120.3086

STATE OF CALIFORNIA

BOARD OF EQUALIZATION

APPEALS DIVISION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	HEARING DECISION AND RECOMMENDATION REDACTED TEXT
Petitioner	)	

The above entitled matter came on regularly for hearing before Hearing Officer Anthony I. Picciano on Wednesday, February 6, 1991 in Van Nuys, California.

Appearing for Petitioner:	REDACTED TEXT President REDACTED TEXT Attorney at Law
Appearing for the Sales And Use Tax Department:	Greg McNamee Supervising Tax Auditor Roger J. Pasarow Tax Auditor

Protested Item

The protested tax liability for the period October 1, 1985 through December 31, 1988 is measured by:

Item	State, Local and County
E. Disallowed claimed custom program lease receipts	$180,493

TRANSIT DISTRICT BREAKDOWN (IN DOLLARS)

ITEM	SMCT	LACT	TOTAL
E.	18,525	123,820	142,345

Petitioner's Contentions

E. The petitioner contends that the amount separately stated on its invoices to California customers is not taxable as exempt license fees for custom programming in accordance with Sales and Use Tax Regulation 1502.

Summary

The petitioner is a corporation that designs and leases computer programs for the pension service industry. It has been in business since 1981. There have been no prior audits of the petitioner.

The item that remains in dispute is the exemption disallowed by the Sales and Use Tax Department (Department) for the lease of custom programs.

Mr. Roger J. Pasarow, the Department's representative, stated that the petitioner has two types of invoices: those for California customers and those for out-of-state customers. The only difference between the two types of invoices is that, on the invoices for California customers, there is a separately stated charge for custom programming of $475. In addition, there is a charge of $450 on those invoices for lease of the prewritten programs providing a total of $925 of which tax is paid on $450. The invoices for out-of-state customers show a flat fee of $925 on which there is no tax charged or paid by the petitioner. The out-of-state sales are not in question in this matter.

Mr. Pasarow, during his review of the petitioner's operation, decided that the flat amount charged wasn't for custom programming. He reasoned that if there is custom programming being performed by the petitioner, then that charge would vary from customer to customer and be based on time and materials expended. Further, he noted that the petitioner's contract provides for custom programming for which it charges separately. In that there is no provision other than that noted in the contract, the use of an arbitrary number for the value of custom programming is inappropriate. The auditor believed that there was some customization provided for petitioner's customers without extra charge, but the value of it was incapable of being quantified by the staff. He also reasoned that, considering the contract allowed for the unilateral cancellation by a customer, it would be both inefficient and costly to the petitioner to do substantial customization in light of the possible economic impact of having done the work and then losing the customer after only thirty days. Mr. Pasarow suggested that the charges for customization for the programs had to be substantial in light of all the facts and found that although he agreed that there was a certain amount of custom programming done, it was insubstantial in nature. He also noted that the user's manual was the same for all customers

which, he argued, tends to prove that there is very little custom programming done by the petitioner. Mr. Pasarow's opinion was that "a deduction for custom programming could not really be measured by a flat rate charge." He felt that the petitioner's customers are buying a maintenance agreement to provide updates to the standard program as the laws in the pension/profit sharing arena change.

The petitioner's representative, Mr. [G], stated ·that the petitioner designs and leases computer software for the pension service industry and provides consulting services for that industry. Pursuant to its standard System License Agreement, petitioner grants a license to its customers to use its software computer product for analyzing and managing pension and profit-sharing data. Petitioner's prewritten system must be modified to conform with the customer's particular hardware and unique application needs. Consequently, each California customer who purchases a license to use the system pays a license fee that is comprised of two separately stated amounts: a charge for the basic prewritten system, and a charge for custom modifications to that system. Custom modifications to the basic prewritten system include, but are not limited to, changes pursuant to the special order of the customer that: (1) facilitate the special design of the various pension and profit sharing plans administered by the customer, (2) incorporate each individual actuary's peculiar interpretation of the law; and (3) enable the customer to generate reports according to its individual specifications. There is from $1,000 to $2,500 charged at the time that the customer comes on board for the loading of the system on its computers and for such training as is necessary for the customer's personnel.

Mr. [M] said that when the petitioner first considered going into the business, it looked at what the competition was doing. There was a major firm that provided a time share service and allowed its customers to use the firm's system on such a basis. Those customers were denied flexibility and the cost of such service was too great for small businesses. There was another major competitor that provided a hardware/software package to its clients. This approach required a large dollar investment to start with for the specialized hardware and then monthly payments thereafter. This system had the same limitation of the other competitor in that it was not very flexible. The petitioner after having viewed the marketplace in 1981, elected to establish a process whereby there would be a basic software system provided that would operate on personal computers and have the ability to be modified to suit the needs of individual pension plan administrators. Mr. [M] said that it was clear from the outset to the petitioner's customers that they would all receive the benefit of the flexibility of the system and the custom modifications as were necessary to suit their particular needs. The contract has a provision for custom programming that was included to protect the petitioner from having to provide customization that was outside the scope of the norm.

Mr. [M] argued that the auditor was establishing criteria that are not required under the law. He agreed that customers can cancel the agreement with the petitioner on a thirty-day notice but, in fact, that does not occur very often. In those cases the petitioner may lose money. He also said it is the petitioner's choice as to whether or not it charges for the customization on a flat rate or otherwise. The decision to charge on a flat rate was arrived at so that all the customers would be aware and would be able to plan for their cost of the service. The custom programming that is separately provided for in the license agreement is most generally the

moving of data from an old and different system to the petitioner's system. He said that there is no requirement under the law that there must be an hourly rate charge for customization of programs. The customers are aware that perhaps some receive a little more for their money than others but have not objected to this method of billing and seem quite satisfied with it.

