



STATE BOARD OF EQUALIZATION

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January 4, 2013

Dear Interested Party:

Enclosed are the Agenda and Issue Paper for the January 15, 2013 Business Taxes Committee meeting. This meeting will address whether the Board should amend Regulation 1502, *Computers, Programs, and Data Processing*, to clarify how sales and use tax generally applies to transfers of non-custom computer programs (hereafter prewritten software) recorded on tangible storage media; and/or amend Regulation 1507, *Technology Transfer Agreements*, to clarify how the technology-transfer-agreement statutes (Rev. & Tax. Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)) apply to transfers of prewritten software recorded on tangible storage media.

Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m.** on **January 15, 2013** in Room 121 at the address shown above.

Sincerely,

Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department

JLM: rsw

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC 71)
Senator George Runner (Ret.), Member, Second District (MIC 78)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. Robert Thomas, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Carey, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges
Mr. Randy Ferris
Ms. Christine Bisauta
Mr. Robert Tucker
Mr. Bradley Heller
Mr. David Hunter
Mr. Jeffrey McGuire
Ms. Susanne Buehler
Mr. Bradley Miller
Ms. Kirsten Stark
Mr. Robert Wilke
Ms. Lynn Whitaker

AGENDA —January 15, 2013 Business Taxes Committee Meeting
Application of Tax to Sales of Prewritten Software Recorded on Tangible Storage Media

<p>Action 1 — Whether to amend Regulation 1502, <i>Computers, Programs, and Data Processing</i>, to clarify how sales and use tax applies to transfers of non-custom computer programs (hereafter prewritten software) recorded on tangible storage media.</p> <p>Issue Paper Alternative 1 – Staff Recommendation See Issue Paper, Page 1, <i>Issue 1</i></p>	<p>Alternative 1 Authorize staff to conduct additional, focused interested parties meetings on the issues which, based on prior interested parties meetings, have the best potential for immediate resolution. These issues include the application tax to optional software maintenance contracts that include the transfer of a back-up copy of the same or similar prewritten software recorded on tangible storage media and the application of tax to site license transactions.</p>
<p>Action 2 — Whether to amend Regulation 1507, <i>Technology Transfer Agreements</i>, to clarify how the technology-transfer-agreement statutes (Rev. & Tax. Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)) (TTA statutes) apply to transfers of prewritten software recorded on tangible storage media.</p> <p>Issue Paper Alternative 1 – Staff Recommendation See Issue Paper, Pages 1-2, <i>Issue 2</i></p>	<p>Alternative 1 Staff requests the Board’s authorization to continue discussing the application of the TTA statutes to sales of prewritten software recorded on tangible storage media, but make no amendments to Regulation 1507 at this time because industry</p>

AGENDA —January 15, 2013 Business Taxes Committee Meeting
Application of Tax to Sales of Prewritten Software Recorded on Tangible Storage Media

<p>Action 2 (continued)</p>	<p>and staff have yet to reach a consensus regarding the application of the TTA statutes</p> <p>If staff is able to make progress towards a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media, then staff would seek further guidance from the Board as to whether additional interested parties meetings are warranted.</p>
<p>Action 3 — Whether to amend Regulation 1502, <i>Computers Programs, and Data Processing</i> and/or Regulation 1507, <i>Technology Transfer Agreements</i>.</p> <p>Issue Paper, Other Alternatives (Alternatives 2-6) See Issue Paper, Pages 2-3</p> <p>Alternative 2 – Mr. Patrick J. Leone’s Recommendation Alternative 3 – Paul Hastings LLP’s Recommendation Alternative 4 – Ernst & Young LLP’s Recommendation Alternative 5 – Software Industry Recommendation Alternative 6 – SoFTEC’s and SVLG’s Compromise Proposal</p>	<p>Staff received several recommendations (Alternative 2-6) during the interested parties process, but the interested parties did not submit specific regulatory language with the recommendations. If the Board were to indicate approval of one or more of these alternatives, staff requests the Board’s direction as to whether staff should work with the interested party or parties who recommended the alternative(s) to develop specific regulatory language for the Board’s consideration.</p>

Issue Paper Number 13-002



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- Board Meeting
 Business Taxes Committee
 Customer Services and Administrative Efficiency Committee
 Legislative Committee
 Property Tax Committee
 Other

Application of Tax to Sales of Prewritten Software Recorded on Tangible Storage Media

I. Issues

Whether the Board should:

1. Amend Regulation 1502, *Computers, Programs, and Data Processing*, to clarify how sales and use tax generally applies to transfers of non-custom computer programs (hereafter prewritten software) recorded on tangible storage media; and/or
2. Amend Regulation 1507, *Technology Transfer Agreements*, to clarify how the technology-transfer-agreement statutes (Rev. & Tax. Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)) (TTA statutes) apply to transfers of prewritten software recorded on tangible storage media?

II. Alternative 1 - Staff Recommendations

Issue 1:

Authorize staff to conduct additional interested parties meetings to separately:

- Discuss the text of amendments to Regulation 1502 to expressly clarify that when a consumer purchases prewritten software via a download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a back-up copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software itself, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract;
- Try to reach some consensus between industry and staff as to whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax; and
- If some consensus can be reached, discuss the text of amendments to Regulation 1502 that would further clarify the treatment of charges for site licenses.

Issue 2:

Authorize staff to continue discussing the application of the TTA statutes to sales of prewritten software recorded on tangible storage media, but make no amendments to Regulation 1507 at this time because industry and staff have not yet reached a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media. If staff is able to make progress towards a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on

tangible storage media, then staff would seek further guidance from the Board as to whether additional interested parties meetings are warranted when staff reports back to the Board on the results of the focused interested parties meetings that staff is recommending.

III. Other Alternatives Considered¹

Issues 1 and 2:

Alternative 2 – Mr. Patrick J. Leone’s Recommendations

The Board received a letter from Mr. Patrick J. Leone dated July 13, 2012, in response to the initial discussion paper, recommending that Regulation 1507 be amended to provide that any transfer of software subject to a license agreement is a TTA, and that the measure of tax should be limited to the price of the storage media, or 200% of the cost of materials and labor to produce the company’s own tangible storage media upon which the software is transferred. Mr. Leone further recommends that Regulation 1507 should be amended to clarify that as long as the retailer has the right to transfer and does transfer the right to use prewritten software, then the sale of the software on tangible storage media qualifies as a TTA.

