STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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August 26, 1986

Mr. R--- B. R---, Attorney
---, ---, ---, --- & ---
XXXX --- --- ---
--- Floor
--- ---, CA XXXXX

T--- W--- T--- Corporation – S- -- XX-XXXXXX
Word processing services – magnetic storage media

Dear Mr. R---:

In your April 8, 1986 letter to Mr. Joseph J. Cohen, District Principal Auditor for the Board's Hollywood Office, which was referred to me for reply, you request a ruling from the Board that, under the circumstances described below, your client, T--- W--- T--- Corporation, is not liable for sale or use tax on its word processing services, other than its separately stated charged amounts for the cost of the storage media which it transfers to its customers.

In summary, your April 8 letter to Mr. Cohen, Mr. Cohen's April 23, 1986 memo to Mr. Gary Jugum, Assistant Chief Counsel, and your May 22, 1986 letter to Mr. Jugum, together establish the following facts. T--- W--- provides typing and word processing services for its customers. The customer furnishes the taxpayer a handwritten or typewritten manuscript containing edit marks and instructions. The taxpayer keyboards the information into its word processing machines, using magnetic diskettes or magnetic cards as storage media. Normally, only an original is produced and delivered, although a reading copy of the text or additional photocopies are occasionally requested by the customer. When a reading copy or additional photocopies are requested, the taxpayer delivers the required number of photocopies and charges sales tax for the copies.

In many instances, and at the customer's request, the information recorded on the storage media is delivered to the customer. In most instances, the taxpayer will provide the blank storage media used to record the information, but occasionally, it is provided by the customer. The storage media may be used by the customer in its own machines which interpret the stored information for further processing and printing. However, the customer does not normally print out the contents of the storage media, and the purpose of the storage media is to facilitate any corrections or further updating of the text.

The taxpayer bills its customers separately for the specific word processing services provided. Sales tax is charged only on the marked up cost of the blank storage media when it is provided by the taxpayer. (I assume the taxpayer does not charge anything when the customer provides the storage media).

Mr. Cohen contends that a portion of the typing services, representing the fabrication of the blank storage media, is a sale. His view is that, of the itemized charges for typing services, 50% represents fabrication labor of the blank storage media, because approximately the same amount of labor is involved in producing the storage media and the word-processed manuscript.

On the other hand, you contend that under the true object of the contract test set out in Sales and Use Tax Regulation 1501, the true object of the taxpayer's transactions with its customers is the providing of word processing services. The production of a printed manuscript from customer-furnished information could not be accomplished without the use of storage media. Thus, none of the labor expended by the taxpayer is attributable to the production of the storage media, which is only an intermediate step in producing the manuscripts. You point out that the transfers of the storage media are not even covered in the taxpayer's contracts.

You contend that the underlying issue in determining the measure of tax is whether the transactions are properly characterized as sales of tangible personal property or as a performance of services. You contend that the provision of word processing services in which the end product is in human readable form, where storage media are provided incidentally, is a nontaxable performance of services. In such a transaction, the only item which is taxable is the separately stated charge for the storage media.

Opinion

Our opinion is that tax applies to 50% of T--- W---'s charges for typing services to its clients when it transfers storage media to the customer, in addition to the edited manuscript. Tax applies whether the taxpayer encodes customer-supplied media or taxpayer-supplied media. That portion of the total charges which do not represent typing services, but rather are allocable to the taxpayer's effort to produce the manuscript, are nontaxable, and that portion of the total charges which are allocable to the effort to produce a copy of the encoded media, are fully taxable. We reach this conclusion for the following reasons.

First, assume that a taxpayer providing word processing services transferred only a corrected manuscript to its customers. Clearly, in this situation, no sales or use tax would be due, since the Board has always regarded typing services as a service enterprise, and the tangible personal property (the paper) on which the words were written was an incidental part of the transaction. This principle is set out in Sales and Use Tax Regulation 1502.1. You note that this regulation was adopted by the Board after the tax periods in question here. However, we agree with you that these same principles were applicable to transactions which occurred before Regulation 1502.1 was adopted by the Board.

