STATE OF CALIFORNIA

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June 24, 1991

Mr. L--- S---
M---, S---, B--- & S---
XXXX Avenue ---, Suite XXX
--- ---, Pennsylvania XXXXX-XXXX

RE: I--- S--- M---, Inc.

Dear Mr. S---:

This is in response to your letter dated May 9, 1991. In response to your previous letter, I wrote you a letter dated December 26, 1990 regarding the application of tax to the business of I--- S--- M---, Inc. (ISM). You now provide additional facts and ask for a reconsideration of our prior advice.

ISM contracts with its customers to provide each customer computer software in tangible form and a user's guide. Each customer is provided upgrades of these two items one to three times each year. The customer also submits certain data to ISM on a monthly basis. ISM uses this data to generate reports, which I assume are different for each customer, on paper as well as on computer disc. These items are provided to each respective customer. ISM charges each customer a one-time charge plus an additional monthly charge. These charges are lump sum with no separate allocation between the charge for software, user's guide, or other activity.

In my previous letter, I noted that we did not have sufficient information to ascertain whether the activity you characterized as data processing services would constitute a taxable sale of tangible personal property or a nontaxable service if provided alone. However, I also stated that even if that activity were regarded as a service, it was required as part of the sale of tangible personal property. As a service which is part of the sale of tangible personal property, the charge would be included in the measure of tax on the sale of the tangible personal property.

You read my previous letter as stating that the entire charge is subject to sales tax pursuant to (f)(1)(C) of Regulation 1502. You believe that provisions does not apply to the facts involved in ISM's sales since it relates to maintenance contracts sold in connection with the sale of prewritten computer programs where the real object sought by the buyer is the computer program and not the maintenance services. Actually, subdivision (f)(1)(C) of Regulation 1502 would be applicable to to the sale of a maintenance contract for a prewritten computer program even if the maintenance contract is not sold in connection with the prewritten program. (For example, the customer already owns the prewritten program and only thereafter enters into the maintenance contract, or the customer obtains the software without purchasing it, such as by gift, and thereafter enters into a maintenance contract.) The true object of that maintenance contract is to obtain the updates in tangible form.

The charge for the maintenance contract is always taxable because the contract is for the sale of tangible personal property (the updates). Whether the maintenance contract is optional relates only to the question of whether tax applies to a separate charge for an activity which would be regarded as a nontaxable service if provided alone, such as telephone consultation. If the maintenance contract is required as part of the purchase of the prewritten program, the service would be required as part of that sale, and the charge for that service would be subject to tax. Even if the maintenance contract is optional or totally unrelated to the underlying sale of the prewritten program, if the service is required in order to purchase the maintenance contract, then that service is also part of the sale of the tangible personal property and the charge for the service is subject to tax.

Subdivision (f)(1)(C) of Regulation 1520 specifically covers this transaction. ISM's customer purchases tangible personal property, computer software in tangible form and a user's guide, and is also required to purchase a maintenance contract (updates to the software in tangible form as well as updates to the user's guide) that also includes service as a required part of that sale. Thus, the ale in question does come within subdivision (f)(1)(C) of Regulation 1502. My reference to subdivision (f)(1)(C) of Regulation 1502 was also intended as an example of a regulatory provision that states that taxable gross receipts include charges for services that are part of the sale of tangible personal property. This is the reason that the citation referred you to see Regulation 1660(c)(1) as well as Regulation 1502(f)(1)(C).

You ask the following questions, which are the same questions we answered in response to your previous letter:

> "(1) Does the 'processing services' arrangement provided by ISM fall within the definition of 'original information from customer-furnished data' as defined in the California Sales and Use Tax Regulations"
>
> "(2) Is the PC software system which ISM provides to each customer pursuant to a non-exclusive and non-transferable license subject to tax?
>
> "(3) Is the user's guide provided by ISM to each customer subject to tax?

"(4) Are the upgrades to the PC software system provided by ISM to the customer one to three times a year subject to tax?

"(5) Are the upgrades to the user's guides provided by ISM to the customer one to three times per year subject to tax?

"(6) If any of the above are taxable, what is the property method of determining allocation of the purchase price?"

From the description in the brochures that you have now provided us, it appears that some or all of the processing provided by ISM qualifies as the service of processing customer furnished information. However, you have provided us no information that warrants a change in our conclusion that this service is merely part of the sale of tangible personal property.

ISM provides the customer with computer software. Obviously, the customer wants that actual software. ISM also provides updates to that software in tangible form. The customer also wants those actual updates. That the software is designed to be interrelated with the other items provided to the customer which are derived from the processing of that customer's information simply does not change the fact that an important part of this contract is the sale of the tangible personal property. I note that the brochures you have provided us confirms this conclusion. Among the representations in those brochures is the following statement:

"The easy-to-use PC-based software system supplements the benefits of the charts. With the analysis diskette supplied each month, I/S teams can dig deeper into capacity planning and performance issues. With the PC system, they can identify the causes of problems and assess the impact of proposed system changes through modeling exercises - - before committing resources to those changes.

"Capacity planning functions are provided to analyze the growth of workloads, estimate new workloads, estimate latent demand, and build a capacity plan reflecting processor upgrades as appropriate.

"Performance management tools are provided to perform in-depth analysis on the processor complex, real storage, the paging subsystem and the I/O subsystem.

"Modeling tools are provided to forecast the impact of changes in CPUs, real storage, the paging subsystem, the I/O subsystem and workloads.

"Extensive ouput [sic] device support is provided to produce presentation-quality graphics output."

This representation shows that the tangible personal property provided to the customer has an independent valuable purpose. This confirms our conclusion that ISM is making a sale of tangible personal property. (I note that this representation, and the facts underlying it, are not determinative, but merely support our conclusion.)

In answer to your specific questions, we regard this contract as a sale of the tangible personal property about which you inquire in your questions two through five. The processing performed by ISM appears to qualify as the service of processing customer furnished information, but since the customer cannot purchase the software without also purchasing the service, that service is a required part of the sale of the tangible personal property. IN answer to your question six, allocation is neither necessary nor allowed. ISM is making a sale of tangible personal property along with required service, and the entire charge for that contract is subject to sales or use tax.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl
cc: Mr. Glenn A. Bystrom