Alternative 3 – Paul Hastings LLP’s Recommendations

Paul Hastings LLP recommends that Regulation 1507 be amended to provide that any agreement that allows copyrighted software to be copied onto a computer is a TTA, and that the taxable measure is limited to the value of the tangible storage media used to transfer prewritten software in a software TTA. (See August 1, 2012 letter from Paul Hastings LLP; see also, November 2, 2012 letter from Paul Hastings LLP.)

Alternative 4 – Ernst & Young LLP’s Recommendations

Ernst & Young LLP’s August 3, 2012 letter recommends that Regulation 1507 be amended to provide that the TTA statutes exempt charges to use an “embedded patented process,” and provide an optional percentage that can be used to exclude a portion of the charges for tangible personal property that performs an embedded patented process, such as a computer printer, from the measure of sales and use tax.

Alternative 5 – Software Industry Recommendations

The broader software industry recommends that Regulation 1502 and/or Regulation 1507 should be amended to provide that prewritten software is not tangible personal property and that all transfers of prewritten software on tangible storage media are TTAs. (See August 1, 2012, and November 6, 2012, letters from Mr. Mark Nebergall.)² In addition, the broader software industry recommends that Regulation 1502 and/or Regulation 1507 be amended to limit the taxable measure to the value of the

¹ The following alternatives were recommended by interested parties during the interested parties process, but the interested parties did not submit specific regulatory language with their alternatives. Therefore, if the Board agrees with one or more of the following alternatives, the Board can direct staff to work with the interested party or parties who recommended that alternative or those alternatives to develop specific regulatory language for the Board’s consideration and potential adoption.

² Mr. Nebergall’s letters were both sent on behalf of the California Chamber of Commerce, California Manufacturers and Technology Association, California Taxpayers Association, Council on State Taxation, Silicon Valley Leadership Group (SVLG), Software Finance and Tax Executives Council (SoFTEC), and TechAmerica. Mr. Nebergall’s November 6, 2012, letter was also sent on behalf of the Silicon Valley Tax Directors Group.

tangible storage media used to transfer prewritten software in a software TTA, or, alternatively, that the amendments exclude charges for tangible storage media from the taxable measure because the storage media is immaterial and should be ignored for sales and use tax purposes. (See Mr. Nebergall's August 1, 2012, letter.)

Alternative 6 –SoFTEC's and SVLG's Compromise Proposal

SoFTEC and SVLG recommend that the Board amend Regulation 1502 and/or Regulation 1507 to provide that:

- “Sales of prewritten computer software on tangible storage media, such as disks or CD[-]ROMs, regardless whether sold by the developer of the software or a third-party retailer, where the end user license agreement allows the purchaser to make no more than 5 copies of the software, would not be treated as a TTA and would be subject to sales and use tax at 100% of the sales price.
- “All other sales of copies of prewritten computer software on tangible storage media, such as disks or CD-ROMs, regardless whether sold by the developer of the software or a third-party retailer, would be treated as TTAs with the result [that] the tangible storage media would be treated as insignificant or irrelevant and not subject to sales or use tax, similar to the way so-called ‘gold masters’ are treated under the second sentence of Regulation 1502(f)(1)(B).
- “The TTA statutes would apply to prewritten computer software sold together with other tangible personal property that is not a mere storage medium (such as a disk or CD[-]ROM). If the fair market value of the prewritten computer software is 20% or less of the total selling price, there would be a rebuttable presumption that the entire selling price is subject to sales or use tax. Additionally, if the fair market value of the software is more than 20% of the total selling price, there would be a rebuttable presumption that 20% of the selling price would be for the software and not subject to tax. Taxpayers would be able to rebut the presumption with evidence that a different amount is attributable to the non-taxable software component of the sales price.³
- “The state would honor claims for refunds of sales tax from sellers and use tax from purchasers consistent with the above formulae.”

(See December 3, 2012 letter from SoFTEC and SVLG.)

IV. Background

A. Background Information Regarding Regulation 1502 and RTC Section 6010.9

The Legislature enacted Revenue and Taxation Code (RTC) section 6010.9 in 1982 to specifically address the application of the Sales and Use Tax Law to sales and purchases of computer programs on tangible storage media in a manner that provides “state incentives for the development and utilization of computer software.” (Stats. 1982, ch. 1274, §§ 1, 2.) Under RTC section 6010.9, charges for “the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program” and “separately stated charges for [custom] modifications to an existing prewritten program which are prepared to the special order of the customer” are not subject to sales or use tax, even if the custom computer programs or custom modifications are transferred on tangible storage media. (RTC, § 6010.9, first sentence and subd. (d).) However, charges for “a ‘canned’ or prewritten computer program which is held or existing for general or repeated sale or lease,” did not

³ The December 3, 2012 letter provides that “prewritten computer software sold together with other tangible personal property that is not a mere storage medium,” includes prewritten software embedded in tangible personal property, such as a coffee maker or automobile.

receive an exclusion, “even if the prewritten or ‘canned program’ was initially developed on a custom basis or for in-house use.” (RTC, § 6010.9, subd. (d).)

Following the enactment of RTC section 6010.9, the Board amended Regulation 1502, subdivision (f) in 1988 to address the application of tax to charges for custom computer programs, custom modifications to prewritten computer programs, and canned or prewritten computer programs in conformity with RTC section 6010.9. Also in 1988, the First District Court of Appeal interpreted RTC section 6010.9 in *Touche Ross & Co. v. State Bd. of Equalization* (1988) 203 Cal.App.3d 1057 (hereafter *Touche Ross*), which involved the taxable sale of a business that included a library of used, customized and internally developed computer programs recorded on computer storage media. The court held that section 6010.9 was declaratory of, rather than a change in, existing law. (*Id.* at p. 1062.) Further, the court went on to hold that, once a program had been created and was in the possession of the original customer, the design or development service had been completed, and the program itself was a tangible personal asset to the customer. Therefore, a subsequent sale of that program by the initial customer could no longer be characterized as a “service” transaction, but rather would constitute a transfer of tangible personal property. Thus, the court concluded that the subsequent sale of such computer programs was subject to sales tax under the general provisions of RTC section 6051. (*Id.* at p. 1064.)

