STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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October 5, 2012

Dear Interested Party:

Enclosed is the *Second Discussion Paper* regarding non-custom computer programs recorded on tangible storage media and technology transfer agreements. This document includes a discussion of whether to amend Regulation 1502, *Computers, Programs, and Data Processing* and/or Regulation 1507, *Technology Transfer Agreements*.

A second interested parties meeting is scheduled for **October 11, 2012 at 10:00 a.m. in Room 121** to discuss these issues. If you are unable to attend the meeting but would like to provide input for discussion, send your submission to the above address or send a fax to (916) 322-4530 before the October 11, 2012 meeting. 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 attending the meeting or presenting their comments.

If you plan to attend the meeting on October 11, 2012, or would like to participate via teleconference, please let staff know by contacting Mr. Robert Wilke at (916) 445-2137 or Robert.Wilke@boe.ca.gov prior to October 9, 2012. This will allow staff to make alternate room arrangements, if necessary, and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the October 11, 2012 meeting must be received by November 2, 2012. They should be submitted in writing to the above address or by email to Mr. Wilke.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Kirsten Stark, Supervisor, Business Taxes Committee and Training Section at (916) 322-0849.

Sincerely,

Susanne Buehler

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

SB: 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 (MIC 78)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)
Mr. Robert Thomas, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, 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. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges
Mr. Randy Ferris
Mr. Jeffrey L. McGuire
Mr. Jeff Vest
Mr. David Levine
Mr. Robert Tucker
Mr. Bradley Heller
Mr. Robert Ingenito
Mr. Bill Benson, Jr.
Mr. Todd Gilman
Mr. Kevin Hanks
Mr. Stephen Rudd
Ms. Kirsten Stark
Ms. Laureen Simpson
Mr. Robert Wilke
Ms. Lynn Whitaker

SECOND DISCUSSION PAPER

Regulation 1502, *Computers, Programs, and Data Processing*, and Regulation 1507, *Technology Transfer Agreements*

ISSUES

Whether the State Board of Equalization (Board) should:

1. Amend Regulation 1502, *Computers, Programs, and Data Processing*, to clarify how sales and use tax generally applies to transfers of non-custom computer programs (hereafter prewritten software) recorded on tangible storage media; and/or
2. Amend Regulation 1507, *Technology Transfer Agreements*, to clarify how the technology-transfer-agreement statutes (Rev. & Tax. Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)) (TTA statutes) apply to transfers of prewritten software recorded on tangible storage media?

BACKGROUND

A. <u>General Background Information Regarding Relevant Statutes</u>

Revenue and Taxation Code (RTC) section 6006, subdivision (a) provides that a "sale" includes "any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration." RTC section 6009 provides that "'Use' includes the exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business."

RTC section 6016 provides that "tangible personal property" is "personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses."

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

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

B. Specific Background Information Regarding Regulation 1502 and RTC Section 6010.9

The Board initially adopted Regulation 1502, *Computers, Programs, and Data Processing*, in 1972 to prescribe the application of the Sales and Use Tax Law to data processing and computer programming services. However, there was still confusion over whether tax applied to the sale or lease of "custom" computer programs transferred on tangible storage media after Regulation 1502's implementation. As a result, the Legislature enacted RTC section 6010.9 in 1982 to specifically address the application of the Sales and Use Tax Law to sales and purchases of computer programs on tangible storage media in a manner that provides "state incentives for the development and utilization of computer software." (Stats. 1982, ch. 1274, §§ 1, 2.) Under RTC section 6010.9, charges for "the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program" and "separately stated charges for [custom] modifications to an existing prewritten program which are prepared to the special order of the customer" are not subject to sales or use tax, even if the custom computer programs or custom modifications are transferred on tangible storage media. (RTC § 6010.9, first sentence and subd. (d), respectively.) However, charges for "a 'canned' or prewritten computer program which is held or existing for general or repeated sale or lease," did not receive an exclusion, "even if the prewritten or 'canned program' was initially developed on a custom basis or for in-house use." (RTC § 6010.9, subd. (d).)

Following the enactment of RTC section 6010.9, the Board amended Regulation 1502, subdivision (f) in 1988 to address the application of tax to charges for custom computer programs, custom modifications to prewritten computer programs, and canned or prewritten computer programs in conformity with RTC section 6010.9. Also in 1988, the First District Court of Appeal interpreted RTC section 6010.9 in *Touche Ross & Co. v. State Bd. of Equalization* (1988) 203 Cal.App.3d 1057 (hereafter *Touche Ross*), which involved the taxable sale of a business that included a library of used, customized and internally developed computer programs recorded on computer storage media. The court held that section 6010.9 was declaratory of, rather than a change in, existing law. (*Id.* at p. 1062.) Further, the court went on to hold that, once a program had been created and was in the possession of the original customer, the design or development service had been completed, and the program itself was a tangible personal asset to the customer. Therefore, a subsequent sale of that program by the initial customer could no longer be characterized as a "service" transaction, but rather would constitute a transfer of tangible personal property. Thus, the court concluded that the subsequent sale of such computer programs was subject to sales tax under the general provisions of RTC section 6051. (*Id.* at p. 1064.)

