



Private Letter Ruling 04-006

Redacted Version

Sales Tax—Items Included in Cost Price

September 7, 2004

This private letter ruling addresses what items of tangible personal property and services that are part of a purchase of a communications system are included in cost price under La. Rev. Stat. Ann. § 47:301(3)(a).

Facts

Company A and Company B entered into a communications system whereby Company A contracted to purchase a fully-implemented communications system designed by Company B. Full implementation of the system spans 31 months. The contract price breakdown provides:

1. Equipment and canned software

Title to all equipment comprising the system passes to Company A upon shipment. No sales or use tax is paid to any other state on the equipment. The origin of the shipment of this equipment is from Company B's out-of-state manufacturing facilities to a final shipping destination to one of two points in Louisiana: the location of Company B's Louisiana installation sub-contractors or Company A's warehouse in Louisiana. From these locations, the equipment is then transported to the applicable installation site.

Company B's software, which is installed into the communications equipment prior to the shipment of the tangible personal property from the out-of-state manufacturing facilities, is not prepared, created, adapted, or modified to meet any specific needs of Company A. Instead, the software transferred is comprised of prewritten modules, or programs, that are combined and installed to properly integrate the communications system. Ownership of the software does not pass to Company A. Instead, the company is granted a perpetual software license agreement, which allows Company A to use, but not own, the software. Additionally, no sales or use tax is paid to any other state on the transfer of the Company B software to Company A.

2. Shipping

All equipment will be shipped by common carrier from Company B's out-of-state manufacturing facilities into Louisiana. According to the terms set forth in section 5.3 of the Contract, all freight charges will be pre-paid by Company B and will be invoiced in a final statement to Company A at the completion of the system implementation. Title to the equipment and risk of loss for the equipment passes to Company A upon shipment. Company B will pack and ship all equipment in accordance with good practices.

3. Installation Labor

All equipment installed at the master site and remote locations will be performed by Company B's sub-contractors. Company A will assist with the equipment installation in vehicles. After installation, the equipment can be removed without permanent damage to it or

its surroundings. The charges for “installation labor” also include the travel costs for installation personnel.

4. Non-installation Labor

This category includes labor and travel costs for any Company B personnel or sub-contractors to perform any of the following five activities not related to the installation of the system: initial design review, engineering, safety audits, project management, and system tuning performed by system technologists. These activities are necessary for a functioning communications system to be completed; they are not supplemental features that Company A can refuse to purchase.

The initial design review charges relate to a meeting that included Company B's project manager and engineers and Company A's project team to review the design of the radio system and make any changes prior to manufacturing. Engineering charges are for Company B engineers working on and offsite to determine the specifications for Company A's system and to ensure that the system is performing satisfactorily. Safety audit charges relate to Company B subcontractors who perform audits at the primary site and each tower site to ensure that safety standards are met prior to the installation of any equipment. The charges for project management relate to Company B's project managers' on and offsite labor and travel costs. The charges for system technologists relate to labor and travel costs for technologists who perform the tuning and optimization of the system at the various sites.

5. Training Costs

The training costs relate to Company B providing “train the trainer” classes at various Company A locations. The training provided by Company B covers the operation and maintenance of the new system. The training was an optional feature of the negotiations, and Company B did not require training to be purchased as part of the sale. Because Company A has chosen to maintain the system once installed, the company decided to purchase this optional feature so its employees will be prepared to give proper support after system implementation. The fees for training include labor, travel, and material cost for providing training on Company B equipment.

The contract between Company B and Company A requires a percentage down payment after the signing of the contract and another percentage payment at completion of the detail design review. These two payments were made in Month 3 and Month 4, four and three months, respectively, prior to the delivery of any tangible personal property into Louisiana.

A total of six equipment shipments have been or will be made into Louisiana. The dates of the shipments are: Month 7, Month 8, Month 9, Month 13, Month 17, and Month 26. In the months following the importation of equipment into the state, Company A has or will pay use tax on the value of the equipment shipped into Louisiana during the previous month.

