



CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

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GAVIN NEWSOM
Governor

NICOLAS MADUROS
Director

October 18, 2019

Dear Interested Party:

Enclosed is the Discussion Paper on proposed amendments to Regulation 1507, Technology Transfer Agreements. Staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

November 5, 2019
Room 121 at 10:00 a.m.
450 N Street, Sacramento, CA

The event will be webcast for those unable to attend in person. The webcast will be available on our website: www.cdtfa.ca.gov. During and after the webcast, you may submit comments or questions via email to BTfD-BTC.InformationRequests@cdtfa.ca.gov. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Trista.Gonzalez@cdtfa.ca.gov by November 20, 2019. You should submit written comments including proposed language if you have suggestions you would like considered during this process. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to the CDTFA webpage at (<http://www.cdtfa.ca.gov/taxes-and-fees/business-taxes-committee.htm>) for copies of discussion papers and calendars of current and prior issues.

Thank you for your consideration. Staff looks forward to your comments and suggestions. Should you have any questions, please feel free to contact Business Taxes Committee staff member Mr. Robert Prasad at 1-916-445-2710, who will be leading the meeting.

Sincerely,

A handwritten signature in black ink that reads "Trista Gonzalez".

Trista Gonzalez, Chief
Tax Policy Bureau
Business Tax and Fee Division

TG:rp

Enclosures

cc: (all with enclosures)

Mr. Nicolas Maduros (MIC 104)
Ms. Katie Hagen (MIC 104)
Mr. Robert Tucker (MIC 83)
Ms. Michele Pielsticker (MIC 105)
Ms. Susanne Buehler (MIC 43)
Mr. Jason Mallet (MIC 25)
Mr. Wayne Mashihara (MIC 47)
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Ms. Lynn Whitaker (MIC 50)
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Mr. Marc Alviso (MIC 104)
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Ms. Karina Magana (MIC 47)
Mr. Bradley Miller (MIC 92)
Mr. Alfred Buck (MIC 70)
Mr. Robert Wilke (MIC 50)
Mr. Robert Prasad (MIC 50)

Discussion Paper

Proposed Amendments to Regulation 1507, *Technology Transfer Agreements*

I. ISSUE

The proposed amendments to Regulation 1507, *Technology Transfer Agreements*, are intended to clarify, make specific, and fill in the gaps in the California Sales and Use Tax Law (“SUTL”) with respect to the application of Revenue and Taxation Code (“RTC”) sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10) (collectively, the “TTA statutes”). In particular, the proposed amendments clarify, make specific, and fill in the gaps in the TTA statutes with respect to transfers of computer programs where a program is stored on tangible media and is transferred pursuant to a technology transfer agreement (“TTA”). The proposed amendments are consistent with the California Supreme Court decisions in *Preston*¹ and *Navistar*,² and the California Court of Appeal’s decisions in *Lucent*³ and *Nortel*.⁴

II. PROPOSED AMENDMENTS TO REGULATION 1507

CDTFA proposes to amend Regulation 1507 as follows:

- Under subdivision (a), amend the current definitions for the terms: “technology transfer agreement,” “copyright interest,” “patent interest,” and “assign or license,” along with providing new examples, amending one example, and eliminating one example.
- Under subdivision (a), add definitions for the terms: “hold,” “substantially equivalent,” “subject to,” “program,” “hardware,” “external storage media,” “internal storage media,” “physically useful,” “essential storage media,” and “convenient external storage media,” along with providing new examples.
- Under subdivision (b)(1)(A), add new subdivisions (i) and (ii) to define the “reasonable fair market value” of tangible personal property (“TPP”) and to provide a new rebuttable presumption, respectively, when there is a separately stated price for the TPP in the TTA, along with providing a new example.
- Amend subdivision (b)(2) and add a new example to clarify that, for non-TTA transactions (where the transfer of TPP together with a patent or copyright interest is not made pursuant to a TTA), the transaction may not be subject to tax under another applicable sales and use tax exemption.
- Add new subdivision (b)(4), “Specific Application: Programs,” to provide the application of tax and new examples, as follows: subdivision (b)(4)(A) addresses transfers of programs stored on convenient external storage media; subdivision (b)(4)(B) addresses transfers of programs stored on essential storage media; subdivision (b)(4)(C) addresses

¹ *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197.

² *Navistar International Transportation Corp. v. State Board of Equalization* (1994) 8 Cal.4th 868.

³ *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19.

⁴ *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1295.

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transfers of programs by remote telecommunications in TTA transactions; and subdivision (b)(4)(D) defines the “combined cost of materials and labor” used to produce a program stored on essential storage media.

- Add new subdivision (b)(5), “Safe Harbor Provisions: Convenient External Storage Media and Essential Storage Media,” to provide a rebuttable presumption applied to TTAs for the portion of the gross receipts or sales price attributable to the transferred TPP in sales of programs on convenient external storage media, essential external storage media, and hardware containing internal storage media under new subdivisions (b)(5)(A), (b)(5)(B)(i), and (b)(5)(B)(ii), respectively.
- Add new subdivision (b)(6), “Records for Transactions Outside the Safe Harbor Provisions,” to delineate the information and documentary evidence necessary to rebut the presumptions (allocating the gross receipts or sales price attributable to the transferred TPP sold in TTA transactions) set forth in the Safe Harbor Provisions of new subdivision (b)(5).
- Add the following additional citations to Regulation 1507’s reference note: section 6016 of the RTC; 17 U.S.C. § 106 (Exclusive rights in copyrighted works); 35 U.S.C. § 271 (Infringement of patent); *Navistar International Transportation Corporation v. State Board of Equalization* (1994) 8 Cal.4th 868, 35 Cal.Rptr.2d 651; *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1259, 119 Cal.Rptr.3d 905; *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19, 193 Cal.Rptr.3d 323; Regulation 1502, “Computers, Programs and Data Processing;” and Regulation 1540, “Advertising Agencies and Commercial Artists.”

III. BACKGROUND

A. California Sales and Use Tax Law

California imposes a sales tax upon all retailers measured by the gross receipts for the retail sale of TPP in this state, unless the sale is specifically exempted or excluded from taxation by statute. (RTC § 6051.) While the sales tax is imposed upon the retailer for the privilege of selling TPP at retail in California, the retailer may collect sales tax reimbursement from its customer if the contract of sale so provides. (Civ. Code, § 1656.1; Cal. Code of Regs., tit. 18 (“Regulation”), § 1700.)

When sales tax does not apply, use tax is imposed upon the consumer, measured by the sales price of TPP purchased from a retailer for the storage, use, or other consumption of TPP in California, unless the storage, use or consumption is specifically exempted or excluded from taxation by statute. (RTC § 6201.) However, every retailer “engaged in business” in California that makes sales subject to use tax is required to collect use tax from its customers and remit it to the State, and such retailers are liable if they fail to collect and remit the use tax. (Regulation 1684.)

A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of TPP for consideration. (RTC § 6006.) In general, gross receipts and sales price mean the total

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* amount for which TPP is sold (valued in money, whether paid in money or otherwise), without any deduction for, among other things, the cost of the property sold and the cost of any services that are a part of the sale. (RTC §§ 6011, subds. (a) and (b), and 6012, subds. (a) and (b).) TPP is personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (RTC § 6016.)

B. Application of Tax: Pre-Technology Transfer Agreement Statutes

Prior to enactment of the TTA statutes, California law on the taxability of programs transferred on storage media was set forth in *Navistar* and Regulation 1502, “Computers, Programs, and Data Processing.” In *Navistar*, the California Supreme Court held that the sale of a prewritten and non-custom program on storage media constitutes “. . . a transfer of a tangible personal asset produced by the original programmer's services. As such, it is subject to sales tax. (§ 6051.)” (*Touche Ross, supra*, 203 Cal.App.3d at p. 1064, 250 Cal.Rptr. 408.)” (*Navistar, supra*, 8 Cal.4th at p. 881.)

Similarly, Regulation 1502, subdivision (f), “Computer Programs,” provides as follows:

- (1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media. *Tax applies to the sale or lease of the storage media on which or into which such prewritten (canned) programs have been recorded, coded, or punched.*
 - (A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.
 - (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.

(Italics added.)

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C. Technology Transfer Agreement Statutes

RTC sections 6011 and 6012 were amended in 1993 to specify the measure of tax when intangible property is transferred with TPP pursuant to a TTA. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)) The TTA statutes define a TTA as “any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.” (RTC §§ 6011, subd. (c)(10)(D), and 6012, subd. (c)(10)(D).)

The TTA statutes further provide that sales price and gross receipts do not include the amount charged for intangible personal property transferred with TPP in any TTA, if the TTA separately states a reasonable price for the TPP. (RTC §§ 6011, subd. (c)(10)(A), and 6012, subd. (c)(10)(A).) If there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, TPP transferred under a TTA by using the price at which the TPP or like TPP was previously sold, leased, or offered for sale or lease, to third parties for a separate price. (RTC §§ 6011, subd. (c)(10)(B), and 6012, subd. (c)(10)(B).) And, in the absence of previous sales, leases, or offers to sell or lease, TPP or like TPP, to third parties for a separate price, the TTA statutes provide that the taxable measure is equal to 200 percent of the cost of materials and labor used to produce the TPP. (RTC §§ 6011, subd. (c)(10)(C), and 6012, subd. (c)(10)(C).)

D. Regulation 1507

The Legislature has expressly granted quasi-legislative rulemaking authority to CDTFA with respect to the administration and enforcement of the SUTL. (RTC § 7051.) “Because agencies granted such substantive rulemaking power are truly ‘making law,’ their quasi-legislative rules have the dignity of statutes.” (*Western State Petroleum Assn. v. State Bd. of Equalization* (2013) 57 Cal.4th 401, 414.) With its quasi-legislative rulemaking power, CDTFA can adopt regulations that are “consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute.” (Gov. Code, § 11342.)

Regulation 1507 was originally adopted in 2002 to implement the TTA statutes and incorporate the California Supreme Court’s holding in *Preston*. As relevant here, the last sentence in the second paragraph of Regulation 1507, subdivision (a)(1), as adopted in 2002, provided that TTA “does not mean an agreement for the transfer of prewritten software” (the “prewritten software provision”). Regulation 1507 did not contain any other provisions that specifically applied to transfers of computer programs stored on storage media pursuant to a TTA.

E. *Nortel Networks, Inc. v. State Board of Equalization*

In 2011, the Court of Appeal in *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1259, invalidated the prewritten software provision in Regulation 1507. Accordingly, in 2011, the Board of Equalization (“BOE”) amended Regulation 1507 to repeal the prewritten software provision that was held to be invalid by the Court of Appeal in *Nortel*.

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F. *Lucent Technologies, Inc. v. State Board of Equalization*

In 2015, the Court of Appeal in *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19, found that AT&T Corporation and Lucent Technologies, Inc. (collectively “Lucent”) sold digital switches and software that was recorded on convenient (or disposable) external storage media, together with the rights to copy the software onto a switch and, thereafter, to use the software. The court then applied the “physical usefulness test” in the TTA context to determine that tax applied to the charges for the switches and blank tapes and compact discs used to transmit the computer software; but, tax did not apply to the charges for the “software and licenses to use it.” (*Lucent, supra*, 241 Cal.App.4th at pp. 28, 37-38.)

