STATE OF CALIFORNIA

330.2215

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2637
FAX: (916) 323-3387

October 28, 1996

Mr. R--- M---
--- & --- LLP
XXXX --- Blvd., Suite XXXX
--- ---, CA XXXXX-XXXX

Re: Unidentified Taxpayer

Dear Mr. M---:

This is in response to your September 19, 1996 letter to Assistant Chief Counsel Gary Jugum asking us to reconsider our opinion on how tax applies to your client's (hereafter "the Company") operations as previously set forth in our September 29, 1995 letter to Mr. J--- F--- of your office. We again note that you are requesting a "ruling" from the legal staff. We previously stated in our correspondence to Mr. F--- that the Board staff does not issue rulings. Revenue and Taxation Code section 6596 sets forth the circumstances under which a taxpayer may be relieved of liability for taxes when relying on a written response to a written request for an opinion. In order to come within the provisions of section 6596, all relevant facts, including the identity of the taxpayer, must be disclosed. This opinion does not come within section 6596 because you have not identified your client.

You state that the underlying facts surrounding your client's business activities have not changed. Mr. F--- previously provided us with the following information about the Company's operations:

> "The Company provides automobile dealerships, motor vehicle leasing companies, automobile auctions, financial institutions and insurance companies access to the California Department of Motor Vehicle's ('DMV') database through the Company's computers and modems. Clients may make inquiries in the DMV database for information, such as the status of vehicle registrations or property liens.

"All applications and inquiries must be transmitted through the Company's host computer, located in California, which checks that the DMV security requirements have been met. The Company then transmits the message to the DMV over a high-speed dedicated telephone line. The DMV computer transmits its responses back to the Company's host computer over a high-speed dedicated telephone line. The Company then transmits back to the appropriate client.

"As part of the service, the Company provides its customers with:

"(1) Access to the DMV's database through the Company's on-line system and

"(2) installation of and support for the equipment, applications, communications and/or operating system ('access equipment') and documentation. The equipment is located on the client's premises. However, title to the equipment does not pass to the client at any time.

"**2. <u>Taxpayer's Service Charges</u>:**

"(a) The Company charges a one-time start-up fee. This charge covers the initial installation of the Company's access equipment at the client's location.

"(b) The Company charges for each inquiry. A 'Per Transaction Fee' represents a charge for the DMV database information and is charged each time a client accesses the DMV database. The Company is directly billed by the DMV. The transaction fee billed by the Company to the client includes the payment to the DMV.

"(c) A 'Per Minute Connect Fee' is also charged for each portion of a minute that the client is connected via telephone to the Company's on-line system. This charge is intended to reimburse the Company for telecommunication costs.

"(d) A monthly support fee is charged for the initial training, equipment, support services and communication software. Note that the Company pays sales/use tax on the cost of equipment provided to its clients.

"(e) In addition, a separately stated monthly equipment maintenance charge is also invoiced to the clients."

Your September 19, 1996 letter provides the following additional information:

"On an average percentage basis, the Company makes the following charges to its customers:

"**Transaction Charges:**

- Connect Time	7.00%
- Transaction Fees	64.56%

"**Monthly Charges:**

- Telephone Support	17.47%
- Software License Fee	2.91%
- Maintenance on Hardware	3.66%
- Install Fee	2.54%
- Other	1.86%

"**Total** **100%**

"The Company makes the following two separately stated monthly charges on its invoice sent to its clients:

(1) Maintenance
(2) Support Monthly License Fee

"The maintenance charge relates to hardware provided to the clients. No software is included in this charge. Although the hardware is located on the site of the provider, it is not leased to clients. The company paid sales or use tax on its purchase of the hardware.

"The support monthly license fee consists of two components, telephone support and a software license fee. Telephone support consists of customer questions regarding passwords (about 90% of telephone support) and other inquiries (about 10% of telephone support). The software license fee consists of upgrades to software (primarily the expansion of inquiry capabilities of the software) and a license fee."

You ask us to reconsider the conclusions reached in our September 29, 1995 letter to Mr. F--- and find that the Company's charges for software licensing and updates are not subject to tax pursuant to Regulation 1501.

Discussion

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases it in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by the lessor's purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).) When the lease is a continuing sale and purchase because either or both of the foregoing conditions are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) The lessee owes the tax and the lessor is required to collect it from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).)

Regulation 1501 provides that persons engaged in the business of rendering a service are the consumers of property they use incidentally in rendering the service. The distinction between the sale (or lease) of tangible personal property and the transfer of such property incidental to the providing of a service is based on the true object of the contract. In pertinent part, Regulation 1501 states:

> "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 ...."

In this case, the Company is providing its customers with information acquired from the DMV at the customer's site. To do so, the Company provides computer hardware and software to its customers as well as software updates, software support, and hardware maintenance. The customer inputs an inquiry regarding a DMV record at the customer's site and, using the continually updated software provided by the Company, receives a response to that inquiry on a computer terminal provided by the Company. While the customer receives the benefits of the Company's service, the true object of the contract is to have computer terminal access at the customer's site in order to make inquiries for, and receive DMV information at will. We would agree that the Company is providing a service if it required its customers to telephone a representative of the Company, provide a verbal inquiry, and await a verbal or written response from that Company representative. This, however, is not the case. The customer wants the ability to form its own DMV inquiries at its own location and receive information electronically at its site. The Company fulfills this need by providing tangible personal property in the form of hardware, software, and updates to its customers that allows them to have immediate electronic access to DMV records. The providing of this tangible personal property is the true object of the contract such that the rental receipts from the lease of this property may not be excluded from tax pursuant to Regulation 1501. Instead, the application of tax on the rental receipts from this property is based on the leasing rules of the Sales and Use Tax Law.