Company A's remittances in the months following the months in which equipment was imported into the state include the use tax that became due upon the use, consumption, distribution, and storage of the equipment within the state during the previous month. However, Company A's remittances also include a second element, the use tax payments upon the sales of the non-

installation labor services, which were considered to be part of the cost price of the system, and thus, taxable.

This second element is necessary to account for these taxable services for which Company B received reimbursement but for which no use tax was remitted to the state at the point that the payments were made. These payments occurred after the signing of the contract with Company B and after completion of the detail design review but prior to the point that any equipment or software had been shipped into the state.

To calculate this second element, Company A divides the value of the previous month's shipment by the total taxable amount¹ to obtain a percentage of the total taxable amount to the current invoice, to obtain the "percentage of taxable amount." This percentage is then multiplied by the value of the first three invoice payments for non-installation labor (Month 3, Month 4, and Month 5) upon which tax was not remitted at the time that the contract payments were made.

As future shipments are received, Company A intends to accrue use tax based on this methodology until tax has been accrued for all equipment imported into Louisiana, and tax on all non-installation labor has also been remitted. Charges for installation will be separately invoiced. Charges for shipping and training will be separately stated at final acceptance.

Ruling Requested

What are the sales and use tax consequences surrounding the Contract? Specifically, what are the sales and use tax consequences for:

1. Equipment and canned software
2. Shipping charges
3. Installation labor
4. Non-installation labor
5. Training charges
6. Method of accruing taxes

Ruling

1. Equipment and canned software
 - a. Equipment

Ownership of all equipment for the communications system passed to Company A at a point out-of-state, with no other jurisdiction collecting sales or use tax on the transfer of the equipment. The equipment was shipped into the state of Louisiana and was eventually transported and installed at the Louisiana sites.

¹ The total taxable amount of the contract has been calculated by Company B and Company A to be approximately 85 percent of the total contract amount. This percentage has been calculated by determining that the taxable components of the contract are equipment and software and non-installation labor. The remaining total contract amount is composed of the following items, which were considered to be nontaxable: shipping, installation labor, and training costs.

“Use” means and includes the exercise of any right or power over tangible personal property incident to the ownership thereof. La. Rev. Stat. Ann. § 47:301(18)(a)(i). In the situation at hand, Company A is exercising rights and powers over tangible personal property by importing property into the state, storing it here, and directing its installation at sites across the state. Due to its exercise of rights and powers over the property, Company A owes a use tax on the equipment that it brings into the state of Louisiana for use and consumption here. According to § 47:301(3)(a), the use tax due to the state shall be assessed on the lower of the market value or cost price of the equipment, which in this instance, is the cost price that Company A pays for the equipment.

b. Canned software

La. Rev. Stat. Ann. § 47:301(22) defines “computer software” as:

a set of statements, data, or instructions to be used directly or indirectly in a computer in order to bring about a certain result in any form in which those statements, data, or instructions may be embodied, transmitted, or fixed, by any method now known or hereafter developed, regardless of whether the statements, data, or instructions are capable of being perceived by or communicated to humans. Computer software includes all types of software including operational, applicational, utilities, compilers, and all other forms.

La. Rev. Stat. Ann. § 47:301(23) provides a definition of “custom computer software,” as computer software that has been prepared, created, adapted, or modified to the special order of a particular purchaser, licensee, or user.

The software installed by Company B onto the equipment prior to its shipment from the out-of-state manufacturing facility was not prepared, created, adapted, or modified to meet any specific needs of Company A. Instead, the software transferred was comprised of prewritten modules, or programs, that are combined and installed to properly integrate the communications system and provide certain features chosen by Company A. Thus, because the Company B software was not customized under the provisions of § 47:301(23), it is “canned” computer software, which, under the decision *South Central Bell v. Barthelemy*, 94-0499 (La. 10/17/94), 643 So.2d 1240, is tangible personal property.²

“Use” means and includes the exercise of any right or power over tangible personal property incident to the ownership thereof. Section 47:301(18)(a)(i). In the situation at hand, Company A is exercising rights and powers over tangible personal property by importing the software into the state, storing it here, and using it to operate the communications system. Due to its exercise of rights and powers over the property,

² The transfer of custom computer software was also classified as a transfer of tangible personal property, according to *South Central Bell v. Barthelemy*. This treatment changed with the passage of Act 7 of the 2002 1st Extraordinary Session, which amended the definition of tangible personal property in La. Rev. Stat. Ann. § 47:301(16)(h) to provide a four-year incremental exclusion from the definition of tangible personal property for custom computer software. (See Louisiana Revenue Ruling 02-008 for further explanation of the phase-in of the exclusion.)

