



STATE BOARD OF EQUALIZATION

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State Controller

DAVID J. GAU
Executive Director

June 17, 2016

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 1507, *Technology Transfer Agreements*. Before the issue is presented at the Board's January 2017 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

June 30, 2016
Room 121 at 1:00 p.m.
450 N Street, Sacramento, CA

If you would like to participate by teleconference, call 1-888-808-6929 and enter access code 7495412. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Lynn.Whitaker@boe.ca.gov by July 15, 2016. You should submit written comments including proposed language if you have suggestions you would like considered during this process. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to the BOE webpage at (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. Staff looks forward to your comments and suggestions. Should you have any questions, please feel free to contact Business Taxes Committee staff member Mr. Robert Wilke at 1-916-445-2137, who will be leading the meeting.

Sincerely,

Chief, Tax Policy Division
Business Tax and Fee Department

JP:rsw

Enclosures

cc: (all with enclosures, via email and/or hardcopy as requested)

Honorable Fiona Ma, CPA, Chairwoman
Honorable Diane L. Harkey, Vice Chair
Honorable George Runner, First District
Honorable Jerome E. Horton, Third District
Honorable Betty T. Yee, State Controller, c/o Ms. Yvette Stowers (MIC 73)
Ms. Genevieve Jopanda, Board Member's Office, Second District
Ms. Kathryn Asprey, Board Member's Office, Second District
Mr. John Vigna, Board Member's Office, Second District
Mr. Tim Morland, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, Board Member's Office, Second District
Mr. Russell Lowery, Board Member's Office, Fourth District
Mr. Ted Matthies, Board Member's Office, Fourth District
Mr. Jay Hite, Board Member's Office, Fourth District
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Mr. Clifford Oakes, Board Member's Office, Fourth District
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Ms. Susanne Buehler (MIC 43)
Mr. Todd Gilman (MIC 70)
Mr. Wayne Mashihara (MIC 47)
Mr. Kevin Hanks (MIC 49)
Mr. Mark Durham (MIC 67)
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Mr. Jeff Angeja (MIC 85)
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Mr. Michael Patno (MIC 50)
Mr. Robert Wilke (MIC 50)

INITIAL DISCUSSION PAPER

Software Technology Transfer Agreements

Issue

Whether the Board should amend Regulation 1507, *Technology Transfer Agreements*, to clarify the requirements to establish that an agreement for the transfer of software on tangible storage media is a software technology transfer agreement (software TTA), in accordance with the holding in *Lucent*¹, and clarify the measure of tax when software is transferred under a software TTA.

Background

General

California imposes a sales tax measured by a retailer's gross receipts from the retail sale of tangible personal property inside this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code (RTC), § 6051.) While the sales tax is imposed upon the retailer for the privilege of selling tangible personal property at retail in California, the retailer may collect sales tax reimbursement from the customer if the contract of sale so provides. (Reg. 1700, *Reimbursement for Sales Tax*.) It is presumed that all gross receipts are subject to the tax until the contrary is established, and the burden of proving that a sale of tangible personal property is not a sale at retail is upon the person who makes the sale unless he or she accepts a resale certificate from the purchaser. (RTC, § 6091.)

When sales tax does not apply, use tax is imposed upon the consumer, measured by the sales price of property purchased from a retailer for the storage, use, or other consumption of the property in California, unless specifically exempted or excluded from taxation by statute. (RTC, § 6201.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the Board, and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (Reg. 1684, *Collection of Use Tax by Retailers*.)

A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (RTC, § 6006.) In general, gross receipts and sales price mean the total amount for which tangible personal property is sold, without any deduction for, among other things, the cost of the property sold and the cost of any services that are a part of the sale. (RTC, §§ 6011, 6012.) Tangible personal property is personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (RTC, § 6016.)

RTC sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10) (collectively the technology transfer agreement (TTA) statutes)

On June 4, 1992, the Board adopted a memorandum opinion deciding the *Petition for Redetermination of Intel Corporation (Intel)* regarding two agreements (or contracts) involving transfers of intellectual property and tangible personal property. Under the first contract, Intel transferred a license to use a patented process for producing integrated circuits, along with

¹ *Lucent Technologies, Inc. v. Board of Equalization* (2015) 241 Cal.App.4th 19.

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written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. Under the second contract, Intel transferred a license to produce an integrated circuit it had designed, a license to use a patented process for producing the integrated circuit, and copies of the existing proprietary written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. The Board concluded that both contracts provided for two transfers for sales and use tax purposes: a taxable transfer of tangible personal property consisting of engineering notes, manuals, schematics, database tapes, drawings, and test tapes, and a nontaxable sale of intangible property consisting of the licenses to use copyrighted or patented information. The Board further concluded that, “in the absence of a contract price for the tangible elements, the tax applies only to the value attributable to the tangible elements including the cost of manufacturing the specific tangible properties. This includes material costs, fabrication labor, and a suitable markup for overhead and profit.” In addition, in the opinion, the Board found that a suitable markup “was 100% of the cost of materials and labor.”