C. Background Regarding TTA Statutes and Regulation 1507

1. The Enactment of the 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. Under the first contract, Intel transferred a license to use a patented process for producing integrated circuits, along with 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 in a manner that, but for the licenses, would infringe upon the copyright or patent interests at issue. 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, 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." (Rev. & Tax. Code, §§ 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.*, subd. (c)(10)(A)-(C).)

2. Relevant California Supreme Cases Decided Prior to 2011

The California Supreme Court has distinguished between and applied different tests to determine whether tax applies to transfers of tangible personal property with intangible property and whether tax applies to transfers of tangible personal property together with the provision of services. In *Simplicity Pattern Co. v. State Bd. of Equalization* (1980) 27 Cal.3d 900, 912 (hereafter *Simplicity Pattern*) decided prior to the enactment of the TTA statutes, the court held that the transfer of tangible personal property, film negatives and master recordings, that were "physically useful in the manufacturing process" were subject to sales tax even though the tangible personal property was "valued in part for [its] intellectual content."

In *Navistar International Transp. Corp. v. State Bd. of Equalization* (1994) 8 Cal.4th 868 (hereafter *Navistar*) decided after the enactment of the TTA statutes, the manufacturer Navistar sought a refund of sales taxes assessed by the Board on drawings and designs, manuals and procedures, and software included in Navistar's sale of its Solar Division to a wholly owned subsidiary of Caterpillar, Inc. The California Supreme Court held that the "true object" of the contract test in Regulation 1501, *Service Enterprises Generally,* only applies to determine whether tax applies to the transfer of tangible personal property with the performance of services, and that the true object of the contract test did not apply to the transfer of the design documents and manuals because the transfer was not incidental to the performance of a service. (*Id.* at p. 876-877.) The Court also affirmed the use of the "physically useful" test found in *Simplicity Pattern* to determine whether tangible personal property is taxable, but, in interpreting the "physically useful" test, the Court held that, for items valued in part for their intellectual property, physical usefulness in a manufacturing process is not a prerequisite to the imposition of the sales tax. (*Id.* at p. 878.) In addition, the Court found that the transfer of an item valued in part for its intellectual property is subject to tax, unless the transfer also involves a separate and distinct transfer of an intangible property right, such as a copyright. (*Id*. at p. 877-878.) The Court explained that "A copyright is an intangible right that includes the exclusive right to reproduce, publish, and sell the literary work that is the subject of the copyright. (17 U.S.C. § 106.) The copyright is separate and distinct from the material object embodying the work. (*Id.*, § 202.)" (*Id*. at p. 877.) However, the Court found that the buyer "purchased the documents in question for their own sake" and that the sale of the documents did not involve the "separate and distinct transfer of an intangible right." (*Id.* at pp. 877-878.) Therefore, the Court found that "the documents involved here must be characterized as tangible personal property for purposes of tax law, thus rendering their sale taxable." (*Id.* at p. 880.) Because the case did not involve copyrights and patents, the TTA statutes did not apply. (*Ibid.*)

Regarding the transfer of software, Navistar contended that because the software was custom-developed in-house for its own business use, rather than for general or repeated sales, the software was custom software and therefore not taxable. (*Navistar*, *supra*, at p. 880.) The Court, however, relying on the rationale in *Touche Ross*, held that Navistar's transfer of software was taxable because, at the time of the sale, the service performed in developing the software for Navistar had been completed. Thus, when the sale occurred, the software no longer constituted specially ordered custom software under RTC section 6010.9. (*Navistar* at p. 883.)

In *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 (hereafter *Preston*), the California Supreme Court discussed the meaning of the TTA statutes before applying them to a number of written agreements transferring the right to reproduce copyrighted artwork (i.e., illustrations and designs) in children's books and on rubber stamps to two book publishers and a rubber stamp manufacturer, respectively. The Court stated that: "Read as a whole and giving the statutory language its ordinary meaning, *sections 6011(c)(10)* and *6012(c)(10)* unambiguously establish that the value of a patent or copyright interest transferred pursuant to a technology transfer agreement is *not* subject to sales tax even if the agreement also transfers tangible personal property. . . . In other words, these provisions exclude the value of a patent or copyright interest from taxation whenever a person who owns a patent or copyright transfers that patent or copyright to another person so the latter person can make and sell a product embodying that patent or copyright." (*Preston*, *supra*, at pp. 213-214, italics in original.) The Court also found that the agreements transferring the rights to reproduce copyrighted artwork in children's books and on rubber stamps constituted TTAs because they transferred the right to make and sell products that were subject to the transferor's copyrights. (*Id.* at p. 215.)

