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November 17, 1994

Mr. S--- S---
Associate Editor
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P. O. Box XXX
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Re: Unidentified Taxpayer - Taxation of License and Royalty Fees

Dear Mr. S---:

This is in response to your letter dated September 21, 1994 regarding the application of California sales and use tax to computer program license and royalty fees. You provide the following hypothetical:

> "Acme Software Development Company is an out-of-state company that already has nexus with California. It develops a spell checking program/technology which it licenses to Bee Company, which is based in California. Bee will not be using the Acme program/technology itself, but rather, will incorporate the spell checker into a word processing program, BeeWord, which Bee has developed and is selling to the general public.
>
> "The contract between Acme and Bee required Bee to pay an initial license fee of $100,000 to Acme. Thereafter, Bee is required to pay Acme [a] $20 royalty for each copy of Bee Word which Bee sells."

You ask:

> "1. Is the initial license fee ($100,000) from Bee to Acme subject to California sales tax?
>
> "2. Is the $20 per copy royalty subject to California sales tax?

Discussion

Subdivision (f) of Regulation 1502 (a copy of which is enclosed) explains the application of tax to sales of software. Subdivision (f)(1)(B) applies to your hypothetical:

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

This means that a sale of software in tangible form for use by the transferee is a taxable sale of tangible personal property. On the other hand, if a transaction is actually a transfer of the right to copy and sell software under circumstances that such copying and selling would otherwise be a violation of the transferor's federally protected copyright interests, we do not regard the transaction as a sale of tangible personal property, even if some storage media is incidentally transferred. Under such circumstances, sales tax does not apply to the transferror's charges. If the transferee obtains the software for the purpose of copying and selling, and not for use, the transaction is not taxable whether the transferee sells the program in the identical form as received, modifies it and sells the modified program, or incorporates it into another program and then sells that program. Thus, provided a federal copyright attaches to the spell checking program and it is transferred solely for the purpose of being copied and sold as part of the word processing program, tax does not apply to Acme's initial fee or to the royalty fee.

If you have further questions, feel free to write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:plh
Enclosure: Reg. 1502

cc: --- Sacramento District Office - --