

M e m o r a n d u m**330.3440**

To: Out-of-State - Auditing (DMA)

Date: June 26, 1970

From: Tax Counsel (GJJ)

Subject:

This is in response to your memo of March 24, 1970 in which you raise three questions as to the application of the tax to certain of taxpayer's leases of computer equipment.

We understand that taxpayer is engaged primarily in the business of leasing computers and related equipment. As of June 30, 1969 the computer equipment owned by the company consisted of 231 computer systems essentially all of which were purchased by taxpayer from "B". Taxpayer does not repair, maintain or service the equipment which it leases. Taxpayer requires that the "B" equipment owned and leased by it be maintained under "B"'s standard maintenance agreement, all or a portion of the cost of which, in most instances, is borne directly by the company.

Your first question concerns the taxability of excess maintenance charges for servicing leased equipment. According to the terms of a typical "Agreement For "B" Machine Use" entered into between taxpayer and its customer, taxpayer agrees to enter into and maintain in force a "B" maintenance agreement covering the machines which are the subject of the lease. It is the obligation of taxpayer's customer to use its best efforts to cause "B" to keep the machines in good working order in accordance with the provisions of the "B" maintenance agreement and pursuant to taxpayer's written authorization to "B" to accept the directions of taxpayer's customer with respect thereto. The agreement provides:

“[Taxpayer's] liability for payment of charges under the "B" Maintenance Agreement shall be limited to "B"'s minimum monthly maintenance charge or \$... per month, whichever is lower. Customer shall pay, at its own expense, all "B" Maintenance and service charges in excess of [taxpayer's] liability therefor, whether such charges are incurred under the "B" Maintenance Agreement or otherwise, and in addition will pay expenses, if any, of "B"'s Customer Engineers charged by "B" in connection with maintenance and repair service.”

“Excess maintenance charges” are billed by “B” to taxpayer, and taxpayer, in turn, rebills its customer at the amount billed to it.

Taxpayer argues that since excess maintenance is available to the customer as a convenience which enables the customer to obtain maintenance services outside of normal working hours, our Regulation 1546(b) (3) (B), dealing with mandatory contracts, is inapplicable. Taxpayer states that its customer could have its maintenance work performed during normal working hours and is “under no compulsion, requirement or mandate to contract for or pay this excess maintenance coverage.”

It is our opinion that any amount paid by taxpayer's customer to taxpayer as an “excess maintenance charge” is a part of the rental receipts of the leased equipment and as such is subject to tax. The “excess maintenance charge” is merely a part of the “gross receipts” or “sales price” of the equipment associated with a service a part of the sale of the equipment.

Paragraph (b) (3) of Regulation 1546 is not, in its own terms, strictly in point. Taxpayer has, in part, entered into a lump-sum mandatory maintenance contract with its customer. That is, to the extent that taxpayer provides a package of maintenance service within its flat rental charge, taxpayer is providing its customer with a lump-sum mandatory maintenance service; the tax consequences of which are specifically governed by the regulation. However, to the extent that taxpayer provides to its customer this maintenance service at a variable price, we think the general principles of the Sales Tax Law are applicable.

The question becomes, are the “excess maintenance charges” a part of the rental price (gross receipts or sales price) of the computers. For purposes of the Sales and Use Tax Law, we think that such charges must properly be regarded as rental charges. We have said that where the lessee must secure maintenance services from his lessor, maintenance charges are subject to tax as charges for services a part of the sale. It is the obligation of taxpayer's customer here to pay to taxpayer (1) “all ... maintenance and service charges [incurred by taxpayer] in excess of” the fixed amount which taxpayer has agreed to absorb and (2) all charges for “B”'s customer engineers charged to taxpayer in connection with maintenance, and repair services. Since the services provided are a part of the sale or purchase of the equipment, receipts attributable to the performance of those services are subject to the tax as a part of the rental price of the equipment.

In our opinion such charges are includable in the measure of tax liability under the rental agreement even though some of the charges might vary with the customer's choice of the time for the work to be performed. Fundamentally, all maintenance expenses are the obligation of taxpayer and any “excess maintenance charge” recovered, under the lease agreement, by taxpayer from its customer constitutes a part of the rental receipts which taxpayer will utilize to cover its operating expenses. The law provides that “gross receipts” or “sales price” means the total amount for which tangible personal property is rented without any deduction on account of any expenses [Rev. & Tax. Code, §§ 6012, 6011].