Further, and as relevant here, the Court explained the fundamental attributes of transfers involving copyrights and patents. The Court stated:

> Patents give an owner "the exclusive right to manufacture, use, and sell his invention." [Citation omitted.] Thus, the license of a patent interest, by definition, gives the licensee the right to make a product or to use a process. In contrast, "copyright protects originality rather than novelty or invention–conferring only 'the sole right of multiplying copies.'" (*Mazer* [*v. Stein* (1954)] 347 U.S. [201], 218, 74 S.Ct. 460, fn. omitted.) Thus, the license of a copyright interest can only give the licensee the right to reproduce the copyrighted material in a product–and not the right to make and sell a product. Because *sections 6011(c)(10)* and *6012(c)(10)* expressly exempt the assignment or license of the right to make and sell a product subject to *either* a patent *or* copyright from taxation, they must encompass agreements, like Preston's, that license the right to reproduce copyrighted material in a product to be manufactured and sold by the licensee. (*Preston*, *supra*, at pp. 215-216, italics in original.)

The Court then went on to specifically distinguish the portion of the sales agreement at issue in *Navistar* from the sales agreements at issue in *Preston*. It explained that *Navistar* did not involve the transfer of separate and distinct intangible property rights, but *Preston* did involve "the separate and distinct transfer of a copyright--an intangible right distinct from 'any material object in which the work is embodied,'" that is the right to produce and sell products embodying the copyrighted work. Accordingly, the Court decided that the TTA statutes applied in *Preston*. (*Preston*, *supra*, at p. 220.)

Preston also invalidated a non-TTA provision of Regulation 1540, *Advertising Agencies and Commercial Artists*, pertaining to the taxability of lump-sum charges involving copyright interests that the court found was in conflict with the TTA statutes. (*Preston*, *supra*, at p. 219.)

3. Regulation 1507

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

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

> "Technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.
>
> A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to [a] technology transfer agreement.

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." [A]n "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." (Reg. 1507, subd. (a)(2));

- "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)); and
- "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), italics added.)

In addition, the regulation provides that "'Assign or license' means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement." (Reg. 1507, subd. (a)(4).)

4. The Court of Appeal's 2011 *Nortel* Case

Subdivision (a) of Regulation 1507 originally provided that "[a] technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502." On January 18, 2011, however, this provision was invalidated by the Second District Court of Appeal in *Nortel Networks, Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259, 1278 (hereafter *Nortel*).

The Court of Appeal noted that the factual basis for its *Nortel* decision was uniquely limited. Footnote 2 to the entire statement of facts explains that "[o]wing to state budgetary problems, the sole expert witness designated by the state refused to be deposed because his fee was unpaid. As a result, he was not permitted to testify at trial, a lapse the trial court aptly forecast as 'fatal' to the state's defense. Nortel was the beneficiary of the state's fiscal distress: to make its factual findings, the trial court had to rely exclusively on technical testimony from a procession of Nortel-friendly witnesses. The court found the testimony 'credible in all respects,' based on the witnesses' candor and demeanor." (*Nortel*, *supra*, at p. 1265, fn. 2).

Based upon the limited factual record and stipulated facts, the court found that "Nortel and Pacific Bell entered [into] licensing agreements giving Pacific Bell the right to use Nortel's software programs in the switches" Pacific Bell purchased from Nortel. (*Nortel*, *supra*, at p. 1265.) The licensing agreements concerned "two types of licensed software . . . [: (A)] prewritten operator workstation programs (that connect customers to operators), data center programs (that connect customers to directory assistance), and switch-connection programs (that allow switches to communicate)"; and (B) "switch-specific programs (SSP's) that operate the switch and enable it to process telephone calls." (*Ibid*.) "The three prewritten programs licensed by Nortel are copyrighted . . . [and] subject to Nortel's patents." (*Id*. at p. 1278.) "Each SSP is unique, is created for a particular switch, and cannot be used to operate any other switch"; and "[o]wing to their uniqueness, SSP's are 'never' offered for general sale, or for repeated sale or lease." (*Id*. at p. 1265.) Also, "Nortel copyrights its SSP's: each program is 'an original work of authorship created by the Nortel software programmers'" and the "SSP itself incorporates one or more processes that are subject to—and implement—Nortel's patent interests." (*Id*. at p. 1266.)

