OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18124128
	) CDTFA Acct. No. 100-642034
ACFN FRANCHISED, INC.	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Edward Davis, Attorney Jeffrey Kerr, President and CEO
For Respondent:	Chad Bacchus, Tax Counsel III Scott Claremon, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, ACFN Franchised Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition of a Notice of Determination (NOD) dated December 16, 2010. The NOD is for $55,993.40 in tax, plus applicable interest, for the period January 1, 2006, through December 31, 2008 (liability period). The NOD includes a credit for use tax payments of $25,555.70 made by third parties and applied towards appellant's liability.[2]

In a related and consolidated matter, claims for refund in the amount of $16,328.95 were filed on behalf of six additional persons (other than appellant) who reported and paid use tax directly to CDTFA, in connection with the transactions at issue in this appeal.[3] CDTFA granted

[1] Sales taxes were formerly administered by the State Board of Equalization (SBE). In 2017, functions of SBE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to SBE.

[2] The payments reduced the NOD liability to $30,437.70. A claim for refund of the $25,555.70 in use tax payments is not before us. R&TC section 6902(a), in pertinent part, requires a claim for refund to be filed within six months from the date the determination become final.

these refund claims in their entirety, and the payments were refunded from the payor's accounts with CDTFA, and thereafter paid (applied) towards appellant's account with CDTFA.[4]

Office of Tax Appeals (OTA) Administrative Law Judges Andrew J. Kwee, Josh Lambert, and Suzanne B. Brown held an oral hearing for this matter in Sacramento, California, on July 20, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for a decision.

ISSUE

Whether appellant's initial franchise fees are taxable as a part of the sale of tangible personal property.

FACTUAL FINDINGS

1. Appellant, a corporation formed under California law, operates an automated teller machine (ATM) network in this state. Appellant has been acting as a franchisor since 2003. As a franchisor, appellant enters into American Consumer Financial Network (ACFN®) Franchise Agreements (Franchise Agreements) with third parties (franchisees).
2. The standard Franchise Agreement grants the franchisee the right to operate an ACFN® business within a specified geographic location, and a license to use appellant's trademarks (e.g., ACFN®), service marks, and business logo.
3. An ACFN® business consists of the maintenance and operation of ATMs by the franchisee at a location(s) selected by the franchisee and approved by appellant. The franchisee purchases ATMs from appellant and uses them to provide ATM services, financial transaction processing services, and related financial services over appellant's ATM network. The ATMs bear appellant's trademarks, service marks, and logo. Specifically, the franchisee engages in the business of marketing "ATM services to hotels, retail locations, and other entertainment and travel-based businesses and will install ATMs at those host locations." The franchisee first purchases the ATMs from

[3] Shortly after the NOD was issued, CDTFA changed its policy and ceased accepting third party payments. As a result, there were an additional $16,328.95 in payments which were applied towards the payors' accounts with CDTFA, as opposed to appellant's account with CDTFA.

[4] A claim for refund on behalf of appellant for the $16,328.95 in payments applied towards its account with CDTFA is not before us. (See footnote 2, above, for the timeframe to file a claim for refund.) On a related note, the related claims for refund filed on behalf of third parties in the amount of $16,328.95 were granted and are not at issue in this appeal.

appellant, then finds a retailer, hotel, or other business willing to host the ATM, and thereafter performs all the services and maintenance required of the ATM. A franchisee is prohibited from charging the host location a fee for installing an ATM at the host's location.

4. Appellant imposed various additional fees on franchisees with respect to the operation of the business, and these fees are detailed in the Franchise Agreement.

5. The following is one example of how the ACFN® business model worked during the liability period. A franchisee installed an ATM at a hotel located in San Diego, California, on July 21, 2008. During 2008, the ATM collected $2,808.40 in surcharges from customers, representing 952 transactions. Of this amount, $588.00 was paid to the hotel, $2,100.80 was paid to the franchisee, and $119.60 was retained by appellant (representing administration fees and communications fees).[5] In addition, appellant collected $502.23 in interchange fees directly from the ATM cardholders' respective banks.[6]

6. Appellant's franchisees are required to pay the following fee upfront to appellant upon entering into a Franchise Agreement:

> 3.1. INITIAL FRANCHISE FEE. You agree to pay us a nonrecurring and nonrefundable initial lump sum franchise fee in the amount of [$29,500], which will be due upon your execution of this agreement. The fee will be fully earned by us upon execution of this Agreement. We will provide you with one (1) automated teller machine and (1) extra cash cassette as part of your initial franchise fee.

