STATE OF CALIFORNIA

BOARD OF EQUALIZATION

120.0667

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
B--- P--- S---	)	No. SR -- XX-XXXXXX-010
Taxpayer	)	

The preliminary hearing on the above taxpayer's petition for redetermination was held on June 24, 1987, in San Francisco, California.

Hearing Officer: James E. Mahler

Appearing for Successor-in–Interest: K--- B C---
Attorney at Law

R--- J. B---
C--- V--- P---

Appearing for the Board: Gerald Hodgkinson
Tax Representative

Protested Item

The protested tax liability for the period October 1, 1985, through November 30, 1985, is measured by:

Item	State, Local and County
Lease receipts not reported	$1,665,848

Taxpayer's Contentions

1. The disk media held in escrow was not "leased" for sales and use tax purposes.

2. All or substantially all the consideration paid for the programs was for electronic transmission and not for the disk media held in escrow.

3. The measure on which tax has been asserted includes charges for customer lists or other intangibles unrelated to software.

4. The disk media held in escrow was physically located in California for only 33.68 percent of the alleged lease term.

Summary

Petitioner is a California corporation which was engaged in the business of selling micro-computer systems, including both hardware and software, to banks and other financial institutions. Petitioner owned two computer programs which it had written to sell to its customers: the "D--- Software", which allowed D--- brand micro-computers to communicate with one another; and the "I--- software" which could be used to perform financial calculations on [name] brand computers.

Petitioner was experiencing financial difficulties. According to testimony at the preliminary hearing, part of the problem resulted from the bankruptcy of the D--- network system, and part resulted because of "bugs" in the [name] software. Petitioner therefore decided to sell its business or assets.

On October 25, 1985, petitioner contracted to sell all its tangible and intangible assets to A--- C---, Inc. (ACI). The net selling price was $1,956,127.25, of which $100,000 was allocated to the D--- software and $1,565,848.48 was allocated to the [name] software and "other intangible assets". The "other intangible assets" were not expressly defined, but apparently included customer lists as well as non-depreciable assets such as catalogs and advertising materials.

According to testimony at the hearing, ACI was engaged in marketing computer systems to banks in competition with petitioner. Petitioner suspects that ACI purchased petitioner's assets, not for the purpose of use in its business, but simply to protect its own business from competition by removing petitioner's system from the market. As of the date of the hearing, ACI had not as yet marketed either the D--- or [name] software.

Section 1.3 of the sale contract provided that petitioner would transfer "marketable title" in the assets to ACI. With regard to the programs, that section went on to state:

> "The source code for the proprietary software run on [name] [computers] will be transmitted by network wire from disk media owned by B---P--- (which disk media shall hereinafter be referred to as "B--- Media') to tape media owned by ACI. The B--- Media will not be sold, transferred or delivered to ACI, notwithstanding anything to the contrary in the Agreement or any Exhibit hereto or the bill of sale, but will remain the property of B--- and in its possession, provided, however, that following transmittal of the software the B--- media will be placed in escrow with a bank or other escrow agent agreeable to ACI and will be available upon request for a period of five years to verify the accuracy of the software transmitted to ACI as provided above. During the period of escrow, B--- will not (i) remove the B--- Media from the escrow, (ii) use or make copies of the B--- Media, or (iii) permit any person other than ACI to have access to the B---

> Media. Upon written instructions from ACI, B--- agrees to erase the B--- Media and certify same to ACI.
>
> "The retention of the B--- Media by B--- shall not imply any retention of ownership or other rights to the [name] [computer] software transmitted to ACI, the ownership of which shall pass to ACI upon transmission. The ownership of the written support documentation for said source code shall be transferred to ACI under the bill of sale provided for in this Agreement."

According to testimony at the hearing, the wire transfer occurred at ACI's place of business. Both the transmitting and the receiving computers were located in a single office. ACI had insisted on wire transfer in an attempt to avoid sales or use tax on the transaction.

According to further testimony, the "escrow" was in fact a safe deposit box rented by petitioner in a California bank. As of the date of the hearing, ACI had never requested or been allowed access to the disk media stored there. Shortly after the hearing, petitioner advised the hearing officer that the disk media had been transferred to a safe deposit box in an out-of-state bank on July 2, 1987.

The staff takes the position that the deposit of the disk media in escrow was a transfer of "effective possession, use and control" to ACI. The staff believes that the escrow was therefore a lease for sales and use tax purposes. Tax was asserted on the entire $1,665,848 contract price for the two programs and "other intangible assets".

Analysis and Conclusions

The transfer of title or possession of canned programs on disks or other tangible media, for a consideration, is generally a sale for sales and use tax purposes. Tax applies to the entire amount charged to the customer, including license fees and other user fees. However, the Board has recently declared that tax does not apply:

> "…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."

This language is being incorporated into Sales and Use Tax Regulation 1502 as part of a new subdivision (f)(1)(B).