The court further found that the "completed SSPs [are] shipped to Pacific Bell on disks, magnetic tapes, or cartridges, also known as 'storage media,'" and that "Nortel provides Pacific Bell with the three prewritten programs." (*Nortel*, *supra*, at p. 1267.) "The licensing agreements allow Pacific Bell to copy the software from the storage media and load it into the operating memory of a switch's computer hardware. This authorization to copy the software onto its computers allows Pacific Bell to use the programs without violating Nortel's copyright." (*Id*. at p. 1268.) And, "[t]he license gives Pacific Bell the right to produce telephonic communications, without fear of infringing upon Nortel's patents." (*Ibid*.) Furthermore, "Pacific Bell used the patented processes contained in the SSP's to create and sell a product; namely, telephone communications for consumers," including "basic and long distance telephone calls; call forwarding; caller identification; call waiting; conference calling; music-on-hold; and voice mail." (*Id*. at p. 1274.)

Therefore, based upon the above findings and the parties' stipulations, the court found that Nortel licensed the right to copy the SSP software onto Pacific Bell's switch for the purpose of making and selling a product (i.e., phone calls), which constituted a qualifying copyright interest under the TTA statutes (*id*. at p. 1275); that Nortel also licensed the right to copy the prewritten programs onto Pacific Bell's switch for the purpose of making and selling phone calls and that, as such, the prewritten programs were transferred pursuant to a TTA (*id*. at p. 1278); that Nortel licensed the right to make and sell phone calls subject to Nortel's patent interests to Pacific Bell within the meaning of the TTA statutes (*id*. at pp. 1273-1274); and that Nortel also "licensed the right to use [the SSPs to perform] patented 'processes' within the meaning of the TTA statutes" (*id*. at p. 1275).

Because the Board and Nortel stipulated to the cost of producing the storage media upon which the SSPs and prewritten computer programs were transferred to Pacific Bell, the parties did not litigate, and the court did not analyze, whether the SSPs and prewritten programs on tangible storage media were tangible personal property within the meaning of RTC section 6016 at the time they were transferred. Thus, the court also did not analyze the TTA statutes' provisions for determining the price of tangible personal property transferred in a TTA and apparently assumed, without analysis, that the measure of tax could be established by referencing the stipulated "cost of producing the storage media." (See *Nortel*, *supra*, at p. 1268.)

5. 2011 Amendments to Regulation 1507

On May 25, 2011, the Board voted to repeal the sentence in Regulation 1507 regarding prewritten software, which the Second District Court of Appeal invalidated in *Nortel*, pursuant to California Code of Regulations, title 1, section 100. Currently, Regulation 1507 does not contain any reference to computer programs or software.

6. Press Release

On May 27, 2011, the Board issued a press release regarding *Nortel*, which provided that:

> Jerome Horton, Chairman of the State Board of Equalization, today announced that the Board authorized an amendment to make its current regulations consistent with a recent California Court of Appeal decision holding that sales tax does not apply to interests in patents and copyrights transferred with prewritten (or canned) software in a technology transfer agreement (TTA). The Board made the clarifying regulatory change at its Sacramento meeting this week.
>
> The Board announced that the change does not affect the way sales tax is applied to the typical off-the-shelf retail sale of canned, mass-marketed software because the typical retailer does not hold any copyright or patent interests in the software. The change only clarifies that when the holder of copyrights or patents also sells that intellectual property to another in a technology transfer agreement that includes the transfer of software, the amount charged for the copyrights or patents is excluded from the application of sales tax.
>
> "The courts have spoken and the message is clear, canned software is taxable and intellectual property is not," Horton said. "With the help of the industry we will provide further guidance on how tax applies to sales of software."
>
> The California Court of Appeal in January 2011 filed an opinion in Nortel Networks, Inc. v. State Board of Equalization that expressly provides that:
>
> "To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, the regulation exceeds the scope of the Board's authority and does not effectuate the purpose of the TTA statutes: It is, for these reasons, invalid."
>
> On April 27, 2011, the California Supreme Court issued a notice denying the Board's Petition for Review of the Court of Appeal's opinion.

7. TTA Study

On August 23, 2011, the Board authorized staff to conduct a study to evaluate the feasibility of developing an optional percentage that can be used to reasonably estimate the fair market value of tangible personal property in TTAs involving non-custom computer programs transferred on tangible storage media. However, the study has not proceeded because there has been a lack of industry participation thus far.