Company A owes a use tax on the software that it brings into the state of Louisiana for use and consumption here. According to § 47:301(3)(a), the use tax due to the state shall be assessed on the lower of the market value or cost price of the equipment, which in this instance, is the cost price that Company A pays for the software.

2. The shipping charges that are incurred for transporting tangible personal property from out-of-state to a point within Louisiana and are separately itemized by Company B

Section 47:301(3)(a) provides that the use tax due to the state shall be assessed on the lower of the market value or cost price of the equipment and software. The lower value in this situation is cost price and Company A is correctly calculating its use tax based on the “cost price” of the tangible personal property brought into the state.

Section 47:301(3)(a) defines “Cost price” as:

the actual cost of the articles of tangible personal property without any deductions therefrom on account of the cost of materials used, labor, or service cost, except those service costs for installing the articles of tangible personal property if such cost is separately billed to the customer at the time of installation, *transportation charges*, or any other expenses whatsoever, or the reasonable market value of the tangible personal property at the time it becomes susceptible to the use tax, whichever is less. (Emphasis added.)

However, in both *Chicago Bridge and Iron Company vs. Cocreham*, 317 So. 2d 605 (La. 1975), *cert. denied*, 424 U.S. 953 (1976) and *Pensacola Construction Company v. McNamara*, (La., 1990), the Louisiana Supreme Court held § 47:301(3)(a)’s imposition of use tax on transportation or freight charges unconstitutional because there is no parallel sales tax assessment in the statute defining sales price.

Revenue Ruling No. 01-007 issued October 10, 2001, also reflects these court findings by describing that charges by a seller for transportation from the place of sale are excludible from both “sales price” and “cost price” if these charges to the buyer are optional and could be avoided by the buyer by making his own transportation arrangements. In other words, if the shipping forms an inseparable element of the sale of the tangible personal property, then the “sales price” or “cost price” will include these transportation charges.

In the case at hand, title passes to Company A upon shipment by common carrier. Although Company B prepays freight charges, the freight charges are scheduled to be separately billed to Company A at the final acceptance invoice scheduled in Month 31. The shipping arrangements between Company A and Company B are severable charges from the transfer of the equipment. Therefore, the separately invoiced shipping charges do not comprise a portion of the “cost price” of the equipment imported and used within the state.

3. Installation labor to install items of tangible personal property

Installation labor that is separately billed to the customer at the time of installation does not form a portion of the “cost price,” per § 47:301(3)(a). Similarly, § 47:301(13)(a) provides that installation performed in conjunction with the sale of tangible personal property in Louisiana will not comprise any portion of the sales price of the property sold.

In the case at hand, Company B sub-contractors install equipment in Louisiana at the master site, repeater tower sites, dispatch sites, and within the vehicles. In addition, Company A assists with the radio installation in the vehicles. To date, only one invoice, out of the eight invoices provided, has included installation charges. This document shows a separate line item charge for installation services provided at the master site. So long as all future installation services are separately itemized in the invoices provided to Company A, then the charges will not be included in the cost price of the equipment and canned software.

As provided in the statement of facts, the installation charges also include travel costs of installation personnel. Section 47:301(3)(a) excludes all service costs related to installation from the cost price of tangible personal property. Thus, the travel costs of installation personnel would also comprise part of the “service costs” necessary for installing the property and would also be excluded from the cost price.

