State of California **Board of Equalization**
Legal Division

Memorandum

120.0455

To : Mr. Donald J. Hennessy
Assistant Chief Counsel
Appeals Review Section

Date: March 23, 1995

From : Gary J. Jugum
Assistant Chief Counsel

Subject: S--- B--- S---, Inc.
Account No. SR -- XX-XXXXXX-010

The petition for redetermination of tax of the referenced taxpayer was heard in Culver City on November 30, 1994. Pursuant to the direction of the Board, Glenn Bystrom and I met with Mr. E--- R---, principal officer of the corporation, in Culver City on March 21, 1995.

Taxpayer is a retailer of prewritten computer programs and reports and pays sales tax with respect to the sale of such programs. Taxpayer enters into software maintenance contracts with its customers (1) to furnish upgrades to the programs as they are developed and become ready for distribution, (2) to furnish error corrections when faults are located in the program, and (3) to provide consultation services. This is the standard package of goods and services normally "bundled" together in software maintenance contracts. Taxpayer charges a flat fee for the service, on a monthly or semi-annual basis. This is customary pricing mechanism used with software maintenance contracts. That is, there is no specific fee charged for specific services rendered--the charge is a flat amount.

At issue in the audit was the taxability of charges made with respect to the software maintenance contract. Software upgrades, if sold alone, are clearly subject to tax. They are nothing more than prewritten computer programs. Error correction, if sold alone, would be nontaxable, because error correction qualifies as repair or reconditioning under our Regulation 1546. Consultation services, if sold alone, are likewise nontaxable. When the three items discussed are sold as a single package, we have assessed tax on the entire contract price. See Regulation 1502(f)(1)(C).

Taxpayer's contracts with its customers specified that taxpayer would perform its software maintenance services, including transmission of program updates, by remote telecommunications means. In fact, taxpayer would not contract with the customer unless the customer had a modem in order to receive software maintenance by telephone. Taxpayer understood, and it has been the continuing interpretation of this agency, that tax would not apply to charges for software maintenance contracts, where the contract is performed by remote telecommunications means.

In a number of instances, rather than transmitting the upgrades by telephone, taxpayer's employees took a floppy disk to the place of business of the customer, inserted the disk in a disk drive, and copied the program into the memory of the customer's computer by operating the computer. Taxpayer's employees then removed the disk, and returned with the disk to taxpayer's place of business. The computer update was "delivered" in this manner only in circumstances where taxpayer was unable to access the customer's computer by remote means. This would occur when the customer's modem was not operating for some reason, or when, as during the Southern California earthquake, taxpayer was unable to reach the customer by telephone.

It is our opinion that taxpayer's charges to its customers in the circumstances described are not subject to sales tax. The charges are subject to tax only if the transactions are retail sales by title transfer (Rev. & Tax. Code § 6006(a)), or retail sales by processing of customer-furnished tangible personal property (§ 6006(b)), or retail sales by lease of ex-tax property (§ 6006(g)).

There is no title transfer transaction, and there is no lease transaction. The question is whether the activities performed by taxpayer's employees at the customer's place of business constituted "the producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for customers who furnish either directly or indirectly the materials in the producing, fabricating, processing, printing, or imprinting."

Regulation 1526 provides in paragraph (b) as follows:

> "Producing, fabricating, and processing include any operation which results in the creation or production of tangible personal property or which is a step in a process or series of operations resulting in the creation or production of tangible personal property. The terms do not include operations which do not result in the creation or production of tangible personal property or which do not constitute a step in a process or series of operations resulting in the creation or production of tangible personal property, but which constitute merely the repair or reconditioning of tangible personal property to refit it for the use for which it was originally produced."

It is our view that the reprogramming activity conducted by taxpayer at the customer's place of business is a kind of reconditioning of the customer's computer system--tangible personal property--which does not constitute a step in the process of the creation or production of tangible personal property. If the customer has a computer system which is programmable, tax would have been paid with respect to the acquisition of the system. Section 6006(b) is designed to insure that all fabrication charges incurred in the production of a completed article are included in the measure of tax, whether the raw materials are furnished by the retailer or by the retailer's customer. It is a prophylactic rule which has no basis for application in circumstances of the type under consideration. It is our opinion that reprogramming a

programmable piece of equipment does not constitute fabrication or processing of the equipment. If taxpayer's employee were to sit at the customer's keyboard and reprogram the computer by keying in the changes to the extant program, this would no more constitute a fabrication of tangible personal property than would the circumstance of my paying someone to change my television set from Channel 3 to Channel 10. Likewise, it would be our position that charges made for reprogramming a programmable cash register to reflect a change in the sales tax rate would be nontaxable. It would be immaterial to our analysis that the reprogramming effect might be facilitated and expedited by use of a transfer media, such as a floppy disk. The tangible personal property--the equipment itself--might well be in a different "state", but it would not be a new or different property. Indeed, the best example might be an on-off switch. We do not think that turning electronic equipment from off to on (or vice-versa) constitutes taxable fabrication of customer-furnished property within the meaning of that concept as it is employed in section 6006(b) or in Regulation 1525. There, it is our conclusion charges made for reprogramming programmable equipment are charges for the performance of the service, not for the sale of tangible personal property, and are not subject to sales tax.

Our recommendation is that taxpayer's petition for redetermination be granted.

GJJ:sr

cc: Mr. Glenn A. Bystrom - MIC:43
Sales and Use Tax Attorneys