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Second District, Sacramento

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Executive Director

May 14, 2010

Dear Interested Party:

Staff has reviewed comments received in response to our March 11, 2010, interested parties meeting regarding the proposed amendments to Regulation 1507, *Technology Transfer Agreements*. After considering the comments and information provided to date, staff is recommending more amendments to Regulation 1507.

Enclosed is the *Second Discussion Paper* on this subject. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendments to Regulation 1507 (Exhibit 1).

A second interested parties meeting is scheduled for **June 23, 2010, at 10:00 a.m., in Room 122** to discuss the proposed amendments to Regulation 1507. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the June 23, 2010 meeting. If you plan to attend the meeting on June 23, 2010, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Cecilia Watkins at (916) 445-2137 or by e-mail at [cecilia.watkins@boe.ca.gov](mailto:cecilia.watkins@boe.ca.gov) prior to June 18, 2010. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the June 23, 2010, meeting must be received by **July 23, 2010**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1507 for discussion at the **Business Taxes Committee meeting** scheduled for **September 14, 2010**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the September Business Taxes Committee meeting is welcomed. The meeting is scheduled for **9:30 a.m.** in Room 121 at 450 N Street, Sacramento, California.

Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team at (916) 322-5271.

Sincerely,

Jeffrey L. McGuire, Chief  
Tax Policy Division  
Sales and Use Tax Department

JLM: caw

Enclosures

cc: Honorable Betty T. Yee, Chairwoman, First District (MIC 71)  
Honorable Jerome E. Horton, Vice Chair, Fourth District  
Honorable Michelle Steel, Member, Third District  
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel  
Ms. Barbara Alby, Acting Member, Second District (MIC 78)

Via E-mail:

Mr. Alan LoFaso, Board Member's Office, First District  
Mr. Gary Qualset, Board Member's Office, First District  
Ms. Mengjun He, Board Member's Office, First District  
Mr. Doug Anderson, Board Member's Office, Fourth District  
Ms. Regina V. Evans, Board Member's Office, Fourth District  
Ms. Cynthia Suero, Board Member's Office, Fourth District  
Mr. Lee Williams, Board Member's Office, Second District  
Mr. Neil Shah, Board Member's Office, Third District  
Ms. Elizabeth Maeng, Board Member's Office, Third District  
Ms. Natasha Ralston Ratcliff, State Controller's Office  
Mr. Ramon J. Hirsig  
Ms. Kristine Cazadd  
Ms. Randie L. Henry  
Mr. Jeff Vest  
Mr. Randy Ferris  
Mr. Robert Lambert  
Mr. Robert Tucker  
Mr. Jeffrey Graybill  
Mr. Bradley Heller  
Mr. Todd Gilman  
Ms. Laureen Simpson  
Mr. Robert Ingenito Jr.  
Mr. Bill Benson  
Ms. Freda Orendt  
Mr. Stephen Rudd  
Mr. Kevin Hanks  
Mr. James Kuhl  
Mr. Geoffrey E. Lyle  
Ms. Leila Hellmuth  
Ms. Cecilia Watkins  
Ms. Lynn Whitaker

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

#### INTRODUCTION

The Board adopted Sales and Use Tax Regulation (Regulation) 1507, *Technology Transfer Agreements*, in 2002 to implement, interpret, and make specific the provisions of Revenue and Taxation Code (RTC) sections 6010.9, 6011, and 6012, the California Supreme Court's holding in *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197, and Regulation 1502, to the extent that they prescribe the application of the Sales and Use Tax Law to transactions combining the transfer of tangible personal property, including a computer program transferred on tangible storage media, with the transfer of the right to reproduce copyrighted material, make and sell a patented product, or use a method or process patent under a technology transfer agreement (TTA). However, since the initial implementation of Regulation 1507, some taxpayers have been confused about the regulatory requirement that TTAs be "in writing." Furthermore, some taxpayers have been confused about how sales and use tax applies to transfers of the right to use a copyrighted computer program transferred on tangible storage media and the right to use a patented product, including a product that embodies an embedded method or process patent, such as the right to use a computer program that performs a patented process.

#### ISSUES

The issues raised in this paper are whether Regulation 1507 should be amended to:

- Further clarify that to qualify as a TTA, a written agreement must identify a copyright or patent interest and "clearly" assign or license: (A) the right to reproduce the assignor's or licensor's copyrighted material in other property the assignee or licensee produces, reproduces, or manufactures and sells; (B) the right to produce, reproduce, or manufacture, and sell, other property subject to the assignor's or licensor's patent interest; or (C) the right to use a process subject to the assignor's or licensor's patent interest;
- Further explain and illustrate that written agreements are TTAs if they transfer the right to reproduce copyrighted material in other property the assignee or licensee produces, reproduces, or manufactures and sells; however written agreements are not TTAs merely because they transfer the right to use a copyrighted computer program;
- Further explain and illustrate that written agreements are TTAs if they transfer the right to produce, reproduce, or manufacture and sell other property subject to a patent interest; however, written agreements are not TTAs merely because they transfer the right to use a product subject to copyright and/or patent interests (e.g., the right to use a modern automobile or a copyrighted computer program transferred on tangible storage media that performs patented processes); and
- Clarify the definition for the term "computer program," as used in Regulation 1507, by revising the definition to refer to the definition for the term "program," provided in Regulation 1502, *Computers, Programs, and Data Processing*.

These issues are scheduled for discussion at the September 14, 2010, meeting of the Business Taxes Committee.

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

#### BACKGROUND

##### *RTC section 6010.9 & Regulation 1502*

The Board initially adopted Regulation 1502 in 1972 to prescribe the application of sales and use tax to data processing and computer programming services. However, there was still confusion over whether tax applied to the sale or lease of “custom” computer programs transferred on tangible storage media after Regulation 1502’s implementation.

As a result, the Legislature enacted 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 in a manner that provides “state incentives for the development and utilization of computer software.” (Stats. 1982, ch. 1274, §§ 1 and 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), respectively.) However, charges for “a ‘canned’ or prewritten computer program which is held or existing for general or repeated sale or lease, even if the prewritten or ‘canned program’ was initially developed on a custom basis or for in-house use,” did not receive special treatment and remained taxable when the program is transferred on tangible storage media. (RTC § 6010.9, subd. (d).) Therefore, the Board amended Regulation 1502, subdivision (f) in 1988 to address the application of tax to custom computer programs, custom modifications to prewritten computer programs, and canned or prewritten computer programs in conformity with RTC section 6010.9.

Furthermore, as relevant here, Regulation 1502, subdivision (f) has provided that tax does not apply to “license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred,” since at least 1988. And, Regulation 1502, subdivision (f) has not changed in any relevant respect since 1988.<sup>1</sup>

##### *RTC sections 6011 and 6012*

RTC sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10), were enacted in 1993. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)).) They both define a TTA to mean “**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.**” The 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.” (Bold emphasis added.)

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<sup>1</sup> Note: The Board added the last sentence to Regulation 1502, subdivision (f)(1)(D) in 1999 and made some minor grammatical changes and changes to conform the definition for “electronic or digital pre-press instructions” in Regulation 1502, subdivision (f)(2)(F) to the definition for “digital pre-press instructions” in Regulation 1540 in 2002.

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

#### *Preston v. State Board of Equalization*

In *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197 (*Preston*), the California Supreme Court applied the statutory TTA provisions to a number of written agreements:

1. An agreement, under the terms of which, “Preston provided Celestial Arts, a book publisher, with eight illustrations for Remember the Secret, a children’s book. Celestial Arts received ‘the right to reproduce the artwork in the book and in publicity and promotion connected with the book.’ In return, Celestial Arts gave Preston ‘a 5 [percent] of cash received royalty on books sold’ and paid her \$1,500 as an advance against future royalties.”
2. A series of agreements, under the terms of which Preston transferred 54 designs to All Night Media, a rubber stamp manufacturer, and “gave All Night Media ‘[a]ll rights for the use of [Preston’s] artwork on any and all rubber stamp products. . . .’ In return, Preston received a flat fee upon publication of the first All Night Media catalog containing the designs and an additional amount in the form of either a flat fee for each publication of the designs in a subsequent catalog or a 5 percent royalty on sales.”
3. An agreement, under the terms of which “Preston contracted with Enchante, a book publisher, to supply illustrations for a children’s book, The Rainbow Fields. Enchante acquired ‘all of the exclusive rights comprised in the copyrights’ contained in these illustrations, including the ‘unlimited perpetual right to sell, license, distribute, and otherwise use’ these copyrights in any media. In return, Preston received a royalty from Enchante on all book, calendar and poster sales containing the illustrations and a \$7,500 advance on these royalties. Preston also retained the right to reproduce the illustrations ‘solely for portfolio and self-promotion purposes.’” (*Id.* at pp. 204-205.)

The California Supreme Court began its analysis of the agreements by explaining that its prior decision, *Simplicity Pattern Co. v. State Board of Equalization* (1980) 27 Cal.3d 900, established that a sale of tangible personal property “does not become ‘nontaxable whenever its principal purpose is to transfer the intangible content of the physical object being sold.’” (*Preston, supra*, 25 Cal.4th 197, 210.) The court explained further that “[s]ince *Simplicity Pattern*, appellate courts have consistently held that a transfer of tangible property physically useful in the manufacturing process in conjunction with a transfer of intangible property rights in that property results in a taxable sale.” (*Id.* at p. 210.) The court also cited *Capitol Records, Inc. v. State Board of Equalization* (1984) 158 Cal.App.3d 582, and *A & M Records, Inc. v. State Board of Equalization* (1988) 204 Cal.App.3d 358, as examples, stating: “Together, these decisions establish 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. . . . The purpose or nature of the transfer and the form of payment are irrelevant.” (*Id.* at pp. 210-211.)

Then, the California Supreme Court interpreted the statutory TTA provisions, which had been enacted after *Simplicity Pattern*, *Capitol Records*, and *A & M Records*, and concluded 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

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

agreement also transfers tangible personal property. The lone trigger for this exemption is the presence of a technology transfer agreement. **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*, 25 Cal.4th 197, 213-214 [italics in original and bold emphasis added].) The court also concluded that federal law requires a “writing” to legally transfer a copyright interest.<sup>2</sup> (*Id.* at 214.) However, no special language is needed to transfer or assign a copyright, so long as the written agreement “**clearly** transfers one of the rights or any subdivision of the rights” associated with a copyright. (*Id.* at p. 214 [bold emphasis added].)

Further, and as relevant here, the California Supreme Court went on to explain the fundamental attributes of transfers involving copyrights and patents. The court said, “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.’ [Citation 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*, 25 Cal.4th 197, 215-216 [bold emphasis added].)

Therefore, the California Supreme Court found that all of Preston’s agreements constituted TTAs because the agreements were in writing, transferred Preston’s copyrighted tangible artwork, and also “clearly” transferred Preston’s rights to reproduce the artwork. (*Preston, supra*, 25 Cal.4th 197, 214.) However, the court explained that “Preston’s Agreements are not entirely exempt from taxation because they involved a transfer of tangible property for consideration.” (*Id.* at p. 212.) And, as a result, “only the portion of Preston’s income attributable to the Agreements’ temporary transfer of tangible artwork is taxable. Because the Agreements do ‘not separately state a price for the tangible personal property,’ [citations omitted] the amount subject to taxation is either ‘the price at which the tangible personal property was sold, leased, or offered to third parties’ [citation omitted], or ‘200 percent of the cost of materials and labor used to produce the tangible personal property subject to tax’ [citations omitted].” (*Id.* at p. 225.)