In addition, and as relevant here, Regulation 1502, subdivision (f)(1)(D) currently provides that “[t]he sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.” Furthermore, Regulation 1502, subdivision (f)(1)(C) currently provides as follows with regard to prewritten software maintenance contracts:

Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

B. Background Regarding TTA Statutes and Regulation 1507

1. The Enactment of the TTA Statutes

On June 4, 1992, the Board adopted a memorandum opinion deciding the *Petition for Redetermination of Intel Corporation (Intel)* regarding two agreements (or contracts) involving transfers of intellectual property and tangible personal property. Under the first contract, Intel transferred to Burroughs Corporation a license to use a patented process for producing integrated circuits, along with written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. Under the second contract, Intel transferred to Advanced Micro Designs a license to produce an integrated circuit it had designed, a license to use a patented process for producing the integrated circuit, and copies of the existing proprietary written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. The Board concluded that both contracts provided for two transfers for sales and use tax purposes: a taxable transfer of tangible personal property consisting of engineering notes, manuals, schematics, database tapes, drawings, and test tapes, and a nontaxable sale of intangible property consisting of the licenses to use copyrighted or patented information in a manner that, but for the licenses, would infringe upon the copyright or patent interests at issue. The Board further concluded that, “in the absence of a contract price for the tangible elements, the tax applies only to the value attributable to the tangible elements including the cost of manufacturing the specific tangible properties. This includes material costs, fabrication labor, and a suitable markup for overhead and profit.” In this case, the Board found that a suitable markup “was 100% of the cost of materials and labor.”

The TTA statutes were enacted in 1993, a year after the Board’s *Intel* memorandum opinion. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)).) Both provisions define a TTA as “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.” (Rev. & Tax. Code, §§ 6011, subd. (c)(10)(D) and 6012, subd. (c)(10)(D).) The TTA statutes further provide that “sales price” and “gross receipts” do not include the “amount charged for intangible personal property transferred with tangible personal property in any” TTA, if the TTA “separately states a reasonable price for the tangible personal property.” If there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, tangible personal property transferred under a TTA by looking to the “price at which the tangible personal property was sold, leased, or offered to third parties.” And, in the absence of such previous sales, the TTA statutes provide that the taxable measure is equal to “200 percent of the cost of materials and labor used to produce the tangible personal property.” (*Id.*, subd. (c)(10)(A)-(C).)

2. The California Supreme Court’s TTA Case

In *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 (hereafter *Preston*), the California Supreme Court discussed the meaning of the TTA statutes before applying them to a number of written agreements transferring the right to reproduce copyrighted artwork (i.e., illustrations and designs) in

children’s books and on rubber stamps to two book publishers and a rubber stamp manufacturer, respectively. The Court stated that: “Read as a whole and giving the statutory language its ordinary meaning, *sections 6011(c)(10)* and *6012(c)(10)* unambiguously establish that the value of a patent or copyright interest transferred pursuant to a technology transfer agreement is *not* subject to sales tax even if the agreement also transfers tangible personal property In other words, these provisions exclude the value of a patent or copyright interest from taxation whenever a person who owns a patent or copyright transfers that patent or copyright to another person so the latter person can make and sell a product embodying that patent or copyright.” (*Preston, supra*, at pp. 213-214 [italics in original].) The Court also found that the agreements transferring the rights to reproduce copyrighted artwork in children’s books and on rubber stamps constituted TTAs because they transferred the right to make and sell products that were subject to the transferor’s copyrights. (*Id.* at p. 215.)

Further, and as relevant here, the Court explained the fundamental attributes of transfers involving copyrights and patents. The Court stated:

Patents give an owner “the exclusive right to manufacture, use, and sell his invention.” [Citation omitted.] Thus, the license of a patent interest, by definition, gives the licensee the right to make a product or to use a process. In contrast, “copyright protects originality rather than novelty or invention—conferring only ‘the sole right of multiplying copies.’” (*Mazer [v. Stein (1954)]* 347 U.S. [201], 218, 74 S.Ct. 460, fn. omitted.) Thus, the license of a copyright interest can only give the licensee the right to reproduce the copyrighted material in a product—and not the right to make and sell a product. Because *sections 6011(c)(10)* and *6012(c)(10)* expressly exempt the assignment or license of the right to make and sell a product subject to *either* a patent *or* copyright from taxation, they must encompass agreements, like *Preston*’s, that license the right to reproduce copyrighted material in a product to be manufactured and sold by the licensee. (*Preston, supra*, at pp. 215-216 [italics in original].)

The Court then went on to find that the agreements at issue in *Preston* qualified as TTAs because they involved “the separate and distinct transfer of a copyright -- an intangible right distinct from ‘any material object in which the work is embodied,’” that is the right to produce and sell products embodying the copyrighted work. Accordingly, the Court decided that the TTA statutes applied in *Preston*. (*Preston, supra*, at p. 220.)

Preston also invalidated a non-TTA provision of Regulation 1540, *Advertising Agencies and Commercial Artists*, pertaining to the taxability of lump-sum charges involving copyright interests that the court found was in conflict with the TTA statutes. (*Preston, supra*, at p. 219.)

3. Regulation 1507

The Board adopted Regulation 1507 in 2002 to implement the TTA statutes and incorporate the California Supreme Court’s holding in *Preston*. Regulation 1507 defines the term TTA and explains the application of tax to transactions involving TTAs.

Regulation 1507, subdivision (a)(1) currently provides that:

“Technology transfer agreement” means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property

subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to [a] technology transfer agreement.

Regulation 1507, subdivision (a)(1) and (3) explains that, under the TTA provisions, tax will not apply to charges for the right to use a patented process that is external to tangible personal property, but that tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of tangible personal property that performs a process related to “patented technology embedded in the internal design, assembly or operation of the” tangible personal property. (Reg. 1507, subd. (a)(1), example 3, and (a)(3).)

Regulation 1507, subdivision (a)(2) through (4) implements, interprets, and makes specific the terms “process,” “assign or license,” “copyright interest,” and “patent interest” from the TTA statutes. As relevant here, the regulation defines:

- “Copyright interest” to mean “the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission.” [A]n “original work of authorship” includes “any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.” (Reg. 1507, subd. (a)(2));
- “Patent interest” to mean “the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material.” (Reg. 1507, subd. (a)(3)); and
- “Process” to mean “one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but *does not mean or include the mere use of tangible personal property subject to a patent interest.*” (Reg. 1507, subd. (a)(3) [italics added].)

In addition, the regulation provides that “‘Assign or license’ means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement.” (Reg. 1507, subd. (a)(4).)

4. The Court of Appeal's 2011 *Nortel* Case

Subdivision (a) of Regulation 1507 originally provided that “[a] technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502.” On January 18, 2011, however, this provision was invalidated by the Second District Court of Appeal in *Nortel Networks, Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259, 1278 (hereafter *Nortel*).

