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March 16, 2007

RAMON J. HIRSIG
Executive Director

Mr. [B]
[A]
XXX --- ---
--- ---, CA XXXXX
MailStop: XXXXXX

Re: Tax Opinion Request 06-789
[A]
No Tax Account Number

Dear Mr. [B]:

This is in response to your November 8, 2006, letter in which you request information about the application of the Sales and Use Tax Law to five sales scenarios relating to your company's business. Based on the information contained in your letter, I was unable to confirm that you hold a seller's permit. Nor do you give enough information about the totality of your business operations for me to determine whether you should hold a seller's permit. Your letter suggests that you may purchase materials and supplies from out-of-state vendors that do not collect and remit use tax from California customers. If such is the case, among other possible reasons, you should be registered with the Board to self-report the use tax due on these purchases. If you are not the holder of a seller's permit or otherwise registered to self-report use tax and you think you might need to be, please visit our Board's Web site (www.boe.ca.gov) for more information.

You write:

"I am writing to get [a] ruling on 'data recovery services.' The service is usually on disk drives, which lost data due to software issues or physical damage to the drive like fire, water, etc. I would like to know the taxability of the sales scenarios listed below along with the regulations and/or annotations to support the answers.

"Assumptions

- "1. DVD/CD (cost \$1.00) is purchased tax paid or tax is accrued on purchase.
- "2. Refurbished disk drives are purchased tax paid or tax is accrued on purchase.
- "3. Cost of refurbish[ed] dis[k] drive is \$25.00

“4. Average cost of data recover[y] services is \$500 to \$1000 depending on the severity of damage to the disk drive.

“Sales Scenarios

“1. Customer sends their disk drive and we are able to [re]cover the data and put the data back on the disk drive. Customer is sent back the drive with data restored. Sales invoice \$750.00.

“2. Customer sends their disk drive[;] it is damage[d] and unusable. We recover the data and put in on DVD/CD. Customer is sent the recovered data on a DVD/CD along with the broken drive. Sales invoice \$750.00.

“3. Customer sends their disk drive[;] it[']s damage[d] and unusable. We recover the data and put it on a website. The customer is sent back the broken drive and login/password to download the data from a website. Sales invoice \$750.00.

“4. Customer sends their disk drive[;] it[']s damage[d] and unusable. We recover the data and place it on a refurbish[ed] disk drive. The customer is sent back the data on the refurbish[ed] disk drive. We charge one fee with no break out of the refurbish[ed] drive. Sales invoice \$750.00.

“5. Same as [4], but the sales invoice is broken out. Data recover[y] service is \$725.00 and disk drive is \$25.00.”

Based on your letter, I understand you to ask how the California Sales and Use Tax Law applies to different means by which computer storage drive malfunctions are corrected to enable the customer to regain access to pre-existing, stored data.

Discussion

As a starting point, California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property inside this state unless the sale is specifically exempted from taxation by statute. (Rev. & Tax. Code, § 6051.) This tax is imposed on the retailer who may collect reimbursement from its customer if the contract of sale so provides. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (Regulation or 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 the storage, use, or other consumption of that property in California unless specifically exempted or excluded from taxation by statute. (Rev. & Tax. Code, §§ 6201, 6401.) This tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code, § 6202.) Taxable gross receipts or sales price include 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 exemption or exclusion. (Rev. & Tax. Code, §§ 6011, 6012.)

Persons engaged in the business of rendering a service are consumers, not retailers, of the tangible personal property that they use incidentally in rendering the service. (Reg. 1501.) The “true object” of the contract determines whether a particular transaction involves the sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service. Where the true object is the service, Regulation 1501 provides that the transfer of incidental tangible personal property by the person performing the service is a nontaxable event. Thus, tax applies to the service provider’s acquisition of the property used in performing the service.

Accordingly, the initial question is whether you are providing any tangible personal property to your customers. The first and third sales scenarios do not include the transfer of tangible property to the customer. With the exception of the return of the customer’s own storage drives, the customer receives nothing from you in tangible form under both scenarios. Under the first sales scenario, you return the customer’s storage drive after you remedy a malfunction that made the stored data inaccessible. We assume that the first sales scenario arises from a hardware or software malfunction. Regarding remedial measures that correct a hardware problem, such as repairing an inoperable part, we regard this activity as the providing of a service.

However, even when a retailer makes no transfer of tangible personal property, under the Sales and Use Tax Law, “sale” includes the producing, fabricating, or processing of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, or processing (hereafter, collectively, fabrication). (Rev. & Tax. Code, § 6006, subd. (b).) In contrast to potentially taxable fabrication, work done on a used item furnished by the customer is nontaxable repair, reconditioning, or installation labor unless the work produces an item that is fit for a new and different purpose, as subdivision (b) of Regulation 1526 explains:

“Producing, fabricating, and processing include any operation which results in the creation or production of tangible personal property or which is a step in a process or series of operations resulting in the creation or production of tangible personal property. The terms do not include operations which do not result in the creation or production of tangible personal property or which do not constitute a step in a process or series of operations resulting in the creation or production of tangible personal property, but which constitute merely the repair or reconditioning of tangible personal property to refit it for the use for which it was originally produced.”

