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April 22, 1997

Mr. F--- -. T---, Jr.
S--- M---
XXXX --- Avenue, --- --- - XXX
--- ---, California XXXXX

Re: SY – XX-XXXXXX

Dear Mr. T---:

This is in response to your March 3, 1997 letter to Assistant Chief Counsel Gary Jugum regarding the application of tax on optional maintenance agreements that consist of both equipment service and software updates.

You state:

“S--- is a leading supplier of network computing products including workstations, servers, software, microprocessors, and a full range of services and support. S--- operates in a single industry segment and conducts its business through principal operating entities and divisions organized around S---’s principle areas of added value. S--- believes this organizational structure allows it to more efficiently focus on its customers and the products, channels and markets necessary to serve them.

“One of S---’s principal divisions is the S--- Service Division (S--- Service). S--- Service is a leading UNIX operating system service organization. S--- Service provides a wide range of global services for heterogeneous network computing environments, including system support, education, information technology consulting, systems integration, and system/network management.

“In the system support arena, S---Service maintains a field support team of approximately 1,700 which includes mostly software support engineers in its solution centers and in field offices. This field force is complemented by third-party service providers, delivering a full range of system support.

“S--- provides, at no charge, a standard one year warranty for parts and labor on its systems. In addition, S--- also offers post-warranty services on a contractual basis after the initial product warranty has expired. Such post-warranty support services are primarily offered through a four level multi-tiered program called S--- Spectrum. Each level of support is sold for a single price and provides the customer with bundled hardware maintenance, including operating system enhancements, and specific software telephone/on-line support, including patches and enhancements. S--- also provides hardware and software maintenance ala carte for a separately stated price, as well as online and telephone support.”

You ask our opinion on three separate issues related to the above facts. For purposes of clarity, we have separately responded to each of these issues below.

“1. Are the S--- Spectrum post-warranty service support agreements that are sold for a single price and provide the customer with bundled hardware maintenance, including operating system enhancements, and specific software telephone/on-line support, including patches and enhancements, subject to California sales and use tax? If these S--- Spectrum post-warranty service support agreements are subject to tax, is the entire charge taxable or only the portion relating to the software upgrades and enhancements?”

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.) 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 in California. (Rev. & Tax. Code § 6201.) Taxable gross receipts and sales price include all amounts received with respect to a sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011, 6012.) Charges for optional equipment maintenance agreements are not, however, part of a retailer's gross receipts or the sales price of property and are not subject to tax. (Business Taxes Law Guide Annots. 490.0580 (12/13/63), 490.0700 (5/10/60).)

Regulation 1502(f)(1)(C) provides 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. Tax applies to the sale or use of such maintenance agreements inside this state. (Rev. & Tax. Code §§ 6051, 6201, 6401.)¹ Tax also applies to

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 not first functionally used inside this state or brought into California

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 that S--- M--- (hereafter “S---”) offers its customers an optional lump-sum service agreement (upon the expiration of its mandatory warranty) providing for both hardware and software maintenance. Under these facts, we regard the service agreement as both an optional maintenance agreement on the equipment as well as an optional maintenance agreement for the software. Tax applies to that portion of the optional service agreement that represents the charges for the optional software maintenance which include software maintenance for S---’s prewritten operational software (discussed below). S--- should report and pay tax to this Board measured by the amount it receives for the software maintenance agreement portion of the charge for the service agreement.

“2. Are the hardware only support agreements that provide the customer with hardware maintenance, including operating system enhancements, subject to California sales and use tax? If so, is the entire charge taxable or only the portion relating to the operating system enhancements?”

A basic operational program is subject to tax. (See Rev. & Tax. Code § 6010.9; Reg. 1502(f)(2)(A).) A “basic operational program” means, among other things, a computer program which is fundamental and necessary to the functioning of a computer and includes supervisors, monitors, executives and control or master programs which consist of the control program elements of that system. (Rev. & Tax. Code § 995.2.) A maintenance agreement providing updates in tangible form to a prewritten operational program is regarded as the sale of tangible personal property. (See Reg. 1502(f)(1)(C).) Tax also applies to charges for consultation services (i.e., technical support) related to the operational program maintenance agreement unless the consultation is optional and such fees are separately stated. (Reg. 1502(f)(1)(C).)

We understand that S---’s optional “hardware only” support agreements provide both hardware maintenance as well as operational program updates on tangible storage media. We also understand that S---’s operational software is prewritten and not custom. Under these facts, we regard this support agreement as both an optional maintenance agreement on the equipment as well as an optional maintenance agreement for prewritten software. Tax does not apply to that portion of the “hardware only” support agreement which relates to actual hardware maintenance. Tax does apply to that portion of the agreement which represents the charges for the maintenance of the operational programs.

within 90 days of their purchase. (See Reg. 1620(b).) Tax also does not apply where the optional software maintenance agreement requires updates to be delivered by remote telecommunications (e.g., modem or e-mail) and the purchaser does not obtain possession of any tangible personal property such as storage media in the transaction. (Reg. 1502(f)(1)(D).) For purposes of this opinion, however, we assume that neither of these provisions apply to your client’s situation.

“3. Are the software only support agreements that provide the customer with telephone/on-line support, including patches and enhancements, subject to California sales and use tax? If so, is the entire charge taxable or only the portion relating to the patches and enhancements?”

As set forth above, 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. (Reg. 1502(f)(1)(C).) Tax applies to the sale or use of such maintenance agreements inside this state. (Rev. & Tax. Code §§ 6051, 6201, 6401.) 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).)

I hope this answers your questions. If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

WLA/cmm