The TTA statutes were enacted in 1993, a year after the Board’s *Intel* memorandum opinion. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)).) Both provisions define a TTA as “any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.” (RTC, §§ 6011, subd. (c)(10)(D) and 6012, subd. (c)(10)(D).) The TTA statutes further provide that “sales price” and “gross receipts” do not include the “amount charged for intangible personal property transferred with tangible personal property in any” TTA, if the TTA “separately states a reasonable price for the tangible personal property.” If there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, tangible personal property transferred under a TTA by looking to the “price at which the tangible personal property was sold, leased, or offered to third parties.” And, in the absence of previous sales, the TTA statutes provide that the taxable measure is equal to “200 percent of the cost of materials and labor used to produce the tangible personal property.” (*Id.* subds. (c)(10)(A)-(C).)

Regulation 1507

Regulation 1507 was originally adopted in 2002 to implement the TTA statutes and incorporate the California Supreme Court’s holding in *Preston*². Regulation 1507 defines the term TTA and explains the application of tax to transactions involving TTAs.

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

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

² *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197.

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right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

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

Regulation 1507, subdivision (a)(1) and (3), explains that, under the TTA provisions, tax will not apply to charges for the right to use a patented process that is external to tangible personal property, but that tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of tangible personal property that performs a process related to “patented technology embedded in the internal design, assembly or operation of the” tangible personal property. (Reg. 1507, subd. (a)(1), example 3, and (a)(3).)

Regulation 1507, subdivision (a)(2) through (4), implements, interprets, and makes specific the terms “process,” “assign or license,” “copyright interest,” and “patent interest” from the TTA statutes. As relevant here, the regulation defines “copyright interest” to mean “the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission.” (Reg. 1507, subd. (a)(2).) The regulation defines “patent interest” to mean “the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material.” (Reg. 1507, subd. (a)(3).) The regulation defines “process” to mean “one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest.” (Reg. 1507, subd. (a)(3).) In addition, the regulation provides that “[a]ssign or license’ means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement.” (Reg. 1507, subd. (a)(4).)

Regulation 1507, subdivision (b)(1), explains the application of tax to TTAs, including prescribing the gross receipts or sales price attributable to tangible personal property transferred as part of a TTA. Regulation 1507, subdivision (b)(3), *Specific Applications*, provides that when

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artwork and commercial photography are transferred pursuant to a TTA, then tax applies according to Regulation 1540, *Advertising Agencies and Commercial Artists*.

Regulation 1502

Under RTC section 6010.9, sales and use tax does not apply to “the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program, other than a basic operational program (as defined in Section 995.2), either in the form of written procedures or in the form of storage media on which, or in which, the program is recorded, or any required documentation or manuals designed to facilitate the use of the custom computer program so transferred.” However, under RTC section 6010.9, subdivision (d), the term “custom computer program” does not include a “‘canned’ or prewritten computer program.”

Subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing*, defines the terms “computer,” “program,” “custom computer program and programming,” “prewritten program,” and “storage media.” As relevant here, the regulation provides that 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.” (Reg. 1502, subd. (b)(3).) The regulation defines the term “program” to mean “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.” (Reg. 1502, subd. (b)(10).) The regulation defines the term “custom computer program and programming” to mean “a computer program prepared to the special order of the customer” and “includes those services represented by separately stated charges for modification to an existing prewritten program which are prepared to the special order of the customer.” (Reg. 1502, subd. (b)(4).) The regulation defines a “prewritten program” as “a program held or existing for general or repeated sale or lease” and provides that the term “includes a program developed for in-house use which is subsequently offered for sale or lease as a product.” (Reg. 1502, subd. (b)(9).) The regulation defines “storage media” to include “hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.” (Reg. 1502, subd. (b)(13).)

Subdivision (f) of Regulation 1502 prescribes the application of tax to computer programs. Subdivision (f)(1) of Regulation 1502 applies to sales and leases of prewritten programs recorded on storage media or coding sheets. Regulation 1502, subdivision (f)(1), provides that “[t]ax applies to the sale or lease of storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched. Regulation (f)(1)(B) explains that “[t]ax 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.” Regulation 1502, subdivision (f)(1)(B), further provides that “[t]ax 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.” Regulation 1502, subdivision

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(f)(1)(D), explains that “[t]he sale or lease of a prewritten program is not a taxable transaction if . . . the purchaser does not obtain possession of any tangible personal property in the transaction.” This includes transactions where a prewritten program is transferred “by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer” if “the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction” (e.g., download from the internet), and transactions where “the [prewritten] 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” (e.g., load and leave). Subdivision (f)(2) of Regulation 1502 implements the provisions of RTC section 6010.9 excluding charges for custom computer programs and programming from sales and use tax.

Lucent

In *Lucent*, the Second District Court of Appeal applied the TTA statutes to transactions in which Lucent sold nine different telephone companies the following:

- Switches used to connect telephone and data networks;
- Tapes and discs containing copies of switch specific programs (SSPs) to run each switch and copies of generic software designed for use on any switch, which Lucent “designed” and held the copyrights to because all the software constituted “original work[s] of authorship,” and which embodied, implemented, and enabled “at least one of 18 different patents held by” Lucent; and
- The “right to copy the software” onto their switches’ hard drives and the “right to use the software” to route calls and data and offer telephone products to their customers. (*Lucent. supra*, 241 Cal.App.4th at pp. 26-27.)