The Court of Appeal noted that the factual basis for its *Nortel* decision was uniquely limited. Footnote 2 to the entire statement of facts explains that “[o]wing to state budgetary problems, the sole expert witness designated by the state refused to be deposed because his fee was unpaid. As a result, he was not permitted to testify at trial, a lapse the trial court aptly forecast as ‘fatal’ to the state’s defense. Nortel was the beneficiary of the state’s fiscal distress: to make its factual findings, the trial court had to rely exclusively on technical testimony from a procession of Nortel-friendly witnesses. The court found the testimony ‘credible in all respects,’ based on the witnesses’ candor and demeanor.” (*Nortel, supra*, at p. 1265, fn. 2.)

Based upon the limited factual record and stipulated facts, the court found that “Nortel and Pacific Bell entered [into] licensing agreements giving Pacific Bell the right to use Nortel’s software programs in the switches” Pacific Bell purchased from Nortel. (*Nortel, supra*, at p. 1265.) The licensing agreements concerned “two types of licensed software . . . [: (A)] prewritten operator workstation programs (that connect customers to operators), data center programs (that connect customers to directory assistance), and switch-connection programs (that allow switches to communicate);” and (B) “switch-specific programs (SSP’s) that operate the switch and enable it to process telephone calls.” (*Ibid.*) “The three prewritten programs licensed by Nortel are copyrighted . . . [and] subject to Nortel’s patents.” (*Id.* at p. 1278.) “Each SSP is unique, is created for a particular switch, and cannot be used to operate any other switch”; and “[o]wing to their uniqueness, SSP’s are ‘never’ offered for general sale, or for repeated sale or lease.” (*Id.* at p. 1265.) Also, “Nortel copyrights its SSP’s: each program is ‘an original work of authorship created by the Nortel software programmers’” and the “SSP itself incorporates one or more processes that are subject to—and implement—Nortel’s patent interests.” (*Id.* at p. 1266.)

The court further found that the “completed SSPs [are] shipped to Pacific Bell on disks, magnetic tapes, or cartridges, also known as ‘storage media,’” and that “Nortel provides Pacific Bell with the three prewritten programs.” (*Nortel, supra*, at p. 1267.) “The licensing agreements allow Pacific Bell to copy the software from the storage media and load it into the operating memory of a switch’s computer hardware. This authorization to copy the software onto its computers allows Pacific Bell to use the programs without violating Nortel’s copyright.” (*Id.* at p. 1268.) And, “[t]he license gives Pacific Bell the right to produce telephonic communications, without fear of infringing upon Nortel’s patents.” (*Ibid.*) Furthermore, “Pacific Bell used the patented processes contained in the SSP’s to create and sell a product; namely, telephone communications for consumers,” including “basic and long distance telephone calls; call forwarding; caller identification; call waiting; conference calling; music-on-hold; and voice mail.” (*Id.* at p. 1274.)

Therefore, based upon the above findings and the parties’ stipulations, the court found that Nortel licensed the right to copy the SSP software onto Pacific Bell’s switch for the purpose of making and selling a product (i.e., phone calls), which constituted a qualifying copyright interest under the TTA statutes (*id.* at p. 1275); that Nortel also licensed the right to copy the prewritten programs onto Pacific Bell’s switch for the purpose of making and selling phone calls and that, as such, the prewritten programs were transferred pursuant to a TTA (*id.* at p. 1278); that Nortel licensed the right to make and

sell phone calls subject to Nortel's patent interests to Pacific Bell within the meaning of the TTA statutes (*id.* at pp. 1273-1274); and that Nortel also "licensed the right to use [the SSPs to perform] patented 'processes' within the meaning of the TTA statutes" (*id.* at p. 1275).

Because the Board and Nortel stipulated to the cost of producing the storage media upon which the SSPs and prewritten computer programs were transferred to Pacific Bell, the parties did not litigate, and the court did not analyze, whether the SSPs and prewritten programs transferred on tangible storage media were tangible personal property within the meaning of RTC section 6016. Thus, the court also did not analyze the TTA statutes' provisions for determining the price of tangible personal property transferred in a TTA and apparently assumed, without analysis, that the measure of tax could be established by referencing the stipulated "cost of producing the storage media."⁴ (See *Nortel, supra*, at p. 1268.)

5. 2011 Amendments to Regulation 1507

On May 25, 2011, the Board voted to repeal the sentence in Regulation 1507 regarding prewritten software, which the Second District Court of Appeal invalidated in *Nortel*, pursuant to California Code of Regulations, title 1, section 100. Currently, Regulation 1507 does not contain any reference to computer programs or software.

6. Press Release

On May 27, 2011, the Board issued a press release regarding *Nortel*, which provided that:

Jerome Horton, Chairman of the State Board of Equalization, today announced that the Board authorized an amendment to make its current regulations consistent with a recent California Court of Appeal decision holding that sales tax does not apply to interests in patents and copyrights transferred with prewritten (or canned) software in a technology transfer agreement (TTA). The Board made the clarifying regulatory change at its Sacramento meeting this week.

The Board announced that the change does not affect the way sales tax is applied to the typical off-the-shelf retail sale of canned, mass-marketed software because the typical retailer does not hold any copyright or patent interests in the software. The change only clarifies that when the holder of copyrights or patents also sells that intellectual property to another in a technology transfer agreement that includes the transfer of software, the amount charged for the copyrights or patents is excluded from the application of sales tax.

"The courts have spoken and the message is clear, canned software is taxable and intellectual property is not," Horton said. "With the help of the industry we will provide further guidance on how tax applies to sales of software."

The California Court of Appeal in January 2011 filed an opinion in *Nortel Networks, Inc. v. State Board of Equalization* that expressly provides that:

⁴ It should be noted that Paul Hasting LLP and the software industry disagree with staff as to what issues were litigated and decided in *Nortel*. (See the August 1 and November 2, 2012, letters from Paul Hastings LLP; and the November 6, 2012, letter from Mr. Mark Nebergall.)

“To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, the regulation exceeds the scope of the Board’s authority and does not effectuate the purpose of the TTA statutes: It is, for these reasons, invalid.”

On April 27, 2011, the California Supreme Court issued a notice denying the Board’s Petition for Review of the Court of Appeal’s opinion.

7. TTA Study

On August 23, 2011, the Board authorized staff to conduct a study to evaluate the feasibility of developing an optional percentage that can be used to reasonably estimate the fair market value of tangible personal property in TTAs involving non-custom computer programs transferred on tangible storage media. However, the study has not proceeded because there has been a lack of industry participation thus far.

8. Pending Litigation

The Board is currently defending suits for refund in *Lucent Technologies, Inc. v. State Bd. of Equalization* (Los Angeles Superior Court Case No. BC402036) (*Lucent I*) and *Lucent Technologies, Inc. v. State Bd. of Equalization* (Los Angeles Superior Court Case No. BC448715) (*Lucent II*), which raise TTA issues regarding the transfer of computer software recorded on tangible storage media for use in conjunction with telephone switches.

