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April 15, 1996

Ms. S--- G---
Sales Tax Department
R--- S---
XXXX N. --- Blvd., Suite XXX
--- ---, CO XXXXX-XXXX

**Re: R--- S--- Company
SC OH XX-XXXXXX**

This is in response to your letter dated February 16, 1996 regarding the application of tax to software support agreements. I note that although you do not mention a previous inquiry, you sent an identical inquiry dated November 17, 1995 to which Ms. Lynn Whitaker, Senior Tax Auditor, responded in a letter to you dated December 11, 1995. It is not clear to me why you were not satisfied with the response provided to you in the December 11, 1995 letter.

You state that R--- S---, a software company with business locations in Colorado and Texas, currently has customers in California to whom R&D sells software packages and software support agreements. You have enclosed a copy of the support agreement for our review. You state:

“Basically, our customers may choose one of three options: full service support, time and material support, or after hours support. Full service support includes telephone hotline support as well as software upgrades released during the maintenance period. We charge one price for this full service support--there is no breakout of price between the hotline and the upgrades. When an upgrade is released, the customers receive a software upgrade tape which they load on their computer system. One of our installers then dials into the customer's system via modem and performs the procedures to actually install the new upgrade. The other two options, time and materials and after hours support, basically consist of telephone hotline support. The customers who choose these options are not entitled to any software upgrades.

“When customers initially purchase our software package, they are required to purchase one of the maintenance options described above for the first year. After the first year, the support agreement becomes optional. If customers elect to discontinue the support, they cannot receive any future software upgrades unless they pay all back support charges.”

DISCUSSION

Retail sales of tangible personal property in California are subject to sales tax, measured by gross receipts, unless specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) When sales tax does not apply, such as when sales take place outside of California, the use tax, measured by the sales price of the property sold, applies to the use of property purchased from a retailer for storage, use, or other consumption in California unless the use is specifically exempt from taxation by statute. (Rev. & Tax. Code §§ 6201, 6401; Reg. 1620.)

The measure of the sales or use tax includes the charge for any services that are part of the sale of tangible personal property. (Rev. & Tax. Code §§ 6011, 6012.) If services are not part of the sale of tangible personal property, then neither the sales tax nor the use tax applies to charges for the services if they do not themselves constitute sales of tangible personal property. (Reg. 1501; see Rev. & Tax. Code §§ 6006(b), 6010(b).)

The sale of a software maintenance contract (updates and error corrections provided on storage media such as tapes) constitutes a sale of tangible personal property. (Reg. 1502(f)(1)(C).) Therefore, under any scenario, the sale of a software maintenance agreement is subject to tax. The only question is whether part of the charge is for nontaxable services, or whether the entire charge is taxable.

Where consultation services are optional and where charges for those services are separately stated, charges for consultation services are not considered charges for the sale of tangible personal property. (Reg. 1502(f)(1)(C).) Such charges are therefore nontaxable. You state that customers are required to purchase one of the maintenance alternatives for the first year. Since this means that with respect to the first year, none of the alternatives is truly optional, the consultation services provided for the first year are taxable, without regard to the alternative chosen by the customer.

Further, with respect to your full service support, you state that you charge one price that includes charges for the hotline and the upgrades. It appears that it is not possible for a customer to purchase the services under the full service support plan without also purchasing the updates and error corrections. Therefore, even if the full service support is truly optional after the first year, as long as the consultation services cannot be purchased without the upgrades, the consultation service charges remain taxable.

You state that after the first year, it is possible for the customer to choose one of the alternatives that includes telephone hotline support services but does not include updates and error corrections. Since it appears that your charges for these telephone hotline support services under your "time and material" plan and your "after hours" plan do not include charges for software updates and error corrections, it appears that the charges are not subject to tax.

I note that you indicate that where a person elects to discontinue support, that person cannot receive any future software upgrades without paying all "back support charges." Such charges would be considered part of the sale of the software upgrades and would therefore be subject to tax.

In summary, the charge for the sale of a maintenance contract on storage media is always taxable because the sale of such a maintenance contract constitutes a sale of tangible personal property. Charges for consultation services that are not optional and separately stated are also taxable. On the other hand, separately stated charges for optional consultation services are not taxable.

If you have further questions, please feel free to write or call me at the address or telephone number listed above.

Sincerely,

Kelly W. Ching
Staff Counsel

KWC:cl

cc: Out-of-State District Administrator (OH)