



STATE BOARD OF EQUALIZATION
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July 21, 1988

Ms. [M]
Tax Department
[T]
P. O. Box XXXX, M/S XXXX
---, --- XXXXXX

[T] – S- -- XX-XXXXXX
Knowledge Engineering Agreement with [E]

Dear Ms. [M]:

In your letter dated February 22, 1988 to the Board's legal staff which we received May 16, 1988, you ask that we review a contract and other documents you enclosed and give you our opinion regarding how sales and use tax applies to this contract between [T] and [E].

The agreement you enclosed, although unsigned, is dated 6/23/86, and is entitled "General Terms and Conditions – [E]/[T] – Knowledge Engineering." I have quoted below relevant provisions of that agreement for purposes of this opinion:

"1. RECITALS

"WHEREAS, [T] is in the business of providing knowledge engineering expertise and the services of knowledge Engineers to assist customers in developing computerized systems and data bases generally known in the industry as an Expert System; and

"WHEREAS, [E] has expertise in one or more particular domain and desires to obtain Knowledge Engineering expertise from [T] relating to the potential application of Expert Systems Technology to such domain; and

"WHEREAS, the parties desire to assign personnel to work together in one or more projects combining [T]'s Expert Systems techniques and methods with [E]'s domain knowledge."

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“3.3 Domain Knowledge: Data and information specific to a domain, part of which may be furnished by [E] and part of which may be readily available to the general public.”

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“3.5 Expert System: A developing computer science technology that uses artificial intelligence techniques to address problems which require human-like logic and which utilizes the Knowledge Base.

“3.6 Jointly Owned Technology: Ideas, inventions, hardware, firmware, software or documentation, whether or not protectable by copyrights, patents or trade secrets, developed in the performance of the Services.

“3.7 Knowledge Base: Domain knowledge that has been assimilated, refined or structured by [T] and [E] through the use of Domain Knowledge and [T] Technology.”

* * * * *

“3.14 Third Party Products: Hardware and/or software required and obtained by either [E] or [T] from companies other than [T], necessary for development and/or [E] utilization of the Knowledge Base.

“4. DESCRIPTION OF SERVICES:

“[T] shall provide the services of Knowledge Engineers to [E] to develop a computer program and Knowledge Base to result in Expert System for [E]’s use as more specifically stated in the Purchase Order.”

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“4.1.3 If a Knowledge Base is developed, which [E] finds desirable and useful, a copy of such Knowledge Base shall be delivered to [E] in accordance with the Purchase Order.”

* * * * *

“5.1 Labor: “Services for each Knowledge Engineer shall be charged at the monthly rate stated in the Purchase Order.”

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“5.3 Non-Service Charges: Third Party Products procured by [T] shall require the prior approval by the Domain Expert and charges for such products shall be invoiced without markup.”

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“9.3 Jointly Owned Technology, if any is developed, shall be owned jointly by [E] and [T], with each party possessing full rights and incidents of ownership over Jointly Owned Technology, without accounting to either party, however, the developing party shall promptly notify the other party upon the discovery of such technology. [T] and [E] shall cooperate to take the necessary actions to legally protect the jointly owned technology including filing patent applications, registering copyrights, and the like. The parties shall cooperate in the filing or obtaining patents, patent applications, copyrights, trademarks or similar protection covering Jointly Owned Technology or any portion thereof. Each party retains a worldwide, royalty-free, unrestricted right to use such Jointly Owned Technology of portions thereof.”

Opinion

Our review of this agreement indicates that the agreement is one for services only, and not for services which are a part of the sale or lease of tangible personal property. Under the Sales and Use Tax Law, services which are included as a part of the sale or lease of tangible personal property are subject to tax, but services per se are not taxable. (Revenue and Taxation Code Sections 6011(b)(1), 6012(b)(1)). In order to determine whether a contract calls for nontaxable services or taxable sales of tangible property, Sales and Use Tax Regulation 1501 applies the true object of the contract test. The provisions quoted above indicate that the true object of this agreement was for [T] to provide to [E] knowledge engineering services, and was not for the transfer of tangible personal property. Of course, if any tangible personal property was transferred by [T] to [E] in connection with the performance of this contract, tax would apply to those charges for such tangible property. We assume that [T] recognizes this in paragraph 5.2 of the agreement, which requires [T] to charge [E] for third-party products without markup.

We note that under paragraph 4.1.3 of the agreement, [T] will transfer to [E] a copy of any knowledge base developed. We assume that this transfer would take the form of tangible personal property, such as a tape, disk, or other magnetic storage media. Our opinion is that such

a transfer of storage media would be merely incidental to the performance by [T] of the service of developing the knowledge base, and not a sale of tangible property.

It is also possible that an "Expert System" developed by [T] and transferred to [E] might be considered a computer program, as that term is defined in Revenue and Taxation Code Section 6010.9. Subdivision (c) of that section defines a computer program to mean"

“Computer program’ means the complete plan for the solution of a problem, such as the complete sequence of automatic data-processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs.”

Even if we were to conclude that the Expert System is a computer program, rather than data or information, it would nevertheless be regarded as a nontaxable computer program under the provisions of Section 6010.9, since it would be prepared by [T] to the special order of [E] pursuant to this agreement. [T] would be considered to be providing the service of developing the custom program, rather than selling the program. See also Sales and Use Tax Regulation 1502(f)(2).

I enclose for your information a copy of Regulations 1501 and 1502. Please feel free to contact me if you have any further questions or comments about this letter.

Sincerely,

John Abbott
Tax Counsel

JA:jb
Enclosure