Next, assume that a taxpayer transferred only encoded media (diskettes or cards) to its customers, rather than a manuscript on paper. In this case, the customers will use the media to print out their own manuscripts. Here, tax applies to 100% of the taxpayer's charges for the transfer of the encoded media, even though the charges are largely for the taxpayer's services of typing (keyboarding) the data supplied by the customers onto the media. The same result would apply whether the customers supplied to the taxpayer a marked up manuscript plus its own media, or merely supplied a marked up manuscript without the media. We consider 100% of the charges are taxable, and this result is supported by Intellidata, Inc. v. State Board of Equalization, 139 Cal.App.3d 594. In that case, the taxpayer unsuccessfully contended that its keyboarding activities were services, not sales, in part because the value of the punch cards on which it supplied the data to its customers represented a small fraction of the total charge. The court disagreed, and held that the true object of the contract between the taxpayer and its customers was to obtain the fabricated punch cards. Tax applied to the entire charge notwithstanding that the cost of the charge represented the services of keypunching the data onto the cards. We think Intellidata is authority for the proposition that if a taxpayer such as T--- W--- were to transfer only media, the charges for the typing services would be fully taxable, even though the cost of the blank media is minor in relation to the typing services provided.

Neither one of these situations, of course, represents the facts in this case. Nevertheless, we think the principles set out above apply here. Our view is that the transactions between T--- W--- and its customers are a mixture of sales and services. It is clear that when the customer supplies a marked up manuscript to T--- W---, and receives in return a corrected version of the manuscript, T--- W--- has supplied nontaxable typing services to its customer and the paper on which the manuscript is printed is merely incidental to the transaction. Thus, that portion of the charges which represent T--- W---'s efforts to produce the corrected manuscript are properly characterized as nontaxable service transactions. Mr. Cohen's contentions accurately reflect that these services are indeed nontaxable.

However, it is also clear that T--- W--- is transferring to its customers not merely blank media, but rather media which it has encoded (or an identical copy of that media) as a result of the same typing services which went into producing the corrected manuscripts. As you point out on page 2 of your May 22, 1986 letter:

> The production of a printed manuscript from customer-furnished information could not be accomplished without the use of magnetic media. Thus, none of the labor expended by the taxpayer is in fact attributable to the production of machine readable information, which is only an intermediate step in producing the true object of the contracts.

While it is true that the taxpayer must use magnetic media to produce the manuscripts on its equipment, it does not follow that the taxpayer must transfer that media (or a copy) to its customers. What we are concerned with is not the taxpayer's use of the media, but rather the customer's use of that media. If all the customer wants is the corrected manuscript, it has no use for the media.

You point out that the customer may in fact never use the media for any purpose other than to store the encoded information, and specifically may never use the media to print out another copy of the manuscript. It still remains the case that the transfer is a retail sale of the media because tax applies when a customer stores tangible personal property, as well as when a customer makes some use of the property other than storage. A retail sale is a sale for any purpose other than resale in the regular course of business. Revenue and Taxation Code Sections 6007, 6008, 6201.

As you point out, T--- W--- separately charges its customers for the marked up cost of blank storage media, if T--- W--- supplies the media. However, T--- W--- is not transferring blank media to its customers; rather, it is transferring media which have been encoded with the keystrokes used to produce both the corrected manuscript and the media. In this situation, our view is that T--- W--- is underreporting sales tax on the media. As in the Intellidata case, T--- W--- has transferred tangible property which has a value greatly in excess of the blank media. The charge which is subject to sales or use tax should include the value of the services which T--- W--- is rendering to its customers. Of course, we have acknowledged that these same typing (keyboarding) services have also gone into the effort by the taxpayer to produce the corrected manuscripts. In this situation, our conclusion is that where the charges for the typing services have not been properly allocated between the exempt service transaction and the taxable sale, and an equal amount of effort has gone into producing both the service and the sale, the taxable portion of the charges for the typing services should be 50% of the total.

Please feel free to contact me if you have any further questions or comments about this letter.

Sincerely,

John Abbott
Tax Counsel

JA:hb

cc: Hollywood – District Principal Auditor