8. Pending Litigation

The Board is currently defending suits for refund in *Lucent Technologies, Inc. v. State Bd. of Equalization* **(**Los Angeles Superior Court Case No. BC402036) (*Lucent I*) and *Lucent Technologies, Inc. v. State Bd. of Equalization* (Los Angeles Superior Court Case No. BC448715) (*Lucent II*), which raise TTA issues regarding the transfer of computer software recorded on storage media for use in conjunction with telephone switches.

D. Background Regarding Interested Parties Process

Prior to the distribution of the initial discussion paper regarding the taxation of software following the Court of Appeal's *Nortel* decision, Industry had urged Board staff to concede that *Nortel* establishes a broad exemption for all sales of prewritten software transferred on tangible storage media because practically all computer programs are subject to copyrights and the Second District Court of Appeal cited *Preston* in holding that "[t]ransferring the right to reproduce [a] copyrighted work is a TTA." (*Nortel*, *supra*, at p. 1274.) Industry had also urged Board staff to establish a policy limiting the measure of sales and use tax in TTAs involving the transfer of prewritten software encoded on tangible storage media (i.e., the disk, thumb drive, etc.) to the cost of the storage media alone, based upon the measure of tax ultimately utilized in *Nortel*.

In the initial discussion paper distributed on June 29, 2012, Board staff disagreed with such a concession because Board staff does not believe that such a broad reading of *Nortel* is either legally justified or appropriate, and the Board has not conceded that refunds are due in the *Lucent I* and *Lucent II* lawsuits. Board staff explained that there is authority, both scientific and legal, that supports the conclusion that prewritten software recorded on tangible storage media is tangible personal property. Board staff further explained that, after the *Nortel* decision and the 2011 amendments to Regulation 1507, Board staff is of the opinion that the TTA statutes can and will apply to the transfer of prewritten software recorded on tangible storage media if the transfer is part of a TTA, that is 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"; and that Board staff is prepared to apply the TTA statutes to determine the amount paid for tangible personal property transferred under a TTA, including by looking to the separately stated price at which the same or like tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party by other retailers that do not hold any patents or copyrights (non-holders). Board staff also noted that Regulation 1507 provides 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, and that the Court of Appeal did not invalidate those provisions in the *Nortel* decision.

The Board received a letter from Mr. Patrick J. Leone dated July 13, 2012, in response to the initial discussion paper, which suggested that "any transfer of software subject to a license agreement should be considered an exempt TTA and that tax should be limited to the cost of any storage media upon which the software is transferred," and that Regulation 1507 "should clarify that as long as the retailer has the right to transfer and does transfer the right to use the software, even if they were not the original holder of the patent or copyright, it still qualifies as a TTA."

The initial interested parties meeting regarding the taxation of software following the Court of Appeal's *Nortel* decision was conducted on July 17, 2012. During the meeting, the interested parties urged Board staff to concede that software is intangible, agree that all transfers of prewritten software recorded on tangible storage media are TTAs, and agree that the Board should amend Regulation 1507 to limit the measure of tax in all such "software TTAs" to the cost of the tangible storage media or, preferably, disregard the tangible storage media as de minimis and exempt the entire software TTA from sales and use tax. Some interested parties also questioned the validity of Regulation 1507's provisions regarding embedded processes.

The Board received an August 1, 2012, letter from Mr. Mark Nebergall, which provided the California Chamber of Commerce's, California Manufacturers and Technology Association's, California Taxpayers Association's, Council on State Taxation's, Silicon Valley Leadership Group's, Software Finance and Tax Executives Council's (SoFTEC's), and TechAmerica's comments following the initial discussion of the taxation of software after the Court of Appeal's *Nortel* decision. The letter, in summary, argued that prewritten software is not tangible personal property, that, as a result of *Nortel*, all transfers of prewritten software on tangible storage media are TTAs, and that, pursuant to *Nortel*, the taxable measure is limited to the value of the tangible storage media used to transfer prewritten software in a software TTA. The letter further provided that "The unanimous industry consensus at the interested parties' meeting was that the industry read *Nortel* as holding that the taxable value in a software [ ] TTA is limited to the value of the storage media, which is immaterial and should be ignored." Therefore, the letter recommended that the Board entirely exempt or exclude charges for prewritten software transferred on tangible storage media, including what the letter referred to as "embedded software," from sales and use tax.

The Board received an August 1, 2012, letter from Paul Hastings LLP containing its comments regarding the initial discussion paper. In summary, the letter asserts that the initial discussion paper did not analyze the TTA statutes and applicable case law, but, instead, set forth Board staff's model for taxing software, which conflicts with the TTA statutes and is invalid under *Preston*. The letter also asserts that the *Nortel* courts did address the taxable measure, the *Nortel* courts considered and rejected a number of the arguments made in the initial discussion paper, including the arguments based on Board staff's analysis of *Touche Ross* and *Navistar*, and that the *Nortel* decision was based upon a full factual record. Furthermore, Paul Hastings LLP argues that the *Nortel* decision is final and held that an agreement that allows software to be copied onto a computer is a TTA and that the taxable tangible personal property in such a software TTA is limited to the storage media.

