STATE OF CALIFORNIA

120.0544

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May 29, 1997

Ms. L--- E---
S---, Inc.
XXX East --- Road
--- ---, California XXXXX-XXXX

Re: SY -- XX-XXXXXX

Dear Ms. E---:

This is in response to your letter dated March 24, 1997 asking how tax applies to your company's sales of software maintenance agreements and related items.

You state:

"Background facts:

"End User Software License Agreement

"S--- negotiates a broad based 'End User Software License Agreement' with a customer prior to accepting their first order. The license agreement contains such items as: restrictions on use of licensed software, defines technical terms, specifies rights granted under the license, limits liability, delineates ownership, etc. . . . The license agreement does not list prices or quantities of software to be licensed, nor does it state the manner of delivery of the software. The license agreement is not a 'contract to sell,' it is an agreement which governs the terms of any future sales.

"S--- believes that a 'contract to sell' is established at the point when an individual purchase order is reviewed and accepted by S---. . . .

"Prior to the acceptance of a purchase order, S--- has no obligation to its customer, nor does the customer have any obligation to S---. After the acceptance of a purchase order, each party is obligated to fulfill their part of the agreement. After fulfilling their respective obligations, the parties are once again, unbeholden to each other . . . until such time as another purchase order is submitted and accepted.

"Electronic Software Transmission (EST)

"S--- has recently implemented the technology to deliver software electronically. Customers selecting EST will sign an addendum to their existing License Agreement specifying any terms and conditions that are unique to EST. For example, the software deemed to be 'delivered' at the point when the key is available on the internet, the software is available for downloading, and the customer has been (electronically) notified that the software and the key are both electronically accessible. The customer is instructed that there will be no shipping receiver, and agrees to accept the email notification as proof of delivery. Customers must 'qualify' for EST (primarily for security reasons), and must designate EST as the means of shipping of their purchase orders.

"S--- also makes all software documentation available electronically. It is conceivable that a customer selecting EST will never receive a single tangible item from S---." (Emphasis in original.)

You raise a series of "issues" based on these facts. Since not all of your issues pose specific questions eliciting a response, we have analyzed each section of your letter in which you reach a conclusion on how tax applies. For purposes of clarity, we have set forth the relevant factual background from each portion of your letter along with our corresponding analysis.

"S--- licenses software, and software maintenance agreements to their customers. Maintenance agreements are optional, but due to the complexity of the software the vast majority of customer elect to purchase them. Maintenance agreements are usually sold in 12 month terms which renew annually unless terminated by either party. Currently, the software updates provided in the maintenance agreements are delivered in tangible form.

"S--- has several customers who wish to renew their maintenance agreements, and submit a new purchase order for maintenance to be delivered electronically. If existing customers submit a purchase order which requires EST, and the updates are, in fact, delivered electronically, will the current purchase of maintenance be taxable?"

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.) Tax does not apply to the sale or lease of software that is transferred by remote telecommunications (e.g., modem or e-mail) where the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. (Reg. 1502(f)(1)(D).)

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 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--- enters into 12 month optional software maintenance agreements through the receipt and acceptance of a separate purchase order from its customers. These agreements currently provide software updates in tangible form and are subject to tax pursuant to Regulation 1502(f)(1)(C). S---' customers now wish to renew their maintenance agreements by submitting new purchase orders which require the transmission of software updates solely by remote telecommunications. We understand this to mean that S---' customers will terminate their previous software maintenance agreements at the end of the 12 month update period and then provide your company with new purchase orders for optional software maintenance requiring updates to be delivered exclusively by remote telecommunications. Under these facts, the new optional software maintenance agreements will not be subject to tax provided S--- delivers its software updates solely by remote telecommunications (e.g. via e-mail or Internet transmissions) and its customers do not receive any tangible personal property (such as storage media) as part of its update transaction. Tax will continue to apply to the entire 12 month charge for optional software maintenance where S--- and its customers contract for updates to be delivered in tangible form through new purchase orders or the renewal of existing purchase orders requiring the delivery of updates in tangible form.

> "All sales of S--- product include documentation. Customers will receive their documentation in one of three formats: paper copy, CD ROM, or via EST. When

[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 within 90 days of their purchase. (See Reg. 1620(b).)

the documentation is delivered either via CD ROM, or EST, it contains a search engine. The search engine enables a key word search of the documentation. The search engine does not work on the software itself, and is in no way an enabler of any of the actual software capabilities."

Regulation 1502(f)(1)(D) provides that the seller of a prewritten computer program transferred by remote telecommunications is the consumer of property used to produce written documentation or manuals designed to facilitate the use of the program where the documentation or manuals are transferred at no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge. Regulation 1502(f)(1) provides that tax applies on the sale or lease of prewritten software.

We understand that S--- will provide its customers with software documentation when it transfers software or software updates to its customers via remote telecommunications. You state that this documentation will be in the form of paper, CD ROM, or by EST. Tax does not apply on S---' transfer of documentation by remote telecommunications (i.e., an EST transmission) since S---' customers will not receive any tangible personal property. S--- is either the consumer of the documentation (where it does not separately state a charge for these items) or owes tax measured by the separately stated charge for these materials where it transfers its documentation to customers on paper.

You state that S---' CD ROMs contain both documentation and a search engine. We understand that the search engine consists of prewritten software designed to provide access to the information contained on the CD ROM. Under these facts, S--- is selling tangible personal property containing prewritten software in the form of a search engine. Its charge for that software is subject to tax and is measured by either S---' separate charge for the search engine (provided this charge is not artificially low in order to avoid tax), or on a portion of S---' overall charge for the software or software update transferred via remote telecommunications.

"Customers of S--- have requested that they be allowed to designate ***on each purchase order*** the method of delivery desired. And, since each purchase order is a 'complete sales agreement,' the taxability of that transaction should be determined based on the terms of the purchase order."

Paragraph 5.1 of S---' End User Software License Agreement (hereafter "the Agreement") requires its customers to submit a purchase order to your company in order to receive goods or services. Any purchase order accepted by your company is subject to the terms of the Agreement. Under these facts, we regard each purchase order submitted to and accepted by your company as a separate sales agreement between S--- and the customer submitting the purchase order. The terms of each sale consist of all the terms of the Agreement not in conflict with the specific terms of the purchase order and acceptance.

You state that each product sold by S--- is complete in itself. That is, S--- transfers a wholly operational program to its customer each time S--- sells a product pursuant a purchase order submitted by a customer. You further state that the product transferred by S--- does not consist of a password or other authorization to utilize additional segments or modules of software or other tangible personal property previously transferred by S--- to its customers. (See, e.g., BTLG Annots. 120.0552 (1/6/92); 295.0743 (5/2/95).) Under these facts, tax does not apply to S---' sales of software to customers who request electronic transmission of the software on their purchase order provided S--- then transfers the software pursuant to the provisions of Regulation 1502(f)(1)(D).

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

WLA/cmm

cc: San Jose District Administrator (GH)