Furthermore, and as additionally relevant here, the California Supreme Court found that “the legislative history validates our interpretation of *sections 6011(c)(10)* and *6012(c)(10)*, even if the statutory language is ambiguous.” (*Preston, supra*, 25 Cal.4th 197, 216.) The court said that the statutory TTA provisions “grew out of the Board’s decision in *Petition of Intel Corporation* (June 4, 1992)” and the express purpose of the assembly bill sponsored by Charles Quackenbush, which contained the statutory TTA provisions, “was to ‘implement [the] decision of the Board of Equalization (BOE) with regards to . . . the Intel Corporation’ appeal.” (*Ibid.*) The court explained that “[i]n *Intel*, petitioner licensed several patents and copyrights to other companies

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<sup>2</sup> Federal law currently requires a writing to transfer or assign an interest in a copyright or patent. (17 U.S.C. § 204 and 35 U.S.C. § 261, respectively.)

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

so they could manufacture integrated circuits embodying these patents and copyrights. As part of the license agreements, petitioner transferred tangible property consisting of ‘written information, instructions, schematics, database tapes, and test tapes.’ [Citation omitted.] The Board held that these agreements created two separate and distinct transactions for tax purposes. The first transaction involved the transfer of tangible personal property and was subject to sales tax. The second transaction involved the nontaxable transfer of intangible property. In reaching this conclusion, the Board broadly defined ‘intangible property’ as ‘the license to use the information under the copyright *or* patent.’ [Citation omitted].” (*Ibid.*)

The California Supreme Court also explained that there was some debate between the Assembly and the Senate as to the proper scope of the statutory TTA provisions. Specifically, the issue was whether the statutory TTA provisions should apply to an agreement that transfers a copyright interest, but not a patent interest, particularly where the value of the tangible personal property being transferred is substantial in relation to the value of the copyright interest being transferred. (*Preston, supra*, 25 Cal.4th 197, 217.) The court also explained that the Board’s analysis of the assembly bill opposed the expansion of the Board’s decision in *Petition of Intel Corporation* to apply to agreements that transfer a copyright interest, but not a patent interest, where the value of the tangible personal property being transferred is substantial in relation to the value of the copyright interest being transferred. (*Id.* at pp. 217-218.) However, the court noted that the Legislature disagreed with the Board’s analysis and enacted the statutory TTA provisions with the broad language applicable to transfers of both patent *and* copyright interests. (*Id.* at p. 218.)

#### *Doctrine of Patent Exhaustion*

Since the 19th century, the United States Supreme Court has applied the “doctrine of patent exhaustion” to sales of products that embody patented technology, including method or process patents. (*Quanta Computer, Inc. v. L.G. Electronic, Inc.* (2008) 128 S.Ct. 2109, 2115.)<sup>3</sup> The doctrine “provides that the initial authorized sale of a patented item terminates all patent rights to that item.” (*Id.* at p. 2115.) Therefore, for practical purposes, “when a patented item is ‘once lawfully made and sold, there is no restriction on [its] use to be implied for the benefit of the patentee.’” (*Id.* at p. 2118 [emphasis in original].)

In other words, a manufacturer does need authorization from a patent holder to make and sell a product embodying the patent holder’s patent, including a method or process patent. Otherwise, the product would infringe upon the patent holder’s patent rights under federal patent law. However, once the product is manufactured and sold pursuant to the patent holder’s authorization, the patent holder has no further patent rights (or property) interest in the *mere* use of the finished product. Therefore, the purchaser has the right to use the finished product, separate and apart from any transfer of an interest in the patent holder’s patent under federal patent law and any purported transfer of such an interest from the patent holder to the purchaser would be a nullity.

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<sup>3</sup> The citation to the official United States Supreme Court Reports is 553 U.S. 617 for this opinion. However, this discussion paper uses the citation to the unofficial Supreme Court Reporter because it is currently paginated.

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

For example, in *Quanta Computers, Inc.*, L.G. Electronics, Inc. (LG), purchased three patents, including at least one method or process patent, covering:

- A “system for ensuring that the most current data are retrieved from main memory”;
- An “efficient method of organizing read and write requests”; and
- “[M]ethods that establish a rotating priority system” for granting multiple devices access to a bus connecting two computer components.

LG licensed the patents to Intel Corporation (Intel) and under the terms of the license gave Intel the right to manufacture and sell microprocessors and chipsets that use LG’s patents. Then, Intel manufactured and sold microprocessors and chipsets, which embodied the patented processes, to Quanta Computer (Quanta) and other manufacturers for incorporation into their finished computers for sale to end consumers. LG then filed a complaint against Quanta claiming that its finished computers infringed upon LG’s method patents because they performed the specified data processes. (*Quanta Computer, supra*, 128 S. Ct. at pp. 2113-2114.) However, the United States Supreme Court disagreed with LG and held that the authorized manufacture and sale of Intel’s microprocessors and chipsets exhausted LG’s patent rights with regard to the finished Intel products and their use in Quanta’s finished computers. Therefore, neither Quanta nor its customers needed further licenses from LG or Intel to use the Intel products and finished computers to perform the processes specified in LG’s patents under federal patent law. (*Id.* at p. 2122.)

#### *Regulation 1507*

Regulation 1507 was originally adopted in 2002 and incorporates the California Supreme Court’s holding in *Preston*. 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. A technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing*.

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

Regulation 1507, subdivision (a)(1) also 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 tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of the tangible personal property. (Regulation 1507, subd. (a)(1), example 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 RTC sections 6011, subdivision (c)(10)(D), and 6012, subdivision (c)(10)(D). As relevant here, the regulation currently defines “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.” (Regulation 1507, subd. (a)(3).) In addition, the regulation currently 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.” (Regulation 1507, subd. (a)(4).)

#### DISCUSSION

Board staff understands that some taxpayers have been confused about the statutory and regulatory requirement that TTAs be “in writing.” They believe that sales documents that do not identify a copyright or patent interest and only list the amount charged for the sale or lease of tangible personal property, such as product invoices, are TTAs even though the documents do not contain any language that could be construed to transfer: (A) the right to reproduce copyrighted material in other property for sale; (B) the right to produce, reproduce, or manufacture, and sell, tangible personal property subject to a patent interest; or (C) the right to use a process subject to a patent interest. However, staff believes this interpretation of the “in writing” requirement is incorrect because the California Supreme Court has held that an agreement is a TTA only if it is in writing and clearly transfers one of the rights or any subdivision of the rights associated with a copyright or patent; and these types of sales documents would not satisfy the federal requirements to transfer a copyright or patent interest. (See, e.g., *Radio Television Espanola, S.A., v. New World Entertainment, Ltd.* (9th Cir. 1999) 183 F.3d 922 [requiring a writing that evidences the parties’ intent to transfer a copyright] and *McClaskey v. Harbison-Walker Refractories Co.* (3d Cir. 1943) 138 F.2d 493 [requiring a writing that unambiguously transfers a patent interest].)

Board staff understands that some taxpayers have mistakenly concluded that RTC sections 6011’s and 6012’s TTA provisions and/or Regulation 1507 somehow exclude charges for the mere right to use a computer program transferred on tangible storage media from tax if the program is copyrighted or performs an embedded patented process. Again, staff believes this interpretation of the TTA provisions is incorrect because it purports to exclude charges for the mere transfer and use of computer programs from the measure of tax that would not qualify as nontaxable charges for “custom computer programs or programming” or “custom modifications to prewritten programs,” as defined in RTC section 6010.9 and Regulation 1507. This

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

interpretation is incorrect because it assumes that the TTA provisions apply to charges that are neither for the transfer of the right to reproduce copyrighted material in other property for sale nor the right to produce, reproduce, or manufacture and sell, other property subject to a patent interest, nor the right to use a process, subject to a patent interest, and directly conflicts with the California Supreme Court's opinion in *Preston*. Moreover, this interpretation is also incorrect because it conflicts with the current provisions of Regulation 1507, subdivision (a)(1), example 3, regarding embedded and external processes, and Regulation 1507, subdivision (a)(3), which defines "process." Finally, this interpretation is incorrect because it assumes that a patent holder retains the right to control the mere use of a patented product or a product that performs an embedded patented process after its authorized sale or lease, despite the doctrine of patent exhaustion, as discussed and applied by the United States Supreme Court in *Quanta Computers*.

Furthermore, Board staff understands that some taxpayers have mistakenly concluded that RTC sections 6011's and 6012's TTA provisions and/or Regulation 1507 somehow exclude charges for the right to use other types of tangible personal property, such as an egg vaccinator, from tax if the tangible personal property performs an embedded patented process with or without the aid of a computer program. This interpretation is incorrect because it conflicts with RTC sections 6011 and 6012, as interpreted by the California Supreme Court in *Preston*, the current provisions of Regulation 1507, subdivision (a)(1), example 3, regarding embedded and external processes, and Regulation 1507, subdivision (a)(3), which defines "process." Additionally, this interpretation is incorrect because it also ignores the doctrine of patent exhaustion as discussed and applied by the United States Supreme Court in *Quanta Computers*.

In addition, Board staff believes that some of the confusion may be due to the current wording in Regulation 1507, subdivision (a)(1), defining the term "technology transfer agreement," subdivision (a)(3), defining the term "process," and subdivision (a)(4), defining the phrase "assign or license." Board staff also believes that some of the confusion may be due to the use of the word "software," instead of the word "computer program" in Regulation 1507, subdivision (a)(1). Finally, Board staff further believes that some of the confusion is due to the current wording of the examples in Regulation 1507, subdivision (a)(1), including example 3; the lack of examples illustrating transactions involving computer programs and other tangible personal property that performs embedded patented processes; and the lack of examples explaining why charges for the transfer of tangible personal property produced pursuant to a technology transfer agreement are subject to tax, even if the property performs an embedded patented process.

