

Rulemaking File  
Table of Contents  
Title18. Public Revenue  
Sales and Use Tax  
Regulation 1502 *Computers, Programs, and Data Processing*

[OAL Approval](#)

[Index](#)

1. [Final Statement of Reasons](#)
2. [Updated Informative Digest](#)
3. [Business Tax Committee Minutes, August 13, 2013](#)
4. [Reporter's Transcript Business Taxes Committee, August 13, 2013](#)
5. [Estimate of Cost or Savings, August 26, 2013](#)
6. [Economic and Fiscal Impact Statements, October 8, 2013](#)
7. [Notice of Publications](#)
8. [Notice to Interested Parties, October 18, 2013](#)
9. [Statement of Compliance](#)
10. [Reporter's Transcript, Item F3, December 17, 2013](#)
11. [Draft Minutes, December 17, 2013, and Exhibits](#)

**State of California  
Office of Administrative Law**

**In re:**  
**Board of Equalization**

**NOTICE OF APPROVAL OF REGULATORY  
ACTION**

**Regulatory Action:**

**Government Code Section 11349.3**

**Title 18, California Code of Regulations**

**OAL File No. 2014-0213-01 S**

**Adopt sections:**  
**Amend sections: 1502**  
**Repeal sections:**

---

This rulemaking action clarifies the tax status of purchases of optional computer program maintenance contracts that include a backup copy of the computer program.

OAL approves this regulatory action pursuant to section 11349.3 of the Government Code. This regulatory action becomes effective on 7/1/2014.

Date: 3/4/2014



Dale P. Mentink  
Senior Staff Counsel

For: DEBRA M. CORNEZ  
Director

Original: Cynthia Bridges  
Copy: Richard Bennion

RECEIVED

MAR 5 2014

Board Proceedings

**OFFICE OF ADMINISTRATIVE LAW**

300 Capitol Mall, Suite 1250  
Sacramento, CA 95814  
(916) 323-6225 FAX (916) 323-6826



**DEBRA M. CORNEZ**  
Director

**MEMORANDUM**

TO: Richard Bennion  
FROM: OAL Front Desk   
DATE: 3/5/2014  
RE: Return of Approved Rulemaking Materials  
OAL File No. 2014-0213-01S

OAL hereby returns this file your agency submitted for our review (OAL File No. 2014-0213-01S regarding Computers, Programs, and Data Processing).

Enclosures If this is an approved file, it contains a copy of the regulation(s) stamped "ENDORSED APPROVED" by the Office of Administrative Law and "ENDORSED FILED" by the Secretary of State. The effective date of an approved regulation is specified on the Form 400 (see item B.5). **Beginning January 1, 2013**, unless an exemption applies, Government Code section 11343.4 states the effective date of an approved regulation is determined by the date the regulation is filed with the Secretary of State (see the date the Form 400 was stamped "ENDORSED FILED" by the Secretary of State) as follows:

- (1) **January 1** if the regulation or order of repeal is filed on September 1 to November 30, inclusive.
- (2) **April 1** if the regulation or order of repeal is filed on December 1 to February 29, inclusive.
- (3) **July 1** if the regulation or order of repeal is filed on March 1 to May 31, inclusive.
- (4) **October 1** if the regulation or order of repeal is filed on June 1 to August 31, inclusive.

If an exemption applies concerning the effective date of the regulation approved in this file, then it will be specified on the Form 400. The Notice of Approval that OAL sends to the state agency will contain the effective date of the regulation. The history note that will appear at the end of the regulation section in the California Code of Regulations will also include the regulation's effective date. Additionally, the effective date of the regulation will be noted on OAL's Web site once OAL posts the Internet Web site link to the full text of the regulation that is received from the state agency. (Gov. Code, secs. 11343 and 11344.)

**Please note this new requirement:** Unless an exemption applies, Government Code section 11343 now requires:

1. **Section 11343(c)(1):** Within 15 days of OAL filing a state agency's regulation with the Secretary of State, the state agency is required to post the regulation on its Internet Web site in an easily marked and identifiable location. The state agency shall keep the regulation posted on its Internet Web site for at least six months from the date the regulation is filed with the Secretary of State.
2. **Section 11343(c)(2):** Within five (5) days of posting its regulation on its Internet Web site, the state agency shall send to OAL the Internet Web site link of each regulation that the agency posts on its Internet Web site pursuant to section 11343(c)(1).

OAL has established an email address for state agencies to send the Internet Web site link to for each regulation the agency posts. Please send the Internet Web site link for each regulation posted to OAL at [postedregslink@oal.ca.gov](mailto:postedregslink@oal.ca.gov).

**NOTE ABOUT EXEMPTIONS.** Posting and linking requirements do not apply to emergency regulations; regulations adopted by FPPC or Conflict of Interest regulations approved by FPPC; and regulations not subject to OAL/APA review. However, an exempt agency may choose to comply with these requirements, and OAL will post the information accordingly.

**DO NOT DISCARD OR DESTROY THIS FILE**

Due to its legal significance, you are required by law to preserve this rulemaking record. Government Code section 11347.3(d) requires that this record be available to the public and to the courts for possible later review. Government Code section 11347.3(e) further provides that "...no item contained in the file shall be removed, altered, or destroyed or otherwise disposed of." See also the State Records Management Act (Government Code section 14740 et seq.) and the State Administrative Manual (SAM) section 1600 et seq.) regarding retention of your records.

If you decide not to keep the rulemaking records at your agency/office or at the State Records Center, you may transmit it to the State Archives with instructions that the Secretary of State shall not remove, alter, or destroy or otherwise dispose of any item contained in the file. See Government Code section 11347.3(f).

Enclosures

## NOTICE PUBLICATION/REGULATORY SUBMISSION

(See instructions on reverse)

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS	NOTICE FILE NUMBER <b>Z-2013-1008-04</b>	REGULATORY ACTION NUMBER <b>2014-0213-015</b>	EMERGENCY NUMBER
For use by Office of Administrative Law (OAL) only			
NOTICE		REGULATIONS	

ENDORSED FILED  
IN THE OFFICE OF

2014 MAR -4 PM 2:07

2014 FEB 13 AM 10:43

OFFICE OF  
ADMINISTRATIVE LAW
  
 DEBRA BOWEN  
 SECRETARY OF STATE
AGENCY WITH RULEMAKING AUTHORITY  
State Board of Equalization

AGENCY FILE NUMBER (If any)

**A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)**

1. SUBJECT OF NOTICE	TITLE(S)	FIRST SECTION AFFECTED	2. REQUESTED PUBLICATION DATE
3. NOTICE TYPE <input type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other	4. AGENCY CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)
<b>OAL USE ONLY</b> <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn	ACTION ON PROPOSED NOTICE	NOTICE REGISTER NUMBER <b>2013 422</b>	PUBLICATION DATE <b>10/18/2013</b>

**B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)**

1a. SUBJECT OF REGULATION(S) Computers, Programs, and Data Processing	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)	
<b>SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)</b>	ADOPT
	AMEND 1502
TITLE(S) 18	REPEAL
3. TYPE OF FILING	
<input checked="" type="checkbox"/> Regular Rulemaking (Gov. Code §11346)	<input type="checkbox"/> Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.
<input type="checkbox"/> Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))
<input type="checkbox"/> Emergency (Gov. Code, §11346.1(b))	<input type="checkbox"/> Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)
	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))
	<input type="checkbox"/> File & Print
	<input type="checkbox"/> Other (Specify) _____
	<input type="checkbox"/> Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
	<input type="checkbox"/> Print Only
4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)	
5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)	
<input checked="" type="checkbox"/> Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a))	<input type="checkbox"/> Effective on filing with Secretary of State
	<input type="checkbox"/> §100 Changes Without Regulatory Effect
	<input type="checkbox"/> Effective other (Specify) _____
6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY	
<input type="checkbox"/> Department of Finance (Form STD. 399) (SAM §6660)	<input type="checkbox"/> Fair Political Practices Commission
<input type="checkbox"/> Other (Specify) _____	<input type="checkbox"/> State Fire Marshal
7. CONTACT PERSON Richard E. Bennion	TELEPHONE NUMBER (916) 445-2130
FAX NUMBER (Optional) (916) 324-3984	E-MAIL ADDRESS (Optional) rbennion@boe.ca.gov

8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

SIGNATURE OF AGENCY HEAD OR DESIGNEE 	DATE February 12, 2014
TYPED NAME AND TITLE OF AGENCY Joann Richmond, Chief, Board Proceedings Division	

For use by Office of Administrative Law (OAL) only

ENDORSED APPROVED

MAR 04 2014

Office of Administrative Law

**Final Text of Proposed Amendments to  
California Code of Regulations, Title 18, Section 1502**

**1502. Computers, Programs, and Data Processing.**

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing

industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property (cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax. (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for date entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and

sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media; inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which ~~the~~ prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to

restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

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

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

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

(D) 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 the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a "canned" or prewritten computer program which is held or existing for general or

repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016, Revenue and Taxation Code.

Archives, 1020 O Street, Sacramento, CA 95814, (916) 653-7715. Please have the agency name and the date filed (see below) when making a request.

File# 2014-0213-01  
**BOARD OF EQUALIZATION**  
 Computers, Programs, and Data Processing

This rulemaking action clarifies the tax status of purchases of optional computer program maintenance contracts that include a backup copy of the computer program.

Title 18  
 California Code of Regulations  
 AMEND: 1502  
 Filed 03/04/2014  
 Effective 07/01/2014  
 Agency Contact:  
 Richard E. Bennion (916) 445-2130

File# 2014-0117-02  
**BOARD OF PILOT COMMISSIONERS**  
 Training Programs

This rulemaking by the Board of Pilot Commissioners makes substantive changes to CCR Title 7, by amending section 213 with regard to training programs for new pilots. The regulations are effective on filing with the Secretary of State.

Title 7  
 California Code of Regulations  
 AMEND: 213  
 Filed 02/27/2014  
 Effective 02/27/2014  
 Agency Contact:  
 Amanda Esquivias (916) 324-7514

File# 2014-0123-03  
**DEPARTMENT OF FOOD AND AGRICULTURE**  
 Registration and Fees for Egg Handlers

In this resubmitted rulemaking action, the Department is adopting section 1358.3 into title 3 of the California Code of Regulations. The purpose of this action is to establish procedures for any person engaged in business in this State as an egg producer or handler, and any out of state egg producer or handler selling eggs into California to submit an application for registration and to pay a registration fee to the Department. This regulation contains two forms, a registration form and a renewal form, which are incorporated by reference.

Title 3  
 California Code of Regulations  
 ADOPT: 1358.3  
 Filed 03/05/2014  
 Effective 04/01/2014  
 Agency Contact: Thami Rodgers (916) 698-3276

File# 2014-0213-04  
**DEPARTMENT OF FOOD AND AGRICULTURE**  
 Light Brown Apple Moth Interior Quarantine

This regulatory action clarifies that the requirements for a regulated area are the same as those for a quarantine area.

Title 3  
 California Code of Regulations  
 AMEND: 3434(b)(c)(d)  
 Filed 02/26/2014  
 Effective 04/01/2014  
 Agency Contact: Stephen S. Brown (916) 654-1017

File# 2014-0113-01  
**DEPARTMENT OF HEALTH CARE SERVICES**  
 Two-Plan Model Modification

This rulemaking action by the Department of Health Care Services (DHCS) modifies regulations concerning the "Two-Plan Model" of managed health care. This amendment provides DHCS with the ability to contract with an Alternate Health Care Service Plan (AHCS) to provide medical services to beneficiaries who demonstrate a specific linkage to the AHCS.

Title 22  
 California Code of Regulations  
 AMEND: 53800, 53810 REPEAL: 53830  
 Filed 02/26/2014  
 Effective 04/01/2014  
 Agency Contact: Ben Carranco (916) 440-7766

File# 2014-0211-01  
**DEPARTMENT OF JUSTICE**  
 Conflict-of-Interest Code

This is a Conflict of Interest Code filing that has been approved by FPPC and is being submitted for filing with the Secretary of State and printing only.

Title 11  
 California Code of Regulations  
 AMEND: 20  
 Filed 02/27/2014  
 Effective 03/29/2014  
 Agency Contact: Ted Prim (916) 324-5481

File# 2014-0218-01  
**EDUCATION AUDIT APPEALS PANEL**  
 Supplement to Audits of K-12 LEAs — FY 2013-14

Rulemaking File Index  
Title 18. Public Revenue  
Sales and Use Tax

Regulation 1502 *Computers, Programs, and Data Processing*

1. [Final Statement of Reasons](#)
2. [Updated Informative Digest](#)
3. [Business Tax Committee Minutes, August 13, 2013](#)
  - Minutes
  - Deputy Director memo dated August 2, 2013
  - BTC Agenda
  - Formail Issue Paper Number 13-007
  - Exhibit 1 Revenue Estimate
  - Exhibit 2 Text Regulation 1502
  - Exhibit 3 Report on Discussion of “Site Licenses”
4. [Reporter’s Transcript Business Taxes Committee, August 13, 2013](#)
5. [Estimate of Cost or Savings, August 26, 2013](#)
6. [Economic and Fiscal Impact Statements, October 8, 2013](#)
7. [Notice of Publications](#)
  - Form 400 and Notice, Publication Date October 18, 2013
  - Email sent to Interested Parties, October 18, 2013
  - CA Regulatory Notice Register 2013, Volume No. 42-Z
8. [Notice to Interested Parties, October 18, 2013](#)

[The following items are exhibited:](#)

  - Notice of Hearing
  - Initial Statement of Reasons
  - Proposed Text of Regulation 1502
  - Regulation History
9. [Statement of Compliance](#)
10. [Reporter’s Transcript, Item F3, December 17, 2013](#)
11. [Draft Minutes, December 17, 2013, and Exhibits](#)
  - Notice of Proposed Regulatory Action
  - Initial Statement of Reasons
  - Proposed Text of Regulation 1502
  - Regulation History

VERIFICATION

I, Richard E. Bennion, Regulations Coordinator of the State Board of Equalization, state that the rulemaking file of which the contents as listed in the index is complete, and that the record was closed on February 12, 2014 and that the attached copy is complete.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

February 12, 2014

A handwritten signature in black ink, appearing to read "Richard E. Bennion", written in a cursive style.

Richard E. Bennion  
Regulations Coordinator  
State Board of Equalization

**Final Statement of Reasons for the Adoption of the  
Proposed Amendments to California Code of Regulations,  
Title 18, Section 1502, *Computers, Programs, and Data Processing***

Update of Information in the Initial Statement of Reasons

The factual basis, specific purpose, and necessity for, the problems to be addressed by, and the anticipated benefits from the adoption of the proposed amendments to California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, are the same as provided in the initial statement of reasons. The State Board of Equalization (Board) did not make any changes to the text of the proposed amendments prior to the Board's adoption of the proposed amendments at the conclusion of the December 17, 2013, public hearing.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The adoption of the proposed amendments to Regulation 1502 was not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1502 or the proposed amendments to Regulation 1502.

The Board did not rely on any data or any technical, theoretical, or empirical study, report, or similar document in proposing or adopting the proposed amendments to Regulation 1502 that was not identified in the initial statement of reasons, or which was otherwise not identified or made available for public review prior to the close of the public comment period.

In addition, the factual basis has not changed for the Board's initial determination that the proposed regulatory action will not have a significant adverse economic impact on business and the Board's economic impact assessment, which determined that the Board's proposed regulatory action:

- Will neither create nor eliminate jobs in the State of California;
- Nor result in the elimination of existing businesses;
- Nor create or expand business in the State of California; and
- Will not affect the health and welfare of California residents, worker safety, or the state's environment.

The proposed regulation may affect small business.

#### No Mandate on Local Agencies or School Districts

The Board has determined that the adoption of the proposed amendments to Regulation 1502 does not impose a mandate on local agencies or school districts.

#### Public Comments

The Board did not receive any written comments regarding the proposed regulatory action and no interested parties appeared at the December 17, 2013, public hearing to comment on the proposed regulatory action.

#### Determinations Regarding Alternatives

By its motion on December 17, 2013, the Board determined that no alternative to the proposed amendments to Regulation 1502 would be more effective in carrying out the purposes for which the amendments are proposed, would be as effective and less burdensome to affected private persons than the adopted amendments, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of law.

The Board did not reject any reasonable alternatives to the proposed amendments to Regulation 1502 that would lessen any adverse impact the proposed amendments may have on small business.

No reasonable alternatives have been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

**Updated Informative Digest for the State Board of Equalization’s  
Adoption of Proposed Amendments to California Code of Regulations,  
Title 18, Section 1502, *Computers, Programs, and Data Processing***

On December 17, 2013, the State Board of Equalization (Board) held a public hearing on and unanimously voted to adopt the proposed amendments to California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, without making any changes to the original proposed text of the amendments. There have not been any changes to the applicable laws or the effects of, the objectives of, and anticipated benefits from the adoption of the proposed amendments to Regulation 1502 described in the informative digest included in the notice of proposed regulatory action.

The Board did not receive any written comments regarding the proposed regulatory action and no interested parties appeared at the public hearing on December 17, 2013, to comment on the proposed regulatory action. The informative digest included in the notice of proposed regulatory action provides:

“Current Law

“Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

“The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

entitled to receive, during the contract period, telephone or on-site consultation services.

“Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

“Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)”

*“Need for Clarification”*

“Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

"Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

"As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff's recommendation.

#### *"Interested Parties Process"*

"Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

"Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage

media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

“Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)’s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)’s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

“As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

“Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff’s draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall’s recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*“August 13, 2013, Business Taxes Committee Meeting*

“Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff’s draft amendments to Regulation 1502, subdivision

(f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

“The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

“The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).”

**BOARD OF EQUALIZATION****BUSINESS TAXES COMMITTEE MEETING MINUTES**

HONORABLE BETTY T. YEE, COMMITTEE CHAIR

450 N STREET, SACRAMENTO

MEETING DATE: AUGUST 13, 2013, TIME: 10:00 A.M.

---

**ACTION ITEMS & STATUS REPORT ITEMS****Agenda Item No: 1****Title: Proposed Regulation 1705, *Relief of Liability*.****Issue:**

Should the Board amend Regulation 1705, *Relief of Liability*, to extend to a person section 6596 relief for reliance on a prior audit of another person if they are in the same industry, have a common controlling ownership and shared accounting functions?

**Committee Discussion:**

Staff introduced the issue and explained that the proposed amendments would extend relief of liability in situations involving reliance on the prior audit of another person provided they met the requirements established.