7. The Franchise Agreement does not specifically state that any other items are included as consideration for payment of the initial franchise fee. The Franchise Agreement specially sets forth a list of additional fees that the franchisee is required to pay to appellant on a one-time or on-going basis as part of operating an ACFN® business.

8. The Franchise Agreement includes the sale of one ATM to the franchisee. The Franchise Agreement further states that: "purchases of additional ATMs to be located at approved

[5] Appellant charges the franchisee a monthly administration fee based on the number of ATMs owned by the franchisee, plus a communications fee for every ATM transaction processed by the ATM.

[6] Appellant charges the ATM card holder's bank an interchange fee on every transaction.

locations within [appellant's network] are governed by this Agreement and do not require a separate Franchise Agreement."

9. The terms of the Franchise Agreement require, in pertinent part, that franchisees "must purchase all ATMs for use in the [ACFN®] BUSINESS from [appellant] at our then current prices, or, at our direction, from sources or suppliers approved or designated in writing by [appellant]." During the liability period, appellant charged its franchisees $4,995 per additional ATM sold pursuant to the Franchise Agreement. The invoices state "All Sales Tax for ATMs is due to your local tax collector and is your responsibility."

10. Appellant also provided franchisees a document titled "Franchise Disclosure Document" containing various representations about the terms and conditions of entering into a franchise agreement with appellant. The Franchise Agreement incorporates by reference the Franchise Disclosure Document, and provides that "nothing in this Agreement is intended to disclaim the representations we made in the franchise disclosure document that we provided to you."

11. Appellant's Franchise Disclosure Document explains what is included with the initial franchise fee and provides:

> The initial franchise fee is $29,500. See Item 5 for more information on what items are included in the initial franchise fee . . .
>
> ITEM 5 ¶ INITIAL FEES ¶ You must pay us a nonrefundable initial franchise fee in the amount of $29,500 before your business opens . . . The initial franchise fee is not refundable under any circumstances, regardless whether you pay it in full when you sign the Franchise Agreement or whether you elect to have us finance part of the initial franchise fee. As part of the initial franchise fee we will provide you with one ATM (our then current designed make and model) and one extra cash cassette at no additional expense. [Citation omitted.] Also included in the initial franchise fee is the cost of initial training for your Managing Owner [definition omitted] and one other person, as well as related travel expenses (up to $500), hotel accommodations and daily lunches for your Managing Owner during initial training . . . ¶ The cost for each ATM is currently $4,995.

12. Item 5 of the Franchise Disclosure Document does not specifically state that any additional items, services, or intangibles, such as the right to operate an ACFN® business, are included or transferred as consideration for payment of the initial franchise fee.

13. The Franchise Agreement specifies that the initial training lasts for three working days, and covers the operation of an ACFN® business. The training takes place at appellant's location in San Jose, California. Furthermore, attendance at the training is mandatory and a franchisee may not commence business operations unless the franchisee "complete[s] the initial training to [appellant's] satisfaction."
14. The Franchise Agreement states that appellant reserves the right to terminate the Franchise Agreement for listed reasons, including if the franchisee "fails to successfully complete initial training to [appellant's] satisfaction." The initial franchise fee is due and non-refundable regardless of whether the franchisee successfully completes the mandatory training or appellant terminates the Franchise Agreement.
15. Pursuant to the Franchise Agreement, appellant is required to provide marketing and other guidance to franchisees including access to marketing and public relations programs and media and advertising materials developed by appellant; telephone consultation; buying advisory services; access to ongoing marketing programs; newsletter services to inform franchisees of current events relevant to the ACFN® Business; meetings, seminars, and conventions; research and development on how to operate the business; and access to ongoing guidance from appellant for an additional fee. Appellant also provides general guidance regarding operating issues, based on on-site inspections made by appellant. Appellant also provides guidance pertaining to standards and operating procedures for the business; employee training; advertising and marketing programs; administrative, bookkeeping, and accounting procedures and services; and purchasing of ancillary goods, equipment, materials, supplies and services.
16. The Franchise Agreement also specifies that appellant has no liability for any sales or use tax in connection with the business conducted by its franchisees, and that payment for such taxes are the responsibility of its franchisees.
17. Appellant did not charge, collect, or remit tax to CDTFA on the sale of ATMs or on the franchise fees.
18. Upon audit, CDTFA determined that the $29,500 franchise fees were taxable.
19. On September 17, 2009, CDTFA requested that appellant provide documentation to show the amount of initial franchise fees that it collected from franchisees during the liability period. Appellant refused to provide information responsive to this request. Thereafter,

