



STATE BOARD OF EQUALIZATION

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KRISTINE CAZADD
Interim Executive Director

October 8, 2010

Dear Interested Party:

Staff has reviewed comments received in response to our June 23, 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 *Third Discussion Paper* on this subject. This document provides the background, a discussion of the issue, and an explanation of staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendments to Regulation 1507 (Exhibit 1).

A third interested parties meeting is scheduled for **October 26, 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 October 26, 2010 meeting. If you plan to attend the meeting or would like to participate via teleconference, please let staff know by contacting Ms. Lynn Whitaker at (916) 324-8483 or by e-mail at Lynn.Whitaker@boe.ca.gov prior to October 21, 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 wish to submit subsequent to the October 26, 2010, meeting must be received by **November 16, 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 **January 27, 2011**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the January 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,

Susanne Buehler, Acting Chief
Tax Policy Division
Sales and Use Tax Department

SB:llw

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 email:

Mr. Alan LoFaso, 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
Ms. Kristine Cazadd
Mr. Jeffrey L. McGuire
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. Lynn Whitaker

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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 (hereafter *Preston*), and Regulation 1502, to the extent that they prescribe the application of the Sales and Use Tax Law (RTC § 6001 et seq.) to transactions combining the transfer of tangible personal property with the transfer of the right to make and sell a product subject to a patent or copyright interest or the right to use a patented process under a technology transfer agreement (TTA). However, since the initial implementation of Regulation 1507, there has continued to be some confusion about whether, and to what extent, tax applies to charges for the right to use copyrighted works and patented inventions and to charges for the right to use tangible personal property, including computer programs transferred on tangible storage media, within the meaning of the Sales and Use Tax Law.

As a result of the confusion, Board staff believes that Regulation 1507 should be revised to provide taxpayers and Board staff with more guidance about how to determine whether charges are in fact charges for the “use” of tangible personal property, which may be subject to tax, or charges for the “use” of intangible property, such as the right to use a copyrighted work or patented invention, which are not subject to tax. Further, Board staff believes that Regulation 1507 should be revised to provide taxpayers and Board staff with more guidance about how to determine whether a contract is in fact a TTA because it “assigns or licenses . . . the right to make and sell a product or to use a process that is subject to [a] patent or copyright interest,” as provided in RTC sections 6011, subdivision (c)(10) and 6012, subdivision (c)(10). Finally, Board staff believes that Regulation 1507 should be revised so that it explains how the Sales and Use Tax Law applies to separate and distinct transfers of copyright and patent interests as part of TTAs and as part of other types of contracts. Therefore, Board staff invites interested parties to attend an interested parties meeting to discuss the issues identified below and the attached draft of Board staff's suggested revisions to Regulation 1507.

ISSUES

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

- Add a definition for tangible personal property that incorporates the provisions of RTC section 6016, defining tangible personal property, and provide that the definition includes tangible personal property that performs an embedded patented process;
- Add a definition of “embedded patented process” and explain when a process is “embedded” in tangible personal property;
- Add a definition for the “right to use tangible personal property” that incorporates the provisions of RTC section 6009 defining the “use” of tangible personal property;

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- Add a definition for the “right to use a patented process,” which expressly excludes the right to use tangible personal property that performs an embedded patented process;
- More directly implement, interpret, and make specific the general statutory definition for TTA, which is an “agreement under which a person who holds a patent or copyright interest assigns or licenses . . . the right to make and sell a product or to use a process that is subject to [a] patent or copyright interest,” by explaining what it specifically means to transfer the “right to make and sell a product that is subject to a copyright or patent interest” or “use a process that is subject to a patent interest” within the meaning of the Sales and Use Tax Law;
- Clarify the definition for the term “computer program,” as used in Regulation 1507, by referring to the definition for the term “program,” provided in Regulation 1502, *Computers, Programs, and Data Processing*;
- Clarify that: (A) tax applies to charges for tangible personal property, including the right to use tangible personal property that performs an embedded patented process, unless an exclusion or exemption applies; (B) tax does not apply to charges for the transfer of intangible property, including copyright and patent interests, separate and distinct from the transfer of tangible personal property, regardless of whether the charges are included in a TTA; (C) the taxpayer must determine the portion of the total contract price paid for the transfer of tangible personal property in truly mixed transactions involving the separate and distinct transfer of intangible personal property; and (D) TTAs are, in essence, types of contracts that transfer certain statutorily enumerated patent and copyright interests separately and distinctly from the transfer of tangible personal property and that there is a statutorily specified formula for determining the portion of the total contract price paid for the transfer of tangible personal property in TTAs;
- Clarify that tax applies to charges for computer programs, custom computer programming, and the right to reproduce computer programs as provided in Regulation 1502;
- Provide an example of a mixed transaction that involves the transfer of copies of a copyrighted work and the separate and distinct transfer of the right to perform the copyrighted work, but is not a TTA, and explain how tax applies to such a transaction;
- Provide examples of mixed transactions that constitute TTAs because they involve the transfer of the right to make and sell a product subject to the transferor’s copyright or patent interest and explain how tax applies to such transactions; and
- Provide an example that includes a series of transactions that illustrate the application of tax to the sale of the right to use tangible personal property that performs an embedded patented process and the sale of the right to use a patented process with

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and without a TTA, and distinguish between sales of the two different types of property rights for sales and use tax purposes.

BACKGROUND

Scope of the Sales and Use Taxes

RTC section 6006, subdivision (a) provides that a “sale” includes “any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration.” RTC section 6009 provides that “‘Use’ includes the exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business.” RTC section 6016 provides that “tangible personal property” is “personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.”

RTC section 6051 imposes a sales tax on retailers for the privilege of selling tangible personal property at retail. The tax is measured by their gross receipts from the retail sale of tangible personal property in California and RTC section 6012, subdivision (a) provides that: “‘Gross receipts’ mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise, without any deduction on account of . . . [t]he cost of the property sold” or any other expenses.

When sales tax does not apply, RTC section 6201 imposes a use tax on the sales price of tangible personal property purchased from a retailer for storage, use, or other consumption in California. RTC section 6011, subdivision (a) provides that “‘Sales’ price means the total amount for which tangible personal property is sold or leased or rented, as the case may be, valued in money, whether paid in money or otherwise, without any deduction on account of . . . [t]he cost of the property sold” or any other expenses.

Sales and use taxes do not apply to transactions that do not involve the sale or purchase of tangible personal property. Furthermore, sales and use taxes do not apply to any charges that are not properly included in the gross receipts from, or the sales price paid for, tangible personal property, even if a transaction involves the sale or purchase of tangible personal property (i.e., charges for services that are not incidental to the sale or purchase of tangible personal property).

Performance of Services and Transfers of Tangible Personal Property

The California Supreme Court and the California Court of Appeal explained how tax applies to transactions involving the performance of services and the transfer of tangible personal property in *Navistar International Transportation Corporation v. State Board of Equalization* (1994) 8 Cal.4th 868 (hereafter *Navistar*) and *Dell Inc. v. Superior Court* (2008) 159 Cal.App.4th 911 (hereafter *Dell*), respectively. Both courts explained that: “Where services and tangible [personal] property are inseparably *bundled* together, determination of the taxability of the transaction turns upon whether the purchaser’s ‘true object’ was to obtain the finished [tangible] product or the service.” (*Dell*, 159 Cal.App.4th at p. 923 [citing Regulation 1501, *Service Enterprises Generally, & Navistar* (emphasis added)].) Furthermore, the Court of

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Appeal explained that bundled transactions are distinguishable from mixed “transactions in which goods and services are sold together yet are readily separable” and said that: “In mixed transactions, the separate elements of the transaction are analyzed as separate transactions for tax purposes. The tangible property aspect of the transaction is taxed and the service aspect of the transaction is not taxed.” (*Dell*, 159 Cal.App.4th at p. 925 [citations omitted].)

RTC section 6010.9 & Regulation 1502

The Board initially adopted Regulation 1502 in 1972 to prescribe the application of the Sales and Use Tax Law 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 on tangible storage media in a manner that provides “state incentives for the development and utilization of computer software.” (Stats. 1982, ch. 1274, §§ 1, 2.) Under RTC section 6010.9, charges for “the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program” and “separately stated charges for [custom] modifications to an existing prewritten program which are prepared to the special order of the customer” are not subject to sales or use tax, even if the custom computer programs or custom modifications are transferred on tangible storage media. (RTC § 6010.9, first sentence & subd. (d), respectively.) However, charges for “a ‘canned’ or prewritten computer program which is held or existing for general or repeated sale or lease,” did not receive special treatment, “even if the prewritten or ‘canned program’ was initially developed on a custom basis or for in-house use,” 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 charges for custom computer programs, custom modifications to prewritten computer programs, and canned or prewritten computer programs in conformity with RTC section 6010.9.

Further, Regulation 1502, subdivision (f) provides that: “The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer’s computer except when the seller transfers title to or possession of storage media or installation of the program is a part of the sale of the computer.” Additionally, as relevant here, Regulation 1502, subdivision (f) provides that: “Tax applies to the entire amount charged to the customer” for prewritten software transferred on tangible storage media and “[w]here the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax.” However, since at least 1988, Regulation 1502, subdivision (f), has also 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

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consideration to third parties, even if a tangible copy of the program is transferred.” And, Regulation 1502, subdivision (f) has not changed in any relevant respect since 1988.¹

Transfers of Intangible Property and Tangible Personal Property

The California Supreme Court and the California Court of Appeal have also explained how tax applies to transactions involving the transfer of tangible personal property and the transfer of intangible property in *Navistar*, *Preston*, and *Dell*. Both courts have explained that “California views sales of tangible property bundled with intangibles, rather than services, differently” from sale of tangible personal property bundled with services and that Regulation 1501’s “true object test, ‘by its terms, applies only to transactions involving the performance of a service.’” (*Dell, supra*, 159 Cal.App.4th at p. 924 [citing *Preston*].)