4. Non-installation labor

Section 47:301(3)(a) directs that materials used, labor, and service costs, except service costs for installing the article of tangible personal property, are included in the cost price of articles of tangible personal property. La. Reg. 61:I.4301.C. *Cost Price*— provides further clarification of this provision:

d. In arriving at actual cost of tangible personal property for the purpose of the required comparison (of reasonable market value versus actual cost price), all labor and overhead costs which are billed to the purchaser of the property, except for separately stated installation charges, are included. *In the case of property manufactured; fabricated and/or altered to perform a specific function prior to the tax incident, every item of cost must be included. Thus, material, labor, overhead, and any other cost of any nature whatsoever must be included.* However; labor, overhead, and other costs which represent services rendered to the property by the owner or his employees are not to be included.... (Emphasis added.)

The emphasized language explains that when property is manufactured, fabricated, or altered to perform a specific function, which is the situation with the communications system purchased by Company A, then every service item necessary to complete the manufacturing, fabrication, or alteration of the communications system must be included in the cost price.

As pointed out in *Chicago Bridge and Iron Company* and *Pensacola Construction Company*, the sales and use taxes are complimentary and the tax burden under each must be uniform. The demarcation of which services are included or excluded from the “sales price” will apply with equal force regarding which elements are included in “cost price.” Thus, consideration of the provisions of the regulation quoted above, in addition to Louisiana jurisprudence explaining the extent of which services are included in “sales price,” will provide guidance in the situation at hand regarding the non-installation labor at issue.

In *Owen Healthcare, Inc. v. Blank*, 02-0530 (La. App. 3 Cir. 10/30/02), 829 So. 2d 1149, and *Lake Charles Mem'l Hosp. v. Parish of Calcasieu*, 98-519 (La. App. 3 Cir. 12/9/98), 728 So. 2d 454, *writ denied*, 99-0071 (La. 3/12/99), 739 So. 2d 213, the Third Circuit Court of Appeals provided parameters for deciding when services shall be included in the sales price.

The court stated that when the services are incidental³ to the sale of the property, they are included in the sales price. Conversely, if the services are separate and distinct from the sale, then the services are not part of the sales price.

According to the facts provided by Company A, the non-installation labor will be composed of project managers, project implementation team members, and subcontractors, all of whom are provided and coordinated by Company B. These Company B personnel and subcontractors provide labor not related to the installation of the equipment.

These labor costs are properly included within the cost price because they represent part of labor costs charged to the customer as part of the sale of the communications system. Page two of the document entitled “Communications System Agreement” defines “system” as the equipment, software, and services combined together; thus, the item that has been transferred is an operational system, including the services necessary to make that system functional.

The five non-installation services are incidental to the sale of the system and are included in the cost price. In addition, these charges include travel costs of the Company B personnel and subcontractors and the expenses for safety audits of the sites. Because § 47:301(3)(a) includes all service costs (excluding installation) within the cost price of tangible personal property, the travel costs of Company B personnel and subcontractors providing non-installation labor would also be taxable.

5. Training Methods

Company B’s training services are an optional element of the contract. Company A is not obligated to purchase training, although Company B is the only company able to offer training on its own equipment. Company A was able to choose from a variety of training packages and only chose training relating to the operation and maintenance of the system. The training was necessary primarily due to the fact that Company A has chosen to maintain its system and therefore needed its employees to be educated in order to provide proper support.

The charges by Company B are for labor charges for Company B trainers and the travel costs for the trainers. Additionally, training material costs related to the training manuals used in classes are also included in the training charges.

Because a purchaser of a Company B communications system receives a fully operational and functional system without the training services and a purchaser is not obligated to contract for training, the training costs represent optional services that are separate and distinct from the sale of the communications system.

As provided in La. Reg. 61:I.4301.C. *Cost Price*—d. “...In the case of property manufactured; fabricated and/or altered to perform a specific function prior to the tax incident, every item of cost must be included...” In this instance, the completion and final implementation of the system will still take place even without the training. Separately stated charges for personnel training are commercially severable charges because the

³ *Webster’s New Universal Unabridged Dictionary* 654 (2d ed. 1983) defines “incidental” as “1. occurring or likely to occur as an unpredictable or minor concomitant. 2. of a minor, casual, or subordinate nature”

equipment and activities necessary to bring the equipment to the market and make the equipment operational for the purchaser are separate from the training services that Company A purchases at its own discretion and option. Thus, the training charges and travel costs for the trainers are not part of the cost price and are not subject to the use tax.

