State of California

Board of Equalization

Business Taxes Appeals Review Section

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: REDACTED TEXT	)	DECISION AND RECOMMENDATION
Petitioner	)	

The above-referenced matter came on regularly for hearing before Tony Nevarez on March 8, 1991, in REDACTED TEXT, California. On April 18, 1991, a Decision and Recommendation was issued recommending that the petition be granted. Subsequently, both the Sales and Use Tax Department and petitioner requested reconsideration. The matter was re-scheduled for conference and was heard on September 17, 1991 in REDACTED TEXT, California.

This Decision and Recommendation supersedes the prior Decision and Recommendation dated April 18, 1991.

Appearing for Petitioner: REDACTED TEXT

Appearing for Sales and Use Tax Department: REDACTED TEXT

Protested Item

The protested tax liability for the period July 1, 1985 through June 30, 1988, is measured by:

Item	State, Local and County
Unreported receipts from sale of "price updates" culled from taxpayer's data base and delivered to customers on computer floppy disk	$ REDACTED TEXT

Petitioner's Contentions

The "price updates" which it sells to pharmacies are not taxable since such updates are simply the product of researching drug price changes and delivering such price changes to its customers. Furthermore, such price updates are not maintenance contracts sold in connection with the sale of computer equipment or software.

Summary

Petitioner is a corporation engaged in the business of retailing computer hardware, software and related supplies, as well as engaging in the repair of computers. The corporation began in business in 1981 and its business caters primarily to the pharmaceutical industry. This is the first audit of this account.

During the audit, audit staff representing the Sales and Use Tax Department (Department) examined petitioner's general ledgers, sales journals, sales invoices, sales agreements, and miscellaneous business tax schedules. The audit initially set up a measure of tax comprised of eight audit items. Petitioner protests only one audit item.

The Department noted that in addition to selling computer hardware, petitioner sold computer software programs to various pharmacies. The basic software program was intended to provide a basic operating system for the computer and at the same time contained drug prices on the most common drugs and drug products used by the pharmacists. In addition to the basic computer software program, petitioner sold to the pharmacies what it termed a "price update" feature for a flat fee per month. The price update feature (hereinafter "update") entitled purchasers of the basic program to receive price updates on those prescription drugs and drug products on a twice-monthly basis.

Initially, the Department contended that the sale of the price update feature was a taxable transaction because the price updates were in essence a maintenance contract, and were sold in conjunction with the underlying software program. My original Decision and Recommendation, dated April 18, 1991, accepted the characterization of the updates as maintenance contracts, but nonetheless concluded that the sale of the updates were non-taxable sales of optional maintenance contracts. Both the Department and petitioner took issue with my decision, thus a rehearing was scheduled.

During the subsequent conference, held in September of 1991, petitioner supplied additional clarifying information and details which bear upon this case. Petitioner conceded that it sells canned software and that these sales are properly taxed. Petitioner also explained that in conjunction with the sale of the software program, it sells the standard maintenance contracts which cover the software and hardware. The maintenance contract covering the software includes the error corrections feature and the program improvements feature. They also sell the standard phone consultation services. Petitioner took no issue with the treatment by the audit staff of these items.

Contained within the basic software program, continued petitioner, are several specific "files" including a Patient File, Doctor File, Accounts Receivable File, Drug Formulary File, and the Drug Price File. The Drug Price File contains a listing of over 7,000 individual drugs and drug products, and their corresponding prices. The basic software package, when sold, contains the file of the current prices on these drugs and drug products. What the updates are intended to do, is update the prices of these drugs and drug products on a twice monthly basis. Thus, continued petitioner, these updates are not maintenance contracts because they have nothing to do with the underlying software; they have no impact upon the continued operation or non-operation of the underlying software. If the updates are not purchased, the software continues to operate as it was intended to do, stated petitioner.

During the conference, petitioner once again explained the operation of its price update system. According to petitioner, drug and drug product prices are maintained on the main computer data base at its headquarters. An employee keeps abreast of the changes in prices of the different drugs and drug products and promptly inputs these price changes into the main computer data base. Twice per month the new prices are transferred onto a computer diskette and sent to the pharmacies which have purchased the update. Petitioner continues to send the price updates irrespective of whether the pharmacies' underlying software has been affected by subsequent error corrections or program improvements.

Petitioner vigorously contests characterizing the price updates as a program or a program update. Petitioner points out that a program is defined in the Regulation as performing a complete function or routine. In contrast, the update does not perform a separate function or routine. The information transferred on the computer diskette cannot perform a function nor can it stand alone and be useful. Its only utility comes when it is combined with the software. Add to these facts, continued petitioner, the fact that it sells separately the program updates and error corrections, and it is obvious that these updates are not separate programs nor are they within the contemplation of the traditional maintenance contract.

