

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

120.2828

APPEALS DIVISION

In the Matter of the Petition
for Redetermination Under the
Sales and Use Tax Law of:

[X]

Petitioner

HEARING
DECISION AND RECOMMENDATION

The above-referenced matter came on regularly for hearing before Hearing Officer Janet Saunders on May 3, 1991 in Sacramento, California.

Appearing for Petitioner:

[X]

Appearing for the Sales &
Use Tax Department

[Y]

Senior Tax Auditor

Protested Items

The protested tax liability for the period July 1, 1987 to June 30, 1989, is measured by:

<u>Item</u>	<u>State, Local and County</u>
A. Purchase subject to use tax Purchase of supplies from out-of-state vendors	\$311
B. Taxable Sales Understated Sales of optical character recognition scanning not reported as taxable sales. (Created on diskette form.)	<u>144,552</u>
Total	\$144,863

Parties' contentions

Petitioner provides optical character recognition services including the conversion of typed documents into computer readable files. Petitioner contends that pursuant to Sales and Use Tax Regulation 1502(d) (1) and Regulation 1502(d) (5) (A) and (C), it is not subject to tax.

The Sales and Use Tax Department (SUTD) (formerly Department of Business Taxes) contends that petitioner is converting customer furnished data from one physical form to another and that such conversion is taxable under Regulation 1502(d) (1).

Summary

Petitioner, a partnership, operates a business called [X] providing optical character recognition services. It is also a retailer of computer hardware and software. This is its first audit.

Optical character recognition services are a process whereby a written document, such as a legal transcript, is scanned by a computer system and converted to a computer readable disk. Certain portions of the original transcript are extracted and not included in the disk. Much of petitioner's business involves the conversion of legal transcripts. In a letter dated April 16, 1991, entered into the record as Exhibit One, petitioner described the extracting process as follows:

“For example, when [X] scans a legal transcript, we do not merely convert every piece of information on a given page, we extract only the text of the testimony and page numbering information leaving out any additional text or notations such as headers, footers or hand written notes that are on the page, separating the wheat from the chaff if you will. The whole reason for **extracting** only a certain portion of what is on the page is to satisfy the needs of the client; if we were to leave in all of that additional information in the final output, the results of our work would be nearly as useless to our clients purposes as the paper version they supplied to us because it would contain un-wanted information that would interfere with their ability to search the desired information. If [X] were to provide “mere” conversions rather than full processing services, the commercial viability of the operation would be seriously impaired because we would not be addressing the needs of the client.”

During the scanning phase of petitioner's operation, the extraction is performed by having the scanner selectively ignore information on certain parts of pages. After the material is scanned and inputted, there is a phase of manual correction. In this correcting phase, extraction continues as certain extra data is deleted by's operators. Petitioner claims that the whole process closely matches the process described in Regulation 1502(d) (5) (C) as being a non-taxable service.

Regarding the sequencing phase of its operations, petitioner notes in Exhibit One “sequencing customer-furnished information is also a key part of [X]’s scanning service. In order for the results of our service to be useful, some re-sequencing of the pages must be done. A very common instance of this occurs when we are processing a legal transcript that has additional pages, usually “numbered” (i), (ii), (iii) ... or (A), (B), (C) ... , in-between some sequentially numbered pages. When this occurs, the additional pages must be moved elsewhere in the resultant computer file, usually the end, so that the customer’s software will be able to accurately count the pages when using the data resulting from our services. [X] uses both automatic and manual methods to do this re-sequencing in the ‘custom formatting’ phase.”

It is petitioner’s claim that the extracting and sequencing phases are an integral part of the conversion process to disk readable form and that without the extracting and sequencing, the resultant output would be of greatly reduced or of no value to its clients; that the object of the sale is the whole service and not just the computer-readable output.

The SUTD asserts that the service provided by petitioner is merely a conversion of customer furnished data from one physical form (the typed transcript) to another physical form (computer readable material) and that no original information is generated. In a SUTD memo to Jim Speed, San Francisco District Principal Auditor, dated June 24, 1990, the SUTD’s position is stated as follows:

“Tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation, as stated in section (d) (1) of Regulation 1502. When the taxpayer converts data files from one format to another without developing any original information (i.e., sorting, extracting, summarizing, etc.) the entire charge is subject to tax. Also, the charge for merely correcting the optical conversions done by the clients would constitute fabrication labor and would be subject to tax. Of course, any contracts for the actual service of researching and developing original information, would not be subject to tax.”

