

Memorandum

490.0585

To : Mr. Donald Herrmann
Out-of-State Auditing, New York

Date: December 18, 1992

From : David H. Levine
Senior Tax Counsel

Telephone: (916) 445-5550
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Subject: D--- of California, Inc
SY --- XX-XXXXXX

Your memorandum dated November 4, 1992 has been referred by Out-of-State District Principal Auditor Jack Warner to the Legal Division for response. D--- sells and leases equipment along with maintenance agreements. Your questions relate to whether those maintenance agreements are subject to tax as mandatory maintenance agreements.

Prior to addressing the specific facts involved in the subject transactions, I will answer your general question regarding what constitutes a mandatory maintenance agreement within the meaning of Regulation 1546 (see also Regulation 1655). You ask whether the determination is made in the context of the seller's regular business practices or whether the determination is made on a transaction by transaction basis. That is, you ask whether a maintenance agreement is optional if the seller is willing *on occasion* to sell the equipment without requiring the purchaser to purchase the maintenance agreement, or is it mandatory when a purchaser must purchase it in order to purchase the tangible personal property even if other purchasers are not required to purchase the maintenance agreement.

Whether a particular maintenance agreement is mandatory depends on the terms of that *particular* transaction. If a purchaser is required to purchase a maintenance agreement in order to purchase tangible personal property, the maintenance agreement is mandatory within the meaning of Regulation 1546 without regard to whether any other purchaser faces the same requirement.

Many sellers treat all their customers the same. When a seller treats all its customers the same, the fact that some customers obtain property with a maintenance agreement and

some obtain the same property at the same price but without the maintenance agreement shows that the maintenance agreement is optional (i.e., since some customers did not take a maintenance agreement and all are treated the same, the others could also have obtained the tangible property without taking the maintenance agreement). Thus, the fact the some purchasers obtain the tangible personal property without being required to purchase a maintenance agreement is relevant to the analysis.

Some sellers do not treat all their customers the same. A seller may treat certain preferred customers or large customers with economic clout differently than it treats nonpreferred small customers. For example, a seller may sell 10,000 units, 1,000 under a single contract to General Motors and the other 9,000 to individual purchasers. The seller may sell the property to GM without requiring GM to obtain a maintenance agreement (and may sell the units for a lower price, but that is not relevant here). The seller may require each of the other 9,000 individual purchasers to obtain a maintenance agreement from the seller, except the 5 purchasers who are in seller's immediate family. The fact that GM and the seller's family were not required to purchase maintenance agreements does not make the 8,995 maintenance agreements the other purchasers were required to purchase optional. Rather, each of those other purchasers were required to purchase the maintenance agreements, and they are therefore mandatory maintenance agreements within the meaning of Regulation 1546.

When a maintenance agreement is required as part of a particular sale of tangible personal property, the charges for that agreement are taxable. If the maintenance agreement is required for six months and then can be renewed or not at the election of the purchaser, the agreement nevertheless is a mandatory maintenance agreement, but only for the first six months. That is, the charge for the first six months is taxable, but if the agreement is renewed, the renewal is an optional maintenance agreement the charge for which is not subject to tax.

The D--- contract

With these general rules in mind, I will address the transactions about which you inquire. Initially, however, I note that I do not understand your explanation of those transactions, and my opinion is necessarily based on the facts that I believe are applicable.

The contract appears to cover three types of transactions, an outright sale, a transaction referred to as a lease, and a transaction referred to as a rental. The term rental is used to cover a transaction where D--- is the lessor of the equipment to its customer. The term lease is apparently used to cover the common type of arrangement where the customer contracts to *purchase* property from D--- and thereafter contracts with a financing company to either sell and leaseback the subject property or assign the contract of sale to the financing company prior to completion of the sale and then lease the property.

We have been provided virtually no information with respect to any potential transaction between the purchaser and a third party financing company. It does not appear likely that any such transaction would affect the analysis, and since no information has been provided I will not engage in a discussion of hypothetical transactions (i.e., I would have to think up the most likely of the various scenarios for those transactions to properly cover the subject). Instead, I will examine only the transaction between D--- and its customers.

The contract covers the sale of the equipment, maintenance of that equipment, and other services provided by D---. Section I states that it continues in effect, month to month, until terminated by either party upon 60 days notice. D--- asserts that this provision means that the maintenance agreement is not mandatory since, upon payment of the sales price and sales tax, title passes to the purchaser.

Section II.D states that purchaser agrees to buy the computer and use it in connection with the D--- Service. That same provision has a reference to "if the equipment is leased." This appears to be a reference to the type of transaction mentioned above where D--- has made an outright sale and the lessor is a third party. The face of the contract has a location to enter the term and cost of the lease along with the statement "per separate lease agreement." Section VI of Schedule A, quoted below, confirms that this separate lease agreement is a lease agreement where neither the lessor nor the lessee is D---. As noted above, since an exemplar of any such agreement has not been provided to us, this opinion does not consider such transactions. The provision also states that if the equipment is rented, certain of the rentals would be credited to the purchase price (this covers the situation where D--- is the lessor). The face of the contract includes a line to indicate the cost of the rental per month with the statement "per Schedule A." However, I do not see any reference in Schedule A to rentals.

