

**M e m o r a n d u m****120.0048**

To: Mr. Ed Pedeupe  
Audit Evaluation and Planning Unit

Date: June 14, 1990

From: John Abbott  
Senior Tax Counsel

Subject: K--- H---, Inc. – SR -- XX-XXXXXX  
Training materials for computer programs – word processing and graphics

On March 15, 1990, you forwarded to the legal staff a memorandum from San Francisco Audit to Headquarters Principal Tax Auditor, dated February 26, 1990, concerning the above taxpayer's contracts with software manufacturers, its customers. Your questions are whether the disks the taxpayer supplies qualify as custom computer programs, and if not, whether the taxpayer is contracting for a service or for the sale of tangible personal property.

The San Francisco audit memorandum states as follows:

“Background

“Taxpayer sells off-the-shelf training materials for the more popular P.C. programs - - Lotus, Wordperfect, etc. These packaged classes are intended for use with a ‘live’ instructor and are sold as text files on computer disks. They are sold under taxpayer’s name and include limited reproduction rights. A typical package includes an instructor guide, workbook, overhead masters, and handouts.

“Transaction in Question

“Occasionally, taxpayer enters into a contract with a software manufacturer to merely develop a course for a program not yet on the market. This type of transaction differs from, the other - -

“Customer/manufacture is required to edit the course material.  
Taxpayer transfers all reproduction rights.  
Customer/manufacture markets the package under its own name.

“While we have historically taxed a transfer of a disk as a sale of tangible personal property, some recent cases (including C.A.D.) have recognized situations in which transactions may be viewed as much more than the sale of a disk. Inasmuch as this transaction has a strong service element - - manuscript for course, workbooks, overheads, and handouts – we’d like your opinion as to the application of tax to these custom courses. Agreement copies are attached for your reference.

The memorandum enclosed an Independent Contractor Services Agreement Between A--- Corporation and the taxpayer dated December 30, 1987. Supplemental agreement no. 1 attached to the Services Agreement lists the following as the “deliverables” which the Services Agreement requires the taxpayer to produce for A---:

“1. Product Training Materials

“This product will consist of an Instructor Led Training Course to be used for classroom training of sales representatives. The text will focus on the features and benefits of the graphics package. The deliverables for the courseware includes:

- “Disk containing Instructor’s Guide
- Disk containing Participant’s Workbook
- Disk containing overheads
- Disk containing sample files

“2. Reseller Workbook

“This product shall be used to promote the features and benefits of the product thereby enabling the resellers to effectively market the product. The reseller workbook shall consist of a scripted 10 minute demonstration with accompanying keystrokes and appropriate instructional lessons to teach the reseller how to do the demonstration.

- Disk containing the Reseller Workbook
- Disk containing sample files needed to perform the demonstration”

Schedule B attached to the Services Agreement sets out additional “assumptions” regarding the product training materials to be supplied by the taxpayer. Schedule B states in part:

“All deliverables are word-processed disk copy, MS Word 3.01 for the Mac.

“The Overheads are word-processed disk and paper copy. They will be produced in MS Word 3.01 for the Mac and MacDraw.

“A--- provides KHI, at no cost, Style Sheet Guidelines for Product Training Materials.

“A--- handles production of materials.”

### Opinion

In answer to your first question, the taxpayer is not transferring a custom computer program under the Services Agreement. Instead, the taxpayer is using two applications programs, Microsoft Word and MacDraw, to produce the deliverables called for under the Service Agreement. Schedule B specified the computer programs to be used by the taxpayer to produce the deliverables so that the customer can further process and edit the deliverables transferred by the taxpayer. The customer will have these same programs or other programs capable of reading the output produced by Microsoft Word and MacDraw.

Our opinion is that the deliverables which consist of data in the form of word processed disk copy are not subject to tax. Under Regulation 1501, tax does not apply to an author's transfer of an original manuscript to a publisher, since the true object of the contract is considered to be the expression of an idea, and not the furnishing of tangible property. It would make no difference whether the author transferred the manuscript on paper or computer readable storage media. Similarly, the taxpayer's word processed disk copy is an original manuscript for use by A--- in producing the training materials.

Some of the deliverables, whether encoded on storage media or printed on hard copy, consist of graphic material for overheads produced by the taxpayer using MacDraw, a graphics applications program. Our opinion is that tax applies to these deliverables. In the case of graphics or artwork, the true object of the contract is considered to be the tangible property on which the graphics or artwork is drawn. In our view, the same result applies regardless of whether the graphic output is on a disk and is thus capable of being edited or manipulated by the customer. Therefore, tax applies to a portion of the charges made by the taxpayer to A---, which represents an amount reasonably allocated to the MacDraw-formatted deliverables.

JA:jb