

**M e m o r a n d u m****120.3645****To :** Mr. Donald J. Hennessy**Date:** January 31, 1995**From :** David H. Levine**Subject:** E--- S--- G---

Since the Board hearings and related activities interrupted our discussion of this matter, I am laying out my views in the memorandum. You questioned the analysis in my response to petitioner's request for reconsideration. Petitioner had customized a prewritten program for its customer. It made a separately itemized charge for the customization, and neither paid tax nor was assessed tax on such charge. It also made a monthly charge for the software, without further itemization. I concluded that the monthly charge did not qualify as a charge for a customized program since well over half the charge was attributable to the prewritten program.

The petitioner contended that even though it made a separately itemized charge for the customization and another charge for the prewritten portion, the entire charge must be regarded as nontaxable if 50 percent or more of the total charge is for customization. This contention is clearly wrong, and is unsupported by the applicable statute or the wording and logic of the applicable regulation.

As relevant here, Revenue and Taxation Code section 6010.9 states that a custom computer program "includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.... Modification to an existing prewritten program to meet the customer's needs is custom computer programming only to the extent of the modification." (Emphasis added.) If we were to look only to this language, I do not think there could be any dispute whatsoever. It appears that, under a strict reading of the statute without regulatory clarification, separate itemization would be irrelevant - charges attributable to modifications would always be nontaxable and charges attributable to the prewritten program would always be taxable.

However, Regulation 1502 does clarify the application of tax to such contracts. The relevant provision is subdivision (f)(2)(B):

"However, charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as services part of the sale of the prewritten program.

"When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified

program unless the modification is so significant that the new program qualifies as a custom program....”

The first paragraph of this provision is the only portion that states the rule applicable to transactions, such as in the E--- case, where there is a separate statement of the charges for modifications. When there is such a separate statement of charges for customization, what is nontaxable is the separately itemized charges for customization. The second paragraph of this provision states the rule applicable when there is no separate itemization of charges for customization. Thus, under this provision, it is only under circumstances where there is no separate itemization of charges for modifications where we look to whether the program is at least 50 percent customization. Thus, the wording of this provision clearly supports my view, and my interpretation of this provision is consistent with the wording of the statute while petitioner's view is not. Furthermore, I concluded that, if there is a separate statement of charges for customization, the portion of the charge not itemized as for customization is not automatically regarded as taxable. Instead, I concluded that the 50 percent analysis must be performed with respect to that portion of the charge if it contains any non-itemized amounts for customization. This view is also clearly supported by the logic of the regulatory provision.

Arguably there should be no 50 percent rule under the statutory language because the statute appears to say that charges for customization are nontaxable only to their actual extent. However, the logic of the regulatory rule is that we are not going to split the baby. If the seller separately itemizes a charge for modifications, it is in effect selling two items, the prewritten program and the customization. If it does not separately itemize a charge for customization, then it is selling one item, and either the entire program qualifies as a custom program or none of it does.

In the present matter, E--- made a separate charge for customization and another charge that was not separately itemized between prewritten portions and custom portions. In effect, it sold about \$485,000 worth of customization and the remainder of the program for \$7,225 per month. Thus, the second paragraph of subdivision (f)(2)(B) of Regulation 1502, which applies only with respect to charges that are in lump sum, cannot apply to the entire charge since there was a separate charge for itemization. However, this is the very reason that it is appropriate to perform additional analysis on the sale (lease) of the remainder of the program to ascertain whether that portion of the sale qualifies, separately, as a custom program. If 50 percent or more of the charge for that portion of the program is for customization, then under the second paragraph of subdivision (f)(2)(B) of Regulation 1502, that charge also qualifies (separately) as a charge for nontaxable customization. If less than 50 percent of the charge is for the customization, then the second paragraph of subdivision (f)(2)(B) of Regulation 1502 mandates a conclusion that such charge is a taxable charge for the sale (lease) of a prewritten program.

I note that a deviation from the rule stated above could cause problems in addition to being wrong (in my opinion). For one thing, there is now certainty: if a seller separately charges for customization, that charge is nontaxable and the remainder is taxable (except in the unusual circumstance that 50 percent or more of the remaining charge is also for customization). I

believe that both the industry and the Board has so regarded such transactions, without the further analysis that petitioner here proposes.

What petitioner is really contending is that we should disregard its separate statement of itemization so that it can climb back into the rule applicable to lump sum billings. As explained above, there is no support for such contention in either the language or logic of the statute and regulation. If such a rule were adopted, we should be prepared to grant refunds on this basis. That is, sellers of such property who hear of such a rule will certainly review their records to determine which programs sold during the last three years with a separately itemized charge for customization qualify as entirely nontaxable even though such sellers and the Board have relied on such separate statement to ascertain which portions of the contract were for the sale of customization (nontaxable) and which were for the prewritten program (taxable).

If you wish to discuss further, please let me know.

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cc: Mr. William D. Dunn