

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

120.0410

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
D--- T--- Inc.) No. SR -- XX-XXXXXXX-010
)
)
)
Petitioner)

The Appeals conference in the above-referenced matter was held by Paul O. Smith, Staff Counsel on September 13, 1993, in San Diego, California.

Appearing for Petitioner:

J--- C---, Jr., C.P.A.

Appearing for the
Sales and Use Tax Department:

Phillip K. Klepin, CPA
District Principal Auditor

Kelly Reilly
Senior Tax Auditor

Protested Item

The protested tax liability for the period July 1, 1987 through December 31, 1990, is measured by:

<u>Item</u>	<u>Amount</u>
B. Claimed exempt sales disallowed on an actual basis.	\$426,003

Contentions

Petitioner contends that its original sales of software included the customers' right to receive subsequent error corrections that enabled the software to perform as originally intended. Therefore, absent an update in the software, all optional software maintenance service agreements sold during the period in issue were exempt services. Petitioner also contends that diskettes containing such corrections could be purchased for resale, and are considered part of the original sale of the program.

Summary

During the period in issue petitioner D--- T--- Inc., sold library automation software, and computer hardware and peripherals for operation of the software. Petitioner also sold optional "Software Service And Maintenance contracts" (maintenance contracts) that provided a customer with 15 hours of phone support related to the software installation and usage, and any and all software updates and enhancements. Customers paid an initial lump-sum amount for the contract, and before its expiration they were notified of petitioner's renewal terms. Petitioner advised its customers that with a maintenance contract it would receive all updates and enhancements at no additional charge plus phone support. Petitioner also advised its customers that any enhancements without a current contract would be charged at an amount per module, and any required technical support was available at an hourly rate.

Petitioner states that in 1987, it sent error corrections to the 4.1 version of the program by diskette to all customers reporting bugs, and in 1989, and 1990, sent diskettes with error corrections to all customers.¹ Customers without a maintenance contract also received the error corrections at no charge. In June 1988, petitioner sent out a major program upgrade of version 4.1 to version 5.0, to only those customers covered by a maintenance contract. Petitioner concedes that its 1978 maintenance contract sales are taxable.

At the conference of September 13, 1993, petitioner offered into evidence petitioner's Exhibit C, "Summary of Bugs reported in the Card Datalog software in 1989 and 1990", together with supporting detail by user. This report suggests that numerous bug types, such as data corruption, procedure error, cosmetics, features not working as expected, and enhancement request, were reported by petitioner's customers in 1989, and 1990. Petitioner also provided copies of its "Program Changes Log", which show the various program corrections, enhancements, modifications, and updates to the main master disks for program version 4.1, that occurred in 1987.

¹ In letters dated November 18, 1991, and November 22, 1991, petitioner's President, D--- T. C---, stated that "In 1987, 1988, and 1990, we sent bug fixes and minor enhancements for free to all of our customers." In a letter dated October 11, 1993, Mr. C--- states that the term "minor enhancements" used in these letters meant "corrections to bugs and design flaws that should have been in the original product."

Petitioner contends that all program enhancements and modifications, except 1988, were mislabeled. Petitioner contends they were actually the correction of errors in the program that enabled the program to operate as originally intended. Those diskettes containing such corrections were purchased for resale, and should be considered part of the original sale of the program. Petitioner also contends that since there were no updates in the program, other than 1988, the maintenance contracts sold during 1987, 1989, and 1990, represented the sale of an exempt service. Petitioner provided the Sales and Use Tax Department (Department) and me with a copy of an opinion letter dated December 29, 1986, to Robert J. Fields from David H. Levine, Tax Counsel for the Board. Petitioner contends that the hypothetical situation set forth in the letter supports its position. This letter provided in relevant part that "If, during the course of an individual contract, no tangible personal property was transferred, then no tax would be due on that contract."²

The Department conducted an audit of petitioner's records and determined that each sale of petitioner's maintenance contracts constituted a taxable sale. On October 29, 1991, the Department issued a Notice of Determination to petitioner. On December 11, 1991, the Department acknowledged petitioner's letter of November 18, 1991, as a Petition for Redetermination.

Analysis and Conclusions

Revenue and Taxation Code section 6006 defines a sale as the transfer of title or possession of tangible personal property for consideration. Section 6010 defines purchase in the same terms. Sales and Use Tax Regulation 1502 was amended in 1987 to provide a more explicit interpretation of how the Sales and Use Tax Law applied to the computer industry, and specifically addresses maintenance contracts for prewritten computer programs.³ This regulation provides in relevant part that if the purchase of the maintenance contract is optional, but the customer does not have the option to purchase consultation services in addition to the sale or lease of storage media containing updates or error corrections, then the charge for consultation services are taxable as part of the sale or lease of the storage media.