Instead, the courts have said that, with respect to the concurrent transfer of tangible personal and intangible property, a sale of tangible property is still taxable, even if the transfer of the tangible personal property is incidental to the transfer of intangible property. (*Dell, supra*, 159 Cal.App.4th at p. 924 [citing *Preston* and *Navistar*]; compare Reg. 1501, where the sale of the tangible personal property is deemed incidental and hence not subject to tax when the true object of the transaction is the service to be rendered.) Moreover, the courts have concluded that amounts charged for the sale of tangible personal property embodying intangible intellectual property are fully taxable, “even if the principal object of the sale was to transfer the intangible or intellectual content embodied in” the tangible personal property. (*Ibid*, [citing *Navistar*].) However, the courts have also said that, in a truly mixed transaction, where there is a sale of tangible personal property and a “**separate and distinct transfer of an intangible property right**,” with each being a “**significant object of the contract and neither being incidental to the other**,” the separate elements of the transaction are analyzed as separate transactions for tax purpose” and only the “tangible property aspect of the transaction is taxed.” (*Id.* at p. 925 [citing *Preston*’s discussion of *Navistar* (emphasis added)].)

TTA Provisions

On June 4, 1992, the Board adopted a memorandum opinion deciding the petition for redetermination of Intel Corporation (Intel) regarding two agreements (or contracts) involving transfers of intellectual property. Under the first contract, Intel transferred a license to use a patented process for producing integrated circuits and written information, instructions, schematics, database tapes, and test tapes, at least some of which were copyrighted, to the purchaser for a single, lump-sum amount. Under the second contract, Intel transferred a license to produce an integrated circuit it designed, a license to use a patented process for producing the integrated circuit, and copies of the existing proprietary written information, instructions, schematics, database tapes, and test tapes, at least some of which were copyrighted, to the purchaser for a single, lump-sum amount. The Board concluded that the contracts provided for two separate and distinct transfers for tax purposes. A taxable transfer of tangible personal property consisting of engineering notes, manuals, schematics, database tapes, drawings, and test

¹ 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.

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tapes, and a nontaxable transfer of intangible property consisting of the licenses to use copyrighted or patented information. The Board further concluded that, “in the absence of a contract price for the tangible elements, the tax applies only to the value attributable to the tangible elements including the cost of manufacturing the specific tangible properties.”

RTC sections 6011, subdivision (c)(10) and 6012, subdivision (c)(10) were enacted in 1993, a year after the Board’s Intel memorandum opinion. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)).) Both provisions define a TTA 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**” (emphasis added). 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**” (emphasis added). And, if there is no separately stated price, the statutes provide a formula for determining the gross receipts from, or the sales price for, tangible personal property transferred under a TTA by looking to the “price at which the tangible personal property was sold, leased, or offered for sale to third parties,” or, in the absence of previous sales, “200 percent of the cost of materials and labor used to produce the tangible personal property.”

The author of the TTA provisions, Charles Quakenbush, stated that they are intended to implement the Board’s memorandum opinion regarding Intel’s petition for redetermination. (February 26, 1993, Bill Analysis from the Assem. Rev. & Tax. Com.) The Board initially concurred that the TTA provisions were consistent with the Board’s practices. (April 15, 1993, Bill Analysis from the Assem. Policy Com., Rev. & Tax.) However, before the TTA provisions were finally enacted, the Board did raise a concern that the “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 [in Intel] concerns licenses of patent and copyright interests.” (August 17, 1993, Sen. Floor Analysis.)

Preston v. State Board of Equalization

In *Preston* the California Supreme Court discussed the meaning of the statutory TTA provisions before applying them to a number of written agreements transferring the right to reproduce copyrighted artwork (i.e., illustrations and designs) in children’s books and on rubber stamps to two book publishers and a rubber stamp manufacturer, respectively. The California Supreme Court said that: “Read as a whole and giving the statutory language its ordinary meaning, *sections 6011(c)(10) and 6012(c)(10)* unambiguously establish that the value of a patent or copyright interest transferred pursuant to a technology transfer agreement is *not* subject to sales tax even if the agreement also transfers tangible personal property. . . . **In other words, these provisions exclude the value of a patent or copyright interest from taxation whenever a person who owns a patent or copyright transfers that patent or copyright to another person so the latter person can make and sell a product embodying that patent or copyright.**” (*Preston, supra*, 25 Cal.4th 197, 213-214 [italics in original; bold emphasis added].) The court also said that federal law requires a “writing” to legally transfer a copyright interest. (*Id.* at p. 214.) However, no special language is needed to transfer or assign a copyright, so long

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as the written agreement “**clearly** transfers one of the rights or any subdivision of the rights” associated with a copyright. (*Id.* at p. 214 [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 [italics in original; 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 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.*)

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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.)

Tangible Personal Property May Embody Patented Inventions

The United States Supreme Court has recognized that patented inventions, including processes, may be embodied by (or embedded in) tangible personal property and that, in such cases, the manufacture and sale of such property requires a right to use the patented invention. (See *United States v. Univis Lens Co.* (1942) 316 U.S. 241 (hereafter *Univis*) and *Quanta Computer, Inc. v. L.G. Electronic, Inc.* (2008) 128 S.Ct. 2109 (hereafter *Quanta*)). In addition, the Court has said that once tangible personal property is manufactured pursuant to the right to use a patented invention and sold, the sale includes the right to use and sell the property, whether patented or unpatented. (*Univis*, 316 U.S. at p. 249; *Quanta*, 128 S.Ct. at p. 2115.) Furthermore, the Court has said that where tangible personal property is capable of use only in practicing a patent, the patent monopoly is relinquished after its authorized sale. (*Univis*, 316 U.S. at p. 249; *Quanta*, 128 S.Ct. at p. 2116.)

In *Univis*, the United States Supreme Court concluded that lens blanks embodied a single patent² for multifocal eyeglass because the lenses embodied “essential features of the patented device” and the lens blanks had no “utility until . . . ground and polished as the finished lens of the patent.” (*Univis, supra*, 316 U.S. at p. 249.) In *Quanta, supra*, the Court concluded that microprocessors and chipsets manufactured by Intel Corporation embodied three patents, including at least one method or process patent, because the microprocessors and chipsets embodied essential features of the patented inventions and their reasonable and intended use was to be connected to computers where they would practice the patents. (*Quanta, supra*, 128 S.Ct. at p. 2119.)

The United States Supreme Court said that: “Like the Univis lens blanks, the Intel Products constitute a material part of the patented invention and all but completely practice the patent. Here, as in *Univis*, the . . . article substantially embodies the patent because the only step necessary to practice the patent is the application of common processes or the addition of standard parts. Everything inventive about each patent is embodied in the Intel Products.” (*Quanta, supra*, 128 S.Ct. at p. 2120.) The Court said that, in effect, “Intel all but practiced the

² “The essential, or inventive, feature of the Univis lens patents was the fusing together of different lens segments to create bi- and tri-focal lenses. The finishing process performed by the finishing and prescription retailers after the fusing was not unique.” (*Quanta, supra*, 128 S.Ct. at p. 2119 [describing *Univis* patent].)

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patent[s] itself by designing its products to practice the patents, lacking only the addition of standard parts.” (*Ibid.*) Furthermore, the Court said that:

In each case [*Univis* and *Quanta*], the final step to practice the patent is common and noninventive: grinding a lens to the customer’s prescription, or connecting a microprocessor or chipset to buses or memory. The Intel Products embody the essential features of the LGE Patents because they carry out all the inventive processes when combined, according to their design, with standard components. (*Ibid.*)

Regulation 1507

Regulation 1507 was originally adopted in 2002 and incorporates the California Supreme Court’s holding in *Preston*. Regulation 1507 does not address the general application of the Sales and Use Tax Law to transfers of intangible property, such as copyrights and patents. Instead, Regulation 1507 defines what is a TTA and explains the application of tax to transactions involving TTAs.

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

“Technology transfer agreement” means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

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

Regulation 1507, subdivision (a)(1) and (3), 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 tangible personal property that performs a process related to “patented technology embedded in the internal design, assembly or operation of the” tangible personal property. (Regulation 1507, subd. (a)(1), example 3, and (a)(3).)

Regulation 1507, subdivision (a)(2) through (4), implements, interprets, and makes specific the terms “process,” “assign or license,” “copyright interest,” and “patent interest” from 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

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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 there is some general confusion regarding Regulation 1507 and the application of the Sales and Use Tax Law to copyright and patent interests, and Board staff is proposing to revise Regulation 1507 in order to further clarify its current provisions and more fully prescribe the application of tax to transactions involving transfers of copyright and patent interests.

Board staff believes this general confusion exists, in large part, because some taxpayers are either unaware of or do not fully understand the import of the courts’ decisions in *Navistar*, *Preston*, and *Dell*, which explain that tax does not apply to “separate and distinct transfers” of copyright and patent interests, even when transferred with tangible personal property. Board staff also understands that this confusion leads some taxpayers to conclude that the statutory and regulatory TTA provisions provide the only exclusion or exemption from tax for transfers of copyright and patent interests. Additionally, Board staff understands that this confusion leads some taxpayers to conclude that the statutory definition of a TTA, which provides 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,” must be construed to include all transfers of copyright and patent interests.

Board staff further understands that some taxpayers have been confused about the 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. 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. Furthermore, it appears that these taxpayers are missing the primary import of the TTA provisions, which is to allow taxpayers to enter into written contracts that contain a separately stated price for the tangible personal property being transferred along with the right to make and sell a product subject to a copyright or patent interest or to use a patented process, and require the Board to respect that separately stated price (if reasonable) as the measure of tax for the transfer of the tangible personal property. Although, the TTA provisions do provide two alternative formulas for determining the gross receipts from or sales price for tangible personal property transferred in a TTA in the absence of a separately stated price.