CDTFA estimated the amount of initial franchise fees by multiplying $29,500 x 8, because appellant reported eight new California businesses on its Franchise Disclosure Document for the liability period. Additionally, because the Franchise Agreement required the franchisee to pay tax to the state, CDTFA included a $4,995 allowance for each new business, representing the taxable measure presumably self-reported by the franchisees. The amount of the allowance was estimated based on the cost for each ATM as disclosed in the Franchise Disclosure Document: $4,995. After the allowance, CDTFA calculated unreported taxable franchise fees of $196,040 for the liability period ($236,000 - $39,960 = $196,040).[7]

20. During the period June 26, 2009, through September 2, 2009, appellant's franchisees remitted a total of $25,555.70 in use tax to CDTFA on the purchase of ATMs from appellant, which CDTFA accepted as payments made on behalf of appellant.

21. Additional franchisees reported and paid a total of $16,328.95 in use tax towards the liability disclosed by audit through the period ending May 10, 2010, which CDTFA accepted as payments made by the franchisees and applied towards the franchisees' accounts with CDTFA.

22. On December 16, 2010, CDTFA issued an NOD to appellant for the liability as determined by audit. The NOD included a $25,555.70 credit for tax paid by franchisees.

23. On April 12, 2012, timely claims for refund of $16,328.95 were filed on behalf of the six franchisees who made those payments.

24. In a decision dated November 21, 2018, CDTFA granted the refund claims, and reapplied the $16,328.95 in use tax from the claimants' accounts to appellant's seller's permit account with CDTFA. The decision also granted a reduction of applicable interest on the third-party tax payments, but otherwise denied the petition.[8] This timely appeal followed.

[7] The audit determined an additional underreporting based on disallowed claimed nontaxable sales, and unreported purchases subject to use tax. We do not discuss these items because they are not at issue in this appeal. Additionally, we offer no opinion on the merits of CDTFA's calculation of the initial franchise fees collected by appellant ($196,040) because appellant agrees with this calculation.

[8] The issue before CDTFA was whether interest accrued from the date of the claimants' payments to the date those payments were applied towards appellant's account. CDTFA's decision found that it did not.

25. On March 4, 2020, during a prehearing conference, the parties agreed that the only issue for OTA to decide in this appeal was whether tax applies to $196,040 in initial franchise fees collected by appellant. Appellant does not dispute any other items in the NOD.

DISCUSSION

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) A sale includes any transfer of title or possession of tangible personal property for a consideration. (R&TC, § 6006(a).)

The term gross receipts (measure of tax) means the total amount of the sale or lease or rental price of tangible personal property, and includes any services that are a part of that sale. (R&TC, § 6012(b)(1).) On the other hand, tax does not apply to the sale of intangible personal property or to the provision of services. (R&TC, §§ 6006, 6007, 6051.) Tangible personal property is personal property which may be seen, weighed, measured, felt, or touched, or which is in any mother manner perceptible to the senses. (R&TC, § 6016.) The R&TC does not define what is meant by intangible personal property or services; however, these concepts are defined in caselaw. (*Dell, Inc. v. Superior Court* (2008) 159 Cal.App.4th 911, 923 (*Dell, Inc*.).) Services means the performance of labor for the benefit of another. (*Ibid*.) Intangible personal property generally means property that is a right rather than a physical object. (*Ibid*.) Intangible property includes a license to use information under a copyright or patent. (*Preston v. State Bd. of Equalization* (SBE) (2001) 25 Cal.4th 197, 216; *Nortel Networks Inc. v. SBE* (2011) 191 Cal.App.4th 1259, 1269.)

A bundled transaction occurs when the provision of services and transfer of tangible personal property are inextricably intertwined in a single transaction. (*Dell, Inc. v. Superior Court*, *supra*, at p. 924; see also R&TC, §§ 6006, 6012.) Such a bundled transaction is either a taxable sale or a nontaxable service transaction in its entirety. (*Ibid*.) California Code of Regulations, title 18, (Regulation) section 1501 interprets and implements the R&TC, and

establishes the true object test to determine whether a bundled transaction involves a taxable sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a nontaxable service.[9] (Cal. Code Regs., tit. 18, § 1501; see, e.g., *Appeal of Thomas Conglomerate*, 2021-OTA-030P.) Under the true object test, it must be determined whether the real object sought by the buyer is the service per se or property produced by the service. (*Ibid*.) If the true object of the contract is the service, the transaction is nontaxable even if some tangible personal property is transferred. (*Ibid*.) If the transaction is regarded as a sale of tangible personal property, tax applies to the gross receipts from the furnishing thereof, without deduction for any work, labor, skill, thought, time spent, or any other expense. (*Ibid*.)