Your September 19, 1996 letter states that the Company does not lease its computer hardware to its customers. We note, however, that a lease of tangible personal property contemplates a temporary transfer of possession to, and use of the property by, another for consideration who agrees to return the property at a future time. (See Civ. Code § 1925; Rev. & Tax. Code § 6006.3; Reg. 1660(a); see also 42 Cal.Jur.3d, Leases of Personal Property, § 1, p. 510.) In this case, the Company is providing hardware to its customers at their location in consideration for the customer's agreement to pay all amounts charged to that customer as part of the overall transaction. We further assume that the Company is providing this hardware in substantially the same form as acquired and that each customer is required to return this equipment to the Company upon the termination of the agreement. Under these facts, the Company is leasing computer hardware to its customers. Tax does not apply on the rental receipts from this lease, however, since the Company has paid tax or tax reimbursement on this equipment.[1] If the rental receipts from the lease of the equipment are not taxable, the fees for maintenance of the equipment are also not subject to tax. (See Reg. 1660(c).)

We understand from your letter that the Company's lease of its prewritten software is a continuing sale and purchase since the Company either does not pay tax or tax reimbursement on this software or does not lease the software in substantially the same form as acquired. Tax therefore applies on the rental receipts from this software. We further assume that the Company's rental receipts (the approximate 2.91 percent of the total monthly charge) represent a commercially reasonable amount for the software and that they are not artificially reduced in order to avoid or minimize tax. (See BTLG Annots. 295.0660 (5/21/51) (a fictitious price charged solely to avoid tax will be ignored as a sham), 295.0680 (4/9/51), 395.1000 (12/23/65), 395.1040 (3/10/59).) If so, tax applies on the 2.91 percent amount and not a higher amount that might have been allocated to rental receipts in order to make the lease commercially reasonable.

You also indicate that the Company provides software upgrades and telephone support to its customers on an optional basis. Regulation 1502(f)(1)(C) explains the application of tax on these types of agreements:

> "Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

---

[1] We note that the Company does not allocate any amount of its total monthly charge toward the rental of hardware provided to customers. Since the Company paid tax or tax reimbursement on this equipment and (we assume) is leasing this equipment in substantially the same form as acquired, it is not necessary to allocate a portion of the monthly charges made by the Company to a rental amount for this equipment since tax does not apply on the rental receipts. However, if the Company did not pay tax or tax reimbursement on the equipment, we would allocate a portion of the entire transaction charge to an amount for "rentals payable" of the equipment and assess tax on that amount. In other words, the Company may not provide extax property to its customers and avoid tax liability merely by not allocating a charge to its customer for use of the property.

"....

"If the purchase of the maintenance contract is optional with the purchase, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media. If, however, the purchaser may, at its option, contract for the consultation services for a separately stated price, in addition to the charges made for the storage media, then the charges for the consultation services are nontaxable."

This means that an optional maintenance agreement that contemplates the providing of program updates on storage media is regarded as a contract for the sale of tangible personal property. Tax applies to the sale or use of such maintenance agreements inside this state. (Rev. & Tax. Code §§ 6051, 6201, 6401.)[2] Tax also applies to charges for consultation services (i.e., technical support) unless the consultation is optional and such fees are separately stated. (Reg. 1502(f)(1)(C).)

The Company is making retail sales of tangible personal property when it sells the optional maintenance agreements which contemplate the providing of software updates on storage media. Since the Company does not separately state its charges for its telephone consultation, tax applies on the entire charge for the software maintenance. Tax would not apply to the Company's charges for its maintenance agreements if the contract of sale required the Company to deliver software updates exclusively by remote telecommunications (e.g., e-mail or modem) and no tangible personal property was transferred to the customer as part of the maintenance agreement. (See Reg. 1502(f)(1)(D).)

Finally, you argue that the Company's charges should be non-taxable pursuant to *MCI Airsignal, Inc. v. State Bd. of Equalization* (1991) 1 Cal.App.4th 1527 and since the charges for software licensing are less than 10 percent of the Company's total charges to the customer. In *MCI,* the Court found that paging devices supplied to customers for telephonic paging were consumed by the taxpayer as part of the providing of a service. To reach this result, the Court relied on the fact that MCI's customers were provided with pagers that had no functional use whatsoever independent of MCI's paging services and which had no value or purpose except as part of the services provided by MCI. (*Id*. at pp. 1529, 1531 fn.3.) The customers could not use, reactivate, or operate the pagers with any other utility provider. In the Company's situation, however, the computer hardware and software have independent value since this property is not solely and exclusively functional with the Company's DMV operations. That is, we assume that the hardware could by used for other purposes (i.e., the hardware could operate other software) and that the software could operate on other types of hardware. Under these facts, *MCI* does not

[2] Tax applies to the optional maintenance agreement whether or not the Company separately states (or even provides) consultation services. Tax does not apply where an optional software maintenance agreement requires updates to be delivered to a customer outside this state and the updates are not first functionally used inside this state or brought into California within 90 days of their purchase. (See Reg. 1620(b).)

apply to the Company's operations. Your remaining contention that the software licensing should be non-taxable as a "de minimis" charge is without authority. We are unaware of any "threshold" amount for excluding charges for software when they are provided as part of an integrated transaction with a customer.[3] You should provide us with the citation to any authority(ies) you believe support your contention.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Tax Counsel

WLA:rz

cc: Hollywood District Administrator - (AA)

[3] We acknowledge that Regulation 1546 contains a 10 percent threshold amount for determining when a repairman is the consumer or retailer of parts. Regulation 1546 only applies, however, in instances involving the installation, repair, or reconditioning of property.