#### **Proposed Amendments**

The proposed amendments to Regulation 1507 illustrated in attached Exhibit 1 do not reinterpret the provisions of RTC sections 6010.9, 6011, and 6012, nor *Preston*, nor Regulation 1502. Rather, they are intended to more fully incorporate the California Supreme Court's extensive discussion regarding transfers of copyright and patent interests in *Preston*, further clarify the Board's longstanding interpretation and application of the statutes, regulations, and the California Supreme Court's opinion, and provide additional examples to further illustrate the application of tax. The proposed amendments:

1. Revise subdivision (a)(1) (defining TTA) to more specifically incorporate the California Supreme Court's discussion, from *Preston*, regarding the way that copyright and patent interests are assigned and licensed under federal copyright and patent law and the types

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

of transfers of copyright and patent interests that are excluded from tax under the TTA provisions;

2. Revise subdivision (a)(1) and (4) to explain that a TTA means and includes an agreement that “clearly assigns or licenses” the required copyright or patent interests and explain that an agreement “clearly licenses or assigns” the required copyright and patent interests when it satisfies the requirements to transfer such interests under federal copyright and patent law”;
3. Separate the definition for the term patented “process” from the definition for the term “patent interest” in subdivision (a)(3), refine the definition for the term “process” to its essence, which is “one or more acts or steps that are patented by the United States Patent and Trademark Office,” and expressly state that the transfer of the right to use a patented process does not include the mere transfer of the right to use property that performs an embedded process;
4. Add subdivision (a)(6) to define the term “computer program” by reference to the definition for the term “program” in Regulation 1502, and revise subdivisions (a)(1) and (b)(3) to more specifically explain that the TTA provisions do not apply to an agreement for the transfer and/or reproduction of a computer program because Regulation 1502 fully prescribes the application of tax to charges for computer programs, including license fees or royalty payments for the right to reproduce a computer program;
5. Revise subdivision (b)(1) to expressly state that taxable amounts received for tangible personal property, include, but are not limited to, amounts received for the right to use tangible personal property;
6. Move the examples from subdivision (a)(1) to new subdivision (c);
7. Revise examples 1 and 2 so that they explain why the agreements at issue are or are not TTAs and explain how tax applies to the amounts received for the tangible personal property and copyright and patent interests being transferred;
8. Revise example 3 to clarify that there is one TTA that includes the lease of a medical device and the transfer of the right to perform a separate patented process, and explain how tax applies to the amounts received for the device and the patent interest transferred under the TTA;
9. Add example 4 to illustrate that: (a) amounts received for the transfer of the right to reproduce and sell a copyrighted computer program have been expressly excluded from tax under Regulation 1502 since at least 1988; and (b) agreements for the mere sale of copyrighted computer programs that perform embedded patented processes and agreements for the mere sale of the right to use computer programs are not TTAs and are subject to tax as provided in Regulation 1502;
10. Add example 5 to illustrate that tax does not apply to amounts received for the transfer of the right to manufacture and sell patented manufacturing equipment that is operated by a copyrighted computer program and performs embedded patented processes, under a TTA; and illustrate how tax applies to subsequent contracts to sell additional

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

manufacturing equipment manufactured pursuant to the TTA that also performs embedded patented processes, and sales of widgets produced with the manufacturing equipment;

11. Add example 6 to illustrate that tax does not apply to amounts received for the transfer of the right to manufacture and sell a computer assisted braking system that performs embedded patented processes, but tax applies to sales of automobiles that incorporate the braking system even though the automobiles will be capable of performing the same embedded patented processes; and
12. Add example 7 to illustrate that a written agreement for the manufacture and sale of hair cutting devices that perform embedded patented processes is not a TTA and that the sale of the products is subject to tax because the agreement is merely an agreement for the transfer and use of tangible personal property.

Staff believes the proposed amendments will serve taxpayers by specifically incorporating the California Supreme Court's discussion of the statutory TTA provisions and transfers of copyright and patent interest in *Preston*. The proposed amendments will also serve taxpayers by further clarifying, and implementing, defining, and making specific the Board's longstanding interpretation of the application of the Sales and Use Tax Law to amounts received for the right to use tangible personal property, including computer programs transferred on tangible storage media.

#### Interested Parties Meeting & Comments

Board staff met with interested parties on March 11, 2010, to discuss staff's proposed revisions to the regulation dated February 26, 2010. During the meeting, the interested parties questioned staff's addition of the word "clearly" to Regulation 1507, subdivision (a)(1) and requested that staff explain how the addition of the word "clearly" explicates the original meaning of the regulation. Staff explained that the term "clearly" comes directly from the California Supreme Court's decision in *Preston* and staff added the word "clearly" to the proposed language for renumbered Regulation 1507, subdivision (a)(5) to specify that a written agreement "clearly assigns or licenses" a copyright or patent interest when it meets the requirements for such a written assignment or license under federal copyright and patent law. The interested parties also asked staff to revise the examples in Regulation 1507 so that they better explain why tax does or does not apply, and both staff and the interested parties agreed that Regulation 1507 should contain more examples showing when tax does not apply to the transfer of an interest in a copyright or patent. In response to these concerns, staff substantially revised the current examples in Regulation 1507 so that they better explain why tax applies or does not apply, and revised new examples 5 and 6 so that there is in fact a TTA present in both fact patterns.

During the interested parties meeting, Mr. Jeffrey Varga of Paul, Hastings, Janofsky, and Walker, LLP, and Ms. Michele Pielsticker of the California Taxpayer's Association stated their opinions that the Board lacks authority to amend Regulation 1507 as proposed by staff because the amendments conflict with the Revenue and Taxation Code and because the Board is in litigation with Mr. Varga's clients and the Board has argued that Regulation 1507 applies to the pending litigation. Following the interested parties meeting, staff received a letter from Mr. Varga, containing written comments which he submitted on behalf of AT&T, Inc., Alcatel-

## SECOND DISCUSSION PAPER

### Proposal to Amend Regulation 1507, *Technology Transfer Agreements*

Lucent USA, Inc., and Nortel Networks, Inc., and a letter from Ms. Pielsticker containing comments which she submitted on behalf of the California Taxpayers' Association, California Chamber of Commerce, California Manufacturers and Technology Association, and TechAmerica. (See Exhibits 2 and 3.) Both letters: (1) stated the senders' opinions that the Board lacks authority to amend Regulation 1507 as proposed by staff because the amendments conflict with or offer an overly narrow interpretation of the Revenue and Taxation Code; (2) opposed the adoption of staff's amendments because the Board has argued that Regulation 1507 applies to pending litigation between the Board and Mr. Varga's clients; and (3) asserted that it is inappropriate for the Board to amend Regulation 1507 while the specific litigation is pending.

Board staff respectfully disagrees with Mr. Varga's and Ms. Pielsticker's comments. Board staff believes that all of the proposed amendments to Regulation 1507 set forth in Exhibit 1 to this Second Discussion Paper are fully supported by and do not conflict with any of the provisions of the RTC, including the TTA provisions as interpreted by the California Supreme Court in *Preston*, and are fully supported by and do not conflict with federal copyright and patent law, including the doctrine of patent exhaustion, as explained by the United States Supreme Court in *Quanta Computer*. Board staff also believes that the proposed amendments are necessary to provide guidance to all of the different types of businesses that may be contemplating transfers of patents and copyrights and that no sound legal or administrative reasons exist to postpone rulemaking simply because the amended regulation may have an effect on litigation. Moreover, in this case, there is no telling when the pending litigation will be completed and there is also no way of being certain that no new litigation will commence before the pending litigation is completed; and it is unlikely that any one judicial decision will fully resolve all of the issues that are being addressed in the proposed amendments to Regulation 1507.

Furthermore, California's legislative authority is vested in the Legislature pursuant to the express provisions of the California Constitution (Cal. Const., art IV, § 1) and the doctrine of "Separation of Powers." The Legislature enacted RTC section 7051 to specifically impose the duty on the Board to enforce all of the provisions of the Sales and Use Tax Law, including the TTA provisions, and this duty is not obviated during litigation. In addition, the Legislature enacted RTC section 7051 to expressly delegate authority to the Board to prescribe, adopt, and enforce regulations to clarify, interpret, implement, and make specific the statutory provisions of the RTC when necessary to administer or enforce the Sales and Use Tax Law. And, the Legislature did not enact any law restricting the Board's rulemaking authority or requiring the Board to postpone necessary action because rulemaking may have an effect on a matter that is currently in litigation.

Finally, Board staff believes that a decision to postpone rulemaking could create further public confusion regarding the validity of the current version of Regulation 1507 and the Board's longstanding interpretation and application of the TTA provisions and the California Supreme Court's opinion in *Preston*. Therefore, at this time, staff believes that the proposed amendments are necessary and should not be postponed. And, staff intends to request that the Board's Business Tax Committee authorize staff to commence formal rulemaking on September 14, 2010, and publish the proposed amendments to Regulation 1507 illustrated in Exhibit 1.

## **SECOND DISCUSSION PAPER**

### **Proposal to Amend Regulation 1507, *Technology Transfer Agreements***

#### **Summary**

While Regulation 1507 does not alter the definition of a TTA as provided under RTC sections 6011 and 6012, and while the regulation is valid as currently written, the regulation would benefit from further clarification that makes more specific the definitions of TTA and “process,” and from a clear statement (with appropriate examples) that a TTA does not mean an agreement for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest, as mistakenly contended by some taxpayers. Accordingly, at this time, Board staff intends to recommend that the Board amend Regulation 1507 as illustrated in Exhibit 1. However, staff invites interested parties to comment on the text of Exhibit 1 and staff will consider those comments before we finalize the text of the proposed amendments for submission to the Board in September.

Current as of 5/13/2010

**(a) DEFINITIONS.**

(1) “Technology transfer agreement” means and includes an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that identifies a copyright or patent interest and clearly assigns or licenses: (A) the right to reproduce the assignor’s or licensor’s copyrighted material in a copyright interest in tangible personal property for the purpose of reproducing and selling other property the assignee or licensee produces, reproduces, or manufactures, and sells; subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for (B) the right to produce, reproduce, or manufacture, and sell tangible personal property subject to the assignor’s or licensor’s patent interest; or a written agreement that assigns or licenses or (C) the right to use a process subject to a the assignor’s or licensor’s patent interest, as defined in this regulation.

A technology transfer agreement does not mean or include an agreement for the mere transfer of any tangible personal property produced, reproduced, or manufactured pursuant to a technology transfer agreement, nor an agreement for the mere transfer of any property derived, created, manufactured, or otherwise processed by property produced, reproduced, or manufactured pursuant to a technology transfer agreement, nor an agreement for the mere transfer and use of tangible personal property. A technology transfer agreement also does not mean an agreement for the transfer or reproduction of a computer program ~~prewritten~~ software as defined in subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing*.

~~Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce and sell tangible personal property subject to Company X’s copyright interest in the artwork. Company X’s transfer of artwork and copyright interest to Company Y constitutes a technology transfer agreement. Company Y’s sales of tangible personal property containing reproductions of Company X’s artwork do not constitute a technology transfer agreement.~~

~~Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) its patent interests to sell widgets and the process used to manufacture such widgets to Company Y. Company X’s transfer of its patent interests to Company Y constitutes a technology transfer agreement. Company Y’s sale or storage, use, or other consumption of any widgets that it manufactures does not constitute a technology transfer agreement. Company Y’s sale or storage, use, or other consumption of any tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement.~~

~~Example No. 3: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the use, application or manipulation of the medical device. Company X charges a monthly rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company~~

~~Y. Company X's lease of the medical device to Company Y to perform the separately patented process is not a technology transfer agreement and tax applies to the entire rentals payable for the medical equipment. Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.~~

(2) "Copyright interest" means 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. For purposes of this regulation, an "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.

(3) "Patent interest" means 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.

~~(4) "Process" means one or more acts or steps that are 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. Such a separate patented process may either be external to a product or relate to a patented technology embedded in the internal design, assembly or operation of a product. As used in this regulation, "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 that performs an embedded process by the owner of such property, the owner's agents, or the owner's customers, regardless of whether the process is subject to a patented interest.~~

~~(45) "Clearly assigns or licenses" means to transfer in writing a patent or copyright or patent interest to a person who is not the original holder of the copyright or patent or copyright interest in a writing that meets the requirements of title 17 United States Code~~

(copyrights) or title 35 United States Code (patents), respectively, where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent ~~that is the subject of provided in the~~ written technology transfer agreement.