Schedule A is a listing of the various equipment that D--- has available for sale to its customers. One column is titled "Price" and the other column is titled "MMC." I have not found a definition of MMC in the documents we have, but I assume it stands for "**Mandatory Maintenance Charge.**" Section I of the terms and conditions states that "D--- will maintain the equipment in good working order, providing on call at the doctor's office, the necessary labor and parts and make the necessary adjustments, replacements and repairs" Section VI states:

"The equipment can be purchased outright, leased or rented. When the equipment is purchased the computer shall become, upon payment of the sales prices and sales tax, the sole and exclusive property of the Practice. Title to the computer shall not vest in the Practice until full payment of the sales prices and applicable sales taxes. When the equipment is leased, title passes to the leasing company and a separate lease agreement between the practice and the leasing company governs title to the equipment. When the equipment is rented, title to the equipment remains with D---."

Schedule B is a listing of software sold by D--- to its customer. Section II of the terms and conditions states:

"D--- will provide support for all of its proprietary software and the Practice is required to accept and pay for such software support..." (Emphasis in original.)

Discussion

The easy answer to your question is that, if any maintenance is required in order to purchase the equipment, the charge for that mandatory maintenance is subject to tax. The terms of D---'s contract are not entirely clear on this point, and there is surely other documentation (e.g., brochures and other sales literature, and any other contracts, including the third party financing contracts) which would shed light on this issue. Since such other documentation has not been provided to us, my analysis is limited to the contract itself.

D--- argues that since either party can cancel upon 60 days notice, the maintenance is optional. It is not clear just what can be canceled upon 60 days notice. It is clear, however, that at a minimum the purchaser must purchase at least 60 days of maintenance. This maintenance is mandatory, and the charge for it is subject to tax. It is also clear that the purchaser is required to accept and pay for software support. That support is mandatory, and the charge for it is also subject to tax.

Now we reach the more difficult question, is *any* of the maintenance optional? Section I of the agreement states that either party can cancel on 60 days notice, but Section II.D states that the purchaser agrees to use the equipment in connection with the D--- Service, and the maintenance charge is itemized on Schedule B along with the charges for other services. D--- asserts that the purchaser could cancel but the equipment would remain the property of the customer. However, the contract states that D--- owns the equipment until it is paid for, and this would mean that if the customer canceled prior to paying for the equipment, under the terms of the contract D--- would own the equipment.^{1/}

If the purchaser is entitled to terminate the maintenance agreement after 60 days, then

^{1/}Under Uniform Commercial Code § 2401, such a retention of title by D--- until the purchase price is paid is a retention of title solely for purposes of security. Thus, notwithstanding the provisions of the contract, the purchaser owns any equipment it has contracted to purchase upon D---'s completion of its responsibilities with respect to physical delivery of the property. My reference to this contractual provision is solely for the purpose of demonstrating that the contractual provisions related to the issue at hand are not entirely clear and that D---'s assertions are contrary to the literal provisions of the contract.

I would agree that the maintenance agreement would be regarded as optional after 60 days. However, even though the contract is susceptible to such an interpretation, it is anything but clear, and based on the information we have at this time, I am not prepared to conclude that the maintenance is optional after 60 days.

A complete package of *all* relevant documents (i.e., all contract documents and relevant sales literature) would assist in the analysis. Other facts relevant to the analysis, as indicated above, would be the answers to the following questions. Do any of D---'s customers terminate the maintenance agreement after 60 days?^{2/} If so, do these customers have the same contract as D---'s other customers? If the answer to each of these questions is yes, it would be convincing evidence that the parties to the contract understood the provision in question to provide for a mandatory maintenance agreement for 60 days, and optional renewals thereafter.

The discussion above relates to transactions where D--- makes outright sales of the equipment in question. When D--- is renting the equipment, that is, when D--- retains true ownership of the equipment and as the lessor leases the equipment to its customers, there is nothing in the documentation we have that indicates that D--- would continue to lease the equipment without requiring the lessee to also purchase the maintenance agreement from D---. Without further documentation, I conclude that all maintenance charges related to leases by D--- are mandatory.

In summary, I conclude that the charge for software support is subject to tax and that all charges for maintenance are taxable when D--- is the lessor of the equipment. I conclude that when D--- is selling the equipment outright, the charge for the first 60 days of maintenance are taxable. I do not have sufficient information to reach a conclusion with respect to the charges for maintenance beyond 60 days when D--- makes outright sales of the equipment.

If you have further questions, feel free to write again. If you do so, please provide a step by step chronological description of the transactions about which you inquire along with any other information, as mentioned above, which you obtain.

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cc: Out-of-State District Administrator

^{2/}Please bear in mind that this question relates to D---'s customers, that is, those persons identified in the contract as "the practice." This question does *not* relate to the lessors who might purchase the property from that customer and lease it back.