



STATE BOARD OF EQUALIZATION

May 15, 1975

[X]

Dear [X]:

Enclosed is a copy of Decision and Recommendation made in the matter of the petition filed on behalf of [X].

We have directed that an adjustment be made to allow credit for the repossession loss. No adjustment is recommended with respect to the balance of the petitioned items.

In the event you do not concur and wish to pursue the matter to a hearing before the Board, please notify Mr. H. K. Lackmann, Supervising Auditor, State Board of Equalization, P. O. Box 1799, Sacramento, California 95808, within thirty days.

Very truly yours,

Joseph Manarolla
Tax Counsel

JM:rt

Enclosure

bc: Out-of-State – District Administrator
Enclosed are copies of Decision and Recommendation.

STATE OF CALIFORNIA **130.0215**
BOARD OF EQUALIZATION

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

[X]

Petitioner

DECISION AND RECOMMENDATIONS
OF HEARING OFFICER

The above entitled matter came on regularly for hearing on Tuesday, April 22, 1975, in Sacramento, California.

Appearing for Petitioner: [Y]

Appearing for the Board: Mr. S. Stein, District Administrator
Mr. D. Allen, District Principal Auditor

Protested Items
(Period 7/1/69 to 6/30/72)

	Measure of Tax
A. Sales of Software.	\$331,872
C. Bad debt/repossession loss disallowed - treated as additional sales in audit. (Of the above amount, Petitioner protests the inclusion of \$1,054,814 claimed to be a repossession loss on [X] transaction.)	\$1,615,930

Petitioner's Contentions

(1) Petitioner believes that prior to March 26, 1972, the effective date of Regulation 1502, tax was not applicable to sales of software and the application of the regulation to periods prior to its effective date is an improper retroactive application.

(2) The bad debt attributable to the repossession of equipment from [X] should be allowed.

Summary of Petition

Petitioner is a corporation engaged in manufacturing, selling and leasing conventional office equipment and electronic data processing equipment.

The first protested item, described broadly as sales of software, generally involves the sales of prewritten (canned) programs. The audit has followed Business Taxes General Bulletin 68-7 and Regulation 1502 in which the basic provisions of Bulletin 68-7 were incorporated in arriving at the classification of the programs as prewritten taxable programs. The sales of such programs were established on the basis of the test period. Petitioner takes no exception to the auditing procedures and methods used to establish the taxable measure of such programs but contends that the sales of the programs constitute sales of exempt services, particularly so prior to March 26, 1972, the effective date of the regulation.

The second protested item involves the repossession of equipment for which Petitioner has claimed a bad debt credit.

It appears that in September 1969 Petitioner sold a [X] data processing system to [X] on a conditional sales agreement. Tax was properly reported and paid on the sale. Thereafter, [X] encountered financial difficulties as a result of which Petitioner proposed to exercise its rights as the secured party under the security agreement and retake the equipment. However, according to Petitioner's description of the transactions as contained in its petition, [X] ceased doing business about February 1, 1971 and a new corporation was incorporated in California as [X2] with many of the same employees and the same major financial backer. [X] transferred all its rights, title and interest in the equipment to [X2] subject to the existing security interest in favor of Petitioner. [X] requested Petitioner's consent to the transaction and, by agreement of January 25, 1971, Petitioner consented to the transfer, with [X2] assuming the obligation of [X]. However, the agreement expressly provides in paragraph 3, that "This consent shall in no way release [X] from any of its obligations under the Sales Agreement.

[X] account receivable balance on Petitioner's records was cancelled and a billing in an equal amount was made to [2].

The transfer of the equipment from [X] to [X2] was deemed to be an exempt occasional sale.

[X2] also encountered financial difficulties and became delinquent in its payments to Petitioner. As a result Petitioner repossessed the equipment from [X2] on February 28, 1972 and wrote off the remaining balance owed on the equipment. Petitioner then claimed a credit for bad debt loss in its second quarter 1972 Sales and Use Tax return. The claim has been disallowed by the audit.