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Board staff additionally understands that some taxpayers have mistakenly concluded that RTC sections 6011's and 6012's TTA provisions and/or Regulation 1507 somehow exclude from tax charges for the mere right to use tangible personal property, including a computer program transferred on tangible storage media, if the tangible personal property contains reproductions of copyrighted works or embodies and 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 tangible personal property from the measure of tax that would not qualify as nontaxable charges for the "separate and distinct transfer" of a copyright or patent interest and is inconsistent with the courts' opinions in *Navistar*, *Preston*, and *Dell*. 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."

Board staff believes that some of the general confusion may be due to the fact that Regulation 1507 discusses TTAs in isolation and does not address the general application of the Sales and Use Tax Law to transfers of copyright and patent interests. Board staff further believes that some of the confusion may be due to the current wording in Regulation 1507, subdivision (a)(1), defining the statutory 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 term "computer program," in Regulation 1507, subdivision (a)(1), and some of the confusion may be caused because Regulation 1507 does not refer readers to Regulation 1502 for the specific application of tax to computer programs.

Finally, Board staff 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 a clear definition for an "embedded" patented process; the lack of examples of tangible personal property that performs embedded patented processes; and the lack of examples explaining why charges for the transfer of tangible personal property 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 the RTC, nor *Preston*, nor any of the other California court decisions cited above, nor Regulation 1502, nor Regulation 1507. Rather, they are intended to more fully prescribe the application of the Sales and Use Tax Law to transfers of copyright and patent interests; incorporate the California courts' extensive discussions regarding transfers of intangible property, including copyright and patent interests, in *Navistar*, *Preston*, and *Dell*; further clarify the Board's longstanding interpretation and application of the TTA statutes and the California Supreme Court's opinion in *Preston*; and provide additional examples to further illustrate the application of tax. The proposed amendments:

1. Revise the title of Regulation 1507 so that it changes from "Technology Transfer Agreements" to "Transfers of Patent and Copyright Interests";

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2. Add new subdivision (a)(1) to incorporate the definition of “tangible personal property” from RTC section 6016 and explain that the definition includes tangible personal property that performs an embedded patented process;
3. Add new subdivision (a)(2) to define “embedded patented process” and explain that an embedded patented process is “a patented process that is ‘embedded’ in the internal design, assembly, or operation of tangible personal property because the tangible personal property embodies essential features of the patented process and a reasonable and intended use of the tangible personal property is the performance of the patented process”;
4. Add new subdivision (a)(3) to define the right to use tangible personal property by incorporating the definition of “use” in RTC section 6009;
5. Renumber current subdivision (a)(2), defining “copyright interest,” as subdivision (a)(4);
6. Separate the definition for the term patented “process” from the definition for the term “patent interest” in current subdivision (a)(3), and renumber the provisions defining “patent interest” as subdivision (a)(5);
7. Separate the first and second sentences in the current provisions defining “process,” refine the definition for the term “process” in the first sentence to its essence, which is “one or more acts or steps that are patented by the United States Patent and Trademark Office,” and renumber the first sentence as subdivision (a)(6);
8. Revise the provisions in the second sentence in the current provisions defining “process,” so that they define the “right to use a patented process,” and renumber the provisions as subdivision (a)(7);
9. Revise current subdivision (a)(1) defining “TTA” to more specifically incorporate the California Supreme Court’s discussion, from *Preston*, regarding the TTA requirements, the way that copyright and patent interests are assigned and licensed, and the types of transfers of copyright and patent interests that are excluded from tax under the TTA provisions, renumber current subdivision (a)(1) as subdivision (a)(8), and delete the examples from the subdivision;
10. Add subparagraphs (A) through (C) to renumbered subdivision (a)(8) to explicate what it means to “clearly assign or license the right to make and sell a product subject to the assignor’s or licensor’s copyright interest,” “clearly assign or license the right to make and sell a product subject to the assignor’s or licensor’s patent interest,” and “clearly assign or license the right to use a patented process subject to the assignor’s or licensor’s patent interest,” respectively, and add subparagraph (D) to clarify that “No specific wording is required to clearly assign or license the right to make and sell a product subject to a copyright or patent interest, or the right to use a patented process subject to a patent interest”;

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11. Add subdivision (a)(9) to define the term “computer program” by reference to the definition for the term “program” in Regulation 1502, and revise renumbered subdivision (a)(8) 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;
12. Separate the first, second, and third sentences in subdivision (b)(1), renumber the second sentence as subdivision (b)(2) and the third sentence as subdivision (b)(3), and revise subdivision (b)(1) describing the application of tax to tangible personal property so that it expressly states that taxable amounts received for tangible personal property, include, but are not limited to, “charges for the right to use tangible personal property that performs an embedded patented process, unless an exclusion or exemption applies”;
13. Revise renumbered subdivision (b)(2) so that it clearly states that tax does not apply to transfers of intangible property, including copyright and patent interests, “separately and distinctly” from tangible personal property and incorporates the *Dell* test for determining whether there is in fact a separate and distinct transfer of intangible property;
14. Revise renumbered subdivision (b)(3) so that it clearly explains how tax applies to mixed transactions involving the transfer of tangible personal property and the separate and distinct transfer of intangible property, including a copyright or patent interest, whether or not the transactions are TTAs;
15. Delete current subdivision (b)(2), renumber current subdivision (b)(3) as subdivision (b)(4), and revise renumbered subdivision (b)(4) to refer readers to Regulation 1502 for the specific application of tax to transfers of computer programs;
16. Add a new subdivision (c), containing examples illustrating the application of tax;
17. Add a new example 1 to new subdivision (c), which illustrates the application of tax to a mixed transaction involving the transfer of tangible personal property and the separate and distinct transfer of a copyright interest, which is not a TTA because it does not involve the transfer of “the right to make and sell a product . . . that is subject to [a] . . . copyright interest”;
18. Move current example 1 from current subdivision (a)(1) to new subdivision (c), renumber example 1 as example 2, and revise renumbered example 2 so that it explains why the contract between Company X and Company Y is a TTA and explains how tax applies to the amounts received for the tangible personal property and copyright interests being transferred in the example;
19. Move current example 2 from current subdivision (a)(1) to new subdivision (c), renumber example 2 as example 3, and update and revise renumbered example 3 so that it refers to a modern “scanner,” instead of a “widget,” and so that it explains why the contract between Company X and Company Y is a TTA and how tax applies to the

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amounts received for the tangible personal property and patent interests being transferred in the example;

20. Add a new example 4 to new subdivision (c), which contains a series of transactions that illustrate how tax applies to charges for coffee makers that perform an embedded patented process for brewing coffee, including charges for the right to use the coffee makers, and how tax applies to the separate and distinct transfers of the right to use the patented brewing process without using the coffee makers and the right to use a patented manufacturing process; and
21. Revised the reference note to include citations to RTC sections 6009 and 6016, defining “use” and “tangible personal property,” respectively, and *Navistar* and *Dell*.

After careful consideration, Board staff believes the proposed revisions will serve taxpayers by specifically incorporating the California courts’ discussions of how tax applies to transfers of intangible property, including copyright and patent interests, and the California Supreme Court’s discussion of the statutory TTA provisions in *Preston*. The proposed revisions will also serve taxpayers by further clarifying, 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.

Interested Parties Meeting & Comments

Board staff last met with interested parties with respect to this topic on June 23, 2010, to discuss staff’s proposed revisions to Regulation 1507, dated May 14, 2010. During the discussion, Board staff heard comments indicating that the proposed revisions did not do enough to clarify the application of tax to mixed transactions involving the sale of tangible personal property that performs an embedded patented process and the separate and distinct transfer of the right to use a patented process separate from the use of the tangible personal property. Board staff also heard comments indicating that the examples should be revised to indicate that tax applies to the sale or purchase of tangible personal property, “unless an exclusion or exemption applies.” Staff generally agreed with both comments, and Board staff tried to add more clarity to the current proposed revisions, as indicated above.

Mr. Varga’s Comments

Following the meeting, Board staff received a letter from Mr. Jeffrey G. Varga of Paul, Hastings, Janofsky, and Walker LLP, (Exhibit 2) which respectfully opposed the proposed revisions, but also included a number of specific comments regarding the current regulation, the proposed May revisions, and the second discussion paper. Mr. Varga’s letter questioned the relevance of the United States Supreme Court’s decision in *Quanta* discussed in the second discussion paper to the taxation of TTAs and questioned the discussion of the doctrine of patent exhaustion in the second discussion paper. Mr. Varga’s letter noted that the term “embedded” is not a term of art used in patent law and asserted that the proposed revisions to example 3 and the additional examples in May did not do enough to explain what it means for a patented process to be “embedded” in the internal design, assembly, or operation of tangible personal property.

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Furthermore, Mr. Varga's letter asserted that the use of the terms "identifies," "embedded," "mere use," and "clearly" in the proposed May revisions are confusing. Mr. Varga's letter separately questioned example 4 regarding the transfer of a prewritten computer program and asserted that "agreements that license the right to use prewritten software programs can be [TTAs]." Mr. Varga's letter additionally asserted that the TTA statutes exempt any transfer of copyright or patent interests from taxation. Mr. Varga's letter also corrected the assertion in the second discussion paper that federal copyright and patent law requires a writing to transfer a copyright or patent interest in all circumstances.

Mr. Schrottenboer's Comments

Board staff also received a letter from Mr. Ronald B. Schrottenboer of Fenwick & West LLP, which contained a number of comments regarding the second discussion paper and proposed May revisions, some of which are similar to Mr. Varga's comments. (Exhibit 3.) Mr. Schrottenboer's letter notes that the word "clearly" is not in the statutory TTA provisions, asserts that *Preston* does not make clarity a legal requirement for a TTA, and opposes adding the word "clearly" to Regulation 1507. Mr. Schrottenboer's letter recommends that Board staff not change the word "product" to "tangible personal property" in the regulatory definition of a TTA because it would narrow the meaning of the statutory TTA provisions. Mr. Schrottenboer's letter asserts that the transfer of any of the exclusive rights of a copyright or patent holder should constitute a TTA. Mr. Schrottenboer's letter also asserts that Regulation 1502 cannot "override" the statutory TTA provisions and that transfers of the right to reproduce computer programs can be TTAs.