The Board received an August 3, 2012, letter from Mr. Eric J. Miethke, which provided Pacific Gas & Electric Company's (PG&E's) comments on the initial discussion paper. In the letter, PG&E explained that public utilities often contract directly with the holders of various technologies, but, for various reasons, the public utilities often arrange their transactions so that they ultimately acquire technology through intermediaries. PG&E suggested that in the utility situation, as opposed to the situation where "mass-produced software [is] sold through general retailers to the general public," the use of intermediaries to make the ultimate sale to the consumer should not prevent an otherwise qualified agreement from satisfying the definition of a TTA. In the letter, PG&E also recommend that, rather than develop "embedded criterion," the Board should focus on "the nature of the rights transferred along with tangible personal property, how those rights relate to the tangible personal property being transferred, and how the whole transaction relates to the intent of the Legislature in adopting the TTA statute."

The Board received a letter from Ernst & Young LLP on August 3, 2012, containing its comments regarding the initial discussion paper. In the letter, Ernst & Young LLP indicated it believes that the TTA statutes exempt charges to use an "embedded patented process," such as the right to use a computer printer. In the letter, Ernst & Young LLP also makes the following statement:

> We recognize that there will be many comments on methods to value the property transferred with a TTA. One can foresee a great amount of effort that may have to be expended to audit the true selling price of the property transferred in a TTA. As such, for ease of administration, in the instance where there is in fact a Technology Transfer Agreement in place, it may be appropriate to amend Regulation 1507 to provide for a nominal safe harbor percentage to acknowledge and account for the existence of the intangible rights that are transferred with tangible personal property. This should be accompanied by a rebuttable presumption clause under which the BOE can apply the statutes as written.

The Board also received a second letter from Mr. Nebergall dated August 10, 2012, which was sent solely on behalf of SoFTEC. This letter reiterated SoFTEC's agreement with the position in Mr. Nebergall's earlier letter that "The court of appeals in *Nortel* held prewritten computer software was intangible property." However, in the spirit of compromise, the letter also explained that:

> Our member companies would support an amendment to Regulation 1507 containing the following elements:
>
> - Sales of prewritten computer software on tangible storage media, such as disks or CDROMs, regardless whether sold by the developer of the software or a third-party retailer, would be subject to sales and use tax at 50% of the sales price.
> - Sales of a single copy of prewritten computer software on tangible storage media, together with the right to make multiple copies of the software for use

by the purchaser, would be subject to sales and use tax at 50% of the selling price of a single copy without the right to make copies, with the balance of the sales price not subject to tax.

- The TTA statutes would apply to prewritten computer software sold together with other tangible personal property that is not a mere storage medium (such as a disk or CDROM). If the fair market value of the prewritten computer software is 20% or less of the total selling price, there would be a rebuttable presumption that the entire selling price is subject to sale or use tax. Software "embedded at the time of manufacture" of the tangible personal property, even if separately stated on the sales invoice, would not be a TTA.
- The state would handle directly claims for refunds by purchasers.

One of the overarching policy considerations that went into developing this proposal is that all sellers of software sold on disk should be treated alike. Some sellers should not be able to sell their products partially free of sales tax while other sellers are fully burdened with sales or use tax on their sales. For example, if sales by the developer of a software product were eligible for TTA treatment and sales by third-party retailers were not, the software developer could sell free of tax while the third-party retailer could not. The playing field should be level for all sellers of prewritten computer software.

DISCUSSION

A. <u>Areas of Agreement</u>

Board staff agrees with SoFTEC's comments that "all sellers of software sold on disk should be treated alike," to the extent such treatment is consistent with existing law. Board staff also agrees with SoFTEC's comments that "[s]ome sellers should not be able to sell their products partially free of sales tax while other sellers are fully burdened with sales or use tax on their sales" and that "[t]he playing field should be level for all sellers of prewritten computer software."

In addition, the Board has previously agreed with industry that, under existing law, tax does not apply to retailers' transfers of prewritten software via remote telecommunications equipment or transactions in which retailers install prewritten software on their customers' computers under the circumstances set forth in Regulation 1502, subdivision (f)(1)(D) (i.e., "load and leave"). Furthermore, the Board has previously agreed to only tax 50 percent of the lump-sum charges for optional software maintenance agreements that include prewritten software transferred on tangible storage media, as set forth in Regulation 1502, subdivision (f)(1)(C).