There is nothing in the record to show that petitioner ever noticed or registered a copyright in the D--- and [NAME] which it wrote. However, the programs were undoubtedly entitled to copyright protection. (See Apple Computer, Inc., v. Formula Intern., Inc. 725 F.2d 521.) Furthermore, a copyright in any work "subsists from its creation…." (17 U.S.C. Section 302(a)). We conclude that the programs were programs "to which a federal copyright attaches" for sales and use tax purposes.

The sale contract between petitioner and ACI speaks in terms of "marketable title" and "ownership" of the programs, and does not expressly refer to a right to reproduce or copy. However, the last paragraph of Section 1.3 does provide that petitioner retained no "ownership or other rights" to the [name] software. While the matter is not free from doubt, we conclude that this language was sufficient to transfer the copyright to ACI.

The contract required a lump-sum payment rather than a license fee or royalty. In our opinion, however, the lump-sum payment was in lieu of a license fee or royalty, and is equivalent to a license fee or royalty for sales and use tax purposes.

Finally, petitioner points out that ACI never actually marketed these programs, and suspects that ACI never in fact intended to do so. Petitioner may be correct, but it is equally possible that ACI intended to market the programs but could not do so because of the "bugs".

More importantly, we believe that the intent to publish and distribute for a consideration should be determined by the objective facts of the transactions, rather than by hindsight or speculation. ACI was engaged in the business of marketing computer programs to banks, and it purchased the rights to programs which had previously been marketed to banks. ACI was careful to ensure that it obtained "marketable title" to the programs under the sale contract. Accordingly, we conclude that ACI acquired the programs "to be published and distributed for a consideration to third parties."

For these reasons, we conclude that tax does not apply to the transfer of the programs. In view of our decision, it is not necessary to discuss petitioner's contentions.

Recommendation

It is recommended that the account be redetermined deleting the protested item from the measure of tax.

10/29/87

James E. Mahler, Hearing Officer Date

M e m o r a n d u m

120.0667

To: Ms. Sylvia Landgraf
Supervising Tax Auditor
San Jose

Date: February 18, 1992

From: David H. Levine
Senior Tax Counsel

Subject: E--- S---, Inc.
SR -- XX-XXXXXX

This is in response to your memorandum dated September 13, 1991, regarding the application of tax to the sale of computer software. As you know, we have been holding this memorandum while the Board considered the I--- petition. We appreciate your patience. The Board has now acted in the I--- matter, basically granting the petition. While not on the identical issue presented here, the Board's action in I--- indicates that the Board does not intend to interpret subdivision (f)(1)(B) of Regulation 1502 in an unduly restrictive manner. Thus, this opinion is consistent with the implications of the Board's decision in I---.

D--- E--- Corporation purchased E--- S---, Inc. Assets of E--- included computer software the sale of which taxpayers argue is not subject to sales tax. Taxpayers assert two reasons that the sale is not taxable. They argue that the transfer was by remote telecommunications and also that the sale was actually of the copyright.

The first contention can be dispensed with easily. Taxpayers point to section 10.1(e) of the purchase agreement which states that the software will be transferred by remote telecommunications and the buyer would not receive any hard disks, floppy disks, or other software. The staff points to section 1.1 of the sale agreement which provides that the seller was selling all assets, which included papers and records in the seller's custody relating to ownership and use of the assets and also including all archived and escrowed software versions, with documentation. This provision certainly indicates that the parties contemplated some transfer of tangible personal property directly relating to the software storage media. Further support for the staff's position includes the auditor's observations and discussions with D--- employees which indicate that software storage media in tangible form were transferred to the purchaser at the [California] location. D--- employees had access to the software tapes and documentation and storage cabinets in [California]. D--- employees indicated that they could use these programs in case of problems with the current computer software.

If the software had been transferred to the purchaser solely by way of remote telecommunications, then we would agree that under subdivision (f)(1)(D) of Regulation 1502, sales tax does not apply. However, it appears that there was a transfer in California of computer software on storage media in tangible form. Please note, however, that whether the purchaser obtained the software in tangible form is a question of fact. Taxpayers dispute the audit staff's conclusions. If this were simply a question of whether the software was transmitted via remote telecommunications (nontaxable) or by storage media (taxable), we would recommend that you carefully consider the facts asserted by taxpayers to support their argument that the software was transmitted via telecommunications.

Taxpayer's alternate argument is that the seller made a nontaxable transfer of the right to reproduce or copy the software for which a federal copyright attached in order for the program to be published and distributed for consideration to third parties. We agree that if the software were transferred solely for the purpose of transferring the right to reproduce or copy the program to which a federal copyright attached in order for the program to be published and distributed to third parties, the sale is not subject to sales tax even if a tangible copy of the program is transferred concurrently with the granting of the right to publish and distribute the software. (Reg. 1502(f)(1)(B).)

Prior to applying the regulatory provision to this transaction, I note an incorrect statement in taxpayers' letter to the Board dated July 10, 1991. Taxpayers assert that subdivision (f)(1)(B) of Regulation 1502 was adopted as a form of sale for resale to avoid double tax on the author and publisher of copyrighted software programs. This is simply incorrect. If this were the case, we would likely have to regard manufacturing aids as purchased for resale. The actual reason for this regulatory provision is that we regard such a sale to be that of the copyright, which is a separate property right recognized by federal law and is an intangible, the sale of which would not be subject to tax if not accompanied by tangible personal property. As noted in the regulation, storage media used to transmit a program meeting these requirements is regarded as merely incidental. That is, we regard such a transaction as the sale of the intangible copyright and not as a sale of the tangible property.