Further, Mr. Schrottenboer's letter suggests that the phrase "separate patented process" proposed to be added to the definition of "process" in the May revisions is confusing and not consistent with the statutory TTA provisions, and that the proposed replacement of the word "transferred" with the word "coupled" in current subdivision (b)(2) in the proposed May revisions makes the language less clear. Furthermore, Mr. Schrottenboer's letter refines the doctrine of patent exhaustion as discussed in the second discussion paper, notes that he understands that Board staff is trying to incorporate the doctrine of patent exhaustion into the definition of process in the proposed may revisions, and suggests that the language referring to "patented technology embedded in the internal design, assembly, or operation of a product" needs to be narrowed to better capture the doctrine. Mr. Schrottenboer's letter also contained statements indicating that he reads the proposed May revisions to Regulation 1507 (and possibly the current regulation) as imposing sales and use taxes on the separate and distinct transfer of a patent or copyright interest in the absence of a TTA.

Response to Written Comments

Board staff appreciates Mr. Varga's and Mr. Schrottenboer's written comments and the participation of the interested parties in helping clarify Regulation 1507. Board staff carefully considered Mr. Varga's and Mr. Schrottenboer's written comments and believes that they further illustrate that there is a need to clarify Regulation 1507, although staff continues to believe the current regulation is sound and consistent with the statutory TTA provisions and *Preston*. In addition, Board staff agreed with some of their comments, including Mr. Varga's comment regarding the requirements for transferring non-exclusive licenses to use copyright and patent interests, and tried to incorporate the agreed to comments into the current proposed revisions.

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Overall, Board staff realized that part of the reason why Regulation 1507 may be confusing is because it does not directly discuss the application of tax to all transfers of copyright and patent interests, just TTAs, and may inadvertently give readers the impression that the separate and distinct transfer of a copyright or patent interest can be subject to sales and use taxes in the absence of a TTA. Therefore, the current proposed revisions do broaden the scope of the regulation to clarify this important point of the Sales and Use Tax Law. In addition, the current proposed revisions do provide an example illustrating the application of tax to the separate and distinct transfer of a copyright interest without a TTA.

Moreover, broadening the scope of the regulation clarifies that TTAs do not encompass every imaginable separate and distinct transfer of a copyright or patent interest and that TTAs are just one type of contract that can be used to transfer separate and distinct interests in copyrights and patents. And, this clarification helps the regulation provide a better explanation of what it means to transfer “the right to make and sell a product or to use a process that is subject to [a] patent or copyright interest,” since every transfer of the right to use a patent or copyright interest does not necessarily transfer the requisite right to make and sell a product. Therefore, the current proposed revisions more specifically explain what it means to transfer the right to make and sell a product subject to a copyright or patent interest.

Further, Board staff recognized that it needed to clarify that the use of the term “embedded” in Regulation 1507 reflects concepts inherent in the Sales and Use Tax Law; and that the term is simply intended to help readers distinguish between (1) the transfer of the right to use tangible personal property, including the vast array of products that embody the essential features of a patented process and perform the process as part of their reasonable and intended use, such as modern coffee makers, and (2) the transfer of a the right to use a patented process “separately and distinctly” from the right to use tangible personal property.

Furthermore, Board staff recognized that the doctrine of patent exhaustion is not exactly the same as the sales and use tax principal being conveyed through the regulation’s use of the word “embedded.” However, Board staff believes that the United States Supreme Court’s decisions in *Univis* and *Quanta* contain language that is familiar to taxpayers who transfer patents, that the court’s description of products that substantially embody patented inventions provide a reasonable method of describing tangible personal property that performs an embedded patented process, and that the court’s description can be used to clarify the meaning of “embedded” in Regulation 1507. Therefore, the current proposed revisions do specifically define the term “embedded” in a way that Board staff believes explicates the applicable sales and use tax principals by borrowing from the federal patent law’s description of property that embodies a patented invention, rather than the doctrine of patent exhaustion itself. In addition, the current proposed revisions contain new example 4, which further illustrates the sales and use tax principal that charges to use tangible personal property, such as a coffee maker, are not excluded or exempt from tax solely because the tangible personal property performs an embedded patent process and the purchaser also has the right to use the patented process under federal patent law.

Finally, Board staff respectfully disagrees with the written comments to the extent that they assert that charges to use tangible personal property are excluded or exempt from sales and use taxes pursuant to the statutory TTA provisions, and believe that such a conclusion is

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inconsistent with the California courts' opinions in *Navistar*, *Preston*, and *Dell*. Also, Board staff believes that *Preston* did recognize that TTAs need to "clearly" transfer one of the copyright or patent interests specified in the statutory TTA provisions. In addition, Board staff believes that the Legislature intended for RTC section 6010.9 and Regulation 1502 to continue to govern transfers of computer programs when it enacted the statutory TTA provisions.

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 (1) explains the application of tax to the broad array of transfers of copyright and patent interests, (2) makes more specific the definitions of TTA and "process," and (3) provides a clear statement (with appropriate definitions and examples) that a TTA does not mean an agreement for the use of tangible personal property that performs an embedded patented process. 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 and submit the text of the proposed amendments to the Board for consideration at a future Board meeting.

Current as of 10/7/2010

**Regulation 1507. Transfers of Patent and Copyright Interest~~Technology Transfer~~
Agreements.**

(a) Definitions.

(1) “Tangible Personal Property” means personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses, and includes, but is not limited to, tangible personal property that performs an embedded patented process.

(2) “Embedded patented process” means a patented process that is embedded in the internal design, assembly, or operation of tangible personal property because the tangible personal property embodies essential features of the patented process and a reasonable and intended use of the tangible personal property is the performance of the patented process.

(3) “Right to use tangible personal property” means any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business.

(4) “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.

(5) “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 invention, including a process, machine, manufacture, composition of matter, or material.

(6) “Process” means one or more acts or steps that are patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property.

(7) “Right to use a patented process” means and includes the right to use a patented process performed with or without an item of tangible personal property, but does not include the right to use tangible personal property, as defined in this subdivision, including but not limited to the right to use tangible personal property that performs an embedded patented process.

(84) “Technology transfer agreement” means and includes an ~~contract~~ agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) for the sale or purchase of tangible personal property that clearly assigns or licenses:

- The right to make and sell a product subject to the assignor’s or licensor’s 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~~
- The right to make and sell a product subject to the assignor’s or licensor’s patent interest; ~~for the right to manufacture and sell property subject to the patent interest, or~~
- The right to use a patented process subject to the assignor’s or licensor’s patent interest ~~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 or include an ~~contract~~ agreement for the transfer of any tangible personal property produced, reproduced, or manufactured pursuant to a technology transfer agreement, nor an ~~contract~~ agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property produced, reproduced, or manufactured pursuant to a technology transfer agreement. A technology transfer agreement also does not mean an ~~contract~~ 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*.

(A) A contract clearly assigns or licenses the right to make and sell a product subject to the assignor’s or licensor’s copyright interest if: (i) the contract is executed by an assignor or licensor that has a copyright interest in an original work of authorship, (ii) the contract identifies the original work of authorship and transfers from the assignor or licensor to the assignee or licensee the right to reproduce and sell copies of the work or the right to produce a derivative work from the original work of authorship and the right to sell the derivative work or the right to reproduce and sell copies of the derivative work; and (iii) absent such assignment or license, the assignee’s or licensee’s reproduction and sale of the original work of authorship, or production of a derivative work and sale of the derivative work or reproduction and sale of copies of the derivative work would

infringe upon the assignor's or licensor's copyright interest in the original work of authorship.

(B) A contract clearly assigns or licenses the right to make and sell a product subject to the assignor's or licensor's patent interest if: (i) the contract is executed by an assignor or licensor that has a patent interest in a patented invention; (ii) the contract identifies the assignor's or licensor's patent interest in the patented invention and transfers from the assignor or licensor to the assignee or licensee the right to produce, reproduce, or manufacture, and sell the patented invention or a product that is subject to the patent interest because it embodies essential features of the patented invention; and (iii) absent such assignment or license, the assignee's or licensee's production, reproduction, or manufacture, and sale of the patented invention or a product that embodies essential features of the patented invention would infringe upon the assignor's or licensor's patent interest.

(C) A contract clearly assigns or licenses the right to use a patented process if: (i) the contract is executed by an assignor or licensor that has a patent interest in a patented process; (ii) the contract identifies the assignor's or licensor's patent interest and transfers from the assignor or licensor to the assignee or licensee the right to use the patented process; and (iii) absent such assignment or license, the assignee's or licensee's use of the patented process would infringe upon the assignor's or licensor's patent interest. However, a contract does not assign or license the right to use a patented process if the contract only assigns or licenses the right to use tangible personal property, as defined in this subdivision, including, but not limited to, tangible personal property that performs an embedded patented process.

(D) No specific wording is required to clearly assign or license the right to make and sell a product subject to a copyright or patent interest, or the right to use a patented process subject to a patent interest if the terms of the contract satisfy the requirements of this paragraph.

(9) "Computer program" means a "program" as defined in 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 a 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. “Process” means 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.~~

~~(4) “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.~~

(b) Application of Tax.

(1) Sales and Purchases of Tangible Personal Property. In the absence of an applicable exclusion or exemption, ~~t~~Fax applies to the gross receipts from and the sales price paid ~~amounts received for the sale or storage, use, or other consumption of any~~ tangible personal property, including, but not limited to, charges for the right to use tangible personal property that performs an embedded patented process transferred in a technology transfer agreement.