Petitioner also vigorously argues that what it sells is in reality a service, and any transfer of tangible personal property, i.e., the diskette, is merely incidental to the rendition of such services. According to petitioner, its employees collect the price change information to create their own central data base of drugs and drug prices. This data base is continually being updated. What the customers purchase with the updates, continues petitioner, is the service of having someone research all relevant price changes and input them onto a media which is accessible by the software in their own computer.

Only a small portion of the main data base is transferred with the transfer of each diskette. The information is transferred onto either a 3-1/2 inch, 5-1/4 inch, or other size diskette, according to the customer's special requirements. According to petitioner, most, but not all of the diskettes transferred, contain the identical information. The diskettes are purchased in bulk and the updated information is transferred by its employees onto the diskette for mailing to the customer. In a few cases, however, a separate, made-to-order diskette is prepared for the customer. This occurs in those instances where the customer's software or hardware is incompatible with the program format utilized by petitioner with the data base. In those cases, a separate and different computer operation is required to access the same information and transfer that information onto the disk intended for the customer.

When the price update diskette is fed into their computer, the software will access the price changes and incorporate the drug and drug product files accordingly. Petitioner states that the price changes can be obtained by anyone, free of charge, through published sources either from the drug companies or from the state agencies which monitor such price changes. Petitioner further stated that many of its initial customers do not purchase the updates, choosing instead to track the price changes and input such changes themselves.

Analysis and Conclusions

The Revenue and Taxation (Rev. and Tax.) Code imposes a sales tax upon the privilege of selling tangible personal property at retail. Liability for the tax is not extinguished until the tax is paid or satisfactory proof of exemption is shown. (See, generally, Rev. and Tax. Code, sections 6051, et. seg.; Western L. Co. v. State Bd. of Equalization (1938) 11 Cal.2d 156, 164.) The measure of tax is the retailer's "gross receipts" which includes: "All receipts, cash, credits, and property of any kind .... " (Rev. and Tax. Code, section 6012(b) (2).) The burden of proving entitlement to an exemption from the tax is upon the taxpayer and does not shift from the taxpayer to the Board since the taxpayer is in the best position to create and maintain records of his transactions. (H.J.Heinz Co. v. State Board of Equalization (1962) 209 Cal.App.2d 1, 4; Pope v. State Bd. of Equalization (1988) 202 Cal.App.3d 73, 84.)

From the facts collected thus far, I accept as correct the characterization that what petitioner sells is not a program update or maintenance contract. It appears that what petitioner is selling in each transaction, is a small portion of the information from its data base on a computer diskette. It also appears that in the majority of transactions, petitioner is transferring the identical information with each diskette, albeit on different types of diskettes.

Not surprisingly, the taxability or non-taxability of precisely this transaction is not easily solved by reference to statutes or regulations, because there are none on point.

A review of Sales and Use Tax Regulation (Regulation) 1502 indicates that the exemption from tax for manipulation or processing of customer-furnished information (1502(d)) does not apply here because the information being manipulated or processed belongs to petitioner in the first instance. At the same time, the provisions for data processing (Regulation 1502) or word processing (Regulation 1502.1) also do not apply since petitioner is performing neither process.

Regulation 1501 dealing with service enterprises appears to be the only authority to draw upon. When the true object of the contract of sale is a service, charges for such activity are not subject to tax. In general, the regulation provides that:

> "Persons engaged in the business of rendering service are consumers, not retailers, of the tangible personal property which they use incidentally in rendering the service. Tax, accordingly, applies to the sale of the property to them. …
>
> "The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of 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. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred .... [Tax would not apply where] the true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property .... Tax would apply to the sale of mere copies of an author's works or the sale of manuscripts written by other authors where the manuscript itself is of particular value as an item of tangible personal property and the purchaser's primary interest is in the physical property. Tax would also apply

> to the sale of artistic expressions in the form of paintings and sculptures even though the work of art may express an original idea since the purchaser desires the tangible object itself; that is, since the true object of the contract is the work of art in its physical form.
>
> "When a transaction is regarded as a sale of tangible personal property, tax applies to the gross receipts from the furnishing thereof, without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property…"

In interpreting this regulation with regard to similar businesses, the Board has adopted several rulings which are published in the Business Taxes Law Guide as Sales and Use Tax Annotations. Of some similarity is Annotation number 515.0950 (7/26/88) which holds that charges for researching information on a taxpayer-owned data base and sending that information to a customer via a computer printout are nontaxable. Quoted in its entirety, the Annotation provides:

> "A client contacts the taxpayer with the medical name of the client's ailment. The client commonly questions a diagnosis their doctor has given. The taxpayer researches the most current medical information on the ailment in a computer data base and sends the client a computer printout discussing the ailment. The charge for such research and computer printout is for a nontaxable service. The true object of the transaction is medical diagnosis. The computer printout is the means to transmit the product of the service and is only incidental to providing the service of medical research and diagnosis. The charges for such a service are not subject to tax."