1. The *Lucent* Court Determined That Magnetic Tapes and Compact Disks Used Only to Deliver Software to a User’s Digital Telephone Switch Constituted Convenient Storage Media

The *Lucent* court determined that each tape or disk was merely a “convenient storage media [used] to transfer [the] copyrighted content’ and hence not in itself *essential or physically useful* to the later use of the intangible personal property.” (*Lucent, supra*, 241 Cal.App.4th, at pp. 33-34, italics added.) The court stated that, in the TTA context, to hold that software transferred on convenient (or disposable) storage media is TPP would be inconsistent with prior California decisions, which held that:

... when tangible and intangible property is inextricably intertwined, whether the property is subject to sales tax turns on whether the tangible property is “*essential*” or “*physically useful*” to the subsequent use of the intangible personal property. (*Preston, supra*, 25 Cal.4th at pp. 211-212; *Navistar, supra*, 8 Cal.4th at p. 878.)

(*Lucent, supra*, 241 Cal.App.4th at p. 33, italics added.)⁵

2. The *Lucent* Court Applied the Physical Usefulness Test

In applying the physical usefulness test, the *Lucent* court stated:

Where, as here, the taxable component is intangible personal property, the default rule is to determine whether the tangible portion of the transaction is “*essential*” or “*physically useful*” to the purchaser’s subsequent use of the intangible personal property portion of the transaction..... Thus, when a seller confers an intangible

⁵ In contrast, in the non-TTA (all-or-nothing sales tax) context, the California Supreme Court has ruled that physical usefulness is not a necessary precondition to taxability. Specifically, in *Navistar*, the California Supreme Court stated: “Because the sale of books is taxable, it is apparent that physical usefulness in a manufacturing process is not a prerequisite to the imposition of sales tax on items valued in part for their intellectual content.” (*Navistar, supra*, 8 Cal.4th at p. 878.) The Court in *Navistar* also approvingly cites Regulation 1502 after quoting *Touche Ross*:

A subsequent sale of that program by the initial customer can no longer be characterized as a “service” transaction, but rather is a transfer of a tangible personal asset produced by the original programmer's services. As such, it is subject to sales tax. (§ 6051.) (*Touche Ross, supra*, 203 Cal.App.3d at p. 1064, 250 Cal.Rptr. 408.) Those observations are consistent with the Board's implementing regulation, which states that a prewritten or taxable program includes “a program developed for in-house use which is subsequently offered for sale or lease as a product.” (Cal. Code Regs., tit. 18, § 1502, subd. (b).)

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license to copy a copyrighted matter and gives the buyer a physical copy of the copyrighted matter needed to make use of that license – as is the case with film negatives, master audio recordings, or artwork to be used to make rubber stamps or for integration into a printing plate for a book – the entire transaction is subject to the sales tax. [Citations.] Conversely, when a seller grants an intangible license to copy copyrighted material or to use a patent and transfers the material using tangible media that is *not essential* to the buyer's use of the license or any further manufacturing process—as is the case when software is transmitted via a disk that is “*not essential*” or *otherwise physically useful* to the buyer's subsequent use of that software—the entire transaction is not subject to the sales tax. [Citation.]

This default rule is thus an all-or-nothing affair; depending on the centrality of the tangible personal property to the subsequent use of the intangible personal property, either the entire transaction is taxable or it is not.

But this is only the default rule. In 1993, our Legislature enacted the technology transfer agreement statutes and thereby set up a special rule for technology transfer agreements by excluding them from the definition of “sales” and “gross receipts.”

(*Lucent, supra*, 241 Cal.App.4th at pp. 31-32, italics added.)

3. The *Lucent* Court Rejected the BOE’s Tangibility Test Argument

The *Lucent* court rejected the BOE’s argument that the software stored on storage media was TPP; the BOE had argued that the software could be perceived under the tangibility test set forth in RTC section 6016, consistent with the *Navistar* decision. Instead (in lieu of applying the statutory tangibility test), the court determined that, under the facts of this case, when tangible and intangible property are “inextricably intertwined,” prior to applying the TTA statutory allocation rules to determine the portion of the gross receipts or sales price allocable to the TPP, the physical usefulness test should be applied.

The following is the *Lucent* court’s summation of the BOE’s tangibility test argument:

The Board argues that the computer software in this case is tangible personal property, and offers the following syllogism in support of its position: (1) tangible personal property is property that “may be seen . . . or which is in any other manner perceptible to the senses” (§ 6016); (2) the act of placing data—in this case, AT&T/Lucent's software—on magnetic tapes and compact discs physically alters those tapes and discs; ergo, (3) the software can be (microscopically) seen and perceived by the senses, thereby rendering it tangible personal property.

(*Lucent, supra*, 241 Cal.App.4th at p. 33.)

In response to BOE’s tangibility test argument, the *Lucent* court stated:

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We reject this [Board's] syllogism for two reasons. First and foremost, it is inconsistent with precedent. As detailed above, when tangible and intangible property is inextricably intertwined, whether the property is subject to the sales tax turns on whether the tangible property is “essential” or “physically useful” to the subsequent use of the intangible personal property. [Citations.] More to the point, the California courts have on multiple occasions held that the transmission of software using a tape or disc in conjunction with the grant of a license to copy or use that software does not yield a taxable transaction because the tape or disc is “merely . . . a convenient storage medium [used] to transfer [the] copyrighted content’ and hence not in itself essential or physically useful to the later use of the intangible personal property.” [Citations.]

Second, the Board's construction of section 6016 leads to an absurd result..... If we accepted the Board's construction of section 6016, AT&T/Lucent would be liable for nearly \$25 million in sales tax because it decided to transmit its software to the telephone companies using tapes and discs, but would have been liable for no sales tax on the software if it had instead transmitted the software electronically (via e-mail or through uploading it to a remote server on the Internet for later download by the telephone companies) (Cal. Code Regs., tit. 18, § 1502, subd. (f)(1)(D) [sale or lease of prewritten program is not subject to tax if it is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, provided that the purchaser does not obtain any TPP in the same transaction]). Ascribing such tremendous consequences to the manner in which a software program is transmitted -- when that manner is wholly collateral to the subsequent use of the licenses regarding that software and when that manner is so easily manipulated by the buyer and seller -- is an absurd result nowhere sanctioned by the language of, or policy underlying, California's sales tax law.

(*Lucent, supra*, 241 Cal.App.4th at pp. 33-34, underlining and italics added.)

The *Lucent* court then concluded as follows:

As we conclude above, the fact that placing a computer program on storage media physically alters that media does not thereby transmogrify the software itself into tangible personal property; the media is tangible, the software is not.

(*Lucent, supra*, 241 Cal.App.4th at p. 42.)

4. Explanation of the *Lucent* Court's Application of the Physical Usefulness Test

To summarize, the *Lucent* court first addressed the BOE's tangibility test arguments (pursuant to RTC section 6016) based on prior court decisions discussing the physical usefulness of TPP in the post-sale use of transferred intellectual property (“IP”) interests, including *Navistar*, *Preston*,

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Simplicity Pattern,⁶ *Dell*,⁷ and *Microsoft*⁸ (discussed below). The court held that the first and foremost reason for its decision to reject the RTC section 6016 tangibility test was because the BOE's argument was inconsistent with such precedents, which applied the physical usefulness test.

The *Lucent* court then concluded that, in the TTA context, when TPP and intangible property are inextricably intertwined in a transaction, the default rule is the physical usefulness test; that is, whether the tangible portion of the transaction is “*essential*” or “*physically useful*” to the purchaser's subsequent or post-sale use of the assigned or licensed IP rights.⁹ Accordingly, the court determined that the transmission of software using a tape or disc, in conjunction with a qualifying grant of a license to copy or use that software, results in the software not being treated as TPP because the tape or disc was merely a *convenient* storage medium used to transfer the copyrighted content; the tape or disc was not in itself *essential* or *physically useful* to the later use of the intangible personal property (the licensed patent and copyright interests).

The *Lucent* court, however, went on to acknowledge that the physical usefulness test it was applying was just the default rule because, in 1993, the Legislature passed the TTA statutes, which provide a definition for a TTA and three mechanisms for allocating the value of the TPP transferred pursuant to a TTA. Yet, instead of applying the tangible versus intangible allocation provisions of the TTA statutes as written, the court first applied the physical usefulness test to the software transferred on convenient external storage media pursuant to a TTA.

In other words, after holding that the convenient external storage media was not physically useful to the post-sale use of the IP interests, the *Lucent* court determined that the software stored on such media -- while satisfying the RTC section 6016 tangibility test -- should nevertheless be treated as if it were intangible. Then, the court went on to apply the TTA statutory allocation rules, holding that two times the cost of the blank convenient external storage media was the taxable amount of the TPP under such rules, whereas the software recorded on the convenient external storage media should be treated as if it were intangible.¹⁰

G. Court Precedents Discussing the Physical Usefulness Test Applied in *Lucent*

The following are quotations of the key holdings in California cases involving the “physical usefulness” test applied in *Lucent*.

L. *Simplicity Pattern Company, Inc. v. State Board of Equalization*

In *Simplicity*, the California Supreme Court stated:

⁶ *Simplicity Pattern Company, Inc. v. State Board of Equalization* (1980) 27 Cal.3d 900.

⁷ *Dell Inc. v. Super. Ct.* (2008) 159 Cal.App.4th 911.

⁸ *Microsoft Corporation v. Franchise Tax Board* (2013) 212 Cal.App.4th 78.

⁹ The *Lucent* court's conclusion regarding the necessity of applying the physical usefulness test is contrary to the holding of the California Supreme Court in *Navistar*, which was a pre-TTA case, see footnote 7 above.

¹⁰ The *Lucent* court determined that software stored on convenient (or disposable) storage media should be treated as if it were intangible -- despite the court admittedly finding that the software satisfied the tangibility test set forth in RTC section 6016. (See *Lucent, supra*, 241 Cal.App.4th at pp. 27, 33-34.)

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We conclude that the completed film negatives and master recordings were tangible personal property for sales tax purposes. Though valued in part for their intellectual content, they also were *physically useful* in the manufacturing process. Their value as physical objects permitted measuring the tax on their sale by the price received for their entire worth.

(*Simplicity*, *supra*, 27 Cal.3d at p. 912, italics added.)

2. *Navistar International Transportation Corporation v. State Board of Equalization*

In *Navistar*, the California Supreme Court stated:

The statement [in *Simplicity*] does not constitute a holding that *physical usefulness* in the buyer's manufacturing process is a necessary condition to the taxation of the sale of items valued in part for their intellectual property content. [I]t is apparent that *physical usefulness* in a manufacturing process is not a prerequisite to the imposition of sales tax on the items valued in part for their intellectual content.

(*Navistar*, *supra*, 8 Cal.4th at p. 878, italics added.)

3. *Preston v. State Board of Equalization*

In *Preston*, the California Supreme Court stated:

Like printing plates, master recordings and film negatives, the tangible artwork was *physically useful* and *essential* in the ultimate production of books and rubber stamps incorporating the copyright in the artwork. Without the physical artwork, the contracts were essentially "worthless." As such, the artwork is not like a manuscript, which only furnishes "verbal guidance" and is not *essential* to the manufacturing process.

(*Preston*, *supra*, 25 Cal.4th at pp. 211-212, italics added.)

4. *Dell Inc. v. Superior Court*

In *Dell*, the Court of Appeal distinguished bundled transactions from mixed transactions, stating:

Bundled transactions are distinguishable from transactions in which goods and services are sold together yet are readily separable – so-called mixed transactions. [Citations.] One respected commentator has stated that "a 'mixed transaction' involving separately identifiable transfers of goods and services can and should be distinguished from a '*bundled transaction*' involving *goods and services* that are *inextricably intertwined* in a single transaction." [Citation.]