(2) Separate and Distinct Sales and Purchases of Intangible Property. Tax does not apply to amounts received for the ~~assignment and licensing of a patent or copyright interest as part of a technology transfer agreement~~ sale or storage, use, or other consumption of intangible property, including a copyright or patent interest, that is transferred separately and distinctly from the sale or purchase of tangible personal property and the right to use tangible personal property. A copyright or patent interest is transferred separately and distinctly from the sale or purchase of tangible personal property if the copyright or patent interest is a significant object of the contract transferring such interest and the interest is not incidental to the sale or purchase of tangible personal property.

(3) Mixed Transactions. If a contract for the sale or purchase of tangible personal property also provides for a separate and distinct sale or purchase of intangible property, including a copyright or patent interest, the taxpayer must determine the portion of the total contract price attributable to the sale or purchase of tangible personal property. If the contract is not a technology transfer agreement and does not contain a reasonable, separately stated selling price for the tangible personal property transferred, the taxpayer must determine and report the portion of the total contract price included in the gross receipts or the sales price paid for the tangible personal property based upon all the facts and circumstances, and the amount so reported is subject to audit verification by the Board. 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 (similar) 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 (similar) 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 with a patent or copyright interest, where the transfer is not pursuant to a technology transfer agreement.~~

(43) 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*.
- (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 (Sale of Manuscripts and Right to Perform Copyrighted Work): Company X is a California retailer and holds a copyright interest in a dramatic work. Company X enters into a written lump-sum contract to sell 20 copies of the manuscript for the dramatic work to Company B, a production company, for delivery and use in California and to grant Company B a license to publicly perform the dramatic work. Tax applies to Company X's gross receipts from the sale of the copies of the manuscript, unless an exclusion or exemption applies, but tax will not apply to the portion of the contract price attributable to the license to perform the copyrighted dramatic work. Furthermore, the contract is not a technology transfer agreement because it does not transfer the right to make and sell a product subject to a copyright or patent interest or to use a patented process, but only transfers a license to perform a dramatic work. Therefore, Company X must determine the portion of the total contract price attributable to the sale of the copies of the manuscript based upon all of the facts and circumstances and report and pay tax upon that amount.

Example No. 2 (Sale of Right to Reproduce and Sell Copies of Copyrighted Work): Company X is a California retailer that holds a copyright interest in certain tangible artwork. Company X enters into a written contact that transfers (temporarily or otherwise) to Company Y its tangible artwork for delivery and use in California and a license authorizing Company Y to reproduce the artwork and sell copies subject to Company X's copyright interest. Tax applies to Company X's gross receipts from the transfer of the tangible artwork, unless an exclusion or exemption applies, but tax does not apply to the portion of the contract price attributable to the separate and distinct transfer of the license to reproduce and sell copies of the copyrighted artwork. Furthermore, Company X's contract with Company Y constitutes a technology transfer agreement because the contract identifies a copyright interest in artwork and clearly assigns or licenses the right to reproduce the copyrighted artwork and sell products (the copies) subject to Company X's copyright interest in the artwork. Therefore, Company X must determine the gross receipts from the transfer of the tangible artwork in accordance with subdivision (b)(3)(A)-(C).

Company Y's subsequent written contracts to sell tangible personal property containing reproductions of Company X's artwork (tangible copies) do not constitute technology transfer agreements. They are contracts for the sale 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 contracts, unless an exclusion or exemption applies.

Example No. 3 (Sale of Right to Manufacture and Sell a Patented Product): Company X is a California electronics manufacturer and retailer and holds a patent

interest in the design of a portable scanner. Company X enters into a written contract that transfers (temporarily or otherwise) to Company Y, a related California electronics manufacturer and retailer, one such portable scanner for delivery and use in California, and a license allowing Company Y to manufacture and sell portable scanners incorporating Company X's patented design. Tax applies to Company X's gross receipts from the transfer of the portable scanner to Company Y, unless an exclusion or exemption applies, but tax does not apply to the portion of the contract price attributable to the license to manufacture and sell portable scanners incorporating Company X's patented design. Furthermore, Company X's contract transferring the portable scanner and the license to manufacture and sell portable scanners to Company Y constitutes a technology transfer agreement because the contract identifies a patent interest in a patented invention (the design of the portable scanner) and clearly assigns or licenses the right to manufacture and sell tangible personal property subject to that interest (portable scanners incorporating Company X's patented design). Therefore, Company X must determine the gross receipts from the transfer of the electronic scanner in accordance with subdivision (b)(3)(A)-(C).

Then, Company Y manufactures portable scanners and enters into a written contract to sell 20 portable scanners to Company Z for delivery and use in California. Company Y's contract to sell portable scanners that it manufactures does not constitute a technology transfer agreement. It is an agreement for the mere transfer of tangible personal property (the electronic scanners) produced, reproduced, or manufactured pursuant to a technology transfer agreement. Therefore, tax applies to Company Y's gross receipts from the sale of the portable scanners, unless an exclusion or exemption applies.

Example No. 4 (Sale of Right to Use Tangible Personal Property Distinguished from Sale of Right to Use a Patented Process with or without a Technology Transfer Agreement): Company W, a California manufacturer and retailer of coffee makers, has a patent interest in a patented process for brewing hot beverages (coffee, tea, etc.). Company W manufactures a coffee maker that embodies essential features of the patented process for brewing hot beverages and the reasonable and intended use of the coffee maker is to perform the patented brewing process. Company W also has a patent interest in a patented process for manufacturing coffee makers.

Company W enters into a written contract that transfers 40 coffee makers, which were manufactured using its patented manufacturing process and which embody essential features of the patented process for brewing hot beverages and perform the patented process whenever they brew hot beverages, to Company X for delivery in California and use by its employees at its 20 California locations. The contract contains a separately stated price for the 40 coffee makers and also requires Company X to pay an additional charge each time the coffee makers perform the patented process for brewing hot beverages. In the absence of an applicable exclusion or exemption, tax applies to Company W's gross receipts from the transfer of the coffee makers to Company X, including the additional charges for each time the coffee makers perform the patented process for brewing hot beverages because the process is embedded in the internal

design, assembly, or operation of the coffee makers and the charges are for the right to use tangible personal property that performs an embedded patented process. Furthermore, the contract is not a technology transfer agreement because it does not involve the transfer of the right to make and sell tangible personal property that is subject to a copyright or patent interest, and it only transfers the right to use a process embedded in the internal design, assembly, or operation of the coffee makers and does not transfer the right to use a patented process separate from the right to use the 40 coffee makers.

Next, Company W enters into a written contract that licenses Company Y, a related manufacturer and retailer of coffee makers, to use Company W's patented process for brewing hot beverages and use its patented process for manufacturing coffee makers for a one-year period, but does not transfer any tangible personal property to Company Y. The contract requires Company Y to pay a fee each time it uses the patented process for brewing hot beverages or the patented process for manufacturing coffee makers. The contract is not subject to the provision of the Sales and Use Tax Law and cannot be a technology transfer agreement because the contract does not involve the transfer of tangible personal property. Furthermore, the amounts Company W charges or receives for the transfers of the licenses to use the patented processes are not subject to tax because the amounts are not charges for the sale or storage, use, or other consumption of tangible personal property.

Then, after Company Y's licenses have expired, Company W enters into a written contract with Company Z, another related California manufacturer and retailer of coffee makers, that:

(A) Transfers 30 coffee makers, which were manufactured using Company W's patented manufacturing process and which embody essential features of the patented process for brewing hot beverages and perform the patented process whenever they brew hot beverages, for delivery to Company Z in California and use by Company Z's employees at its 15 California locations; and contains a separately stated price for the 30 coffee makers and requires Company Z to pay an additional separately stated charge each time the coffee makers perform the patented process for brewing hot beverages;

(B) Transfers the same license to Company Z, as Company Y had, to use Company W's patented process for brewing hot beverages separate and apart from using the 30 coffee makers for a one-year period and contains a separately stated charge Company Z must pay each time Company Z uses Company W's patented process for brewing hot beverages without using the 30 coffee makers; and

(C) Transfers the same license to Company Z, as Company Y had, to use Company W's patented process for manufacturing coffee makers for a one-year period, and contains a separately stated charge that Company Z must pay each time it uses W's patented manufacturing process.

In the absence of an exclusion or exemption, tax applies to Company W's gross receipts from the transfer of the 30 coffee makers to Company Z. In addition, Company W's gross receipts include any charges for the 30 coffee makers and any charges Company Z must pay to use the 30 coffee makers, including the patented brewing process embedded in the internal design, assembly, or operation of the 30 coffee makers. However, tax does not apply to the portion of the contract price attributable to the separate and distinct licenses to use the patented process for brewing hot beverages without using the 30 coffee makers and the license to use the patented process for manufacturing coffee makers.

Furthermore, Company W's contract transferring the coffee makers and the licenses to use the patented process for brewing hot beverages without using the 30 coffee makers and to use the patented process for manufacturing coffee makers to Company Z constitutes a technology transfer agreement because the contract identifies patent interests in two patented processes and clearly assigns or licenses the right to use the processes separately and distinctly from the right to use tangible personal property. Therefore, in accordance with subdivision (b)(3)(A)-(C), Company W's gross receipts from the technology transfer agreement shall be the separately stated price for the 30 coffee makers and the separately stated charges Company Z must pay each time those 30 coffee makers perform the patented process for brewing hot beverages, provided the separately stated price and additional charges represent a reasonable fair market value for the 30 coffee makers.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6009, 6011, and 6012, and 6016, Revenue and Taxation Code; *Preston v. State Board of Equalization* (2001) 25 Cal. 4th 197, 105 Cal. Rptr. 2d 407; *Navistar International Transportation Corporation v. State Board of Equalization* (1994) 8 Cal. 4th 868, 35 Cal. Rptr. 2d 651; *Dell, Inc. v. Superior Court* (2008) 159 Cal. App. 4th 911, 71 Cal. Rptr. 3d 905.

