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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
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(916) 445-8900

June 5, 1981

Mr. J--- L. O---, Senior Counsel
T--- Incorporated
XXXXX --- --- Drive
---, California XXXXX

IN REPLY REFER TO:
SY -- XX-XXXXXX

Dear Mr. O---:

Confirming our recent telcom, our meeting is scheduled for 10:00 a.m. Friday, June 12, in Room 297 at the Board offices at 1020 N Street, Sacramento.

In preparation for that meeting, I have set forth below my preliminary conclusions regarding the questions you asked in your letter of May 5, 1981.

Question No. 1

You state that the Board has ruled that your purchases of prewritten computer programs which were delivered in machine-readable form (i.e. recorded on magnetic tape) are subject to tax, including royalties paid on the use of such programs in providing computer services to your clients under certain "lease" or "license" agreements. Under the terms of the original purchase agreements these programs are updated, modified, improved, etc. at no extra cost. You have received these changes from your program supplies electronically via telephone lines without the transfer of any tangible personal property. (The latter fact is my assumption, based on our conversation. Actually, based on what we know of similar situations we would expect such changes to be accompanied by certain human-readable materials in the form of changes in manuals, coding sheets, etc.) Over time the "functionality" of the programs is greatly increased and the royalties paid by your clients have grown by the enhanced marketability of your product. You ask whether tax applies to the total royalties or whether some apportionment of the royalties can be made, allocating some part to the program changes made by electronic means without the transfer of tangible personal property.

Discussion

The sales tax is imposed upon the sale of tangible personal property and not upon the sale of a computer program per se. What happens to the computer program after the sale of the tangible property on which it is recorded is irrelevant for sales tax purposes, even though most of the price is attributable to the computer program. It is also immaterial whether the total price for the property (i.e. magnetic tape) is $1,000 in a lump sum or $1,000 in royalties spread out over some indefinite period. Sales tax applies to the total price paid for the property. (See Regulation 1502 (f)(1) and (k). See also the Analysis of Regulation 1502 by Jugum and Ochsner, 9/15/79, III, D, at pp. 63-68.) Thus, all of the royalties paid as part of the original purchase price for the property are taxable. The later changes made to the program are considered to be services which are a part of the sale. Under Section 6012 of the Revenue and Taxation Code, taxable gross receipts include any services which are a part of the sale. (§6012(c)(1).)

Question No. 2

You have established computer centers in other states and these centers are marketing the same programs to their clients, thus increasing the amount of royalties paid. In some cases the program is recorded on a magnetic tape and the copy is sent to the out-of-state center. In other cases, the original tape and all associated property is relocated out-of-state. In some cases these out-of-state centers provide service to both California and non-California clients. In other cases the center serves no California clients. You again ask whether the taxable gross receipts may be apportioned in some way.

Discussion

Assuming that the original magnetic tape on which any given computer program was recorded was first functionally used by you in California (i.e. was used for some purpose other than solely holding the property for sale in the regular course of business), there was a completed taxable sale here and the subsequent uses of the property has no effect on the application of tax to this transaction. As noted above, we are taxing the sale or use of the tangible personal property and not the computer program. Thus, the use of the program out-of-state by non-Californians has no effect on whether the original transaction is subject to tax. It only effects the amount of the total price paid for the property. There is no principle in the sales tax law which places a geographical limitation on the transactions which may be considered for purposes of determining the sales price. For example, the price for a satellite might be based on its use in outer space by a foreign government. If the sale is otherwise taxable, there is no prohibition against including charges for such use in the taxable measure, since it is merely the means for computing the agreed sales price.

If you feel this analysis is in error, it would be helpful to have complete documentation of the arrangements under which you purchased the subject programs.

I will look forward to seeing you next Friday.

Very truly yours,

Richard H. Ochsner
Tax Counsel

RHO:jw

cc: Mr. Don Hennessy
Mr. Jim Mahler