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July 11, 1994

BURTON W. OLIVER
Executive Director

Ms. A--- D---
Multistate Tax Manager
--- & ---
XXX --- Street
--- ---, CA XXXXX

Re: **Sales and Use Tax - Ruling Request**

Dear Ms. D---:

This is in reply to your April 19, 1994 letter regarding the application of sales tax to charges by your client to operate an on-line entertainment service. You provided the following background facts:

"Our client (the "Company") operates an on-line interactive entertainment service which enables subscribers at different geographic locations to use personal computers to communicate with each other on a real time basis.

"Each subscriber uses a personal computer, a modem and the Company's supplied software to operate the service. To access the Company's service, a subscriber dials a local phone number which accesses a third-party switched data network operated by a long-distance telecommunications provider. This data network links the user to the host computer network which is located at the Company's headquarters in California.

"Upon payment of a shipping and handling fee, a new customer is sent the basic software on floppy disks with instructions for installation and use of the service. There is no separate charge for this software as it has no value on its own. The basic software's purpose is to provide access to the Company's entertainment services when connected to the Company's host computer. The software is not sold separately in stores and, in general, can only be obtained from the Company after registration is approved. The Company also conducts marketing programs

where the access software is distributed with third-party products. In these instances, no shipping and handling fees are charged to the customer.

"The subscriber may then select one of three basic membership plans which allows access to the Company's host computer through the data network. The difference in the plans is based solely on the number of hours on the host computer included in the monthly subscription charge. Additional access hours are billed separately at a fixed hourly rate.

"Once the subscriber invokes the basic software and establishes the on-line data network link to the Company's host computer, an approved subscriber is provided with various options concerning the different real time interactive entertainment activities involving other subscribers.

"Periodically (approximately every 8-10 months), the access software is upgraded and existing subscribers are sent software enhancements on floppy disks. No separate charge is made for the enhancements."

Given this information, you asked whether we agree with your conclusion that tax does not apply to the Company's monthly subscription charge which allows the subscriber access to the host computer network by the subscriber's personal computer equipped with a modem. We agree that tax does not apply to the charge for the subscription service. As you noted, Sales and Use Tax Regulation 1502, Computers, Programs, and Data Processing, provides at subdivision (c)(7) that charges for access to a computer by means of remote telecommunications are not subject to tax.

Your second question was whether the result would be different if the Company separately stated an initial sign-up/membership charge. Tax does not apply to the Company's charge for access to the host computer whether or not the Company separately states an initial sign-up membership fee, assuming the fee is not a charge for tangible personal property.

You note that the Company sends the customers software upon the customers paying a "shipping and handling" fee. In such case, assuming that the fee, excluding any nontaxable transportation charge, is 50 percent or more of the Company's purchase price of the software, the transaction is a retail sale of the software subject to sales tax (Cf. Sales and Use Tax Reg 1670, Gifts, Marketing Aids, Premiums and Prizes.)

As you know, with certain exceptions, tax does not apply to separately stated charges for transportation of property from the retailer's place of business or other point from which shipment is made directly to the purchaser. We have taken the position that a designation of "postage and handling," coupled with the actual amount of postage placed on a package mailed

to a customer, constitutes a separate statement of transportation charges. See Sales and Use Tax Annotation 557.0450.

The Board recently authorized for publication an amendment to Sales and Use Tax Regulation 1628, Transportation Charges, subdivision (a) which, if adopted, would provide that, if a separately stated charge is made for "shipping and handling", the portion of the charge which represents actual shipment may be excluded from the measure of tax whether or not the actual amount is affixed to, or noted on the package. Unless the proposed amendment becomes effective, our view is expressed by the annotation; that is, the Company may not exclude the transportation charge from the measure of tax unless the charge is truly stated to the customer separately from the handling charge, either on a document or on the package.

The Company is the consumer of, and tax applies to the sale to the Company of, software which the Company provides at no charge to other persons to distribute the software with the other person's products.

Finally, you asked for the application of tax to the enhancements on floppy disks. Your facts state that the Company does not make a separate charge for the enhancement. We assume that the Company is not required to provide the enhancements to the customer. In such case, the Company is the consumer of the storage media which becomes the software the Company transfers to the customers. Tax applies to the sale of the storage media to the Company.

Very truly yours,

Ronald L. Dick
Senior Staff Counsel

RLD:plh

cc: Sacramento District Administrator - KH
Mr. David H. Levine