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**VIA FACSIMILE (916/322-4530)
AND U.S. MAIL**

July 30, 2010

Mr. Jeffrey L. McGuire, Chief
Tax Policy Division (MIC: 92)
Board of Equalization
450 N Street
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Re: Comments to Proposed Amendments to Regulation 1507, *Technology Transfer Agreements*

Dear Mr. McGuire:

In our letter dated March 25, 2010, we set forth the reasons why we oppose the adoption of those proposed amendments to Regulation 1507¹ that were discussed in our letter. We respectfully submit the additional amendments to Regulation 1507 attached to your May 14, 2010 letter to interested parties did not cure the problems we identified. For the sake of brevity, we will not repeat our comments in our March 25 letter but incorporate them here by reference.

We respectfully continue to oppose the proposed amendments to Regulation 1507. In fact, we believe the proposed amendments to Regulation 1507 illustrate fundamental problems with some of the provisions in the current regulation itself, some of which are discussed below.

I. PROBLEMS WITH THE APPLICATION OF PATENT AND COPYRIGHT LAW IN THE SECOND DISCUSSION PAPER AND IN THE PROPOSED AMENDMENTS TO REGULATION 1507.

The proposed amendments to Regulation 1507 purport to apply Patent Law and Copyright Law. Yet, we were informed at the June 23, 2010 interested parties meeting that Board staff, in drafting these proposed amendments, did not consult with outside experts

¹ All references to Regulation 1507 are to California Code of Regulations, title 18, section 1507.

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in Patent Law and Copyright Law. Rather, the intellectual property concepts set forth in these proposed amendments were based on research of Patent Law and Copyright Law conducted by the Board's Legal Department.

Although we have the greatest respect for the attorneys within the Board's Legal Department, we believe it is essential that persons expert in Patent Law and Copyright Law be consulted. Without input from such experts, Regulation 1507 will unintentionally but inevitably misstate or misapply certain intellectual property laws.

We identify below some of these errors which appear in the Second Discussion Paper and in the proposed amendments to Regulation 1507.²

A. Neither the Doctrine of Patent Exhaustion nor the Holding in *Quanta* Is Relevant.

The Board invokes the doctrine of "patent exhaustion," as illustrated in *Quanta Computer, Inc. v. LG Electronics, Inc.* (2008) 553 U.S. 617 [128 S.Ct. 2109]. (Agenda Pages 7-8, 10, 13 of 46.) We disagree that this doctrine and *Quanta* are germane when they are applied to the TTA Statutes: Revenue and Taxation Code sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10).³

In *Quanta*, LG Electronics licensed to Intel Corporation patents that included certain "method" or "process" claims; i.e., patents that described methods or processes for performing certain functions. (*Quanta, supra*, 128 S.Ct. at p. 2114.) LGE also licensed to Intel the right to manufacture and sell microprocessors and chipsets that used ("practiced") those patents. (*Ibid.*) Thus, Intel could make, use, and sell its own products practicing LGE's patents. (*Ibid.*) The microprocessors and chipsets that Intel manufactured and sold substantially "embodied" LGE's process patent claims. (*Id.* at pp. 2113, 2118, 2120.)

LGE did not, however, license any third party to, among other things, combine the microprocessors and chipsets from Intel with items, components, or the like acquired from sources other than from LGE or Intel. (*Quanta, supra*, 128 S.Ct. at p. 2114.)

² Board staff graciously indicated that if the Board received our submission by July 30, 2010, the Board should be able to fully incorporate and address our position in the formal issue paper. We greatly appreciate the Board staff's professional courtesy in this regard.

³ All statutory references are to the Revenue and Taxation Code, unless otherwise indicated.

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Quanta and related entities (“third parties” to the license between LGE and Intel) purchased microprocessors and chipsets from Intel. (*Quanta, supra*, 128 S.Ct. at p. 2114.) Quanta, however, manufactured computers that practiced LGE’s patents using Intel parts in combination with non-Intel memory and buses. (*Ibid.*)

LGE alleged the combination of Intel parts with non-Intel memory and buses infringed certain LGE patents. (*Quanta, supra*, 128 S.Ct. at p. 2114.) The Supreme Court disagreed. It held there was no infringement by Intel’s customer, Quanta. LGE had licensed to Intel the right to practice any of LGE’s patents and to sell products practicing those patents. (*Id.* at p. 2122.) Thus, Intel’s authorized sale to Quanta exhausted LGE’s process patents substantially embodied in Intel’s microprocessors and chipsets: “The authorized sale of an article that substantially embodies a patent exhausts the patent holder’s rights and prevents the patent holder from invoking patent law to control postsale use of the article.” (*Ibid.*)

The issue under sections 6011(c)(10)(D) and 6012(c)(10)(D) is entirely different. No such “authorized sale” appears to be relevant in determining whether an agreement is a “technology transfer agreement.”

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.” Thus, the pertinent relationship is between the patent holder, on the one hand, and the assignee or licensee, on the other hand, *not* the relationship between the patent holder, on the one hand, and the *customer* of the assignee or licensee, on the other hand.

In *Quanta*, the question was whether the patent holder (LGE) could pursue patent claims against a third party (Intel’s customer, Quanta) – not the rights conveyed from the patent holder (LGE) to the licensee (Intel). Under sections 6011(c)(10)(D) and 6012(c)(10)(D), however, the question *is* the rights conveyed by the patent holder to the assignee or licensee – not whether the patent holder could pursue patent claims against third parties (the customers of the assignee or licensee).

B. Even If *Quanta* Were Applicable, the Agreement Between the Patent Holder, on the One Hand, and the Assignee or Licensee, on the Other Hand, Is Not a Nullity.

The Second Discussion Paper states, “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.” (Agenda Page 7 of 46, bold and italics in original.)

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Even if *Quanta* were analogous (which it is not), its holding does not support the contention that the described transfer “from the patent holder to the purchaser would be a *nullity*.” (*Ibid.*, bold and italics added.)

As stated, sections 6011(c)(10)(D) and 6012(c)(10)(D) do not deal with the transfer of a patent from the patent holder, on the one hand, to a third party (*i.e.*, the purchaser of the assignee’s or licensee’s product), on the other hand. Thus, reference to the word “nullity” in the context of sections 6011(c)(10) and 6012(c)(10) is puzzling.

If, however, there were a technology transfer agreement between the patent holder, on the one hand (*e.g.* LGE) and the assignee’s or licensee’s customer (*e.g.* *Quanta*), on the other hand, the doctrine of patent exhaustion does not make such an agreement a “nullity.” To the contrary, there can be a valid transfer of a right to use a patented process even if the assignee or licensee may also have a “patent exhaustion” defense.

In *MedImmune, Inc. v. Genentech, Inc.* (2007) 549 U.S. 118 (“*MedImmune*”), the licensee believed a patent was invalid and unenforceable and that, in any event, the drug manufactured by the licensee was not covered by the patent. (*Id.* at pp. 121-22.) Nonetheless, the licensee continued to pay royalties *under an existing license agreement* because it was unwilling to risk the serious consequences that would arise if it challenged the patent without the protection afforded by that license agreement. This is because if the patent holder were to prevail in a patent infringement action against the licensee, the licensee could be liable for treble damages, attorney’s fees, and an injunction from selling the drug. (*Id.* at p. 122.)

The Supreme Court in *MedImmune* considered whether a justiciable case or controversy existed where the patent licensee sought declaratory judgment of patent invalidity without terminating or breaching its license agreement. (*MedImmune, supra*, 549 U.S. at pp. 120-21.) The Supreme Court held it did. The licensee’s continued payment of royalties in accordance with the *existing license agreement* did not preclude the licensee from bringing suit to challenge the patent’s validity or enforceability. Thus, the patent holder still could transfer its patent rights even though the licensee could raise an affirmative defense with respect to the patent.

In sum, a transfer is not a “nullity” merely because the transferee may also have a patent exhaustion defense. This is because, under *MedImmune*, if a dispute over the validity or enforceability of the patent should arise, the existence of the agreement would enable the transferee to continue practicing the patent without fear of liability for patent infringement if a court were to rule against it with respect to the validity or enforceability of the patent.

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C. Reference to “Embedded” in the Second Discussion Paper and in the Proposed Amendments to Regulation 1507 Finds No Support in Patent Law.

The Second Discussion Paper and the proposed amendments to Regulation 1507 repeatedly use the word “embedded” in the following contexts: “embedded patented process” (Agenda Pages 9, 10 of 46), “embedded patented processes” (e.g. *id.* at pp. 10, 11), “embedded and external processes” (*id.* at p. 10), “embedded process” (*id.* at pp. 9, 16), “patented technology embedded in the internal design, assembly or operation” of a product, a medical device, automobiles, or a hair cutting device (*id.* at pp. 16, 19, 21), “patents [held] for certain processes embedded in and performed by the computer program” (*id.* at p. 19), and “patents [held] for certain processes embedded in and performed by the manufacturing equipment with the aid of the computer program” (*id.* at p. 20).

The word “embedded” is not a term of art in Patent Law. Significantly, the Second Discussion Paper does not cite to any statute under the Patent Law, any patent case, or even a treatise on Patent Law to support its arguments and examples regarding when and under what circumstances patented technology is “embedded.”

Moreover, the TTA Statutes do not exclude from the definition of a “technology transfer agreement” an agreement that assigns or licenses the right to use a process – whether “embedded” or not – as long as the agreement is a “technology transfer agreement” within the meaning of sections 6011(c)(10)(D) and 6012(c)(10)(D). Moreover, when an embedded patented process is transferred with tangible personal property (assuming the concept of “embedded” even exists in Patent Law), the value of the tangible personal property will always be subject to tax. (See Cal. Rev. & Tax. Code §§ 6011(c)(10)(A), (B), (C), 6012(c)(10)(A), (B), (C).)