The Court of Appeal addressed non-bundled transactions (mixed transactions) in *Dell, Inc.* and concluded that optional computer service contracts were readily separable from the sale of computers because: the service contracts were optional; Dell sold the service contracts independently of the computers; and the charge for the computer was reduced by a specified sum if the customer declined the service contract. (*Dell, Inc. v. Superior Court*, *supra*, at p. 929.) As such, the court concluded that *optional* service contracts were not bundled with the sale of Dell's computers and treated these as two separate transactions: an optional service contract (service or intangible property) and a sale of a computer.

When the transfer of intangible and tangible personal property is inextricably intertwined in a single transaction, courts still apply a default rule that is "an all-or-nothing affair" and treat the transaction as taxable or nontaxable in its entirety. (*Lucent Technologies, Inc. v. SBE* (2015) 241 Cal.App.4th 19, 31.)[10] In such bundled transactions, the fact that the true object of the contract is intangible personal property, as opposed to tangible personal property, is not relevant. (*Ibid.* [citing *Preston v. SBE*, *supra*, at p. 211].) In other words, notwithstanding Regulation section 1501 (which would not otherwise tax such a transaction) the California Supreme Court

[9] R&TC section 7051 grants CDTFA the authority to prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of the Sales and Use Tax Law. The courts have concluded that the legislative delegation in R&TC section 7051 is proper even though it confers some degree of discretion on CDTFA. (*Henry's Restaurants of Pomona, Inc. v. SBE* (1973) 30 Cal.App.3d 1009, 1020.)

[10] The Court of Appeal's holding in *Lucent Technologies, Inc*. is limited to a scenario involving a technology transfer agreement assigning or licensing a right to make and sell a product or use a process that is subject to a patent or copyright pursuant to R&TC section 6012(c)(10), which is an exception to the general rule. Nevertheless, the court in *Lucent Technologies, Inc.* provides useful background dicta summarizing caselaw on the default rule.

has concluded that "transfers of tangible property remain taxable even if these transfers are merely incidental to transfers of intangible property rights." (*Preston v. SBE*, *supra*, at p. 211.)

In the instant case, it is helpful to have a basic understanding of what is generally meant by "franchise" and "franchise agreement."

> **Franchise**. *N*. . . The sole right granted by the owner of a trademark or tradename to engage in business or sell a good or service in a certain area. ¶ . . . ¶
>
> **Franchise agreement**. The contract between a franchisor and franchisee establishing the terms and conditions of the franchise relationship.

(Black's Law Dict. (8th ed. 2004) p. 683, col. 2.)

As relevant here, appellant first contends that the Franchise Agreement transfers to the franchisee a "legal right" to operate a franchise business in this state, and the franchise transaction is not a sale of tangible personal property because the stated cost of the ATM is less than 50 percent (i.e., $4,995 / $29,500) of the initial franchise fee.

A sale is a transfer of a title or possession to tangible personal property for a consideration. (R&TC, § 6006(a).) There is no specific statutory exclusion from the definition of a "sale" for property sold below cost. (*Ibid*.) The first step is to identify the transaction at issue and identify whether it involves a sale of tangible personal property, intangibles, or the provision of services. Here, it is undisputed that the consideration paid by the franchisee pursuant to the Finance Agreement is the $29,500 initial franchise fee. This is also the specific "sale" asserted by CDTFA (i.e., the document which, among other things, transfers the ATMs to appellant's customers).

The nature of the transaction (tangible personal property, services, or intangibles)

Next, we turn to whether tangible personal property is received in exchange, whether in whole or part, for the initial franchise fee. The Franchise Agreement grants a franchise to operate an ACFN® business within a specified geographic area, and a license to use appellant's trademarks in the operation of the franchise for up to ten years, unless terminated earlier by either party. The Franchise Agreement requires the franchisee to pay numerous other fees, 25 of which (in addition to the initial franchise fee) are described in the Franchise Disclosure Document. One of the required fees is titled "initial franchise fee." Although one might posit that the analysis should end here because the Finance Agreement identifies the fee at issue as an "initial franchise fee," and a franchise right is an intangible, we must follow the law, and the

Sales and Use Tax Law requires an examination of the transaction, as opposed to accepting the title provided by the parties.

