

## Memorandum

**To:** 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

**Date:** March 18, 2016

**From:** Randy Ferris  
Chief Counsel



**Subject:** Chief Counsel Matter, March 29-30, 2016

**Item Number M** \_\_\_\_\_

*Lucent Technologies, Inc. v. State Board of Equalization* and Sales and Use Tax Regulations 1502, *Computers, Programs, and Data Processing*, and 1507, *Technology Transfer Agreements*

On January 20, 2016, the Board's petition for review of the Court of Appeal's opinion deciding *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19 (Case No. B257808, opinion filed Oct. 8) (hereafter *Lucent*) was denied by the California Supreme Court. This memorandum provides background information and presents options for appropriately implementing the *Lucent* opinion.

In *Lucent*, the Court of Appeal applied the provisions of Revenue and Taxation Code (RTC) sections 6011, subdivision (c)(10) and 6012, subdivision (c)(10) (collectively the technology transfer agreement (TTA) statutes) to transactions in which AT&T Corporation and Lucent Technologies, Inc. (collectively Lucent) sold telephone companies: (1) switches used to connect telephone and data networks; (2) written instructions on how to use the switches; and (3) copies of copyrighted switch-specific software and generic software recorded on tapes and discs, which were each subject to at least one patent held by Lucent, together with the right to copy the software onto the switches' hard drives and the right to use the software to route calls and data and offer call waiting and other features (hereafter telephone products) to their customers. The Court of Appeal held that the transactions constituted software TTAs because: (1) the software was copyrighted and patented; (2) Lucent established that it was the holder of the copyrights and patents; and (3) Lucent established that it transferred a portion of its copyright and patent interests in the software to the telephone companies so that they could produce telephone products that were subject to Lucent's copyrights and patents. The Court of Appeal also held that under the TTA statutes the charges for the right to copy and use the software under the TTAs were not subject to sales and use tax, but that the "price of the blank media" transferred was subject to tax.

As discussed in more detail below, the Legal Department recommends that the Board: (1) make amendments to Sales and Use Tax 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 TTA, in accordance with the primary holding in *Lucent*, and clarify the measure of tax when software is transferred under a software TTA; and (2) make conforming amendments to Regulation 1502, *Computers, Programs, and Data Processing*. The Legal Department also recommends that the Board issue a notice to clarify that: (1) the typical off-the-shelf retail sale of canned, mass-marketed software still 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; and (2) *Lucent* is only dispositive with respect to software transmitted on tangible storage media that is wholly collateral to the subsequent use of the licenses regarding that software and is not dispositive with respect to embedded non-custom software or pre-loaded non-custom software, which were not at issue in *Lucent*.

### Background

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

- 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, subject to Lucent's copyrights 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.)

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. (*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 process.'" (*Ibid.*) 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.)

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 four of the "contracts listed a price for the blank media," and the court 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 *Lucent* court opined: “. . . 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,<sup>1</sup> 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, notwithstanding 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.

Furthermore, 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* (2009) 159 Cal.App.4th 911, 924-925;

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<sup>1</sup> 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.

- 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 v. State Bd. of Equalization* (2001) 25 Cal.4th 197, 211-212 (hereafter *Preston*)]);
- 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]);
- 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].)

It should be noted that the *Lucent* court 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.<sup>2</sup> 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 at issue 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, while the *Lucent* court did not expressly invalidate any provisions in Regulations 1502 and 1507, 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.)

### Potential Rulemaking and Other Possible Administrative Actions

#### A. Implementing the *Lucent* Opinion

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<sup>2</sup> Moreover, the *Lucent* court did not discuss RTC section 995, which provides that, for property tax purposes, “[s]torage media for computer programs shall be valued . . . as if there were no computer program on such media except basic operational programs”; thus, the *Lucent* opinion has no precedential effect with respect to property tax.

Read together, the *Nortel* and *Lucent* opinions primarily hold that:

- The TTA statutes apply when the *holder* of the copyright to non-custom copyrighted software transfers a copy of the software on tangible storage media, the right to reproduce or copy the copyrighted software, and the right to make and sell “products” that the buyer could not legally make without using a copy of the copyrighted software;
- The TTA statutes also apply when the *holder* of a patent that is embodied, implemented, and enabled by non-custom software transfers a copy of the software on tangible storage media with the right to make and sell a product that is subject to the patent or to use a patented process that is embodied, implemented, and enabled by the software; and
- When there is a software TTA (as described above), the measure of tax is limited to the amount charged for the 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 storage media 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.