The background letter which became the ruling indicates that a customer would call in a medical name to the taxpayer. The taxpayer would then locate the information on its pre-existing data base and print a hard copy for the customer. It is presumed that under the facts of that case, more than one customer received the identical information on a printout. Yet that case held that the transactions were non-taxable as a service.

This case, however, posits a very different situation wherein the petitioner copies select information onto a computer diskette and delivers that diskette to its customers. The diskette is copied or produced en masse for each distribution. With the very few exceptions noted above, there is nothing to distinguish one diskette from another. I believe that petitioner is making tangible personal property and that this case falls within the provisions set forth in section 6006 of the Revenue and Taxation Code as a taxable sale.

A "sale" is defined within section 6006 of the Revenue and Taxation Code to mean and include:

* * *

> “(b) The producing, fabrication, processing, … of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, processing … [or],

* * *

"(f) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer. …"

Although the process by which petitioner creates the final product for sale in this case involves some degree of services, this does not necessarily lead to the conclusion that all receipts from such sale are non-taxable. Every tangible article sold at retail is a combination of value created by incorporating both material and services. It is only where the true object of the transaction is the performance of specialized services rather than the finished article itself that the sale of the final product crosses the line and becomes non-taxable. (See, generally, Duffy v. State Bd. of Equalization (1984) 152 Cal.App.3d 1156, 1164; 199 Cal.Rptr. 886; MCI Airsignal. Inc. v. State Bd. of Equalization (1991) 1 Cal.App.4th 1527, 1530-1531.)

In a case such as this, where petitioner mass-produces the identical diskette for sale to hundreds of customers, I can only conclude that the receipts from such sales are taxable as charges for the production, fabrication or processing of tangible personal property and are not exempt as receipts from the provision of services.

Recommendation

Redetermine without adjustment.

_____ 3-27-92

Tony Nevarez, Staff Counsel Date

State of California

Board of Equalization

Appeals Division

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: REDACTED TEXT	)	HEARING
	)	DECISION AND RECOMMENDATION
Petitioner	)	

The above-referenced matter came on regularly for hearing before Hearing Officer Tony Nevarez on March 8, 1991, in REDACTED TEXT, California.

Appearing for Petitioner: REDACTED TEXT

Appearing for Sales and Use Tax Department: REDACTED TEXT

Protested Item

The protested tax liability for the period July 1, 1985 through June 30, 1988, is measured by:

Item	State, Local and County
Unreported receipts from sale of Computer program maintenance contracts	$ REDACTED TEXT

Petitioner's Contentions

The price update feature which it sells to pharmacies which purchase its software is an optional maintenance contract and the receipts derived from such sales are non-taxable.

Summary

Petitioner is a corporation engaged in the business of retailing computer hardware, software, and related supplies, as well as engaging in the repair of computers. The corporation began in business in REDACTED TEXT and its business caters primarily to the pharmaceutical industry. This is the first audit of this account.

During the audit, audit staff representing the Sales and Use Tax Department (Department) examined petitioner's general ledgers, sales journals, sales invoices, sales agreements, and miscellaneous business tax schedules. The audit initially set up a measure of tax comprised of eight audit items. Petitioner protests only one audit item.

The Department determined that in addition to selling computer hardware, petitioner sold computer programs to various pharmacies. Its basic program consists of a drug product information data base and the prices for approximately 6,000 such drugs and drug products. In addition to the basic computer program, petitioner sold what it termed a "price update" feature for a flat fee per month. The price update feature (hereinafter "Update") entitled purchasers of the basic program to receive price updates on the drugs and drug products on a twice-monthly basis.

The Department determined that the Update was in reality a maintenance contract. The Department further determined that purchase of such an Update was not optional to the purchasers of the basic program. Therefore, the Department included within the measure of tax all receipts from such Update contracts. The Notice of Determination was issued on July 31, 1989, and this petition for redetermination was timely filed.

During the hearing on this petition, the Department repeated its contention that receipts from the Updates were taxable items and cited to a copy of petitioner's form agreement which had been obtained by the audit staff. Pursuant to the sample agreement, the Updates were not clearly identified as being optional, therefore, all receipts were considered to be taxable receipts.

