

M e m o r a n d u m**515.1183**

To : Mr. David B. Weld
Supervising Tax Auditor - Downey

Date: June 30, 1992

From : David H. Levine
Senior Tax Counsel

ATSS 485-5550
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Subject: I--- C--- I---

This is in response to your memorandum dated March 27, 1992 regarding the application of tax to the business conducted by I--- C--- I--- (I---). I--- enters into contracts to monitor persons who apparently would otherwise be incarcerated. For ease of reference, I will refer to such monitored persons as offenders. In order to monitor the offenders, certain equipment is installed at the offender's home and on the offender's person. The question here is whether the transfer of that equipment is the lease of tangible personal property subject to use tax.

FACTS

The transactions at issue consist of two separate contracts. I--- contracts, usually with state or federal courts, to monitor offenders. However, I--- in turn contracts with another person, B--- M--- (B---), who performs a significant portion of the actual monitoring. In effect, I--- is a middle person selling to state and federal courts the monitoring performed by B---.

A. Contract Between I--- and B---

Although the contract is between I--- and C--- R--- I---. (C---), I--- has explained that prior to execution of that contract C--- was taken over by B---. For this reason, notwithstanding the reference in the contract to C---, I will refer to that person as B---. The contract is entitled "Electronic Monitoring Program Service Agreement." It states that B--- will provide to I--- certain products and services. The basic equipment consists of a radio frequency transmitter, a field monitoring device (FMD), and a host computer system. The transmitters and FMD's are issued to ICI and the host computer system is located at B---'s offices. The field equipment communicates with the host computer system through the offender's standard telephone line. B--- also provides to I---, without further cost (i.e., included in the per unit charge), sufficient field equipment supplies (batteries, latches, and straps) for up to four installations per year per unit. Supplies in excess of this amount are provided for an additional, separate charge. Installation tools and instruments are also supplied to I--- without additional cost. B--- bears all telephone service charges associated with the field equipment/computer communications.

The transmitter is, in effect, an ankle bracelet that attaches to the offender's ankle. The FMD is installed at the offender's home and is plugged into a telephone jack and power line. Other equipment will be discussed below.

When an offender violates his or her restrictions by being too far away from the FMD, the FMD knows it and notifies B--- by telephone transmission. B--- thereafter notifies I---, following guidelines for that notification as set forth in the contract. This includes, depending upon the circumstances, immediate notification to pre-identified I--- staff, next day notification, and next working day notification. This information is communicated by telephone. Hard copy reports are maintained at B--- offices and provided to I--- upon request. FAX transmissions of such reports are also provided upon request. Each working day a summary of all violations since the last report is provided to I---.

I---'s responsibilities under the contract include: retaining complete authority for case selection and case management as agreed between it and its contracting agencies; responsibility for all liaison work with its contracting agencies; providing necessary information to B--- with respect to offenders, etc.; and assuming responsibility and costs for shipping equipment and associated supplies returned to B---.

Under the contract, B--- provides all products and services covered by the contract at a daily cost on per unit/per day basis. The field equipment units considered for billing are those in actual use (meaning the equipment is assigned to an offender or the data is entered into the computer). Further, field equipment units in I---'s inventory which are in excess of those needed for five working days, which excess units are pursuant to I---'s request (that is, requested spares), are considered billable units. The contract states that the intent of the billing plan is to bill I--- only for those units in actual use and requested spares. The charge for in-use units ranges from \$7.00 per unit/per day to \$6.00 per unit/per day depending upon how many units are in service. Spare units are billed at \$4.50 per day/per unit.

Although the prices are not set forth in the contract, it appears that B--- agrees to provide to I--- any other services and equipment which B--- begins to offer. Literature that has been provided to us indicates that there is other equipment than that discussed above. One such type of equipment is a remote alarm terminal. It is not clear whether this is something that would be provided by B--- to I---, or rather whether it is something that B--- previously would have provided to C--- prior to its being taken over by B---. That is, it appears that the remote alarm terminal is used by the person with the host computer, which in this case is B--- (prior to being taken over by B---, C--- acquired the equipment from B--- and was the person who would have used the host computer).

The literature also describes a drive-by monitor which is a portable monitoring unit designed to be hand-carried or used in a car. The literature explains that drive-by surveillance enables the supervising personnel to monitor a greater number of offenders.

B. Contract Between ICI and Contracting Agency

In a letter dated December 10, 1991, I--- advised you that it obtains equipment from B--- for a fee of \$7.00 per day, and then charges \$10.00 per day per monitored offender, which includes a monitoring service fee of \$3.00 per day. In a letter dated February 4, 1992, I--- stated that the information it had provided the staff previously was incorrect. I--- explained that its billings consist of a \$10.00 per day charge for “monitoring service.” That service includes appropriate monitoring equipment for which I--- pays \$7.00 per day to B--- for the equipment and the monitoring services provided by B---. In a letter dated February 28, 1992, I--- provided a copy of its contract with B--- and advised us that it has no formal written agreement with the contracting agencies. Our opinion is based on the assumption that the information provided in I---’s February 4 letter is accurate.

ANALYSIS

I--- inquires as to whether the recent decision in MCI Airsignal, Inc. v. State Board of Equalization affects our conclusion in this case (your office had previously concluded that I--- was making taxable leases to the contracting agencies, with tax measured by the \$10.00 daily fee). Although there are some similarities between the facts involved in the MCI Airsignal case and the facts here, there are also differences. Without regard to the similarities and differences, we believe that it is not necessary to look to the MCI Airsignal case to reach our conclusion here. That is, the decision in MCI Airsignal has no affect on our conclusion herein.