Petitioner does not contest the tax asserted on item A pertaining to the purchase of supplies from out-of-state vendors. Petitioner also does not contest a measure of \$9,940 pertaining to item B.

Analysis and Conclusions

Sales or use tax applies only to the retail sale or taxable use of tangible personal property, and not to the performance of services. See Revenue and Taxation Code sections 6006 and 6007 and Sales and Use Tax Regulation 1501. In the case at hand, petitioner argues that it is performing a service and thus is tax exempt; the SUTD argues that petitioner is selling tangible personal property in the form of a computer readable disk and is thus subject to tax. In many instances, the performance of a service involves the transfer of personal property incidental to the performance of a service; Regulation 1501 addresses service enterprises generally and provides in pertinent part:

“Persons engaged in the business of rendering service are consumers, not retailers, of the tangible personal property which they use incidentally in rendering the service. Tax, accordingly, applies to the sale of the property to them. If in addition to rendering service they regularly sell tangible personal property to consumers, they are retailers with respect to such sales and they must obtain permits, file returns and remit tax measured by such sales. If their purchases of tangible personal property are predominantly for consumption rather than for resale, they should not give resale certificates covering such purchases but should follow the procedure prescribed in the regulation governing “Tax-Paid Purchases Resold.”

“The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. For example, a firm which performs business advisory, record keeping, payroll and tax services for small businesses and furnishes forms, binders, and other property to its clients as an incident to the rendition of its services is the consumer and not the retailer of such tangible personal property. The true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property.”

Regulation 1502(c) (4). Charges for the transfer of computer generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs.

Regulation 1502(c) (5). Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see (d) below.

Regulation 1502(d). MANIPULATION OF CUSTOMER-FURNISHED INFORMATION AS SALE OR SERVICE.

(1) GENERAL. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(5) PROCESSING OF CUSTOMER-FURNISHED INFORMATION.

(A) “Processing of customer-furnished information” means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting, and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) “Processing of customer-furnished information” does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (3) the mere converting of data from one medium to another. ... (Emphasis added.)

To determine which subdivision of Regulation 1502 is applicable to petitioner’s case, it is necessary to consider the specific tasks performed by its company. One function is to convert data from one medium to another; data is converted from a written page to a computer disk. This task falls within Regulation 1502(d) (5) (B) as a taxable transaction.

Another function described by petitioner is the extraction and sequencing of data. Extraction and sequencing are examples of tasks comprising the “processing of customer-furnished information” and are considered a service pursuant to Regulation 1502(d) (1) and 1502(d) (5) (A). The extraction described by petitioner in Exhibit One involves deleting notations such as headers; footers or hand written notes and an unspecified “additional text.” The sequencing described by petitioner was limited to moving pages which were numbered in between sequentially numbered pages. Also, the pages were manually corrected as a check to the computer scanning process. These processes seem minor when compared to the overall usefulness of having a document be computer readable. For example, a computer readable legal transcript will enable petitioner’s client to readily find all data in the disk; these elementary computer functions are very useful in the review of a legal transcript and of much greater importance than whether or not a header is included. The deletion of hand written notes is of greater significance but there is no indication on the record of the extent to which this particular task was performed.

Thus, it is concluded that the true object of the contract between the parties is the conversion of data from one medium to another; that pursuant to Sales and Use Tax Regulations 1501 and (d) (5) (B), the tasks performed by petitioner and the transfer tangible personal property is a taxable event. While petitioner does perform some sequencing and extraction work, these functions are of minimum significance in relation to the end product; thus, these tasks do not constitute the developing of original information as described in Regulation 1502 (d) (5) (A). It is found herein that the tasks performed by petitioner are not the “processing of customer-furnished information” and thus, subdivision (d) (5) (C) of Regulation 1502, which provides that contracts for the processing of customer-furnished information are services, does not apply.

[X]

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May 30, 1991
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Recommendation

Redetermine without adjustment.

Janet Saunders, Hearing Officer

May 30, 1991