The corollary of this holding is that, when software on storage media is sold by a non-holder-retailer, the transaction is not a software TTA and the full retail selling price is subject to tax.<sup>3</sup> 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 software on storage media from the holder (or the holder’s authorized distributor), the non-holder-retailer only obtains title to 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 TTA statutes purposes, one cannot be a licensor or a sub-licensor without first being a holder.<sup>4</sup> (*Lucent, supra*, 241 Cal.App.4th at p. 38 (“the technology transfer agreement 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.

For purposes of establishing the proper measure of tax when a non-holder-retailer sells storage media on which 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 notwithstanding 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). 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 customers promise (i.e., “I agree”) to only copy and use the software as

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<sup>3</sup> This corollary is consistent with the Board’s Legal Department’s post-*Nortel* guidance regarding non-holder-retailer transactions involving storage media on which non-custom software is placed.

<sup>4</sup> Moreover, Regulation 1507 currently requires TTAs to be “evidenced by a writing,” and the court did not invalidate that requirement in *Lucent*.

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 is not subject to either sales or use tax.

The foregoing also provides guidance on how to establish the proper measure of tax when a holder-retailer sells off-the-shelf canned, mass-marketed software directly to retail purchasers in TTA transactions (i.e., “non-typical” retail transactions). If the holder-retailer allows a non-holder-retailer to sell the same or like storage media on which the software is placed, then the retail fair market value of the tangible personal property 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 seller of storage media on which the software is placed, 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).)

When the holder-retailer is the exclusive seller of storage media on which the software is placed, under *Lucent*, if the holder-retailer also sells like storage media to third parties for a separately stated price, then that separately stated price should be used for the taxable measure. If no such like or comparable transactions exist, the measure of tax should be presumed to be the cost of the storage media to the holder-retailer plus a reasonable retail mark-up. (See RTC, §§ 6011, subd. (c)(10)(C), 6012, subd. (c)(10)(C).) In the past, the Board has considered a mark-up of 100 percent to be reasonable under similar circumstances. (See *Intel Corp.*, Mem. Opn., June 4, 1992.)

In sum, in response to *Lucent*, the Board must consider whether to implement and codify *Lucent*’s holdings into Regulation 1507 and make conforming amendments to Regulation 1502, subdivision (f)(1), including amendments providing that tax applies to tangible storage media, which is deemed to be blank notwithstanding the physical alterations caused by placing software on the storage media, used to transfer a non-custom computer program so that it can be published and distributed for a consideration to third parties under a software TTA. At a minimum, first, these amendments would clarify that tax applies to the retail fair market value of the storage media, which is deemed to be blank, transferred in a “golden master transaction.” (See Reg. 1502, subd. (f)(1)(B).) Such an amendment is necessary because the *Lucent* court has made it clear that, under the current language of Regulation 1502, golden master transactions have been taxed incorrectly by treating the storage media used to transmit the program as “merely incidental.” (See *ibid.*) Second, the general rule that “all license fees, including site licensing and other end users fees are includable in the measure of tax” must be amended to take into account the *Lucent* court’s application of the TTA statutes to software TTAs. (*Lucent, supra*, 241 Cal.App.4th at p. 39; see Reg. 1502, subd. (f)(1)(B).) The foregoing discussion demonstrates that there are a variety of fact patterns involving exclusive holder-retailers, non-exclusive holder-retailers and non-holder-retailers that must be considered with respect to the necessary amendments.

### Recommendation

In accordance with the holdings in *Lucent*, the Legal Department recommends the Board make amendments to Regulations 1502 and 1507 to clarify: (1) the requirements to establish that an agreement for the transfer of non-custom software on tangible storage media is a software TTA; (2) the measure of tax when software is transferred under a software TTA; and (3) the measure of tax when storage media on which software is placed is sold at retail in a non-TTA transaction. Procedurally, this recommended rulemaking could be initiated through either a Chief Counsel Matters agenda item or an interested parties process overseen by the Business Taxes Committee.