Mr. Joseph Vinatieri representing Anderson Audio Visual addressed the Board. He stated the language of the amendments were narrowly crafted by staff and believes the changes, if approved, will no longer penalize taxpayers for following erroneous advice. He thanked the Board for their time on the matter.

Ms. Mandel asked staff if there are similar regulations in the other tax programs of the Board and whether there is a plan to amend them to be consistent with the Sales and Use Tax program. Ms. Buehler of the Tax Policy Division stated amending regulations from other tax programs would be the next step after the Board approved staff recommendations.

**Committee Action:**

Upon motion by Mr. Horton and seconded by Ms. Mandel, without objection, the Committee approved and authorized for publication amendments to Regulation 1705, *Relief of Liability*. The Members then directed staff to amend similar regulations in other tax and fee programs. A copy of the proposed amendments to the regulation is attached.

**Agenda Item No: 2**

**Title: Proposed Amendments to Regulation 1502, *Computers, Programs, and Data Processing*, and Report on Discussion of “Site Licenses.”**

**Action Item 1**

**Proposed Amendments to Regulation 1502, *Computers, Programs, and Data Processing*.**

**Issue:**

Request approval and authorization to publish proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*, to expressly clarify when a consumer purchases a non-custom computer program (hereafter, prewritten program) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then tax does not apply to the charge for the prewritten program itself, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

**Committee Discussion:**

Staff introduced the topic for discussion. Mr. Mark Nebergall, President, Software Finance and Tax Executives Council, also speaking on behalf of a broad-based California business coalition, expressed his opinion that Regulation 1502 inherently conflicts with the statutes regarding technology transfer agreements. Mr. Nebergall stated that the business community does not object to the proposed amendments but added that sellers of software do not generally package backup copies with optional maintenance contracts. Mr. Nebergall acknowledged that the proposal provides a partial resolution.

**Committee Action:**

Upon motion by Mr. Runner and seconded by Mr. Horton, without objection, the Committee approved and authorized for publication the proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*. A copy of the proposed amendments to Regulation 1502 is attached.

**Discussion Item 1**

**Report on Discussion of Site Licenses.**

**Issue:**

Report on discussions with the software industry regarding whether it is necessary for the Board to amend Regulation 1502, *Computers, Programs, and Data Processing*, to clarify that any charges for “site licenses” to use a non-custom computer program (hereafter, prewritten program) recorded on tangible storage media should be excluded from the measure of tax, and, if so, the extent of the exclusion that should be provided by the regulation.

**Committee Discussion:**

Staff stated that it met with interested parties to try to reach a consensus as to whether and to what extent site licenses should be excluded from the measure of tax. Staff explained that the meetings with interested parties have given staff a better understanding of the term “site license” and some of the common business practices of the software industry. Staff stated that it does not believe that the information provided thus far establishes that there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) that would render the charges for the right to reproduce or copy a program as exempt or excluded from tax. Staff also noted that Regulation 1502, subdivision (f)(1)(B) is consistent with the Legal Department’s historical treatment of site licenses. Furthermore, staff stated that it does not recommend any amendments be made to Regulation 1502 to clarify the application of tax to site licenses or define the term site license.

Staff further explained that there was a general consensus that many site license issues could be effectively addressed by clarifying the record keeping requirements and the audit verification procedures related to the nontaxable sale of prewritten programs transferred via electronic download and load-and-leave transactions. Staff stated that it is continuing to work with the interested parties to provide clarifying guidance in the Audit Manual and is optimistic that an agreement can be reached regarding reasonable audit verification procedures for establishing the nontaxable sale of prewritten programs.

Mr. Nebergall explained there is a fundamental disagreement with staff regarding whether a site license that allows a purchaser to make copies for use on other machines is a separate and distinct right. Mr. Nebergall stated that when tax is applied to all charges it is in conflict with the technology transfer agreement statutes. Mr. Nebergall indicated that the industry is moving away from providing software on tangible storage media and that this issue only arises when the initial sale of the software is on tangible media. Mr. Nebergall also requested that the Board direct staff to work on guidance regarding software sold on tangible personal property other than a separate tangible storage medium (i.e., what staff generally refers to as “embedded software”).

Ms. Therese Twomey, representing the California Taxpayers Association (CalTax), explained that CalTax and the telecommunications and oil industries are working with the Property Tax Department regarding embedded software and expressed the need for guidance for sales and use tax purposes as well.

In response to the speakers’ comments, staff explained that when the object of the contract is tangible personal property, a site license for the right to use that product is not a transfer of a separate and distinct right. With respect to embedded software, staff stated that property taxes and sales and use taxes are separate issues. Staff also noted that it has not expanded discussions beyond the two focused issues and acknowledged there is current ongoing litigation.

Mr. Horton stated that if the issue were bifurcated between an audit and legal issue that a possible solution could be found with audit guidance. Mr. Horton further suggested that staff develop Audit Manual guidance that will provide sample language which may be included in a sales agreement to reflect the parties’ intent to transfer the software electronically without the transfer of tangible personal property. Ms. Yee directed staff to develop a timeline for the proposed audit manual guidelines and, respecting confidentiality, look at the cases currently held in abeyance, pending the technology transfer agreement issue, to determine if they may contain guidance with respect to electronic transfers of software.

/s/ Betty T. Yee

Honorable Betty T. Yee, Committee Chair

/s/ Cynthia Bridges

Cynthia Bridges, Executive Director

BOARD APPROVED

at the September 10, 2013 Board Meeting

/s/ Joann Richmond

Joann Richmond, Chief  
Board Proceedings Division

**Regulation 1705. *Relief of Liability.***

*Reference:* Section 6596, Revenue and Taxation Code.

**(a) IN GENERAL.** A person may be relieved from the liability for the payment of sales and use taxes, including any penalties and interest added to those taxes, when that liability resulted from the failure to make a timely return or a payment and such failure was found by the Board to be due to reasonable reliance on:

(1) Written advice given by the Board under the conditions set forth in subdivision (b) below, or

(2) Written advice in the form of an annotation or legal ruling of counsel under the conditions set forth in subdivision (d) below; or

(3) Written advice given by the Board in a prior audit under the conditions set forth in subdivision (c) below. As used in this regulation, the term "prior audit" means any audit conducted prior to the current examination where the issue in question was examined.

Written advice from the Board may only be relied upon by the person to whom it was originally issued or a legal or statutory successor to that person. Written advice from the Board which was received during a prior audit of the person under the conditions set forth in subdivision (c) below, may be relied upon by the person audited or a person with shared accounting and common ownership with the audited person or by a legal or statutory successor to those persons.

The term "written advice" includes advice that was incorrect at the time it was issued as well as advice that was correct at the time it was issued, but, subsequent to issuance, was invalidated by a change in statutory or constitutional law, by a change in Board regulations, or by a final decision of a court of competent jurisdiction. Prior written advice may not be relied upon subsequent to: (1) the effective date of a change in statutory or constitutional law and Board regulations or the date of a final decision of a court of competent jurisdiction regardless that the Board did not provide notice of such action; or (2) the person receiving a subsequent writing notifying the person that the advice was not valid at the time it was issued or was subsequently rendered invalid. As generally used in this regulation, the term "written advice" includes both written advice provided in a written communication under subdivision (b) below and written advice provided in a prior audit of the person under subdivision (c) below.

**(b) ADVICE PROVIDED IN A WRITTEN COMMUNICATION.**

(1) Advice from the Board provided to the person in a written communication must have been in response to a specific written inquiry from the person seeking relief from liability, or from his

\*\*\*

The proposed amendments contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

or her representative. To be considered a specific written inquiry for purposes of this regulation, representatives must identify the specific person for whom the advice is requested. Such inquiry must have set forth and fully described the facts and circumstances of the activity or transactions for which the advice was requested.

(2) A person may write to the Board and propose a use tax reporting methodology for qualified purchases subject to use tax. If the Board concludes that the reporting method reflects the person's use tax liability for the defined population, then the Board may write to the person approving the use of the reporting method. The approval shall be subject to certain conditions. The following conditions shall be included in the approval:

- (A) The defined population of the purchases that will be included in the reporting method;
- (B) The percentage of purchases of the defined population that is subject to tax;
- (C) The length of time the writing shall remain in effect;
- (D) The definition of a significant or material change that will require rescinding the approved reporting method; and
- (E) Other conditions as required.

The written approval of the use tax reporting methodology is void and shall not be relied upon for the purposes of Revenue and Taxation Code section 6596 if the taxpayer files a claim for refund for tax that had been reported based upon this reporting method.

**(c) WRITTEN ADVICE PROVIDED IN A PRIOR AUDIT.** Presentation of the person's books and records for examination by an auditor shall be deemed to be a written request for the audit report: by the audited person and any person with shared accounting and common ownership with the audited person. If a prior audit report of the person requesting relief contains written evidence which demonstrates that the issue in question was examined, either in a sample or census (actual) review, such evidence will be considered "written advice from the Board" for purposes of this regulation. A census (actual) review, as opposed to a sample review, involves examination of 100% of the person's transactions pertaining to the issue in question. For written advice contained in a prior audit to apply to the person's activity or transaction in question, the facts and conditions relating to the activity or transaction must not have changed from those which occurred during the period of operation in the prior audit. Audit comments, schedules, and other writings prepared by the Board that become part of the audit work papers which reflect that the activity or transaction in question was properly reported and no amount was due are sufficient for a finding for relief from liability, unless it can be shown that the person seeking relief knew such advice was erroneous.

\*\*\*

The proposed amendments contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

For the purposes of this section a person is considered to have shared accounting and common ownership if the person:

- (1) Is engaged in the same line of business as the audited person,
- (2) Has common verifiable controlling ownership of 50% or greater ownership or a common majority shareholder with the audited person, and
- (3) Shares centralized accounting functions with the audited person. The audited person routinely follows the same business practices that are followed by each entity involved. Evidence that may indicate sharing of centralized accounting functions includes, but is not limited to, the following:

- (A) Quantifiable control of the accounting practices of each business by the common ownership or management that dictates office policies for accounting and tax return preparation.
- (B) Shared accounting staff or an outside firm who maintain books and records and prepares sales and use tax returns
- (C) Shared accounting policies and procedures.

These requirements must be established as existing during the periods for which relief is sought. A subsequent written notification stating that the advice was not valid at the time it was issued or was subsequently rendered invalid to any party with shared accounting and common ownership, including the audited party, serves as notification to all parties with shared accounting and common ownership, including the audited party, that the prior written advice may not be relied upon as of the notification date.

**(d) ANNOTATIONS AND LEGAL RULINGS OF COUNSEL.** Advice from the Board provided to the person in the form of an annotation or legal ruling of counsel shall constitute written advice only if:

- (1) The underlying legal ruling of counsel involving the fact pattern at issue is addressed to the person or to his or her representative under the conditions set forth in subdivision (b) above; or
- (2) The annotation or legal ruling of counsel is provided to the person or his or her representative by the Board within the body of a written communication and involves the same fact pattern as that presented in the subject annotation or legal ruling of counsel.

**(e) TRADE OR INDUSTRY ASSOCIATIONS OR FRANCHISORS.** A trade or industry association requesting advice on behalf of its member(s) must identify and include the specific

\*\*\*

The proposed amendments contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

member name(s) for whom the advice is requested for relief from liability under this regulation. A franchisor requesting advice on behalf of its franchisee(s) must identify and include the specific franchisee name(s) for whom the advice is requested for relief from liability under this regulation.

For an identified trade or industry member or franchisee to receive relief based on advice provided in the written communication to the trade or industry association or franchisor, the activity or transactions in question must involve the same facts and circumstances as those presented in the written inquiry by the association or franchisor.

\*\*\*

The proposed amendments contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

**Regulation 1502. *Computers, Programs, and Data Processing.***

*Reference:* Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016, Revenue and Taxation Code.

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to

typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if and), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive,

during the contract period, storage media on which ~~the~~ prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

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

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

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

(D) 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 the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0043  
1-916-445-1441 • FAX 1-916-322-7175  
[www.boe.ca.gov](http://www.boe.ca.gov)

BETTY T. YEE  
First District, San Francisco

SEN GEORGE RUNNER (Ret.)  
Second District, Lancaster

MICHELLE STEEL  
Third District, Orange County

JEROME E. HORTON  
Fourth District, Los Angeles

JOHN CHIANG  
State Controller

CYNTHIA BRIDGES  
Executive Director

August 2, 2013

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the August 13, 2013 Business Taxes Committee meeting. This meeting will address proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*. Staff will also report on discussions with interested parties regarding charges for "site licenses."

Action 1 on the Agenda concerns proposed amendments to Regulation 1502 to clarify the application of tax to optional software maintenance contracts that include a backup copy of the same or similar prewritten program recorded on tangible storage media. Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m.** on **August 13, 2013** in Room 121 at the address shown above.

Sincerely,

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

JLM: rsw

Enclosures

cc: (all with enclosures)

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

(via email)

Mr. David Hunter, Board Member's Office, Fourth District  
Mr. Neil Shah, Board Member's Office, Third District  
Mr. Tim Treichel, Board Member's Office, Third District  
Mr. Alan LoFaso, Board Member's Office, First District  
Ms. Mengjun He, Board Member's Office, First District  
Mr. Sean Wallentine, Board Member's Office, Second District  
Mr. James Kuhl, Board Member's Office, Second District  
Mr. Lee Williams, Board Member's Office, Second District  
Mr. Alan Giorgi, Board Member's Office, Second District  
Ms. Lynne Kinst, Board Member's Office, Second District  
Ms. Natasha Ralston Ratcliff, State Controller's Office  
Ms. Cynthia Bridges (MIC:73)  
Mr. Randy Ferris (MIC:83)  
Mr. Robert Tucker (MIC:82)  
Mr. Bradley Heller (MIC:82)  
Ms. Susanne Buehler (MIC:92)  
Mr. Bradley Miller (MIC:92)  
Ms. Kirsten Stark (MIC:50)  
Mr. Clifford Oakes (MIC:50)  
Mr. Robert Wilke (MIC:50)



**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>(a) In General. “Automatic data processing services” are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.</p> <p>Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as “data processing firms.”</p> <p>(b) Definition of Terms.</p> <p>(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.</p> <p>(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.</p> <p>(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.</p> <p>(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.</p>
---	--

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<b>Action 1 – Staff Recommendation</b>	<p>(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.</p> <p>(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.</p> <p>(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.</p> <p>(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.</p> <p>(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.</p> <p>(10) Program. “Program” is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. “Subdivision” includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. “Problem” means and includes any problem that may be addressed or resolved by a program or subdivision; and the “problem” addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. “Problem” further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.</p> <p>(11) Proof Listing. A tabulated listing of input.</p> <p>(12) Source Documents. A document supplied by a customer of a data processing firm from which basic</p>
--	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>data are extracted (e.g., sales invoice).</p> <p>(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.</p> <p>(c) Basic Applications of Tax.</p> <p>(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.</p> <p>(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property (cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.</p> <p>(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.</p> <p>(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).</p> <p>(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)</p> <p>(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation</p>
---	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<b>Action 1 – Staff Recommendation</b>	<p>1660 for application of tax to leases.)</p> <p>(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)</p> <p>(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.</p> <p>(d) Manipulation of Customer-Furnished Information as Sale or Service.</p> <p>(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.</p> <p>(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).</p> <p>Agreements providing solely for date entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.</p> <p>(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing.</p>
--	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<b>Action 1 – Staff Recommendation</b>	<p>Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 “Mailing-Services.”)</p> <p>(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.</p> <p>(5) Processing of Customer-Furnished Information.</p> <p>(A) “Processing of customer-furnished information” means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.</p> <p>(B) “Processing of customer-furnished information” does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.</p>
--	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.</p> <p>Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.</p> <p>(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.</p> <p>(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if and), cost of materials, and labor cost to produce the items bear to the total job cost.</p> <p>(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer.</p>
---	--

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.</p> <p>(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.</p> <p>(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.</p> <p>(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.</p> <p>(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.</p> <p>(f) Computer Programs.</p> <p>(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.</p> <p>(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for</p>
---	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.</p> <p>(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.</p> <p>(C) Maintenance contracts sold in connection with the sale or lease of <u>a</u> prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which <del>the</del> prewritten program improvements or error corrections have been recorded. <u>The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program.</u> The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.</p> <p>If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.</p> <p>For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of</p>
---	--

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, *Computers, Programs, and Data Processing***

<p><b>Action 1 – Staff Recommendation</b></p>	<p>tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.</p> <p>If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.</p> <p>(D) 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 the installation of the program is a part of the sale of the computer. <u>Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.</u></p> <p>If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.</p> <p>(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.</p> <p>Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable</p>
---	--

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>(2) Custom Programs.</p> <p>(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.</p> <p>(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.</p> <p>When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.</p> <p>(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.</p> <p>(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.</p> <p>(E) A computer program prepared to the special order of a customer to operate for the first time in</p>
---	---

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<p><b>Action 1 – Staff Recommendation</b></p>	<p>connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.</p> <p>(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a “canned” or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.</p> <p>(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.</p> <ol style="list-style-type: none"><li>(1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).</li><li>(2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).</li><li>(3) Consulting services (e.g., study of all or part of a data processing system).</li><li>(4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).</li><li>(5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).</li><li>(6) Providing technical help, analysts, and programmers, usually on an hourly basis.</li><li>(7) Training Services.</li></ol>
---	--

**AGENDA — August 13, 2013 Business Taxes Committee Meeting**  
**Proposed Amendments to Regulation 1502, Computers, Programs, and Data Processing**

<b>Action 1 – Staff Recommendation</b>	<p>(8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)</p> <p>(9) Consultation as to use of equipment.</p> <p>(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."</p> <p>(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)</p>
--	--

Issue Paper Number 13-007



BOARD OF EQUALIZATION  
**KEY AGENCY ISSUE**

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

---

## **Amendments to Regulation 1502, *Computers, Programs, and Data Processing***

### **I. Issue**

Whether the Board should amend Regulation 1502, *Computers, Programs, and Data Processing*, to expressly clarify that when a consumer purchases a non-custom computer program (hereafter, prewritten program) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then tax does not apply to the charge for the prewritten program itself, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

### **II. Alternative 1 – Staff Recommendation**

Approve and authorize publication of Board staff’s recommended amendments to Regulation 1502, as set forth in Exhibit 2. After discussing the proposed amendments with the interested parties and reviewing the interested parties’ comments, Board staff recommends Regulation 1502 be amended to:

- Clarify that maintenance contracts, including “optional” maintenance contracts, sold in connection with the sale or lease of a prewritten program may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. (Proposed amendments to subdivision (f)(1)(C).)
- Expressly provide that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media, and are subject to tax at 50 percent of the lump-sum charge. (Proposed amendments to subdivision (f)(1)(D).)