(*Dell*, *supra*, 159 Cal.App.4th at p. 925, italics added.)

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5. *Microsoft Corporation v. Franchise Tax Board*

In *Microsoft*, an income tax case, the Court of Appeal stated:

But even under the rationale of *Simplicity*, we question whether plaintiff's Gold Master disks are analogous to film negatives and master recordings. The disks themselves were not *essential* to the reproduction process. Rather, they were simply a means used to transmit plaintiff's software programs. Presumably plaintiff could have used other, outmoded methods to transfer such data to the OEM's [original equipment manufacturers], including floppy discs, punch cards, or even paper printouts of the code itself. Thus, there was nothing unique about the Gold Master disks themselves. Instead they served merely as a *convenient* storage medium to transfer plaintiff's copyrighted content: "Inputting a software program from a storage medium into the computer's memory 'entails the preparation of a copy.'" [Citation.]

(*Microsoft, supra*, 212 Cal.App.4th at p. 92, italics added.)

6. *Nortel Networks, Inc. v. State Bd. of Equalization*

In *Nortel*, the Court of Appeal stated the following with respect to a disk used only to transfer a program to a user's digital telephone switch:

Pacific Bell made little use of the tangible disk containing the program, which was simply copied onto its computers, but it made continuous use of the intangible information contained on the disk, information that was necessary to run the switch. Pacific Bell's ability to use the information contained in the SSP [switch specific program] was an intangible personal property right.

(*Nortel, supra*, 191 Cal.App.4th at p. 1276.)

H. Non-TTA SUTL Appellate Court Decisions on Programs Transferred on Storage Media

Navistar and *Touche Ross*¹¹ are two non-TTA, "all-or-nothing" cases involving transfers of computer programs on storage media. In *Navistar* (the transfer of patents and copyrights was not at issue), the California Supreme Court held that: "the computer programs were tangible personal property that had been transferred as part of a sale and therefore were taxable." And, in *Touche Ross* (a pre-TTA statutes case), the Court of Appeal held that computer programs developed specifically for the taxpayer and used in the taxpayer's business were "tangible personal assets."

In *Lucent*, however, in the TTA context, the court distinguished these decisions, stating that:

¹¹ *Touche Ross & Co. v. State Board of Equalization* (1988) 203 Cal.App.3d 1057.

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The Board offers . . . further reasons in support of its position. First, it argues that two California cases -- *Navistar* 8 Cal.4th 868 and *Touche Ross* 203 Cal.App.3d 1057 -- are consistent with its view that the sale of computer software on physical media is a transaction subject to the sales tax. However, both of these cases involved the sale of computer software “for its own sake” and not in conjunction with the concurrent sale of intellectual property rights. [Citations.] Neither case had occasion to consider the issue before us now -- namely, whether the transmission of software through a physical media *as a means of effectuating the grant of a license to copy and use that software is subject to the sales tax*. As noted above, *courts assess taxability in this context* [that is, under the TTA statutes] *using a different rule than they use to assess taxability in the context at issue in Navistar and Touche Ross* [i.e., non-TTA software cases].

(*Lucent, supra*, 241 Cal.App.4th at p. 34, italics added.)

I. California SUTL Supporting the Proposed Regulatory Amendments

The following discusses other applicable California legal authorities, which support the proposed regulatory amendments.

1. RTC Section 6016

RTC section 6016 provides that “tangible personal property” is property that “may be seen . . . or which is in any other manner perceptible to the senses.” The *Lucent* opinion expressly agrees with the application of RTC section 6016 to programs on storage media; the court stated: “by definition -- the use of the tape or disc to transmit the software necessarily puts content on the tape or disc and thereby alters its physical structure.” (*Lucent, supra*, 241 Cal.App.4th at pp. 33-34.) Furthermore, in interpreting section 6016, the California Court of Appeal held, in *Searles Valley Minerals Operations, Inc. v. State Board of Equalization* (2008) 160 Cal.App.4th 514, that electrons, and hence electricity, constitute TPP.

2. RTC Section 6010.9

Under RTC section 6010.9, subdivision (c), “computer program” means “the complete plan for the solution of a problem, such as the complete sequence of automatic data-processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs.”

With respect to this statutory definition, Regulation 1502, subdivision (b)(10), provides that:

"Program" is "the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem"

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further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

3. Regulation 1502, subdivision (f)(1) (Prewritten Programs)

The provisions of Regulation 1502 remain in effect except to the extent that they are expressly superseded by the TTA statutes, Regulation 1507, or case law thereunder. Regulation 1502, subdivision (f)(1) provides:

(1) PREWRITTEN (CANNED) PROGRAMS. Prewritten programs may be transferred to the customer in the form of storage media Tax applies to the sale or lease of the storage media or coding.....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.

4. Regulation 1502, subdivision (f)(1)(B) (the “Golden Master” disk)

Regulation 1502, subdivision (f)(1)(B), provides:

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 or 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.

IV. DISCUSSION

A. First Interested Parties Discussion and Comments

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The BOE, the predecessor of CDTFA, held an interested parties meeting on June 30, 2016, to discuss its initial proposed amendments to Regulation 1507, which were distributed with the Initial Discussion Paper. During the meeting, interested parties raised many questions and expressed their concerns with the proposed amendments. There appeared to be a general consensus among interested parties that the proposed amendments were not sufficient to properly codify *Lucent*. Most of the concerns expressed during the first interested parties meeting were reiterated in written comments submitted by the interested parties to the BOE subsequent to the interested parties meeting.

After reviewing those written and oral comments and also the court decisions in *Nortel* and *Lucent*, CDTFA staff has carefully considered, in the context of the TTA statutes, the application of tax to the transfer of computer programs when those programs are recorded on convenient (or disposable) external storage media, recorded on essential external storage media, or preloaded on internal storage media in the hardware. Staff notes that both *Nortel* and *Lucent* only involved the transfers of programs recorded on convenient external storage media.

Specifically, the *Nortel* court described the programs at issue in that case as follows:

. . . the prewritten programs are contained in the storage media external to the switch hardware, and are loaded onto the switch computers; they are not embedded in the hardware at the time of manufacture. The license gave Pacific Bell the right to reproduce the copyrighted material on its computers.

(*Nortel, supra*, 191 Cal.App.4th at p. 1278.)

Accordingly, the *Nortel* court did not explore the application of tax to programs transferred on internal storage media stored in the hardware or on essential external storage media, where the storage media is necessary to the post-sale use of an assigned or licensed patent or copyright interest.

Likewise, as discussed above, *Lucent* similarly involved sales of software transferred on convenient (or disposable) external storage media; so the *Lucent* court did not address programs transferred on internal storage media in the hardware or on essential external storage media. Instead, the court applied the “physical usefulness” test in the context of sales made pursuant to a TTA to determine whether software transferred on convenient external storage media should be considered as tangible or intangible property for purposes of the allocation provisions of the TTA statutes. Under the court’s application of the physical usefulness test, when tangible and intangible property are inextricably intertwined -- such as in a TTA transaction where a licensed program is transferred on storage media -- whether the program is subject to sales tax turns on whether the storage media is “essential” or “physically useful” to the subsequent use of the intangible property (the assigned or licensed patent or copyright interests). (*Lucent, supra*, 241 Cal.App.4th at p. 33.)

Accordingly, CDTFA staff’s position is that, after *Nortel* and *Lucent*, the preferable approach to clarifying the critical issues (including the application of tax to sales and leases of software

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* transferred on storage media pursuant to a TTA) is to amend Regulation 1507 to apply the “physical usefulness” test as described and applied in the *Lucent* decision in determining whether programs recorded on different types of storage media should be treated as TPP. Once that determination has been made, the TTA statutes’ allocation provisions can then be applied to determine the portion of the gross receipts or sales price allocable to the TPP transferred pursuant to the TTA.

B. Proposed Amendments to Regulation 1507

1. Regulation 1507, subdivision (a)(1) “Technology transfer agreement”

RTC sections 6011, subdivision (c)(10)(D), and 6012, subdivision (c)(10)(D), provide that “technology transfer agreement” means “any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.”

The statutory language by its express terms defines a TTA as an agreement, made by a person who holds a patent or copyright interest (an IP interest), under which the IP interest holder assigns or licenses, to another person, the necessary IP interests to qualify the agreement as a TTA.

The proposed amendment to Regulation 1507, subdivision (a)(1), clarifies and makes specific the statutory language to provide that, in order for an agreement to qualify as a TTA, the agreement must specify that the holder of the IP interest is making a concurrent transfer of TPP along with the assignment or license of the IP interest to the same person. As discussed above, if there is only an assignment or a license of an IP interest, and no TPP is transferred as part of the same transaction, the transaction would not be subject to tax under the SUTL because there would have been no retail sale of TPP. Accordingly, the amended definition of TTA requires that the IP interest holder sells TPP to the same assignee or licensee in the same transaction. The proposed amendment further specifies that the right to “use a process” may only be subject to a patent interest because a “process” may not be copyrighted under the IP law.¹²

2. Regulation 1507, subdivision (a)(2) “Hold”

The proposed amendment also adds new subdivision (a)(2) to provide that a person “holds” a patent or copyright interest only if that person “has the right to assign or license” that IP interest to other persons. New subdivision (a)(2) provides a new example illustrating the definition of “hold.”

3. Regulation 1507, subdivision (a)(3) “Copyright interest”

¹² Under 17 U.S.C. § 102, subdivision (b), “[i]n no case does copyright protection for an original authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work.”

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The proposed amendment redefines the term “copyright interest” under subdivision (a)(3) by directly referencing the federal copyright statute.¹³ This eliminates any potential unintended inconsistencies between the federal and state definitions.

4. Regulation 1507, subdivision (a)(4) “Patent interest”

The proposed amendment redefines the term “patent interest” under subdivision (a)(4) by directly referencing the federal patent statute. Again, this eliminates any potential unintended inconsistencies between the federal and state definitions.¹⁴

Furthermore, the proposed amendment removes the definition of “process” from subdivision (a)(4), because the definition of “process” under the federal patent law (35 U.S.C. § 100, subd. (b)) is incorporated by reference in the definition of “patent interest” under the federal patent statute; specifically, “process” is defined as “process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or materials.”

5. Regulation 1507, subdivisions (a)(5) “Assign or license,” and (a)(6) “Substantially equivalent”

Under subdivision (a)(5), the proposed amendment redefines “assign or license” to clarify that an assignment or license of a patent or copyright interest may be “in whole or in part” to an assignee or licensee. Such proposed amendment is consistent with the California Supreme Court decision in *Preston*, in which the Court states:

. . . the limited scope of the rights transferred in some of the Agreements does not mean that no copyrights were assigned or licensed. “The ownership of a copyright may be transferred in whole *or in part* by means of conveyance or by operation of law” Any of the exclusive rights comprised in a copyright, including any

¹³ The proposed amendment incorporates by reference the federal copyright law (17 U.S.C. § 106) under which the holder of a copyright interest has the exclusive rights to do and to authorize any of the following:

- (1) to reproduce the copyrighted work in copies or phonorecords;
- (2) to prepare derivative works based upon the copyrighted work;
- (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
- (4) in the case of literary, musical, dramatic and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
- (5) in the case of literary, musical, dramatic and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly; and
- (6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

¹⁴ As relevant herein, the federal patent law (35 U.S.C. § 271) provides: “. . . whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefor, infringes the patent.”

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subdivision of any of the rights specified by section 106, may be transferred . . . and
owned separately.

(*Preston, supra*, 25 Cal.4th at pp. 214-215, italics added.)