In the case of remedial measures to correct a software malfunction involving a corrupted file allocation table (FAT) that no longer records the location of the customer’s data on the storage device, we regard this activity as processing consumer-furnished information, not fabrication of customer-furnished tangible personal property. Charges for processing consumer-furnished information are not subject to tax. (Reg. 1502, subds. (c)(5), (d)(1) & (5).) “Processing consumer-furnished information” means developing original information from data furnished by the customer. (Reg. 1502, subd. (d)(5)(A).) Examples include summarizing, computing, extracting, sorting, and sequencing. (*Ibid.*) A newly created FAT will enable the customer to regain access to the data. We regard your creation of original information in the

form of a new FAT as summarizing and sorting the customer's existing data. Accordingly, creation of a FAT for the customer's data is "processing consumer-furnished information" and sales tax will not apply to charges for this service.

Under the third sales scenario, the damaged or malfunctioning storage drive is returned to the customer and the data is loaded to a Web site from where it may be downloaded by the customer. We do not regard the transfer of information by remote telecommunications as the transfer of tangible personal property. Thus, if your customers obtain their data only by accessing it and downloading it from your Web site, you would not be regarded as selling tangible personal property, and no tax would apply to your charges for such service. (See, e.g., Reg. 1502, subd. (f)(1)(D); Reg. 1540, subd. (b)(2)(B).)

The remaining three sales scenarios (scenarios 2, 4 and 5) involve the transfer of tangible personal property in the form of a storage medium that was not furnished by the customer and which contains the customer's restored data. Accordingly, the question to be resolved is whether you are selling tangible personal property or transferring the stored data in tangible form incidental to the providing of a service. Regulation 1501 explains:

"The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service."

Regulation 1502 applies this general rule to computers, programs, and data processing. Generally, it provides that the transfer of title, for consideration, of tangible personal property, including property on which information has been recorded or incorporated (e.g., the conversion of customer-furnished tangible personal property from one physical form of recordation to another), is a sale subject to tax. (Reg. 1502, subds. (c)(1) - (2), (d)(1) & (5)(B).) For example, when a contract requires only the conversion (not processing) of customer-furnished data (i.e., putting the words or symbols on a disk, and not creating the words or symbols), the object of the contract is not the contractor's ideas, analysis or data interpretation, but instead is the acquisition of a functionally usable piece of tangible personal property that is subject to tax. (See, e.g., Sales and Use Tax Annot. 120.0118 [08/12/94].¹)

However, as indicated above, subdivisions (c)(5) and (d)(1) of Regulation 1502 provide that, under certain circumstances, charges for processing customer-furnished information are not subject to tax. As previously discussed, processing of customer-furnished information means the developing of "original" information from data furnished by the customer, and processing of customer-furnished information includes summarizing, computing, *extracting*, sorting, and sequencing of data, and the updating of a continuous file of information maintained by the customer with the data processing firm. (Reg. 1502, subd. (d)(5)(A).) For example, where a data processing firm enters into a contract for the processing of customer-furnished information, the *transfer* of the original information to the customer is considered to be the rendition of a

¹ Sales and Use Tax Annotations are summaries of legal opinions by the lawyers of the State Board of Equalization's Legal Department that address specific inquiries. (See Reg. 5200 [discussing the effect and use of annotations].)

service. (Reg. 1502, subd. (d)(5)(C).) Tax does not apply to the charges made under contracts providing for the transfer of the original information regardless of the storage media used to transfer the original information. (Reg. 1502, subd. (d)(5)(C).)

We assume that these three remaining sales scenarios (2, 4 and 5) arise from an unreparable storage device or corrupted data. For purposes of Regulation 1502, we regard the data as no longer existing in its original form, and any recovered data constitutes “original information” derived from data furnished by the customer. Accordingly, the “true object” of the contract is performance of a data recovery service. The storage medium that you furnish the customer is merely incidental to providing this service. Therefore, with the exception noted below, no sales tax applies to these sales scenarios.

Finally, the last sales scenario (5) you describe provides for a separately stated \$25 charge for the refurbished disk drive transferred. Although your company would generally be considered to be the consumer of all tangible personal property (e.g., refurbished disk drives, DVD/CD, etc.), when you make a separate charge for the property transferred, the charge is subject to tax. (See, e.g., Reg. 1502, subd. (c)(8).) However, you suggest that you may acquire the property transferred on a tax-paid basis. If this is the case, you would appear to be entitled to take a tax-paid purchases resold deduction, which would, in effect, “net out” the tax consequences of making a separate charge for the refurbished disk drive. (See Reg. 1701.) You would definitely need to hold a seller’s permit to take a tax-paid purchases resold deduction.

Our opinion is based on the facts, representations, and assumptions set forth above. If the facts are different than those we describe and assume in this response, then our opinion might be different. How tax applies in any “fact-based” situation ultimately depends on what actually transpires between the parties to the contract and would be subject to audit verification. For your reference, we are also enclosing a copy of Regulation 1502. If you have any further questions, please write again.

Sincerely,

Mike Llewellyn Tax Counsel

ML/ef

Enclosure: Regulation 1502

cc: --- --- District Administrator (--)