6. Method of Accruing use taxes on equipment shipped into Louisiana

Section 47:301(3)(a) provides that “the use, or consumption, or distribution, or storage to be used or consumed in this state of tangible personal property, shall each be equivalent to a sale at retail, and the tax shall thereupon immediately levy and be collected in the manner provided herein, provided there shall be no duplication of the tax in any event.” Because the use tax is levied at the instant the use, consumption, distribution, or storage to be used or consumed in this state of tangible personal property occurs, the use tax is not payable until one of these events triggers the levy of the tax.

Company A’s six monthly remittances in Months 7, 8, 9, 13, 17, and 26 have included or will include two elements: first, the use tax that is due upon the use, consumption, distribution, and storage of the equipment within the state and second, the use tax payments upon the sales of non-installation services that are incidental to the sale of the communications system.

As for the first element, Company A’s method of remitting the use tax upon the value of the equipment imported into the state as it is brought into the state is in compliance with the method of collection provided in § 47:303(A)(2). The use tax is levied upon the equipment as each item is imported during the six separate shipments and Company A’s remitting of the use tax in the month following the importation of the tangible personal property is correct.

The second remittance amount is necessary to account for the percentage payment made after the signing of the contract and the percentage payment made at the completion of the detail design review. These payments were made prior to the use tax becoming due with the first shipment of property into the state in Month 7. These charges relate to non-installation labor, which as discussed above, are incidental to the transfer of the system and are included in the cost price.

Company A’s plan to remit use tax upon the value of the incidental services previously rendered and paid at the outset of the communications system contract signing and design is in compliance with the method of collection provided in § 47:303(A)(2). The statute provides for the levy of the tax upon the use, or consumption, or distribution, or storage to be used or consumed in this state of *tangible personal property*. Thus, the levy attaches upon the use of tangible personal property within the state. Since the incidental services rendered prior to the importation apply to the design, engineering, and management of the entire communications system, and not any one piece of equipment, it is appropriate to proportionally assign the value of the non-installation labor to the value of the equipment along with the accrual of the use tax upon each of the six monthly installments.

Company A proportionally assigned the value of the non-installation labor to the value of the equipment to each of the six monthly installments through the use of a fraction, the “percentage of taxable amount,” whose numerator is the previous month’s shipment and

whose denominator is the total cost price amount of equipment shipped into the state. This method for dividing the non-installation labor equally among the six equipment use tax remittances brings Company A in compliance with the provisions of § 47:303(A)(2). To otherwise determine that the entire levy upon all of the incidental services attaches at the moment the first item of equipment is imported into the state, regardless of the value of that equipment, would not recognize the contributions that the non-installation labor provides to the overall success of the entire communications system. Since the equipment is shipped and enters the state in stages and the use tax is due upon the tangible personal property in stages, so does the accrual of the use tax upon the non-installation labor become due, proportionate to the cost value of the equipment that has entered the state.

Summary

In conclusion, Company A is exercising rights and powers over the equipment and software used and consumed within the state, and Company A is correctly accruing use tax upon the cost price paid for these articles of tangible personal property in the month following the importation of the property into the state. Additionally, the five non-installation services included under the category “non-installation labor” are incidental to the sale of the system and are included in the communication system’s cost price.

The shipping charges for transporting the equipment via common carrier into the state will not be part of the “cost price” because they will be separately invoiced on the final invoice. Similarly, so long as the installation charges for installing the equipment at the Louisiana sites are separately invoiced, these charges will not comprise a portion of the “cost price.” Also not included within the “cost price” are the training costs paid for Company B training on the communications system; these charges represent optional services that are separate and distinct from the sale of the communications system.

Finally, Company A’s six monthly remittances properly include two elements: first, the use tax that is due upon the use, consumption, distribution, and storage of the equipment within the state and second, the use tax payments upon a percentage of the sales of non-installation services that are incidental to the sale of the communications system.

If you have any questions or need additional information, please contact the Policy Services Division at 225.219.2780.

Sincerely,

Cynthia Bridges
Secretary

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