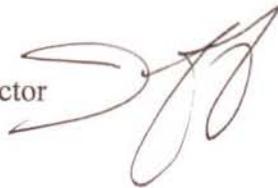


**M e m o r a n d u m**

**To** : Honorable Jerome E. Horton, Chairman  
Honorable Michelle Steel, Vice Chair  
Honorable Betty T. Yee, First District  
Senator George Runner, Second District  
Honorable John Chiang, State Controller

**Date:** August 4, 2011

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



**Subject** : **Study on Optional Reporting Methods - Regulation 1507**  
**August 24, 2011 Business Taxes Committee Meeting Agenda**

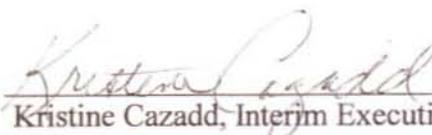
The following item is on the Board's August 24, 2011 Business Taxes Committee Meeting Agenda. Staff is requesting approval to conduct a study in cooperation with Industry to determine the feasibility of developing an optional percentage which can be used in estimating fair market value of tangible personal property sold with a technology transfer agreement. Attached is an Informal Issue Paper on this item.

Business Taxes Committee

Regulation 1507, *Technology Transfer Agreements*

Approval is sought to conduct a study that would evaluate the feasibility of developing an optional percentage to reasonably estimate the fair market value of tangible personal property in technology transfer agreements involving prewritten software transferred on tangible storage media pursuant to subdivision (c)(10)(C) of sections 6011 and 6012 of the Revenue and Taxation Code.

Approved:

  
Kristine Cazadd, Interim Executive Director

JLM:jmp

Attachment: Informal Issue Paper, "Study on Technology Transfer Agreements."

- For Information  
 For Discussion  
 For Decision Making

BOARD OF EQUALIZATION  
**INFORMAL ISSUE PAPER**

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## **Study on Technology Transfer Agreements (TTA)**

### **Issue**

Should the Board of Equalization conduct a study to evaluate the feasibility of developing an optional percentage that can be used to reasonably estimate the fair market value of tangible personal property in technology agreements involving prewritten software transferred on tangible storage media?

### **Background**

Sections 6011 and 6012 of the Revenue and Taxation Code, subdivision (c)(10) 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. The application of tax to TTA is also addressed in Regulation 1507, *Technology Transfer Agreements*. The regulation provides that tax applies to the amounts received for tangible personal property transferred in a TTA and that the sales price of the tangible personal property shall be:

1. A reasonable separately stated sale price for the tangible personal property.
2. If there is no separately stated sales price, the separately stated price at which the property was previously sold, leased or offered for sale.
3. If neither of the above exists, 200 percent of the cost of the labor and materials used to produce the tangible personal property.

In the recent *Nortel* opinion, the California Court determined that the transfer of a prewritten software license may qualify as a TTA. As a result, Regulation 1507 was recently revised to delete the provisions that specified that a TTA does not mean an agreement for the transfer of prewritten software.

In trying to develop reasonable methods to calculate the taxable fair market value of the tangible personal property transferred in a TTA and to provide guidance on how to support and verify such methods, it has become apparent that a case by case approach to cost accounting, bookkeeping, reporting, and auditing TTA's for sales and use tax purposes is difficult and poses an administrative burden on taxpayers and the Board.

### **Discussion of the Issue**

Before an interested parties process is pursued to discuss a regulatory or administrative solution, staff believes it needs to work with a focus group of Industry members who are directly engaged in the sale of prewritten software through a qualified TTA to evaluate the feasibility of developing an optional percentage based on the accounting methods followed, the type of products sold, and the transactions at issue.

For those sales that qualify as TTA, establishing or verifying the retail value based on cost may pose difficulties because costs are not always booked by product line or in the same year as the sale. In order to determine the retail value of a particular product, the retailer would need to track all related costs on a per product and per unit basis, without regard to the year the cost was expensed or capitalized. In addition to administrative challenges faced by taxpayers, staff may have difficulty verifying the figures. For taxpayers and staff, establishing and verifying fair market value on a case by case basis would be a difficult and time consuming task. If feasible and supported by the data developed in a study with Industry, the promulgation of an optional percentage to calculate the sales price of the tangible personal property could save taxpayers and staff time and provide certainty in the numbers. The adoption of an optional percentage would also provide taxpayers protection against claims of unreasonable allocation of a sale price for the tangible personal property transferred in a TTA.

### **Use of Taxable Percentages in Regulations.**

Several Sales and Use Tax regulations currently provide for the use of a percentage in determining the taxable portion of a transaction, including the following examples. The use of the percentages assists taxpayers in reporting correctly and assists auditors in verifying the reported amounts.

Regulation 1502, *Computers, Programs and Data Processing*: Subdivision (f)(1)(C) regarding lump-sum charges for software optional maintenance contracts.

Regulation 1521, *Construction Contractors*: Subdivision (c)(1)(B) regarding the sales price of on-premise electric signs.

Regulation 1602, *Food Products*: Subdivision (b) regarding combination packages.

### **Alternatives**

Do not conduct a study to evaluate the feasibility of developing an optional percentage.

### **Recommendation**

Staff recommends conducting a study with Industry to evaluate the feasibility of developing an optional percentage that can be used to reasonably estimate the fair market value of tangible personal property in technology agreements involving prewritten software transferred on tangible storage media. If the study concludes that it is feasible to use an optional percentage, the issue can be addressed through the interested parties' process.

### **Critical Time Frames**

The completion of a study is a step in providing specific and simple guidelines to taxpayers and staff to follow in reporting and auditing sales of software with qualifying TTA and should be conducted promptly.

### **Preparation and Reviews**

Prepared by the Tax Policy Division, Sales and Use Tax Department and the Taxes and Fees Division, Legal Department.

Current as of: August 5, 2011