D. There Is No Requirement for a Writing Under All Circumstances.

The Second Discussion Paper states as follows:

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.)

(Agenda Page 6 of 46, fn. 2.) This is an incorrect statement of intellectual property law. The requirement for a writing applies only to assignment of ownership of a patent or copyright, not to a non-exclusive license of a patent or copyright. (*Waymark Corp. v. Porta Sys. Corp.* (Fed. Cir. 2003) 334 F.3d 1358, 1364 (“*Waymark*”) [“Only assignments need be in writing under 35 U.S.C. § 261. Licenses may be oral.”]; *I.A.E., Inc. v. Shaver* (7th Cir. 1996) 74 F.3d 768, 775 [“Therefore, even though section 204(a) of the Copyright Act

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invalidates any transfer of copyright ownership that is not in writing, section 101 explicitly removes a nonexclusive license from the section 204(a) writing requirement.”].) To the extent some of the language in *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 (“*Preston*”) suggests that the writing requirement applies to licenses of a copyright, this appears to be because the licenses in that case were exclusive licenses (*id.* at p. 215), and an exclusive license to a copyright is considered a “transfer of copyright ownership.” (17 U.S.C. § 101.)

Further, Board staff’s citations regarding the writing requirement are misplaced. (Agenda Page 9 of 46.) First, *Radio Television Espanola, S.A., v. New World Entertainment, Ltd.* (9th Cir. 1999) 183 F.3d 922, which Board cites regarding transfer of a copyright interest, makes clear that the writing requirement does not apply to nonexclusive licenses. (*Id.* at p. 926, fn. 4.)

Likewise, Board staff’s citation, at Agenda Page 9 of 46, to *McClaskey v. Harbison-Walker Refractories Co.* (3d Cir. 1943) 138 F.2d 493 regarding transfer of a patent interest cannot be an appropriate commentary on 35 U.S.C. section 261, the statute upon which Board relies, because 35 U.S.C. section 261 was not enacted until 1952, nine years after *McClaskey* was decided. Furthermore, patent law is currently governed by Federal Circuit case law. (18 U.S.C. § 1295.) The Federal Circuit has made clear that the writing requirement does not apply to nonexclusive patent licenses. (*Waymark, supra*, 334 F.3d at p. 1364 [“Only assignments need be in writing under 35 U.S.C. § 261. Licenses may be oral.”].)

E. The Examples in the Proposed Amendments to Regulation 1507 Are Confusing and Provide No Clarity to the Interpretation of the TTA Statutes

The examples in the proposed amendments to Regulation 1507 do not clarify the meaning of the TTA Statutes. To the contrary, they are confusing and, to the extent they conflict with the TTA Statutes, are invalid. By way of illustration only (and not an exhaustive list of our concerns) we note the following:

Example No. 3, although slightly amended from its original version, remains confusing and unhelpful. What is a “process external to the medical device”? What is a “separate patented process [that] relate[s] to the patented technology embedded in the internal design, assembly or operation of the medical device”? How are these processes embedded? Where? When?

And, as discussed above, nothing in the TTA Statutes authorizes the exclusion from the definition of a “technology transfer agreement” an agreement that assigns or licenses the right to use separate patented process, whether or not they relate to a patented technology embedded in the internal design, assembly or operation of an apparatus, if the agreement otherwise meets the requirements of sections 6011(c)(10)(D) and 6012(c)(10)(D).

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Example No. 4 provides in part as follows:

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.

There is nothing in the TTA Statutes or its legislative history that supports the tax treatment set forth above. To the contrary, the legislative history indicates agreements that license the right to use prewritten software programs can be technology transfer agreements if the requirements of sections 6011(c)(10)(D) and 6012(c)(10)(D) are met.

Board conceded as much during the drafting of the TTA Statutes. When Board staff commented on Assembly Bill No. 103 ("AB 103"), which became the TTA Statutes, staff stated it thought AB 103 was intended "to clarify the application of tax on transactions such as Intel's." (State Bd. of Equalization, analysis of Assem. Bill No. 103, as amended Aug. 17, 1993, p. 2.) "However," continued Board staff, "with the proposed definition of technology transfer agreement [which definition was enacted, without change], *other transfers* of patented processes could be exempted." (*Ibid.*, bold and italics added.)

One "transfer" Board staff specifically foresaw was the transfer of the right to use prewritten software programs:

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.

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(State Bd. of Equalization, analysis of Assem. Bill No. 103, as amended Aug. 17, 1993, pp. 3-4, bold and italics added.)

Board staff must have been referring to use of *prewritten* software programs in its prediction because use of *custom* software already was excluded from tax by section 6010.9. Moreover, Board staff did not state this interpretation would be incorrect. Finally, Board staff made no reference to whether the process was, or was not, embedded in the computer program or elsewhere.

Yet the Legislature, having been advised by Board staff about the statute's meaning, left intact the phrase "to use a process" in sections 6011(c)(10)(D) and 6012(c)(10)(D), thereby "strongly signal[ing] a legislative intent" (*Preston, supra*, 25 Cal.4th at p. 218) to apply the TTA Statutes to agreements that license the right to use prewritten software programs.

F. At Best, the Use of Words Such as "Identifies," "Embedded," "Mere Use," and "Clearly" Leads to Confusion and Uncertainty.

We are concerned that these vague, ambiguous, and confusing terms will lead persons not trained in intellectual property law to incorrectly interpret agreements that substantively transfer copyright and patent interests consistent with Patent Law and Copyright Law. Thus, even though an agreement substantively transfers copyright and patent interests consistent with Patent Law and Copyright Law, such a person may nevertheless mistakenly believe that these interests had not been "identified" with sufficient specificity and had not been transferred "clearly" enough.

Moreover, a person not versed in intellectual property law may mistakenly characterize a patented process as "embedded" when it is not.

We are also concerned that Regulation 1507 does not distinguish between "use" of a process, which evidently can support a technology transfer agreement (see Example No. 3) and "mere use" of a process, which the Board contends cannot support a technology transfer agreement (see Regulation 1507(a)(4)). The proposed amendments to Regulation 1507 do not explain the difference between these terms, thus perpetuating the confusion that now exists in the current version of Regulation 1507.

Finally, we would observe that the statutory definition of a "technology transfer agreement" looks to the *substance* of the agreement without requiring any particular form. (See Cal. Rev. & Tax. Code §§ 6011(c)(10)(D) and 6012(c)(10)(D).) To the extent the proposed amendments to Regulation 1507 would exclude from the regulatory definition an agreement that did not contain the language these proposed amendments intend to require, even though the agreement met the substantive standards of sections 6011(c)(10)(D) and 6012(c)(10)(D), such amendments would conflict with the TTA Statutes and would be invalid.

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II. THE SECOND DISCUSSION PAPER SUGGESTS THE LEGISLATURE BROADENED THE TTA STATUTES ONLY BY MAKING THEM APPLICABLE TO PATENT AND COPYRIGHT INTERESTS; IN FACT, THE TTA STATUTES ARE BROADER THAN THAT

The Second Discussion Paper states Board's analysis of AB 103 "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." (Agenda Page 7 of 46.) However, the Second Discussion Paper observes that the Supreme Court in *Preston* "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." (Agenda Page 7 of 46, italics in original.)

Preston, however, observed that the Legislature expanded the TTA Statutes as follows:

When Assembly Bill No. 103 reached the Senate, some 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. If taxpayers are able to structure a contract so that a large proportion of the value of the tangible personal property is assigned to the intangible copyright – e.g., in a sale of a painting, assigning all but the price of canvas and oils to the intangible copyright to make posters of the painting--their sales tax liability would be reduced." (Sen. Com. on Rev. & Tax., analysis of proposed amends. to Assem. Bill No. 103, July 7, 1993, p. 3.) 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. (Sen. Com. on Rev. & Tax., analysis of proposed amends. to Assem. Bill No. 103, July 7, 1993, p. 3.)

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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 [agreements] that qualify for an exemption”* (Assem. Floor Analysis, Conc. in Sen. Amends. to Assem. Bill No. 103, as amended Aug. 17, 1993, p. 2.) In doing so, the Senate apparently concluded that Assembly Bill No. 103 adequately addressed the concern “by requiring that a ‘reasonable price’ or ‘fair market retail value’ of like property be used to value the tangible personal property being transferred.” (Sen. Com. on Rev. & Tax., rev. analysis of proposed amends. to Assem. Bill No. 103, July 7, 1993, p. 3.)

Soon after the Senate declined to limit the scope of Assembly Bill No. 103, the Board voiced its own concerns over the scope of the proposed exemption. *Noting that it “may be more broad than intended,” the Board claimed that the proposed definition of technology transfer agreement would encompass licenses of copyrights in artwork, photographs, film strips and technical drawings.* (State Bd. of Equalization, analysis of Assem. Bill No. 103, as amended Aug. 17, 1993, pp. 2-3, italics omitted.) The Board further acknowledged that the bill, as written, *“would provide opportunities for the exclusion of a portion of gross receipts” from taxation whenever a “seller of commercial art” separately charges “for the right to make and sell copies of the original artwork.”* (Ibid.)

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. Board indicates that this bill could exempt many transactions, such as licenses of photographs, film strips or other artwork which currently are subject to taxation.” (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 Cal. Dept. Finance, analysis of Assem. Bill No. 103, as amended

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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. (Compare Stats. 1993, ch. 887, § 1, pp. 4826-4828 with Sen. Amend. to Assem. Bill No. 103, Aug. 17, 1993.) This decision to adopt the broad language of Assembly Bill No. 103 despite repeated warnings about its scope strongly signals a legislative intent to apply sections 6011(c)(10) and 6012(c)(10) to copyrights in artwork.