² This involved the sale of a canned program, and a maintenance agreement characterized as an "optional continuation of the warranty". Under the agreement enhancements to the program would be provided at no additional cost, if and as they became available. There was no representation that during the course of the agreement there would be any enhancements.

³ Amended November 18, 1987, effective March 4, 1988. Petitioner's 1987, and a portion of 1988, maintenance contracts were sold prior to the effective date of the amendment of Regulation 1502. However, since the amendment of the regulation was to make clear and specific the Board's existing interpretations of the application of tax to prewritten computer programs, the amendment is given retroactive effect.

If, however, the purchase of a maintenance contract is optional, and consultation services may be purchased separate and apart from storage media with error corrections or program enhancements, then separately stated charges for the optional consultation services are not taxable. The charges for the sale or lease of storage media containing updates or error corrections remain taxable. Thus, the charge for updates and error corrections provided on storage media (tangible personal property) are taxable. (See Sales and Use Tax Reg., § 1502, subd. (f)((1)(C).)

Petitioner argues that its original sales of software included the right to subsequent error corrections that enabled the software to perform as originally intended. Petitioner draws support for this argument because it sent error corrections to all customers, including those without a maintenance contract. Absent an update in the software, petitioner concludes that all optional software maintenance service agreements sold during the period in issue were in effect exempt consultation contracts. I disagree.

Petitioner sold its maintenance contracts separate and apart from the original sale of the software. The purchase of a maintenance contract was optional. Nowhere does petitioner advise a customer that if it did not purchase a maintenance contract, the customer would nonetheless receive all error corrections free of charge. Petitioner advised all of its customers that any subsequent enhancements (which petitioner argues were error corrections), without a current maintenance contract, would be charged at an amount per module, and technical support was available at an hourly rate. However, even though petitioner gratuitously provided error corrections to its customers without a maintenance contract, I cannot agree that petitioner's maintenance contracts were merely consultation contracts. As stated above, Regulation 1502 was amended to make clear and specific its application to the computer industry. The terms of this regulation precisely address the type of maintenance contracts offered by petitioner.

Here, petitioner charged its customers a lump-sum amount for a maintenance contract that provided the customer with all updates, enhancements, and technical support, at no additional charge. Customers purchasing or renewing a maintenance contract during the period in issue did not have the option to purchase a contract for error corrections or enhancements apart from consultation services. Further, petitioner transferred all error corrections to a program to its customers by diskette. Under the regulation, this transaction was a taxable transfer of tangible personal property. When there is a taxable transfer of tangible personal property, tax applies to the gross receipts from the transaction, with only those deductions allowed by statute. (See Rev. & Tax. Code, § 6012; see also Simplicity Pattern Co. v. State Bd. of Equalization (1980) 27 Cal.3d 900, 907.) Accordingly, the lump-sum amounts petitioner charged for its maintenance contracts were fully taxable, even though a portion of the charge was for consultation services. (See Sales and Use Tax Reg., § 1502, subd. (f)((1)(C).) This is because the consultation services were a mandatory part of a contract under which petitioner sold tangible personal property.

Petitioner's reliance on Mr. Levine's letter of December 29, 1986, is misplaced. This letter provides that "When tangible personal property (tapes, disks, or drums as previously explained) is transferred in performing enhancements [including error corrections], these transfers are taxable as either sales or leases. (Rev. & Tax. Code, §§ 6051, 6201; Reg.1502.)" Here, there was a transfer of the error corrections by diskette, and there was no option for a customer to purchase consultation services for a separately stated amount under the maintenance contract. Thus, the Department properly determined that the lump-sum contract charges were taxable as part of the sale of the diskettes.

I now address petitioner's argument that "diskettes containing such corrections could be purchased for resale by D--- T---, and are considered part of the original sale of the program." I assume that petitioner is contending that because the diskettes containing error corrections were provided to all customers, including those that had not purchased a maintenance contract, the sale price of the diskettes were included in the original sale of the program. The facts do not support this contention. Petitioner was required by its maintenance contract to provide diskettes containing error corrections to those customers that had purchased a maintenance contract. There are no facts that support the reformation of the contracts to remove this requirement. Therefore, I must conclude that the sale price of the diskettes were not included in the original sale of the program.

Recommendation

Deny the petition.

Paul O. Smith, Staff Counsel

Date