It first bears mentioning that the Franchise Agreement transfers certain rights in exchange for the transfer of various items of consideration. The license to operate the ACFN® business and the limited right to use appellant's trademarks are only two sticks in the bundle of rights transferred to the franchisee, and the initial franchise fee is just one item of consideration received by appellant under the Franchise Agreement. Now, if we look specifically at what was exchanged for the initial transfer fee under the terms of the Franchise Agreement, appellant's Franchise Disclosure Document defines "what items are included in the initial franchise fee" and identifies only two elements: (1) the tangible personal property (ATM and cash cassette for the ATM) and (2) three days of training, including travel expenses to San Jose, California, hotel accommodations, and meals. Payment of the initial franchise fee does not explicitly transfer to the franchisee any intangible property, such as the ability to engage in business using appellant's trademark. Instead, it is the Franchise Agreement which transfers such rights, and that agreement also requires other items of consideration be paid to appellant. Thus, we note that the initial franchise fee is not clearly delineated as the consideration paid for the transfer of the intangible rights under the Franchise Agreement. This, however, does not necessarily preclude assigning value to the intangible elements.

Neither the Franchise Agreement nor the Franchise Disclosure Document specifically transfer or identify any other items which are transferred to the franchisee as consideration for payment of the $29,500. Nevertheless, the cost for an additional ATM is $4,995, the cost for an additional cash cassette is $495, the travel was valued at $500, and appellant's witness testified at the hearing that the value of the training is approximately $1,000. As such, one might plausibly infer from these facts that the value of the tangible personal property is $5,490, the value of the training services and travel is $1,500, and that the franchisee must have intended to pay at least some portion of the balance to appellant as a premium or incentive in exchange for appellant's agreement to enter into a business relationship with the franchisee. On the other hand, the Finance Agreement also requires the franchisee to agree to pay a number of additional and specifically listed fees to appellant on a recurring basis, and this could also plausibly be interpreted as the consideration (or additional consideration) for the intangible elements. Whatever the parties' motivations might have been, the actual contract, the Franchise

Agreement, did not specifically allocate any portion of the initial franchise fee towards anything, whether services or intangibles, other than the ATM, cash cassette, and training. As such, we are unable to allocate a specific dollar amount of consideration transferred under the Finance Agreement to intangibles. We do not affirmatively reach a finding that no portion of the initial finance fee is paid for the transfer of intangibles. However, we also do not allocate a value, if any, to the intangibles because, for the reasons discussed below, it is unnecessary to do so.

Appellant argues that the Franchise Agreement provides for the provision of many services, in addition to the intangible rights to use appellant's trademarks and operate an ACFN® business. Here, the Franchise Agreement authorizes, subject to certain terms and conditions, the franchisee to engage in an ACFN® business using appellant's trademark. The Franchise Agreement also authorizes appellant to terminate that business relationship subject to certain conditions. In addition, Item 5 in the Franchise Disclosure Document itemizes five pages of one-time and recurring fees that must be paid as consideration for the listed services provided under the Franchise Agreement. According to the terms, the $29,500 initial franchise fee is due and payable as a nonrecurring and nonrefundable charge at the time of signing the agreement, and regardless of whether the franchisee ever engages in an ACFN® business or uses appellant's trademark. In addition, it is undisputed that the $29,500 is paid, whether in whole or in part, in exchange for transfer of an ATM with a stated value of $5,490. Based on all the facts, we find that, pursuant to the agreement between the parties, the $29,500 initial franchise fee was required to be paid in exchange for receiving the training and related travel benefits, the ATM, and the cash cassette. We will also discuss the intangible element, and, below, we will assume for purpose of analysis that some portion of the $29,500 fee is allocable to intangibles.

Mixed versus bundled transactions

Next, the application of tax to this transaction depends on whether it is a bundled or mixed transaction. Appellant concedes that a portion of the initial franchise fee is taxable to the extent allocable to tangible personal property (which appellant values at approximately $5,490). In addition, appellant contends that the balance of the initial franchise fee is nontaxable (services or intangibles). Nevertheless, the test for whether a transaction is a bundled transaction is whether the tangible personal property is inextricably intertwined in a single transaction with intangibles and/or services. (*Dell, Inc. v. Superior Court*, *supra*, at p. 924; see R&TC, §§ 6006, 6012.) Here, the focus is on the relationship between the elements of the transaction. When the

service is optional and there is a fixed and an ascertainable relationship between the value of the tangible personal property and the value of the services rendered, and each is a consequential element capable of a separate and distinct transaction, then the services and tangible personal property must be analyzed as separate transactions. (*Id*. at p. 918.)

