

M e m o r a n d u m**120.2780**

To : Mr. Jack E. Warner
District Principal Auditor (OH)

Date: January 29, 1993

From : Elizabeth Abreu (916) 454-8208
Tax Counsel ATSS 324-8208

Subject: T--- S---, Inc.
SS - XX-XXXXXX

This is in response to your memorandum dated December 8, 1992, requesting our advice concerning the transfer of 12" optical disks by T--- S--- to its customers which are primarily law firms and corporate and government legal departments.

According to the promotional materials attached to your memorandum, T--- "automates" documents (mainly documents relating to litigation, e.g., depositions, interrogatories, contracts etc.) through a five step procedure.

First, a document is scanned by its equipment and the image of the document is temporarily stored on a "MO" disk. While the image is on the MO disk, the operator uses proprietary software to "flag" certain images with annotations such as "handwritten."

Second, the image is permanently stored in laser data image format on a "WORM" disk. Such disks can store approximately 80,000 printed pages.

Third, every printed word is converted to ASCII. It is unclear whether this is done from the WORM disk or MO disk and whether the converted text is stored on the same WORM disk which contains the laser data image.

Up to this point the sale of a WORM disk which contains the images of the documents and the disk containing the ASCII text would be taxable. Despite Mr. M---'s characterization of such operations as computing, summarizing, extracting etc., in fact all T--- has done is convert data from one medium (paper documents) to another (laser and computer disks). Regulation 1502(d)(5)(B). It has not created any original information. The flagging of handwritten notes should not sufficient to make this a nontaxable transaction because the true object of the transaction is to have a document converted from one medium to another, not to flag handwritten notes.^{1/}

^{1/} This issue is not, however, free from doubt. T--- may argue that the annotations are original information and that the insertion of annotations is one of the customer's main purposes for having the information scanned and encoded on computer disks.

The fourth step, however, changes the character of the transaction. Apparently T---'s software creates a separate database file which contains an index of every word that appears in each document that is scanned and converted. The promotional material states: "T--- uses highspeed workstations to index each word into an inverted file structure, making them easily and efficiently searchable." We believe that this means that when a customer directs his or her computer to retrieve all documents containing a particular word or phrase, such as "ABC Corporation," the customer's software program will first search the index database file (as opposed to searching each document file) for that word or phrase. We assume that each word or phrase in the index contains a cross-reference to the document files which contain the word or phrase. Using the cross-reference, the program lists or displays those document files.

Creating an index is a sorting and sequencing function. Such functions are included in the examples of processing of customer-furnished information. Regulation 1502(d)(5)(A).

Regulation 1502(d)(5)(C) reads:

"Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

"Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendition of a service. Except as described in (c)(8) above and (d)(5)(E) below, tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax."

Additional copies of records, reports tabulation, and storage media are taxable. Regulation 1502(d)(5)(E) and (F).

We believe that under Regulation 1502(d)(5), except for charges for duplicate copies, none of T---'s charges are subject to tax since the customer is contracting for both the disks containing computer text of the paper documents and an index of the words in the computer text. Regulation 1502(d)(5)(C) does not provide for an allocation between operations which, by themselves, would be taxable, and operations which are not taxable. Rather, under this

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regulation it appears that if customer-furnished data is processed, the entire transaction relating to the copying and processing of the data is nontaxable.

EA:cl

cc: Mr. John M. Feeley (--- District - --)