Taxpayers state that D--- had acquired the right to copy and distribute the software in question pursuant to an agreement dated August 7, 1989. E---'s shareholders decided to sell E--- and taxpayers state that upon hearing of this, D--- decided to acquire complete ownership of the software in order to protect its publishing rights and keep it from D---'s competitors. D---'s personnel indicate that after the subject sale, D--- has continued to reproduce, publish, and distribute the software to its customers, the ultimate users of the software.

If the statements by taxpayers are accurate, then this transaction comes within subdivision (f)(1)(B) of Regulation 1502 and the sale is not subject to sales tax. It appears that there are two reasons that staff believes this transaction does not qualify as nontaxable under subdivision (f)(1)(B). Staff believes that taxpayers are attempting to construe the transaction as a royalty when in actuality is an outright sale for an agreed price. Based on this, the staff believes

it is a taxable sale of a prewritten program under subdivision (f)(1)(E) of Regulation 1502. If a transaction is taxable, it is taxable whether the sales price is paid up front in lump sum or as a royalty. The only difference would be that if the amount of the sales price was not certain at the time of the sale, the gross receipts would be taxable in the quarter in which they become certain. (See BTLG Annot. 295.0570 (1/4/79).) Similarly, if a transaction is nontaxable, it is nontaxable regardless of whether the consideration is paid in lump sum or by royalty. Therefore, the fact that the purchaser will pay the seller in lump sum does not affect whether subdivision (f)(1)(B) applies to make the transaction nontaxable.

Another reason that staff believes that the transaction is taxable is based on observations and discussions with E--- and D--- employees that indicate that the software and related documentation were purchased and used by D--- for research and development activities and not solely for publication and distribution by D---. If this were research and development to expand on the subject software in order to publish and sell the expanded software, this would not be regarded as a taxable functional use under these circumstances. For example, if a person purchases a software kernel for publishing and distribution of an expanded software version which will use that kernel as its core, that purchase would be nontaxable under subdivision (f)(1)(B) of Regulation 1502 because the purchaser purchased the kernel for publishing and distribution. On the other hand, if a person purchases the copyright to software for purposes of publishing and distribution in addition to obtaining the software for functional use for its intended purpose, then the purchase price attributable to that purchase for functional use would be subject to sales tax.

The software in question was a CAD program. If by use in research and development activity staff means that D--- used the subject software for its functional purposes of computer aided design and had acquired the software in tangible form, then a portion of the purchase price might be subject to sales tax. However, prior to making this conclusion, the staff must consider several factors. D--- had purchased certain rights under the copyright in 1989. If D--- were making functional use of the software for its intended purpose, D--- may have acquired that right under its 1989 purchase (and presumably sales tax may have applied to that portion of the purchase price. If true, it is likely that no further sales tax is due with respect to the sale in 1990. If D--- had not acquired such rights previously and was actually functionally using the subject software, the taxable measure would only be that portion of the sales price which was equal to the retail value of that right to use.

Thus, if the purchase price were $10,000,000 and E--- would have sold an end user the same right to sue the program for $10,000, the taxable measure on the sale would be $10,000. My guess is that if these were the facts in this case and the staff assessed tax on $10,000, the taxpayers probably would not object. However, one final note. If D--- had not made a previous purchase of the right to publish and distribute the software and did in fact make some functional use of the software related to the purchase currently under review, it is nevertheless relatively clear that the purpose for D---'s purchase was to acquire rights under the intangible copyright. There is no indication in the contract that D--- intended to functionally use the software for its

intended purpose. The classic case where we would apportion part of the purchase price towards the right to use the software is when the purchaser does not acquire all rights to the software, lock, stock, and barrel. For example, when D--- made the purchase in 1989, it did not acquire all rights to the software. If that contract between E--- and D--- did not include the right of D--- to make functional use of the software, then D--- presumably would not have had the right to use it without, presumably, paying royalties to E--- for "selling" the software to itself for its own use. On the other hand, in a transaction such as the current one where the purchaser purchases all rights to the software, there would obviously be no need to specify the purchaser's right to use. When a purchaser purchases all right to copyrighted software and will make some functional use, there are three possibilities for application of tax: since the purchaser will make functional use, the entire sales price is taxable; since the purchaser purchases the software for taxable and nontaxable purposes, tax applies to the sales price allocable to the taxable activity; and since the primary purpose of the acquisition is for the nontaxable copyright, no tax applies.

In the case at issue, it appears very likely that even if D--- is making some functional use of the software and it did not have the right to make such functional use before this purchase, such functional use would be very incidental to its primary purpose for acquiring all right to the subject software. If this assumption is true, we believe that this transaction should be regarded as a nontaxable sale of the intangible copyrights to the software.

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

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cc: San Jose District Administrator