V. Discussion

General Discussion of Prewritten Software

During the Board’s March 20, 2012, Business Taxes Committee meeting the Board authorized staff to initiate an interested parties process to discuss whether it is necessary to amend Regulation 1507 to explain when an agreement for the transfer of software on tangible storage media qualifies as a TTA and how tax applies to tangible personal property transferred in a software TTA following the Court of Appeal’s *Nortel* decision. Throughout the interested parties process, the interested parties urged Board staff to concede that *Nortel* establishes a broad exemption for all sales of prewritten software transferred on tangible storage media and recommend that the Board incorporate the broad exemption into Regulation 1507. In addition, it should be noted that Paul Hastings LLP argues that the *Nortel* decision held that an agreement that allows copyrighted software to be copied onto a computer is a TTA. (See August 1, 2012 letter from Paul Hastings LLP; see also, November 2, 2012, letter from Paul Hastings LLP.) However, it appears that the broader software industry consensus is that prewritten software is not tangible personal property and that, as a result of *Nortel*, all transfers of prewritten software on tangible storage media are TTAs. (See August 1, 2012, and November 6, 2012 letters from Mr. Mark Nebergall.) Furthermore, Paul Hastings LLP and the software industry agree that, pursuant to *Nortel*, the taxable measure is limited to the value of the tangible storage media used to transfer prewritten software in a software TTA (see both August 1, 2012 letters); however, the software industry consensus is that the value of the storage media used to transfer prewritten software is immaterial and should be ignored for sales and use tax purposes. (See Mr. Nebergall’s August 1, 2012 letter.)

In the initial discussion paper distributed on June 29, 2012, and the second discussion paper distributed on October 5, 2012, Board staff disagreed with such a concession because Board staff does not believe that such a broad reading of *Nortel* is either legally justified or appropriate, and the Board has not

conceded that refunds are due in the *Lucent I* and *Lucent II* lawsuits. Board staff explained that there is both legal authority and scientific evidence that supports the conclusion that prewritten software recorded on tangible storage media is tangible personal property. Board staff further explained that, after the *Nortel* decision and the 2011 amendments to Regulation 1507, Board staff is of the opinion that the TTA statutes can and will apply to the transfer of prewritten software recorded on tangible storage media if the transfer is part of a TTA, that is an “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”; and that Board staff is prepared to apply the TTA statutes to determine the amount paid for tangible personal property transferred under a TTA, including by looking to the separately stated price at which the same or like tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party by other retailers that do not hold any patents or copyrights (non-holders). Therefore, Board staff and industry have not yet reached a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media.

Discussion of Embedded Patented Processes

During the interested parties’ process, some interested parties also questioned the validity of Regulation 1507’s provisions regarding embedded processes. For example, Ernst & Young LLP’s August 3, 2012 letter indicates that Earnest & Young LLP believes that the TTA statutes exempt charges for the use of an “embedded patented process” from sales and use tax, such as charges for the use of a computer printer that performs an embedded patented process, and the August 3, 2012 letter suggests that it might be appropriate to amend Regulation 1507 to provide an optional percentage that can be used to exclude a portion of the charges for tangible personal property that performs an embedded patented process or processes, such as a computer printer, from the measure of sales and use tax. Also Pacific Gas & Electric Company (PG&E) recommended that, rather than develop “embedded criteri[a]” to implement Regulation 1507, the Board should focus on “the nature of the rights transferred along with tangible personal property, how those rights relate to the tangible personal property being transferred, and how the whole transaction relates to the intent of the Legislature in adopting the TTA statute.” (August 3, 2012 letter from Mr. Eric J. Miethke.)

Board staff noted in the initial and second discussion papers that Regulation 1507 provides that tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of tangible personal property that performs a process related to patented technology embedded in the internal design, assembly or operation of the tangible personal property, and that the Court of Appeal did not invalidate those provisions in the *Nortel* decision. However, in both discussion papers, Board staff also noted that it agrees with PG&E that, in determining whether an agreement qualifies as a TTA, it is necessary to look at the nature of the rights transferred with tangible personal property; and Board staff expressed its willingness to work with industry to help retailers distinguish a patented process that is embedded in the internal design, assembly or operation of tangible personal property from a patented process that is external to the tangible personal property, if necessary.

Discussion of Transactions Involving Intermediaries

During the interested parties’ process, PG&E also explained that public utilities often contract directly with the holders of various technologies, but, for various reasons, the public utilities often arrange their transactions so that they ultimately acquire technology through intermediaries. Then, PG&E suggested that in the utility situation, as opposed to the situation where “mass-produced software [is] sold through general retailers to the general public,” the use of intermediaries to make the ultimate sale to the

consumer should not prevent an otherwise qualified agreement from satisfying the definition of a TTA.

In the second discussion paper, Board staff also expressed its willingness to work directly with public utilities or other industries to help them identify their typical types of transactions that involve a separate and distinct transfer of a copyright or patent interest with tangible personal property of whatever kind. Furthermore, Board staff indicated that it is prepared to recognize separate and distinct transfers of copyright and patent interests from one person to an intermediary (or a chain of intermediaries) and then from the intermediary (or final intermediary in the chain) to the end person ultimately acquiring the interests and respect that any charges for the separate and distinct transfer of copyright or patent interests through the series of transactions are not subject to sales and use tax. However, Board staff noted that staff will require documentation to establish that a holder of a patent or copyright interest assigned or licensed a copyright or patent interest to an unrelated third party because staff is unaware of any reasonable basis to infer generally that holders of a patent or copyright interest orally or impliedly assign valuable intellectual property to unrelated third parties. Furthermore, staff also noted that Regulation 1507 requires that a TTA be in writing.

Discussion of First Compromise Proposal

During the interested parties' process, staff received two proposals to reach a compromise regarding the taxation of prewritten software recorded on tangible storage media. First, Mr. Nebergall's August 10, 2012 letter, which was sent solely on behalf of SoFTEC, provided, in relevant part, that SoFTEC continues to believe that prewritten software is intangible property, but that, in the spirit of compromise:

Our member companies would support an amendment to Regulation 1507 containing the following elements:

- Sales of prewritten computer software on tangible storage media, such as disks or CD[-]ROMs, regardless whether sold by the developer of the software or a third-party retailer, would be subject to sales and use tax at 50% of the sales price.
- Sales of a single copy of prewritten computer software on tangible storage media, together with the right to make multiple copies of the software for use by the purchaser, would be subject to sales and use tax at 50% of the selling price of a single copy without the right to make copies, with the balance of the sales price not subject to tax.
- The TTA statutes would apply to prewritten computer software sold together with other tangible personal property that is not a mere storage medium (such as a disk or CD[-]ROM). If the fair market value of the prewritten computer software is 20% or less of the total selling price, there would be a rebuttable presumption that the entire selling price is subject to sale or use tax. Software "embedded at the time of manufacture" of the tangible personal property, even if separately stated on the sales invoice, would not be a TTA.