The proposed amendment also clarifies that, in order for an agreement to qualify as a TTA, there must in fact be an assignment or a license of an IP interest to a person where the person does not already possess the same or a substantially equivalent IP interest, such as from a prior assignment or license or under the IP law. To explain, under such IP law principles as patent exhaustion,¹⁵ implied license,¹⁶ and equitable estoppel,¹⁷ purchasers of TPP may have implied or automatic rights to use transferred TPP for its intended purpose even in the absence of an explicit assignment or license of an IP interest. In such cases (where the transferee already has the right to use the TPP via a prior assignment or license or pursuant to IP law), any purported TTA containing an assignment or license of the same or a substantially equivalent IP interest will, in fact, be a nullity and sham because it lacks objective economic reality other than creating a potential tax benefit under the SUTL.¹⁸ In other words, under the principles of economic reality and substance over form, no copyright or patent interest will have been transferred by the purported assignment or license; therefore, the transaction will not qualify as a TTA. As held in *Lucent*, TTA statutes “require a bona fide transfer of intellectual property rights.” (*Lucent, supra*, 241 Cal.App.4th at p. 38.)

Accordingly, the proposed amendment to subdivision (a)(5) clarifies that in order to “assign or license” a patent or copyright interest under a TTA, there must be a transfer of an IP interest to a person where that person would not otherwise have the same or a substantially equivalent interest. New subdivision (a)(6) defines IP interests as “‘substantially equivalent’ if, in an unregulated competitive market, a purchaser would be willing to pay roughly the same amount for different but similar rights.”

These proposed amendments are also consistent with the legislative intent of the TTA statutes. During the 1993 legislative session, the Legislature -- after being cautioned and fully acknowledging that taxpayers may attempt to exclude portions of taxable gross receipts under the cloak of a TTA -- stated its intent to narrowly apply the TTA statutes.¹⁹ By specifically defining “assign or license” and “substantially equivalent,” the regulation clarifies what is considered as a bona fide transfer of IP rights under the TTA statutes.

6. Regulation 1507, subdivision (a)(7) “Subject to”

¹⁵ See *Quanta Computer, Inc. v. LG Electronics, Inc.* (2008) 553 U.S. 617.

¹⁶ See *De Forest Radio Tel. Co. v. United States* (1927) 273 U.S. 236 (patent); *Effects Associates, Inc. v. Cohen* (9th Cir. 1990) 908 F.2d 555 (copyright).

¹⁷ See *A.C. Aukerman Co. v. R.L. Chaides Constr. Co.* (Fed. Cir. 1992) 960 F.2d 1020 (patent); *United States v. King Features Entertainment, Inc.* (9th Cir. 1988) 843 F.2d 394, 399 (copyright).

¹⁸ See *Northrop Corp. v. State Board of Equalization* (1980) 110 Cal.App.3d 132, 139; *Fashion Valley Mall, LLC v. San Diego* (2009) 176 Cal.App.4th 327, 334-5; *Mapo, Inc. v. State Board of Equalization* (1975) 53 Cal.App.3d 246; *Lerman v. Comm’r* (3d. Cir. 1991) 939 F.2d 44; *Knetsch v. United States* (1960) 364 U.S. 361.

¹⁹ See State Bd. of Equalization, Analysis of Assem. Bill No. 103 (1993), Aug. 17, 1993, p. 2. (Attachment B.)

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The proposed amendment defines “subject to” under new subdivisions (a)(7)(A) and (a)(7)(B) for “make and sell a product” subject to a patent or copyright interest and “use a process” subject to a patent interest, respectively. Subdivision (a)(7)(C) provides a rebuttable presumption that a transferee’s right to make and sell a product or to use a process is “subject to” the assigned or licensed patent or copyright interest.

The proposed new definition of “subject to” is necessary because an agreement is not a TTA if it only exists in form and not substance.²⁰ Thus, a taxpayer who claims a tax exemption under the TTA statutes may not simply label an agreement as a TTA without providing substantiating evidence that the act of making and selling a product or using a process would require an assignment or license of a copyright or patent interest from the holder of that IP interest.

In addressing the taxpayer’s burden of proof under the TTA statutes, the *Lucent* court stated that a taxpayer should not be required to disprove all possible patent or copyright defenses in a TTA tax refund action because that would risk transforming a tax dispute into a full-blown copyright or patent trial. (See *Lucent, supra*, 241 Cal.App.4th at p. 41.) To alleviate this burden, and for purposes of administrative convenience, a rebuttable presumption is proposed under subdivision (a)(7)(C), which provides that if a taxpayer proves that: (i) the transferor held a patent or copyright interest, (ii) the transferor entered into an agreement under which it assigned or licensed that patent or copyright interest to another person, and (iii) under that agreement, the transferee was permitted to make and sell a product or to use a process, then the taxpayer will be rebuttably presumed to have met its burden of proving the “subject to” requirement. Proposed subdivision (a)(7)(C), however, provides that such presumption may be rebutted if evidence is presented that the transferor’s assignment or license of the IP interest set forth in the agreement was unnecessary for the use of the transferred TPP; that is, the transferee would have enjoyed the same or substantially equivalent interests or rights to use the TPP without the explicit assignment or license of the IP interest. Under such circumstances, the transaction would not qualify for the TTA exemption because the agreement is devoid of economic substance outside of the potential tax benefit under the SUTL.

7. Regulation 1507, subdivisions (a)(8) “Program,” (a)(10) “External storage media,” and (a)(11) “Internal storage media”

The proposed amendment adds the definitions for “program,” “external storage media” and “internal storage media” in new subdivisions (a)(8), (a)(10) and (a)(11), respectively. Current Regulation 1507 does not have provisions that specifically apply to sales or leases of software

²⁰*General Mills v. Franchise Tax Board* (2009) 172 Cal.App.4th 1535, 1543; see also *Northrop Corp. v. State Board of Equalization* (1980) 110 Cal.App.3d 132, 139 [“To permit the true nature of a transaction to be disguised by mere formalisms . . . would seriously impair the effective administration of . . . tax policies”].) In *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 760-761, the California Supreme Court states:

“In applying the doctrine of substance over form, the [United States Supreme] Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.” [Citation.] Thus, we focus on the actual rights and benefits acquired, not the labels used.

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* transferred on physical media pursuant to a TTA. Regulation 1502, *Computer, Programs, and Data Processing*, generally applies to all sales, licenses, and leases involving computers and programs. These new definitions clarify that Regulation 1502's definition of "program" and "storage media" apply to Regulation 1507 for TTA transactions. These definitions are also consistent with RTC section 6010.9, subdivision (c) "computer program," and subdivision (a) "storage media."

Additionally, new subdivision (a)(10), which defines "external storage media," specifically lists, among other items, "dongles" as an external storage device upon which a program may be recorded. "Dongle" refers to a small piece of hardware that connects to another device to provide it with additional functionality such as providing an authorization key or a copy protection mechanism for commercial software.²¹

8. Regulation 1507, subdivision (a)(9) "Hardware"

The proposed amendment adds a definition for "hardware" under new subdivision (a)(9). In the TTA context, the scope of "hardware" is broader than "computer" as defined in RTC section 6010.9, subdivision (b), and Regulation 1502, subdivision (b)(3). This is because most modern digital or electronic devices contain more than one control unit and each unit may, in and of itself, be considered a "computer" under the definition set forth in Regulation 1502. Specifically, an internal or embedded program is not restricted to the software built into the internal memory or hard drive of what is typically thought of as a computer, but also includes the software that resides internally within other digital or electronic devices, appliances, and equipment that -- while they may contain one or more control units that may each technically qualify individually as a computer -- are not typically thought of as computers.

9. Regulation 1507, subdivision (a)(12) "Physically useful," (a)(13) "Essential storage media," and (a)(14) "Convenient external storage media"

The proposed amendment adds definitions for "physically useful," "essential storage media," and "convenient external storage media" under new subdivisions (a)(12), (a)(13) and (a)(14), respectively. These new definitions clarify the application of the physical usefulness test applied by the *Lucent* decision for transfers of programs on different types of storage media in the TTA context (discussed above).

Furthermore, four new examples have been added under subdivision (a)(13), to illustrate different types of "essential storage media"; and, two new examples have been added under subdivision (a)(14), to illustrate different types of "convenient external storage media."

10. Regulation 1507, subdivision (b)(1)(A)(i) Application of Tax: "Reasonable fair market value"

Under the three allocation provisions set forth in the TTA statutes, gross receipts or sales price does not include "[t]he amount charged for intangible personal property transferred with tangible

²¹ See Wikipedia definition of "dongle," available at: <https://en.wikipedia.org/wiki/Dongle>.

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personal property in any technology transfer agreement, if the technology transfer agreement separately states a reasonable price for the tangible personal property.” (RTC §§ 6011, subd. (c)(10)(A), and 6012, subd. (c)(10)(A).)

RTC sections 6011, subd. (c)(10)(B), and 6012, subd. (c)(10)(B), provide:

If the technology transfer agreement does not separately state a price for the tangible personal property, and the tangible personal property or like tangible personal property has been previously sold or leased, or offered for sale or lease, to third parties at a separate price, the price at which the tangible personal property was sold, leased, or offered to third parties shall be used to establish the retail fair market value of the tangible personal property subject to tax. The remaining amount charged under the technology transfer agreement is for the intangible personal property transferred.

RTC sections 6011, subd. (c)(10)(C), and 6012, subd. (c)(10)(C), provide:

If the technology transfer agreement does not separately state a price for the tangible personal property, and the tangible personal property or like tangible personal property has not been previously sold or leased, or offered for sale or lease, to third parties at a separate price, the retail fair market value shall be equal to 200 percent of the cost of materials and labor used to produce the tangible personal property subject to tax. The remaining amount charged under the technology transfer agreement is for the intangible personal property transferred.

The term “reasonable fair market value,” however, is not defined in the SUTL. The proposed amendment defines “reasonable fair market value” under new subdivision (b)(1)(A)(i), as used in the first allocation provision of subdivision (b)(1)(A) of Regulation 1507 and RTC sections 6011, subdivision (c)(10)(A), and 6012, subdivision (c)(10)(A), of the TTA statutes.

Because there is no SUTL statutory definition of “fair market value,” the definition of “reasonable fair market value” under new subdivision (b)(1)(A)(i) is based (with necessary modifications for the SUTL) on the property tax statutory definition of fair market value provided by RTC section 110, subdivision (a) -- as it applies to TPP and addresses the legal right to use TPP. RTC section 110, subdivision (a), provides as follows:

... “full cash value” or “fair market value” means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

Such property tax definition of “fair market value” has been modified to add “for sale at retail” to reflect the application of tax under the SUTL.

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In addition, the phrase: “assuming there was no assignment or licensing agreement,” was added to the definition of “reasonable fair market value” under new subdivision (b)(1)(A)(i), because (under the statutory TTA allocation provisions) it is necessary to first determine the value of the TPP separate and apart from the value of the assigned or licensed IP interests. As discussed above, under such IP law principles as patent exhaustion,²² implied license,²³ and equitable estoppel,²⁴ purchasers of TPP may have implied or automatic rights to use the transferred TPP for certain purposes -- typically, purposes relating to the TPP’s intended use -- even in the absence of an assignment or license of any IP interest pursuant to a TTA. Thus, the legal rights to use the TPP (absent the assignment or license of the IP interest) must be determined by taking into consideration such IP law principles (as well as potential other existing assignments or licenses of IP interests, and the possible existence of any enforceable IP restrictions on the use of the TPP).