A. Contract between I--- and Contracting Agency

What the contracting agency seeks under this contract is monitoring of participating offenders to ensure that those offenders do not violate the terms of the relevant court orders. If these agencies accomplished their goals by obtaining the equipment involved here, including the host computer, and performed the monitoring themselves, then clearly the transfer of the tangible personal property would be a lease unless the agencies purchased the equipment outright. However, this is not what they contracted for, and the property which is used to perform the monitoring is not self-executing. (See, e.g., Culligan Water Conditioning. v. State Board of Equalization (1976) 17 Cal.3d 86.) That is, there is clearly some service element involved in this transaction. The question is whether the contract is one for the providing of service with an incidental transfer of tangible personal property, one for the sale of tangible personal property that includes service as part of that sale, or one for mixed sales of tangible personal property and providing of service.

Although valuable tangible personal property is obviously required in order to accomplish the purpose of the transaction, it is also clear that the service component of the transaction is significant. The computer must be specifically set up for each particular offender, with that particular offender’s restrictions entered into the computer. Although it is not clear from I---’s correspondence exactly what is provided to the contracting agencies, presumably I--- provides the agencies reports that are roughly equivalent to those received by I--- from B---, including telephone and written reports. If these reports were the only tangible personal property

transferred, they would qualify as commissioned reports (as opposed to off-the-shelf reports), and would be regarded as transferred incidentally to the providing of service (i.e., the service required to compile the reports).

This is not a situation where, after the equipment is provided, the supplier has completed its responsibilities. Rather, this appears to be a true contract for the providing of the service of monitoring, and the person performing the monitoring uses certain equipment to accomplish its duties. The equipment provides the service supplier the information needed to compile commissioned reports. The information can be provided only if the property is installed at the offender's premises and on the offender's person. Under the particular circumstances involved here, we believe that the transfer of that equipment is not a sale, but rather is a use of that property by the service provider. Therefore, we conclude that the charge by I--- to the contracting agencies is not subject to sales or use tax.

B. Contract Between I--- and B---

Our analysis of this contract is similar to our analysis of the contract between I--- and its contracting agencies. However, there are some differences between the two contracts, and with respect to those differences we reach a different conclusion. The primary portion of this contract is a service contract with an incidental transfer of tangible personal property. That is, even though the contract refers to a charge per unit/per day, we conclude that charge is for the service of monitoring that requires the incidental transfer of tangible personal property and is not merely a charge for the tangible personal property. This is confirmed by the billing provisions of the contract. I--- is billed based on a per unit/per day basis with respect to units actually being used to monitor offenders. Apparently, I--- can maintain units in its inventory for up to five working days without being charged for those units since they are not being used for monitoring purposes.

Notwithstanding the provisions mentioned above, I--- may wish to have more units in its inventory than it may retain in that inventory without charge. These are characterized as "requested spares." The requested spares are considered billable units and are billed at \$4.50 per day/per unit. Although we would agree with the parties' likely arguments that these requested spares are related to B---'s service of monitoring offenders, we would not agree with any argument that these requested spares are "merely" incidental to the providing of service. Rather, with respect to these requested spares, I--- chooses to lease tangible personal property from B--- in order for I--- to conduct its business in the way it chooses. We conclude that, with respect to requested spares for which B--- charges I---, B--- is leasing tangible personal property to I---. I note that if we were to conclude that B--- was always leasing tangible personal property to I--- when it provided any tangible personal property, which we do not, the proper measure of rentals payable would be the \$4.50 per day/per unit that I--- is charged for requested spares.

I--- may also purchase other supplies. That is, B--- provides to I--- sufficient field equipment supplies such as batteries, latches, and straps, for I--- to perform up to four installations per year per unit. We regard these as transferred incidentally to the monitoring service. When I--- requires supplies above this amount, I--- purchases such supplies from B---

for the amounts itemized on page 2 of the contract. With respect to these additional supplies, B--- is selling tangible personal property to I---.

It is not clear whether any other tangible personal property besides that discussed above is provided by B--- to I---. In B---'s literature, it discusses a drive-by monitor. This is a receiver that the monitoring person can place in his or her automobile. If I--- were to obtain such a monitor from B---, we would regard that transfer of tangible personal property to be a lease of tangible personal property (assuming it was not an outright sale). That is, I--- would be obtaining the monitor to perform the service itself, and not incidental to service provided by B---.

With respect to any tangible personal property which B--- leases to I--- such as requested spares and drive-by monitors, I assume that B--- had not paid any California sales tax reimbursement or use tax. Furthermore, it appears that B--- may be the manufacturer of such items and therefore would not be leasing them in substantially the same form as acquired. Therefore, for either or both of these reasons, any such leases are continuing sales of tangible personal property in California. I--- owes use tax measured by the rentals payable for these leases, which tax B--- is required to collect from I--- and pay to California. With respect to any of the field supplies sold by B--- to I---, or any other tangible personal property sold by B--- to I---, I--- owes use tax measured by purchase price, which tax B--- is required to collect from I--- and pay to California. With respect to the property provided by B--- to I--- which B--- is not regarded as leasing to I---, B--- is consuming that property. If that property was purchased for use in California (that is, was not used more than 90 days outside California prior to its first entry), B--- owes use tax measured by its cost for that property.

We hope that the analysis provided above answers your questions. If not, feel free to write us again. In your letter, you stated that the taxpayer considers the documents you provided us to be proprietary and confidential and you indicate that they should be returned with any response.

Actually, I--- indicated that they would like these documents back if our records are not considered confidential. I am including the documents along with this memorandum. Since our records are considered confidential, it appears that the taxpayer has acquiesced in our retention of these documents. It seems to me that we probably should retain these documents. However, I leave it to you to make that decision.

DHL:cl

Enclosures

cc: Downey District Administrator