Cite as Det. No. 92-340, 12 WTD 493 (1992).

DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In The Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 92-340
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 155: RETAIL SALES -- "CANNED" SOFTWARE -- ANNUAL OR MONTHLY FEES FOR SUPPORT SERVICE, UPGRADES, ADDITIONS, MODIFICATIONS TO CANNED SOFTWARE. A separate package of goods and services purchased to assist in effective use of a "canned" software program is subject to use tax, because the upgrades and modifications are to canned software and are themselves retail sales. This is so, even though the contract is separate from the original canned software purchase and is renewed on an annual or monthly basis either by an action of the taxpayer or by no action followed by payment for the next contract term.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

DATE AND PLACE OF CONFERENCE: . . .

NATURE OF ACTION:

Taxpayer petitions for correction of assessment of use tax on contracts for telephone support and modification tapes or code delivered to repair or upgrade separately-purchased canned computer software programs.

FACTS AND ISSUES:

Adler, A.L.J. -- Taxpayer purchased several computer programs. The programs are generally delivered on magnetic tapes, but they can also be delivered on computer disks or through modems. At or

near the time of these software purchases, taxpayer also entered into contracts with the software producers. The contracts are variously titled but provide for generally the same types of fee and term arrangements as well as the same products and services. Examples of the contracts examined by the auditor are listed below:

Contract 1. Hardware Maintenance provides for remedial maintenance as required; preventive maintenance as necessary; and repair parts, labor and services as necessary. Its initial term is for one year; it is automatically renewed at then-current rates unless terminated in writing by either party 60 days prior to expiration.

Contract 2. Software Support Agreement states the seller will monitor the buyer's contacts with it and provide the following: updates to the products at no additional charge; news bulletins on its products; one move of the system per year to a designated machine ("rehost"); "reasonable" toll-free telephone support; a system for reporting malfunctions, programming errors and problems ("bugs"); replacements or "workarounds" to correct the bugs; and a support engineer to assist in use of the products. The term is automatically renewed for additional periods unless either party gives 90 days' written notice of termination prior to the end of the current term.

Contract 3. Software Maintenance Agreement provides telephone support and assistance with problems shown to be in the programs; updates to the program "consisting of modifications and improvements to each Licensed Program and/or Documentation...required to achieve the specifications...for the Licensed Program and/or Documentation" are provided as necessary and without charge. The term is one year and begins at the time the related software is shipped. The fee is payable in advance on a quarterly or annual basis. The contract automatically renews unless either party gives 30 days' written notice of termination prior to the end of the current term.

Contract 4. Maintenance Support Agreement provides "comprehensive maintenance support" for both hardware and software products covered, including all labor, parts and materials necessary; telephone support as necessary, updates to correct problems or modify software or documentation as they are made available; use of the seller's bulletin board; and a problem-reporting service. The initial term is one year, with automatic renewals unless either party gives 30 days' written notice of termination prior to the end of the current term.

Contract 5. Warranty "Plus" Support Agreement extends the warranty of the system purchased to one year and covers all parts, labor and travel expenses. The seller agrees to provide

telephone assistance for problem isolation and identification, replacement of defective "modules" with on-site installation if necessary, remedial maintenance as necessary to return equipment to proper operating condition, "bug fixes" and minor software/firmware updates concurrent with planned or remedial maintenance, and one planned maintenance and "cal check" per year. The charge is five percent of the system's list price, and it is only available at the time the system is purchased.

Contract 6. Master Service Contract provides for hardware on- and off-site maintenance. For software, it provides telephone support, updates of code and/or documentation containing modifications and revisions, a bulletin, access to on-line support services, and a "critical issues" tracking service. Its term is one year, and it renews unless either party gives 60 days' written notice of termination prior to the end of the current term.