B. <u>Responses to SoFTEC's Proposals</u>

Board staff greatly appreciates SoFTEC's willingness to seek common ground regarding the taxation of prewritten software transferred on tangible storage media. However, while a 50:50

split could be viewed as a compromise, in the apparent absence of a persuasive legal basis for doing so, staff cannot recommend that the Board should exempt or exclude 50 percent of the charges for prewritten computer programs transferred on tangible storage media from sales and use tax. In addition, it would appear that such a position would likely not provide a lasting resolution in light of the general industry assertion that prewritten software, itself, is not tangible personal property.

However, staff believes that the certain level playing field sought by SoFTEC could also be established through staff's view that the typical retail sale of prewritten software recorded in tangible form to an end consumer is 100 percent taxable, regardless of the copyrights and patents held by the retailer, because the typical retail sale gives the consumer nothing more than the ability to copy the software onto a computer and use the software for its intended purpose, with no conferred rights to make and sell a product. This includes transactions where prewritten software is loaded onto a computer prior to the retail sale of the computer to the end consumer. Moreover, staff notes that, in some of these types of retail transactions, the end consumer does not even obtain the ability to copy the software onto a computer.

Furthermore, Board staff can offer to continue to work with industry to identify prewritten software transactions that fall outside of the typical off-the-shelf retail sales model described above because they include the sale of separate and distinct copyright or patent interests. And, as qualifying transactions are identified, Board staff will work with industry to determine if there is some basis to recommend that the Board adopt an optional percentage to exempt or exclude some portion of a lump-sum charge.

If industry and the Board ultimately reach some agreement regarding the taxation of prewritten software recorded on tangible storage media that supports the Board's granting claims for refunds, then the Board will directly handle claims for refunds filed by consumers who paid excess use tax and retailers that paid excess sales tax or excess sales tax reimbursement to the Board. Since the sales tax is actually imposed on and paid by the retailer, if there is an overpayment of this tax, it is the retailer who must file the claim for refund. (RTC, § 6901.) However, the collection of sales tax reimbursement is a matter of contract between retailers and their customers and retailers are responsible for returning excess sales tax reimbursement directly to their customers, not the Board. (See Reg. 1700, *Reimbursement for Sales Tax*.)

Finally, subject to Board direction, staff is also willing to discuss whether amendments to Regulation 1502 should be considered to clarify how digital downloads and load-and-leave transactions can be paired appropriately with optional software maintenance contracts to effectively achieve the 50:50 approach proposed by SoFTEC for software transactions where tangible storage media is ultimately transferred, regardless of whether or not the transaction is a TTA.

C. Responses to Comments Regarding "Embedded Software" and Embedded Processes

Regulation 1502, subdivision (b)(3) provides that the term storage media "[i]ncludes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded." Board staff does not distinguish between different types of tangible storage media, and Board staff does not think it is generally relevant to distinguish between prewritten software recorded on different types of tangible storage media, including the wide array of tangible devices upon which information can be recorded.

Further, the *Nortel* decision did not invalidate the provisions of Regulation 1507 regarding embedded patented processes, and Board staff is still willing to work with industry to help retailers distinguish a patented process that is embedded in the internal design, assembly or operation of tangible personal property from a patented process that is external to the tangible personal property, if necessary.

D. Response to PG&E's Comments Regarding "Intermediaries"

Board staff recognizes PG&E's concerns regarding public utilities' use of intermediaries to acquire technology that is not mass produced and sold by general retailers to the general public. Board staff will work directly with public utilities or other industries to help them identify their typical types of transactions that involve a separate and distinct transfer of a copyright or patent interest with tangible personal property of whatever kind. Furthermore, Board staff will recognize separate and distinct transfers of copyright and patent interests from one person to an intermediary (or a chain of intermediaries) and then from the intermediary (or final intermediary in the chain) to the end person ultimately acquiring the interests and respect that any charges for the separate and distinct transfer of the copyright or patent interests through the series of transactions are not subject to sales and use tax. However, Board staff will require documentation to establish that a holder of a patent or copyright interest assigned or licensed a copyright or patent interest to an unrelated third party because staff is unaware of any reasonable basis to infer generally that holders of a patent or copyright interest orally or impliedly assign valuable intellectual property to unrelated third parties. Furthermore, staff also notes that Regulation 1507 requires that a TTA be in writing.

