STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

March 16, 1988

Mr. J--- M. V---
P---, M--- & S---
P.O. Box XXX
--- ---, CA XXXXX

Re: S--- M---, Inc.
SR – XX-XXXXXX
SR – XX-XXXXXX

Dear Mr. V---:

Your letter date February 2, 1988 to Assistant Chief Counsel Gary Jugum has been referred to me for response. You ask whether a computer software license transaction is subject to sales or use tax. You state:

> "In the subject transaction, S--- is the licensee of certain computer programs ('Software Products') which it obtains from an out-of-state author/licensor 'A Co.' The Software Products are copyrighted by A Co. and various rights under said copyrights are transferred to S--- for which royalty payments are made. Copies of the Software Products may be distributed in modified or unmodified form by S--- for a consideration to third parties. The instant request for written advice is only with respect to the transaction between S--- and the author/licensor A Co., and not with respect to the transaction between S--- and its customers. In the latter transaction, S--- reports and remits to the Board sales tax computed on the gross receipts received therefrom.

". . . .

"There are two agreements which must be read together and which set forth the terms of S---'s license with A Co. - - Software Agreement Number SOFT-000XXX ("Software Agreement') and Sublicensing Agreement Number SUB-000XXXA ('Sublicensing Agreement'). . . .

". . . .

"Section 2.01 of both the Software Agreement and the Sublicensing Agreement sets forth the principal rights granted to S--- under the license. These rights include the right to modify the Software Product and to prepare derivative works based thereon. Section 2.01 of the Sublicensing Agreement provides that S--- is granted the right to make copies of Sublicensed Products which are defined as computer programs in object code format based on said Software Product received from A Co. and to distribute the same to third parties. Section 7.05(b) of the Software Agreement discusses the distribution by S--- of copies of the Software Product either in modified or unmodified form. Each copy is required to contain the appropriate copyright notice under Section 7.07 of the Software Agreement and Section 2.02 and 20.8(b) of Sublicensing Agreement. The royalty fees paid by S--- to A Co. are a combination of up-front payments and per copy sublicensing fees. These fees are tied directly to the rights granted to S--- to modify the Software Product, to prepare derivative works based thereon and to sublicense copies of the modified or unmodified version of said Software Product. See, Software Agreement Section 5.01; Sublicensing Agreement Sections 4.01-4.02; Supplement Numbers 1 and 2.

"It is S---'s belief that none of the royalty fees it pays to A co. should be taxable since the sole purpose for the subject license is to grant S--- the right to market copies of said Software Products for A. Co. in either a modified or unmodified form. As the Product is copyrighted and various rights under the copyright are transferred therewith, virtually all of the royalties S--- is paying to A Co. are for these intangible copyright interests. As such, the should be nontaxable under Regulation 1502(f)(1)(B) which only purports to tax site licensing and other end user fees. Given the integrated nature of S---'s license with A Co., it is submitted that none of the royalty fees paid by S--- should be considered end user fees. . . ."

Initially, we address your characterization of the contracts as set forth in the paragraph quoted immediately above. You state that the "sole purpose" of the license is to grant S--- the right to sell copies of the program, and that the fees paid by S--- should not be considered end user fees. We disagree with your characterization since the contracts specifically grant S--- end user rights, as cited below. That is, based on the contracts provided to us, we conclude that a portion of the fees paid by S--- are, in fact, attributable to end user fees.

We also call your attention to Supplement Number 1 and Supplement Number 2, each of which refers to Agreement Number SOFT-000XXX, which is the Software Agreement. (Although you state that Supplement Number 2 applies to the Sublicense Agreement, it specifically refers to the Software Agreement.) Both supplements list designated CPUs and identifies charges as "Right-to-use fees" and sublicensing fees. This confirms our conclusion that a portion of the fees are end user fees.

You cite subparagraph (f)(1)(B) of Regulation 1502 in support of your assertion that amounts paid by S--- under the agreements are not subject to tax. That provision states:

> "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 user fees, are includable 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.

Under this provision, tax does not apply to charges made for the right to copy a software program to which a federal copyright attaches when those copies will be sold to third parties. Tax does apply, however, to charges made for the right to otherwise use the software program.

All amounts paid by S--- for the Software Agreement are subject to tax because the rights acquired are to use the software program and not to sell copies. (§ 2.01 ("solely for [S---'s] own internal business purposes:").) The distributions referred to in section 7.05(b) are to persons holding licenses from the licensor equivalent to the license held by S---; there is no indication that these copies are sold.

Parts of the Sublicensing Agreement appear to come within the nontaxable result. The rights specified in section 2.01(a) are, in effect, to make copies of the program for sale. Portions of the rights specified in section 2.01(c) for testing CPUs and in section 2.01(b) are for S---'s own use. The amounts paid for these rights are subject to tax.

In summary, amounts paid under the Sublicensing Agreement for the right to copy the software for sale and for demonstration for sale are not subject to sales or use tax. All other amounts are subject to sales or use tax. If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Tax Counsel

DHL:ss

bc: --- --- – District Administrator