The first paragraph of the example under subdivision (b)(A) illustrates what it means by “assuming there was no assignment or licensing agreement.” Under the patent exhaustion doctrine,²⁵ a purchaser may use transferred TPP for its intended purpose even without an explicit license of any patent interest pursuant to a licensing agreement. Therefore, under such circumstances, the TPP should be valued as if it would be used by the purchaser for its intended purpose and not as if the purchaser could mass produce the TPP for sale to the public, which is not implicated in the sale and requires a separate license of a patent interest.

11. Regulation 1507, subdivision (b)(1)(A)(ii)

The proposed amendment adds a new rebuttable presumption under new subdivision (b)(1)(A)(ii) for purposes of efficient tax administration. Such rebuttable presumption provides that if a separately stated price for TPP in a TTA is lower than either the seller’s separate price of the same or like TPP (comparable sales approach) or the TTA statutes’ cost basis approach, then that separately stated price does not constitute the TPP’s reasonable fair market value.

Such rebuttable presumption is consistent with the two established methods for appraising fair market value: the comparable sales approach (stated in subdivision (b)(1)(B) of current Regulation 1507), and the cost approach (stated in subdivision (b)(1)(C) of current Regulation 1507). Therefore, if the TTA’s separately stated price for the TPP is below fair market value determined either by using either the comparable sales approach or the cost approach, then the taxpayer would need to affirmatively rebut the presumption that the separately stated price does not reflect reasonable fair market value; this is illustrated in the second paragraph of the new example set forth under subdivision (b)(1)(A).

12. Regulation 1507, subdivision (b)(2)

The proposed amendment adds “unless the transaction is not otherwise subject to tax” to the end of subdivision (b)(2), followed by a new example, to clarify that other tax exemptions or

²² See *Quanta Computer, Inc. v. LG Electronics, Inc.* (2008) 553 U.S. 617.

²³ See *De Forest Radio Tel. Co. v. United States* (1927) 273 U.S. 236 (patent); *Effects Associates, Inc. v. Cohen* (9th Cir. 1990) 908 F.2d 555 (copyright).

²⁴ See *A.C. Aukerman Co. v. R.L. Chaides Constr. Co.* (Fed. Cir. 1992) 960 F.2d 1020 (patent); *United States v. King Features Entertainment, Inc.* (9th Cir. 1988) 843 F.2d 394, 399 (copyright).

²⁵ See *Quanta Computer, Inc. v. LG Electronics, Inc.* (2008) 553 U.S. 617.

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* exclusions under the SUTL may apply to the sale or the storage, use or other consumption of TPP transferred together with an assignment or license of a patent or copyright interest (separate and apart from the TTA exemption), including the exemptions and exclusions provided in Regulation 1502.

A new example is added to illustrate the so-called “Golden Master” disk tax exemption provided in Regulation 1502, subdivision (f)(1)(B), which also involves both tangible and intangible components. This example demonstrates a situation where the copyright license only allows the licensee to copy the program for sale to others (but not to use the program on its computer). Such transaction is not a TTA transaction, and thus, the TTA statutes’ allocation provisions are inapplicable. Instead, the entire gross receipts or sales price is not subject to tax under the provisions of Regulation 1502, subdivision (f)(1)(B).

13. Regulation 1507, subdivisions (b)(4)(A) and (B). Specific Application: Programs

The proposed amendment adds new subdivisions (b)(4)(A) and (B) to clarify the application of the TTA statutes to programs stored on convenient external storage media and programs stored (or preloaded) on essential storage media, respectively. These two new provisions are consistent with the “physical usefulness” test discussed above. Specifically, the *Lucent* court adopted the physical usefulness test to find that programs transferred on storage media that is merely convenient (or disposable), and thus wholly collateral to the subsequent use of the assigned or licensed IP rights, is not physically useful. In other words, such storage media is not essential or physically useful to the post-transfer use of the assigned or licensed patent or copyright interests. New subdivisions (b)(4)(A) and (B) apply the physical usefulness test to clarify the application of tax to a program that is transferred in a TTA transaction on convenient external storage media (e.g., treated as intangible in *Lucent*), as opposed to the treatment of a program transferred in a TTA transaction on essential storage media (e.g., treated as TPP, as illustrated in new Example Nos. 1 and 2 under new subdivision (b)(4)).

14. Regulation 1507, subdivision (b)(4)(C)

The proposed amendment adds new subdivision (b)(4)(C) to clarify that, in non-TTA transactions, the sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer, provided that the purchaser does not obtain possession of any TPP, as provided by Regulation 1502, subdivision (f)(1)(D). Such exemption from taxation, however, does not apply to TTA transactions because, by definition, the assignment or license of a patent or copyright interest to a person pursuant to a TTA will always be accompanied by a concurrent transfer of TPP to the same person in the same transaction.

As illustrated by new Example No. 3 (under new subdivision (b)(4)), the exemption from taxation provided by Regulation 1502, subdivision (f)(1)(D), does not apply to a TTA transaction in which a program is transferred to the purchaser through remote telecommunications, and in the same transaction, other TPP is also transferred to the same purchaser, whereby the purchaser may download the program and install it on essential external storage media or in the internal storage

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* media of the transferred hardware. In TTA transactions, consistent with RTC section 6016 and case law (including *Navistar* and *Searles Valley* [electrons, and hence electricity, constitute TPP]), when the exemption set forth in Regulation 1502, subdivision (f)(1)(D), is inapplicable, programs transferred through remote telecommunications to essential external storage media or the internal storage media in a purchaser’s hardware should be treated as TPP in the same manner as if they were preloaded or stored in such essential storage media at the time of sale.

15. Regulation 1507, subdivision (b)(4)(D)

The proposed amendment adds a new definition for “combined cost of materials and labor” used to produce a program stored on essential storage media under new subdivision (b)(4)(D), which means all such costs incurred during the entire software life cycle from the initial specification of requirements through to the delivery, deployment, and maintenance of the software, with further specificity.²⁶

While the TTA statutes allocate the cost of materials and labor to produce TPP, they do not provide for an allocation of the cost of materials and labor when multiple units of the TPP are sold, such as in the case of programs stored on essential storage media. Proposed new subdivision (b)(4)(D) fills in that statutory gap by providing that, if multiple copies of a program stored on essential external storage media are sold or multiple units of hardware are sold that contain a copy of the program stored on internal storage media, then the combined cost of materials and labor used to produce the program shall be reasonably allocated to each copy or unit sold. Proposed new subdivision (b)(4)(D), however, does not specify a single methodology because the potential variations in TTA transactions involving programs on essential storage media are far too diverse. Nevertheless, the proposed amendment provides two new examples of reasonable allocations of the cost of materials and labor used to produce programs stored and transferred on essential storage media under the specified factual situations.

Example No. 1 illustrates the application of the TTA exemption in allocating the cost of materials and labor to TPP using the cost approach for a transaction involving the lump sum sales price of a machine with a program stored on its internal storage media. In this example, the program was

²⁶ The description of the software life cycle is based on the declaration by Professor Todd Millstein of UCLA, BOE’s computer science expert in *Lucent* (Attachment C), as well as financial and cost accounting principles under Statement of Financial Accounting Standards No. 86 (“FAS 86”) (<https://www.fasb.org/pdf/fas86.pdf>). Specifically, Professor Millstein states in his declaration:

3. As a technical term in the fields of computer science and software engineering, “software production” most commonly refers to the entire software life cycle, from the initial specification of requirements through to the delivery, deployment, and maintenance of a software product (Sommerville p. 7). Another common name for this life cycle is the “software production process” (Ghezzi p. 385).

4. The cost of producing software includes the costs of all the following phases, with each phase possibly iterated multiple times: requirements analysis and specification; software design; software acquisition; implementation; documentation; configuration management; software testing; debugging; product delivery and deployment; and product maintenance.

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* purchased by the manufacturer from a third-party software developer and the manufacturer's cost to purchase the program from the third-party software developer per unit is known.

Example No. 2 illustrates the following:

- All costs of materials and labor used to produce the program stored on essential storage media (including all such costs incurred during the software life cycle) are to be included in determining the cost of materials and labor incurred in producing the software to be recorded on essential physical media prior to sale. (See Attachments C and D.)
- Under the TTA statutes' cost allocation approach, all costs of materials and labor are considered regardless of whether the manufacturer expenses or capitalizes those costs under its financial accounting policies pursuant to generally accepted accounting principles (GAAP).²⁷
- When fiscal year-end financial statements are available disclosing the amortization method used by the taxpayer for its capitalized software development costs over a multiple-year period, and the taxpayer has provided evidence of the number of units of the program sold during the fiscal year in which the TTA transaction took place, a reasonable estimate generally may be made to allocate the portion of those costs attributable to each unit sold.

16. Regulation 1507, subdivision (b)(5). Safe Harbor Provisions: Convenient External Storage Media and Essential Storage Media

The proposed amendment adds new subdivision (b)(5), to provide two new rebuttable presumptions in subdivisions (b)(5)(A) and (b)(5)(B) for convenient external storage media and essential storage media, respectively. These new rebuttable presumptions simplify the administration of the TTA statutes and address the fact that taxpayers in TTA transactions (normally retailers or purchasers) may have only limited access to information regarding the cost of materials and labor used to produce a program.

New subdivision (b)(5)(A) provides a rebuttable presumption that, when a program is transferred pursuant to a TTA to the purchaser on convenient external storage media, the portion of the gross receipts or sales price attributable to the TPP equals 200 percent of its cost of the blank media to the transferor. This rebuttable presumption is consistent with the *Nortel* and *Lucent* decisions (discussed above), in which the courts applied the physical usefulness test, and held that a program transferred on convenient external storage media should be treated as if it were an intangible; and, that for purposes of applying the TTA statutes, the only TPP transferred in such TTA transaction was the blank convenient external storage media.

New subdivisions (b)(5)(B)(i) and (ii) provide new rebuttable presumptions that, when the program is transferred pursuant to a TTA to the purchaser on essential external storage media or

²⁷ Note that the expensing or capitalizing of software development costs relates to the principle of conservatism of GAAP, but those considerations are irrelevant for purposes of the TTA statutes' cost allocation provisions. (See FAS 86, August 1985, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," a part of GAAP, <https://www.fasb.org/pdf/fas86.pdf>.)

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Proposed Amendments to Regulation 1507, *Technology Transfer Agreements* hardware containing internal storage media, respectively, that the portion of the gross receipts or sales price attributable to the TPP is the entire gross receipts or sales price, without reduction, for the essential external storage media or hardware containing internal storage media, together with any programs stored thereon. These rebuttable presumptions apply the *Lucent* physical usefulness test. Under that test, programs transferred in a TTA must be treated as TPP when they are transferred on essential external storage media or hardware containing internal storage media.

17. Regulation 1507, subdivision (b)(6) Records for Transactions Outside the Safe Harbor Provisions

The proposed amendment adds new subdivisions (b)(6)(A) and (B), to delineate the information and documentary evidence that the seller or purchaser, respectively, must obtain and retain in order to rebut the presumptions set forth in the Safe Harbor Provisions of new subdivision (b)(5); that is, the evidence needed to meet the burden of proof that the portion of the gross receipts or sales price attributable to the transferred TPP in a TTA is less than the rebuttably presumed amount set forth in new subdivision (b)(5).

New subdivision (b)(6)(A) of the proposed amendment lists the required information and documentary evidence in sales tax transactions where the seller is obligated to pay sales tax, and in use tax transactions where the seller is obligated to collect and remit the use tax. For these transactions, it is the seller who has the obligation to obtain, retain, and submit the substantiating information and documentary evidence if the seller wishes to rebut the presumptions set forth in the Safe Harbor Provisions of new subdivision (b)(5).