The only other specifically included element to the initial franchise fee is the training component, which is a service (we will address the intangible element separately, below). The Franchise Agreement specifies that the training is *mandatory*. If a franchisee pays the initial franchise fee and purchases an ATM, that alone is not sufficient to allow the franchisee to engage in business using the ATM; appellant will not allow the franchisee to engage in business with or otherwise use the ATM unless the franchisee *successfully* completes the mandatory training. If the franchisee fails to complete the training, then appellant has the right to terminate the Franchise Agreement, and the franchisee is prohibited from operating any of the ATMs without obtaining written agreement from appellant. During the hearing, appellant's witness also testified that appellant would not sell ATMs without an existing Franchise Agreement. Based on the totality of the circumstances, and consistent with *Dell, Inc*., we conclude that the training services are not optional. Instead, we find the training services are mandatory and, as such, are inextricably intertwined with the sale of the ATM. We find that the initial franchise fee was payable in connection with, at a minimum, a bundled transaction for the sale of the ATM and cash cassette, and the provision of mandatory services.

The true object of the contract test for bundled services and tangible personal property

The next question is whether the true object of the bundled transaction is the ATM (tangible personal property) or the mandatory training on how to operate an ACFN® business (services). It is important to emphasize here that the inquiry is on "the purchaser's," as opposed to the seller's, true object. (*Dell Inc. v. Superior Court, supra*, at p. 923.) Here, we find that, between the training and the ATM, the purchaser's true object in paying the initial franchise fee was the tangible personal property. It should be reasonable to conclude that the purchaser intended to obtain the ATM with the expectation of receiving a stream of surcharge revenue based on the number of transactions processed by the ATM. On the other hand, the mandatory training was imposed entirely for the "satisfaction" of appellant, and as a precondition for the franchisee's operation of the ATM business. If the purchaser's true object was to receive the in-person training from appellant, we find it unlikely that appellant would have needed to make the

training a prerequisite to operation of the ATMs, or had to include a provision in the Franchise Agreement that failure to complete the training was grounds for appellant, at its sole election, to terminate the Franchise Agreement (which would have further precluded the purchaser from operating the ATM absent written agreement from appellant). Therefore, we conclude that the provision of the training services and travel to and from the training center is incidental to the transfer of the tangible personal property.

Intangibles bundled with tangible personal property

Finally, we turn to the intangible element. Here, appellant contends that a significant element of the contract – the right to operate a franchise under appellant's trademark – was intangible.[11]

California does not tax the sale or use of intangible property, which generally means and includes property that is a right rather than a physical object. (*Navistar Intl. Transportation Corp. v. SBE, supra,* 8 Cal.4th at p. 874-875; R&TC, §§ 6006(a), 6007.) California views sales of tangible property bundled with intangibles, rather than services, differently.

When the true object of a bundled transaction involving intangible and tangible property is the tangible personal property, the sale "would be, as regulation 1501 states, subject to tax." (*Navistar Intl. Transportation Corp. v. SBE, supra,* 8 Cal.4th at p. 877; R&TC, § 6006(a).) However, on the flip side, the California Supreme Court has rejected the notion that the true object of the contract test may be applied to conclude that a transfer of tangible personal property is not taxable if the transfer of tangible personal property is incidental to the transfer of intangible property. (*Preston v. SBE, supra*, 25 Cal.4th 197, 210-211.) As such, the regulatory true object test, "by its terms, applies only to transactions involving 'the performance of a service.' " (*Preston v. SBE, supra*, 25 Cal.4th 197, 209.)

In *Dell, supra*, the court provided a succinct summary of the application of tax to bundled transactions involving intangibles:

> The California Supreme Court has thus rejected the position that 'a transfer of tangible property is not taxable if the transfer is incidental to the transfer of intangible property.' [Citation.] In *Navistar*, the court held that the transfer of drawings and designs embodying technology for the manufacture of industrial turbine engines was taxable even if the principal object of the sale was to transfer the intangible or intellectual content embodied in the documents. [Citation.]

[11] We note that trademarks are not included in the definition of a technology transfer agreement. (See R&TC, § 6012(c)(10)(D).)