Lucent’s Agreements were TTAs

In *Lucent*, the Court of Appeal said that a TTA “is an agreement that satisfies three elements: (1) a person holds a patent or copyright; (2) that person assigns or licenses to another the right to make and sell a product or to use a process; and (3) the resulting product or process is subject to the assignor’s or licensor’s patent or copyright interest.” (*Lucent, supra*, 241 Cal.App.4th at p. 36.) The Court of Appeal also refused to overrule *Nortel Networks, Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259 (hereafter *Nortel*). (*Id.* at p. 40.) Instead, the *Lucent* court held that the transactions at issue constituted TTAs because Lucent established that the software was copyrighted and patented and that Lucent was the holder of the copyrights and patents. (*Id.* at p. 36.) Specifically, the court found Lucent established that it transferred “a portion of its copyright interests in the software when it granted the telephone companies a license to ‘reproduce [its] copyrighted work.’” (*Id.* at p. 37.) The court also found that Lucent “transferred a portion of its patent rights when it granted the telephone companies licenses to use the processes embodied in its software” (*Ibid.*) Further, the court found Lucent established that: (1) “the resulting products – the telephone products the telephone companies sold to their customers – were ‘subject to’” Lucent’s copyright interests because, “[w]ithout ‘incorporat[ing] a copy of’” the software, “the switches could not” produce the telephone products “the telephone companies were selling”; and (2) the telephone products were “‘subject to’” Lucent’s patents “because ‘[t]he license of a patent interest . . . gives the licensee the right to make a product or use a

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process.” (*Ibid.*) As a result, Lucent was the holder of the copyrights and patents involved in its software TTAs, Lucent was the exclusive retailer of that software on the tapes and discs used to transmit the software transferred under its software TTAs, and Lucent (the exclusive retailer) actually transferred the rights to make and sell products and use a process subject to Lucent’s patent and copyright interests in its software TTAs. Therefore, the court held that tax applied to the “3,954 blank tapes and/or compact discs used to transmit the software,” but did not apply to the charges for the “software and licenses.” (*Id.* at pp. 28, 37-38.)

Lucent’s Historical Explanation

In *Lucent*, the Court of Appeal explained how tax has historically applied and currently applies to transactions involving tangible personal property and intangible personal property. Specifically, the court said that:

- “Where the transaction involves components that are ‘readily separable’ and not ‘inextricably intertwined,’ the sales tax is assessed against the component of the transaction involving tangible personal property and not assessed against the remaining, non-taxable component” (*Lucent, supra*, 241 Cal.App.4th at p. 30 [citing *Dell, Inc. v. Superior Court* (2008) 159 Cal.App.4th 911, 924-925]);
- When the tangible personal property component of a transaction is inextricably intertwined with a non-taxable intangible personal property component, “the default rule [prior to the enactment of the TTA statutes was] to determine whether the tangible portion of the transaction [was] ‘essential’ or ‘physically useful’ to the purchaser’s subsequent use of the intangible personal property portion of the transaction” and “the ‘true object’ of the transaction [was] irrelevant.” (*Id.* at p. 31 [citing *Preston, supra*, 25 Cal.4th at pp. 211-212]);
- Thus, “when a seller [conferred] an intangible license to copy a copyrighted matter and [gave] the buyer a physical copy of the copyrighted matter needed to make use of that license – as is the case with film negatives, master audio recordings, or artwork to be used to make rubber stamps or for integration into a printing plate for a book – the entire transaction [was] subject to sales tax” prior to the enactment of the TTA statutes; however, “when a seller [granted] an intangible license to copy copyrighted material or to use a patent and [transferred] the material using tangible media that [was] not essential to the buyer’s use of the license or any further manufacturing process – as is the case when software is transmitted via a disc that is ‘not essential’ or otherwise physically useful to the buyer’s subsequent use of that software – the entire transaction [was] *not* subject to the sales tax” prior to the enactment of the TTA statutes, meaning that the prior “default rule [was] thus an all-or-nothing affair.” (*Id.* at p. 31 [citing *Preston, supra*, 25 Cal.4th at pp. 211-212 and *Microsoft Corp. v. Franchise Tax Board* (2012) 212 Cal.App.4th 78, 92 (hereafter *Microsoft*)]);
- However, the cases establishing the default, all-or-nothing rule have been superseded by the TTA statutes and, when the TTA statutes apply, tax is imposed on the charges for “the tangible personal property that is transferred [as determined under the TTA statutes] but not on ‘[t]he amount charged for [the] intangible personal property transferred.’” (*Id.* at p. 32 [citing the TTA statutes and *Preston, supra*, 25 Cal.4th at p. 212].)

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Software on Tapes and Discs

In *Lucent*, the Board argued that Lucent’s software was tangible personal property, as defined in RTC section 6016, once it was recorded on the tapes and discs used to transmit the software to the telephone companies in its transactions. (*Lucent, supra*, 241 Cal.App.4th at p. 33.) However, the court rejected the argument that the physical alteration of the tapes and discs used to transmit copies of Lucent’s software under Lucent’s software TTAs made the copies tangible personal property subject to tax. (*Id.* at pp. 33-34.) Instead, the court said that “the California courts have on multiple occasions held that the transmission of software using a tape or disc in conjunction with the grant of a license to copy or use that software does not yield a taxable transaction because the tape or disc is ‘merely . . . a convenient storage medium [used] to transfer [the] copyrighted content’ and hence not in itself essential or physically useful to the later use of the intangible property.” (*Id.* at p. 33 [citing and quoting from *Microsoft, supra*, 212 Cal.App.4th at p. 92 and citing *Nortel, supra*, as being in accord].) The court also said that, under Regulation 1502, tax would not apply if Lucent “transmitted the software electronically” and that “[a]scribing such tremendous consequences to the manner in which a software program is transmitted – when that manner is wholly collateral to the subsequent use of the licenses regarding that software and when the manner is so easily manipulated by the buyer and seller – is an absurd result.”