In the second discussion paper, staff explained that in the apparent absence of a persuasive legal basis for doing so, staff could not recommend that the Board exempt or exclude 50 percent of the charges for prewritten computer programs transferred on tangible storage media from sales and use tax. Staff expressed its concern that such a position would likely not provide a lasting resolution in light of the general software industry assertion that prewritten software, itself, is not tangible personal property. Staff stated its view that the typical retail sale of prewritten software recorded in tangible form to an end

consumer is 100 percent taxable, regardless of the copyrights and patents held by the retailer, because the typical retail sale gives the consumer nothing more than the ability to copy the software onto a computer and use the software for its intended purpose, with no conferred rights to make and sell a product. And, staff noted that, in some types of retail transactions, such as where prewritten software is loaded onto a computer prior to the retail sale of the computer, the consumer does not even obtain the ability to copy the software.

However, Board staff also offered to continue to work with industry to identify prewritten software transactions that fall outside of the typical off-the-shelf retail sales model described above because they include the sale of separate and distinct copyright or patent interests. And, as qualifying transactions are identified, Board staff offered to work with industry to determine if there is some basis to recommend that the Board adopt an optional percentage to exempt or exclude some portion of a lump-sum charge. In addition, staff expressed its willingness, subject to Board direction, to discuss whether amendments to Regulation 1502 should be considered to clarify how digital downloads and load-and-leave transactions can be paired appropriately with optional software maintenance contracts to effectively achieve the 50:50 approach proposed by SoFTEC for software transactions where tangible storage media is ultimately transferred, regardless of whether or not the transaction is a TTA.

Furthermore, Board staff explained that, because the *Nortel* decision did not address the taxation of site licenses, Board staff is not presently prepared to recommend that the Board change the taxation of site licenses. However, Board staff agrees with SoFTEC that the sale of prewritten software together with the right to make multiple copies, known in the industry as “site licenses” or “multi-user licenses,” merits separate discussion. Therefore, staff expressed its willingness, under the direction of the Board, to work with the providers of such software to determine if some charges for their “site licenses” may be properly classified as charges for the separate and distinct transfer of copyright or patent interests, and, if so, jointly develop a uniform method for determining the taxable portion of lump-sum charges that include charges for such site licenses, if necessary. Furthermore, Board staff noted that the limited analysis of site licenses in SoFTEC’s August 10, 2012 letter provides a useful starting point for future discussions, but that it may not fully capture the complexity of the site license issue and does not provide enough information for Board staff to reach any conclusions at this time. Therefore, further factual development is necessary before staff can reach any conclusions regarding specific site licenses.

Discussion of Second Compromise Proposal

Mr. Nebergall’s December 3, 2012 letter, which was sent on behalf of SoFTEC and SVLG, outlined revisions to SoFTEC’s earlier proposal to compromise and explained that both SoFTEC and SVLG would support amendments to Regulation 1502 and/or 1507 that incorporate the following elements:

- “Sales of prewritten computer software on tangible storage media, such as disks or CD[-]ROMs, regardless whether sold by the developer of the software or a third-party retailer, where the end user license agreement allows the purchaser to make no more than 5 copies of the software, would not be treated as a TTA and would be subject to sales and use tax at 100% of the sales price.
- “All other sales of copies of prewritten computer software on tangible storage media, such as disks or CD-ROMs, regardless whether sold by the developer of the software or a third-party retailer, would be treated as TTAs with the result [that] the tangible storage media would be treated as insignificant or irrelevant and not subject to sales or use tax, similar to the way so-called ‘gold masters’ are treated under the second sentence of Regulation 1502(f)(1)(B).
- “The TTA statutes would apply to prewritten computer software sold together with other tangible personal property that is not a mere storage medium (such as a disk or CD[-]ROM). If the fair

market value of the prewritten computer software is 20% or less of the total selling price, there would be a rebuttable presumption that the entire selling price is subject to sales or use tax. Additionally, if the fair market value of the software is more than 20% of the total selling price, there would be a rebuttable presumption that 20% of the selling price would be for the software and not subject to tax. Taxpayers would be able to rebut the presumption with evidence that a different amount is attributable to the non-taxable software component of the sales price.⁵

- “The state would honor claims for refunds of sales tax from sellers and use tax from purchasers consistent with the above formulae.”

Again, Board staff believes that, in the apparent absence of a persuasive legal basis for doing so, staff cannot recommend that the Board incorporate the December compromise proposal into either Regulation 1502 or 1507 at this time. In addition, staff continues to be concerned that neither compromise proposal would likely provide a lasting resolution in light of the general software industry assertion that prewritten software, itself, is not tangible personal property. However, staff is still willing, subject to the Board’s further direction, to work with industry to develop specific amendments to Regulation 1502 to clarify how digital downloads and load-and-leave transactions can be paired appropriately with optional software maintenance contracts to effectively achieve the 50:50 approach suggested in SoFTEC’s first compromise proposal for software transactions where tangible storage media is ultimately transferred, regardless of whether or not the transaction is a TTA. Staff is also willing, under the further direction of the Board, to work with software providers to determine if there is a persuasive basis to classify some or all of the charges for “site licenses” as nontaxable charges for the separate and distinct transfer of copyright or patent interests, and, if so, jointly develop a uniform method for determining the taxable portion of lump-sum charges for prewritten software recorded on tangible storage media that include charges for such site licenses, if necessary.

If the Board approves staff’s recommendation to hold interested parties meetings focused on the issues that staff has identified as having the best potential for speedy resolution, staff would not view this as a disapproval of any of the remaining aspects of the compromise proposals. Rather, staff would continue to work with the interested parties to further develop the compromise proposals (e.g., by obtaining information regarding the number of site licenses that are typically included in various types of common retail transactions and information about how retailers and auditors could effectively determine the fair market value of prewritten software sold together with other tangible personal property that is not a mere storage medium); and staff would seek further guidance from the Board as to whether additional interested parties meetings on any of the other aspects of the compromise proposals are warranted when staff reports back to the Board on the results of the focused interested parties meetings staff is recommending.

