STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
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October 20, 1997

Mr. R--- B---
E---, Incorporated
XXX --- Road
---, --- XXXXX-XXXX

Re: E---, Incorporated
SC --- XX-XXXXXX

Dear Mr. B---:

Your July 7, 1997 letter to Ms. Judy Bearry was referred to the Legal Division on September 17, 1997 for a response. You ask how tax applies to your company's charges to customers for its software and software licenses.

You provide us with the following background:

> "1. Unlike a shrink wrapped license, which becomes effective where the package is opened, our license is executed (i.e., when the final signature is physically applied to the license) in Delaware under the laws of Delaware . . . . As such the license does not recognize any entities other than: E---, Inc., the Licensee, the State of Delaware and the Federal Government.
>
> "2. The license is not tied exclusively to any specific copy of the software, since the user can (and often does) install various copies of the software on various computers over the lifetime of the license.
>
> "3. The license makes no statement or restriction as to the physical location of the use of the software. Since the software is easily transferred and can be placed on portable computers, we have no way to determine where the software is to be used over the period of the license. Our experience shows that shipping address is an insufficient test for location of usage.

> "4. Our training course business is independent of the software sales. It is a 3 1/2 day course taught a maximum of 3 times a year in California and only involves renting of computers the years we hold a 'public' course. We had no courses in California before 1994. Otherwise it is a consultant like activity where all we do is provide the instructors, and the companies provide all the facilities. Please note that: 1) the software does not require training; 2) course attendees do not need to be licensees and many of them are not; 3) the software license clearly states that it is not to be used for training . . . . Thus, purchase of the software license does not entitle one to attend the course, and conversely, course attendance does not provide a software license.
>
> "5. Although at this time the software is only made available to the end user by disk, in the future we have plans to provide it over the Internet. Also, the software is not used in the form on the disk, and installed copy of the software is placed on the end users computer and this copy runs independently of the disk (i.e. the disk does not need to be in the computer in order for the software to run)."

You ask a series of questions based on the above facts. For purposes of this opinion, we assume that the software transferred by your company is prewritten, non-custom software.

> "1. How does California maintain jurisdiction over a contract generated and executed exclusively in Delaware?"

Some background regarding the California Sales and Use Tax Law may be helpful in understanding our response. California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) This tax is imposed on the retailer who may collect reimbursement from its customer where the contract of sale so provides. (Civ. Code § 1656.1; Reg. 1700.) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use, or other consumption of property in California. (Rev. & Tax. Code §§ 6201, 6401.) This tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code § 6202.) A retailer engaged in business inside this state is required to collect this tax from its customers and remit it to this Board. (Rev. & Tax. Code §§ 6202, 6203.)

Subdivision (f) of Regulation 1502 (copy enclosed) addresses the application of tax to sales of computer programs. With regard to prewritten (canned) software, subdivision (f)(1) provides:

> "Prewritten programs may be transferred to the customer in the form of storage media or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.
>
> ". . .
>
> "(B) 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 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.
>
> ". . . ."

We understand that your company executes its license agreements with its customers in Delaware. As a result of that license agreement, your company transfers tangible personal property in the form of computer disks to customers located in California. This transfer of computer disks for consideration is a sale which we assume occurs outside this state such that E---'s sale is not subject to California sales tax. (See Rev. & Tax. Code §§ 6006(a), 6010.5; Cal. U. Com. Code § 2401.) Your California customers nevertheless use this software inside this state by installing and running the programs on their computers. These customers owe use tax on the software they purchase from your company. Your company is engaged in business inside this state (see our response to question four below) and is therefore required to collect this tax from its customers and remit it to the Board.

You specifically ask how "California maintain[s] jurisdiction over a contract generated and executed in Delaware?" First, California's involvement with E---'s operations is only evident when E--- transfers tangible personal property to persons for storage, use, or

consumption inside this state. This is presumed to occur when property is either shipped into this state, or when E--- delivers property to a purchaser outside this state that it knows to be a resident of California. (See Rev. & Tax. Code §§ 6246, 6247.) Second, Revenue and Taxation Code section 6203 imposes a duty on your company to collect use tax from its customers since E--- is engaged in business inside this state. (See our response to question four below.) The United States Constitution permits the imposition of this collection duty based on E---'s "nexus" to California arising from its physical presence inside this state. (See, e.g., *Quill Corp. v. North Dakota* (1992) 119 L.Ed.2d 91.) The net result is that California maintains jurisdiction over your company's use tax collection obligation based on its contacts with California. Your company's license agreement with its customers does not alter that obligation.

> "2. If the software is taxable, how do we evaluate its worth, since we charge for the license and not the software? What is the tax on the software?"