Also, in *Lucent*, the Board argued that Lucent’s agreements for the transfer of software on tapes and discs could only qualify as TTAs if Lucent’s agreements transferred “‘meaningful’ copyright and patent rights” to the telephone companies, meaning “the right to mass-produce or sell downstream some patented or copyrighted item,” and that the mere transfer of the rights any customer would need to copy and make conventional use of the software recorded on the tapes and discs was insufficient, alone, to create a software TTA. (*Lucent, supra*, 241 Cal.App.4th at p. 38.) However, the Court of Appeal rejected this argument and said that the “requirement that the transferred intellectual property interest be ‘meaningful’ or more than ‘conventional’ appears nowhere in the statute.” (*Ibid.*) “[T]he argument is inconsistent with federal copyright law, which provides that rights to a copyrighted work may be transferred piecemeal.” (*Ibid.*) A TTA “may be based upon the transfer of a single copyright right.” (*Ibid.*) Also, the TTA statutes “require [an agreement to include a] bona fide transfer of intellectual property rights” (patent or copyright interests) to qualify as a TTA, but do not otherwise require that the rights be “meaningful.” (*Ibid.*) Therefore, even though the TTA statutes expressly define a TTA as an “agreement under which a person who holds a patent or copyright interest assigns or licenses to another person *the right to make and sell a product or to use a process* that is subject to the patent or copyright interest” (emphasis added), *Lucent* provides that a software TTA may be based solely on a patent or copyright holder’s agreement to transfer software recorded on tapes and discs (or similar wholly collateral tangible storage media) and the right to copy the software, subject to the holder’s patent or copyright interests, without the transfer of the right to make and sell a product or use a process.

Measure of Tax in Lucent’s TTAs

In *Lucent*, the Court of Appeal also analyzed and applied the TTA statutes’ provisions for determining the price of tangible personal property transferred under a TTA. The court determined that only four of the “contracts listed a price for the blank media,” and the court

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looked “primarily to the price that [Lucent] had charged third parties for the blank media” to establish the amount paid for the 3,954 tapes and discs used to transmit the software. (*Lucent, supra*, 241 Cal.App.4th at p. 42.) Of particular note, the Board argued that “blank media is not ‘like’ the tapes and discs that actually contained [Lucent’s] software”; and the *Lucent* court opined that “. . . the fact that placing a computer program on storage media physically alters that media does not thereby transmogrify the software itself into tangible personal property; the media is tangible, the software is not.” (*Id.* at p. 42.) Thus, when the subject software TTA transactions were consummated (i.e., when title to and possession of the storage media was transferred), under the TTA statutes, the *Lucent* court considered the storage media to be the same tangible personal property it was before it was physically altered by having the software placed on it. Hence, for Sales and Use Tax Law purposes, the court found that Lucent sold its customers storage media at retail that the court deemed to be blank. Accordingly, notwithstanding the physical alterations to the storage media caused by placing the software thereon, the *Lucent* court affirmed the trial court’s use of the price of the blank storage media as “the price of the tangible personal property” subject to tax under the TTA statutes. (*Ibid.*)

Because Lucent did not separately state a reasonable price for the tangible personal property (i.e., a separately stated price that reflects the retail fair market value of the tangible personal property), the trial court established this measure of tax under RTC section 6012, subdivision (c)(10)(B), which states:

If the technology transfer agreement does not separately state a price for the tangible personal property,³ and the tangible personal property or like tangible personal property has been previously sold or leased, or offered for sale or lease, to third parties at a separate price, the price at which the tangible personal property was sold, leased, or offered to third parties shall be used to establish the retail fair market value of the tangible personal property subject to tax. The remaining amount charged under the technology transfer agreement is for the intangible personal property transferred.

(See *Lucent, supra*, 241 Cal.App.4th at p. 42 [explaining that the trial court “looked primarily to the price that AT&T/Lucent had charged third parties for blank media”].) In other words, despite the undisputed physical alterations to the storage media, because both the trial court and the *Lucent* court deemed the storage media to be blank at the time of retail sale for purposes of the Sales and Use Tax Law, the *Lucent* court affirmed the trial court’s use of the retail selling price of the blank storage media to third parties as the appropriate measure of tax under the TTA statutes.

Items Not Covered by Lucent

In *Lucent*, the Court of Appeal did not apply the TTA statutes to software that was embedded in a device at the time of manufacture or preloaded on a device prior to delivery to a consumer.

³ When a TTA is established, subdivision (c)(10)(B) only comes into play if the TTA fails to state “a reasonable price for the tangible personal property.” (RTC, §§ 6011, subd. (c)(10)(A), 6012, subd. (c)(10)(A) [emphasis added].) Thus, subdivision (c)(10)(B) comes into play when the TTA does not separately state a price for the tangible personal property or separately states a price that is not reasonable.