E. Response to Comments Regarding Site Licenses

The *Nortel* decision did not address the taxation of site licenses and Board staff is not prepared to recommend that the Board change the taxation of site licenses at this time. However, Board staff agrees with SoFTEC that the "sale of prewritten software together with the right to make multiple copies, known in the industry as 'site licenses' or 'multi-user licenses,' merits separate discussion." Therefore, staff, under the direction of the Board, is open to working with the providers of such software to determine if some charges for their "site licenses" may be properly classified as charges for the separate and distinct transfer of copyright or patent interests, and, if so, jointly develop a uniform method for determining the taxable portion of lump-sum charges that include charges for such site licenses, if necessary.

In addition, Board staff believes that the limited analysis of site licenses in SoFTEC's August 10, 2012, letter provides a useful starting point for future discussions, but that it does not fully capture the complexity of the site license issue and does not provide enough information for Board staff to reach any conclusions at this time. Therefore, further factual development is necessary before staff can reach any conclusions regarding specific site licenses.

F. Staff's Understanding of the Applicable Statutes

Board staff continues to believe that prewritten software embodied on tangible storage media is tangible personal property within the express definition provided by RTC section 6016. This is in accordance with the general rule that the sale of prewritten software is subject to tax.

Staff also recognizes that the TTA statutes may exclude charges for certain copyright and patent interests from tax, but there is no basis upon which to interpret either the TTA statutes or the *Nortel* decision as expressly or impliedly holding that software is intangible regardless of whether it is recorded on tangible storage media or not. There is no basis in science or California law to sustain or support such an assertion. And, the TTA statutes do not further refine the definition of the term "tangible personal property" or even refer to "software" or "programs," so there is no basis to conclude that the TTA statutes could change existing, long-standing California law and convert tangible personal property of any kind into intangible copyright or patent interests.

Further, Board staff understands that it may be argued that the *Nortel* decision contains some broad language and that industry may assert that any transfer of the right to copy a copyrighted computer program recorded on tangible storage media onto any computer for any reason constitutes a TTA because it allows the transferee to make a copy of a copyrighted work. (See *Nortel*, *supra*, at p. 1278.) However, that interpretation is inconsistent with the express provisions of the TTA statutes which require that a TTA involving the transfer of a copyright interest include the right to make <u>and</u> sell a product subject to the copyright interest. Furthermore, such a broad interpretation is inconsistent with the California Supreme Court's holdings in *Preston* that copyright TTAs must involve a transfer of a copyright separate and distinct from any material object in which the work is embodied, the license of a copyright interest can only give the licensee the right to reproduce the copyrighted material in a product, and copyright TTAs must include the right to make and sell products subject to copyrights. Finally, Regulation 1507, subdivision (a)(4) provides that the definition of "assign or license" means a transfer 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." Thus, before an agreement can be found to constitute a TTA, the claimant has the burden of showing that the license provides rights beyond that which would otherwise be permitted. Moreover, the *Nortel* court did not explain the issue of how the "products" (telephone calls and telephonic services) that Pacific Bell made and sold were themselves subject to patents or copyrights that Nortel transferred to Pacific Bell. (See *id*. at pp. 1273-1275.) Specifically, the court did not explain how these "products" were copies of or incorporated original works for which Nortel held the copyrights; what specific copyright rights were transferred from Nortel to its customers under the TTA; and what specific product was made by virtue of each respective copyright allegedly subject to the license. (See also *Preston*, *supra*, at p. 215 ["[A] product 'is subject to' a copyright interest (*§§ 6011(c)(10)(D)*, *6012(c)(10)(D)*), if the product is a copy of the protected expression or incorporates a copy of the protected expression."].) Therefore, Board staff cannot agree that the *Nortel* decision prohibits the Board from imposing a sales or use tax on a sale or purchase of prewritten software recorded on tangible storage media.

Finally, Board staff notes that when the Legislature enacted RTC section 6010.9, which is the only RTC section expressly addressing the application of sales and use tax to software, the Legislature clearly expressed its understanding that prewritten software is tangible personal property within the meaning of RTC section 6016 when it is in the "form of written procedures or in the form of storage media on which, or in which, the [software] is recorded." The Legislature also expressed its intent that the Board tax retail sales of prewritten software in tangible form.

SUMMARY

Board staff is open to discussing *Nortel* and whether the Board should amend Regulations 1502 and/or 1507 to clarify how the sales and use tax law applies to transfers of prewritten software on tangible storage media. Staff also is open to recommending amendments to the regulations to clarify the application of tax to software TTAs if the general consensus of interested parties and staff is that the changes would be clarifying and consistent with applicable authorities. Finally, staff remains open to discussing with interested parties whether it may be appropriate for the Board to give consideration to the adoption of an optional percentage that can be used to reasonably estimate the retail fair market value of tangible personal property in TTAs involving prewritten software recorded on tangible storage media.

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

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