### **III. Other Alternative Considered**

Do not approve proposed amendments to Regulation 1502.

## IV. Background

### General

During the Board's discussion regarding the issue of whether to amend Regulation 1502, and/or amend Regulation 1507, *Technology Transfer Agreements*, at the January 15, 2013, Business Taxes Committee meeting, the Board authorized staff to conduct additional, focused interested parties meetings on two issues which, based on prior interested parties meetings, appeared to have the best potential for immediate resolution. One of those issues is potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases a prewritten program via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then tax does not apply to the charge for the prewritten program itself, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

The other Regulation 1502-focused issue concerned potential amendments to change the application of tax to charges for site licenses. However, staff is not requesting any action with regards to "site licenses" at this time. Staff's report on the discussions with the software industry regarding site licenses is set forth in Exhibit 3.

### Current Regulation 1502 – Pertaining to Backup Copies

Regulation 1502 prescribes the application of tax to sales of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is "transferred [in an electronic download transaction] 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." Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is "installed by the seller on the customer's computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer."

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because subdivision (f)(1)(C) provided that "If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections,

then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended subdivision (f)(1)(C), to read as follows:

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

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

The 2002 amendments recognized that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services. The 2002 amendments also established the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property.

## **V. Discussion**

### Need for Clarification Regarding Backup Copies

Board staff thought that some retailers were selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, in this particular situation, there may be some confusion as to:

- Whether the charges for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction qualify as nontaxable charges under Regulation 1502, subdivision (f)(1)(D) when customers also purchase such a maintenance contract and are ultimately entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media that the customers bought or leased in the electronic download or load-and-leave transaction; and
- Whether such a maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

The possible confusion is because the first paragraph of Regulation 1502, subdivision (f)(1)(C) specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and staff thought that some retailers were not sure whether such a backup copy is included in that reference. In addition, there are no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, that entitle customers to

receive tangible storage media.

#### Staff's Initial Recommendation to Clarify the Treatment of Backup Copies

Staff believes that the 2002 amendments to Regulation 1502, subdivision (f)(1)(C) were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is taxable. In addition, staff believes that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), is intended to generally describe maintenance contracts, not limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Furthermore, staff did not believe that the Board intended for optional maintenance contracts to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates. And, staff did not and still does not believe that the current provisions of Regulation 1502 are intended to prohibit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Therefore, Board staff proposed amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that maintenance contracts, including optional maintenance contracts, may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also proposed and still proposes amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

#### Interested Parties Comments – Pertaining to Backup Copies

Board staff conducted an interested parties meeting to discuss the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) on March 6, 2013. During the meeting, Mr. Mark Nebergall expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that staff's proposed amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program to their customers as part of an optional maintenance contract. Staff agreed to consider the recommendation to revise its proposed amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data. Staff also explained that the proposed amendments are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law, and that the clarification may lead to changes in software retailers' current business practices.

Board staff also received written comments from Mr. Nebergall in a letter dated March 22, 2013, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the interested parties meeting, and indicated that the California business community does not oppose staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Staff agreed with Mr. Nebergall's suggested revision to staff's initial proposed amendments to Regulation 1502, subdivision (f)(1)(C), and has incorporated the revision into the proposed amendments to Regulation 1502 illustrated in Exhibit 2. In his March 22, 2013, letter, Mr. Nebergall also explained that:

Our concern with the approach set forth in the initial discussion paper is it may be at odds with the technology transfer agreement (“TTA”) statutes, as construed by the recent decision in *Nortel*. . . . The court in *Nortel* held agreements for the sale of pre-written computer programs are eligible for the TTA exclusion. Our concern with the proposal set forth in the initial discussion paper has to do with cases where the [*sic*] both the underlying software and software maintenance are provided electronically or by load and leave and the backup copy of the underlying software is sold separately. By sold “separately,” we mean the backup copy was sold at the same time as the software but appears as a separate item on the invoice or was sold at a later time. In our view, the TTA statutes would require that sales or use tax only be applied to the amount stated on the invoice for the backup copy. . . . [emphasis provided].

Staff explained that consideration of Mr. Nebergall’s comments regarding the application of the TTA statutes (Rev. & Tax Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)), and the Court of Appeal’s decision in *Nortel Networks, Inc., v. State Board of Equalization* (2011) 191 Cal.App.4th 1259 (hereafter, *Nortel*) are beyond the scope of the Regulation 1502-focused interested parties meetings the Board authorized in January 2013.

## **VI. Alternative 1 - Staff Recommendation**

### **A. Description of Alternative 1**

Staff recommends that the Board approve and authorize publication of Board staff’s proposed amendments to Regulation 1502, as set forth in Exhibit 2. After discussing the proposed amendments with the interested parties and reviewing the interested parties’ comments, Board staff recommends Regulation 1502 be amended to:

- Clarify that maintenance contracts, including “optional” maintenance contracts, sold in connection with the sale or lease of a prewritten program may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. (Proposed amendments to subdivision (f)(1)(C).)
- Expressly provide that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media, and are subject to tax at 50 percent of the lump-sum charge. (Proposed amendments to subdivision (f)(1)(D).)

### **B. Pros of Alternative 1**

- Provides clarification to the public and staff that a backup copy of a prewritten program may be included in maintenance contracts sold in connection with the sale or lease of the same prewritten program.
- Clarifies that optional maintenance contracts are taxed the same, even if they include a backup copy of a prewritten program on tangible storage media.
- Maintains a bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

### **C. Cons of Alternative 1**

None.

**D. Statutory or Regulatory Change for Alternative 1**

No statutory change is required. However, staff's recommendation does require adoption of amendments to Regulation 1502.

**E. Operational Impact of Alternative 1**

Staff will publish the proposed amendments to Regulation 1502 and thereby begin the formal rulemaking process. Staff will also notify taxpayers of the regulatory amendments through other outreach efforts.

**F. Administrative Impact of Alternative 1**

**1. Cost Impact**

The workload associated with publishing the regulation, updating manuals and publications, and engaging in other outreach efforts is considered routine. Any corresponding cost would be absorbed within the Board's existing budget.

**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

**G. Taxpayer/Customer Impact of Alternative 1**

Staff believes the proposed amendments will help taxpayers and staff understand that backup copies of prewritten programs may be provided under maintenance contracts. Staff also believes the proposed amendments will clarify that when a taxpayer purchases a prewritten program in a nontaxable electronic download or load and leave transaction, and also purchases an optional maintenance contract that includes a backup copy of the prewritten program recorded on tangible storage media, only 50% of the lump-sum charge for the optional maintenance contract is subject to tax.

**H. Critical Time Frames of Alternative 1**

None.

**VII. Other Alternative**

**A. Description of Alternative 2**

Do not amend Regulation 1502.

**B. Pros of Alternative 2**

The Board would not incur the workload associated with processing and publicizing the amended regulation.

**C. Cons of Alternative 2**

Taxpayers and staff would not have the additional guidance regarding optional maintenance contracts sold in connection with the nontaxable sale of a prewritten program transferred via the electronic download or load and leave process.

**D. Statutory or Regulatory Changes for Alternative 2**

None.

**E. Operational Impact of Alternative 2**

None.

**F. Administrative Impact of Alternative 2**

**1. Cost Impact**

None.

**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

**G. Taxpayer/Customer Impact of Alternative 2**

Without regulatory amendments, there may continue to be confusion with respect to the application of tax to optional maintenance contracts sold in connection with the sale of prewritten programs transferred via the electronic download or load and leave process.

**H. Critical Time Frames for Alternative 2**

None.

**Preparer/Reviewer Information**

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

Current as of: July 25, 2013

## REVENUE ESTIMATE

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

---

## Amendments to Regulation 1502, *Computers, Programs, and Data Processing*

### I. Issue

Whether the Board should amend Regulation 1502, *Computers, Programs, and Data Processing*, to expressly clarify that when a consumer purchases a non-custom computer program (hereafter, prewritten program) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then tax does not apply to the charge for the prewritten program, and tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

### II. Alternative 1 - Staff Recommendation

Approve and authorize publication of Board staff's recommended amendments to Regulation 1502, as set forth in Exhibit 2. After discussing the proposed amendments with the interested parties and reviewing the interested parties' comments, Board staff recommends Regulation 1502 be amended to:

- Clarify that maintenance contracts, including "optional" maintenance contracts, sold in connection with the sale or lease of a prewritten program may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. (Proposed amendments to subdivision (f)(1)(C).)
- Expressly provide that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media, and are subject to tax at 50 percent of the lump-sum charge. (Proposed amendments to subdivision (f)(1)(D).)

### III. Other Alternative(s) Considered

Do not approve proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*.

## **Background, Methodology, and Assumptions**

### **Alternative 1 – Staff Recommendation**

There is nothing in the Staff Recommendation that would impact revenue. The Staff Recommendation clarifies that maintenance contracts, including “optional” maintenance contracts, sold in connection with the sale or lease of a prewritten program may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. In addition, the Staff Recommendation expressly provides that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media, and are subject to tax at 50 percent of the lump-sum charge.

### **Other Alternatives Considered**

Alternative 2 – Do not approve proposed amendments to Regulation 1502.

There is nothing in Alternative 2 that would impact sales and use tax revenue.

## **Revenue Summary**

Alternative 1 – Staff Recommendation does not have a revenue impact.

Alternative 2 – Alternative 2 does not have a revenue impact.

## **Preparation**

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Joe Fitz, Chief, Research and Statistics Section, Legislative and Research Division, and Ms. Susanne Buehler, Chief, Tax Policy Division, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of July 22, 2013.

**Regulation 1502. *Computers, Programs, and Data Processing.***

*Reference:* Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016, Revenue and Taxation Code.

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

**(c) Basic Applications of Tax.**

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

**(d) Manipulation of Customer-Furnished Information as Sale or Service.**

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to

typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive,

during the contract period, storage media on which ~~the~~ prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

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

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

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

(D) 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 the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

## Report on Discussion of “Site Licenses” For Discussion Only

### Issue

Report on discussions with the software industry regarding whether it is necessary for the Board to amend Regulation 1502, *Computers, Programs, and Data Processing*, to clarify that any charges for “site licenses” to use a non-custom computer program (hereafter, prewritten program) recorded on tangible storage media should be excluded from the measure of tax, and, if so, the extent of the exclusion that should be provided by the regulation.

### Background

#### General

During the Board’s discussion regarding the issue of whether to amend Regulation 1502, and/or amend Regulation 1507, *Technology Transfer Agreements*, at the January 15, 2013, Business Taxes Committee (BTC) meeting, the Board authorized staff to conduct additional, focused interested parties meetings on two issues which, based on prior interested parties meetings, appeared to have the best potential for immediate resolution. One of those issues is to try to reach some consensus between industry and staff as to whether and to what extent charges for “site licenses” to use a prewritten program recorded on tangible storage media should be excluded from the measure of tax; and if some consensus can be reached, discuss the text of amendments to Regulation 1502 that would further clarify the treatment of charges for “site licenses.”

#### Current Regulation 1502 – Pertaining to Site Licenses

Neither the Sales and Use Tax Law nor Regulation 1502 define the term “site license.” Regulation 1502, subdivision (f)(1)(A) and (B) currently provide as follows:

Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer’s premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not

apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

The first two sentences in paragraph (B) are intended to explain that tax applies to the entire amount charged to the customer for a prewritten program recorded on tangible storage media, including charges for the increased use of the prewritten program, no matter how the consideration is characterized, and explain that when such consideration is characterized as license fees, then all the license fees, including license fees denoted as “site licenses” are subject to tax. However, the first two sentences in paragraph (B) do not appear to staff to be intended to tax consideration paid for copyright interests that are truly separate and distinct from the sale of a prewritten program recorded on tangible storage media, as opposed to charges for the increased right to use a copyrighted program, as indicated by the third and fourth sentences in paragraph (B). That paragraph explains that tax does not apply to “license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right.”

## **Discussion**

### Clarification of the “Site License” Issue

The Board’s Legal Department has historically concluded that site license fees which are paid so that a purchaser of a prewritten program recorded on tangible storage media may make additional copies of the program and any other charges that are paid so that the purchaser obtains increased use of the prewritten program represent additional taxable consideration for the sale of the prewritten program, except when the third and fourth sentences of Regulation 1502, subdivision (f)(1)(B) apply. (See Sales and Use Tax Annotations 120.0528 (1/27/86) and 120.0552 (1/6/92).) In order to fully address the site license issue, staff first tried to determine whether there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy a prewritten program to which a federal copyright attaches that is so separate and distinct from the sale of the prewritten program recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax. If staff determined that other circumstances did exist, then staff was going to work to clarify Regulation 1502 so that tax continues to apply to the entire amount charged to the customer for the prewritten program recorded on tangible storage media, but does not apply to license fees for the transfer of copyrights that are sufficiently separate and distinct from the prewritten program recorded on tangible storage media.

### Terminology

Staff was not entirely sure that the term “site license” necessarily provided the correct nomenclature for this topic. This is because staff’s preliminary research indicated that the term “site license” generally referred to a license that allows multiple users to use the same program

or copies of the same program at one location or site, and staff thought the discussion of the “site license” issue might include other licenses that are commonly sold to make and use multiple copies of the same program regardless of the location where the copies are used. Therefore, in the second discussion paper regarding proposed amendments to Regulation 1502, staff invited input from the interested parties as to whether they believed this issue should include a broader discussion of “license fees” paid for the right to reproduce or copy a copyrighted program recorded on tangible storage media.

During the April 10, 2013, interested parties meeting, Mr. Mark Nebergall indicated that the software industry continues to use the term “site license,” but that the term is now commonly understood to refer to a license to make and use copies of the same program regardless of the location where the copies are used. In addition, staff received an April 25, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. The letter provides the following comments regarding the term “site license”:

As an initial threshold issue, we note that Regulation 1502 contains no definition of “site license” for prewritten computer programs and if the Regulation is to be amended to specially treat such licenses, a definition should be included as one of the amendments. The term “site license,” as currently used in the software industry, connotes a license that allows the customer to reproduce or copy the program for use by the customer, as opposed to a license that allows the customer to make copies and distribute or resell the copies to the public. The term “site license” is a holdover from the historical practice of licensing software to a customer for use at [a] particular physical location or “site.”

The term “site license,” as used today, is not so restricted; it is used to describe a license that allows the customer to make a certain number of copies, or an unlimited number of copies, with or without limitation as to the physical location of where the copies may be used. In our view, the term “site license,” as currently understood in the industry, is any license of a prewritten computer program that allows the customer to make additional copies of the program for use on more than one computer. We suggest any amendments to Regulation 1502 that will specially treat licenses to reproduce prewritten computer programs for internal use by the customer include a definition along the lines outlined in this letter.

Based upon Mr. Nebergall’s comments, Board staff believes that the term “site license” is useful for purposes of the current discussion regarding fees paid for the right to reproduce or copy a copyrighted prewritten program recorded on tangible storage media for purposes of using the program, as opposed to fees paid for the right to reproduce or copy a copyrighted prewritten program in order for the program to be published and distributed for a consideration to third parties. Board staff also agrees with Mr. Nebergall’s comment that if Regulation 1502 is amended to specifically address the application of tax to charges for “site licenses,” it would be helpful for the amendments to define the term.

In addition, Board staff believes that, for purposes of our current discussion, Mr. Nebergall's April 25, 2013, letter provides two potential working definitions for the term "site license." Mr. Nebergall's letter states that the term site license, "as currently used in the software industry, connotes a license that allows the customer to reproduce or copy the program for use by the customer, as opposed to a license that allows the customer to make copies and distribute or resell the copies to the public." The letter also provides that the term site license, "as currently understood in the industry, is any license of a computer program that allows the customer to make additional copies of the program for use on more than one computer." Board staff determined that the first potential definition is probably a better fit for the current discussion, than the second potential definition, but staff is not necessarily certain that these are the only possible or potentially useful definitions for the term "site license." Therefore, staff also believes that any specific definition for the term should be evaluated to ensure it is consistent with and helps readers understand any potential amendments which would clarify the application of tax to "site licenses." However, as discussed below, Board staff does not agree that it is necessary to clarify the application of tax to "site licenses," so staff is not recommending any amendments to Regulation 1502 and is not recommending that the regulation incorporate a specific definition for the term "site license" at this time.

#### Common Practice in the Industry

Board staff explained that it only has a limited understanding of the types of licenses that are commonly sold by software retailers and the fees that are commonly charged for such licenses. Therefore, in the second discussion paper, Board staff also invited input regarding the scope of the various types of licenses that software retailers commonly sell in retailer-to-household consumer transactions and retailer-to-business consumer transactions involving the transfer of prewritten programs recorded on tangible storage media. Staff also indicated that staff would appreciate any examples industry could provide. Staff thought that a better understanding of the software industry's common practices in this regard might have helped lead to a consensus as to whether there are any circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B), where charges for the right to reproduce or copy a prewritten program recorded on tangible storage media are exempt or excluded from tax.

In his April 25, 2013, letter, Mr. Nebergall provided the following information in response to staff's request for input regarding the software industry's common licensing practices:

With respect to copyrighted computer programs, the Copyright Act confers upon the *owner* of a copy rights to make certain copies for limited, specific purposes. The *owner* of a copy of a computer program is allowed another copy of the computer program, so long as the additional copy "is created as an additional step in the utilization of the computer program in conjunction with a machine and that is it used in or no other manner." See 17 U.S.C. Sec. 117(a)(1). In addition, the Copyright Act permits the *owner* of a copy to make an additional copy for "archival purposes only." See. 17 U.S.C. Sec. 117(a)(2). These rights are understood to allow the *owner* of a copy of a computer program to copy and install the program on the "hard drive" of a computer, and to allow the making of a an additional copy in the RAM of the computer so the computer can make use of the program. In addition, the *owner* of a copy may make a

“back-up” copy of the program without infringing the copyright owner’s exclusive rights.

These rights to make additional copies allowing the program to be used in a computer and for archival purposes are only conferred upon the “owner” of the copy of the program. However, it is not the practice in the software industry for the owners of the copyright in software to conduct transactions with customers that result in the customer becoming the “owner” of any copy of the program. The common method of transferring any rights in the program to the customer is through the use of an “end user license agreement” that conveys no ownership rights in the copy. At all times, the owner of the copyrights in the software retains ownership of any copies the possession of which might be transferred to the customer; title to the copy doesn’t pass to the customer. This distinction is crucial: Without ownership of a copy of the computer program, the customer would receive no rights to make any copies that might be necessary to use the program on a computer, such as the right to make a copy from a storage disk onto the computer’s hard drive, or from the hard drive to the RAM, or any archival copy. See *MAI Systems Corp. v. Peak Computer, Inc.*, 991 F.2d 511, fn.5 (9th Cir. 1993).

It is the practice in the software industry, however, for the end user license agreement to expressly provide the customer with rights to make copies the same as, or similar to, the rights expressly afforded an owner of a copy under Section 117(a) of the Copyright Act; i.e., the right to make copies essential to the use of the software on a computer and/or an archival copy. We are unaware of any practice in the software industry where the purchaser of a software license would not receive sufficient rights to make the copies needed to install and run the software on a computer. A hypothetical possessor of a copy of a computer program unaccompanied by rights to make copies similar to those described in Section 117(a) of the Copyright Act likely would pay very little, if anything, for such a copy. Someone in possession of a copy of a computer program unaccompanied by a license to make copies essential for use of the program on a computer likely has possession of an infringing, illegal copy.

Applying this framework of copyright law to site licenses, it is readily apparent that the rights to make additional copies of the software and to use them on additional computers are rights specified under the Copyright Act. The right to make any additional copies clearly is encompassed by Section 106(1) of the Copyright Act. Someone who is not an owner of a copy of a computer program, absent [an] agreement with the copyright owner, does not receive any rights to make copies essential for use of the program in a computer and to make an archival copy, [as] those rights also are rights reserved to the holder of the copyright under Section 106(1). Thus, site licenses convey significant intangible copyrights to the customer beyond those a simple owner of a copy would obtain by operation of Section 117(a) of the Copyright Act.

It also is clear from a technological standpoint, given the way computers operate, that it is essential for one to obtain the rights to make copies of the software in order to make use of the software. Thus, even with respect to single user licenses, the grant of the right to make copies essential for the use of the software on a computer goes to the very heart of the software license. The copyright aspects of any computer software license are the very essence of the transaction. Without the requisite right to make certain copies, the possessor of the copy of the software would be unable to use the software on a computer without committing copyright infringement.

[¶] . . . [¶]

When a computer program is transferred to a licensee on a physical storage medium, and rights to make copies of the software are included with the license, the TTA statutes provide guidance on how to divide the sales price into the taxable part attributable to the storage medium and the nontaxable part attributable to the intangible copyright. Thus, attention must be paid to the application of the TTA statutes in any amendments to Reg. 1502 providing guidance with respect to the tax treatment of software site licenses.

[heading omitted]

It is common in the software industry for sellers of computer programs to permit licensees to copy to, install on and use licensed software on more than one computer, thus falling within the classic definition of a “site license.” For instance, an examination of the license terms for the copy of Microsoft “Word” used to prepare this letter reveals it is a site license because, in addition to allowing the installation and use of the copy on a desktop computer, it also allows the copying of the software and its installation on one additional portable device. A separate license is thus not needed to load another copy of the program onto a laptop computer.

Thus, site licenses are not restricted to customers who use software in a business. While many consumer software licenses also are site licenses, it is not common for consumer software licenses to allow the consumer to make more copies than are sufficient for personal, family or household use of the software. We believe it would be unusual for a consumer software license to permit the consumer to use software on more than five (5) computers. However, sometimes software licensed to a business will be single user licenses, and not permit the software to be used on more than a single computer. While the typical customer for a software site license is a business, frequently consumers purchase site licenses, and sometimes businesses purchase software that is a single user license. (*Italics in original.*)

As explained in the Third Discussion Paper, Board staff appreciates the additional background information regarding the differences between the rights of an owner of a copy of a copyrighted

prewritten program recorded on tangible storage media and the rights of a person who is a licensee under the various types of licensing agreements the software industry employs. Board staff also appreciates the additional background information regarding some of the industry's common types of licensing agreements.

In the third discussion paper, staff further explained that it found that Federal law recognizes that the “[o]wnership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied.” (17 U.S.C. § 202.) The additional information provided above, emphasizes that a copyrighted program is a material object or product that consumers may only utilize in conjunction with a machine. It also highlights that federal copyright law recognizes that the owner of a copy of a copyrighted program has the inherent right, as the owner of a material object in which a copyrighted work is embodied, to use its copy in conjunction with at least one machine, including making the additional copies that are necessary to use the program for its intended purpose, such as word processing, and making a backup copy, without infringing on the rights of the copyright holder. Therefore, Board staff stated its belief that federal law's treatment of copies of a copyrighted program confirms that the right to make some copies of a copyrighted program so that it can be used for its intended purpose is part of the bundle of rights associated with the ownership of a copy of the program itself, and the owner of a copy is not required to obtain additional copyrights that are separate and distinct from the ownership of the copy just to use the program for its intended purpose. As a result, Board staff still thinks that, when a copy of a copyrighted prewritten program is recorded on tangible storage media, Regulation 1502 correctly provides that tax applies to all of the charges for the copy.

Furthermore, Mr. Nebergall's April 25, 2013, letter clarifies that “it is not the practice in the software industry for the owners of the copyright in software to conduct transactions with customers that result in the customer becoming the ‘owner’ of any copy of the program. The common method of transferring any rights in the program to the customer is through the use of an ‘end user license agreement’ that conveys no ownership rights in the copy.” However, this fact did not lead staff to the same conclusions as Mr. Nebergall because Board staff understands that “where a transferee receives a particular copy of a copyrighted work pursuant to a written agreement, [the courts] consider all of the provisions of the agreement to determine whether the transferee became an owner of the copy or received a license.” (*Vernor v. Autodesk, Inc.* (9<sup>th</sup> Cir. 2010) 621 F.3d 1102, 1109.) Therefore, whether a person is an owner or a licensee is dependent upon all the facts and circumstances of a particular transaction and staff does not necessarily believe it is fruitful to establish a bright-line rule based upon the principle that every consumer of a copyrighted prewritten program will necessarily be a licensee.

Moreover, Board staff does not agree that Mr. Nebergall's April 25, 2013, letter describes all of the rights the owner of a copy of a copyrighted prewritten program would have under all of the facts and circumstances of every potential situation. For example, the courts have applied the doctrines of implied license and equitable estoppel to prevent inequity in situations where the holder of a copyright has created an expectation that the customer may use a copy of a copyrighted work in specific ways, but does not actually grant the customer a license to make the copies essential to the anticipated use. (See, e.g., *Effects Associates, Inc. v. Cohen* (9th Cir. 1990) 908 F.2d 555, *Food Consulting Group, Inc. v. Azzalino* (9th Cir. 2001) 270 F.3d 821,

footnote 10 [providing that “*Effects Associates* stands for the principle that a seller grants a buyer an implied license to use a product for the purpose for which the seller sold it to the buyer”], and *Hadady Corp. v. Dean Witter Reynolds, Inc.* (C.D. Cal. 1990) 739 F.Supp. 1392.) Also, federal law expressly provides broader rights to the owners of copies of copyrighted programs than described in Mr. Nebergall’s letter (see, e.g., 17 U.S.C. § 117), such as the right to sell the copy under specified circumstances. (17 U.S.C. § 117(b).)

In addition, federal law’s treatment of an owner of a copy of a copyrighted prewritten program, seems to indicate to staff, that, at a minimum, there cannot be a separate and distinct transfer of a copyright interest for sales and use tax purposes, unless the transferee actually receives more rights to copy a copyrighted program than would be included in the bundle of rights held by an owner of that copy, who is not the copyright holder, under similar facts and circumstances. And, the information provided does not establish that the software industry’s typical licensing agreements grant business or household consumers of prewritten programs recorded on tangible storage media more rights than the owners of such copies would have absent such agreements.

As a result, Board staff does not believe that the information provided thus far establishes that there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy a copyrighted prewritten program that is so separate and distinct from the sale of the prewritten program recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax.

#### Mr. Nebergall’s April 25, 2013 Proposals

Finally, Mr. Nebergall’s April 25, 2013, letter ends by summarizing the business community’s beliefs regarding site licenses and suggests two possible approaches to the treatment of site licenses, for sales and use tax purposes, that he indicates are more consistent with the business community’s beliefs than the current provisions of Regulation 1502. The letter provides:

First, and to be clear, the business community believes, and has always believed, site licenses for computer programs, when sold on disk and where the price for the disk is separately stated in the agreement, have never been subject to sales and use tax because of their intangible nature. Such was the law before enactment of the TTA statutes or the decision in *Nortel Networks*. That part of the TTA statutes excluding from tax the amount separately stated in the TTA for the intangible property did not represent any change in the law, it represented merely a codification of existing law. Under California sales and use tax law, a reasonable amount separately stated in an agreement for the sale of intangible property is not subject to tax.

If the agreement between the licensor and the licensee separately states an amount for a tangible storage medium sold together with a site license, the taxable amount should be limited to the amount so separately stated, with the balance treated as non-taxable charges for intangible rights to make copies. Regulation 1502 should be amended to reflect this interplay with the TTA statutes.

When the agreement between the licensor and licensee does not separately state an amount for the tangible storage medium, current Regulation 1502(f)(1)(B) provides “tax applies to the entire amount charged to the customer.” As applied to site licenses, this part of Regulation 1502 results in tax applying to nontaxable charges for intangible property [and] is at odds with both the basic law of California and the TTA statutes, which provide ways to separate the taxable and nontaxable components of a site license.

There may be ways to amend Regulation 1502 to bring it closer [to] the basic law in California that sales of intangible property are not subject to tax and not damage the Board’s litigating position post- *Nortel Networks*. Regulation 1502 already provides that sales of so-called “gold masters” are not subject to tax, with any storage medium treated as incidental Reg. 1502(f)(1)(B). A gold master differs from a site license with respect to the use to which the authorized copies of the software will be put. Under a gold master, the copies are to be resold or distributed to the public. Under a site license, the additional copies will be loaded on additional computers owned by the licensee and used instead of being resold.

One possible approach to the application of the sales and use tax to sales of site licenses would be to focus on the number of copies the license permits the licensee to make, and treat licenses permitting the making of a threshold number of copies as site licenses not subject to tax. If the license permitted the making of a number of copies below the threshold, the copyright interest would, as in the case of the treatment of gold masters with respect to the storage medium, be deemed “incidental,” and ignored with the result tax would apply to the entire amount charged to the customer under the first sentence of Reg. 1502(f)(1)(B). While this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502.

Another possible approach to the issue simply would be to apply tax to the amount the licensor would charge for a single user license as fully taxable, with any additional amounts treated as charged for non-taxable intangible rights to make additional copies. This approach would be consistent with the Staff’s position (with which we disagree) that software becomes tangible personal property when sold on a tangible storage medium, but also recognizes the interplay with the TTA statutes on how to divide a TTA into its taxable and nontaxable components when the seller makes separate sales of like tangible personal property without the intangible property. See Secs. 6011(c)(10)(B), 6012(c)(10)(B). Once again, while this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502. In either case, the seller should be allowed an election to treat the sale under the TTA statutes, thereby permitting alignment between a revised

Regulation 1502 and the basic California law that charges for intangible property are not subject to sales or use tax.

Based upon staff's prior comments, Board staff is not ready to agree that there is necessarily a separate and distinct transfer of the right to reproduce or copy a prewritten program recorded on tangible storage media (i.e., separate and distinct from the sale of the prewritten program recorded on tangible storage media itself), merely because the customer receives more than a single-user license with the program.

Furthermore, it seems that consumers purchase prewritten programs for their own use or other consumption in the common sense, and definitely not for resale. It also seems that there is broad recognition that some incidental copying is necessary for a consumer to use a copy of a prewritten program recorded on tangible storage media in conjunction with any machine. And, the information provided does not help staff see how the true object of consumer prewritten program transactions shifts, even incrementally, from the use or other consumption of the prewritten program, to the obtainment of separate and distinct intellectual property rights, simply because the consumer can use the prewritten program in conjunction with more than one machine. For example, the information provided has not given staff a basis to distinguish a transaction that is structured so that the consumer gets one copy of a prewritten program on tangible storage media and the right to use it on 10 machines from a transaction that is structured so that the consumer gets 10 copies of the same program recorded on tangible storage media to be used on one machine, each. This is because the true object of both transactions appears to be the same, that is the use or other consumption of the prewritten program recorded on tangible storage media, and any copying involved in both transaction is incidental to such use. Therefore, Board staff explained that it cannot agree that the information provided thus far necessarily establishes that there is a transfer of the right to reproduce or copy a copyrighted prewritten program that is sufficiently separate and distinct from the sale of the prewritten program recorded on tangible storage media itself, merely because the customer receives the right to make more than a threshold number of copies of the prewritten program for its own use.

Finally, staff explained that staff believes that consideration of Mr. Nebergall's comments regarding the application of the TTA statutes, and the Court of Appeal's decision in *Nortel* are beyond the scope of the Regulation 1502-focused interested parties meetings the Board authorized in January 2013.

#### June Interested Parties Meeting

During the third interested parties meeting on June 5, 2013, there did not appear to be a consensus between industry and staff regarding a need to change the Board's treatment of specific types of site licenses or licenses to use prewritten programs in general and staff explained that based on the information provided thus far, it concluded that there is no need to amend Regulation 1502 to exempt or exclude any charges for site licenses from tax. Mr. Nebergall expressed the software industry's disappointment with staff's conclusion. However, Mr. Nebergall also acknowledged that there was a period of time when the software industry regularly transferred programs to customers that were recorded on tangible storage media, such as disks, and that the discussion of site licenses is mostly applicable to the industry's historical business practices. Mr. Nebergall also indicated that today the software industry's general

practice is to deliver programs to customers electronically. The main issue that generally arises in today's software industry audits is the need to substantiate the nontaxable sale of electronically transferred programs. And, today's software industry audits can be burdensome because auditors often require retailers to prove a negative, that is that they did not transfer any tangible personal property to the customer in each prewritten program transaction being examined. As a result, Mr. Nebergall indicated that the Board could effectively resolve the main sales and use tax issue affecting the software industry's recent and current business practices if staff worked with industry to draft reasonable software industry audit guidelines. Therefore, during the meeting, staff agreed to work with the software industry to try to address the software industry audit issue in amendments to the Audit Manual.

Following the interested parties meeting, Board staff received a June 19, 2013, letter from Mr. Ronald Schrotenboer in response to the third discussion paper. In the letter, Mr. Schrotenboer states that he was involved in discussions with the Board and Board staff at the time the reference to site licenses was added to Regulation 1502. Mr. Schrotenboer states that, at the time, the Board viewed "a site license as being different than the software royalty arrangements. Site license transactions were viewed as end user transactions. Economically, site licenses were viewed as no different than the software licensor providing multiple tangible copies of the software to the customer, which would all be subject to sales tax." Mr. Schrotenboer also states that he believes that this historical treatment is wrong because "the true object of a consumer software transaction shifts to the obtainment of a separate and distinct intellectual property right" when the consumer obtains a site license to "use the software in conjunction with more machines." Therefore, in the letter, Mr. Schrotenboer recommends that Regulation 1502 be amended to exempt payments for the right to make multiple copies from tax. However, Mr. Schrotenboer's letter did not provide any new information that would persuade staff to recommend that the Board change the historical application of tax to charges for site licenses to use a prewritten program recorded on tangible storage media. Staff did not receive any other written comments in response to the third discussion paper.

## **Summary**

The discussions with the software industry and interested parties provided staff with a better understanding of the term "site license" and some of the common business practices of the software industry. However, Board staff does not believe that the information provided thus far affirmatively establishes that there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy a copyrighted prewritten program that is so separate and distinct from the sale of a prewritten program recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax. Furthermore, Regulation 1502, subdivision (f)(1)(B) is consistent with the Legal Department's historical treatment of site licenses. As a result, staff does not recommend any amendments be made to Regulation 1502 to clarify the application of tax to site licenses or define the term site license.

Although there was not an agreement to further clarify the application of tax to site licenses to use prewritten programs recorded on tangible storage media, there was a general consensus at the June 5, 2013, interested parties meeting, that, on a practical level, many site license issues could be effectively addressed by clarifying the record keeping requirements and the audit verification procedures for establishing the nontaxable sale of prewritten programs via electronic download and load-and-leave transactions. This is because the overwhelming majority of today's business-to-business software transactions involve sales of prewritten programs transferred via electronic download, and charges for an electronically downloaded prewritten program, including charges for a site license to use the program in conjunction with multiple devices, are not taxable under Regulation 1502, subdivision (f)(1)(D) if "the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction." Therefore, Board staff is continuing to work with the interested parties on practical guidance for taxpayers and staff, and staff is optimistic that an agreement can be reached regarding practical record keeping requirements and reasonable audit verification procedures for establishing the nontaxable sale of prewritten programs.

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

Current as of July 22, 2013

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N STREET

SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT

AUGUST 13, 2013

BUSINESS TAXES COMMITTEE

REPORTED BY: Kathleen Skidgel

CSR NO. 9039

P R E S E N T

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

For the Committee:

Betty T. Yee  
Chair

Michelle Steel  
Member

Jerome E. Horton  
Member

George Runner  
Member

Marcy Jo Mandel  
Appearing for John  
Chiang, State Controller  
(per Government Code  
Section 7.9)

Joann Richmond  
Chief, Board Proceedings  
Division

Board of Equalization  
Staff:

Susanne Buehler  
Chief, Tax Policy  
Division

Lawrence Mendel  
Tax Counsel III  
Legal Department

Bradley Heller  
Tax Counsel IV  
Legal Department

---oOo---

INDEX OF SPEAKERS

1		
2	SPEAKER	PAGE
3	Joe Vinatieri	5
4	Mark Nebergall	12, 17
5	Therese Twomey	20

---oOo---

- 6
- 7
- 8
- 9
- 10
- 11
- 12
- 13
- 14
- 15
- 16
- 17
- 18
- 19
- 20
- 21
- 22
- 23
- 24
- 25
- 26
- 27
- 28

1 450 N STREET  
2 SACRAMENTO, CALIFORNIA  
3 AUGUST 13, 2013

4 ---oOo---

5 MR. HORTON: Ms. Richmond, our next matter?

6 MS. RICHMOND: Our next item is the  
7 Business Taxes Committee. Ms. Yee is the Chair of  
8 that committee.

9 Ms. Yee.

10 MS. YEE: Uh, thank you, Ms. Richmond.

11 Good morning, uh, Members. Uh, we will now  
12 convene the Business Taxes Committee. There are two  
13 items on the committee agenda today. Item Number 1  
14 is Proposed Revisions to Regulation 1705, relating  
15 to relief from liability.

16 We do have one speaker for this item. Mr.  
17 Vinatieri, would you please come forward, uh, while  
18 the staff introduces the issue.

19 Good morning.

20 MS. BUEHLER: Good morning. I am Susanne  
21 Buehler with the Sales and Use Tax Department, and  
22 we have two agenda items for your consideration this  
23 morning. We will take each agenda item and their  
24 respective action item separately before moving to  
25 the next.

26 With me for Agenda Item 1 is Mr. Lawrence  
27 Mendel from our Legal Department.

28 For this agenda item we request your

1 approval and authorization to publish proposed  
2 amendments to Sales and Use Tax Regulation 1705 for  
3 relief of liability. The proposed amendments extend  
4 Section 6596 relief to a person who relies on advice  
5 provided in a prior audit of another person.

6 The person seeking relief must be engaged  
7 in the same line of business as the audited person,  
8 have a verifiable controlling interest of at least  
9 50 percent, or be a common majority shareholder of  
10 the audited person and have shared accounting  
11 functions with the audited person.

12 The requirements must be established as  
13 existing for all periods in which relief is sought.  
14 In addition, if any written rescission is provided  
15 to the audited person regarding a prior audit, it  
16 will serve as notification to all parties that the  
17 prior written advice may no longer be relied upon.

18 We have one speaker on this item. And  
19 after their presentation, we'd be happy to answer  
20 any questions that you may have.

21 ---oOo---

22 JOE VINATIERI

23 ---oOo---

24 MS. YEE: Thank you very much, Ms. Buehler.  
25 Good morning, Mr. Vinatieri.

26 MR. VINATIERI: Good morning.

27 MS. YEE: Please introduce yourself  
28 formerly for the record. You have two minutes.

1 MR. VINATIERI: I'm Joe Vinatieri on behalf  
2 of Bewley, Lassleben & Miller.

3 It's good to see everyone today. It has  
4 been a while since I've been here and, uh, it's good  
5 to see everyone.

6 I appreciate the opportunity to comment  
7 this morning. I represent Anderson Audio Visual;  
8 this is a case heard by this Board, as I'm sure you  
9 all recall, in Culver City, uh, last September.

10 The Board heard -- held against the  
11 taxpayer in that case but acknowledged the  
12 unfairness of the situation under 6596/1705 and  
13 directed the staff to review the situation and a  
14 possible change in Regulation 1705.

15 Today is the outcome of that effort. And  
16 let me just explain that incorrect advice in the  
17 context of an audit is something that I see fairly  
18 often. Uh, the context is usually you'll have  
19 something written by an auditor, then there's a  
20 follow-up audit. And the new auditor comes in and  
21 says, "Oh, you're doing it incorrectly." And the  
22 taxpayer says, "Well, but, I'm just doing what the  
23 prior auditor told me."

24 And it's something that you're going to  
25 have in a large audit program, unfortunately, but it  
26 does -- does happen. And that's what happened in  
27 this case.

28 Um, the language in front of you today

1 is -- is narrowly crafted. And it recognizes that  
2 where taxpayers have similar businesses and the  
3 ownership is similar, that those businesses may rely  
4 on those audit work papers, even if incorrect, and  
5 they won't be penalized for following those audit  
6 work papers. They're doing what they're told to do,  
7 and that's the whole point of voluntary compliance  
8 and why we have audits. Unfortunately, we have  
9 human beings doing audits and human beings doing --  
10 being taxpayers, and so that you're going to have  
11 mistakes on occasion.

12 So, what you're doing today, candidly, is  
13 correct and it's within the spirit of the Taxpayers'  
14 Bill of Rights. Some of us were around when 6596  
15 was born. And -- and what you are doing today just  
16 carries out the legislative intent and carries out  
17 the intent when this Board did six -- 1705 and took  
18 the context of 6596 into the audit context. That  
19 was very, very important.

20 And I might add, this agency is one of the  
21 few agencies in the country that recognizes prior  
22 erroneous, incorrect advice and -- or reliance  
23 thereon. Many states do not have a statute, let  
24 alone a regulation. So this Board is to be  
25 commended. I know that California gets dinged on  
26 taxpayer fairness a lot of times. But this is one  
27 of the areas where California is a leader.

28 Um, I want to thank the Board. I want to

1 thank the staff for the excellent work that was done  
2 on this because we had to go around and around a  
3 couple of times to -- to get it right. And what you  
4 have in front of you is right, and it's all about  
5 fairness. And we appreciate you doing this, not  
6 only for this -- uh, it's going to affect this  
7 taxpayer, but it's going to affect many other  
8 taxpayers in the State of California for the future.

9 Thank you.

10 MS. YEE: Thank you very much,  
11 Mr. Vinatieri.

12 Um, questions or comments, Members?

13 Ms. Mandel, please.

14 MS. MANDEL: Sure. Um, I can't remember  
15 whether this came up when, um, the meetings were  
16 going on or not, but before us we have 1502 which is  
17 the sales and use tax regu- -- starting early today  
18 with my voice -- regulation. But there are similar  
19 regulations under the sort of conforming laws,  
20 aren't there, for the other programs, the 6596? Do  
21 we have other regulations that are the mirror of  
22 this one for our other programs; I believe we do.

23 MR. MENDEL: Yeah.

24 MS. MANDEL: Yeah.

25 So is there -- is there a plan or thought  
26 about conforming those regs? Did that --

27 MS. BUEHLER: At this point we don't have a  
28 plan. But I think, with the approval of the Board

1 today with this regulation, that would be our next  
2 steps.

3 MS. MANDEL: Okay. Thank you.

4 MS. YEE: Thank you.

5 Other questions or comments, Members?

6 Mister, uh -- Mr. Horton.

7 MR. HORTON: Thank you, Madam Chair.

8 Um, I would just encourage staff to take a  
9 look at the Audit Manual, just to make sure that the  
10 Audit Manual reflects this change, uh, and that our  
11 team members are fully aware of, um, how this  
12 impacts their audit. And to the extent possible, in  
13 order to ensure continuity and synergy, uh, that we  
14 look at doing -- performing concurrent audits, uh,  
15 when we have these -- these holding companies  
16 that -- with wholly owned subsidiaries and so forth,  
17 to the extent possible, and particularly when  
18 there's, uh, similarities at issue. And that we  
19 sort of incorporate this in the Audit Manual  
20 somehow.

21 MS. YEE: Great suggestion. Thank you.

22 Other comments, Members?

23 Hearing none, do we have a motion on this  
24 item?

25 MR. HORTON: So moved.

26 MS. YEE: Okay. We have a motion --

27 MS. MANDEL: Second.

28 MS. YEE: -- by Mr. Horton. Second by

1 Ms. Mandel.

2 Do we want to incorporate further direction  
3 for the staff with respect to other regulations --

4 MR. HORTON: Uh --

5 MS. YEE: -- that may require similar?

6 MR. HORTON: Yes.

7 MS. YEE: Okay. Great.

8 Uh, we have a motion by Mr. Horton. Second  
9 by Ms. Mandel.

10 Without objection, that motion carries.

11 And, uh -- okay. Very good.

12 MS. BUEHLER: All right.

13 MR. VINATIERI: Thank you.

14 MS. YEE: Thank you very much,  
15 Mr. Vinatieri.

16 Our second item is, uh, proposed revisions  
17 to Regulation 1502, relating to computers, programs  
18 and data processing.

19 We have two public speakers on this item.  
20 If they would please come forward. We have, uh,  
21 Mr. Mark Nebergall and Ms. Therese Twomey from  
22 CalTax. Please come forward while we have the, uh,  
23 staff introduce the issue.

24 MS. BUEHLER: For Agenda Item 2,  
25 Mr. Bradley Heller from our Legal Department is  
26 joining me.

27 For this agenda item, we have one action  
28 item and one item for discussions. Both of these

1 items were the subject of separate focused  
2 interested parties meet- -- interested parties  
3 meetings.

4 Action 1 is regarding proposed amendments  
5 to Regulation 1502, Computers, Programs and Data  
6 Processing, to clarify the application of tax to  
7 maintenance contracts sold in connection with  
8 pre-written computer programs.

9 For the discussion item, we will report on  
10 discussions with interested parties regarding  
11 changes for -- charges for site licenses.

12 In Action 1 we request your approval and  
13 authorization to publish proposed amendments to  
14 Sales and Use Tax Regulation 1502. Staff's  
15 recommended amendments include clarifying that  
16 maintenance contracts, including optional contracts,  
17 sold in connection with the sale or lease of a  
18 pre-written computer program may include a backup  
19 copy and, when an optional maintenance contracts are  
20 paired with a nontaxable or electronic download or  
21 load-and-leave transactions, tax applies to 50  
22 percent of the lump sum charge for the maintenance  
23 contract.

24 We do have speakers, and we'd be happy to  
25 answer any questions you have after their  
26 presentation for this agenda item.

27 MS. YEE: Great. Thank you, Ms. Buehler.

28 Uh, let's turn to the speakers. Good

1 morning. If you'll introduce yourselves formerly  
2 for the record. You'll have two minutes each.

3 ---oOo---

4 MARK NEBERGALL

5 ---oOo---

6 MR. NEBERGALL: Sure thing.

7 My name's Mark Nebergall. I'm the  
8 President of the Software Finance and Tax Executives  
9 Council. Uh, I'm also here representing a broad  
10 business coalition that's interested in this -- in  
11 these issues.

12 And just to sort of set the stage, uh, the  
13 whole reason we're here is because a few years ago  
14 the Court of Appeals decided a case called Nortel.  
15 And in response to Nor- -- the Nortel case held that  
16 the -- the Technology Transfer Agreement statutes  
17 applied to sales of, uh, computer software.

18 In response to Nortel, uh, the Board  
19 repealed that part of section -- of Regulation 1507  
20 that said that the TTA statutes did not apply to  
21 computer software.

22 Um, and that raises an inherent conflict  
23 between the provisions of Regulation 1502 that says  
24 that, uh, the measure of the tax applies to all  
25 license fees with respect to software, and you have  
26 the TTA statute that says that you should divide the  
27 measure of the tax between the intangible property  
28 and -- and the tangible storage medium.

1           Uh, the -- the matter on -- with regard to  
2 the amendment of Regulation 1502, uh, partially  
3 resolves the issue as to when a -- a, uh -- a  
4 customer receives a downloaded software and also  
5 receives a backup copy of the disk. The Board  
6 insists that, uh, even though the sale of software  
7 and the download may be a separate and distinct  
8 transaction from the sale of the backup copy, that  
9 the sale of the backup -- separate sale of the  
10 backup copy will taint, for sales tax purposes,  
11 the -- the otherwise nontaxable download.

12           Uh, the business community doesn't have any  
13 objection to the proposed revision that, uh -- uh,  
14 that has been recommended. We just don't feel that  
15 there's a whole lot of sellers out there that  
16 package, uh, backup copies of software with software  
17 maintenance. Typically those were sold as part of a  
18 separate transaction; that is part of the problem.

19           Um, with respect --

20           Is this discussion right now two -- is my  
21 two minutes limited to the -- to the -- to the  
22 Regulation 1502, or are we going to get into the --  
23 the site license issue as well?

24           MS. YEE: Or are we going to -- I'm sorry?

25           MR. NEBERGALL: There's -- there's two  
26 separate issues.

27           MS. YEE: Yes.

28           MR. NEBERGALL: There's the software

1 maintenance, and there's also the, uh, the site  
2 license.

3 MS. YEE: Site licenses?

4 MR. NEBERGALL: Yeah.

5 MS. BUEHLER: We will address the site  
6 licenses after we're done with this.

7 MS. YEE: Yes.

8 MR. NEBERGALL: So I get an extra two  
9 minutes?

10 MS. YEE: Yes. We'll come back to you with  
11 that, yeah.

12 MR. NEBERGALL: Okay. Uh, I will hold my  
13 fire on the site licenses then.

14 MS. YEE: Okay. Very good. Thank you.

15 Uh, next speaker. Good morning.

16 MS. TWOMEY: Good morning. Therese Twomey  
17 with the California Taxpayers Association.

18 Also, I'd like to reserve my comments to  
19 the site license discussion.

20 MS. YEE: Okay. Very well.

21 Um, questions or comments, Members?

22 MS. STEEL: I. --

23 MS. YEE: Ms. Steel.

24 MS. STEEL: I just want to say thank you to  
25 Chairwoman Yee to initiating this because it's about  
26 time to move forward and, you know, something  
27 started.

28 We are now really moving fast as, uh -- as

1 fast as technology's moving forward. So I think  
2 this is about time to do it and we can move little  
3 more -- I mean faster than, you know, catch up with  
4 technology.

5 So thank you very much working on this.  
6 And, you know, we need little, uh, forward --  
7 thinking forward and, you know, catch up with those  
8 technologies and all these licenses, maintenance and  
9 other stuffs. So thank you.

10 MS. YEE: Thank you, Ms. Steel.

11 Other comments or questions, Members?

12 Okay. Um, why don't we go ahead and take  
13 action on this particular issue. Uh, is there a  
14 motion?

15 MR. RUNNER: So move.

16 MS. YEE: Okay. Motion by Mr. Runner. Is  
17 there --

18 MR. HORTON: Second.

19 MS. YEE: -- a second? By Mr. Horton.

20 Without objection, Members?

21 Okay. The staff recommendation on issue  
22 number one is adopted.

23 Uh, why don't we move on to the site  
24 license issue then.

25 MS. BUEHLER: Our final item for discussion  
26 is site licenses. Staff met with interested parties  
27 to reach -- to try to reach a consensus as to  
28 whether, and to what extent, site licenses should be

1 excluded from the measure of tax.

2 The discussions provided staff with a  
3 better understanding of the term "site license" and  
4 some of the common business practices of the  
5 software industry. However, staff does not believe  
6 that the information provided thus far establishes  
7 that there are any other circumstances not already  
8 described in Regulation 1502 subdivision (f)(1)(B)  
9 that would render the charges for the right to  
10 reproduce or copy a program as exempt or excluded  
11 from tax.

12 Furthermore, Regulation 1502 subdivision  
13 (f)(1)(B) is consistent with the Legal Department's  
14 historical treatment of site licenses. As a result,  
15 staff does not recommend any amendments be made to  
16 Regulation 1502 to clarify the application of tax to  
17 site licenses or to define the term "site license."

18 There was a general consensus at the  
19 June 5th, 2013 interested parties meeting that on a  
20 practical level many site license issues could be  
21 effectively addressed by clarifying the  
22 record-keeping requirements and the audit  
23 verification procedures related to the nontaxable  
24 sale of pre-written programs transferred via  
25 electronic download and load-and-leave transactions.

26 Board staff is continuing to work with  
27 interested parties on clarify guidance provided in  
28 the Audit Manual. Staff is optimistic that an

1 agreement can be reached regarding reasonable audit  
2 verification procedures for establishing the  
3 nontaxable sale of pre-written programs.

4 We'd be happy to answer any questions you  
5 may have after this speaker's presentation for this  
6 action item.

7 MS. YEE: Okay. Thank you, Ms. Buehler.

8 Uh, let me go back to the speakers. If,  
9 uh, again, you'll reintroduce yourselves.

10 MR. NEBERGALL: Sure.

11 MS. YEE: And take two minutes each on this  
12 issue.

13 ---oOo---

14 MARK NEBERGALL

15 ---oOo---

16 MR. NEBERGALL: Sure thing.

17 Mark Nebergall, President of the Software  
18 Finance and Tax Executives Council. Uh, also on  
19 behalf of a California business coalition.

20 Um, the business community fundamentally  
21 disagrees, uh, with the -- with the staff on the  
22 site license issue. And in particular, uh, in their  
23 issue paper they state that the staff is not ready  
24 to agree that there's necessarily a separate and  
25 distinct transfer of a right to reproduce software,  
26 uh, in -- in -- in -- when it's sold as a site  
27 license.

28 And just so you know what a site license is

1 and how it's different from a -- a single-use  
2 license, the site license allows the purchaser of  
3 the copy of the software to make copies, additional  
4 copies of the software, for use on other machines.  
5 And we believe that that is, as a matter of law, a  
6 separate and distinct intangible copyright right.

7 And the regulation that says that, uh --  
8 that those are subject to tax on a hundred percent  
9 of the purchase price, is not only wrong, but it's  
10 in conflict with the -- the TTA statutes.

11 And we believe that there should be a  
12 regulation that applies to TTA statutes to site  
13 licenses. And we believe that the further work  
14 should be done on that. And, uh -- but we also  
15 agree that the issue only arises when the initial  
16 copy of the software is sold, uh, on a tangible  
17 storage medium.

18 Very, very few companies these days sell  
19 copies of software on disk. As I'm sure you're all  
20 aware, everybody downloads stuff. At least that's,  
21 you know, the state of affairs today. And, you  
22 know, the business is moving even, you know, towards  
23 delivery of software functionality in the Cloud; so  
24 there's not even any need to download software  
25 anymore.

26 The problem that the business community  
27 encounters is on audit. When software is delivered  
28 electronically, there's been -- there's been

1 requests for the taxpayer to show that no disk was  
2 delivered. And it's very, very difficult to prove a  
3 negative.

4 We've been working with the staff on the  
5 development of some changes to the Audit Manual that  
6 we believe may -- may make a lot of these problems  
7 go away. But it doesn't solve the legal question  
8 of -- of whether a site license, when it's delivered  
9 on a -- when a copy of the software is delivered on  
10 a disk should be subject to tax at one hundred  
11 percent.

12 MS. YEE: Thank you very much.

13 Next speaker, please.

14 MR. NEBERGALL: I've got one more thing --

15 MS. YEE: Oh, I'm sorry.

16 MR. NEBERGALL: -- I'd like to bring up.

17 There's -- there's sort of one other issue  
18 hanging out there that, uh -- and it has to do with  
19 what we call embedded software, where the software  
20 is delivered not on a tangible storage medium but is  
21 included in a -- in a piece of machinery, such as a  
22 computer. We would like to see, uh, the Board  
23 direct the staff to -- to conduct some, uh, some  
24 work on that issue as well. It's -- it's sort of  
25 what I'll call the third issue in the basket of the  
26 Nortel TTA statute issues.

27 MS. YEE: Okay.

28 MR. NEBERGALL: Thank you.

1 MS. YEE: Thank you.

2 ---oOo---

3 THERESE TWOMEY

4 ---oOo---

5 MS. TWOMEY: Therese Twomey with the  
6 California Taxpayers Association.

7 Uh, first of all, we wanted to clarify  
8 that, although the comments made by Mr. Nebergall  
9 represent the software industry, we represent a  
10 broad coalition of telecom communication industry,  
11 the oil refineries, as well as manufacturers, and we  
12 share Mr. Nebergall's concerns about the discussions  
13 and the IP meetings concerning site licenses.

14 Um, at this point we believe that the  
15 discussions, the way they're going, they are  
16 inconsistent with existing law. We'd like the  
17 opportunity to continue working with your staff in  
18 order to ensure that implementation is along the  
19 lines of where the statutes currently remain.

20 Um, with regards to embedded software, I  
21 know that we've been working, um, with Senator  
22 Runner on the property tax side. It's clear that we  
23 need guidance on the property tax side, as well as  
24 the sales tax side, on embedded software.

25 And once again, we look forward to working  
26 with BOE staff on both issues in both areas.

27 MS. YEE: Thank you very much,  
28 Ms. Twomey.

1           Let me go back to, uh, Ms. Buehler and Mr.  
2 Heller. Responses to Mr. Nebergall's comments?

3           MR. HELLER: I guess, in order, I think,  
4 uh -- I guess staff and industry do have a  
5 disagreement about the treatment of site licenses.  
6 And I think it's -- it all -- it very much goes to  
7 our fundamental understanding of what are computer  
8 programs and what are -- what is the object of the  
9 contract when you're purchasing a computer -- or I  
10 should say a pre-written computer program on  
11 tangible storage media and you're buying what  
12 we've -- what we've given the name "site license"  
13 meaning the right to use it on more than one  
14 machine.

15           Meaning -- I think in our discussions that  
16 included the situation where you have the right to  
17 use it on two machines, say, your desktop and your  
18 laptop. And honestly, staff really did not see any  
19 information that -- that indicated that the object  
20 of the contract wasn't the actual program itself and  
21 the use of the program. And that all of the  
22 copying, whatever copying there was, was absolutely  
23 incidental to the use of the program itself. And  
24 that's why we don't think that there's a separate  
25 and distinct transfer.

26           However, we -- you know, we did look at  
27 industry's comments. And we don't -- you know, we  
28 appreciated their participation. We just -- nothing

1 in there convinced us though that there were  
2 something separate and distinct in the site license  
3 situation.

4 And -- and again, uh, you know, we could  
5 keep looking at it. But, at this point, I don't  
6 believe there's any more information that the  
7 industry intends to provide or has that would  
8 convince us differently. And, again, I think it  
9 goes back to the fundamental understanding of what  
10 that -- that computer program is.

11 MS. YEE: Mm-hmm.

12 MR. HELLER: And if it's tangible personal  
13 property and the object of the contract is using  
14 tangible personal property, then staff doesn't see  
15 why the -- the regulation's wrong in saying charges  
16 for the use of tangible personal property are  
17 subject to tax.

18 If you agree with the industry that the  
19 program itself is an intangible, then any charges  
20 for copying your intangible or using your intangible  
21 I would -- you might agree with them were not  
22 subject to tax. But staff can't agree with that.

23 Um, let's see, with regard to, um, embedded  
24 software, that really was not an issue that was  
25 assigned to staff. But I think that also, again,  
26 completely relates to how you view the software  
27 itself.

28 Essentially, if -- if software transferred

1 on tangible storage media is tangible personal  
2 property, then we don't know how we could see that  
3 software that's embedded in actual tangible personal  
4 property isn't tangible personal property itself.  
5 Meaning, like, everything that's included in the box  
6 that your computer seems tangible to staff, and  
7 we've found no evidence to indicate otherwise. And  
8 that in this area of property tax law and sales and  
9 use tax law are just different in that respect.

10 MS. YEE: Right.

11 MR. HELLER: At least to this point.

12 And then, um, in addition though, staff is  
13 very -- well, I should say agrees with industry that  
14 today's business practices really generally don't  
15 involve the transfer of programs on tangible storage  
16 media when they're sold with broad site licenses,  
17 for like large companies. And we do think we can be  
18 successful in, uh, drafting Audit Manual guidelines  
19 that will hopefully eliminate -- or I should say  
20 make it more efficient so that we aren't spending  
21 more time auditing transfer -- electronic transfers  
22 and we're focusing on transactions where there's  
23 actually a transfer of tangible personal property  
24 involved.

25 Um, beyond that though, I would say also,  
26 staff has really not tried to engage in discussions  
27 of Technology Transfer Agreements beyond the two  
28 focused issues, um, that were assigned to the

1 Business Taxes Committee. And mainly just because  
2 the Board is currently engaged in litigation  
3 regarding many of those issues and we're waiting to  
4 see what guidance we get from the -- the courts.

5 MS. YEE: Okay. Thank you, Mr. Heller.

6 Uh, let me turn to Mr. Horton, but I think  
7 with respect to the issue about embedded software,  
8 Senator Runner, I'm going to look to you for, you  
9 know, just maybe a --

10 MR. RUNNER: I think -- again, I think  
11 we're trying to define the difference between  
12 embedded software on a sales tax issue and on a  
13 property tax issue.

14 MS. YEE: Right.

15 MR. RUNNER: So I think, you know, the  
16 issue that we've been dealing with on the property  
17 tax issue. I think the nature of this discussion is  
18 more on the sales tax --

19 MS. YEE: Yeah.

20 MR. RUNNER: -- side.

21 MS. YEE: I think we're all searching to  
22 see what process may be instructive --

23 MR. RUNNER: Right.

24 MS. YEE: -- to the other. So I -- I  
25 didn't know if you wanted to maybe, uh, agendize an  
26 update on that for the next, you know, Board  
27 meeting, but it's --

28 MR. RUNNER: We -- we certainly can. We

1 obviously have been working with both industry and  
2 also assessors on -- on -- on that issue.

3 There's -- again, it's a --

4 MS. YEE: Yeah.

5 MR. RUNNER: It's a tough issue to find  
6 some common ground on.

7 MS. YEE: Right.

8 MR. RUNNER: And it's certainly an ongoing  
9 discussion.

10 MS. YEE: Okay. Very good. Thank you.

11 Mr. Horton.

12 MR. HORTON: I think Mr. Heller may have  
13 focused us in his comments, in that we may want to  
14 bifurcate these issues. Uh, one being under the  
15 umbrella of an audit issue, and then the other a  
16 legal issue. Uh, because relative to the legal  
17 position in -- in the Nortel case, I don't know that  
18 there's a need for a change. And particularly when  
19 you have, in today's technology, you can just walk  
20 by a phone and transfer information.

21 And so, um, it is relatively easy to do  
22 that. But the complexity of having to prove that  
23 could be a double negative, or it could be as simple  
24 of the Board and the industry coming to an agreement  
25 as to what language could be codified in the  
26 contract in order to reflect that, um -- that no  
27 tangible personal property is transferred or  
28 intended to be transferred in the acts of the -- of

1 the purchaser.

2 We can't control that. I mean, as a  
3 retailer, you can't control what the purchaser  
4 ultimately does and how they do that. But given  
5 modern technology, I could -- you know, you could  
6 transfer a program to -- with the push of a button,  
7 without the use of any tangible personal property.

8 So, uh, I think if we bifurcated, we could  
9 probably find the solution to the problem on the  
10 audit side.

11 MS. YEE: Thank you, Mr. Horton.

12 Other comments, Members?

13 Let me weigh in a little bit on this. Uh,  
14 I -- I agree with you, Mr. Horton, for the most  
15 part. What I'm concerned about is really, uh,  
16 obviously looking at the fact that we have still  
17 related litigation in this area.

18 MR. HORTON: Mm-hmm.

19 MS. YEE: Uh, I'm wondering if what might  
20 be instructive to us in terms of Audit Manual  
21 changes is to look at, uh, I think some of the  
22 audits that have been put on hold that are pending  
23 that have some, uh -- well, pending resolution of  
24 the Technology Transfer Agreement discussion, but  
25 whether looking at some of those audits may provide  
26 some guidance to us.

27 And I do want to put a little bit more of a  
28 timeline and process on how we look at some of these

1 Audit Manual changes. I think ongoing engagement  
2 with industry is always good. Uh, I -- I may want  
3 to formalize this process a little bit more just  
4 because, uh, it -- it seems to kind of keep hanging  
5 out there. And obviously with the sensitivity about  
6 other issues that are unresolved, but it seems to be  
7 a good place to start might be other audits that  
8 have been held in abeyance pending the TTA  
9 discussion and whether that can provide us any  
10 guidance with respect to the electronic transactions  
11 and -- and what may, uh, be appropriate for Audit  
12 Manual changes.

13 Other comments, Members?

14 Okay. Um, so I -- I'm going to ask the  
15 staff to come back and propose a timeline and just  
16 maybe, uh, put a little bit more clarification on  
17 the process for the Audit Manual changes. And then,  
18 uh, if there could be some look -- obviously, um,  
19 respecting confidentiality -- of what some of the  
20 pending audits may, uh, entail that could help guide  
21 this process would be helpful.

22 MS. BUEHLER: Will do.

23 MS. YEE: Okay.

24 MR. HORTON: Madam Chair, if I may.

25 Um, I like -- I would also like staff to --  
26 to -- to see if we can develop, uh, some safe harbor  
27 language for the industry, uh, that is acceptable  
28 from an audit perspective, that brings clarity, uh,

1 for the industry and, uh -- uh, in -- in regards to  
2 subsequent audits.

3 MS. YEE: Thank you.

4 MR. HORTON: Thank you, Madam Chair.

5 MS. YEE: All right. Without any further  
6 comment --

7 Very good. Thank you. Thank you to staff,  
8 thank you to the interested parties. The Business  
9 Taxes Committee is, uh, hereby adjourned.

10 MR. NEBERGALL: Thank you.

11 MS. YEE: Thank you.

12 ----oOo----

13

14

15

16

17

18

19

20

21

22

23

24

25

26

27

28

REPORTER'S CERTIFICATE

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

State of California )  
 ) ss  
County of Sacramento )

I, KATHLEEN SKIDGEL, Hearing Reporter for the California State Board of Equalization certify that on August 13, 2013 I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that the preceding pages 1 through 28 constitute a complete and accurate transcription of the shorthand writing.

Dated: September 3, 2013

*Kathleen Skidgel*



KATHLEEN SKIDGEL, CSR #9039  
Hearing Reporter

**ESTIMATE OF COST OR SAVINGS RESULTING  
FROM PROPOSED REGULATORY ACTION**

**Proposed Amendment of Sales and Use Tax Regulation 1502, *Computers, Programs, and Data Processing***

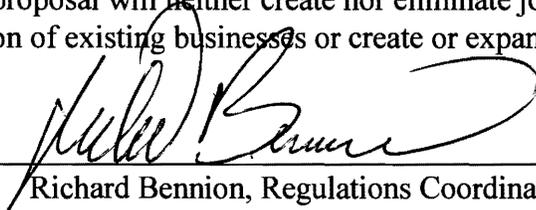
STATEMENT OF COST OR SAVINGS FOR NOTICE OF PUBLIC HEARING

The State Board of Equalization has determined that the proposed action does not impose a mandate on local agencies or school districts. Further, the Board has determined that the action will result in no direct or indirect cost or savings to any State agency, any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code or other non-discretionary cost or savings imposed on local agencies, or cost or savings in Federal funding to the State of California.

The cost impact on private persons or businesses will be insignificant. This proposal will not have a significant adverse economic impact on businesses.

This proposal will not be detrimental to California businesses in competing with businesses in other states.

This proposal will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses or create or expand business in the State of California.

Statement  
Prepared by  Date 8-26-13  
Richard Bennion, Regulations Coordinator

Approved by  Date 8/26/13  
Randy Ferris, Chief Counsel

**If Costs or Savings are Identified, Signatures of Chief, Fiscal Management Division, and Chief, Board Proceedings Division, are Required**

Approved by \_\_\_\_\_ Date \_\_\_\_\_  
Chief, Financial Management Division

Approved by \_\_\_\_\_ Date \_\_\_\_\_  
Chief, Board Proceedings Division

**NOTE: SAM Section 6660 requires that estimates resulting in cost or savings be submitted for Department of Finance concurrence before the notice of proposed regulatory action is released.**

**ECONOMIC AND FISCAL IMPACT STATEMENT**

**(REGULATIONS AND ORDERS)**

ST 399 (REV. 12/2008)

*See SAM Section 6601 - 6616 for Instructions and Code Citations*

DEPARTMENT NAME State Board of Equalization	CONTACT PERSON Rick Bennion	TELEPHONE NUMBER 916-445-2130
DESCRIPTIVE TITLE FROM NOTICE REGISTER OR FORM 400 Title 18, Section 1502, Computers, Programs, and Data ProcessingFood Products		NOTICE FILE NUMBER Z

**ECONOMIC IMPACT STATEMENT**

**A. ESTIMATED PRIVATE SECTOR COST IMPACTS (Include calculations and assumptions in the rulemaking record.)**

1. Check the appropriate box(es) below to indicate whether this regulation:

- a. Impacts businesses and/or employees
- b. Impacts small businesses
- c. Impacts jobs or occupations
- d. Impacts California competitiveness
- e. Imposes reporting requirements
- f. Imposes prescriptive instead of performance
- g. Impacts individuals
- h. None of the above (Explain below. Complete the Fiscal Impact Statement as appropriate.)

h. (cont.) Please see the attached .

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: \_\_\_\_\_ Describe the types of businesses (Include nonprofits.): \_\_\_\_\_

Enter the number or percentage of total businesses impacted that are small businesses: \_\_\_\_\_

Enter the number of businesses that will be created: \_\_\_\_\_ eliminated: \_\_\_\_\_

Explain: \_\_\_\_\_

4. Indicate the geographic extent of impacts:  Statewide  Local or regional (List areas.): \_\_\_\_\_

5. Enter the number of jobs created: \_\_\_\_\_ or eliminated: \_\_\_\_\_ Describe the types of jobs or occupations impacted: \_\_\_\_\_

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

Yes  No If yes, explain briefly: \_\_\_\_\_

**B. ESTIMATED COSTS (Include calculations and assumptions in the rulemaking record.)**

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? \$ \_\_\_\_\_

a. Initial costs for a small business: \$ \_\_\_\_\_ Annual ongoing costs: \$ \_\_\_\_\_ Years: \_\_\_\_\_

b. Initial costs for a typical business: \$ \_\_\_\_\_ Annual ongoing costs: \$ \_\_\_\_\_ Years: \_\_\_\_\_

c. Initial costs for an individual: \$ \_\_\_\_\_ Annual ongoing costs: \$ \_\_\_\_\_ Years: \_\_\_\_\_

Describe other economic costs that may occur: \_\_\_\_\_

**ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 12/2008)**

2. If multiple industries are impacted, enter the share of total costs for each industry: \_\_\_\_\_

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. (Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.): \$ \_\_\_\_\_

4. Will this regulation directly impact housing costs?  Yes  No If yes, enter the annual dollar cost per housing unit: \_\_\_\_\_ and the number of units: \_\_\_\_\_

5. Are there comparable Federal regulations?  Yes  No Explain the need for State regulation given the existence or absence of Federal regulations: \_\_\_\_\_

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: \$ \_\_\_\_\_

---

**C. ESTIMATED BENEFITS (Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)**

---

1. Briefly summarize the benefits that may result from this regulation and who will benefit: \_\_\_\_\_

2. Are the benefits the result of:  specific statutory requirements, or  goals developed by the agency based on broad statutory authority?

Explain: \_\_\_\_\_

3. What are the total statewide benefits from this regulation over its lifetime? \$ \_\_\_\_\_

---

**D. ALTERNATIVES TO THE REGULATION (Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)**

---

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: \_\_\_\_\_

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: \$ _____	Cost: \$ _____
Alternative 1:	Benefit: \$ _____	Cost: \$ _____
Alternative 2:	Benefit: \$ _____	Cost: \$ _____

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: \_\_\_\_\_

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs?  Yes  No

Explain: \_\_\_\_\_

---

**E. MAJOR REGULATIONS (Include calculations and assumptions in the rulemaking record.) Cal/EPA boards, offices, and departments are subject to the following additional requirements per Health and Safety Code section 57005.**

---

ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 12/2008)

1 Will the estimated costs of this regulation to California business enterprises exceed \$10 million?  Yes  No (If No, skip the rest of this section.)

2. Briefly describe each equally as an effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

Alternative 1: \_\_\_\_\_

Alternative 2: \_\_\_\_\_

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation: \$ \_\_\_\_\_ Cost-effectiveness ratio: \$ \_\_\_\_\_

Alternative 1: \$ \_\_\_\_\_ Cost-effectiveness ratio: \$ \_\_\_\_\_

Alternative 2: \$ \_\_\_\_\_ Cost-effectiveness ratio: \$ \_\_\_\_\_

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT (Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

a. is provided in \_\_\_\_\_, Budget Act of \_\_\_\_\_ or Chapter \_\_\_\_\_, Statutes of \_\_\_\_\_

b. will be requested in the \_\_\_\_\_ Governor's Budget for appropriation in Budget Act of \_\_\_\_\_  
(FISCAL YEAR)

2. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

a. implements the Federal mandate contained in \_\_\_\_\_

b. implements the court mandate set forth by the \_\_\_\_\_  
court in the case of \_\_\_\_\_ vs. \_\_\_\_\_

c. implements a mandate of the people of this State expressed in their approval of Proposition No. \_\_\_\_\_ at the \_\_\_\_\_  
election; (DATE)

d. is issued only in response to a specific request from the \_\_\_\_\_  
\_\_\_\_\_, which is/are the only local entity(s) affected;

e. will be fully financed from the \_\_\_\_\_ authorized by Section \_\_\_\_\_  
(FEES, REVENUE, ETC.)  
\_\_\_\_\_ of the \_\_\_\_\_ Code;

f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit;

g. creates, eliminates, or changes the penalty for a new crime or infraction contained in \_\_\_\_\_

3. Savings of approximately \$ \_\_\_\_\_ annually.

4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law regulations.

**ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 2-98)**

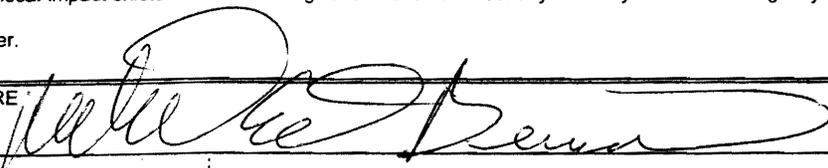
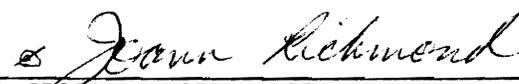
5. No fiscal impact exists because this regulation does not affect any local entity or program.
6. Other.

**B. FISCAL EFFECT ON STATE GOVERNMENT** *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year. It is anticipated that State agencies will:
- a. be able to absorb these additional costs within their existing budgets and resources.
- b. request an increase in the currently authorized budget level for the \_\_\_\_\_ fiscal year.
2. Savings of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any State agency or program.
4. Other.

**C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS** *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
2. Savings of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.
4. Other.

SIGNATURE: 	TITLE: Regulations Coordinator
AGENCY SECRETARY <sup>1</sup> APPROVAL/CONCURRENCE: 	DATE: 10/8/13
DEPARTMENT OF FINANCE <sup>2</sup> APPROVAL/CONCURRENCE:  Exempt under SAM section 6660	DATE:

1. The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.
2. Finance approval and signature is required when SAM sections 6600-6670 require completion of the Fiscal Impact Statement in the STD. 399.

**Attachment to Economic and Fiscal Impact  
Statement (STD. 399 (Rev. 12/2008)) for the Proposed Amendments to  
California Code of Regulations, Title 18, Section 1502,  
*Computers, Programs, and Data Processing***

Subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The State Board of Equalization's (Board's) proposed amendments to subdivision (f)(1)(C) and (D) of Regulation 1502 clarify that, under existing law:

- A backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same or similar prewritten program;
- Tax still applies to 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchaser to receive tangible storage media, even if a backup copy of a prewritten program is recorded on the tangible storage media; and
- An optional maintenance contract, subject to tax at 50 percent of the lump-sum charge, may be appropriately paired with a separate nontaxable electronic download or load-and-leave transaction without changing the way tax applies to the electronic download or load-and-leave transaction.

Therefore, the proposed amendments do not change the taxation of prewritten programs or optional maintenance contracts under existing law.

The proposed amendments to Regulation 1502 make it clear that software retailers may include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with separate nontaxable electronic download or load-and-leave transactions, or both. However, the proposed amendments do not require that software retailers include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts or pair taxable optional maintenance contracts with nontaxable download or load-and-leave transactions. Therefore, the proposed amendments do not impose any costs on software retailers.

Further, the Board understands that, in 2013, software retailers generally sell or lease prewritten programs in nontaxable download or load-and-leave transactions. The Board understands that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program recorded on tangible storage media to their customers as part of an optional maintenance contract. And, the Board only anticipates that some retailers will choose to include backup copies of prewritten programs recorded on tangible storage media in some of their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with some of their separate nontaxable electronic download or load-and-leave transactions, or both if there is a business reason for doing so. Therefore, the proposed amendments to Regulation 1502 will not have a significant positive or negative effect on software retailers' current business practices, and the Board does not

anticipate that software retailers will make significant changes to their current business practices solely due to the proposed clarifying amendments to Regulation 1502.

Furthermore, the Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

Therefore, based upon the foregoing information and all of the information in the rulemaking file, the Board is not aware of any cost impacts that a representative private person or business, such as a software consumer or retailer, would necessarily incur in reasonable compliance with the proposed regulatory action, and the Board has determined that the proposed amendments to Regulation 1502:

- Will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states;
- Will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California;
- Will not have a significant effect on housing costs;
- Will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California; and
- Will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

Finally, Regulation 1502 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

**NOTICE PUBLICATION/REGULATIONS SUBMISSION**(See instructions on  
reverse)

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS	NOTICE FILE NUMBER <b>Z-2013-1008-04</b>	REGULATORY ACTION NUMBER	EMERGENCY NUMBER
------------------	---	--------------------------	------------------

For use by Office of Administrative Law (OAL) only

**RECEIVED FOR FILING PUBLICATION DATE**

OCT 08 '13    OCT 18 '13

Office of Administrative Law  
NOTICE

REGULATIONS

AGENCY WITH RULEMAKING AUTHORITY  
State Board of Equalization

AGENCY FILE NUMBER (if any)

**A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)**

1. SUBJECT OF NOTICE Computers, Programs, and Data Processing		TITLE(S) 18	FIRST SECTION AFFECTED 1502	2. REQUESTED PUBLICATION DATE October 18, 2013
3. NOTICE TYPE <input checked="" type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other		4. AGENCY CONTACT PERSON Richard E. Bennion	TELEPHONE NUMBER (916) 445-2130	FAX NUMBER (Optional) (916) 324-3984
OAL USE ONLY <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn	ACTION ON PROPOSED NOTICE		NOTICE REGISTER NUMBER	PUBLICATION DATE

**B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)**

1a. SUBJECT OF REGULATION(S)	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
------------------------------	--

2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)

SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)	ADOPT
	AMEND
	REPEAL
TITLE(S)	

3. TYPE OF FILING

<input type="checkbox"/> Regular Rulemaking (Gov. Code §11346)	<input type="checkbox"/> Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))	<input type="checkbox"/> Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
<input type="checkbox"/> Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)	<input type="checkbox"/> Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)	<input type="checkbox"/> File & Print	<input type="checkbox"/> Print Only
<input type="checkbox"/> Emergency (Gov. Code, §11346.1(b))		<input type="checkbox"/> Other (Specify) _____	

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

<input type="checkbox"/> Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a))	<input type="checkbox"/> Effective on filing with Secretary of State	<input type="checkbox"/> §100 Changes Without Regulatory Effect	<input type="checkbox"/> Effective other (Specify) _____
---	--	---	--

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

<input type="checkbox"/> Department of Finance (Form STD. 399) (SAM §6660)	<input type="checkbox"/> Fair Political Practices Commission	<input type="checkbox"/> State Fire Marshal
<input type="checkbox"/> Other (Specify) _____		

7. CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)	E-MAIL ADDRESS (Optional)
-------------------	------------------	-----------------------	---------------------------

8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

For use by Office of Administrative Law (OAL) only

SIGNATURE OF AGENCY HEAD OR DESIGNEE	DATE
TYPED NAME AND TITLE OF SIGNATORY	

## **Notice of Proposed Regulatory Action**

### **The State Board of Equalization Proposes to Adopt Amendments to California Code of Regulations, Title 18, Section 1502, *Computers, Programs, and Data Processing***

#### NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, which prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a prewritten program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

#### PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov) at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

#### AUTHORITY

RTC section 7051

#### REFERENCE

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016

## INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

### Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting

periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

*Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that

expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff's recommendation.

### *Interested Parties Process*

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle

customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

#### NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

#### NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

## NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

## NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

## RESULTS OF THE ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

## NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

## DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

## CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at

[Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov), or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

#### WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1502. The Board will only consider written comments received by that time.

#### AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

#### SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such

changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

#### AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

## Bennion, Richard

---

**From:** State Board of Equalization - Announcement of Regulatory Change  
<Legal.Regulations@BOE.CA.GOV>  
**Sent:** Friday, October 18, 2013 2:31 PM  
**To:** BOE\_REGULATIONS@LISTSERV.STATE.CA.GOV  
**Subject:** State Board of Equalization - Announcement of Regulatory Change 1502

The State Board of Equalization proposes to adopt amendments to Regulation 1502, *Computers, Programs, and Data Processing*. A public hearing regarding the proposed amendments will be held in Room 121, 450 N Street, Sacramento, at 10:00 a.m., or as soon thereafter as the matter may be heard, on Tuesday, December 17, 2013.

The proposed amendments to Regulation 1502 clarify that a maintenance contract may provide that the purchaser is entitled to receive a backup copy of a prewritten program recorded on tangible storage media and that a taxable optional maintenance contract may be appropriately paired with a nontaxable electronic download or load-and-leave transaction.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link:  
[http://www.boe.ca.gov/regs/reg\\_1502\\_2013.htm](http://www.boe.ca.gov/regs/reg_1502_2013.htm)

Questions regarding the substance of the proposed amendments should be directed to Mr. Bradley Heller, Tax Counsel IV, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), telephone (916) 323-3091, or FAX (916) 323-3387.

Written comments for the Board's consideration, notices of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed regulatory action should be directed to Mr. Rick Bennion, Regulations Coordinator, telephone (916) 445-2130, fax (916) 324-3984, e-mail [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov) or by mail to: State Board of Equalization, Attn: Rick Bennion, MIC: 30, P.O. Box 942879-0080, Sacramento, CA 94279-0080.

Please DO NOT REPLY to this message, as it was sent from an "announcement list."

Subscription Information: To unsubscribe from this list please visit the page: <http://www.boe.ca.gov/aprc/index.htm>

Privacy Policy Information: Your information is collected in accordance with our Privacy Policy  
<http://www.boe.ca.gov/info/privacyinfo.htm>

Technical Problems: If you cannot view the link included in the body of this message, please contact the Board's webmaster at [webmaster@boe.ca.gov](mailto:webmaster@boe.ca.gov)

## Bennion, Richard

---

**From:** BOE-Board Meeting Material  
**Sent:** Friday, October 18, 2013 9:34 AM  
**To:** Alonzo, Mary Ann (Legal); Angeja, Jeff (Legal); Angeles, Joel; Armenta, Christopher; Baetge, Michelle; Bartolo, Lynn; Bennion, Richard; Benson, Bill; Bisauta, Christine (Legal); Blake, Sue; BOE-Board Meeting Material; Boyle, Kevin; Bridges, Cynthia; Chung, Sophia (Legal); Cruz, Giovan; Davis, Toya P.; Delgado, Maria; Duran, David; Elliott, Claudia; Epolite, Anthony (Legal); Ferris, Randy (Legal); Ford, Ladeena L; Garcia, Laura; Gau, David; Gilman, Todd; Giorgi, Alan; Giorgi, Dolores; Goehring, Teresa; Hale, Mike; Hamilton, Tabitha; Hanohano, Rebecca; Harvill, Mai; He, Mengjun; Heller, Bradley (Legal); Hellmuth, Leila; Herrera, Cristina; Holmes, Dana; Hughes, Shellie L; Jacobson, Andrew; Kinkle, Sherrie L; Kinst, Lynne; Kruckenberg, Kendra; Kuhl, James; Lambert, Robert (Legal); Levine, David H. (Legal); LoFaso, Alan; Madrigal, Claudia; Maeng, Elizabeth; Mandel, Marcy Jo; Matsumoto, Sid; McGuire, Jeff; Miller, Brad; Mandel, Marcy Jo @ SCO; Moon, Richard (Legal); Morquecho, Raymond; Nienow, Trecia (Legal); Oakes, Clifford; Pielsticker, Michele; Ralston, Natasha; Richmond, Joann; Riley, Denise (Legal); Salazar, Ramon; Salgado-Ponce, Sylvia; Schultz, Glenna; Shah, Neil; Silva, Monica (Legal); Singh, Sam; Smith, Kevin (Legal); Smith, Rose; Stowers, Yvette; Suero-Gabler, Cynthia; Torres, Rodrigo; Torres, Rodrigo; Tran, Mai (Legal); Treichelt, Tim; Tucker, Robert (Legal); Vasquez, Rosalyn; Vigil, Michael; Wallentine, Sean; Whitaker, Lynn; White, Sharon; Williams, Lee; Zivkovich, Robert  
**Subject:** State Board of Equalization - Announcement of Regulatory Change 1502

The State Board of Equalization proposes to adopt amendments to Regulation 1502, *Computers, Programs, and Data Processing*. A public hearing regarding the proposed amendments will be held in Room 121, 450 N Street, Sacramento, at 10:00 a.m., or as soon thereafter as the matter may be heard, on Tuesday, December 17, 2013.

The proposed amendments to Regulation 1502 clarify that a maintenance contract may provide that the purchaser is entitled to receive a backup copy of a prewritten program recorded on tangible storage media and that a taxable optional maintenance contract may be appropriately paired with a nontaxable electronic download or load-and-leave transaction.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link:  
[http://www.boe.ca.gov/regs/reg\\_1502\\_2013.htm](http://www.boe.ca.gov/regs/reg_1502_2013.htm)

Questions regarding the substance of the proposed amendments should be directed to Mr. Bradley Heller, Tax Counsel IV, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), telephone (916) 323-3091, or FAX (916) 323-3387.

Written comments for the Board's consideration, notices of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed regulatory action should be directed to Mr. Rick Bennion, Regulations Coordinator, telephone (916) 445-2130, fax (916) 324-3984, e-mail [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov) or by mail to: State Board of Equalization, Attn: Rick Bennion, MIC: 80, P.O. Box 942879-0080, Sacramento, CA 94279-0080.

---

Please do not reply to this message.

Board Proceedings Division, MIC:80  
Rick Bennion  
Regulations Coordinator  
Phone (916) 445-2130  
Fax (916) 324-3984  
[Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov)

INITIAL STATEMENT OF REASONS AND INFORMATION

The Board has prepared an initial statement of the reasons for the proposed action and has available all the information upon which the proposal is based.

TEXT OF PROPOSAL

Copies of the exact language of the proposed regulations, and any document incorporated by reference, and of the initial statement of reasons, and all of the information upon which the proposal is based, may be obtained at the hearing or prior to the hearing upon request from the Board at 2450 Del Paso Road, Suite 105, Sacramento, California 95834.

AVAILABILITY AND LOCATION OF THE FINAL STATEMENT OF REASONS AND RULEMAKING FILE

All the information upon which the proposed regulations are based is contained in the rulemaking file which is available for public inspection by contacting the person named below.

You may obtain a copy of the final statement of reasons once it has been prepared, by making a written request to the contact person named below or by accessing the website listed below.

CONTACT PERSON

Inquiries or comments concerning the proposed rule-making action may be addressed to:

Name: Andrea Leiva, Policy Analyst
Address: 2450 Del Paso Road, Suite 105 Sacramento, CA 95834
Telephone No.: 916-575-7182
Fax No.: 916-575-7292
E-mail Address: andrea.leiva@dca.ca.gov

The backup contact person is:

Name: Mona Maggio, Executive Officer
Address: 2450 Del Paso Road, Suite 105 Sacramento, CA 95834
Telephone No.: 916-575-7170
Fax No.: 916-575-7292
E-mail Address: mona.maggio@dca.ca.gov

WEBSITE ACCESS

Materials regarding this proposal can be found at http://www.optometry.ca.gov/lawsregs/propregs.shtml.

TITLE 18. BOARD OF EQUALIZATION

The State Board of Equalization Proposes to Adopt Amendments to California Code of Regulations, Title 18, Section 1502, Computers, Programs, and Data Processing

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, Computers, Programs, and Data Processing, which prescribes the application of sales and use tax to the sale or lease of pre-written programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a pre-written program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the pre-written program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as

the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

#### AUTHORITY

RTC section 7051.

#### REFERENCE

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016.

#### INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

##### Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

*Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer’s charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to “improvements” and “error corrections.” Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board’s January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff’s recommendation.

*Interested Parties Process*

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regu-

lation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchasers to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended to limit the application of subdivision (f)(1)(C)’s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)’s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to

restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and

- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

**NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

**NO COST OR SAVINGS TO STATE AGENCIES,  
LOCAL AGENCIES, AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

**NO SIGNIFICANT STATEWIDE ADVERSE  
ECONOMIC IMPACT DIRECTLY  
AFFECTING BUSINESS**

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

**NO COST IMPACTS TO PRIVATE PERSONS  
OR BUSINESSES**

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

**RESULTS OF THE ECONOMIC IMPACT  
ANALYSIS REQUIRED BY GOVERNMENT  
CODE SECTION 11346.3, SUBDIVISION (b)**

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

**NO SIGNIFICANT EFFECT ON  
HOUSING COSTS**

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

**DETERMINATION REGARDING  
ALTERNATIVES**

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

**CONTACT PERSONS**

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov), or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

**WRITTEN COMMENT PERIOD**

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regula-

tion 1502. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

TITLE 22. DEPARTMENT OF HEALTH CARE SERVICES

NOTICE OF RULEMAKING AFTER EMERGENCY ADOPTION

SUBJECT: Drug Medi-Cal Rates (2011-2012), DHCS-12-003E

NOTICE IS HEREBY GIVEN that the Department of Health Care Services (Department) has adopted the regulations in California Code of Regulations (CCR), Title 22, Division 3, Chapter 3, Article 7, Section 51516.1, on an emergency basis. These emergency regulations became effective on September 18, 2013, and will remain in effect for a period of 180 days. The purpose of this rulemaking is to adopt the emergency regulations on a permanent basis.

WRITTEN COMMENT PERIOD

Any interested person or his or her duly authorized representative may submit written comments to the Department relevant to the regulatory action described in this notice. Please label any comments as pertaining to Drug Medi-Cal Rates (2011-2012), DHCS-12-003E, and submit using any of the following methods:

- Mail: Department of Health Care Services  
Office of Regulations, MS 0015  
P.O. Box 997413  
Sacramento, CA 95899-7413
- Hand Delivery: Department of Health Care Services  
Office of Regulations  
1501 Capitol Avenue, Suite 5084  
Sacramento, CA 95814
- FAX: (916) 440-5748
- Email: [regulations@dhcs.ca.gov](mailto:regulations@dhcs.ca.gov)

The written comment period closes on December 4, 2013, at 5:00 p.m. Any written comments, regardless of the method of transmittal, must be received by the Office of Regulations by 5:00 p.m. on this date, for consideration.

Written comments should include the author's contact information so the Department can provide notification of any further changes to the regulation proposal.

A public hearing has not been scheduled for this rulemaking. However, the Department will conduct a hearing if a written request for a public hearing is received from any interested person or his or her duly authorized representative, no later than 15 days prior to the close of the written comment period, pursuant to Government Code Section 11346.8.



STATE OF CALIFORNIA

**STATE BOARD OF EQUALIZATION**

450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-80  
916-445-2130 • FAX 916-324-3984  
[www.boe.ca.gov](http://www.boe.ca.gov)

BETTY T. YEE  
First District, San Francisco

SEN. GEORGE RUNNER (RET.)  
Second District, Lancaster

MICHELLE STEEL  
Third District, Rolling Hills Estates

JEROME E. HORTON  
Fourth District, Los Angeles

JOHN CHIANG  
State Controller

CYNTHIA BRIDGES  
Executive Director

**October 18, 2013**

**To Interested Parties:**

**Notice of Proposed Regulatory Action**

**The State Board of Equalization Proposes to Adopt Amendments to  
California Code of Regulations, Title 18, Section 1502,  
*Computers, Programs, and Data Processing***

**NOTICE IS HEREBY GIVEN**

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, which prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a prewritten program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

**PUBLIC HEARING**

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov) at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

## **AUTHORITY**

RTC section 7051

## **REFERENCE**

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016

## **INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW**

### Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the

maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

*Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer’s charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and

- Whether the maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to “improvements” and “error corrections.” Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board’s January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff’s recommendation.

#### *Interested Parties Process*

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to

Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

#### **NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

**NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

**NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS**

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

**NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES**

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

**RESULTS OF THE ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

**NO SIGNIFICANT EFFECT ON HOUSING COSTS**

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

## **DETERMINATION REGARDING ALTERNATIVES**

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

## **CONTACT PERSONS**

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov), or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

## **WRITTEN COMMENT PERIOD**

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1502. The Board will only consider written comments received by that time.

## **AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION**

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public

inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

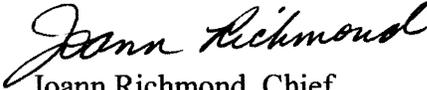
**SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8**

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

**AVAILABILITY OF FINAL STATEMENT OF REASONS**

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

Sincerely,

  
Joann Richmond, Chief  
Board Proceedings Division

JR:reb

**STATE BOARD OF EQUALIZATION**

BOARD APPROVED



At the December 17, 2013 Board Meeting

  
\_\_\_\_\_  
Joann Richmond, Chief  
Board Proceedings Division

**Initial Statement of Reasons for  
Proposed Amendments to California Code of Regulations,  
Title 18, Section 1502, *Computers, Programs, and Data Processing***

SPECIFIC PURPOSE, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS

Current Law

Subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the State Board of Equalization (Board) amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property

and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

### Proposed Amendments

#### *Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that

nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. And, recommended that the Board authorize staff to conduct one focused interested parties meeting regarding potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases a prewritten program in an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then:

- Tax does not apply to the charge for the prewritten program itself; and
- Tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

At the conclusion of the January 15, 2013, Business Taxes Committee meeting, the Board unanimously voted to approve staff's recommendation.

#### *Interested Parties Process*

In preparation for the interested parties meeting, Board staff reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of a prewritten program to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional

maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D). Then, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013.

During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program to their customers as part of an optional maintenance contract.

During the March 6, 2013, interested parties meeting, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data. Staff also explained that the amendments to Regulation 1502 are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law, and that the clarification may lead to changes in software retailers' current business practices.

In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested.

#### *August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007 and distributed it to the Board Members on August 2, 2013, for consideration at the Board's August 13, 2013, Business Taxes Committee meeting. The formal issue paper recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by

Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. At the conclusion of the August 13, 2013, Business Taxes Committee meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 are reasonably necessary for the specific purpose of eliminating any problems software retailers, software consumers, or Board staff may have understanding that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The adoption of the proposed amendments to Regulation 1502 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1502.

#### DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 13-007, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its August 13, 2013, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1502 described above.

#### ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1502 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed

amendments to Regulation 1502 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1502 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

**INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

As previously explained, the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) clarify that, under existing law:

- A backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same or similar prewritten program;
- Tax still applies to 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchaser to receive tangible storage media, even if a backup copy of a prewritten program is recorded on the tangible storage media; and
- An optional maintenance contract, subject to tax at 50 percent of the lump-sum charge, may be appropriately paired with a separate nontaxable electronic download or load-and-leave transaction without changing the way tax applies to the electronic download or load-and-leave transaction.

Therefore, the proposed amendments do not change the taxation of prewritten programs or optional maintenance contracts under existing law.

Further, the proposed amendments to Regulation 1502 make it clear that software retailers may include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, and pair their taxable optional software maintenance contracts with separate nontaxable electronic download or load-and-leave transactions, or both. However, the proposed amendments do not require that software retailers include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts or pair taxable optional maintenance contracts with nontaxable download or load-and-leave transactions. Therefore, the proposed amendments do not impose any costs on software retailers.

Furthermore, the Board understands that, in 2013, software retailers generally sell or lease prewritten programs in nontaxable download or load-and-leave transactions. The Board

understands, based on Mr. Nebergall's comments discussed above, that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program recorded on tangible storage media to their customers as part of an optional maintenance contract. And, the Board only anticipates that some retailers will choose to include backup copies of prewritten programs recorded on tangible storage media in some of their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with some of their separate nontaxable electronic download or load-and-leave transactions, or both if there is a business reason for doing so. As a result, the proposed amendments to Regulation 1502 will not have a significant positive or negative effect on software retailers' current business practices, and the Board does not anticipate that software retailers will make significant changes to their current business practices solely due to the proposed clarifying amendments to Regulation 1502.

Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Regulation 1502 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1502 will not affect the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1502 may affect small business.

**Text of Proposed Amendments to  
California Code of Regulations, Title 18, Section 1502**

**1502. Computers, Programs, and Data Processing.**

(a) In General. “Automatic data processing services” are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as “data processing firms.”

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax. (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art

combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which ~~the~~ prewritten program improvements or

error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

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

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

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

(D) 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 the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a “canned” or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

(1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).

(2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).

(3) Consulting services (e.g., study of all or part of a data processing system).

(4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).

(5) Evaluation of bids (e.g., studies to determine which manufacturer’s proposal for computer equipment would be most beneficial).

(6) Providing technical help, analysts, and programmers, usually on an hourly basis.

(7) Training Services.

(8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)

(9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm’s billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, “Transportation Charges.”

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016, Revenue and Taxation Code.

## Regulation History

**Type of Regulation:** Sales and Use Tax

Regulation: 1502

Title: 1502, *Computers, Programs, and Data Processing*

**Preparation:** Bradley Heller

**Legal Contact:** Bradley Heller

The proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*, clarify that a maintenance contract may provide that the purchaser is entitled to receive a backup copy of a prewritten program recorded on tangible storage media and that a taxable optional maintenance contract may be appropriately paired with a nontaxable electronic download or load-and-leave transaction.

### History of Proposed Amendments:

December 17-19, 2013	Public Hearing
October 18, 2013	OAL publication date; 45-day public comment period begins; Interested Parties mailing
October 8, 2013	Notice to OAL
August 13, 2013	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA

Support: NA

Oppose: NA

## Statement of Compliance

The State Board of Equalization, in process of adopting Sales and Use Taxes Regulation 1502, *Computers, Programs, and Data Processing*, did comply with the provision of Government Code section 11346.4(a)(1) through (4). A notice to interested parties was mailed on October 18, 2013, 60 days prior to the public hearing.

December 16, 2013



Richard Bennion  
Regulations Coordinator  
State Board of Equalization

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION  
450 N STREET  
SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT  
DECEMBER 17, 2013

ITEM F3  
PUBLIC HEARINGS  
PROPOSED ADOPTION OF AMENDMENTS TO SALES AND USE TAX  
REGULATION 1502, COMPUTERS, PROGRAMS, AND DATA  
PROCESSING

REPORTED BY: Kathleen Skidgel  
CSR NO. 9039

P R E S E N T

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

For the Board  
of Equalization:

Jerome E. Horton  
Chairman

Michelle Steel  
Vice-Chairwoman

Betty T. Yee  
Member

George Runner  
Member

Marcy Jo Mandel  
Appearing for John  
Chiang, State Controller  
(per Government Code  
Section 7.9)

Joann Richmond  
Chief, Board Proceedings  
Division

For Board of  
Equalization Staff:

Bradley Heller  
Legal Department

---oOo---

1 450 N STREET  
2 SACRAMENTO, CALIFORNIA  
3 DECEMBER 17, 2013

4 ---oOo---

5 MR. HORTON: Ms. Richmond.

6 MS. RICHMOND: Our next item is F3,  
7 Proposed Adoption of Amendments to Sales and Use Tax  
8 Regulation 1502, Computers, Programs and Data  
9 Processing.

10 MR. HORTON: Thank you very much.

11 We would ask that Mr. Heller please  
12 introduce the issues.

13 MR. HELLER: Good afternoon, Chairman  
14 Horton, Members of the Board.

15 I'm Bradley Heller from the Board's Legal  
16 Department, and I'm here to request that the Board  
17 vote to adopt the proposed amendments to Sales and  
18 Use Tax Regulation 1502, Computers, Programs and  
19 Data Processing.

20 The proposed amendments clarify that an  
21 optional maintenance contract sold in connection  
22 with the sale or lease of a prewritten program,  
23 subject to tax of 50 percent of the lump sum charge,  
24 may provide that the purchaser is entitled to  
25 receive a backup copy of the same or similar  
26 prewritten program recorded on tangible storage  
27 media so that the purchaser may use the backup copy  
28 to restore the prewritten program.

1 MR. HORTON: Thank you, sir.

2 Discussion, Members?

3 MR. RUNNER: Move adoption.

4 MS. STEEL: Move.

5 MR. HORTON: Mr. Runner moves adoption.

6 Member Yee seconds.

7 Without objection, Members, such will be  
8 the order.

9 ---oOo---

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

26

27

28

## 1 REPORTER'S CERTIFICATE

2  
3 State of California )  
4 ) ss  
5 County of Sacramento )  
6

7 I, KATHLEEN SKIDGEL, Hearing Reporter for  
8 the California State Board of Equalization certify  
9 that on December 17, 2013 I recorded verbatim, in  
10 shorthand, to the best of my ability, the  
11 proceedings in the above-entitled hearing; that I  
12 transcribed the shorthand writing into typewriting;  
13 and that the preceding pages 1 through 4 constitute  
14 a complete and accurate transcription of the  
15 shorthand writing.  
16

17 Dated: December 19, 2013  
18

19  
20 *Kathleen Skidgel*

21 KATHLEEN SKIDGEL, CSR #9039

22 Hearing Reporter  
23  
24  
25  
26  
27  
28



**2013 MINUTES OF THE STATE BOARD OF EQUALIZATION**

Tuesday, December 17, 2013

**PUBLIC HEARINGS****F1 2014 Timber Yield Tax Rate**

David Gau, Deputy Director, Property and Special Taxes Department, made introductory remarks regarding section 38202 of the Revenue and Taxation Code, which requires an annual adjustment of the timber yield tax rate (Exhibit 12.4).

Speakers were invited to address the Board, but there were none.

Action: Upon motion of Mr. Runner, seconded by Ms. Yee and unanimously carried, Mr. Horton, Ms. Steel, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, the Board adopted the timber yield tax rate of 2.9 percent for 2014 as recommended by staff.

**F2 Timber Harvest Values and Modified Harvest Values**

David Gau, Deputy Director, Property and Special Taxes Department, was available to answer questions **OR** made introductory remarks regarding the timber harvest values and modified harvest values. On or before December 31, 2013, the Board shall estimate the immediate harvest values of and adopt schedules for timber harvested between January 1, 2014, and June 30, 2014. Additionally, the Board may modify immediate harvest values to reflect material changes in timber values that result from fire or other catastrophic cause for any area or part thereof in which damaged timber is located. (Rev. & Tax. Code, § 38204.) (Exhibit 12.5.)

Speakers were invited to address the Board, but there were none.

Action: Upon motion of Ms. Steel, seconded by Ms. Yee and unanimously carried, Mr. Horton, Ms. Steel, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, the Board adopted the timber harvest values and modified harvest values as recommended by staff.

**F3 Proposed Adoption of Amendments to Sales and Use Tax Regulation 1502, Computers, Programs, and Data Processing**

Bradley Heller, Tax Counsel, Tax and Fee Programs Division, Legal Department, made introductory remarks regarding the proposed amendments to Regulation 1502, which clarify the treatment of a backup copy of a computer program included in maintenance contract and that a taxable optional maintenance contract may be paired with a nontaxable electronic download or load-and-leave transaction (Exhibit 12.6).

Speakers were invited to address the Board, but there were none.

Action: Upon motion of Mr. Runner, seconded by Ms. Yee and unanimously carried, Mr. Horton, Ms. Steel, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, the Board adopted the proposed of amendments to Regulation 1502 as recommended by staff.



STATE OF CALIFORNIA

**STATE BOARD OF EQUALIZATION**

450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-80  
916-445-2130 • FAX 916-324-3984  
[www.boe.ca.gov](http://www.boe.ca.gov)

BETTY T. YEE  
First District, San Francisco

SEN GEORGE RUNNER (RET.)  
Second District, Lancaster

MICHELLE STEEL  
Third District, Rolling Hills Estates

JEROME E. HORTON  
Fourth District, Los Angeles

JOHN CHIANG  
State Controller

CYNTHIA BRIDGES  
Executive Director

**October 18, 2013**

**To Interested Parties:**

**Notice of Proposed Regulatory Action**

**The State Board of Equalization Proposes to Adopt Amendments to  
California Code of Regulations, Title 18, Section 1502,  
*Computers, Programs, and Data Processing***

**NOTICE IS HEREBY GIVEN**

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, which prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a prewritten program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

**PUBLIC HEARING**

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov) at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

## **AUTHORITY**

RTC section 7051

## **REFERENCE**

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016

## **INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW**

### Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the

maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

*Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer’s charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and

- Whether the maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to “improvements” and “error corrections.” Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board’s January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff’s recommendation.

#### *Interested Parties Process*

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to

Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

#### **NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

**NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

**NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS**

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

**NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES**

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

**RESULTS OF THE ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

**NO SIGNIFICANT EFFECT ON HOUSING COSTS**

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

## **DETERMINATION REGARDING ALTERNATIVES**

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

## **CONTACT PERSONS**

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov), or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

## **WRITTEN COMMENT PERIOD**

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1502. The Board will only consider written comments received by that time.

## **AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION**

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public

inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

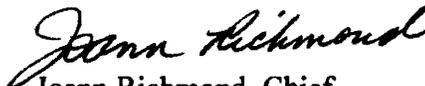
**SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8**

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

**AVAILABILITY OF FINAL STATEMENT OF REASONS**

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

Sincerely,

  
Joann Richmond, Chief  
Board Proceedings Division

JR:reb

**Initial Statement of Reasons for  
Proposed Amendments to California Code of Regulations,  
Title 18, Section 1502, *Computers, Programs, and Data Processing***

**SPECIFIC PURPOSE, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS**

**Current Law**

Subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] 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.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

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

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the State Board of Equalization (Board) amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property

and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

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

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

### Proposed Amendments

#### *Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that

nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. And, recommended that the Board authorize staff to conduct one focused interested parties meeting regarding potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases a prewritten program in an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then:

- Tax does not apply to the charge for the prewritten program itself; and
- Tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

At the conclusion of the January 15, 2013, Business Taxes Committee meeting, the Board unanimously voted to approve staff's recommendation.

#### *Interested Parties Process*

In preparation for the interested parties meeting, Board staff reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of a prewritten program to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional

maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D). Then, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013.

During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program to their customers as part of an optional maintenance contract.

During the March 6, 2013, interested parties meeting, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data. Staff also explained that the amendments to Regulation 1502 are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law, and that the clarification may lead to changes in software retailers' current business practices.

In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested.

#### *August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007 and distributed it to the Board Members on August 2, 2013, for consideration at the Board's August 13, 2013, Business Taxes Committee meeting. The formal issue paper recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by

Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. At the conclusion of the August 13, 2013, Business Taxes Committee meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 are reasonably necessary for the specific purpose of eliminating any problems software retailers, software consumers, or Board staff may have understanding that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The adoption of the proposed amendments to Regulation 1502 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1502.

#### DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 13-007, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its August 13, 2013, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1502 described above.

#### ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1502 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed

amendments to Regulation 1502 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1502 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

**INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

As previously explained, the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) clarify that, under existing law:

- A backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same or similar prewritten program;
- Tax still applies to 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchaser to receive tangible storage media, even if a backup copy of a prewritten program is recorded on the tangible storage media; and
- An optional maintenance contract, subject to tax at 50 percent of the lump-sum charge, may be appropriately paired with a separate nontaxable electronic download or load-and-leave transaction without changing the way tax applies to the electronic download or load-and-leave transaction.

Therefore, the proposed amendments do not change the taxation of prewritten programs or optional maintenance contracts under existing law.

Further, the proposed amendments to Regulation 1502 make it clear that software retailers may include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, and pair their taxable optional software maintenance contracts with separate nontaxable electronic download or load-and-leave transactions, or both. However, the proposed amendments do not require that software retailers include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts or pair taxable optional maintenance contracts with nontaxable download or load-and-leave transactions. Therefore, the proposed amendments do not impose any costs on software retailers.

Furthermore, the Board understands that, in 2013, software retailers generally sell or lease prewritten programs in nontaxable download or load-and-leave transactions. The Board

understands, based on Mr. Nebergall's comments discussed above, that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program recorded on tangible storage media to their customers as part of an optional maintenance contract. And, the Board only anticipates that some retailers will choose to include backup copies of prewritten programs recorded on tangible storage media in some of their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with some of their separate nontaxable electronic download or load-and-leave transactions, or both if there is a business reason for doing so. As a result, the proposed amendments to Regulation 1502 will not have a significant positive or negative effect on software retailers' current business practices, and the Board does not anticipate that software retailers will make significant changes to their current business practices solely due to the proposed clarifying amendments to Regulation 1502.

Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Regulation 1502 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1502 will not affect the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1502 may affect small business.

**Text of Proposed Amendments to  
California Code of Regulations, Title 18, Section 1502**

**1502. Computers, Programs, and Data Processing.**

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax. (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

**(d) Manipulation of Customer-Furnished Information as Sale or Service.**

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art

combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if and), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

e) **Training Services and Materials.** Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) **Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.**

(2) **Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.**

(3) **Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.**

(f) **Computer Programs.**

(1) **Prewritten (Canned) Programs.** Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) **Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.**

(B) **Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.**

(C) **Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which the prewritten program improvements or**

error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

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

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

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

(D) 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 the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a “canned” or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer’s proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm’s billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, “Transportation Charges.”

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016, Revenue and Taxation Code.

## Regulation History

**Type of Regulation:** Sales and Use Tax

Regulation: 1502

Title: 1502, *Computers, Programs, and Data Processing*

**Preparation:** Bradley Heller

**Legal Contact:** Bradley Heller

The proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*, clarify that a maintenance contract may provide that the purchaser is entitled to receive a backup copy of a prewritten program recorded on tangible storage media and that a taxable optional maintenance contract may be appropriately paired with a nontaxable electronic download or load-and-leave transaction.

### History of Proposed Amendments:

December 17-19, 2013	Public Hearing
October 18, 2013	OAL publication date; 45-day public comment period begins; Interested Parties mailing
October 8, 2013	Notice to OAL
August 13, 2013	Business Tax Committee, Board Authorized Publication (Vote 5-0)

**Sponsor:** NA

**Support:** NA

**Oppose:** NA