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Issue 1:

Authorize staff to conduct additional interested parties meetings to separately:

- Discuss the text of amendments to Regulation 1502 to expressly clarify that when a consumer

⁵ Again, staff understands SoFTEC and SVLG to intend that “prewritten computer software sold together with other tangible personal property that is not a mere storage medium” includes prewritten software embedded in tangible personal property, such as a coffee maker or automobile.

purchases prewritten software via a download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a back-up copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software, itself, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract;

- Try to reach some consensus between industry and staff as to whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax; and
- If some consensus can be reached, discuss the text of amendments to Regulation 1502 that would further clarify the treatment of charges for site licenses.

Issue 2:

Authorize staff to continue discussing the application of the TTA statutes to sales of prewritten software recorded on tangible storage media, but make no amendments to Regulation 1507 at this time because industry and staff have not yet reached a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media. If staff is able to make progress towards a consensus regarding the application of the TTA statutes to sales of prewritten software recorded on tangible storage media, then staff would seek further guidance from the Board as to whether additional interested parties meetings are warranted when staff reports back to the Board on the results of the focused interested parties meetings staff is recommending.

B. Pros of Alternative 1

Alternative 1 will permit staff and industry to work on express regulatory language to clarify that when a consumer purchases prewritten software via a download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a back-up copy of the same or similar prewritten software recorded on tangible storage media, then tax does not apply to the charge for the prewritten software, itself, and tax applies to 50 percent of the lump sum charge for the optional maintenance contract.

Alternative 1 will allow staff to continue to discuss site licenses with industry to see if a consensus can be reached as to whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax.

Alternative 1 will also generally allow staff and industry to continue to discuss and explore alternative approaches to reaching a broader consensus regarding the application of sales and use tax to sales of prewritten software recorded on tangible storage media. If staff is able to make progress towards reaching a broader consensus regarding the application of sales and use tax to sales of prewritten software recorded on tangible storage media, then staff would seek further guidance from the Board as to whether additional interested parties meetings are warranted when staff reports back to the Board on the results of the focused interested parties meetings staff is recommending.

C. Cons of Alternative 1

Industry will likely continue to argue that *Nortel* establishes a broad exemption or exclusion for all sales of prewritten software transferred on tangible storage media and recommend that the Board incorporate the broad exemption into Regulation 1507.

D. Statutory or Regulatory Change for Alternative 1

The implementation of alternative 1 does not require any statutory or regulatory changes at this time, however, alternative 1 is intended to lead to the drafting of specific amendments to Regulation 1502 and/or 1507 for the Board's consideration at a subsequent Business Taxes Committee meeting.

E. Operational Impact of Alternative 1

Alternative 1 would not require any changes to Board operations at this time.

F. Administrative Impact of Alternative 1**1. Cost Impact**

The workload associated with conducting additional interested parties meetings is considered routine. Any corresponding cost would be absorbed into the Board's existing budget.

2. Revenue Impact

Not Applicable. If staff's alternative is approved and consensus is reached on any of the focused issues, a revenue estimate will be prepared at that time.

G. Taxpayer/Customer Impact of Alternative 1

Taxpayers and interested parties would be invited to continue to participate in the ongoing interested parties process and charges for prewritten software recorded on tangible storage media would generally remain subject to sales and use tax.

H. Critical Time Frames of Alternative 1

There are no critical time frames with regard to the implementation of alternative 1. If the Board approves of alternative 1, then staff will work with the Chair of the Business Taxes Committee to establish a schedule for the additional interested parties meetings.

VII. Other Alternatives**A. Descriptions of Interested Parties' Alternative Recommendations***Alternative 2 – Mr. Patrick J. Leone's Recommendation*

Mr. Patrick J. Leone recommends that Regulation 1507 be amended to provide that any transfer of software subject to a license agreement is a TTA, and that the measure of tax should be limited to the price of the storage media, or 200% of the cost of materials and labor to produce the company's own tangible storage media upon which the software is transferred. Mr. Leone further recommends that Regulation 1507 should be amended to clarify that as long as the retailer has the right to transfer and does transfer the right to use prewritten software, then the sale of the software on tangible storage media qualifies as a TTA.

Alternative 3 – Paul Hastings LLP's Recommendation

Paul Hastings LLP recommends that Regulation 1507 be amended to provide that any agreement that allows copyrighted software to be copied onto a computer is a TTA, and that the taxable measure is limited to the value of the tangible storage media used to transfer prewritten software in a software TTA.

Alternative 4 – Ernst & Young LLP’s Recommendation

Ernst & Young LLP recommends that Regulation 1507 be amended to provide that the TTA statutes exempt charges to use an embedded patented process, and provide an optional percentage that can be used to exclude a portion of the charges for tangible personally property that performs an embedded patented process, such as a computer printer, from the measure of sales and use tax.

Alternative 5 – Software Industry Recommendation

The broader software industry recommends that Regulation 1502 and/or Regulation 1507 be amended to provide that prewritten software is not tangible personal property and that all transfers of prewritten software on tangible storage media are TTAs. In addition, the broader software industry recommends that Regulation 1502 and/or Regulation 1507 be amended to limit the taxable measure to the value of the tangible storage media used to transfer prewritten software in a software TTA, or, alternatively, that the amendments exclude charges for tangible storage media from the taxable measure because the storage media is immaterial and should be ignored for sales and use tax purposes.

Alternative 6 – SoFTEC’s and SVLG’s Compromise Proposal

SoFTEC and SVLG recommend that Regulation 1502 and/or Regulation 1507 be amended to provide that:

- “Sales of prewritten computer software on tangible storage media, such as disks or CD[-]ROMs, regardless whether sold by the developer of the software or a third-party retailer, where the end user license agreement allows the purchaser to make no more than 5 copies of the software, would not be treated as a TTA and would be subject to sales and use tax at 100% of the sales price.
- “All other sales of copies of prewritten computer software on tangible storage media, such as disks or CD-ROMs, regardless whether sold by the developer of the software or a third-party retailer, would be treated as TTAs with the result [that] the tangible storage media would be treated as insignificant or irrelevant and not subject to sales or use tax, similar to the way so-called ‘gold masters’ are treated under the second sentence of Regulation 1502(f)(1)(B).
- “The TTA statutes would apply to prewritten computer software sold together with other tangible personal property that is not a mere storage medium (such as a disk or CD[-]ROM). If the fair market value of the prewritten computer software is 20% or less of the total selling price, there would be a rebuttable presumption that the entire selling price is subject to sale or use tax. Additionally, if the fair market value of the software is more than 20% of the total selling price, there would be a rebuttable presumption that 20% of the selling price would be for the software and not subject to tax. Taxpayers would be able to rebut the presumption with evidence that a different amount is attributable to the non-taxable software component of the sales price.⁶
- “The state would honor claims for refunds of sales tax from sellers and use tax from purchasers consistent with the above formulae.”