New subdivision (b)(6)(B) of the proposed amendment lists similar required information and documentary evidence for use tax transactions where the purchaser is obligated to report and pay the use tax. For these transactions, it is the purchaser who has the obligation to obtain, retain, and submit the substantiating information and documentary evidence if the purchaser wishes to rebut the presumptions set forth in the Safe Harbor Provisions of new subdivision (b)(5).

ATTACHMENTS:

- A: Draft Proposed Amendments to Regulation 1507
- B: State Board of Equalization, Analysis of Assem. Bill No. 103 (1993)
- C: Declaration by Professor Todd Millstein of UCLA

REGULATION 1507. TECHNOLOGY TRANSFER AGREEMENTS.

Reference: Sections 6011, ~~and 6012,~~ and 6016, Revenue and Taxation Code;
17 U.S.C. § 106; 35 U.S.C. § 271;
Preston v. State Board of Equalization (2001) 25 Cal.4th 197, 105 Cal.Rptr.2d 407;
Navistar International Transportation Corp. v. State Board of Equalization (1994) 8 Cal.4th 868, 35 Cal.Rptr.2d 651;
Nortel Networks, Inc. v. State Board of Equalization (2011) 191 Cal.App.4th 1259, 119 Cal.Rptr.3d 905;
Lucent Technologies, Inc. v. State Board of Equalization (2015) 241 Cal.App.4th 19, 193 Cal.Rptr.3d 323;
“Computers, Programs and Data Processing,” see Regulation 1502;
“Advertising Agencies and Commercial Artists,” see Regulation 1540.

(a) Definitions.

(1) “Technology transfer agreement” means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that under which a person who holds a patent or copyright interest sells tangible personal property to another person and, in addition, assigns or licenses to that person a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to ~~manufacture~~ make and sell ~~property a product that is subject to the patent or copyright interest or use a process that is subject to the patent interest.~~ or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to a technology transfer agreement.

Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce and sell tangible personal property subject to Company X's copyright interest in the artwork. Company X's transfer of artwork and a copyright interest to Company Y constitutes a technology transfer agreement. Company Y's sales of tangible personal property containing reproductions of Company X's artwork do not constitute a technology transfer agreement.

Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) its prototype widget, its patent interests to sell widgets and the process used to manufacture such widgets to Company Y. Company X's transfer of its prototype widget and patent interests to Company Y constitutes a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any widgets that it manufactures does not constitute a technology transfer agreement. Company Y's

sale or storage, use, or other consumption of any tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement.

~~Example No. 3: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the use, application or manipulation of the medical device. Company X charges a monthly rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device to Company Y to perform the separately patented process is not a technology transfer agreement and tax applies to the entire rentals payable for the medical equipment. Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.~~

(2) “Hold:” A person “holds” a patent or copyright interest if that person has the right to assign or license to other persons that patent or copyright interest.

Example: A consumer purchases a bundled game console and video game DVD from a retailer and, in addition, receives a license whereby a third-party game developer that holds relevant patent and copyright interests in the game software authorizes the consumer to use the software to play the game. No technology transfer agreement is created by virtue of this transaction because the retailer does not itself “hold” the relevant patent and copyright interests in the software. Instead, in this situation, the retailer sells the game bundle but it is the third-party game developer who holds, and then licenses, the patent and copyright interests in the software to the consumer.

(23) “Copyright interest” means any legal authority to exercise all of the rights, or any portion of the rights, recognized in a specific copyright under federal copyright law as set forth in 17 U.S.C. § 106. For example, a licensor holds a “copyright interest” if it holds a valid license authorizing the licensee to photocopy a particular copyrighted work, the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes,

~~and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission. For purposes of this regulation, an “original work of authorship” includes any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.~~

~~(34) “Patent interest” means any legal authority to exercise all of the rights, or any portion of the rights, recognized in a specific patent under federal patent law as set forth in 35 U.S.C. § 271. For example, a licensor holds a “patent interest” if it holds a valid license authorizing the licensee to make a product that falls within the scope of the patent interest. the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material. “Process” means one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest.~~

~~(45) “Assign or license” means to transfer as part of a in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement, a patent or copyright interest, in whole or in part, to an assignee or licensee that would not otherwise have either that transferred interest or a substantially equivalent interest.~~

~~(6) “Substantially equivalent:” Interests or rights are “substantially equivalent” if, in an unregulated competitive market, a purchaser would be willing to pay roughly the same amount for different but similar rights. For example, the right to make two archival copies of a computer program generally will be substantially equivalent to the right to make four archival copies of that same computer program because, even though these rights are different, most purchasers would consider them to be of similar economic value.~~

~~(7) “Subject to” means:~~

~~(A) Make and sell a product: A right to make and sell a product is “subject to” a patent or copyright interest in any instance where the act of making and selling the product would require an assignment or license from the patent or copyright holder.~~

~~(B) Use a process: A right to use a process is “subject to” a patent interest in any instance where the act of using the process would require an assignment or license from the patent holder.~~

~~(C) Rebuttable presumption: If a taxpayer meets its burden of proof that: (i) the transferor held a patent or copyright interest, (ii) the transferor entered into an agreement under which it assigned or licensed that patent or copyright interest to the transferee, and (iii)~~

under that agreement, the transferee was permitted to make and sell a product or to use a process, then there shall be a rebuttable presumption that the transferee's right to make and sell a product or to use a process is "subject to" the assigned or licensed patent or copyright interest. The presumption may be rebutted if evidence shows that the assignee or licensee would have enjoyed the same or substantially equivalent rights without the agreement, including, but not limited to, evidence that shows that the transferor's assignment or license of the patent or copyright interest set forth in the agreement was unnecessary for the use of the transferred tangible personal property set forth in the agreement.

Example No. 1: A program developer sells a complicated package of computer programs on storage media to a purchaser, along with a license of patent and copyright interests sufficient to operate the programs and certain future upgrades. The developer later sells upgraded versions of those same programs on storage media to the same purchaser. When transferring the upgraded programs, the developer provides a license reaffirming that the purchaser has all the necessary rights to use the upgraded programs. Assuming that the conditions of subdivision (a)(7)(C) of this regulation are satisfied, the purchaser's licensed right to use the upgraded programs will be presumed to be subject to the developer's patent and copyright interests. This presumption may be rebutted, however, by the presentation of evidence which shows that, by virtue of the first license, the purchaser already had the necessary rights to use the upgraded programs and/or that the second license was unnecessary for the use of the upgraded programs because of the pre-existing license.

Example No. 2: A manufacturer sells a printer cartridge to a consumer, along with a license of patent interests sufficient to use the printer cartridge. Had the manufacturer sold the printer cartridge without that license, the consumer would nevertheless have been able to exercise those same interests because the sale of the patented printer cartridge by default frees the consumer to engage in certain activities that would otherwise infringe the relevant patent. Thus, despite its explicit language, the license at issue does not "assign or license" patent interests because the interests explicitly licensed are in fact redundant to interests that would have transferred regardless.

(8) "Program" means a "program" as defined in Regulation 1502, *Computers, Programs, and Data Processing*.

(9) "Hardware" means the tangible parts or components of a computer or other electronic device, appliance, or equipment, including the internal storage media in the hardware.

(10) "External storage media" means and includes "storage media" as defined in Regulation 1502, *Computers, Programs, and Data Processing*, that is external to the hardware, including without limitation external hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums, dongles, and other external storage devices upon which a program may be recorded.

(11) "Internal storage media" means and includes "storage media" as defined in Regulation 1502, *Computers, Programs, and Data Processing*, that is built into or

internal to the hardware, including without limitation, internal hard disk drives, hard disks, hard drives, fixed disks, solid-state drives, solid-state disks, random-access or volatile memory (RAM), non-volatile primary storage (ROM), and other internal storage devices upon which a program may be recorded.

(12) “Physically useful:” Storage media is “physically useful” if it may be useful in the post-sale exercise of the assigned or licensed patent or copyright interests beyond its use for the initial transfer of a program from one location to another and/or for the archiving of the program.

(13) “Essential storage media” means and includes: (A) internal storage media; and (B) external storage media if it is physically useful.

Example No. 1: In a sale made pursuant to a technology transfer agreement, the transferred external storage media must remain inserted in or connected to the hardware in order for the program recorded thereon to be used by the hardware. The external storage media constitutes essential storage media.

Example No. 2: In a sale made pursuant to a technology transfer agreement, the transferred removable game cartridge or disk is designed to be connected to a video game console and must remain inserted into the console in order for the game program to play. The game cartridge or disk constitutes essential storage media.

Example No. 3: A computer manufacturer installs a word processing program in the internal storage media of a computer, and then, in a sale made pursuant to a technology transfer agreement, sells the computer together with the preloaded word processing program. The internal storage media of the computer constitutes essential storage media.

Example No. 4: Pursuant to a technology transfer agreement, a manufacturer sells bottling equipment with a program that is installed in the internal storage media of the equipment. The internal storage media of the equipment constitutes essential storage media.

(14) “Convenient external storage media” means external storage media that is only useful for the initial transfer of a program from one location to another and/or for the archival storage of the program, and after such initial transfer or archiving, will not be useful in the post-sale exercise of the assigned or licensed patent or copyright interests.

Example No. 1: In a sale of an external magnetic tape made pursuant to a technology transfer agreement, the external magnetic tape is only used to transfer a program to install in and use on the transferee’s computer. After installation, the external magnetic tape is unnecessary for the subsequent use of the assigned or licensed patent or copyright interests, other than with respect to its uses for archival purposes. The external magnetic tape constitutes convenient external storage media.

Example No. 2: In a sale of an external compact disk, together with a dongle containing an authorization key, made pursuant to a technology transfer agreement, the external compact disk

is only used to install a program in the transferee's computer for use thereon and, after installation, is unnecessary for the subsequent use of the assigned or licensed patent or copyright interests, other than with respect to its uses for archival purposes. Each time the transferee uses the program, however, the transferee must first insert the dongle into the computer in order to unlock the program's functionality. In this transfer, while the dongle constitutes essential storage media, the external compact disk constitutes convenient external storage media.

(b) Application of Tax

(1) Tax applies to amounts received for any tangible personal property transferred in a technology transfer agreement. Tax does not apply to amounts received for the assignment or licensing of a patent or copyright interest as part of a technology transfer agreement. The gross receipts or sales price attributable to any tangible personal property transferred as part of a technology transfer agreement shall be:

(A) The separately stated sale price for the tangible personal property, provided the separately stated price represents a reasonable fair market value of the tangible personal property.

(i) For purposes of this regulation, "reasonable fair market value" means the fair market value of tangible personal property, assuming there was no assignment or licensing agreement, if the tangible personal property were exposed for sale at retail in the open market where both the purchaser and the seller have knowledge of all of the uses and purposes to which the tangible personal property is adapted and for which it is capable of being used, and of any enforceable restrictions upon those uses and purposes.

(ii) If the separately stated price for the tangible personal property under subdivision (b)(1)(A) of this regulation is less than the value determined under either subdivision (b)(1)(B) or (b)(1)(C) of this regulation, then there shall be a rebuttable presumption that such separately stated price does not represent the reasonable fair market value of the tangible personal property.

Example: In a transaction made pursuant to a technology transfer agreement, Company X sells a patented medical device to Company Y, and also licenses to Company Y the right to manufacture and sell the medical device to the public. If, in the absence of the licensing agreement, Company Y could use the medical device only for its intended medical purpose, then the reasonable fair market value of the medical device should be determined as if it were going to be used by Company Y only for its intended medical purpose, and not as if Company Y could mass produce the device for sale to the public.