(6) For purposes of this regulation, “computer program” means a “program” as defined in Regulation 1502, *Computers, Programs, and Data Processing.*

## **(b) APPLICATION OF TAX**

(1) Tax applies to amounts received for any tangible personal property transferred as part of a technology transfer agreement, including, but not limited to, amounts received for the right to use tangible personal property. Tax does not apply to amounts received for the assignment or licensing of a copyright or patent ~~or copyright~~ interest as part of a technology transfer agreement. The gross receipts or sales price attributable to any tangible personal property transferred as part of a technology transfer agreement shall be:

(A) The separately stated sale price for the tangible personal property, provided the separately stated price represents a reasonable fair market value of the tangible personal property;

(B) Where there is no such separately stated price, the separate price at which the tangible personal property or like tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party; or,

(C) If there is no such separately stated price and the tangible personal property, or like tangible personal property, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor used to produce the tangible personal property. “Cost of materials” consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a technology transfer agreement. “Cost of labor” includes any charges or value of labor used to create the tangible personal property whether the transferor of the tangible personal property contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the tangible personal property shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer’s normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

(2) Tax applies to all amounts received from the sale or storage, use, or other consumption of tangible personal property ~~transferred~~ coupled with a copyright or patent ~~or copyright~~ interest, where the transfer is not pursuant to a technology transfer agreement.

(3) Specific Applications.

(A) Tax applies to the sale or storage, use, or other consumption of artwork and commercial photography pursuant to a technology transfer agreement as set forth in Regulation 1540, *Advertising Agencies, and Commercial Artists* ~~and Designers~~.

(B) Tax applies to charges for the sale or storage, use, or other consumption of a prewritten computer program as set forth in Regulation 1502. Tax does not apply to charges for the sale or storage, use, or other consumption of a custom computer program, other than a basic operational program, custom programming services, or custom modifications to prewritten computer programs as set forth in Regulation 1502. Tax does not apply to license fees or royalties paid for the right to reproduce or copy a copyrighted computer program in order for the program to be published and distributed to third parties for a consideration, nor any storage media used to transfer the program concurrently with the granting of such right as set forth in Regulation 1502.

**(c) EXAMPLES**

Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce the copyrighted artwork and sell tangible personal property subject to Company X's copyright interest in the artwork. Company X's transfer of artwork and copyright interest to Company Y constitutes a technology transfer agreement because the agreement identifies a copyright interest and clearly assigns or licenses the right to reproduce copyrighted material and produce and sell other property subject to that copyright interest. Therefore, tax applies to amounts Company X receives for the transfer of the tangible artwork, but tax does not apply to amounts Company X receives for the transfer of the right to reproduce the copyrighted material and produce and sell other property subject to Company X's copyright interest. Company Y's agreements to sell tangible personal property containing reproductions of Company X's artwork do not constitute technology transfer agreements. They are agreements for the mere transfer of tangible personal property produced, reproduced, or manufactured pursuant to a technology transfer agreement, and tax applies to all amounts Company Y receives from the sale or storage, use, or other consumption of tangible personal property transferred pursuant to such agreements.

Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) to Company Y a widget, a license allowing Company Y to manufacture and sell widgets, and a license allowing Company Y to use the patented process for manufacturing such widgets. Company X's transfer of the widget and its patent licenses to Company Y constitutes a technology transfer agreement because the agreement identifies a patent interest in the design of the widgets and clearly assigns or licenses the right to manufacture and sell tangible personal property subject to that interest and identifies a patent interest in a process and clearly assigns or licenses the right to use the process subject to that interest. Therefore, tax applies to the amounts Company X receives from Company Y for the widget, but tax does not apply to the amounts Company X receives from Company Y for the right to manufacture and sell widgets.

Then, Company Y manufactures widgets and enters into an agreement, in writing, that transfers 100 widgets to Company Z. Company Y's agreement to sell widgets that it manufactures does not constitute a technology transfer agreement. It is an agreement for the mere transfer of tangible personal property produced, reproduced, or manufactured pursuant

to a technology transfer agreement. Furthermore, Company Y's agreement to sell tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement. Therefore, tax applies to all amounts Company Y receives from the sale or storage, use, or other consumption of tangible personal property transferred pursuant to such agreements.

Example No. 3: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the use, application or manipulation of the medical device. Company X charges a monthly rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device and transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Tax applies to the entire rentals payable for the medical device, but Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.

Example No. 4: Company W holds a copyright in a prewritten word-processing computer program and holds patents for certain processes embedded in and performed by the computer program. Company W, in writing, transfers (temporarily or otherwise) to Company X a copy of the computer program on tangible storage media and a license to use the computer program for word-processing purposes in the operation of its business. The agreement between companies W and X does not constitute a technology transfer agreement because it merely allows Company X to use a computer program. The amount Company W charges Company X for the transfer and use of the prewritten computer program is subject to tax, as provided in Regulation 1502.

Then, Company W, in writing, transfers (temporarily or otherwise) to Company Y a copy of the computer program on tangible storage media and the right to reproduce and sell copies of the computer program subject to Company W's copyright and patents. The agreement between companies W and Y is not a technology transfer agreement because it only concerns the transfer of a computer program and the right to reproduce a computer program. However, tax does not apply to the amounts Company W receives from Company Y for the right to reproduce and sell copies of the copyrighted computer program, which performs embedded patented processes, or the storage media used to transfer the program concurrently with the granting of such right, as provided in Regulation 1502.

Finally, Company Y makes copies of the computer program pursuant to its agreement with Company W and enters into an agreement, in writing, that transfers a copy

of the computer program on tangible storage media to Company Z, but that only allows Company Z and its employees to use the computer program for word-processing purposes in the operation of its business. The agreement between companies Y and Z does not constitute a technology transfer agreement because it merely allows Company Z to use a computer program. The amount Company Y charges Company Z for the transfer and use of the prewritten computer program is subject to tax, as provided in Regulation 1502.

Example No. 5: Company W holds a patent for a type of manufacturing equipment used to make widgets, a copyright in a prewritten computer program that operates the manufacturing equipment, and patents for certain processes embedded in and performed by the manufacturing equipment with the aid of the computer program. Company W, in writing, agrees to transfer (temporarily or otherwise) to Company X the manufacturing equipment with a copy of the computer program already installed, the right to manufacture and sell the manufacturing equipment subject to Company W's patents, and the right to reproduce and sell copies of the computer program subject to Company W's copyright. The agreement between companies W and X is a technology transfer agreement because it identifies patent interests in the manufacturing equipment and clearly assigns or licenses the right to manufacture and sell the manufacturing equipment subject to the patent interests. Therefore, the amounts Company W receives from Company X for the manufacturing equipment, including charges for the use of the manufacturing equipment, are subject to tax, but the amounts Company W receives from Company X for the right to manufacture and sell the manufacturing equipment are not subject to tax, as provided in this regulation. In addition, tax applies to the amount Company W charges Company X for the copy of the prewritten computer program, which was preloaded on and operates the manufacturing equipment, including any charges for using the prewritten computer program, because the transfer of the computer program on tangible storage media is not solely incidental to the granting of the right to copy the computer program; however, tax does not apply to the amount Company W charges Company X for the right to reproduce the copyrighted computer program and sell copies of the computer program, as provided in Regulation 1502.

Then, Company X reproduces copies of the computer program and manufactures more manufacturing equipment pursuant to its technology transfer agreement with Company W, enters into an agreement, in writing, that transfers 10 units of manufacturing equipment with copies of the computer program already installed to Company Y that only allows Company Y and its employees to use the manufacturing equipment and program to manufacture widgets in the operation of Company Y's business. The agreement between companies X and Y does not constitute a technology transfer agreement because it merely transfers a computer program and property that was produced, reproduced, or manufactured pursuant to a technology transfer agreement. Therefore, tax applies to the sales of the manufacturing equipment, and tax applies to any charges for the preloaded, prewritten computer programs, as provided in Regulation 1502.

Company X also begins to manufacture and sell widgets and enters into an agreement, in writing, to transfer 1000 widgets to Company Z. The agreement between companies X and Z does not constitute a technology transfer agreement because it merely involves the transfer of tangible personal property, which is not subject to any patent or copyright interest. Therefore, tax applies to the sale of the widgets.

Example No. 6: Company X, a research and development company, holds patents for processes utilized by a computer-assisted mechanical braking system it developed that is operated by a copyrighted prewritten computer program. Company X, in writing, transfers (temporarily or otherwise) to Company Y, an automobile manufacturer, the mechanical braking system, a copy of the program on tangible storage media, a license to use the program, and the right to incorporate the mechanical braking system into the design of a new automobile and manufacture and sell automobiles with the mechanical braking system, including the computer program. The agreement between companies X and Y is a technology transfer agreement because the agreement identifies patent interests and clearly assigns or licenses the right to manufacture and sell tangible personal property subject to the assignor's or licensor's patent interests. Therefore, tax applies to amounts Company X receives from Company Y for the transfer of the braking system, but tax does not apply to the amounts Company X receives from Company Y for the right to incorporate the patented processes into a new automobile and manufacture and sell automobiles that will perform processes subject to Company X's patents, as provided in this regulation. In addition, tax does not apply to the amount Company X charges Company Y for the right to reproduce and sell copies of the copyrighted computer program; however, tax applies to the amount Company X charges Company Y for the copy of the prewritten computer program on tangible storage media and the license to use the computer program, as provided in Regulation 1502, because the transfer of the computer program on tangible storage media is not solely incidental to the granting of the right to copy the computer program.

Then, Company Y manufactures automobiles with Company X's computer-assisted mechanical braking system and enters into a written agreement for the sale of 100 automobiles to Company Z, a rental company, for use in its rental business. Company Z will rent the automobiles to its customers, who will themselves drive and otherwise use the automobiles, which will perform processes subject to Company X's patents every time a customer uses the brakes. The agreement between companies Y and Z does not constitute a technology transfer agreement because it merely transfers automobiles that were produced pursuant to a technology transfer agreement, gives Company Z and its customers the right to use a patented technology embedded in the internal design, assembly or operation of the automobiles, and the right to use copyrighted prewritten computer programs installed on the automobiles. Therefore, if Company Z does not purchase the automobiles for resale, tax applies to Company Y's sale of the automobiles to Company Z, including any charges for the use of Company X's computer assisted mechanical braking system, patented processes, or copyrighted computer program regardless of whether the charges are separately stated, as provided in this regulation and Regulation 1502.

Example No. 7: Company X has patents for processes included in and performed by a digital device that cuts hair. Company X manufactures the device and enters into a written agreement for the sale of 10 devices to Company Y, a local hair salon, that only allows Company Y and its employees to use the devices to cut hair in the operation of its business. The agreement does not constitute a technology transfer agreement because it merely transfers tangible personal property and the right to use a patented technology embedded in the internal design, assembly or operation of the property. Therefore, tax applies to the amounts charged for the digital devices.



March 26, 2010

Mr. Jeffrey L. McGuire, Chief  
Tax Policy Division (MIC: 92)  
State Board of Equalization  
P.O. Box 942879  
Sacramento, CA 94279-0092

**Subject: Comments Regarding Proposed Amendments to Regulation 1507, *Technology Transfer Agreements***

Dear Mr. McGuire:

The above-listed organizations are writing to express concerns regarding the Board staff's draft of proposed amendments to Regulation 1507, *Technology Transfer Agreements*. The proposed amendments, as explained in the Discussion Paper of February 26, 2010, offer an overly narrow interpretation of Revenue and Taxation Code Sections 6011(c)(10) and 6012(c)(10). Moreover, amendments to Regulation 1507 are inappropriate at this time and are perceived as an effort to unduly influence the outcome of pending litigation.