> *Navistar* did not articulate the precise manner for determining the taxation of concurrent transfers of tangible and intangible property. [Citation.] However, the court's holding that documents containing intangible trade secrets were fully taxable as a sale of tangible property was based 'in part on the absence of a 'separate and distinct transfer of an intangible property right.' [Citation.] In short, the court was concerned with a truly bundled transaction in which taxable and nontaxable items were inextricably intertwined.

(*Dell, Inc. v. Superior Court, supra*, 159 Cal.App.4th at pp. 924-925.)

In *Simplicity Pattern Co. v. SBE* (1980) 27 Cal.3d 900, 906, the California Supreme Court examined the application of tax to film negatives and recordings along with the intangible rights thereto, and concluded that the "tax on their transfer was measurable by what [the purchaser] received for them as a whole, without deduction for amounts paid for their intellectual or other intangible components." (*Id*. at. p. 912.) In reaching this conclusion, the court applied a test analyzing whether the tangible personal property component was physically useful and, so finding, concluded that their "value as physical objects permitted measuring the tax on their sale by the price received for their entire worth." (*Id*. at p. 912)

The California Supreme Court went further in *Navistar*. This case involved the application of tax to the sale of documents containing intellectual content, where the true object of the transaction was the intellectual property. Here, the court again rejected the notion that "a sale becomes nontaxable whenever its principal purpose is to transfer the intellectual content of a physical object." (*Navistar Intl. Transportation Corp. v. SBE, supra,* at p. 877.) The court also concluded that, while physical usefulness of the tangible personal property may be sufficient to determine that tax applies, it is not "a necessary condition to the taxation of the sale of items" when intangible components are bundled with the sale. (*Id*. at p. 878.) The court did acknowledge, however, that if the true object of the contract was the performance of services, as opposed to the tangible personal property, then tax may apply as set forth in Regulation section 1501 (i.e., the transaction would involve the provision of nontaxable services). (*Id.* at p. 877.)

Following *Navistar*, the Legislature enacted R&TC sections 6011(c)(10) and 6012(c)(10), which specifically set forth the method to determine the application of tax to transactions involving technology transfer agreements to transfer a patent or copyright interest for the purpose of reproducing and selling other property subject to the copyright interest. (See Cal. Code Regs., tit. 18, § 1507(a)(1).) For these purposes, a technology transfer agreement

"means any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." (R&TC, § 6012(c)(10)(D).)

In *Preston*, the issue before the California Supreme Court had to do with the transfer of physical copies of artwork, in addition to the license to reproduce those images. The Court summarized existing law and stated that "any transfer of tangible property physically useful in the manufacturing process is subject to sales tax even though the true object of the transfer is an intangible property right like a copyright." (*Preston v. SBE*, *supra*, at p. 211.) The Court noted under the facts of that case, the artwork was not only physically useful, but also essential, in producing books containing the artwork. (*Ibid*.) Of course, if the true object of a bundled transaction involving intangible and tangible property is in fact *the tangible personal property*, the sale "would be, as regulation 1501 states, subject to tax." (*Navistar Intl. Transportation Corp. v. SBE* (1994) 8 Cal.4th 868, 877; R&TC, § 6006(a).) While physical usefulness of the tangible personal property is sufficient to impose tax, the Court further explained that " 'physical usefulness' was not 'a necessary condition to taxation.' " (*Preston v. SBE*, *supra*, at p. 211, citation omitted.) The Court also addressed the then-recent amendments to R&TC sections 6011(c)(10) and 6012(c)(10) and concluded that tax would apply pursuant to those provisions, as amended, to the extent the property at issue involves a technology transfer agreement within the meaning of those R&TC sections.

In summary, the R&TC provides that the gross receipts mean the total amount of the sales price, without any deduction on account of the cost of the materials used, labor or service cost, losses, or any other expense. (R&TC, § 6012(a)(2).) CDTFA promulgated Regulation section 1501 to address transactions involving the provision of services, and Regulation section 1507 to address technology transfer agreements.[12] There is, however, no statute or regulation which specifically addresses the application of tax to bundled transactions involving tangible personal property and intangibles (other than certain transfers of patents and copyrights

[12] In addition, Regulation section 1502(f)(2) addresses the sale of custom computer programs. Neither party contends that Regulation section 1502(f) applies to the transfer of appellant's ATMs, or that the Franchise Agreement involves the sale of a custom computer program from appellant to a franchisee. Furthermore, there is nothing in the record to indicate that, to the extent the ATM utilizes computer programming, that any such programming is customized for each respective franchisee, or that appellant transfers or has a right to transfer any software license to its franchisees. (See Cal. Code Regs., tit. 18, § 1502(f)(2) [discussing the application of tax to custom computer programs].)