Contract 7. Warranty-Plus Agreement provides for updates to correct defects in the licensed programs and other general updates made available during the agreement's term; documentation updates, and telephone assistance. The term is one year and extends for one-year terms unless either party gives 60 days' written notice of termination prior to the end of the current term.

The auditor and his supervisor concluded the agreements were maintenance agreements or contracts for periodic service calls, updates and revisions. As such, they believed the contracts were not for "merely an extended warranty." They applied WAC 458-20-257 (Rule 257), which states, in pertinent part:

> (c) Maintenance agreements. Maintenance agreements, sometimes referred to as service contracts, are agreements which require the specific performance of repairing, cleaning, altering, or improving of tangible personal property on a regular or irregular basis to ensure its continued satisfactory operation.
>
> (6) MIXED AGREEMENTS. If an agreement contains warranty provisions but also requires the actual specific performance of inspection, cleaning, servicing, altering, or improving the property on a regular or irregular basis, without regard to the operating condition of the property, such agreements are fully taxable as maintenance agreements, not warranties.

Taxpayer reluctantly concedes that the use tax might apply to the first contract term, if the transaction is viewed as being

concurrent with and part of the original retail sale of software or hardware.

Beyond the initial term, however, it argues each contract should be viewed as a separate contract and should be evaluated separately for tax purposes. Although the initial contract purchase generally occurs at the same time the product is purchased, taxpayer argues the contracts, particularly for any renewal periods, are completely separate from the retail product purchased.

Taxpayer submitted the following additional information:

1. a copy of a renewal notice from the vendor of Contract 7, which taxpayer states is a solicitation to purchase additional warranty services separate and apart from any actual updates. The letter informs taxpayer its "warranty plus service is due to expire" for the products listed and gives prices for the next renewal term. There is no indication in the letter that the contract for the extended period is intended to change the original terms. Also submitted is a copy of the purchase order for the continued coverage of the various products;

2. a copy of a list of the vendor's "warranty plus" releases. Taxpayer states it made no claims until 1992, even though it apparently was eligible to do so for two years prior to when the claim was made;

3. a copy of a letter from the vendor of Contract 6. The letter states it encloses a maintenance quotation for "your [vendor's name] equipment, as well as exhibits which describe the services offered." The exhibits describe the services listed under Contract 6, above; and

4. a copy of a list of "all software received by [taxpayer] from [vendor]. Taxpayer states the "report demonstrates that several of [vendor's] products were not updates despite [taxpayer] having a warranty contract in place for all of 1991 and 1992.

Taxpayer argues the test of whether the agreements are taxable is contained in Rule 257. Taxpayer states if there is periodic maintenance required, the agreement is subject to sales tax. However, if the agreement requires replacement or repair of the property upon occurrence of some unforeseen event, the agreement is not subject to sales tax. Taxpayer contends it purchased technical telephone assistance, replacement of the product <u>if</u> it is improved or modified and replacement of the product <u>if</u> it fails to perform as specified. It did not purchase maintenance

on any known timeframe or any additional tangible personal property.

Under Rule 257, taxpayer argues the contracts are for warranty services and that the need for replacements, upgrades, or modifications to the software are triggered only by an "unforeseen occurrence." As such, the contracts should not be subject to sales or use tax. It contends what is purchased is a warranty or guarantee that, if an upgrade or update is issued, the purchaser will receive it; however, the fact of updates being issued is not guaranteed. Since they are not guaranteed or predictable, the purchaser is really "buying insurance" in the form of these maintenance agreements.

Taxpayer complained that it doesn't "get anything" tangible under the contracts and expressed dissatisfaction with the concept of paying use tax on the contracts. It further argues the agreements really trade on the purchaser's "paranoia" about having a system fail without access to support, updates and problem debugging. Taxpayer contends the purchaser is buying only a contingency, not tangible personal property; it is buying the assurance that the program will work. It believes this is similar to a recall: if the seller finds a problem, it agrees to replace the defective item. Taxpayer argues it does not buy anything "new"; it is only buying the right to get a replacement for what it bought the first time.