Revenue and Taxation Code Sections 6011(c)(10)(D) and 6012(c)(10)(D) define "technology transfer agreement" 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.**" According to the Discussion Paper, the proposed amendments "Clarify the definition of a TTA, which requires an agreement that *clearly* assigns or licenses the types of copyright or patent interests specified in *Preston*." Discussion Paper at 3 (emphasis in original). We object to this inappropriately narrow interpretation of Sections 6011(c)(10)(D) and 6012(c)(10)(D), an interpretation contrary to *Preston v. State Board of Equalization*, 25 Cal. 4<sup>th</sup> 197 (2001). In *Preston*, the California Supreme Court required a broad interpretation of these statutes based on their legislative history. See *Preston*, 25 Cal. 4<sup>th</sup> at 213 and 215 ("Sections 6011(c)(10)(D) and 6012(c)(10)(D) broadly define a 'technology transfer agreement....The Legislature broadly defined 'technology

Second Discussion Paper  
Interested Party Submission

transfer agreement' to encompass the transfer of **any** copyright interest....") (emphasis in original).

The proposed language in part requires "a written agreement that: (A) Identifies a copyright or patent interest that includes the right to produce or reproduce, and sell, other tangible personal property subject to the copyright or patent interest and clearly assigns ownership of that interest; (B) Identifies a copyright or patent interest and clearly licenses the right to produce, reproduce, or manufacture, and sell, other tangible personal property subject to that interest; or (C) Identifies a patent interest and clearly licenses the right to use a process subject to that interest, as defined in subdivision (a)(4)." Discussion Paper, Exhibit 1, Page 1. The level of specificity required for written agreements transferring tangible property subject to a copyright or patent interest is contrary to the language of Sections 6011(c)(10)(D) 6012(c)(10)(D) and the *Preston* Court's requirement of a broad definition of "technology transfer agreement."

Board staff appears to be attempting to revive certain arguments made to narrow AB 103 (Quackenbush, 1993), the bill that enacted Sections 6011(c)(10) and 6012(c)(10). In the Board's analysis of AB 103, the Board argued: "The provisions of AB 103 could be interpreted to apply in this situation as the right to use a process, i.e., the program. If this were true, the retailer of the software could segregate a portion of the program sales price as a sale of intangible personal property." Attachment 1, State Board of Equalization's Legislative Bill Analysis, AB 103, Amended 08/17/93, Page 4. The Legislature declined to amend AB 103 to address the Board's concerns, indicating intent to keep the statute broad. Nonetheless, Board staff wants to narrow AB 103 by regulation that is inconsistent with the broader statutes.

The proposed amendments also exclude from the definition of "technology transfer agreement" agreements "for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest, by the owner or its customers." Discussion Paper, Exhibit 1, Page 1. Yet, Sections 6011(c)(10)(D) and 6012(c)(10)(D) state that "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.**" Board staff's proposed amendment directly conflicts with the governing statutes.

The proposed amendments include examples of this overly narrow interpretation of Sections 6011(c)(10)(D) and 6012(c)(10)(D). Example No. 3 describes a company that has a patent interest in a word processing program that is licensed to Company Y for employee use only. Example No. 4 states that Company X has a patent interest in a computer program that operates specific equipment and enters into an agreement with Company Y to use the computer program for the operation of the equipment. The proposed amendments state that these are not technology transfer agreements and, as such, are taxable. However, the Board's analysis of AB 103, urging this more narrow interpretation was before the Legislature and the

Second Discussion Paper  
Interested Party Submission

Legislature did not amend the bill in this manner. Thus, the Legislature intended that the statute be interpreted more broadly than the Board would have liked. The proposed amendments to Regulation 1507 conflict with that intent.

The Board is involved in ongoing litigation in which the superior court of Los Angeles held for the taxpayer on the issue of whether the transfer of the right to use certain software programs were pursuant to technology transfer agreements. *Nortel Networks Inc. v. State Board of Equalization*, Los Angeles County Super. Ct., No. BC341568 (August 29, 2008). The case is now on appeal. We respectfully submit that the Board should decline to amend Regulation 1507 until the appellate court has had the opportunity to issue a decision in that case.

We appreciate the opportunity to submit comments on the proposed amendments to Regulation 1507, *Technology Transfer Agreements*.

Respectfully submitted,



Michele Pielsticker  
Vice President and General Counsel

California Taxpayers' Association

California Chamber of Commerce  
California Manufacturers and Technology Association  
TechAmerica

Attachment

Cc: The Honorable Betty Yee, Chair, State Board of Equalization  
The Honorable John Chiang, State Controller  
The Honorable Jerome Horton, Vice Chair, State Board of Equalization  
The Honorable Barbara Alby, Acting Member, State Board of Equalization  
The Honorable Marcy Jo Mandel, Deputy State Controller  
The Honorable Michelle Steel, Member, State Board of Equalization

STATE BOARD OF EQUALIZATION  
LEGISLATIVE BILL ANALYSIS

Bill Number: AB 103 Date Amended: 08/17/93  
Author: Quackenbush Tax: Sales and Use  
Board Position: Neutral, point out problems Related Bills: \_\_\_\_\_

BILL SUMMARY:

This bill would exempt from sales and use tax amounts charged for the value of intangible personal property in certain technology transfer agreements, as defined.

ANALYSIS:

Current Law:

Existing law imposes a sales or use tax on the gross receipts from the sale of tangible personal property, unless specifically exempted by statute. Existing law defines "tangible personal property" as personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. When a transaction is regarded as a sale of tangible personal property, tax applies to the gross receipts from the furnishing thereof, without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property. "Gross receipts" includes the total amount of the sales price of the retail sales of retailers, valued in money or otherwise.

Comments:

- a. Background of bill: According to the author's office, the purpose of this bill is to clarify existing law which is consistent with a Board interpretation involving the application of tax to certain technology transfer agreements. A "technology transfer agreement" is a transaction where one person licenses to another person the right to manufacture, produce, and sell a product that the second party would not otherwise have the right to do. Such transactions are common in high technology industries, such as the computer hardware industry.

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- A photographer may sell all rights to a photograph and make a separate charge for the right to sell prints or negatives of the original.
- The seller of a film strip which is used to make training films could make a separate charge to reproduce copies of the master print for sale.
- The seller of technical drawings used in a manufacturing process can make a separate charge for the right to make copies of technical drawings.
- The seller of mosaics may separately state the charge for the right to make and reproduce copies.
- The seller of a sculpture may separately state a charge for the right to reproduce and sell copies of the original artwork.
- The seller of commercial art may separately charge for the right to make and sell copies of the original artwork.

The current language could also exclude a portion of the sales price of machinery as the sale of intangible personal property if the right to make or sell the machinery or the right to use a process is being transferred to the purchaser. This is true even if the retailer is also the manufacturer of the machinery.

The phrase "to use a process" could be interpreted more broadly than was intended. Black's Law Dictionary defines "process" as a "mode, method or operation whereby a result is produced; and means to prepare for market or to convert into marketable form." Another definition of "process" under the Patent Law is "a definite combination of new or old elements, ingredients, operations, ways, or means to produce a new, improved or old result, and any substantial change therein by omission, to the same or better result, or by modification or substitution, with different function, to the same or better result, is a new and patentable process."

Following are several scenarios under which a problem in interpretation could ensue:

A manufacturer of integrated circuit boards (which also holds the patent for the boards) sells the boards to the manufacturer of hardware, e.g., a computer printer. Since the integrated circuit boards could be considered "a process," the board manufacturer could transfer the right to use the process to the printer manufacturer who could in turn transfer this right to its customers and exclude a portion of the sales price as a sale of an intangible.

- In the case of a sale of computer software, there usually is a licensing agreement which provides that the buyer may use

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In a specific case before the Board, a corporation (Intel), engaged in the manufacture and sale of microprocessors, microcomputers, and memory systems, entered into a contract with another corporation (Burroughs) to license a process for producing integrated circuits to a design developed by Burroughs. The process was to be transferred to Burroughs so that Burroughs could manufacture the integrated circuits using the same process as Intel. The integrated circuit design remained the property of Burroughs. The process design remained the property of Intel. The integrated circuits could then be manufactured for sale to others by both parties.

As part of the contract, Intel transferred some tangible personal property, including written information, instructions, schematics, database tapes, and test tapes. However, the value of these tangible items were of minimal value in relation to the charges for the right to produce the property. The Board held that in agreements of this type, there are for sales and use tax purposes, two transfers. One is the tangible personal property which may consist of engineering notes, manuals, schematics, database tapes, drawings and test tapes. The second is the sale of intangible property which consists of the license to use the information under the copyright or patent. Accordingly, the portion of the total contract price representing the charge for the license to produce the property is exempt from tax and the tangible personal property transferred would remain subject to tax.

- b. Proposed exemption may be more broad than intended. The purpose of the Board's decision in the Intel case was to make certain the application of tax to technology transfer transactions, which involve the licensing of copyright and patent interests in a product to be manufactured for sale-- transfers which generally had not in practice been subject to the tax prior to the time the Board issued its opinion. It is our understanding that the author's intent is to clarify the application of tax on transactions such as Intel's. However, with the proposed definition of technology transfer agreement, other transfers of patented processes could be exempted.

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The bill would exempt amounts charged for an agreement under which a patent or copyright holder assigns to another person a right to make and sell a patented or copyrighted product. This language would provide opportunities for the exclusion of a portion of gross receipts. For example:

A seller of artwork may sell a painting and separately state an amount for the right to reproduce lithographs of the original.

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the program only under certain conditions. The provisions of AB 103 could be interpreted to apply in this situation as the right use a process, i.e., the program. If this were true, the retailer of the software could segregate a portion of the program sales price as a sale of intangible personal property.

- The manufacturer of equipment, such as certain photo processing equipment or custom plastic injection machinery, which holds the patent on a unique process or has purchased the right to use the process could consider part of the sale of the equipment as a sale of an intangible. By agreement this right also could be transferred to the next sale, if any.

c. Intent language could provide retroactive application of tax. Proposed Section 3 of the bill would provide legislative intent language which specifies that this act is intended to clarify the application of the Sales and Use Tax Law with respect to technology transfer agreements, as defined in the bill. However, as stated in comment b., the proposed definition of technology transfer agreements could be interpreted more broadly, and, with this intent language, could even be extended retroactively.

COST ESTIMATE:

Insignificant administrative costs would be incurred if this bill were enacted for notification to taxpayers and Board staff. These costs are absorbable.

REVENUE ESTIMATE:

The state could suffer a revenue loss, since the technology transfer agreements described in the bill could apply to additional transactions currently subject to tax. However, we do not have information on the magnitude of this loss.

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*Sheila 9/9/93*

*MS DS*

*MSW 9/10/93*

Analysis prepared by: Sheila T. Sarem 445-6662 September 7, 1993  
Contact: Margaret S. Shedd 322-2376

*A14*

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THIRD READING

<p><b>SENATE RULES COMMITTEE</b></p> <p>Office of Senate Floor Analyses 1020 N Street, Suite 524 445-6614</p>	Bill No.	AB 103
	Author:	Quackenbush (R), et al
	Amended:	8/17/93
	Vote Required:	21

Committee Votes:

Senate Floor Vote:

COMMITTEE: REV. & TAX		
BILL NO.:	AYE	NO
AB 103		
DATE OF HEARING: 7-14-93		
SENATORS:		
Rockwell	✓	
Dills	✓	
Hurt	✓	
Kopp	✓	
Lockyer	✓	
Maday	✓	
Morgan (VC)	✓	
Greene (CH)	✓	
TOTAL:	8	0

COMMITTEE: APPROPRIATIONS		
BILL NO.:	AYE	NO
AB 103		
DATE OF HEARING: 8-30-93		
SENATORS:		
Alquist	✓	
Berenson	✓	
Dills	✓	
Greene	✓	
Johnston		✓
Kelley	✓	
Kilias		
Leonard	✓	
Lockyer		
Mello	✓	
Torres		
Beverly (VC)	✓	
Presley (CH)		✓
TOTAL:	8	2

Assembly Floor Vote: 53-14, p. 1028, 4/19/93

**SUBJECT:** Sales and use tax: intangible rights: technology transfer agreement

**SOURCE:** The author

**DIGEST:** This bill excludes from the definition of sales price and gross receipts the amount charged for intangible personal property in a technology transfer agreement as specified.

