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May 18, 1981

DOUGLAS D. BELL
 Executive Secretary

A--- B--- C--- Systems
 XXXX --- ---
 --- ---, California XXXXX

Dear Sir:

Your letter of March 9, 1981 requesting advice regarding the application of sales tax to certain data processing services has been referred to the undersigned for response. We have enclosed for your general information a copy of Sales and Use Tax Regulation 1502 which deals with data processing issues. Our discussion below will make reference to Regulation 1502 where appropriate.

You state that your company is engaged in selling turnkey computer packages with the use of the software programs being licensed to the user with no privileges of reselling the software programs. You charge sales tax on the entire package, including both hardware and software, and on charges for modifications or enhancements made to the software program after initial installation. You ask whether sales tax applies to three types of transaction which are described below together with our comments regarding the application of tax.

Type I

(a) Repair to software programs which have become garbled or damaged due to environmental conditions. The repair only restores the program to its original condition and does not improve or modify it.

(b) Similar repairs to data files.

Comment. Assuming that the "repair" is accomplished by furnishing the customer a new disk or tape on which is recorded the "repaired" program or data file, for which a charge is made, both types of transaction are subject to sales tax. See Regulation 1502, subdivisions (c)(1), (2) and (3). The tax applies for the same reason that it would apply to the sale of a duplicate disk or tape on which has been recorded a program or data file. It is simply the transfer for a consideration of tangible personal property and constitutes a taxable sale. Revenue and Taxation Code Section 6006.

Type II

The enlargement of a data file due to a customer's growth where there is no change in, or addition to, existing programs.

Comment. Again assuming that "enlargement" means that for a fee the customer is provided a new disk or tape with the enlarged data file recorded on it, the transaction is subject to sales tax for the same reasons set forth under Type I.

Type III

Data entry performed on the customer's equipment at its place of business on a temporary basis during installation of a system or during seasonal work peaks by sub-contractors supplied by you. You hire and pay the temporary helpers and bill the customer. The data entry includes such things as indexing customer lists, cutting invoices and entering orders.

Comment. The answer to this question has two parts, whether the temporary helpers become your customer's "special employees" and, if not, whether they are providing taxable fabrication labor. While the following comments discuss these issues in general terms, we are unable to provide definitive answers because insufficient information has been provided.

Where the employees work at the customer's site and use the customer's equipment, the charges for their services are not subject to sales tax if the employees are regarded as "special employees" of the customer (as distinguished from independent contractors). No tax applies because the workers are considered to be the customer's employees. Since fabrication labor is taxable only when performed for others (Revenue and Taxation Code Section 6006, subdivision (b) and (f), any fabrication performed by the customer's own employees is not subject to tax.

A number of factors are important in determining whether workers furnished to a customer will be considered special employees. Generally, where the workers are furnished without a place of work, any supervision or any materials, tools, equipment, or supplies, and the payment for the work is based merely on an hourly rate, the workers furnished will be considered special employees.

The general distinction between employees (servants) and independent contractors is relevant to this issue. An independent contractor is one who renders service in the course of an independent employment or occupation. He follows his employer's desires only in the result of the work, and not in the means whereby it is to be accomplished. A servant, on the other hand, is employed to render personal services and remains entirely under the control and direction of the employer. In determining whether a worker is an employee or independent contractor, the primary factor is whether the person for whom the work is done has the legal right to control the activities of the person doing the work. Whether or not he actually uses it, an employer-employee relationship exists if the employer has authority to exercise complete control. Where there is no right to control the mode or manner of performance, the worker is an independent contractor.

The extent of control over a worker's performance is determined from the employment contract. Where the contract contains no express agreement on the issue, then the existence of the right of control must be determined by reasonable inferences drawn from all the circumstances surrounding the relationship of the parties. Thus, whether a worker is a special employee will depend largely on the facts of each case.

If we assume that the temporary workers you supply are independent contractors and not special employees, then the taxability of your charges will depend on what they do and whether they produce or fabricate tangible personal property for your customer.

If the services performed involve merely the direct entry of data into a computer, and nothing more, then the charges are not taxable. On the other hand, if the services involve the fabrication of tangible personal property of physical use to the customer, such as punched cards, paper tape, magnetic disks or tapes, which are to be used as input devices to actuate data processing or other equipment, inventory control cards, membership cards, etc., tax applies to the charges for this fabrication labor. See Regulation 1502, subdivision (c)(2).

If you would like a more specific answer to this third question you will need to provide more detailed information regarding the precise nature of the activities.

Very truly yours,

Richard H. Ochsner
Tax Counsel

RHO:jw
Enclosure