(See December 3, 2012, letter from SoFTEC and SVLG.)

⁶ Again, in this context, staff understands SoFTEC and SVLG to intend that “prewritten computer software sold together with other tangible personal property that is not a mere storage medium” includes prewritten software embedded in tangible personal property, such as a coffee maker or automobile.

B. Pros of Alternatives

Alternatives 2, 3, and 5 would create certainty that tax does not apply to charges for prewritten software recorded on tangible storage media. In addition, alternatives 2 and 3 would ensure that tax continues to apply to charges for tangible storage media upon which prewritten software is recorded.

Alternative 6 would create certainty that: (1) tax applies to all of the charges for prewritten software recorded on tangible storage media that is sold with 5 or fewer site licenses; and (2) tax does not apply to charges for prewritten software transferred on tangible storage media when sold with more than 5 site licenses and tax does not apply to charges for the tangible storage media upon which the software is recorded.

C. Cons of Alternatives

If the Board agrees that prewritten software recorded on tangible storage media is tangible personal property and that at least some transfers of prewritten software recorded on tangible storage media are not TTAs, then alternatives 2, 3, 5, and 6 would establish an overly broad exclusion for charges that the Board agrees are taxable charges for tangible personal property.

In addition, alternative 4 would not do anything to resolve the current confusion regarding the meaning of the *Nortel* decision. Alternative 4 would require the Board to regularly determine the amount charged to use patented processes embedded in all sorts of tangible personal property, and alternative 6 would require the Board to determine the fair market value of all prewritten software embedded in tangible personal property that is not a mere storage medium. And, both alternatives 4 and 6 would create new confusion as to how tax applies to sales of tangible personal property that performs an embedded patented process or contains embedded prewritten software, respectively, and require the Board to exclude some portion of the charges for the multitude of modern items of tangible personal property, such as automobiles, coffee makers, and cellular phones, that perform embedded patented processes or contain embedded prewritten software from tax.

D. Statutory or Regulatory Changes for Alternatives

Given staff's understanding of how the TTA statutes and RTC section 6010.9 should be construed, staff believes that statutory changes would be required to classify prewritten software recorded on tangible storage media, including prewritten software embedded in tangible personal property, as something other than taxable tangible personal property and/or to exclude some of the charges for tangible personal property that performs an embedded patented process or processes from tax.

In addition, Regulation 1502 currently provides that tax applies to the entire amount charged to the customer for prewritten software recorded on tangible storage media, including charges for site licenses. Therefore, if the Board determines that charges for site licenses may be properly characterized, to any extent, as nontaxable charges for the right to copy copyrighted material, then Board staff believes that the Board would need to amend Regulation 1502 to exempt such charges from tax.

E. Operational Impact of Alternatives

If the Board adopts alternative 2, 3, 4, 5, or 6, or some combination of the alternatives, then the Board would need to amend Regulation 1502 and/or 1507 to incorporate the chosen alternative or alternatives, update the Board's publications to incorporate the chosen alternative(s), and then retrain the Board's

auditors and appeals staff and conduct extensive outreach to affected industries and consumers so that everyone has a clear understanding of the changes to the taxation of prewritten software recorded on tangible storage media and/or the taxation of tangible personal property that performs an embedded patented process.

F. Administrative Impact of Alternatives

1. Cost Impact

The workload associated with publishing amended regulations, tax information bulletins, special notices, and updating publications, and training staff is considered routine. Any corresponding cost would be absorbed into the Board's existing budget.

2. Revenue Impact

Not Applicable. If the Board approves one of the interested parties' alternatives and directs that specific regulatory language be prepared, a revenue estimate will be prepared at that time.

G. Taxpayer/Customer Impact of Alternatives

If the Board agrees with alternatives 2, 3, or 5 and implements the alternative(s) retroactively, then the Board will be required to grant timely claims for refund of taxes reported and paid on charges for prewritten software recorded on tangible storage media, and cancel unpaid taxes imposed on charges for prewritten software recorded on tangible storage media. If the Board agrees with alternatives 2, 3, or 5 and implements the alternative(s) prospectively, then the Board will likely be required to deny pending claims for refund and continue to impose, assess, and collect taxes on charges for prewritten software recorded on tangible storage media that was sold prior to the effective date of the prospective change.

If the Board agrees with alternative 4 or the embedded software portion of alternative 6 and implements the alternative retroactively, then the Board will be required to grant timely claims for refund of taxes reported and paid on some of the charges for tangible personal property that performs an embedded patented process, and cancel unpaid taxes imposed on some of the charges for tangible personal property that performs an embedded patented process. If the Board agrees with alternative 4 or the embedded software portion of alternative 6 and implements the alternative prospectively, then the Board will likely be required to deny pending claims for refund and continue to impose, assess, and collect taxes on all the charges for tangible personal property that performs an embedded patented process that was sold prior to the effective date of the prospective change.

If the Board agrees with the portion of alternative 6 that addresses prewritten software recorded on tangible storage media and implements the alternative retroactively, then the Board will be required to grant timely claims for refund of taxes reported and paid on charges for prewritten software recorded on tangible storage media that was sold with more than five site licenses and cancel unpaid taxes imposed on charges for prewritten software recorded on tangible storage media that was sold with more than five site licenses. If the Board agrees with the portion of alternative 6 that addresses prewritten software recorded on tangible storage media and implements the alternative prospectively, then the Board will likely be required to deny pending claims for refund and continue to impose, assess, and collect taxes on all the charges for prewritten software recorded on tangible storage media that was sold with more than five site licenses prior to the effective date of the prospective change.

H. Critical Time Frames for Alternatives

There are pending audits and claims for refund in which taxpayers have argued that *Nortel* exempts some or all of the charges for prewritten software recorded on tangible storage media. If the Board currently agrees with any or all of these arguments, then the Board should provide that direction to staff at this time, rather than have staff wait to resolve the pending cases. However, there are no critical circumstances preventing the Board from continuing to consider such arguments if the Board has not reached a decision regarding their validity at this time.

Preparer/Reviewer Information

Prepared by: Tax and Fee Programs Division, Legal Department; and Tax Policy Division, Sales and Use Tax Department.

Current as of: December 27, 2012