**ANALYSIS:** Existing law imposes a tax on the gross receipts from the sale or use of tangible personal property. Sales price and gross receipts are defined as the total amount paid for the sale, lease or rent of the property. Certain exclusions are allowed. For example, shipping charges are not subject to tax if those charges are separately stated, title to the property transfers before shipment is made, and a third-party carrier makes the shipment.

This bill excludes from the definition of sales price and gross receipts the amount charged for intangible personal property transferred with tangible personal property in a technology transfer agreement. Only the value of the tangible personal property being transferred would be taxed if:

-- the agreement separately states a reasonable price for the tangible personal property or

-- the price attributable to tangible personal property shall be equal to 200 percent of the cost of labor and materials used to produce the tangible personal property in those instances where a value for the property isn't separately stated and there is comparable property.

CONTINUED PE-9

000241

EX 29

LEGISLATIVE INTENT SERVICE (800) 666-1917

AB 103  
Page 2

-- the price for the tangible personal property isn't separately stated, but the fair market retail value of the tangible personal property is determined by the price of identical or like property sold or leased to third parties in prior transactions.

A technology transfer agreement is defined as any agreement in 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 subject to the patent or copyright interest.

Background:

In 1992, the Board of Equalization decided a petition by Intel concerning disputed tax liability. Intel had entered into a technology transfer agreement with Burroughs Corporation concerning the manufacturing process used to make integrated circuits. In the agreement, no distinction was drawn between the price of the tangible personal property being transferred and the right to use the manufacturing process. Initially, sales tax was assessed on the entire contract amount, resulting in a tax liability of \$555,552.

The Board determined that Intel had transferred two separate types of property -- the intangible legal rights to use a manufacturing process protected by copyrights and patents Intel owned and tangible items such as database tapes and schematics. The Board ruled that only the value of the tangible personal property could be subject to sales tax and used a determination of the cost of producing the tangible personal property plus 100% mark-up as the amount subject to tax. This reduced Intel's liability to \$2,722.

States legislative intent that the bill is to clarify the application of Sales and Use Tax Law to technology transfer agreements. States that amendments made by the bill do not create any inference regarding the application of the sales tax to other transactions involving the transfer of both intangible rights and property and tangible personal property.

FISCAL EFFECT: Appropriation: No Fiscal Committee: No Local: No

A technology transfer agreement is an agreement in which one person licenses to another person the right to manufacture, produce or sell a product that the second party could not otherwise produce or sell. Generally, only the sale of tangible personal property is subject to the sales tax. BOE has determined that in very specific situations, the intangible value of a sales transaction which separately transferred intangible legal rights to use a manufacturing process protected by patents was not taxable. This reduced the sales tax for Intel by over \$550,000.

This bill largely codifies the board's position on these transactions. According to the board, however, the exemption in this bill is somewhat broader than provided under board interpretation; because the bill exempts transactions concerning agreements which license patents or copyright interests, whereas the existing board interpretation concerns licenses of patent and copyright interests. BOE indicates that this bill could exempt many transactions, such as licenses of photographs, film strips or other artwork which currently are subject to taxation. BOE could provide no information on the extent of that potential loss.

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STATE OF CALIFORNIA

CONTINUED PE-10  
000242

**SUPPORT:** (Verified 9/1/93)

California Manufacturers Association  
Cal-Tax

**OPPOSITION:** (Verified 9/1/93)

California Tax Reform Association

**ARGUMENTS IN SUPPORT:** According to the author's office, the bill is intended to provide certainty to business taxpayers regarding the tax treatment of technology transfer agreements.

In these agreements, some tangible personal property -- e.g., models, database tapes or drawings -- is transferred at the same time as the intangible right to make a product or use a specific manufacturing process. The difficulty is determining what portion of the contract price represents the tangible personal property being transferred and what portion represents the intangible property rights.

CMA supports AB 103 because it will give certainty to high-tech industries who want to be sure of how they will be treated in regard to the sales tax. Moreover, this bill will define the share of the transfer price which is attributable to tangible personal property, thereby preventing unreasonable or improper tax assessments. The Board of Equalization, in its Intel decision, was correct in stating that a suitable price for tangible personal property includes material costs, labor involved in fabricating the property, and a suitable markup for overhead and profit. AB 103 would simply codify this decision.

**ARGUMENTS IN OPPOSITION:** CTRA feels that this measure by codifying existing practice, opens up opportunities for broader interpretation of the taxation of intangibles. As a result, this measure would potentially cost the state significant tax revenues.

**ASSEMBLY FLOOR VOTE:**

ASSEMBLY BILL NO. 103 (Quackenbush)—An act to amend Sections 6011 and 6012 of the Revenue and Taxation Code, relating to taxation.

Bill read third time, and passed by the following vote:

**AYES—83**

Aguilar	Cortese	Horcher	Quackenbush
Allen	Costa	Johnson	Rainey
Alpert	Eastin	Jones	Richter
Andal	Epple	Karnette	Seastrand
Arcias	Escutia	Klebs	Sher
Boland	Farr	Knight	Solis
Bornstein	Ferguson	Knowers	Statham
Bowler	Frazee	Moore	Takasugi
Brown, Valerie	Goldsmith	Morrow	Umberg
Brulte	Gotch	Mountjoy	Vasconcellos
Caldera	Harvey	Nolan	Weggeland
Cannella	Haynes	Peace	
Connolly	Hoge	Polanco	
Conroy	Honeycutt	Pringle	

**NOES—44**

Baca	Burton	Hauser	Murray
Bates	Campbell	Isenberg	Napolitano
Bowen	Friedman, Barbara	Margolin	
Bronshvag	Friedman, Terry	Martinez	

Bill ordered transmitted to the Senate.

CHANGE UNIT

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DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: August 17, 1993  
POSITION: NEUTRAL, NOTE CONCERNS

BILL NUMBER: AB 103  
AUTHOR: Quackenbush

BILL SUMMARY

SALES & USE TAX: INTANGIBLE PERSONAL PROPERTY

This bill specifies that sales tax would not apply to the amount charged for intangible personal property transferred with tangible personal property in any agreement where a person who holds either a patent or copyright interest assigns or licenses to another person the right to make and sell a product or use a process subject to the patent or copyright.

FISCAL SUMMARY

Code/Department Agency or Revenue Type	SO LA CO RV LC LR	(Fiscal Impact by Fiscal Year)						Code Fund	
		(Dollars in Thousands)							
	PROP	98	FC	1992-93	FC	1993-94	FC	1994-95	
1149 - Sales Tax	RV			-----	See Fiscal Analysis	-----			001/GF
Local Sales Tax	LR			-----	See Fiscal Analysis	-----			

COMMENTS

- According to the author's office, the intent of this bill is to codify the Board of Equalization's (BOE) interpretation of Regulation 1501 as it applied to a technology transfer case before the Board. However, Finance is concerned that this bill may result in a revenue loss due to a likely broader interpretation than currently practiced.
- It is very difficult to provide a clear and precise set of regulations that treat each unique transfer in a consistent manner. The BOE's experience in applying the sales tax to technology transfer transactions is limited, and due to the rapidly changing conditions inherent in high-technology transactions, it would be difficult to codify language based on BOE's interpretation of an individual case.

Analyst/Principal (723) L. Noia	Date 8/26/93	Program Budget Manager Wallis L. Clark	Date 8/26/93
Department Deputy Director			Date

Governor's Office: By: \_\_\_\_\_ Date: \_\_\_\_\_ Position Noted \_\_\_\_\_  
Position Approved \_\_\_\_\_  
Position Disapproved \_\_\_\_\_

BILL ANALYSIS  
FRAB103.723

Form DF-43 (Rev 03/92 Buff)

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EX 27

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(2)

<u>BILL ANALYSIS/ENROLLED BILL REPORT--(CONTINUED)</u>		Form DF-43
AUTHOR	AMENDMENT DATE	BILL NUMBER
Quackenbush	August 17, 1993	AB 103

SUMMARY OF CHANGES

Amendments to this bill since our last analysis of the March 25, 1993 version are mostly technical, but in light of more recent information related to this bill our position has been changed to Neutral, Note Concerns.

ANALYSIS

A. Specific Findings

The sales tax is imposed on the gross receipts from the sale of all tangible personal property in California, unless specifically exempt, without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property. Services, however, are not subject to tax and persons engaged in the business of rendering service are taxed as the consumers, rather than retailers, of the tangible personal property which they use incidentally in rendering the service.

The Board of Equalization's Regulation 1501 defines the taxation of service enterprises generally and states that:

"The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred."

This area of taxation is not always clear where one person licenses to another person the right to manufacture, produce, and sell a product that the second party would not otherwise have the right to do. It has been the Board's interpretation under Regulation 1501 that the true object of these contracts is the right to produce the property and, as a result, that portion of the contract price is exempt from tax even though some tangible personal property such as manuals and instructions may also have been transferred.

AB 103 specifies that the amount charged for intangible personal property transferred with tangible personal property in any agreement where 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, shall be exempt from tax if the agreement separately states a reasonable price for the value of the intangible personal property. This bill would specify that if the agreement does not separately state a price for the tangible personal property, and the property was previously sold, the retail fair market value shall be equal to 200 percent of the cost of materials and labor used to produce the property subject to the tax.

This bill would go into immediate effect, and become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date of this act.

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ALL INFORMATION CONTAINED HEREIN IS UNCLASSIFIED

(3)

BILL ANALYSIS/ENROLLED BILL REPORT--(CONTINUED)		Form DF-43
AUTHOR	AMENDMENT DATE	BILL NUMBER
Quackenbush	August 17, 1993	AB 103

A. Specific Findings (continued)

BACKGROUND

In 1992, BOE ruled on a petition by Intel concerning a technology transfer agreement. The BOE significantly reduced Intel's sales tax liability by ruling that two separate items were transferred by Intel--the intangible legal rights to use a manufacturing process protected by patents and copyrights owned by Intel, and tangible items such as database tapes and schematics--and only the tangible property could be subject to the sales tax. In the Intel agreement, no separate values were provided to distinguish tangible versus intangible items, so BOE used the cost to produce the tangible property plus a 100% mark-up as the amount subject to the sales tax.

COMMENTS

The Intel appeal, which this bill proposes to codify, involved both the right to use a manufacturing process (patent) and the right to use a particular image (copyright). Because this bill refers to patents or copyrights, there is some concern that it may be broaden the Intel decision to include not only high technology agreements where tangible personal property is transferred with very valuable intangible rights to make and sell a product, but also copyright agreements involving a substantial proportion of tangible personal property. Attempts to address this issue by requiring that a "reasonable price" of like property be used to value the tangible personal property somewhat mitigate these concerns, however the threat of a broader interpretation than currently practiced would still exist.

