

Memorandum

To: Susanne Buehler
Chief
Tax Policy Division (MIC:92)

Date: October 24, 2011

From: Cary Huxsoll
Tax Counsel
Tax and Fee Programs Division (MIC:82)

Subject: Legal Opinion Request – Leases of Computers with Prewritten Software
Assignment No. 11-295

This is in response to your July 14, 2011, email in which you request information as to the application of the Sales and Use Tax Law to a lessor's [Taxpayer] leases of computers and software. Specifically, you ask:

Does the loading of prewritten software (tax paid at source) onto a computer (also tax paid at source) and leasing them as a single unit substantially change the form as acquired such that the taxpayer is precluded from applying the provision of Regulation 1660, subdivision (c)(2), "Property Leased in Form Acquired?"

First, I assume that Taxpayer pays sales tax reimbursement or use tax to its vendors when it separately purchases the computer hardware and the prewritten software. Second, I assume that Taxpayer does not separately charge for the installation of the leased software onto the leased computer hardware. Third, I assume that Taxpayer also provides its customers possession of the originally purchased storage media containing the prewritten software (e.g., the original disks provided by the software vendor) so that the customer may re-install the leased software onto the leased computer hardware if necessary. Fourth, I assume that the lease transactions are contracts structured as leases and are, in fact, true leases (e.g., the customer could not obtain title to the leased property at the end of the lease term upon the completion of the required payments by exercising an option to purchase the leased property for a nominal amount). (See Reg. 1660, subd. (a)(2).) Finally, I assume that Taxpayer is not the holder of any patent or copyright interests associated with the prewritten software and that, accordingly, Taxpayer never assigns or licenses patent or copyright interests to the lessees (i.e., I assume that under no circumstances could the leases in question be reasonably characterized as technology transfer agreements). (See Reg. 1507 [discussing the application of tax to technology transfer agreements].)

DISCUSSION

As a starting point, California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, § 6051.) The sales tax is imposed on the retailer, who may collect reimbursement from the customer if the contract of sale so provides. (Civ. Code, § 1656.1; Reg. 1700.) When sales tax does not apply, such as when the sale takes place outside the state, use tax is imposed, measured by the sales price of property purchased from a retailer for storage, use, or other consumption in California. (Rev. & Tax. Code, §§ 6201, 6401.) The use tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code, § 6202.) Taxable gross receipts or sales price includes all amounts received with respect to the sale, with no deduction for the cost of the materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code, §§ 6011, 6012.)

As relevant to your inquiry, a lease¹ of tangible personal property in California is a continuing sale and purchase subject to tax, unless the lessor leases the property in substantially the same form as acquired and has paid California sales tax reimbursement or has made a timely election to pay use tax measured by the purchase price of the property. (Rev. & Tax. Code, §§ 6006, subd. (g)(5), 6006.1, 6010, subd. (e)(5), 6010.1; Reg. 1660, subds. (b)(1)(E) & (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, subd. (c)(1).) The lessee owes the tax and the lessor is required to collect it from the lessee and pay it to the Board. (Rev. & Tax. Code, §§ 6202, 6203, 6204; Reg. 1660, subd. (c)(1).) When a lease is not a continuing sale and purchase because both of the foregoing conditions have been satisfied, no sales or use tax is due with respect to the rentals charged. (Reg. 1660, subd. (c)(2).)

Whether property is leased in substantially the same form as acquired is determined on a case-by-case basis. Property is "leased in substantially the same form as acquired" if the property is acquired by a lessor and then leased to the lessee without there being any substantial changes. (See Reg. 1660, subd. (c)(2).)

The Board's Legal Department has determined that no further tax is due when a lessor purchases two items tax paid and rents them as a single unit, so long as no significant fabrication labor is required to produce the single unit and the single unit is not leased in a substantially different form than the components. (See, e.g., Sales and Use Tax Annotation² (Annotation or Annot.) 330.3940 (8/31/66) [motor attached to boat without significant amount of fabrication labor], 330.4090 (9/5/68) [individual restaurant equipment items assembled into a working unit (a restaurant) prior to leasing], 330.4140 (1/12/68) [bindings attached to snow skis] & 330.4190 (7/7/70) [water softener tank installed to plumbing].)

¹ Generally, the term "lease" implies that the possession of property, but not title to property, is passed to a customer for a consideration and includes rental, hire, and license. (Rev. & Tax. Code, § 6006.3; Reg. 1660, subd. (a)(1).)

² Annotations are summaries of the conclusions reached in selected opinions of attorneys of the Board's Legal Department and are intended to provide guidance regarding the interpretation of Board statutes and regulations as applied by staff to specific factual situations. (See Reg. 5700.)

Here, the transactions in question involve leases of tangible personal property, computer hardware loaded with prewritten canned software. Taxpayer has created a unit by merely loading the software onto the computer hardware prior to transferring the property to its customers. Indeed, since the lessee is receiving the same software on tangible media that was pre-loaded onto the computer, it could have easily installed or could reinstall the software onto the computer if necessary. Thus, as described, Taxpayer does not perform significant fabrication labor to the leased computer. (See Reg. 1502, subd. (f)(1)(D).) Moreover, presumably the lease amount reflects the value of the computer hardware and the software transferred on storage media, and in this case pre-loading the software onto the computer does not add significant value to the computer. Accordingly, the leased property does not constitute a unit leased in a substantially different form than the individual components. The property is thus rented in substantially the same form as acquired. That is, the general functional capabilities, characteristics, or form of the property has not been significantly changed following Taxpayer's acquisition. Given these facts, no sales or use tax is due with respect to the amounts charged for such rentals. (Reg. 1660, subd. (c)(2).)

I trust that this answers your questions. If you have any further questions, please contact me at (916) 323-3092.

CCH/mcb

cc: Trista Gonzalez (MIC:44)
Jason Parker (MIC:44)