

**STATE BOARD OF EQUALIZATION**

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May 8, 1995

Mr. C--- E. K---
Tax Manager
S--- R--- C---, Inc.
XXXX --- --- Drive
P. O. Box XXXXX
--- ---, CA XXXX-XXXX

Re: **SZ – XX-XXXXXX**

Dear Mr. K---:

This is in response to your March 9, 1995 letter to Assistant Chief Counsel Gary Jugum regarding the application of tax with respect to computer software included in your company's sales of Computerized Branch Exchange ("CBX") systems.

You state:

"S--- R---'s major product is the CBX ... line of PBX (Private Branch Exchange) products. A CBX is a computer which serves as an automatic switchboard for any telephone extensions which are routed through the CBX. Individuals may dial the extensions routed through the CBX, dial extensions on other CBX's which may be connected, or dial any other phone in the world via common carrier lines connected to the CBX. Additionally, the CBX may simultaneously or independently be used to provide similar services for transmission of data, with terminals, modems, and computers substituting for telephones in the description above.

"....

"Each CBX is configured to meet the customer's unique requirements. The number of lines, the actual extension numbers, and the type of device on each line (console, terminal, plain phone, featured phone, etc.) must be embedded in the CBX software. So too, the public phone network system trunk, carrier (AT&T, MCI, Sprint), WATS, FX, or TIE lines which are to be connected to the CBX must also be programmed. There might be connections to other CBXs forming an intra-organization network. Further, the CBX has a myriad of optional, extra cost

features (such as Automatic Call Distribution), which require software applications, others which are software themselves.

"Thus, the software of each CBX installation is unique. To generate this unique software, the installation parameters (CBX model, lines, devices, options, etc. as explained above) are coded into input sheets by Customer Installation Specialists working closely with the customers and by software generation specialists employed as S--- R--- headquarters. These input sheets are keyed into [a] PC program named DCT (Data Collection Tool) which is located at each S--- R--- branch office. Once the software has been input and validated, using the parameters defined, it is sent to the S--- R--- Reference Center, located in Santa Clara. These special programs create the appropriate template to produce a customized software package for the specific installation. This customized version, usually in the form of DAT tape, is then thoroughly tested before being delivered with the hardware for installation at the customer's site by our technicians. Our on-site technicians then thoroughly test the software again after installation."

You ask how tax applies on the sale of customized software included in your company's sales of its CBX systems.

Discussion

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) Taxable gross receipts include all amounts received with respect to the sale, with no deduction for the cost of the materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code § 6012.)

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.

"...."

We understand that your company inputs information from its customers into a separate program (the DCT) for use in generating the software necessary to run a customer's individualized CBX system. We assume that this process requires your company to substantially modify prewritten software consisting of the general framework for all CBX systems. Tax does not apply on your company's charges for modifying this software where these charges are separately stated on the sales invoice to your customers. If your company does not separately state these charges and does not market or sell the prewritten component of software, the individualized CBX software is "custom" and not subject to tax only if the charge for customizing the software was more than 50 percent of the contract price for the CBX software. Where these conditions are met, your company's sale of the individualized CBX software is not subject to tax regardless of the form in which the program is transferred (i.e., via disk, tape, or modem), whether or not the software is sold in connection with the sale or lease of computer equipment, and whether or not the charges for the software are separately stated. Where these conditions are not met, tax applies on your company's entire charge for the sale of the software.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:plh

cc: --- --- District Administrator - -