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The *Lucent* court found the facts in *Lucent* were virtually identical to the facts in *Nortel* (*Lucent, supra*, 241 Cal.App.4th at p. 37), and the *Nortel* court expressly stated that the computer programs or software at issue in that case were “not embedded in the hardware at the time of manufacture.” (*Nortel, supra*, 191 Cal.App.4th at p. 1278.) Similarly, the *Lucent* court also did not apply the TTA statutes to a process that was embedded in a device at the time of manufacture. Additionally, the *Lucent* court did not apply the TTA statutes to the off-the-shelf retail sale of canned, mass-marketed software. Finally, the *Lucent* court did not expressly invalidate any provisions in Regulations 1502 and 1507, but the court did state that, when both the TTA statutes and Regulation 1502 may apply to the same transaction, Regulation 1502 must give way to the TTA statutes. (*Lucent, supra*, 241 Cal.App.4th at p. 39.)

Discussion

Interested Parties Meetings

During its meeting on March 30, 2016, the Board authorized staff to begin working on:

1. Amendments to Regulation 1507 to clarify the requirements to establish that an agreement for the transfer of non-custom software⁴ on tangible storage media, such as tapes or discs, is a software TTA, in accordance with the holding in *Lucent*, and clarify the measure of tax when software is transferred under a software TTA; and
2. Amendments to Regulation 1502, *Computers, Programs, and Data Processing*, to conform to the amendments to Regulation 1507.

These issues were added to the [2016 calendar](#) for the Board’s Business Taxes Committee, and staff has scheduled three interested parties meetings to discuss different components of the issues. The interested parties meeting scheduled for June 30, 2016, is to discuss the proposed amendments to Regulation 1507. The interested parties meeting scheduled for August 24, 2016, is to discuss conforming amendments to Regulation 1502. The third interested parties meeting scheduled for October 18, 2016, is to discuss the application of tax to embedded non-custom software and pre-loaded non-custom software.

Staff will provide further analyses of the issues to be discussed at the second and third interested parties meetings in the discussion papers to be distributed prior to those meetings (please see summary on page 14). Staff is currently scheduled to present all of its proposed regulatory amendments to Regulations 1502 and 1507 to the Business Taxes Committee at the January 2017 Board meeting (the specific date will be determined when the Board approves the 2017 Board Calendar).

Specified Claims for Refund

During the Board’s meeting on March 30, 2016, staff also acknowledged that claims for refund based upon software transactions that were similar to the software TTAs in *Lucent* are able to be processed prior to the completion of any rulemaking. Staff said that it was ready to process a

⁴ Non-custom software refers to software that is not a custom computer program or programming as defined in RTC section 6010.9 and Regulation 1502.

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timely valid claim for refund if staff can verify that it relates to a software TTA:

1. Between an exclusive holder-retailer, such as Lucent, and a licensee, such as the telephone companies involved in Lucent's software TTAs;
2. Pursuant to which software was transmitted to the licensee on tangible storage media that was wholly collateral to the licensee's use of the licenses regarding that software, such as the tapes and discs used to transfer Lucent's software.

Staff also said that once that is verified, it is clear, under *Lucent*, that the taxable measure for such a software TTA is the retail fair market value of the tangible storage media, which is deemed to be blank, without any reference to third party transactions involving the same or like storage media containing the same software, as was the case in *Lucent*. However, staff did not specify what type of copyright and/or patent interests that an exclusive holder-retailer must assign or license under an agreement for the transfer of non-custom software on wholly collateral tangible storage media to be similar to the software TTAs in *Lucent*. Therefore, it is important to clarify, prior to any discussions regarding amendments to Regulations 1507 and 1502, that staff understands that *Lucent* rejected the argument that a software TTA must assign or license the right to mass-produce or sell downstream some patented or copyrighted item, and that an exclusive holder-retailer's agreement is similar to the software TTAs in *Lucent* if the agreement assigns or licenses the right to reproduce or copy non-custom software, subject to the exclusive holder-retailer's copyright or patent interest, that is transmitted on wholly collateral storage media.

Software TTAs in General

Read together, the *Nortel* and *Lucent* opinions *may* also be understood to more broadly hold that the TTA statutes apply when a *holder* of the copyright to non-custom copyrighted software or a *holder* of a patent that is embodied, implemented, and enabled by non-custom software:

- Transfers a copy of the software on tangible storage media;
- Transfers the right to reproduce or copy the software, subject to its copyright or patent interest, regardless of whether the holder also transfers the right to make and sell products or to use a process; and
- The tangible storage media is "wholly collateral" to the transferee's subsequent use of licenses regarding the software, meaning the storage media is only being used to transmit the software so that it can be copied and used in conjunction with a computer or computers, and, once the software is copied, the storage media is not essential or otherwise physically useful.

Also, when there is a software TTA (as described above), the measure of tax is limited to the amount charged for the "wholly collateral" storage media used to transfer the non-custom software as determined under the TTA statutes and does not include charges for the licenses to copy and use the software. Under the TTA statutes, the wholly collateral storage media used to transmit non-custom software included in a software TTA is deemed to be blank for purposes of the Sales and Use Tax Law, notwithstanding the physical alterations to the storage media caused by placing the software on the storage media.

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The corollary of this holding is that, when a non-holder-retailer sells tangible storage media on which non-custom software is placed, the transaction is not a software TTA and the full retail selling price for the tangible storage media is subject to tax.⁵ Therefore, the typical off-the-shelf retail sale of canned, mass-marketed software does not constitute a software TTA because the typical retailer can only sell tangible storage media and does not hold any intangible copyright or patent interests in the software to transfer with the storage media.