Analysis and Conclusions

(1) Sale of Prewritten (Canned) Programs

Petitioner does not contest the audit procedure and method under which these programs were classified and the taxable measure established. It is contended, however, that the sales of such programs constitute exempt sales prior to March 26, 1972, the effective date of Regulation 1502.

It is Petitioner's position that prior to the adoption of the regulation it had regarded software as the product of exempt services pursuant to its interpretation that the true object of the contracts with its customers was the service and that the tangible personal property was only incidentally transferred since it believed that the customer was purchasing the software for its informational value and that the medium of transfer was unimportant.

While Regulation 1502 was not adopted until March 26, 1972, the Board's previous consistent ruling that such programs were to be regarded for tax purposes as the transfer of tangible personal property, the sales of which were subject to the tax, was embodied in its Business Taxes general Bulletin 68-7 which was issued on June 17, 1968 and made available for public release. Regulation 1502 merely restated the Board's previous ruling as enunciated in Business Taxes general Bulletin 68-7 with regard to the programs. The regulation did not have the effect of establishing "new law" and does not effect an improper retroactive application.

Petitioner cites Regulation 1502(f)(2) which deals with custom programs and provides that effective July 1, 1972 the sale of custom programs are subject to the tax. This provision does constitute a change in the taxability of custom programs. Prior to July 1, 1972 custom programs were exempt from the tax. However, in the instant case the programs involved have been classified as prewritten (canned) programs, the sales of which consistently have been ruled subject to the tax. The effective date of the taxability of custom programs has no affect on the taxability of the prewritten programs.

(2) Bad Debt Repossession Loss

Under Section (f)(1) of Regulation 1642, a bad debt deduction in connection with a repossession is allowable only to the extent that the retailer sustains a net loss of gross receipts upon which tax has been paid. This will be when the prorata portion of all payments and credits, including the wholesale value of the repossessed article, attributable to the cash sales price of the merchandise, is less than that price. As a general proposition, a retailer incurs an allowable bad debt deduction if the wholesale value of the repossessed merchandise is less than the net contract balance (after excluding unearned insurance and finance charges) at the date of repossession.

The transaction giving rise to the claim for repossession loss clearly establishes a loss of gross receipts upon which the tax was paid.

The facts are not in dispute. Petitioner sold the subject equipment to [X] under a conditional sales agreement and retained a security interest in the equipment. The sales tax applicable to the full sales price was paid to the state. The financial difficulties of [X] resulted in its default in the installment payments and eventually the discontinuance of its business operations. At this point, Petitioner clearly had a right to repossess and had it done so would have been entitled to claim any loss suffered as a result of the repossession pursuant to Regulation 1642.

The question arises as to whether the transfer of [X] equity in the equipment to [X2] and Petitioner's consent to such transfer, destroys Petitioner's right to claim a repossession loss on the subsequent repossession of the equipment from the financially troubled transferee.

We believe that it does not.

While [X] transferred its equity in the equipment to [X2] in consideration of the assumption by [X2] of the obligation owing to Petitioner for the balance of the purchase price of the equipment, that transfer did not have the effect of changing the status of Petitioner as the retailer who paid the applicable tax to the state on the original sales price of the equipment and who, upon repossession of the equipment, suffered the economic loss resulting from the worthless account.

It is concluded that Petitioner is entitled to a repossession loss pursuant to Regulation 1642.

Upon verification by the audit staff of Petitioner's computation of the repossession loss, adjustment should be made to delete such loss from the measure of the tax.

Recommendations

- (1) No adjustment to be made with respect to Item 1, Sales of Software (prewritten (canned) programs).
- (2) Adjustment to be made to allow the applicable repossession loss in accordance with the provisions of Regulation 1642.
- (3) Redetermine to give effect to the adjustment for the repossession loss.