STATE OF CALIFORNIA

120.0560

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In The Matter Of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
T--- S---, INC.	)	No. SR -- XX-XXXXXX-010
Petitioner	)	

The above-referenced matter came on regularly before Staff Counsel James E. Mahler on February 7, 1991, in San Diego, California.

Appearing for Petitioner: L--- J. A---
Vice President

Appearing for the Sales and Use Tax Department: Lloyd J. Geggatt
Senior Tax Auditor

Protested Item

The protested tax liability for the period April 1, 1983, through June 30, 1086, is measured by:

Item	State, Local County & Transit
Disallowed resales ($139,089 less reaudit Adjustment and unprotected amounts)	$7,860

Petitioner's Contentions

1. The true object of the update transactions is intangible information, not tangible personal property.

2. It is not reasonable to tax the entire software maintenance charge merely because the updates are sent to the customers on magnetic tape.

Summary

Petitioner is a corporation which sells laser printers and related software to large corporate, educational and government users. The software is prewritten or "canned", no developed to the special order of individual customers. Petitioner also offers its customers a maintenance policy for the software.

The maintenance policies have two features. First, customers may telephone petitioner at any time during regular business hours (Pacific time) to report problems or "bugs" in their programs and to obtain "bug fixes". Second, petitioner periodically sends the customers "updates" or program enhancements. The updates are transferred to the customers on magnetic tape and, like the underlying software, the updates are "canned". During the periods involved herein, petitioner purchased the tapes ex-tax under resale certificates.

Customers who purchase software from petitioner are not required to purchase a maintenance policy. If they do, the charge varies depending on the particular software program, but apparently ranges from $200 to $600. The charge is billed as a lump sum with no allocation between the telephone consultation and update aspects of the policy. Customers who desire a maintenance policy must purchase the entire package; they are not allowed to purchase only the telephone consultation or only the updates.

Updates are sent to the customers only when they happen to be developed by petitioner. In any given year, some customers may receive updates while other customers do not. Petitioner estimates that about 80 percent of its costs of providing maintenance policies is for the telephone consultation and only about 20 percent is for the updates.

One reason petitioner offers maintenance policies to its customers is to generate good will. According to petitioner, however, the main purpose for providing updates is to benefit petitioner itself, not to benefit the customers. Petitioner's telephone consultation personnel must be able to service all customers equally and quickly. If each customer had its own version of a program (because updates subsequent to purchase had not been incorporated), the time and expense of servicing the customer would be increased. Petitioner therefore views the updates as incidental to the telephone consultation service, intended to make the telephone consultation more efficient.

Petitioner claimed exemptions totaling $18,713,713 on its sales and use tax returns for the period in question. The audit accepted all claimed exemptions for transactions less than $1,000 without investigation. Transactions equal to or greater than $1000 were examined on an actual basis, and sales totaling $139,089 (later reduced to $75,214 in a reaudit) were disallowed.

The disallowed transactions include sales of maintenance policies to four customers. Since only sales of $1,000 or more were examined, and since the price of individual maintenance policies was less than $1,000, we assume that the four disputed transactions are cases where the customer purchased more than one maintenance policy on the same invoice. Updates were transferred to the customer on magnetic tape in all four disputed transactions; the auditor concluded that tax would not apply to the charge for the maintenance policy in cases where no tape or other tangible personal property was transferred.

The four disputed transactions total $7,860, a tax liability of $510.90. Petitioner calculates that $1,3000.76 tax is in dispute, but we do not know how petitioner arrived at that figure.

Analysis and Conclusions

1. Subdivision (a) of Revenue and Taxation Code Section 6006 defines "sale" to include the "transfer of title or possession…of tangible personal property for a consideration." As an exception to this rule, the courts and this Board have long recognized that a transfer of tangible personal property incidentally to the performance of services is not a "sale". (See, e.g., Albers v. State Bd. of Equalization, 237 Cal.App.2d 494, cert. den. 383 U.S. 960.) Sales and use Tax Regulation 1501 provides that the test to determine whether a transaction is a sale or a transfer of property incidentally to services is the true object of the contract, that is, "…is the real object sought by the buyer the service per se or the property produced by the service." (Emphasis added.)