#### B. Embedded and Pre-Loaded Software

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. The Court of Appeal's analysis of whether non-custom software on tangible storage media is taxable tangible personal property or nontaxable intangible personal property focused on the fact that the media was only used to transmit the software for copying onto a device and the media was not essential or physically useful to the purchaser's subsequent use of the software. Thus, the Court of Appeal's analysis indicated that, when the TTA statutes do not apply, tax applies to the sale of non-custom software on a tangible device that is essential or physically useful to the purchaser's subsequent use of the software, such as a computer, car or coffeemaker. However, the Court of Appeal used language in *Lucent* that could be interpreted as suggesting that a holder-retailer's sale of a device, along with the right to copy copyrighted software from the device's hard drive or other tangible storage media into the RAM of the device, could be sufficient to constitute a software TTA. (See *Lucent, supra*, 241 Cal.App.4th at p. 37.)

Therefore, although the *Lucent* decision is not dispositive as to transactions involving embedded or preloaded software, the Board may also choose to address how to apply this suggestive language to sales of devices with storage components that contain embedded or pre-loaded copyrighted software that is copied at least once as part of the devices' utilization of the software. The following are some potential options:

- Option 1: Issue a notice that explains that *Lucent* is only dispositive with respect to software transmitted on tangible storage media that is wholly collateral to the subsequent use of the licenses regarding that software and is not dispositive with respect to embedded non-custom software or preloaded non-custom software, which was not at issue in *Lucent*.
- Option 2: Although not dispositive, rely on the suggestive language in *Lucent* to amend Regulations 1502 and 1507 to clarify that *Lucent* may apply to embedded or preloaded non-custom software or both, but that individual retailers of devices must establish that: (1) they hold copyright or patent interests in embedded or pre-loaded software; (2) the devices copy the software at least once in order to utilize the software; and (3) they are transferring the right to copy the software in a written software TTA.<sup>5</sup> In the absence of such a showing, retailers must report tax on the entire charge for the device, including the embedded and pre-loaded software under the general default rule in *Lucent*. Under this option, as discussed above with respect to off-the-shelf canned, mass-marketed software transactions, the Board may further clarify that software TTAs involving devices cannot have taxable measures that

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<sup>5</sup> See footnote 4, *supra*.

materially differ from the taxable measures when the same devices are sold by non-holder-retailers. As with transactions involving storage media on which software is placed, the Board would need to take into account a variety of fact patterns involving exclusive holder-retailers, non-exclusive holder-retailers and non-holder retailers in promulgating any rules in this area. Procedurally, Option 2 could be initiated through either a Chief Counsel Matters agenda item or an interested parties process overseen by the Business Taxes Committee.

Recommendation

Options 1 and 2 are not mutually exclusive. At a minimum, the Legal Department recommends the Board issue a notice explaining that *Lucent* is only dispositive with respect to software transmitted on tangible storage media wholly collateral to the subsequent use of the licenses regarding that software and is not dispositive with respect to embedded non-custom software or preloaded non-custom software, which was not at issue in *Lucent*. The Board is under no legal obligation to pursue Option 2 since the *Lucent* opinion is not dispositive with respect to such fact patterns.

C. Certain Refund Claims Potentially Ready for Immediate Processing

Based on the *Lucent* opinion itself, unless the Board directs otherwise, staff is prepared to begin processing immediately (i.e., prior to any contemplated rulemaking) any timely, valid refund claims for which staff can verify the existence of a software TTA between an exclusive holder-retailer and a purchaser-licensee pursuant to which software was transmitted on tangible storage media that is wholly collateral to the subsequent use of the licenses regarding that software. Under *Lucent*, it is clear that the taxable measure for such software TTA transactions would be the retail fair market value of the storage media, which is deemed to be blank, without reference to any potentially like transactions involving third-party vendors.

Approved:

  
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David Gau  
Chief Deputy Director

cc: Mr. David Gau

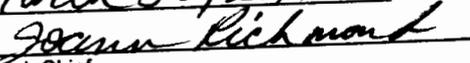
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**STATE BOARD OF EQUALIZATION**



BOARD APPROVED

At the March 30, 2016 Board Meeting

  
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Joann Richmond, Chief  
Board Proceedings Division