STATE BOARD OF EQUALIZATION
LEGAL DIVISION – MIC: 82
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
TELEPHONE (916) 324-3828
FAX (916) 323-3387

May 29, 1996

Mr. [L]
[P]
XXX --- ---
--- ---, California XXXXX

Re: Unidentified Taxpayer

Dear Mr. [L]:

This is in response to your April 4, 1996 letter to Assistant Chief Counsel Gary Jugum requesting a ruling on the application of tax on optional maintenance agreements that consist of both equipment service and software updates. I initially note 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 should provide us with the identity of your client (as well as all relevant facts) in your initial letter to us if you wish an opinion letter coming within the provisions of section 6596.

You state:

> "The client is a manufacturer of industrial equipment used in the production of tangible personal property. One of the component parts of the equipment is a computer which provides necessary automation for the equipment. The computer is integrated into the overall system and is not used for any other purposes. As with any automated system, software controls the computer which in turn controls the equipment. The software was developed by the client specifically for use with the systems sold by the client and is not useful on any other equipment. Likewise, without the software the equipment is not functional and the equipment will not run on any other manufacturer's software. The computer and related software are not major components of the equipment and account for less than 10% of the equipment's total cost.

> "After the expiration of the standard equipment warranty that is provided to the customer at the time of purchase, customers have the option of entering into a lump-sum service agreement with the client. Under the agreement, the client is required to perform various preventative and remedial maintenance procedures on the equipment. Required materials are provided on a no-charge basis. In addition, the client will furnish and install software updates as they are released by the client for equipment covered by a service agreement at no additional charge to the customer.
>
> "The client currently accrues California use tax on the cost of materials furnished under the optional service agreements (as prescribed by Regulation 1546(b)(3)(C)). The issue of the application of tax to the portions of the service agreement attributable to the software has arisen"

You ask whether any portion of the above agreement is considered an optional lump-sum software maintenance agreement subject to tax. If so, you ask us to provide you with guidance in determining when and how tax applies with respect to optional maintenance agreements that include both equipment service and software updates.

Discussion

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.) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption in California. (Rev. & Tax. Code § 6201.) Taxable gross receipts and sales price include all amounts received with respect to a sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011, 6012.) Charges for optional equipment maintenance agreements are not, however, part of a retailer's gross receipts or the sales price of property and are not subject to tax. (Business Taxes Law Guide Annots. 490.0580 (12/13/63), 490.0700 (5/10/60).)

Regulation 1502(f)(1)(C) provides 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.)[1] 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).)

You state that your client offers its customers an optional lump-sum service agreement providing for both its equipment and computer software which runs the equipment. Under these

[1] 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).) Tax also does not apply where the optional software maintenance agreement requires updates to be delivered by remote telecommunications (e.g., modem or e-mail) and the purchaser does not obtain possession of any tangible personal property such as storage media in the transaction. (Reg. 1502(f)(1)(D).) For purposes of this opinion, however, we assume that neither of these provisions apply to your client's situation.

facts, we regard the service agreement as both an optional maintenance agreement on the equipment as well as an optional maintenance agreement for the software. As such, tax applies to that portion of the lump-sum service agreement that represents the charges for the optional software maintenance. Your client should report and pay tax to this Board measured by the amount allocated to the software maintenance agreement portion of the lump-sum charge for the service agreement.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel