State of California

Board of Equalization
Legal Division

M e m o r a n d u m

120.0115.900

To: Mr. Stan Rose

Date : January 14, 1988

Oakland - Auditing

From: John Abbott, Tax Counsel

Subject: U--- Corporation – SR -- XX-XXXXXX
Licenses for reproduction or copying customized basic operating programs

In your November 16, 1987 memo to Legal, you write:

> "Attached is a letter dated November 22, 1983 in which the legal staff decided that the 'Unix' operating system licensed from A--- was taxable when acquired by the taxpayer, modified and resold. We are currently auditing the above taxpayer who has also acquired the 'Unix' operating system, and modifies this system for resale in the same manner as described in the letter.
>
> "We have been holding completion of this audit due to the pending revisions to Regulation 1502. Since the new regulation adoption is likely, we would like some systems. It appears that the new regulation may have intended to tax operational systems since paragraph (f)(2)(A) specifically excludes operational systems from the exclusion of custom computer programs. However, under paragraph (f)(1)(B), charges for the right to reproduce or copy a program to which a federal copyright attaches is exempt from tax. Our taxpayer usually bills their customers a flat fee plus a royalty based upon the number of copies of the operating program that are resold.
>
> "It seems there are at least three possibilities, first these charges are considered entirely for the right to reproduce under a federal copyright, then all charges would be exempt. Second, the charges could be considered fabrication labor (as was the conclusion reached in the letter dated November 22, 1983) in which case the entire charge is subject to tax. And third, it is possible that the flat fee could be considered fabrication labor, and the royalty payments considered exempt as payment for copyright."

The letter you attached was my letter dated November 22, 1983, to Mr. A--- T---, M--- X---, Inc. My conclusion in that letter was that M--- X--- was liable for tax on its licenses of customized basic operating programs where the taxpayer licenses a source code for A--- and customized the source code to operate on the particular computer hardware owned by the customer.

Opinion

Our opinion is that subdivision (f)(1)(B) of the proposed amendments to Regulation 1502, dated October 14, 1987, set out the Board's position on how tax applies under current law to computer program royalties and license payments, whether those programs are basic operating systems or applications programs. Under the facts you relate, we believe that subdivision (f)(1)(B) would exempt from tax both the flat fee and the royalty payments made by U---'s customers. This is because U---'s customers are not the end users of the operating programs, but apparently reproduce the operating programs for sale or license to their customers. If U---'s customers were the end users tax would apply to those flat fees or royalty payments paid to U--- for the use of the programs.

I note that there does not appear to be any indication in my November 22, 1983 letter to M--- X--- which indicates that M--- X---'s customers were not the end users of the customized operating programs. If they were, then my letter still remains correct even after Board's adoption of subdivision (f)(1)(B), since M--- X---'s programs were not licensed solely for reproduction and copying. However, if in fact M--- X--- was transferring the operating systems to its customers for sale or licensing by those customers, then my letter would no longer be correct under subdivision (f)(1)(B).

JB:jb