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December 29, 1986

R--- J. F---
F--- & A---
XXXX --- Ave., Suite XXX
---, CA XXXXX

Re: Installation or Fabrication; Software Licenses

Dear Mr. F---:

This is in response to your letter dated October 21, 1986 regarding whether charges for certain labor are subject to sales tax as fabrication or excluded from sales tax as installation, and whether charges for software maintenance are subject to sales tax.

Fabrication/Installation

You set forth a situation in which equipment is sold for a stated price and a separately stated installation charge. You ask specific questions concerning how to determine if those separately stated installation charges constitute taxable fabrication.

> "1. If the property was fully assembled and tested, or partially assembled and tested prior to shipment does the reassembly constitute installation or fabrication?"

Generally, these charges for reassembly constitute services that are part of the sale of equipment under Revenue and Taxation Code section 6012(b)(1). (Business Taxes Law Guide ("BTLG") Annotation 315.0080 (9/15/65).) However, if the equipment is fully assembled then disassembled for shipment and reassembled at the buyer's place of business, the reassembling will constitute a nontaxable reconditioning of the property rather than fabrication if: (1) the charges for reassembly are separately stated; 2) title to the equipment passed to the buyer prior to its reassembly under the terms of the contract; and 3) the buyer was not required to hire the seller to do the reassembly as a condition to purchasing the equipment. (BTLG Anno. 435.0140 (11/14/67).) Please note that the discussion immediately above applies only to situations in which the equipment is fully assembled prior to its disassembly. The original assembly to produce a completed piece of equipment is always taxable fabrication labor, whether performed by the seller of the equipment or by a person hired by the buyer solely to complete the fabrication.

"2. Is the distinction one of assembly versus plugging in, leveling, balancing and test operating a valid distinction?"

This is a valid distinction. For example, charges for all services involved in producing a finished organ are taxable as fabrication labor. However, charges for the labor of tuning, testing, and adjusting the organ for the purpose of adapting the tone to the particular acoustics of the building in which the organ is installed are charges for installation and are not subject to sales tax under Revenue and Taxation Code section 6012(c)(3). (BTLG 315.0340 (9/21/50).)

"3. Is the distinction one of attaching separate units versus having property delivered in one container?'

This is not a valid distinction. For example, if a piece of equipment consists of four separate units requiring attachment to each other to create the completed product, the labor of attaching those units together is taxable fabrication labor. This is true whether the four separate units are delivered to the buyer in one container or in four separate containers.

"4. Is it installation if the property is delivered in one container and the installer merely unpacks, lubricates, adds fluids and tests the property?"

This question appears to be the same as your question number 2. As such, our answer is, again, that this is nontaxable installation. If I have misunderstood this question, feel free to contact me.

"5. Is the distinction one of whether the seller's representative versus any service agent can 'install' the property?"

This is not a valid distinction. If labor is required to produce the finished product, that labor is fabrication labor regardless of who performs it. If the labor constitutes installation, the charges for such labor are excluded from taxation regardless of who performs that labor. (Rev. & Tax. Code § 6012(c)(3).)

"6. Is it installation if owner of property disassembles property and has an outside agency reassemble the property?"

Generally, if the property has been fully assembled prior to its disassembly and is not substantially different in its reassembled form from its original form, we would consider the outside agency's labor to be the rendering of a nontaxable service. (Reg. 1501; see my response to your question number 1.)

"7. Do any of the answers above change under the guise of a lease transaction?"

There is generally no distinction with regard to your questions between a outright sale and a lease transaction. For purposes of sales and use tax, a lease of tangible personal property, subject to certain stated exception, constitutes a sale and a purchase. (Rev. & Tax. Code §§ 6006(g), 6010(e).)

Software Maintenance

You ask whether charges for the following transaction must be included in the measure of tax:

> "A software manufacturer sells a piece of canned software and in so doing grants a non-exclusive license to the purchaser in perpetuity. The seller also offers a maintenance agreement under which it will make corrections in the software brought to its attention by the specific user or any other user. Under the maintenance agreement, the seller will provide enhancements at no additional cost, if and as they become available. No representation is made that there will be enhancements during the term of the agreement (usually one year at a time). The maintenance agreement is characterized as an optional continuation of the warranty."

The enhancement of a computer program generally results in the fabrication of a complete new program with the changes incorporated in it. Our experience has been that most program modifications or enhancements are made by reading the original program information from auxiliary storage (tape, disk, or drum), making the required modifications, and then recording the modified program into auxiliary storage on a different tape, disk, or drum. After testing the modified program, the original program is destroyed.

A typical program enhancement and maintenance contract is an optional contract that provides for correcting program errors, improvement or updating of computer systems, and consultation services. Generally, the elements covered by the maintenance portion are telephone support to discuss and solve problems, support operating systems, and correction of problems. Program refinement or enhancement and documentation to support changes are generally provided under the enhancement portion of the package. I assume that the enhancements in question do not constitute nontaxable "custom computer programs" under Revenue and Taxation Code section 6010.9.0

When tangible personal property (tapes, disks, or drums as previously explained) is transferred in performing enhancements, these transfers are taxable as either sales or leases. (Rev. & Tax. Code §§ 6051, 6201; Reg. 1502.) Whether a transfer is a sale or lease depends on whether the customer receives title to the property or merely receives the temporary use of the property.

In situations where the customer pays a monthly fee for consulting services and an additional fee for all tangible personal property transferred, only the charges relating to the tangible personal property are subject to tax. In situations where there is a transfer of tangible personal

property in providing program enhancements under a lump-sum optional computer program enhancement and maintenance contract, the total charge made for the contract become subject to tax in the quarterly reporting period in which the first piece of tangible personal property is delivered to the customer. If, during the course of an individual contract, no tangible personal property is transferred, then no tax would be due on that contract.

You should note that revisions to Regulation 1502 have been proposed. If these revisions are adopted, charges for the transfer of certain computer programs and for the fabrication of certain customer owned computer programs, each currently subject to sales tax, may be excluded from taxation. The public hearing on the proposed revisions is scheduled for March,, 1987. We are placing your name on the list of interested parties who will receive notices regarding the proposed revisions.

Sincerely,

David H. Levine
Tax Counsel

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