Mr. [G] indicated that the are two types of invoices for in-state and out-of-state customers to allow the petitioner to maintain such records as are necessary to properly report its sales and use tax in California. All the customers, in or out of state receive the same service. As evidence of this, he provided MCI telephone bills that show large periods of time for phone connections to out-of-state customers which time he testified was modem time that was used to provide customization to that particular customer. He also provided an example of reports on a pension plan that were compiled to the special order of a particular customer. He said a typical example of the type of customization that is provided on the flat rate would be where there is a defined benefit plan that allows for an offset for the payment of social security retirement. This situation allows the actuaries to select various parameters to calculate into the program such as age of retirement and the amount that a person might receive. Each customer that administers this type of offset plan may and probably does have a different set of parameters to be included in its planning. This is an example of the type of service that the petitioner provides for the flat customization fee.

Analysis and Conclusions

Revenue and Taxation Code section 6010.9 provides in pertinent part:

> "'Sale' and 'purchase,' for the purposes of this part, do not include the design, development, writing, translation, lease, or transfer for a consideration of title or possession, of a custom computer program, other than a basic operational program…."

There have been a number of factual and legal issues raised by the Department. The Department argues that in order to receive the exemption provided in the above cited authority, the charges must be ascertainable as they apply to the customization of standard programs; they must be substantial in nature; and they must be individual in nature; that is, they cannot be a flat rate. The Department argued that these are not the requirements for the exemption claimed per se, but instead are the factual considerations that are necessary in order to determine whether the charges are indeed for custom programming. The Department has admitted that it believes there is some custom programming being provided by the petitioner but is concerned that the value claimed is not appropriate considering that other custom programming is also being accomplished. There is no question that the Department must look to the underlying facts involving a claimed exemption. The auditor admitted that there was custom program being provided by the petitioner and, on the basis of that agreed fact, the question that remains is whether or not the petitioner complied with the law in the taking of the exemption claimed.

It appears that part of the problem that the Department has with the petitioner's process is its concern that the price charged is not in all cases reflective of the service provided. "If a

fictitious retail price were charged solely to avoid tax, that price would be ignored as a sham. If, on the other hand, the transaction is bona fide, the tax is measured by the actual gross receipts from the retail sale of the tangible personal property." See Sales and Use Tax Annotation 295.0660. The Department has not alleged that the petitioner is working a sham therefore, the Annotation quoted is applicable to this case. The agreed price, as opposed to market value or some subsequently revealed price, dictates the appropriate sales and use tax treatment. (See Hawley vs Johnson (1943) 58 Cal.App.2d 232, 237.) Consequently, the price charged is the measure of the gross receipts to be considered.

Revenue and Taxation Code Section 6010.9(d) defines custom computer programming to include modification to an existing prewritten program. The Department has agreed that the petitioner is modifying its prewritten program to suit the needs of its customers. Therefore, the petition is providing the exempt custom programming.

Sales and Use Tax Regulation (Regulation) 1502 implements Revenue and Taxation Code Section 6010.9 and provides more detailed requirements for the obtaining of the custom programming exemption. It provides in pertinent part:

> "(f)(2)(A) Tax does not apply to the sale or lease of a custom computer program, other than basic operational program, regardless of the form in which the program is transferred…
>
> (B) "However, charges for custom modification 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% or less of the price of the new program…." (Emphasis Added.)

Exemptions from tax are strictly construed against the taxpayer who has the burden of proving that the statutory requirements have been satisfied (see Standard Oil Company of California v. State Board of Equalization [1974] 39 Cal.App.3d 765, 114 Cal.Rptr. 571; and H. J. Heinz, Co. v. State Board of Equalization [1962] 209 Cal.App.2d 1, 25 Cal.Rptr. 685). We must then examine whether the petitioner has fully complied with the law. The Department's position is that: there has to be substantial modifications to a standard program; there cannot be a flat fee charged for a custom program; if the contract provides for custom charges in the system then that belies the substantial nature of the modifications to the program; it is unreasonable to contract for customization of a substantial nature if the customer can cancel the service with merely a thirty-day notice.

We have considered the possibility that the entire charge might be tax exempt and find that it is not because the basic program is a prewritten program and does not, by the petitioner's own admission, qualify as a custom program. The Regulation above cited provides for an evaluation of whether or not there is a substantial modification only in the case of a charge for a custom program that is not separately stated. The charge in this instance is separately stated therefore, that is not a consideration. The law does not require that a business charge for its product in any specific fashion. The petitioner has provided acceptable reasons for its flat rate approach to the charges for custom programming. In that there is no requirement that such charges be made on a time and materials basis, then the method of charging is not relevant to the question of whether the petitioner should receive the exemption claimed.

Finally, the Department points to the inclusion in the contract and licensing agreement of a provision for custom programming. The audit working papers contain a single invoice for a customer in the state of California upon which there was a charge for "Data Conversion/Consulting." The petitioner's representative indicated that, because there is a flat rate charge for custom programming, there is a point beyond which customization is not provided. He said that it was common for there to be separate charges for data conversion, and as noted in some of the out-of-state invoices, there can be an extra charge under that contractual provision. It is reasonable that if the petitioner is working under a flat fee concept, there must be a limit to the service that it provides. The provision in the contract amounts to a "safety valve" for the petitioner to use in the event a customer desires service that goes beyond the scope of that which is presumed by the parties. Given these facts we find that there is no requirement for the petitioner to charge on an hourly basis and that the petitioner has complied with the letter and intent of the law in claiming its exemptions.

Recommendation

Grant the petition.

May 25, 1991

Anthony I. Picciano, Hearing Officer — Date