Put differently, when a non-holder-retailer purchases at wholesale tangible storage media on which non-custom software is placed, from the holder of copyright or patent interests in the software (or the holder's authorized distributor), the non-holder-retailer only obtains title to and possession of the storage media. The non-holder-retailer is not paying for a license to copy or use the software so that it can sub-license these rights to its retail customers. If such were the case, the shrink-wrap software license would be between the non-holder-retailer and the retail customer, which it is not. For purposes of the TTA statutes, one cannot be a licensor or a sub-licensor without first being a holder. (*Lucent, supra*, 241 Cal.App.4th at p. 38 (“the [TTA] statutes require a bona fide transfer of intellectual property rights”).) Thus, title to the storage media is all the non-holder-retailer sells to its customer in such a non-TTA software-related transaction.

Measure of Tax

Non-holder-retailer Transactions

When a non-holder-retailer sells storage media on which non-custom software is placed, it makes no difference whether the software on the storage media is considered to be tangible under the Sales and Use Tax Law because the transaction is not a TTA or whether the storage media is deemed to be blank despite the physical alterations to the storage media caused by placing the software thereon per the *Lucent* court. All of the consideration the non-holder-retailer receives (i.e., the full retail selling price) is for the transfer of title to the storage media (whether it is deemed to be blank or not) and is subject to tax.

In the subsequent shrink-wrap software license agreement between the holder and the purchaser of the storage media, the holder, who has already been paid by the non-holder-retailer for the storage media pursuant to the wholesale transaction, directly licenses rights to copy and use the software to the retail customer in exchange for the retail customer's promise (i.e., “I agree”) to only copy and use the software as permitted under the express terms of the license. This promise is exclusively for intangible rights, and the holder never receives any gross receipts from the retail customer for the storage media purchased. Accordingly, this subsequent shrink-wrap-license transaction (between the holder and the purchaser) is not subject to either sales or use tax.

Holder-retailer Transactions

The foregoing also provides guidance on how to establish the proper measure of tax when a holder-retailer sells wholly collateral tangible storage media on which off-the-shelf canned, mass-marketed software is recorded, directly to retail purchasers in TTA transactions (i.e., “non-

⁵ This corollary is consistent with the Board's Legal Department's post-*Nortel* guidance regarding non-holder-retailer transactions involving tangible storage media on which non-custom software is recorded.

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typical” retail transactions). If at least one non-holder-retailer sells the same or like storage media on which the non-custom software sold by the holder-retailer is placed, then the retail fair market value of the storage media in the holder-retailer’s TTA transactions is established by the retail selling price of the storage media when sold or offered for sale by the non-holder-retailer in a non-TTA transaction. Thus, when a holder-retailer is not the exclusive retailer of storage media on which its software is recorded, it should be presumed that the holder-retailer’s entire retail selling price is subject to tax, just as the entire retail selling price is subject to tax when the non-holder-retailer sells the same or like storage media in a non-TTA transaction. Such a result is necessary to adhere to the *Lucent* court’s admonition to avoid absurd results. (*Lucent, supra*, 241 Cal.App.4th at p. 34.) In short, such a presumption would ensure that similar transactions are taxed consistently and would not allow holder-retailers to separately state an unreasonable price for the storage media that is inconsistent with the retail fair market value of the storage media established by the like non-holder-retailer transactions. (See RTC, §§ 6011, subd. (c)(10)(A)-(B), 6012, subd. (c)(10)(A)-(B).)

If the holder-retailer is the exclusive retailer of wholly collateral storage media on which the non-custom software is placed, and the holder-retailer also sells blank storage media that is the same or like the storage media used to transmit the software to third parties for a separately stated price, then, under *Lucent* and the TTA statutes, that separately stated price should be used for the taxable measure in the exclusive holder-retailer’s software TTAs. If no such like or similar transactions exist, the measure of tax should then be presumed to be the cost of the storage media to the exclusive holder-retailer plus a reasonable retail mark-up. (See RTC, §§ 6011, subdivision (c)(10)(C), 6012, subdivision (c)(10)(C).) And, staff considers a reasonable mark-up to be 100 percent because, under such circumstances, the TTA statutes provide that the retail fair market value of the wholly collateral storage media is equal to “200 percent” of its cost and the Board has considered a mark-up of 100 percent to be reasonable under similar circumstances. (See *Intel Corp.*, Mem. Opn., June 4, 1992.) Also, the same statutory-based approach should be used to determine the measure of tax if a non-exclusive holder-retailer can establish that all the retailers of the same non-custom software on the same or like wholly collateral storage media sold by the non-exclusive holder-retailer are also holder-retailers, so that there are no non-holder-retailer transactions to establish the retail selling price of the storage media.