Taxpayer agreed that, if the actuality that it would need and receive upgrades, updates, repairs or modifications was "predictable", it would be a retail sale. As such, taxpayer seeks a finding that, if the contracts or terms are separate and apart from the retail purchase of the product, and if the terms on which the seller's obligation to respond are contingent, then the transaction should not be classified as a retail sale.

DISCUSSION:

[1] RCW 82.08.020 imposes tax on retail sales. RCW 82.04.050(2) defines retail sales as:

> The term "sale at retail" or "retail sale" shall include the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following: (a) The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers,. . .

Regarding alteration or modification charges for computer software, Rule 155 states:

> The retail sales tax also applies to all charges to users for the repair, maintenance, alteration, or modification of hardware, equipment, and/or standard, prewritten software or materials.

The rule does not differentiate between alterations or modifications purchased as a part of the initial acquisition and those purchased under renewable-term contracts extending the right of the purchaser to receive the alterations and modifications. If the program is "canned," any modification to it is subject to retail sales tax under the rule. In this case, the updates and modifications to the canned program are available to all customers participating in these types of contracts or still covered by the original warranty periods. Therefore, amounts paid for contracts providing for support services, including any upgrades, modifications, alterations or other debugging services, are subject to use tax. The contracts in this case call for a flat sum to be paid monthly with no itemization of charges for the different services. Since the maintenance and update services are subject to retail sales tax, the full amount of the monthly charge is subject to retail sales tax.

Det. No. 87-359, 4 WTD 327 (1987), addressed a similar situation. The taxpayer argued that a portion of the overall purchase price was for non-retail services and should be separated from the retail-taxable portion of the transaction. As to the portion that taxpayer sought to separate, the Determination stated:

> Any portion of the payment that is to add or improve the standard program in the form of new releases and revisions is not customized but is also in the nature of "canned" or "off-the-shelf" software. Such charges would also be subject to retail sales tax. Also, even if stated separately, charges for service and maintenance contracts are retail sales subject to retail sales tax. WAC 458-20-107 [now addressed in WAC 458-20-257]. We find, therefore, that the assessment of retail sales tax on the total payment is valid.

(Brackets supplied.)

Taxpayer argues 4 WTD 327 does not apply to its situation because the portion of the transaction that taxpayer sought to separate was a part of the original software purchase. Taxpayer contends its facts require that the contracts should be separated from the retail transaction after the initial term. This is because they should be viewed as being for services the seller is only

obligated to provide should an "unforeseen circumstance" necessitating the alteration or modification occur.

We disagree. WAC 458-20-138 (Rule 138) states that the retail sales tax does not apply to the amount charged or received for the rendition of personal services to others. Thus, where a wholly-separate contract exists for personal services only, it is a service contract, not a retail transaction. Such is the case where the vendor's employees only give advice as to correct use and operation of the software or hardware. This is because the canned software is not being altered or modified. The activity is not a "repair, maintenance, alteration or modification;" and, therefore, the transaction is not subject to sales or use tax. On the other hand, where the software is being altered or modified in any way via telephone, the activity is a retail activity, and sales or use tax applies. In this case, no identification of the services and products actually delivered has occurred and no segregation of charges by activity type is shown in the contracts. As a result, we find the contracts are subject to retail sales tax. The auditor properly assessed use tax on the contract prices after he found retail sales tax had not been paid at the time of acquisition.

Finally, we are not persuaded that the taxability of the contracts should be affected by the fact that taxpayer, in some cases, elected not to order upgrades, updates, modifications or fixes as they came available. The alteration issued may not have affected all users equally, particularly if only a certain type of problem was being encountered by a certain type of user. As a result, taxpayer may have felt the program was working as desired without the alteration or that adjusting to the alteration would not be worth the time or effort to accommodate the change.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

DATED this 9th day of December 1992.