

**STATE BOARD OF EQUALIZATION**

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

April 18, 1991

Mr. R--- W. O---
Certified Public Accountant
XXX --- Court
--- ---, California XXXXX

Dear Mr. O---:

This is in response to your letter dated March 4, 1991. Your client is a California retailer of computers and software. You ask for a written ruling or interpretation regarding application of sales tax. As I believe you understand, this response is not one upon which your client may rely within the provisions of Revenue and Taxation Code section 6596 because your client is not identified. Rather, this is an opinion regarding a set of hypothetical facts.

Your client will offer certain maintenance contracts, all of which you describe as optional and not mandatory.

“Contract A is composed of two features which are separately stated and separately priced specific line items. Feature 1 is for ‘Right to Use Software’ the list price of which is \$300. Feature 1, right to use, is a license which allows the customer to copy software updates into his computer. The right to use feature is one per contract (for every system the customer has installed he would need to purchase one right to use if he wanted each of the systems to be updated). A typical large customer with 100 of the Company’s computers would have to purchase 100 contract A’s in order to put updates into each of their 100 computers. The company believes that Right to Use is taxable. Feature 2 in the contract is for media and manuals on how to install/apply software updates etc., the list price of this separately stated feature is \$240. The company believes that Feature 2, the media and materials on which software s provided, is taxable. The customer can purchase just Feature 1 if he so desires.

“Accordingly, a large customer with 100 computers could purchase one Contract A with Features 1 and 2, and then purchase 99 Contract A’s with Feature 1 only and would thereby be able to have the right to install update software on all 100 of his computers but utilizing only 1 set of media and manuals in order to do it

“Contract B incorporates Contract A but adds a new line item, Feature 3 ‘Hardware Parts Replacement, On Site Support, Telephone Support and Hotline’, the list price of this separately priced and stated feature is \$700. The company believes Feature 3 is nontaxable for sales tax purposes and plans to accrue and pay use tax on the value of the parts used in fulfilling the contract.

“In the price book, a customer can see he has various choices, he can purchase Contract A with just Feature 1, buy Contract A with Feature 1 and 2, or buy Contract B with Features 1, 2, and 3, or just 1 and 3.”

You ask three questions each of which is quoted below followed by our response.

“(A) In Contract B, assuming all three features are separately priced and stated, which Features are subject to tax? Just Features 1 and 2?”

We assume that at least one copy of the software is provided to the customer in tangible form, such as on floppy disk. We therefore agree with your opinion regarding Contract A, that is, tax applies to the charge for both Feature 1 and Feature 2.

An item is regarded as a mandatory part of the sale of tangible personal property if the customer cannot obtain the tangible personal property without obtaining the other portion of the contract (such as telephone support and hardware maintenance). On the other hand, that same item is not regarded as a mandatory part of the sale of tangible personal property without purchasing the other item, even if the customer cannot obtain the other item without purchasing the tangible personal property. Therefore, based upon your description, we conclude that Feature 3 is optional. Sales tax would not apply to the charge for Feature 3. We assume that by paying use tax on the “value” of the parts used in fulfilling the contract you mean the cost of the parts. We agree that this is the proper manner to report tax on these parts.

“(B) Do Features 1 and 2 in contracts A and B have to be priced the same? Can Feature 1 have a different price in Contract A than Contract B?”

The company can obviously set its price in any manner it wishes if not in violation of law; however, I assume you are asking whether we would recognize for sales tax purposes such price differentials. It appears that you are asking whether the prices of Features 1 and 2 can be decreased from their clearly established rates with a corresponding increase in the cost of Feature 3 in the hope of avoiding the application of sales tax to the amount of that decrease in the price of Features 1 and 2. We would view that manipulation as a sham to avoid sales tax based upon the facts you have presented. In such a transaction, the same amount of sales tax would apply to the contract for taxable Features 1 and 2 and nontaxable Feature 3 as would apply when only taxable Features 1 and 2 were purchased.

“(C) In Contract B, (if and when the customer really is after hardware maintenance and hotline only) can we require him to purchase Features 1 and 2

(which are taxable) in order to get Feature 3? The company does not plan on ever offering Feature 3 standalone by itself.”

As discussed in my response to your question A, the company does not have to offer Feature 3 alone in order for it to be regarded as optional as long as the customer may purchase the tangible personal property without also purchasing Feature 3.

If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cs/0222F

bc: --- --- District Administrator