Furthermore, assume that the technology transfer agreement contains a separately stated price for the medical device of \$100, based upon the scrap value of its component parts, but the reasonable fair market value of the medical device if offered for sale at retail in the open market to physicians who intend to use the device in their medical practice for its intended medical

purpose is \$1,000. In this situation, there would be a rebuttable presumption that the \$100 separately stated price does not represent the reasonable fair market value of the medical device.

(B) Where there is no such separately stated price, the separate price at which the tangible personal property or like (similar) tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party; or,

(C) If there is no such separately stated price and the tangible personal property, or like (similar) tangible personal property, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor used to produce the tangible personal property. “Cost of materials” consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a technology transfer agreement. “Cost of labor” includes any charges or value of labor used to create the tangible personal property whether the transferor of the tangible personal property contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the tangible personal property shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer's normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

(2) Tax applies to all amounts received from the sale or storage, use, or other consumption of tangible personal property transferred with a patent or copyright interest, where the transfer is not pursuant to a technology transfer agreement, unless another sales and use tax exemption applies.

Example: A software developer sells a program on a disk to a computer manufacturer and retailer, along with an agreement containing a license of a copyright interest. The license only allows the computer manufacturer to reproduce the program to which a federal copyright attaches in order for the program to be published and distributed for consideration to third parties. Tax does not apply to this transaction because the disk used to transfer the program is considered to be merely incidental, as set forth in Regulation 1502, subdivision (f)(1)(B). Thus, there is no need to determine whether there was a qualified technology transfer agreement or to allocate the sales price or gross receipts to the tangible personal property under the provisions of this regulation.

(3) Specific Applications. Tax applies to the sale storage, use, or other consumption of artwork and commercial photography pursuant to a technology transfer agreement as set forth in Regulation 1540, *Advertising Agencies; and Commercial Artists and Designers.*

(4) Specific Application: Programs

(A) A program that is: (i) stored on convenient external storage media, and (ii) transferred pursuant to a technology transfer agreement shall not be treated as tangible personal property for purposes of this regulation.

(B) A program that is: (i) stored or preloaded on essential storage media at the time of transfer, and (ii) transferred pursuant to a technology transfer agreement shall be treated as tangible personal property for purposes of this regulation.

(C) Regulation 1502, subdivision (f)(1)(D), provides that the sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, provided that the purchaser does not obtain possession of any tangible personal property, such as storage media, in the same transaction. In qualifying transactions made pursuant to a technology transfer agreement, however, the assignment or license of a patent or copyright interest will always, by definition, be accompanied by the transfer of tangible personal property to the purchaser. Therefore, the exemption set forth in Regulation 1502, subdivision (f)(1)(D), is inapplicable in technology transfer agreement transactions. Accordingly, with respect to programs downloaded in qualifying technology transfer agreement transactions, if a program is: (i) transferred by remote telecommunications, (ii) to or through the purchaser's hardware, and (iii) transferred along with the transfer of essential storage media or hardware containing internal storage media, to the purchaser in the same transaction, then the program shall be treated as tangible personal property for purposes of this regulation just as if it had been stored or preloaded in the essential storage media or hardware containing internal storage media at the time of sale.

Example No. 1: Where a computer is sold pursuant to a technology transfer agreement with a preloaded word processing program, the preloaded program stored on the computer's internal storage media shall be treated as tangible personal property.

Example No. 2: A dental molding machine is sold pursuant to a technology transfer agreement with a program stored internally in its hardware. The program enables the machine to make dental products. The program stored on the machine's internal storage media shall be treated as tangible personal property.

Example No. 3: A machine is sold pursuant to a technology transfer agreement along with a license to use a program that operates the machine to make widgets. As part of the same transaction, a program is transferred through the Internet, downloaded by the purchaser, and then installed onto the internal storage media of the machine. The program shall be treated as tangible personal property.

(D) The "combined cost of materials and labor" used to produce a program stored on essential storage media means all such costs incurred during the entire software life cycle, from the initial specification of requirements through to the delivery, deployment, and maintenance of the software, including, without limitation, all costs incurred or expended throughout the following production phases, with each phase iterated multiple times: requirements analysis and specification, program design, program acquisition, implementation, documentation, configuration management, testing, debugging, product delivery and deployment, and product maintenance. If multiple copies of a program

stored on essential external storage media are sold or multiple units of hardware are sold that contain a copy of the program stored on internal storage media, then the combined cost of materials and labor used to produce the program shall be reasonably allocated to each copy or unit sold.

Example No. 1: A manufacturer enters into a technology transfer agreement to sell a speaker manufacturing machine, including a program purchased from a third-party software developer stored on internal storage media residing in the hardware, to a purchaser for a lump sum price of \$200,000, together with a patent license to use the machine to make automobile speakers.

The technology transfer agreement contains no separately stated price for the tangible personal property and neither the tangible personal property nor like tangible personal property previously were sold or leased or offered for sale or lease to an unrelated third party.

The cost of materials and labor used to produce each speaker manufacturing machine without the program is \$100,000. The manufacturer's cost to purchase the program from the third-party software developer is \$18,000 per unit sold.

Thus, the total cost of materials and labor to produce the tangible personal property sold pursuant to the technology transfer agreement is \$236,000 ($\$118,000 \times 200\%$). Since the costs attributable to the tangible personal property of \$236,000 are greater than the lump sum sales price of \$200,000, tax applies to the entire gross receipts.

Example No. 2: A game cartridge manufacturer and retailer, CB Games, internally developed a game program designed to be stored in removable game cartridges to be sold to consumers to play on a game console. The removable game cartridge must remain inserted into the game console in order to play the game.

For financial accounting purposes, prior to establishing the technological feasibility of the program, CB Games expensed all research and development costs of the program. Subsequent to establishing the feasibility of the program, CB Games capitalized all costs incurred in developing the program, which were amortized on a straight-line three-year basis. CB Games also expensed the costs of inventory and maintenance when they were incurred.

In the first fiscal year in which the game cartridges were sold, CB Games sold 10,000 cartridges. The cost of the materials and labor to produce the game cartridge without the program was \$1 per unit. As of the last day of the first fiscal year, the total cost of materials and labor to produce the program was \$330,000, which consisted of: research and development costs of \$50,000, capitalized program development costs of \$250,000, and inventory and maintenance costs of \$30,000.

During the first fiscal year, CB Games sold one game cartridge, out of the total of 10,000 game cartridges sold that year, to a purchaser pursuant to a technology transfer agreement, together with a copyright license to use the game cartridge in a console, for \$22. The technology transfer agreement contained no separately stated price for the tangible personal property and neither the

tangible personal property nor like tangible personal property previously were sold or leased or offered for sale or lease to an unrelated third party.

Since CB Games amortizes its capitalized program development costs over a three-year time period, it is reasonable to amortize the cost of materials and labor in producing the tangible personal property over the same three-year time period, regardless of whether the costs were expensed or amortized for financial accounting purposes. Thus, the cost of materials and labor used to produce each cartridge sold pursuant to the technology transfer agreement is \$24 ($\$1 + (\$330,000 / 3) / 10,000$) x 200%). Since the \$24 per unit cost is greater than the sales price of \$22 for the game cartridge sold under the technology transfer agreement, tax applies to the entire gross receipts.

(5) Safe Harbor Provisions: Convenient External Storage Media and Essential Storage Media.

(A) Convenient external storage media: For the sale of a program on convenient external storage media made pursuant to a technology transfer agreement, there shall be a rebuttable presumption that the portion of the gross receipts or sales price attributable to the transferred tangible personal property is equal to 200 percent of the cost of the blank convenient external storage media to the transferor.

(B) Essential storage media:

(i) Essential external storage media: For the sale of a program on essential external storage media made pursuant to a technology transfer agreement, there shall be a rebuttable presumption that the portion of the gross receipts or sales price attributable to the transferred tangible personal property is equal to the gross receipts or sales price of the essential external storage media, together with the program, without any reduction under subdivision (c)(10) of Revenue and Taxation Code sections 6011 or 6012.

(ii) Internal storage media: For the sale of hardware containing internal storage media, upon which a program was recorded at the time of sale, made pursuant to a technology transfer agreement, there shall be a rebuttable presumption that the portion of the gross receipts or sales price attributable to the transferred tangible personal property is equal to the gross receipts or sales price of the hardware containing the internal storage media, together with the program, without any reduction under subdivision (c)(10) of Revenue and Taxation Code sections 6011 or 6012.

(6) Records for Transactions Outside the Safe Harbor Provisions:

(A) In a technology transfer agreement transaction where the seller is obligated to pay sales tax or collect and remit use tax, if the seller determines that the portion of the gross receipts or sales price attributable to the transferred tangible personal property is less than the rebuttably presumed amount set forth in subdivision (b)(5), then the seller must obtain

and retain sufficient evidence to support the amount of the claimed exemption for the assignment or license of a patent or copyright interest as part of the technology transfer agreement. In addition to the written technology transfer agreement, the following information and documentary evidence must be obtained and included in the transactional records maintained by such a seller:

- (i) Name of purchaser;
- (ii) Date of sale;
- (iii) Invoice or contract number;
- (iv) Description of the item sold;
- (v) The nontaxable amount allocated to the assignment or license of a patent or copyright interest as part of a technology transfer agreement;
- (vi) Documentary evidence that the seller held a patent or copyright interest and that the sale to the purchaser granted the rights to make and sell a product subject to a patent or copyright interest, or use a process subject to a patent interest;
- (vii) The taxable amount of the tangible personal property transferred;
- (viii) Documentary evidence that supports the seller's determination of the portion of the gross receipts or sales price allocable to the tangible personal property transferred in the transaction, including:
 - If the agreement separately states a price for the tangible personal property and the seller determines the measure of tax pursuant to subdivision (b)(1)(A), documentary evidence that the price represents the reasonable fair market value of the tangible personal property transferred in the transaction;
 - If the seller determines the measure of tax pursuant to subdivision (b)(1)(B), documentary evidence of the separately stated price at which the tangible personal property was previously sold, leased or offered for sale or lease, to an unrelated third party; or
 - If the seller determines the measure of tax pursuant to subdivision (b)(1)(C), documentary evidence of the combined cost of materials and labor used to produce the tangible personal property, as well as the manufacturer's amortization policy and the number of copies of the program or units of hardware sold.
- (ix) Where the tangible personal property transferred includes a program stored on essential storage media, the seller must adhere to the provisions of subdivision (b)(4)(D) in determining its combined cost of materials and labor.