Staff’s Proposed Regulatory Amendments

General

Currently, Regulation 1507 does not expressly explain that the transferor in a TTA must be a person that “holds a patent or copyright interest” and that a TTA must be an agreement that includes the transfer of tangible personal property. Regulation 1507 contains a definition for the term TTA that applies to agreements that transfer copyright interests and a separate definition for the term TTA that applies to agreements that transfer patent interests, and staff does not believe that the two definitions are currently helpful to Board staff or taxpayers. In addition, examples 2 and 3 in Regulation 1507 illustrate important aspects of TTAs involving the transfer of patent interests, but that these aspects could be illustrated more clearly without changing the meaning of the examples. Therefore, staff proposes to amend Regulation 1507, as illustrated in Exhibit 1, so it contains one definition of TTA in subdivision (a)(1), which expressly provides that a TTA

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“means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) under which a person who holds a patent or copyright interest assigns or licenses the right to make and sell a product or use a process subject to the patent or copyright interest, and also transfers tangible personal property,” consistent with the statutory definition. Staff also proposes to amend Regulation 1507, subdivision (a)(1), to further specify that a TTA does not mean “an agreement that assigns or licenses copyright or patent interests without transferring any tangible personal property.” Staff proposes to add subdivision (a)(5) and (6) to define the terms “holder” and “non-holder.” Staff further proposes to revise the examples in subdivision (a)(1) to clarify that to qualify as a TTA the transferor must be a “holder” and the agreement must transfer tangible personal property and copyright or patent interests. These amendments would ensure that the regulation is consistent with the statutes and provide additional clarification.

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Regulation 1507 does not refer to computer programs or software and Regulation 1507 does not provide any specific guidance with respect to a TTA that includes the transfer of non-custom software on tangible storage media, including guidance regarding the measure of tax in such a TTA. Staff proposes amendments to Regulation 1507, as illustrated in Exhibit 1, to add a new subdivision (c)(1) to:

- Define the terms “software,” “non-custom software,” “computer,” “tangible storage media,” “holder-retailer,” “non-holder-retailer,” “exclusive holder-retailer,” “non-exclusive holder-retailer,” “software TTA,” and “wholly collateral”;
- Explain that tax applies to amounts received for the wholly collateral tangible storage media transferred under a TTA, but does not apply to amounts received for the assignment or licensing of the right to reproduce or copy non-custom software subject to a copyright or patent interest under a software TTA; and
- Explain how to determine the measure of tax for the transfer of the “blank” storage media used to transmit non-custom software in a software TTA based upon whether the same or like wholly collateral tangible storage media on which the same non-custom software is recorded is sold by at least one non-holder-retailer (as explained above).

The proposed amendments clarify the requirements to establish that an agreement for the transfer of non-custom software on tangible storage media, such as tapes or discs, is a software TTA, in accordance with the holding in *Lucent*, and clarify the measure of tax when software is transferred under a software TTA.

Other than the proposed amendments as discussed above, staff does not intend to amend Regulation 1507 to prescribe the specific types of records that one must have to verify that a transaction is a valid software TTA and determine the measure of tax for the transfer of the “blank” storage media in a software TTA. This is because such records are likely to vary on a case-by-case basis. However, staff believes it may be helpful for purposes of future policy development to understand the types of records that may be commonly used in the industry to document a valid software TTA, as well as the measure of tax in such transactions. Therefore, staff is open to discussion and requests input from interested parties with respect to such records.

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Summary

Staff believes the proposed revisions will serve taxpayers by clarifying the general meaning of the term TTA and clarifying the Board's understanding of and making Regulation 1507 consistent with the *Lucent* decision. Staff welcomes any comments, suggestions, and input from interested parties on staff's proposed amendments to Regulation 1507. Staff also invites interested parties to participate in the June 30, 2016 interested parties meeting. The deadline for interested parties to provide written responses regarding the proposed amendments to Regulation 1507 is July 15, 2016.

Staff also welcomes interested parties to submit comments with respect to the topics scheduled for discussion at the second and third interested parties meetings in advance of those meetings. To allow staff sufficient time to consider addressing the written comments received in advance of the issuance of the second and third discussion papers, staff requests that those comments be submitted no later than July 15, 2016 and September 8, 2016, respectively.

Prepared by the Tax Policy Division, Business Tax and Fee Department

Current as of June 17, 2016

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1507. Technology Transfer Agreements.

(a) Definitions.

(1) "Technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) under which a person who holds a patent or copyright interest~~that assigns or licenses the right to make and sell a product or a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to~~ use a process subject to the~~a~~ patent or copyright interest, and also transfers tangible personal property.

A technology transfer agreement does not mean an agreement that assigns or licenses copyright or patent interests without transferring any tangible personal property. A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to a technology transfer agreement, except as provided above.

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

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

Example No. 3: Company X is the holder of patent interests in a medical device and a process external to the medical device that involves the use, application or manipulation of the medical device. Company X manufactures and leases the~~a~~ patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in the~~a~~ process external to the medical

device ~~that involves the use, application or manipulation of the medical device~~. Company X charges a monthly rentals payable for the medical device equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device and transfer of the patent interest to Company Y to perform the separately patented process external to the medical device is ~~not~~ a technology transfer agreement, ~~and~~ tax applies to the entire rentals payable for the medical device equipment, including any charges for the right to perform a process related to the patented technology embedded in the internal design, assembly or operation of the medical device. ~~Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement~~. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. If Company X leases the medical device and only transfers the right to perform a process related to the patented technology embedded in the internal design, assembly or operation of the medical device to Company Y, the lease of the device and transfer of the right to perform the embedded process is not a technology transfer agreement. ~~Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device~~.

(2) "Copyright interest" means the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission. For purposes of this regulation, an "original work of authorship" includes any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.

(3) "Patent interest" means the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material. "Process" means one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of

tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest.

