

(916) 445-6493

July 21, 1988

REDACTED TEXT

REDACTED TEXT

Knowledge Engineering Agreement with REDACTED TEXT

Dear REDACTED TEXT,

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 REDACTED TEXT (REDACTED TEXT) and REDACTED TEXT.

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

"1. RECITALS

"WHEREAS, REDACTED TEXT 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, REDACTED TEXT has expertise in one or more particular domain and desires to obtain Knowledge Engineering expertise from REDACTED TEXT 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 REDACTED TEXT's Expert Systems techniques and methods with REDACTED TEXT'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 REDACTED TEXT 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 REDACTED TEXT and REDACTED TEXT through the use of Domain Knowledge and REDACTED TEXT Technology.”

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

“4. DESCRIPTION OF SERVICES:

“REDACTED TEXT shall provide the services of Knowledge Engineers to REDACTED TEXT to develop a computer program and Knowledge Base to result in Expert System for REDACTED TEXT’s use as more specifically stated in the Purchase Order.”

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

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“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 REDACTED TEXT 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 REDACTED TEXT and REDACTED TEXT, 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. REDACTED TEXT and REDACTED TEXT 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 or 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 REDACTED TEXT to provide to REDACTED TEXT knowledge engineering services, and was not for the transfer of tangible personal property. Of course, if any tangible personal property was transferred by REDACTED TEXT to REDACTED TEXT in connection with the performance of this contract, tax would apply to those charges for such tangible property. We assume that REDACTED TEXT recognizes this in paragraph 5.3 of the agreement, which requires REDACTED TEXT to charge REDACTED TEXT for third-party products without markup.

We note that under paragraph 4.1.3 of the agreement, REDACTED TEXT will transfer to REDACTED TEXT a copy of any knowledge base developed. We assume that this transfer would take the form of tangible 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 REDACTED TEXT 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 REDACTED TEXT and transferred to REDACTED TEXT 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 custom computer program under

the provisions of Section 6010.9, since it would be prepared by REDACTED TEXT to the special order of REDACTED TEXT pursuant to this agreement. REDACTED TEXT 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