According to this bill, it is the intent of the Legislature that this bill not create any inference regarding the application of the Sales and Use Tax Law to other transactions involving the transfer of both intangible rights and property and tangible personal property.

B. Fiscal Analysis

This bill would not impact revenues if the value of intangible personal property identified on these agreements is consistent with the Board of Equalization's interpretation of Regulation 1501. However, the possibility of a broad interpretation of this bill remains, which increases the likelihood of a state and local revenue loss.

Section 2230 of the Revenue and Taxation Code requires the state to reimburse cities and counties for the net loss of revenues from statutes enacted after January 1, 1973, that provide for a sales or use tax exemption. This bill declares that notwithstanding Section 2230, the state shall not reimburse any local agency for revenues lost under this act.

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DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: August 17, 1993  
POSITION: NEUTRAL, NOTE CONCERNS

BILL NUMBER: AB 103  
AUTHOR: Quackenbush

BILL SUMMARY

SALES & USE TAX: INTANGIBLE PERSONAL PROPERTY

This bill specifies that sales tax would not apply to the amount charged for intangible personal property transferred with tangible personal property in any agreement where a person who holds either a patent or copyright interest assigns or licenses to another person the right to make and sell a product or use a process subject to the patent or copyright.

FISCAL SUMMARY

Code/Department Agency or Revenue Type	SO LA CO RV LC LR	(Fiscal Impact by Fiscal Year)						Code Fund
		(Dollars in Thousands)						
	PROP	FC	1992-93	FC	1993-94	FC	1994-95	
1149 - Sales Tax	RV							001/GF
Local Sales Tax	LR							

COMMENTS

- According to the author's office, the intent of this bill is to codify the Board of Equalization's (BOE) interpretation of Regulation 1501 as it applied to a technology transfer case before the Board. However, Finance is concerned that this bill may result in a revenue loss due to a likely broader interpretation than currently practiced.
- It is very difficult to provide a clear and precise set of regulations that treat each unique transfer in a consistent manner. The BOE's experience in applying the sales tax to technology transfer transactions is limited, and due to the rapidly changing conditions inherent in high-technology transactions, it would be difficult to attempt to codify language based on BOE's interpretation of an individual case.

Analyst/Principal (723) L. Noia	Date 8/26/93	Program Budget Manager Wallis L. Clark	Date 8/26/93
Department Deputy Director			

Governor's Office: By: \_\_\_\_\_ Date: \_\_\_\_\_

Position Noted \_\_\_\_\_  
Position Approved \_\_\_\_\_  
Position Disapproved \_\_\_\_\_

BILL ANALYSIS Form DF-43 (Rev 03/92 Buff)  
FRAB103.723

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EX 28

Atlanta  
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(213) 683-6332  
jeffreyvaiga@paulhastings.com

**VIA FACSIMILE (916/322-4530)  
AND OVERNIGHT MAIL**

March 25, 2010

Mr. Jeffrey L. McGuire, Chief  
Tax Policy Division (MIC: 92)  
Board of Equalization  
450 N Street  
P.O. Box 942879  
Sacramento, CA 94279-0092

Re: Comments to Proposed Revisions to Regulation 1507, *Technology Transfer  
Agreements*

Dear Mr. McGuire:

We represent AT&T Inc., Alcatel-Lucent USA Inc. (formerly, Lucent Technologies Inc.), and Nortel Networks Inc. (collectively, "Taxpayers"). Taxpayers respectfully oppose the adoption of those proposed amendments to Regulation 1507 that are discussed in this letter. Those proposed amendments will hereinafter be referred to collectively as the "Subject Proposed Amendments."

We believe the Subject Proposed Amendments have one, and only one, purpose: to exclude from the definition of technology transfer agreements those agreements that would otherwise fall within the statutory definition. The State Board of Equalization (hereinafter, "BOE") lacks authority to do so for the following reasons:

- The Subject Proposed Amendments are contrary to and inconsistent with Revenue and Taxation Code sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10) (hereinafter, "sections 6011(c)(10) and 6012(c)(10)" or the "TTA Statutes"). Therefore, they are invalid.
- The California Supreme Court in *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197, 208 [105 Cal.Rptr.2d 407, 19 P.3d 1148] (hereinafter, "*Preston*") repeatedly emphasized the breadth and expansive interpretation of the TTA Statutes. The Subject Proposed Amendments, however, narrow the TTA Statutes. They are, therefore, in direct conflict with *Preston*.

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 2

- The legislative history to sections 6011(c)(10) and 6012(c)(10) shows the BOE raised certain concerns with Assembly Bill No. 103 (hereinafter, "AB 103"), the bill that eventually became sections 6011(c)(10) and 6012(c)(10). Some of those concerns are similar to at least some of the concerns BOE staff purports to address by seeking adoption of the Subject Proposed Amendments. As will be discussed, the Legislature did not revise the final wording of AB 103, the bill that eventually became sections 6011(c)(10) and 6012(c)(10), the BOE's stated concerns notwithstanding. The BOE does not have authority to promulgate regulations that adopt positions the Legislature inferentially rejected when it enacted sections 6011(c)(10) and 6012(c)(10).

Taxpayers oppose the adoption of the Subject Proposed Amendments for the following additional reasons:

- Many of the Subject Proposed Amendments relate to issues that are the subject of an appeal currently pending in the Court of Appeal of the State of California, Second Appellate District, Division Two, titled *Nortel Networks Inc. v. State Board of Equalization of the State of California*, Case No. B213415 (hereinafter, "Nortel Appeal"). Assuming *arguendo* that the Subject Proposed Amendments are valid – which they are not – it is nevertheless inappropriate for the BOE, a party to this pending lawsuit, to attempt to influence the judicial process by adopting regulations that relate to outstanding issues in pending litigation. If separation of powers means anything, it means that courts decide cases, not litigants – even governmental litigants.
- The proposed amendments to Regulation 1507 will affect the business community, particularly the high technology industry. Yet, there seems to be an effort to rush the adoption process before the issues have been fully vetted. For example, footnote 2 to a document titled "BOARD OF EQUALIZATION BUSINESS TAXES COMMITTEE – MATERIALS PREPARATION AND REVIEW SCHEDULE FOR 2010 – Current as of March 19, 2010," states "[i]t is anticipated that one discussion paper and one interested parties meeting *rather than the standard two* are adequate for this topic." (Bold and italics added).

## I. THE APPLICABLE TEST

The test to determine whether the proposed amendments to Regulation 1507 are valid is whether (i) they are within the scope of authority conferred by the TTA Statutes and, if they are, (ii) whether they are reasonably necessary to effectuate the purpose of the TTA Statutes. (See *Preston, supra*, 25 Cal.4th at p. 219.) If the proposed amendments conflict with sections 6011(c)(10) and 6012(c)(10), then they will exceed the authority conferred on the BOE by the TTA Statutes. (See *ibid.* ["Regulation 1540 conflicts with sections 6011(c)(10) and 6012(c)(10) . . . . As such, Regulation 1540 exceeds the scope of the Board's authority and is invalid."] )

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 3

II. THE SUBJECT PROPOSED AMENDMENTS CONFLICT WITH SECTIONS 6011(C)(10) AND 6012(C)(10); THEY THEREFORE EXCEED THE BOE'S AUTHORITY AND, IF ADOPTED, WOULD BE INVALID

A. Sections 6011(c)(10)(D) and 6012(c)(10)(D)

The requirements for a technology transfer agreement are set forth in identical subdivisions (c)(10)(D) of sections 6011 (defining "sales price" in use tax transactions) and 6012 (defining "gross receipts" in sales tax transactions):

[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.

BOE staff, however, would narrow this definition in numerous ways described below, each of which conflicts with sections 6011(c)(10)(D) and 6012(c)(10)(D).

B. Sections 6011(c)(10)(D) and 6012(c)(10)(D) Are to Be Broadly Construed

The Supreme Court in *Preston* repeatedly stated sections 6011(c)(10)(D) and 6012(c)(10)(D) "broadly" define a technology transfer agreement:

- "Sections 6011(c)(10)(D) and 6012(c)(10)(D) *broadly* define a 'technology transfer agreement . . .'" (*Preston, supra*, 25 Cal.4th at p. 213, bold and italics added.)
- "The Legislature *broadly* defined 'technology transfer agreement' to encompass the transfer of *any* copyright interest . . ." (*Preston, supra*, 25 Cal. 4th at p. 215, italics in original, bold and italics added.)
- "[S]ome analyses raised a concern that the proposed legislation was more expansive than *Intel*. '[T]he use of "or" instead of "and" [in the definition of technology transfer agreement] *broadens* the Board's *Intel* decision to include not only those high technology agreements in which relatively little tangible personal property is transferred along with very valuable intangible rights to make and sell a product, but also copyright agreements involving a substantial proportion of tangible personal property. . . .' To address this concern, the Senate Revenue and Taxation Committee proposed to limit the exemption in sections 6011(c)(10) and 6012(c)(10) to patent 'and' copyright transfers. . . . [¶] The Senate, however, rejected this proposal and made no changes to the definition of 'technology transfer agreement.' Instead, the Senate actually *broadened* 'the types of

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 4

[agreements] that qualify for an exemption . . . .” (*Preston, supra*, 25 Cal.4th at p. 217, bold and italics added.)

- “Several legislative committees echoed these concerns: ‘[T]he exemption in this bill is somewhat broader than provided under board interpretation, because the bill exempts transactions concerning agreements which license patents or copyright interests, whereas the existing board interpretation concerns licenses of patent and copyright interests. The BOE indicates that this bill could exempt many transactions, such as licenses of photographs, film strips or other artwork which currently are subject to taxation. . . .’ [¶] Thus, the Legislature was undoubtedly aware that the language of Assembly Bill No. 103 exempted *any* patent or copyright transfer from taxation, including transfers of copyrights in artwork. Nonetheless, the Legislature enacted this *broad* language *without* change.” (*Preston, supra*, 25 Cal.4th at p. 217, original italics, bold and italics added.)

Yet, every Subject Proposed Amendment is designed to narrow the statutory definition of a technology transfer agreement, in contravention of the Supreme Court’s observation that the “Legislature *broadly* defined ‘technology transfer agreement’ to encompass the transfer of *any* copyright interest . . . .” (*Ibid.*, at p. 215, italics in original, bold and italics added.).

### C. Use of the Word “Clearly” in the Proposed Amendments Conflicts with Sections 6011(c)(10)(D) and 6012(c)(10)(D)

We submit the purpose for including the word “clearly” in the proposed amendments to subdivision (a)(1) of Regulation 1507 is to prevent agreements that would otherwise qualify as technology transfer agreements from meeting the proposed regulatory definition. The BOE is not authorized to take such action for the following reasons, among others:

- Sections 6011(c)(10)(D) and 6012(c)(10)(D) define a “technology transfer agreement” 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.” (Bold and italics added.) Thus, *any* agreement qualifies as a technology transfer agreement so long as it is one 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.

- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to require a person who holds a patent or copyright interest (i) to “clearly” assign or license 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, or (ii) to “clearly” assign ownership of a patent interest that includes

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 5

the right to produce or reproduce, and sell, other tangible personal property subject to the copyright or patent interest.