(4) "Assign or license" means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement.

(5) "Holder" means a person that holds a copyright or patent interest.

(6) "Non-holder" means a person that does not hold a copyright or patent interest.

(b) Application of Tax

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

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

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

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

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

~~(3) Specific Applications.~~
(c) Specific Applications.

(1) Software Technology Transfer Agreements.

(A) Definitions. For purposes of subdivision (c)(1):

1. "Software" means a "program" as defined in Regulation 1502, *Computers, Programs, and Data Processing*. "Non-custom software" means a program other than a "custom computer program and programming" as defined in Regulation 1502.

2. "Computer" means "computer" and "tangible storage media" means "storage media" as defined in Regulation 1502.

3. "Holder-retailer" means a retailer that makes sales of non-custom software and holds a copyright or patent interest in the non-custom software. "Non-holder-retailer" means a retailer that makes sales of non-custom software and does not hold a copyright or patent interest in the software. For purposes of this subdivision, it is presumed that a retailer is a non-holder-retailer of non-custom software until the retailer establishes that it holds copyright or patent interests in the software.

4. "Exclusive holder-retailer" means a holder-retailer that is the only retailer of its non-custom software recorded on a specific type of tangible storage media or like (similar) types of tangible storage media that are wholly collateral to a person's subsequent use of the licenses regarding that software. "Non-exclusive holder-retailer" means a holder-retailer that sells the same non-custom software on the same or like (similar) type of tangible storage media that is wholly collateral to a person's subsequent use of the licenses regarding that software that is sold by other retailers. For purposes of this subdivision, it is rebuttably presumed that a compact disc (CD), a digital video disc (DVD), and a flash drive are like (similar) types of tangible storage media.

5. "Software technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) under which a holder-retailer assigns or licenses the right to reproduce or copy non-custom software subject to the holder-retailer's copyright or patent interest to a person and transmits a copy of the non-custom software to the person on tangible storage media that is wholly collateral to the person's subsequent use of the licenses regarding that software. "Software technology transfer agreement" does not mean or include a non-holder-retailer's agreement to sell tangible storage media on which non-custom software is recorded.

6. Tangible storage media is "wholly collateral" to a person's subsequent use of licenses regarding software recorded on the storage media if the storage media is only being used to transmit the software to the person so that it can be copied and used in conjunction with a computer or computers, and, once the software is copied,

the storage media is not essential or otherwise physically useful, except to restore copies of the software on the computer or computers. A computer's internal storage media, such as a computer's internal hard drive or memory, is not wholly collateral to the subsequent use of software recorded on it.

(B) Application of Tax. Tax applies to amounts received for the wholly collateral tangible storage media transferred under a software technology transfer agreement as provided in subdivision (c)(1)(C). Tax does not apply to amounts received for the assignment or licensing of the right to reproduce or copy non-custom software subject to a copyright or patent interest under a software technology transfer agreement.

When tangible storage media on which non-custom software is recorded is transferred and the transfer is not under a software technology transfer agreement, tax applies to the amount charged for the tangible storage media, as provided in Regulation 1502.

(C) Measure of Tax.

1. When an exclusive holder-retailer sells wholly collateral tangible storage media on which its non-custom software is recorded, under a software technology transfer agreement, the gross receipts or sales price attributable to the wholly collateral tangible storage media shall be:

a. The separately stated reasonable price for which the exclusive holder-retailer has sold the same blank tangible storage media to third parties; and

b. Where there is no such separately stated price, 200 percent of the exclusive holder-retailer's combined cost to produce or acquire the blank tangible storage media. The cost of materials and labor used to develop the non-custom software are not part of the cost to produce or acquire the tangible storage media.

2. For purposes of this subdivision, it is rebuttably presumed that:

a. A non-exclusive holder-retailer sells the same non-custom software on the same or like (similar) type of wholly collateral tangible storage media that is sold by at least one non-holder-retailer; and

b. The non-exclusive holder-retailer's entire retail selling price for the wholly collateral tangible storage media transferred under a software technology transfer agreement is subject to tax regardless of whether any portion of the selling price is referred to as license fees, end user fees, etc.

This is because the retail fair market value of the same or like (similar) type of tangible storage media is established by the non-holder-retailer's sales, the non-holder-retailer's entire retail selling price for the same or like (similar) tangible storage media is subject to tax under Regulation 1502, and any separately stated

price for the same or like (similar) tangible storage media that is less than its entire retail selling price would not represent its reasonable fair market value.

3. The presumptions in subdivision (c)(1)(C)2 do not apply to a non-exclusive holder-retailer that can establish that all the retailers of the same non-custom software on the same or like (similar) types of wholly collateral tangible storage media sold by the non-exclusive holder retailer are also holder-retailers. When the presumptions in subdivision (c)(1)(C)2 do not apply, a non-exclusive holder-retailer shall determine the gross receipts or sales price attributable to the wholly collateral tangible storage media transferred under a software technology transfer agreement under subdivision (c)(1)(C)1.

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

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6011 and 6012, Revenue and Taxation Code; ~~Preston v. State Board of Equalization~~ Preston v. State Board of Equalization (2001) 25 Cal.4th 197, ~~105 Cal. Rptr. 2d 407~~; Lucent Technologies, Inc. v. Board of Equalization (2015) 241 Cal.App.4th 19.