Taxable gross receipts or sales price include all amounts received with respect to a sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011, 6012.) Regulation 1502(f)(1)(B) further provides that tax applies to the entire amount charged to a customer for prewritten software including all license fees. Thus, the taxable measure on the software transferred to your customers consists of the entire fees collected by your company with respect to the license and transfer of software (in tangible form) to its customers.

> "3. Since the software is easily portable, do you wish that sales tax be withheld if we ship to another state that results in use in California? What if it is used in another county or city, how do we determine the tax rate? If so, do we avoid charging sales tax if a shipment to California is to be used outside the state? . . . ."

E--- is required to collect use tax from its customers when property is either shipped to a customer's location inside this state, or when E--- delivers property to a purchaser outside this state that it knows to be a resident of California. (See Rev. & Tax. Code §§ 6246, 6247.[1]) The tax rate E--- should use depends on where it is engaged in business inside this state.

California has a statewide tax rate of 7.25 percent. This rate is made up of the California Sales and Use Tax (Rev. & Tax. Code § 6001 et seq.) and the Bradley-Burns Uniform Local Sales and Use Tax (Rev. & Tax. Code § 7200 et seq.). Any tax above 7.25 percent is imposed by

[1] Revenue and Taxation Code section 6247 creates a presumption that property delivered outside California to a purchaser known by the retailer to be a resident of California was purchased for storage, use, or consumption inside this state. This presumption may, however, be controverted by a statement in writing, signed by the purchaser and retained by the vendor that the property was purchased for use at a designated point or points outside this state.

specially created taxing districts pursuant to the Transaction and Use Tax Law (hereafter "District Tax"). (Rev. & Tax. Code § 7251 et seq.)

When your company ships property to a customer located in a district with no District Tax, the proper tax rate is 7.25 percent. However, if your company ships to a location with its own District Tax, that District Tax applies to the purchaser's use of that property inside the district. (Rev. & Tax. Code § 7262.) Your company is obligated to collect that District Tax from the purchaser only if it is "engaged in business" in the purchaser's district, as defined in Regulation 1827. Regulation 1827(b)(1) and (c) generally provide that if a retailer has either a place of business in a district, or has representatives or agents operating there for the purpose of selling, delivering, or taking orders for tangible personal property, then the retailer is obligated to collect that district's use tax from the purchaser if it ships or delivers the property to the purchaser in the district, or participates in the district in making the sale. In any event, your purchasers owe any applicable District Tax that E--- does not collect from them when E--- is not engaged in business inside that district. As a convenience to your customers, you may wish to voluntarily register to collect all applicable district use tax. (See Reg. 1827(a).)

> "4. Since course sales are independent of software sales, do course sales create nexus for software sales (number of courses by year, 1 - 1994, 3-1995, 2-1996, 2-1997)? The years we did not teach classes in California (i.e. prior to 1994) did we still create nexus?"

Revenue and Taxation Code section 6203 requires a retailer engaged in business in this state to collect use tax from its customers on transactions subject to that tax in California. When a retailer does not have a business location in California, a finding that a retailer is engaged in business inside this state is generally based on the retailer's physical presence inside this state related to sales of tangible personal property. (See, e.g., Rev. & Tax. Code § 6203(b).) This physical presence may be met through activities of employees, agents, or other representatives of the retailer. (*Id.*)

You do not provide us with enough information to determine whether E--- was engaged in business in California prior to 1994. From 1994 to the present, however, it appears that E---'s physical presence inside this state through its teaching of software classes was related to its sales of the very software for which the classes were offered. E---'s activities inside this state therefore create nexus with California and make it a retailer engaged in business inside this state pursuant to Revenue and Taxation Code section 6203. If it has not already done so, E--- should contact Ms. Bearry at the Board's Out-of-State District Office in order to register with this Agency.

> "5. Since the disk is just a transfer media and not used in the normal use of the software (the disk can be destroyed and the software can still be continued to be used) how does it

constitute tangible personal property other than the intrinsic value of the disk?"

Tangible personal property means property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (Rev. & Tax. Code § 6016.) The disks transferred by your company fall within that definition. It is irrelevant that the disks may only be used once to load a software program into a customer's computer. Tax applies to your company's transfer of these disks as set forth in our response to question two above.

You state that E--- has future plans to transfer its software via the Internet. Regulation 1502(f)(1)(D) provides that tax does not apply to the sale or lease of software that is transferred by remote telecommunications (e.g., modem or e-mail) where the purchaser does not obtain possession of any tangible personal property, such as storage media in the transaction. This means that no tax will apply to E---'s sales of software to customers in the future where its sales occur over the Internet and E--- does not provide its customers with any tangible personal property as part of that transaction.

We hope this answers your questions. If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

WLA:cl

Enclosure (Regulation 1502)

cc: Out-of-State District Administrator (OH)