pursuant to a technology transfer agreement). The applicable precedent is set forth entirely in caselaw. As summarized in the cases discussed above, the current state of the caselaw with respect to bundled transactions involving intangibles is as follows: (1) tax does not apply to a bundled transaction involving tangible personal property when the true object of the contract is the provision of nontaxable services; (2) the true object test, by its terms, does not apply to bundled transactions involving tangible personal property and intangibles; (3) nevertheless, at a minimum, tax would apply to a bundled transaction involving tangible personal property and intangibles if it passes either the physically useful test, or the true object test; however, the California Supreme Court has indicated that tax may still apply even if the transaction does not meet either of these two tests;[13] and (4) tax applies differently to certain transfers of patents and copyrights pursuant to a technology transfer agreements.

In the instant case, there is no evidence or argument that the transactions at issue transfer a patent or copyright for the purpose of reproducing and selling the ATMs, or to use a process subject to the patent or copyright within the meaning of R&TC section 6012(c)(10), as such, the provisions governing technology transfer agreements are inapplicable. The facts of this case do not involve a technology transfer agreement. Further, we concluded above that the true object of the contract is not the provision of nontaxable training services, as such, the application of tax depends on the remaining elements: intangibles and tangible personal property.

Here, appellant contends that a significant aspect of the contract was the intangibles, and notes that the value of the tangible personal property is only $5,490, which is less than 50 percent of the initial franchise fee. The value of the training services ($1,000) and travel ($500) combined are approximately 5 percent of the initial franchise fee. Although it is clear that the Finance Agreement transferred intangibles, the Finance Agreement did not specifically allocate any value to intangibles, or specifically state that any intangibles were provided specifically in consideration for payment of the initial franchise fee (this must be inferred or assumed, which we do for purposes of this analysis).[14] The stated value of the tangible personal

[13] The California courts have not addressed what those other scenarios may require for the imposition of taxes. Instead, citing *Navistar*, the California Supreme Court merely explained that this case stands for the proposition that, "'physical usefulness' was not 'a necessary condition to taxation.' " (*Preston v. SBE*, *supra*, at p. 211.)

[14] It is unclear why the Finance Agreement was structured to transfer intangibles, such as the right to use the trademark, but did not specifically allocate a value or a portion of the initial license fee to the intangible aspect. Whether the omission was strategic, or an oversight, it would not change the analysis.

property appears to be approximately 20 percent of the initial franchise fee, and the services 5 percent. Thus, we will assume for purposes of this analysis that the value of the intangibles is approximately 75 percent of the initial franchise fee. Nevertheless, no court case, statute, or regulation has adopted a 75 percent test, 50 percent test, or a 20 percent test, or any threshold test for that matter, to determine the application of tax to a bundled transaction involving intangibles. Here, an ATM is an essential and necessary component required to engage in an ACFN® business. The right to use appellant's trademarks is meaningless without a physical means to process financial transactions in tangible currency.

While the intangible elements may grant appellant's customers the right to operate ATMs displaying appellant's trademark, and the right to connect those ATMs to appellant's network, it is impossible to operate an ACFN® business without an ATM. For that matter, appellant's witness testified that appellant would not sell ATMs without a Franchise Agreement to operate an ACFN® business. In other words, the evidence indicates that the intangibles are a mandatory and required element which is inextricably intertwined with the sale of the ATM. As such, we find that the transfer of the ATM and the right to operate the ATM constitute a bundled transaction for intangibles and tangible personal property. We further find that the ATM is physically useful, if not essential, to the operation of an ACFN® business. As such, we find that the entire initial franchise fee is taxable, without deduction on account of the intangible elements, or the training services, transferred under the Finance Agreement.

In summary, the sale of the training services and intangibles are taxable as a part of the sale of the ATM. Therefore, we find that appellant failed to establish that any further adjustments are warranted.

HOLDING

Appellant's initial franchise fees are taxable as a part of the sale of ATMs.

DISPOSITION

CDTFA's action as set forth in CDTFA's decision is sustained.

DocuSigned by:
3CADA62FB4864CB...
Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
CB1F7DA37831416...
Josh Lambert
Administrative Law Judge

DocuSigned by:
Suzanne B. Brown
47F45ABE89E34D0...
Suzanne B. Brown
Administrative Law Judge

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