(B) In a technology transfer agreement transaction where the purchaser is obligated to report and remit use tax, if the purchaser determines that the portion of the sales price attributable to the transferred tangible personal property is less than the rebuttably presumed amount set forth in subdivision (b)(5), then the purchaser must obtain and retain sufficient evidence to support the amount of the claimed exemption for the assignment or license of a patent or copyright interest as part of the technology transfer agreement. In addition to the written technology transfer agreement, the following information and documentary evidence must be obtained and included in the transactional records maintained by such a purchaser:

(i) Name of seller;

(ii) Date of sale;

(iii) Invoice or contract number;

(iv) Description of the item sold;

(v) The nontaxable amount allocated to the assignment or license of a patent or copyright interest as part of a technology transfer agreement;

(vi) Documentary evidence that the seller held a patent or copyright interest and that the sale to the purchaser granted the rights to make and sell a product subject to a patent or copyright interest, or use a process subject to a patent interest;

(vii) The taxable amount of the tangible personal property transferred;

(viii) Documentary evidence that supports the purchaser's determination of the amount of the sales price allocable to the tangible personal property transferred in the transaction, including:

- If the agreement separately states a price for the tangible personal property and the purchaser determines the measure of tax pursuant to subdivision (b)(1)(A), documentary evidence that the price represents the reasonable fair market value of the tangible personal property transferred in the transaction;
- If the purchaser determines the measure of tax pursuant to subdivision (b)(1)(B), documentary evidence of the separately stated price at which the tangible personal property was previously sold, leased or offered for sale or lease, to an unrelated third party; or
- If the purchaser determines the measure of tax pursuant to subdivision (b)(1)(C), documentary evidence of the combined cost of materials and labor used to produce the tangible personal property, as well as the manufacturer's

amortization policy and the number of copies of the program or units of hardware sold.

(ix) Where the tangible personal property transferred is a program stored on essential storage media, the purchaser must adhere to the provisions of subdivision (b)(4)(D) in determining its combined cost of materials and labor.

STATE BOARD OF EQUALIZATION
LEGISLATIVE BILL ANALYSIS

Bill Number: AB 103 Date Amended: 08/17/93
Author: Quackenbush Tax: Sales and Use
Board Position: Neutral, point out problems Related Bills: _____

BILL SUMMARY:

This bill would exempt from sales and use tax amounts charged for the value of intangible personal property in certain technology transfer agreements, as defined.

ANALYSIS:

Current Law:

Existing law imposes a sales or use tax on the gross receipts from the sale of tangible personal property, unless specifically exempted by statute. Existing law defines "tangible personal property" as personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. When a transaction is regarded as a sale of tangible personal property, tax applies to the gross receipts from the furnishing thereof, without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property. "Gross receipts" includes the total amount of the sales price of the retail sales of retailers, valued in money or otherwise.

Comments:

a. Background of bill. According to the author's office, the purpose of this bill is to clarify existing law which is consistent with a Board interpretation involving the application of tax to certain technology transfer agreements. A "technology transfer agreement" is a transaction where one person licenses to another person the right to manufacture, produce, and sell a product that the second party would not otherwise have the right to do. Such transactions are common in high technology industries, such as the computer hardware industry.

In a specific case before the Board, a corporation (Intel), engaged in the manufacture and sale of microprocessors, microcomputers, and memory systems, entered into a contract with another corporation (Burroughs) to license a process for producing integrated circuits to a design developed by Burroughs. The process was to be transferred to Burroughs so that Burroughs could manufacture the integrated circuits using the same process as Intel. The integrated circuit design remained the property of Burroughs. The process design remained the property of Intel. The integrated circuits could then be manufactured for sale to others by both parties.

As part of the contract, Intel transferred some tangible personal property, including written information, instructions, schematics, database tapes, and test tapes. However, the value of these tangible items were of minimal value in relation to the charges for the right to produce the property. The Board held that in agreements of this type, there are for sales and use tax purposes, two transfers. One is the tangible personal property which may consist of engineering notes, manuals, schematics, database tapes, drawings and test tapes. The second is the sale of intangible property which consists of the license to use the information under the copyright or patent. Accordingly, the portion of the total contract price representing the charge for the license to produce the property is exempt from tax and the tangible personal property transferred would remain subject to tax.

- b. Proposed exemption may be more broad than intended. The purpose of the Board's decision in the Intel case was to make certain the application of tax to technology transfer transactions, which involve the licensing of copyright and patent interests in product to be manufactured for sale-- transfers which generally had not in practice been subject to the tax prior to the time the Board issued its opinion. It is our understanding that the author's intent is to clarify the application of tax on transactions such as Intel's. However, with the proposed definition of technology transfer agreement, other transfers of patented processes could be exempted.

The bill would exempt amounts charged for an agreement under which a patent or copyright holder assigns to another person a right to make and sell a patented or copyrighted product. This language would provide opportunities for the exclusion of a portion of gross receipts. For example:

A seller of artwork may sell a painting and separately state an amount for the right to reproduce lithographs of the original.

A photographer may sell all rights to a photograph and make a separate charge for the right to sell prints or negatives of the original.

The seller of a film strip which is used to make training films could make a separate charge to reproduce copies of the master print for sale.

The seller of technical drawings used in a manufacturing process can make a separate charge for the right to make copies of technical drawings.

The seller of mosaics may separately state the charge for the right to make and reproduce copies.

The seller of a sculpture may separately state a charge for the right to reproduce and sell copies of the original **artwork**.

The seller of commercial art may separately charge for the right to make and sell copies of the original artwork.

The current language could also exclude a portion of the sales price of machinery as the sale of intangible personal property if the right to make or sell the machinery or the right to use a process is being transferred to the purchaser. This is true even if the retailer is also the manufacturer of the machinery.

The phrase "to use a process" could be interpreted more broadly than was intended. Black's Law Dictionary defines "process" as a "mode, method or operation whereby a result is produced; and means to prepare for market or to convert into marketable form." Another definition of "process" under the Patent Law is ". . . a definite combination of new or old elements, ingredients, operations, ways, or means to produce a new, improved or old result, and any substantial change therein by omission, to the same or better result, or by modification or substitution, with different function, to the same or better result, is a new and patentable process."

Following are several scenarios under which a problem in interpretation could ensue:

A manufacturer of integrated circuit boards (which also holds the patent for the boards) sells the boards to the manufacturer of hardware, e.g., a computer printer. Since the integrated circuit boards could be considered "a process," the board manufacturer could transfer the right to use the process to the printer manufacturer who could in turn transfer this right to its customers and exclude a portion of the sales price as a sale of an intangible.

In the case of a sale of computer software, there usually is a licensing agreement which provides that the buyer may use

Assembly Bill 103 (Quackenbush)

the program only under certain conditions. The provisions of AB 103 could be interpreted to apply in this situation as the right use a process, i.e., the program. If this were true, the retailer of the software could segregate a portion of the program sales price as a sale of intangible personal property.

The manufacturer of equipment, such as certain photo processing equipment or custom plastic injection machinery, which holds the patent on a unique process or has purchased the right to use the process could consider part of the sale of the equipment as a sale of an intangible. By agreement this right also could be transferred to the next sale, if any.

- c. Intent language could provide retroactive application of tax. Proposed Section 3 of the bill would provide legislative intent language which specifies that this act is intended to clarify the application of the Sales and Use Tax Law with respect to technology transfer agreements, as defined in the bill. However, as stated in comment b., the proposed definition of technology transfer agreements could be interpreted more broadly, and, with this intent language, could even be extended retroactively.

COST ESTIMATE:

Insignificant administrative costs would be incurred if this bill were enacted for notification to taxpayers and Board staff. These costs are absorbable.

REVENUE ESTIMATE:

The state could suffer a revenue loss, since the technology transfer agreements described in the bill could apply to additional transactions currently subject to tax. However, we do not have information on the magnitude of this loss.

Sheila T. Sarem 9/9/93
Margaret S. Shedd
BW 9/10/93
Analysis prepared by: Sheila T. Sarem 445-6662 September 7, 1993
Contact: Margaret S. Shedd 322-2376

Attachment C: Declaration by Professor Todd Millstein
of UCLA

CONFIRMED COPY

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ORIGINAL FILED
 SUPERIOR COURT OF CALIFORNIA
 COUNTY OF LOS ANGELES

JUL 10 2013

John A. Clarke, Executive Officer/Clerk

9 SUPERIOR COURT OF THE STATE OF CALIFORNIA
 10 COUNTY OF LOS ANGELES

<p> 11 LUCENT TECHNOLOGIES, INC., A 12 Delaware corporation, and AT&T CORP., 13 a New York corporation, 14 15 v. 16 STATE BOARD OF EQUALIZATION OF 17 THE STATE OF CALIFORNIA, 18 Defendant. </p>	<p> CASE NO. BC402036 (Consolidated with Case No. BC448715) DECLARATION OF TODD MILLSTEIN IN SUPPORT OF DEFENDANT'S OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT OR, IN THE ALTERNATIVE, SUMMARY ADJUDICATION </p>
<p> 19 LUCENT TECHNOLOGIES INC., 20 now known as Alcatel-Lucent USA Inc., a Delaware corporation, 21 22 v. 23 STATE BOARD OF EQUALIZATION OF 24 THE STATE OF CALIFORNIA, 25 Defendant </p>	<p> (FILED CONCURRENTLY WITH: 1. MEMORANDUM IN OPPOSITION; 2. OBJECTIONS TO EVIDENCE; 3. OPPOSITION TO REQUEST FOR JUDICIAL NOTICE; 4. SEPARATE STATEMENT OF DISPUTED AND ADDITIONAL FACTS; 5. REQUEST FOR JUDICIAL NOTICE; 6. DECLARATION OF PHILIP SPIELMAN; 7. DECLARATION OF R. POLK WAGNER; 8. DECLARATION OF RONALD N. ITO; 9. INDEX OF EXHIBITS AND EXHIBITS.) Date: July 24, 2013 Time: 8:30 Dept.: 53 Complaint Filed: November 14, 2008 (<i>Lucent I</i>) Complaint Filed: November 2, 2010 (<i>Lucent II</i>) Trial Date: September 23, 2013 </p>
<p> 26 AND RELATED CROSS ACTIONS. </p>	

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 DECLARATION OF TODD MILLSTEIN IN SUPPORT OF DEFENDANT'S OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT/ADJUDICATION (BC402036 consolidated with BC448715)

1 I, Todd Millstein, declare and state:

2 1. I am an Associate Professor in the Computer Science Department at the
3 University of California, Los Angeles. I am an expert in the languages, tools,
4 technologies, and methodologies used in the development of software systems. I have
5 authored more than 40 research publications in this field. I also have a leadership role in
6 many of the premier research conferences in the field, including serving as a Program
7 Committee member for the International Conference on Software Engineering (ICSE)
8 and the Program Chair for the International Conference on Object-Oriented
9 Programming, Systems, Languages, and Applications (OOPSLA) in 2014. I received an
10 A.B. in Computer Science from Brown University in 1996, an M.S. in Computer Science
11 from the University of Washington in 1998, and a Ph.D. in Computer Science from the
12 University of Washington in 2003. I joined the faculty of the University of California,
13 Los Angeles as an Assistant Professor in 2004 and was promoted to Associate Professor
14 with tenure in 2009.

15 2. I have been retained as an expert on behalf of the State Board of
16 Equalization in this action. Based on my expertise in the fields of computer science and
17 software engineering, I am qualified to, and hereby do, offer my opinion in the matters
18 contained in the paragraphs below.

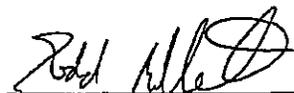
19 3. As a technical term in the fields of computer science and software
20 engineering, "software production" most commonly refers to the entire software life
21 cycle, from the initial specification of requirements through to the delivery, deployment,
22 and maintenance of a software product (Sommerville p.7). Another common name for
23 this life cycle is the "software production process" (Ghezzi p.385).

24 4. The costs of producing software includes the costs of all of the following
25 phases, with each phase possibly iterated multiple times: requirements analysis and
26 specification; software design; software acquisition; implementation; documentation;
27 configuration management; software testing; debugging; product delivery and
28

1 deployment; product maintenance.
2

3 I declare under penalty of perjury of the laws of the State of California that the
4 foregoing is true and correct.

5 Executed this 5th day of June, 2013, at Los Angeles, California.

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8 Todd Millstein
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