During the hearing, petitioner explained the operation of its price update system. According to petitioner, it has a full time employee who keeps abreast of the changes in prices of the approximately 6,000 different drugs and drug products. Twice a month the new prices are transferred onto a computer diskette and sent to the pharmacies which have purchased the Update. The price updates are then incorporated into the drug price software program which the pharmacy uses so that the prices are kept current. The Update, continued petitioner, is similar to the traditional maintenance contract which entitles the purchaser to free upgrades whenever the software is upgraded, or which entitles the purchaser to free corrections whenever the software is found to contain errors or defects.

Petitioner explained at length that the current ownership of the corporation had taken over in early 1985, having taken over the corporation at a time when the corporation was in trusteeship. At that time, continued petitioner, all existing users of the Update system were offered the option of purchasing the Update as well as a standard computer program maintenance agreement. Petitioner also explained that when the new ownership came in, they had no form agreements of their own and that they had for some time used the holdover forms which the old corporation had utilized. Petitioner was unable to explain the origin of the form agreement in the audit workpapers, but opined that the agreement derived from the old corporation. Petitioner stated that the present business uses a modified version of such an agreement in its business transactions.

During the hearing, petitioner stated that the Updates are a form of maintenance contract, but maintained repeatedly that purchase of the Update, as well as all other maintenance contracts it sells, are entirely optional. Petitioner testified that with the sale of the computer program, the first two months of price updates are free to the purchaser and that at the end of the two month

period, the purchaser of the program then chooses to continue the Update contract, or not. Should the purchaser elect to continue the Update, the "Subscription Agreement" is signed and the purchaser begins paying a flat monthly fee which is billed separately. Petitioner estimated that about 70 percent of the purchasers of the software program elect to continue with the price update contract.

At petitioner's request, the record was held open an additional 15 days to allow it to locate and submit sales agreements and other documentation which reflect its contentions that the Updates were in fact optional. Petitioner has submitted extensive documentation which has been reviewed by the audit staff and this hearing officer. Of particular interest, are copies of two different sales agreements. One shows a purchase of the computer system and the Update, and the other shows a purchase of a system without the update.

Analysis and Conclusions

The Revenue and Taxation (Rev. and Tax.) Code imposes a sales tax upon the privilege of selling tangible personal property at retail. Liability for the tax is not extinguished until the tax is paid or satisfactory proof of exemption is shown. (See, generally, Rev. and Tax. Code, sections 6051, et. seq.; Western L. Co. v. State Bd. of Equalization (1938) 11 Cal.2d 156, 164.) The measure of tax is the retailer's "gross receipts" which includes: "All receipts, cash, credits, and property of any kind ...." (Rev. and Tax. Code, section 6012(b) (2).) The burden of proving entitlement to an exemption from the tax is upon the taxpayer and does not shift from the taxpayer to the Board since the taxpayer is in the best position to create and maintain records of his transactions. (H.J.Heinz Co. v. State Board of Equalization (1962) 209 Cal.App. 2d, 1, 4; Pope v. State Bd. of Equalization (1988) 202 Cal.App.3d 73, 84.)

With respect to computer programs, section 6010.9 of the Revenue and Taxation Code and Sales and Use Taxes Regulation 1502, implement the taxing provisions of law. Regulation 1502 provides a succinct statement of the law as relevant to this case:

> "(f) (1) (C) Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.
>
> "If the purchase of the maintenance contract is not optional with the purchaser, then the charges for the maintenance contract are taxable, including charges for consultation services, as part of the sale or lease of the prewritten program.
>
> "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. If, however, the purchaser may, at its option,

> contract for the consultation services for a separately stated price, in addition to the charges made for the storage media, then the charges for the consultation services are nontaxable." (Emphasis added.)

Simply stated, the Regulation provides that receipts derived from the purchase of optional maintenance contracts are nontaxable. Both the Department and petitioner agree that its update system is a form of maintenance contract. Petitioner has maintained consistently that purchase of its Update contract is optional and has always been optional.

Upon receipt of the additional documentation supplied by petitioner, the materials were sent to the Department for review. Upon review, the Department replied by memo dated April 1, 1991, that "the audit staff would have no objection if the taxpayer's petition were granted." Based upon petitioner's testimony and my review of the evidentiary record developed thus far, I must conclude that purchase of petitioner's Updates are optional. That being the case, no tax is due on receipts thus derived.

Recommendation

Grant the petition.

_____ 4-18-91

TONY NEVAREZ, Hearing Officer Date