(*Preston, supra*, 25 Cal.4th at p. 217-218, bold and italics added.)

Thus, the legislative history shows the Legislature was aware that AB 103 exempted *any* transfers of patent or copyright interest from taxation. To the extent the proposed amendments to Regulation 1507 exclude from the operation of the TTA Statutes transfers that otherwise meet the requirements of the TTA Statutes, they conflict with the TTA Statutes and are invalid. (*Preston, supra*, 25 Cal.4th at p. 219 [“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.*” Bold and italics added.])

III. CONCLUSION

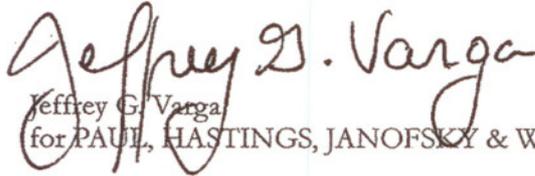
We continue to believe that the proposed amendments to Regulation 1507 discussed in our March 25 letter and those discussed here have one, and only one, purpose: to exclude from the definition of technology transfer agreements those agreements that would otherwise fall within the statutory definition. The Board lacks authority to do so, and such proposed amendments, if adopted, would be invalid

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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.

Sincerely,


Jeffrey G. Varga
for PAUL, HASTINGS, JANOFSKY & WALKER LLP

cc: Mr. Bradley Heller by email (Bradley.Heller@boe.ca.gov)
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RE: Regulation 1507

Dear Mr. McGuire:

The State Board of Equalization staff issued a second discussion paper relating to a proposal to amend Regulation 1507. I have a number of comments to the proposed amendments.

1. The proposed amendment requires that the technology transfer agreement "clearly" assign or license certain rights. This modification introduces a matter of evidence into the regulation. The substantive requirements of a technology transfer agreement in Regulation 1507 should not be defined by the level of evidence. The regulation should not adopt the word "clearly."

The statute does not use the word "clearly." Adding such word would inappropriately narrow what agreements would come within the definition. For example, the use of the word "clearly" could have prevented some or all of the agreements in *Preston v. SBE*, 25 Cal 4th 197 (2001) from qualifying as technology transfer agreements. In *Preston*, the All Night Media Agreement gave All Night Media "all right for the use of Preston's artwork on any and all rubber stamp products . . ." It would be easy for the SBE to argue that such an agreement does not "clearly" assign or license Preston's right to reproduce Preston's copyrighted material. The agreement does not use "copy," "reproduce" or even refer to a copyright. The licensee is given "all rights for the use of." Thus, it could be argued the agreement does not "clearly" assign the right to reproduce the copyrighted work. Consequently, the word "clearly" added to Regulation 1507 could be used to deny transactions that the statute provides, and Supreme Court found, were technology transfer agreements. A level of evidence in the regulation is inappropriate and contrary to the statute.

The sentence in *Preston* "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," is not a statement setting forth the legal requirements for a technology transfer agreement. This sentence says that in the situation described there has been a copyright transfer. But, adding the word "clearly" in Regulation 1507

would contradict the Supreme Court's conclusion about the statute: "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 the patent or copyright to another person so the latter person can make or sell a product embodying that patent or copyright." This language provides the test for a technology transfer agreement, whether or not the agreement "clearly" assigns or licenses specified rights, or whether further evidence or analysis is necessary to show the requirements are satisfied. Thus, the word "clearly" should not be added.

2. Regulation 1507 is proposed to be amended to list the type of rights, in clauses (A), (B), and (C), that need to be in a technology transfer agreement. The proposed listing of the rights inappropriately narrows the transactions that are technology transfer agreements as provided by the statute. The clauses should not be narrower than allowing any of the exclusive rights of a copyright or patent holder. For example, clause (A) as proposed does not include the right to make derivative works. The right to make derivative works is one of the exclusive rights of an owner of a copyright. Licensing the right to make a derivative work would be providing the licensee "the right to make and sell a product . . . that is subject to the . . . copyright interest." Failure to cover this in clause (A) shows that the proposal excludes transactions that are covered by the language of the statute.

Clause (B) also inappropriately changes the word "product" in the statute to "tangible personal property." Requiring "product" to be "tangible personal property" would prevent the statute from applying to transactions that are actually covered by the language of the statute. For example, suppose in *Preston*, Preston entered into the same agreements, but required that the books to be produced could only be electronic books. In those cases, the "product" that is made which incorporates Preston's copyrighted artwork would be an electronic product. Transfer of such electronic product is not a transfer of "tangible personal property," as has been recognized in California for over thirty years. Thus, the proposed change of the regulation would turn a transaction that the Supreme Court actually found was a technology transfer agreement into one that is not, because the "product" to which the licensee is given the rights to make is not a "tangible" book, but rather an electronic book. Thus, limiting "product" to "tangible personal property" inappropriately changes what the statute provides.

3. The final sentence of the paragraph following the definition of technology transfer agreement is proposed to be amended that an agreement for the reproduction of a computer program is not a technology transfer agreement. Such a change is inappropriate. Rev. Tax. Code Sections 6011(c)(10) and 6012(c)(10) were enacted after Regulation 1502 was amended in 1987. What is provided concerning software copyright royalties in 1502(f) cannot override what is provided in the statute in §§ 6011 and 6012. A prior regulation just cannot override a subsequent statute. The regulation should not attempt to carve out a transaction that meets the definition of a technology transfer agreement.

4. The definition of "process" in its proposed second sentence makes a reference to "a separate patented process." The use of the word "separate" here is inappropriate. First, what is a "separate" patented process is unclear and undefined. Separate from what?

Moreover, the statute does not use the word "separate," nor does the statute require the process to be separate from anything. The word "separate" should be deleted from the second sentence in the definition of "process."

5. The final sentence of the definition of "process" states that process does not mean or include the mere use of tangible personal property that performs an imbedded process by the owner of such property, the owner's agents, or the owner's customers, regardless of whether the process is patented. It appears that this sentence is proposed because of the patent exhaustion doctrine.

The patent exhaustion doctrine says that a purchaser from a lawful vendor or patent owner can use the product for its intended purpose even if the product performs a process that would otherwise infringe a patent owned by the seller or a licensor to the seller, if there is no other reasonable and intended use for the product. This final qualifier is an important one. If the product can only be used in one way, namely, to perform the patented process, a rightful owner of the product may use it for that purpose and does not need any license for the patented process from the process patent owner. However, if the product has other non-infringing uses, then the owner of the product cannot use the product to perform the patented process unless a license to the patented process is also obtained. The distinction is whether the product can be used for other non-infringing uses or whether its only reasonable and intended use uses the patented process. In the *Quanta Computer, Inc. v. L.G. Electronic* case cited in the second discussion paper, the products had no use other than what Quanta used them for. Thus, Quanta and its customers, who rightfully obtained the products, did not need a patent license from the owner of the process patent (LG) in order to use the products and the patented process.

The final sentence in the definition of "process" in Regulation 1507 is worded too broadly in that it can inappropriately exclude patented processes where use of the product to perform the patented process would, in fact, require a patent license to the process, even though the owner of the product is using it for one of the product's uses. Thus, the final sentence needs an appropriate qualifier.

6. In section (b)(1), the regulation in the first sentence added a clause, "including, but not limited to, amounts received for the right to use tangible personal property." Such clause should be added to the third sentence of that same paragraph after the words "tangible personal property transferred." Such addition is to clarify that the stated methods in paragraphs (A), (B), and (C) cover the price for the tangible personal property "including . . . amounts received for the right to use tangible personal property."

7. Section (b)(2) of Regulation 1507 is proposed to state that tax applies to amounts received from the sale, storage, use or other consumption of tangible personal property "coupled" with a copyright or patent interest where the transfer is not pursuant to a technology transfer agreement. The SBE staff proposes to change to word "transferred" to "coupled." The word "coupled" is unclear. No definition is provided. When is a patent or copyrighted interest "coupled"?

A more fundamental problem with this section (b)(2) is that it is contrary to Rev. & Tax. Code Sections 6051 and 6201. The sales and use taxes are only applicable to receipts from tangible personal property. Merely because a transaction is not a technology transfer agreement does not make a transfer of tangible personal property along with a patent or copyright interests into a taxable transaction on the amounts paid for the patent or copyright. The basis for the *Intel Corporation* decision was that the agreements Intel entered into transferred, not only tangible personal property, but also intangible personal property, namely, copyright interests and patent interests. Such patent interests and copyright interests were separate, by law, from the tangible property transferred. The SBE staff at the time failed to understand that the copyright and patent interest license were separate and distinct property from tangible items. The SBE staff did not view Intel's situation as different from the transaction in *Navistar International Transportation Corp. v. SBE*. However, *Navistar* did not deal with transfers of separate intangible property like patents and copyrights. The California Supreme Court specifically stated:

Navistar's sale of the documents was not incidental to the performance of a service. Nor was there a separate and distinct transfer of an intangible property right.

Thus, *Intel* was only correctly applying § 6051 to a transaction where different separate items of property were transferred for one aggregate price. The amount paid for the separate intangible property was not taxable because § 6051 does not tax it.

Sections 6011(c)(10) and 6012(c)(10) only deal with the taxation of technology transfer agreements. The statute does not provide that all other transfers of patents and copyright interests that are not part of a technology transfer agreements are taxable. For Regulation 1507 to so provide would be going beyond the statutory provision and would be contradicting §§ 6051 and 6201. Thus, section (b)(2) should be deleted from the regulation.

8. The examples should be correlatively modified to take into account the foregoing comments. Thus, for example, examples 1 and 2 should delete the word "clearly." Further, example 4 should add at the end of the third sentence "and does not use a copyright interest or a patent interest." Further, example 7 should be modified to reflect the suggested changes discussed above in paragraph 6.

Thank you for this opportunity for comment on the proposed regulation.

Sincerely yours,



Ronald B. Schrotenboer