Your second question concerns the taxability of maintenance charges under “net lease” agreements. Under a typical “net lease” agreement:

“[Taxpayer] agrees to appoint the customer as its agent to obtain maintenance services from “B” for machines covered by this agreement. The customer agrees to include the leased machines either within the coverage of its basic maintenance

agreement for purchased machines with “B” or within the coverage of “B”’s standard commercial maintenance contract. Upon receipt of evidence of payment by customer, [taxpayer] shall reimburse the customer (in the form of a credit against monthly maintenance charges) for an amount equal to “B”’s January 1, 1967 minimum monthly maintenance charges for the machines.”

The agreement further provides that:

“In the event the machines covered by this agreement are removed from the State of California... [taxpayer] shall enter into and maintain in force a “B” maintenance agreement covering the machines in lieu of the customer obtaining maintenance services as described above; provided however, in the event [taxpayer] shall so do. (i) [taxpayer] shall pay no more for maintenance of the machines than the “B” April 1, 1967 minimum monthly maintenance charge therefor, and (ii) [taxpayer’s] obligation to reimburse customer for minimum monthly maintenance charges as aforesaid shall terminate.”

We have said, in regard to maintenance charges on leased equipment that such charges are includable in rental receipts if the agreement between the lessor and lessee requires the lessor to maintain the equipment.

Since, by agreement of taxpayer with its customer, taxpayer is the principal in supplying the maintenance services, charges for such services are subject to the tax. The maintenance charge cannot be said to be “paid directly to the manufacturer by the customer and [not] received by [taxpayer],” as has been suggested by taxpayer, because the customer is taxpayer’s agent in both securing and, accordingly, paying for the service.

As we have indicated above, the fact that taxpayer attempts to pass on certain of its business expenses to its customer, by separate statement, at cost, cannot alter the nature of those payments as payments incidental to the letting of the computer equipment.

Your third question concerns field installation charges for the installation of components and modifications to taxpayer’s computers at its customer’s locations. A typical agreement provides:

“ [Taxpayer] shall, upon receipt of a written request from customer, arrange with and pay “B” for such field modifications to any of the machines as are then offered to rental customers of “B”; provided however that the aggregate amount required to be paid to “B” by [taxpayer] for all such modifications shall not, without [taxpayer’s] written consent, exceed 20 percent of the price paid by [taxpayer] to “B” for all the machines described in the annexed schedule of machines as of the commencement date. Effective on the day following the date of completion of each modification the monthly rental charge payable hereunder shall be increased by 90 percent of the additional prime fixed monthly availability charge which would be required to be paid to “B” by a rental customer of “B”, on a month-to-month basis, as a result of such modification. Customer shall itself pay “B” for all “B” field installation charges made in connection with each such modification.”

Taxpayer asserts that:

“These charges reflect a rebilling by [taxpayer] for the charges made by the manufacturer for these installations ... [Taxpayer] is billed by the manufacturer and merely passes these charges directly on to its customer [Taxpayer] merely serves as an intermediary in funneling these charges from the customer to the manufacturer.”

In our opinion taxpayer is not an “intermediary” between “B” and taxpayer's customer but is the principal in furnishing the field modification services to the customer. “B” is a subcontractor, although the customer may be the third party beneficiary of a contract between taxpayer and “B”. However, merely because we would regard taxpayer as the person furnishing the field installation services, it does not follow that the charges would be subject to tax. If the charges are for a true installation task, they are exempt as charges “for labor or services rendered in installing or applying the property sold” [Rev. & Tax. Code §§ 6011, 6012]. Unfortunately this question seems to be one of fact. It is not clear to us whether these charges are true installation charges, i.e., charges for placing, fitting, or adapting parts sold, by lease, by taxpayer pursuant to its lease agreements with its customers. On the assumption that the “field installation charges” are for true installation work, it is our opinion that such charges are not subject to the tax.

GJJ:ph [lb]