1990. Effective on April 1, 1990, and on each anniversary thereof, the fees were to be adjusted by a percentage equal to the increase, if any, in a specified Consumer Price Index. The audit working papers confirm that this fee was the amount actually paid by NBC to petitioner with respect to the Burbank site. Beginning with the last entry for the first quarter, (that is, the first payment, in advance, for the period beginning April 1, 1990), the tax was assessed on monthly payments of $X,XXX, and during the first quarter 1991, an increase in the payments to $X,XXX is reflected. Thus, the contract and the audit working papers reflect the specific amount of NBC's payments to petitioner attributable to the software and that amount began at $X,XXX per month, increasing to $X,XXX per month by the end of the audit period.

Using petitioner's own approach, comparing the total monthly payments made to it by NBC for the Burbank site to petitioner's base fee of $X,XXX per month, petitioner has not carried its burden of showing that at least half of its charge for software was attributable to custom modifications. Petitioner has therefore failed to establish that the software provided to NBC qualifies as nontaxable custom computer programming and there is no basis for adjustment.

Petitioner has attempted to establish that the "NBC program" was a custom program by grouping everything together. As noted above, the analysis of whether a program qualifies as a custom computer program is done on a program by program basis. If there were only one program involved here, then petitioner cannot establish that it was a custom program for the reasons discussed above. It appears, however, that there may have been more than one program involved. Thus, it is possible that one program may qualify as a custom computer program while the others do not. However, I have no basis to make such a conclusion at this time. If petitioner believes that it can make such a showing, I encourage it to file a Request for Reconsideration, with supporting documentation. Such a petition should include a complete breakdown of the $X,XXX monthly fee among all the various programs. That is, all programs involved should be accounted for, and the total of the itemized fees for each program should add

up to $X,XXX. Petitioner must then establish the base price for each of these programs, and that total should add up to $X,XXX. (Both these itemizations should be supported with documentation and explanations.) It would then be apparent which, if any, of the various individual programs would qualify as custom computer programs.

Recommendation

I recommend that the adjustments be made as set forth in the Department's leter to petitioner's representative dated May 17, 1993. These include a $XX,XXX deduction from the measure of tax due to the erroneous listing of such amounts with respect to the leases to KTTV, the deletion of all charges to KMPH since that station self-reported the tax, and an increase of $XX,XXX in the measure of tax due to the error in carrying over the correct amount for the second quarter 1989 to the summary. The amount of the San Diego district tax assessed against petitioner should also be deleted since the tax has been declared unconstitutional. I recommend that the tax then be redetermined without further adjustment.

August 23, 1993

David H. Levine
Senior Staff Counsel
(w/Exhibit A)

Date