- *Preston* does not support the use of the word “clearly” in proposed amendments to subdivision (a)(1) of Regulation 1507. In *Preston*, the Supreme Court merely observed: “Where the wording of the agreement clearly transfers one of the rights or any subdivision of the rights specified in title 17 United States Code section 106, a copyright transfer has occurred.” (*Preston, supra*, 25 Cal.4th at p. 214.) But the Supreme Court also noted: “***All of the Agreements assign or license the right to reproduce Preston’s artwork.*** Because the right to reproduce is one of the exclusive rights comprised in a federal copyright . . . , the Agreements create a valid copyright assignment.” (*Id.*, bold and italics added.) Indeed, “[n]one of the [*Preston*] Agreements, except for the one with Enchante, mention the word ‘copyright.’” *Id.*, fn. 4. Thus, under sections 6011(c)(10)(D) and 6012(c)(10)(D) and *Preston*, all the holder of a patent or copyright interest need do is assign or license a right to make and sell a product or use a process that is subject to the patent or copyright interest. Nothing in the TTA Statutes or in *Preston* requires anything more.

**D. The Adoption of Regulations that Exclude Agreements That Assign or License the Right to Use Computer Programs – Prewritten or Otherwise – Conflict with Sections 6011(c)(10)(D) and 6012(c)(10)(D)**

The Subject Proposed Amendments, if adopted, would exclude from the definition of a technology transfer agreement an agreement “for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest, by the owner or its customers. A technology transfer agreement also does not mean or include an agreement for the transfer of prewritten programs as defined in Regulation 1502, *Computers, Programs, and Data Processing*.”

There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to narrow the definition of a technology transfer agreement in this manner, as the Legislature placed no restrictions in sections 6011(c)(10) and 6012(c)(10) on the types of rights that could be transferred under a technology transfer agreement.

For this same reason, the current version of subdivision (a)(1) of Regulation 1507 that provides “[a] technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of regulation 1502” is invalid. In its Combined Respondent’s Brief and Cross-Appellant’s Opening Brief, filed in the *Nortel* Appeal and served on counsel for the BOE on January 19, 2010, Nortel Networks Inc. explained why this provision is invalid.

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 6

E. Other Proposed Amendments to Subdivision (a)(1) of Regulation 1507 Conflict with Sections 6011(c)(10)(D) and 6012(c)(10)(D)

The Subject Proposed Amendments, if adopted, would require a technology transfer agreement to “clearly” assign or license

the right to produce or reproduce, and sell, other property subject to the copyright interest; the right to produce, reproduce, or manufacture, and sell, tangible personal property subject to the patent interest; or the right to use a process subject to a patent interest, as defined in subdivision (a)(4). Such an assignment or license is reflected in a written agreement that:

(A) Identifies a copyright or patent interest that includes the right to produce or reproduce, and sell, other tangible personal property subject to the copyright or patent interest and clearly assigns ownership of that interest;

(B) Identifies a copyright or patent interest and clearly licenses the right to produce, reproduce, or manufacture, and sell, other tangible personal property subject to that interest; or

(C) Identifies a patent interest and clearly licenses the right to use a process subject to that interest, as defined in subdivision (a)(4).

These proposed amendments also conflict with the TTA Statutes. Here is why:

- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to narrow the word “product” in sections 6011(c)(10)(D) and 6012(c)(10)(D) to mean only “tangible personal property.” (See *Southwestern Bell Tel. Co. v. Director of Revenue* (Mo. 2002) 78 S.W.3d 763, 764 [“telephone services” constitute the “manufacturing” of “products” for purposes of the exemption from Missouri sales taxes]; *Sprint Spectrum LP v. Commissioner of Revenue* (Minn. 2004) 676 N.W.2d 656, 663 [“[I]elecommunications equipment manufactures a product by converting voice and other raw data into a form that can be conveyed, measured, sold, and is perceived by the senses.”], bold and italics added.)

□ In the BOE’s Legislative Bill Analysis of AB 103, as amended Aug. 17, 1993 (hereinafter, “BOE’s Legislative Bill Analysis of AB 103”), at page 1, the BOE stated

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 7

“[a] ‘technology transfer agreement’ is a transaction where one person licenses to another person the right to manufacture, produce, and sell a *product* that the second party would not otherwise have the right to do.” (Bold and italics added.) As seen, even in the definition of a technology transfer agreement used in the BOE’s Legislative Bill Analysis of AB 103, the BOE used the word “product,” not “tangible personal property.”

- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to narrow the definition of a technology transfer agreement to an agreement that merely assigns or licenses the right to produce or reproduce, and sell, other tangible personal property subject to a patent or copyright interest. Rather, under the TTA Statutes any agreement that assigns or licenses *any* rights subject to a patent or copyright interest “to make and sell a product or to use a process that is subject to the patent or copyright interest” qualifies as a technology transfer agreement.
- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to narrow the definition of a technology transfer agreement to an agreement that merely assigns or licenses the right to use a process subject to a patent interest as defined in subdivision (a)(4).
- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that authorizes the BOE to exclude from the definition of a technology transfer agreement an agreement that assigns or licenses the right to use a copyrighted expression of a patented process. Although a process itself cannot be copyrighted, the expression of such patented processes is subject to the copyright interest of the holder of the copyright.
- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that requires a technology transfer agreement to “identify,” clearly or otherwise, the patent or copyright interest being assigned or licensed. Under sections 6011(c)(10)(D) and 6012(c)(10)(D) and *Preston*, all a technology transfer agreement need do is assign or license a right that is subject to the patent or copyright interest of the transferor. (Cal. Rev. & Tax. Code §§ 6011(c)(10)(D), 6012(c)(10)(D); *Preston*, *supra*, 25 Cal.4th at p. 214.)
- There is nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D), *Preston*, or in the legislative history of the TTA Statutes that requires a person who holds a patent or copyright interest to assign “ownership,” clearly or otherwise, of a patent interest that includes the right to produce or reproduce, and sell, other tangible personal property subject to the copyright or patent interest. Indeed, the word “ownership” does not appear in sections 6011(c)(10)(D) and 6012(c)(10)(D).
- The four new examples in proposed amendments to subdivision (a)(1) of Regulation 1507 conflict with sections 6011(c)(10)(D) and 6012(c)(10)(D). Every example

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 8

is designed to remove agreements from the definition of a technology transfer agreement, as each example purports to show the types of agreements that allegedly do *not* constitute technology transfer agreements. The proposed amendments to Regulation 1507 do not contain a single example of an agreement that would satisfy the proposed (and invalid) regulatory requirements. It is especially telling that although the proposed amendments to Regulation 1507 specifically seem to target computer programs, there are no examples of agreements that assign or license the right to use computer programs that in BOE staff's view would meet the requirements of the proposed (and invalid) regulatory requirements.

F. The Proposed Amendments to Subdivision (a)(4) of Regulation 1507 Conflict with Sections 6011(c)(10)(D) and 6012(c)(10)(D)

BOE staff has asked the BOE to adopt the following proposed amendment to subdivision (a)(4) of Regulation 1507:

(4) "Process" means one or more acts or steps that are patented by the United States Patent and Trademark Office. Such separate patented processes may either be external to a product or relate to a patented technology embedded in the internal design, assembly or operation of a product. As used in this regulation, "process" does not mean or include the mere use of tangible personal property in which a patented technology is so embedded, by the owner of such property or the owner's customers.

This definition is contrary to the TTA Statutes and *Preston*.

The TTA Statutes exclude from tax the amount charged for *intangible personal property* transferred with tangible personal property in any technology transfer agreement. "Although there is no statutory definition of intangible property, 'such property is generally defined as property that is a "right" rather than a physical object.'" (*Preston*, *supra*, 25 Cal.4th at p. 208.) "Thus, for purposes of the law of taxation, intangible property is defined as including personal property that is not itself intrinsically valuable, but that derives its value from what it represents or evidences." (*Ibid.*) Under *Preston*, therefore, the right to use personal property – whether that property is tangible or intangible – is itself intangible property. If the personal property embodies or implements patented processes, then an agreement that assigns or licenses the right to use such property has assigned or licensed the right "to use a process that is subject to the patent" within the meaning of sections 6011(c)(10)(D) and 6012(c)(10)(D).

Moreover, in the BOE's Legislative Bill Analysis of AB 103, at pp. 3-4, the BOE identified what it viewed as "problems" with the proposed legislation:

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 9

- In the case of a sale of computer software, there usually is a licensing agreement which provides that the buyer may use the program only under certain conditions. The provisions of AB 103 could be interpreted to apply in this situation as *the right [to] use a process, i.e., the program*. If this were true, the retailer of the software could segregate a portion of the program sales price as a sale of intangible personal property.
- The manufacturer of equipment, such as certain photo processing equipment or custom plastic injection machinery, which holds the patent on a unique process or has purchased the right to use the process could *consider part of the sale of equipment as a sale of an intangible. . . .*

(*Ibid.*, bold and italics added.) Several legislative committees echoed these and other concerns that the BOE perceived with AB 103:

[T]he exemption in this bill is somewhat broader than provided under board interpretation, because the bill exempts transactions concerning agreements which license patents or copyright interests, whereas the existing board interpretation concerns licenses of patent and copyright interests. BOE indicates that this bill could exempt many transactions, such as licenses of photographs, film strips or other artwork which currently are subject to taxation.

(*Preston, supra*, 25 Cal.4th at p. 218, quoting from Appropriations Com., Fiscal Summary of Assem. Bill. No. 103, as amended Aug. 17, 1993, p. 1; Sen. Rules Com., Off. of Sen. Floor Analyses, 3d reading analysis of Assem. Bill. No. 103, as amended Aug. 17, 1993, p. 2. See also *Preston, supra*, 25 Cal.4th at p. 218, quoting from Cal. Dept. Finance, analysis of Assem. Bill No. 103, as amended Aug. 17, 1993, p. 3 [“Because this bill refers to patents or copyrights, there is some concern that it may broaden the Intel decision to include not only high technology agreements where tangible personal property is transferred with very valuable intangible rights to make and sell a product, but also copyright agreements involving a substantial proportion of tangible personal property”].)

“Thus, the Legislature was undoubtedly aware that the language of Assembly Bill No. 103 exempted any patent or copyright transfer from taxation, including transfers of copyrights in artwork. *Nonetheless, the Legislature enacted this broad language without change.*” (*Ibid.*, bold and italics added.)

Mr. Jeffrey L. McGuire  
March 25, 2010  
Page 10

Because the "Legislature enacted this broad language without change," the BOE cannot now promulgate a regulation that is contrary to the TTA Statutes. This is especially true here, where the BOE identified certain "problems" (in the BOE's view) with AB 103 that are equivalent to certain alleged "problems" (again in the BOE's view) that the proposed amendments to Regulation 1507 purport to address.

**III. THE ATTEMPT TO EXPEDITE THE ADOPTION OF THE PROPOSED AMENDMENTS CALLS INTO QUESTION THE THOROUGHNESS AND RELIABILITY OF THE ADOPTION PROCESS**

As discussed above, the proposed amendments to Regulation 1507 will affect the business community, particularly the high technology industry. Yet, there seems to be an effort to push the adoption of these proposed amendments as quickly as possible, before the issues have been fully vetted. Taxpayers respectfully request that standard procedures be followed, including issuing two (or more, if appropriate) discussion papers and holding two (or more, if appropriate) meetings of interested parties.

We thank you for the opportunity to comment on the proposed amendments to Regulation 1507. If you have any questions, please feel free to contact me at 213/683-6332 or at [jeffreyvarga@paulhastings.com](mailto:jeffreyvarga@paulhastings.com).

Sincerely,

  
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