In this case, the staff appears to agree that telephone consultation is a service which would not in itself result in a tax liability. The staff points out that in all four disputed transactions, however, petitioner also transferred program updates on magnetic tape, and magnetic tape is tangible personal property. At least to that extent, the staff believes that petitioner was selling tangible personal property, not rendering services. Petitioner, on the other hand, contends that the primary purpose of the program updates was to benefit or assist the telephone consultation, and that the transfer of tangible personal property was therefore incidental to the service.

In Simplicity Pattern Co. v. State Bd. of Equalization, 27 Cal.3d 900, the California Supreme Court held that a transfer of tangible personal property is not an exempt service transaction merely because the property is valued primarily (or even solely) for the information recorded thereon. In this case, the magnetic tapes were valuable to the customers and were desired by the customers because they contained program updates. The development of the updates was not a service performed for any individual customer because the updates were "canned".

In short, the true object of the contract was the magnetic tapes and the information recorded thereon, not the development of the information per se. There is thus nothing to distinguish petitioner from any seller of books, records, video tapes or other items valued for their "intangible content". To the extent petitioner transferred magnetic tapes to its customers, therefore, we agree with the staff that the transactions were taxable sales of tangible personal property.

2. Petitioner next contends that even if it sold magnetic tapes, it is unreasonable to tax the entire charge to the customer. According to petitioner 80 percent of its costs for these transactions was telephone consultation, and 80 percent of the charge to the customers should therefore be nontaxable. We disagree.

Subdivision (b)(1) of Revenue and Taxation Code Section 6012 defines "gross receipts", which is the measure of sales tax, to mean the total amount for which tangible personal property is sold, including any charges for "services that are a part of the sale". In numerous published and unpublished opinion letters, the Board has consistently held that "services that are a part of the sale" include any services for which the customer must pay as a condition to receiving the property. Thus, Sales and Use Tax Annotation 295.1690 (8/16/78) states:

> "'Services that are a part of the sale' include any the seller must perform in order to produce and sell the property, or for which the purchaser must pay as a condition of the purchase and/or functional use of the property, even where such services might not appear to directly relate to production or sale costs. Thus, charges described by a seller of catalogs as for preproduction research and consultation services and for postproduction merchandising consultation services are part of the taxable sales price of the catalogs, whether separately stated or not. The first 'service' is a necessary prelude to catalog production; and the second is furnished only to catalog purchasers who are required to pay for the service when they purchase the catalogs, whether or not it is desired or used."

With specific regard to program updates, Annotation 120.0110 (11/5/79) provides:

> "Taxpayer leased a conned program to its customer. For a set monthly fee, taxpayer also notified the customer of any recently developed improvements to the program. If the customer desired to incorporate the improvements into the program, upon payment of an additional charge, taxpayer recorded the entire improved program on magnetic tape supplied by the customer and transferred the tape to the customer.
>
> "The recording of the improved program is a taxable fabrication under Regulation 1502(c)(2). The monthly fee to receive notice of the improvements is included in the measure of tax, since payment of the fee is a prerequisite to purchasing the improvements.

The Board's policy in this area has recently been incorporated into Sales and Use Tax Regulation 1502. Subdivision (f)(1)(C) of the regulation (effective March 4, 1988, after the periods in question here) now provides:

> "If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media…."

Customers who purchased petitioner's maintenance policies had to purchase the entire package. Any customer desiring the program updates therefore had to pay for the telephone consultation as well. It follows that the telephone consultation was a service that was part of the sale of the program updates, and that the entire charge to the customer is subject to tax.

Recommendation

Redetermine in accordance with the reaudit dated February 28, 1989, and without other adjustment to the tax.

_____ 7/16/91

James E. Mahler, Staff Counsel Date