

**STATE BOARD OF EQUALIZATION**

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December 15, 1992

BURTON W. OLIVER
Executive Director

Ms. J--- W---
Credit/Collections
Z---, Inc.
XXX E. --- Avenue
---, CA XXXXX-XXXX

Re: SY --H XX-XXXXXX

Dear Ms. W---:

This is in response to your letter dated August 12, 1992. I apologize for the delay. This is a developing area and we needed to ensure uniformity in application of the tax by considering your inquiry along with several others in the context of a recent decision by the Board.

In a letter dated January 30, 1992, Z---'s Assistant Controller J--- S--- asked whether Z--- was correct in collecting sale tax reimbursement on certain royalty payments. I responded in a letter dated March 5, 1992. In that letter, I concluded that all your receipts from the contract in question were subject to tax. However, as I noted in that letter, my conclusion was based on the limited information provided to us. Your customer continues to believe that the charges are not taxable. You have now provided us a copy of the contract and ask that we review it and advise you as to which of you is correct.

FACTS

Z--- agreed to transfer tangible personal property along with a certain license to E--- S--- S---, Inc. (ESS) and ESS agreed to pay Z--- \$25,000 within seven days of the contract's effective date (September 20, 1991), \$25,000 more upon ESS's first shipment of devices utilizing the technology transferred to it, and royalties based on the number of such devices sold by ESS. The contract also provided that Z--- would provide up to 80 hours of consultations to ESS during the first year of the contract. Z--- agreed to provide up to 80 additional hours of consultations at the rate of \$250 per hour. The parties would negotiate regarding any further consultations required by ESS.

The contract provides that ESS has the right to "use the Z8 as a core or building block to design, have designed, manufacture, have manufactured, and sell integrated circuits" An ambiguity arises due to the term "use." That term could be interpreted to mean the use by ESS of the tangible personal property transferred by Z--- to manufacture the finished product (e.g., special tooling is used in this manner). However, the terms "core or building block" indicate that ESS sought the right to reproduce the Z8 and incorporate those reproductions into integrated circuits to be produced and sold by ESS, and my understanding is this was the purpose of the contract. The fact that the contract requires ESS to include a copyright notice (© 1980 Z---) on all devices using the Z8 "core" is consistent with this understanding.

DISCUSSION

Z---'s first letter to us indicated that ESS believed that the two \$25,000 payments were not subject to tax because they were related to consultations. Ms. S--- asked whether the contract could be amended so that the two \$25,000 payments would not be taxable. I explained that the charge for services which are part of the sale of tangible personal property are included in the measure of tax, without regard to post-execution attempts to amend the contract.

The relevant question is whether the contract between Z--- and ESS contains as its primary component the sale of tangible personal property. If so, the first 80 hours of consultation would be regarded as part of that sale. Under such circumstances, even if the charges for that consultation were separately stated (they are not), the charges would remain taxable, but any additional consultation provided by Z--- which ESS were to *elect* to purchase at the rate of \$250 per hour would be optional services which would not be regarded as part of the taxable sale of tangible personal property.

Ms. S---'s letter did not indicate that the transaction in question was of the type sometimes referred to as a transfer of technology. The contract you have now provided us does so indicate. On June 4, 1992, the Board issued an opinion in the matter of the Petition for Redetermination of I--- Corporation. That opinion dealt with application of tax to technology transfer agreements.

A. Technology transfer versus sale of tangible property

In the I--- opinion, the agreements under consideration were identified as technology transfer agreements, which are contracts under which the transferor, whose interests in a particular product include the ownership of patents or copyrights, or both, grants to a transferee the right to make and sell the product in question. That is, technology transfer agreements for purposes of sales and use tax involve the licensing by the transferor of the right to reproduce and sell, which rights are recognized as intangible property rights under federal law. (Were a person to manufacture and sell a product so protected without also obtaining the owner's permission to

do so, that person would be violating the owner's federally protected intangible property rights.) Technology transfer agreements also commonly involve the transfer of "soft" properties, such as notes and drawings.

Under such agreements, the transferor knows how to make the product but the transferee does not. The "soft" items transferred, notes and drawings, explain the technology. The tangible personal property transferred is transferred for the purpose of enabling the transferee/licensee to understand the technology involved in making the product, the acquisition of such right (to make and sell the product) being the transferee's purpose for entering into the contract. In these types of transactions, the transferee does not know how to make the product without having access to the "soft" documentation for use as reference materials in the manufacturing process and, usually, without having access to engineering personnel or the transferor.^{1/}

A technology transfer such as discussed above has been distinguished by the Board from those cases involving licensing of federally protected copyright or patent interests where the property transferred is transferred for use only. Thus, in U---s, a case presently in litigation, the Board taxed certain transfers of copyrighted databases recorded onto magnetic tapes. The tangible personal property transferred to the purchaser, the tapes, could be used directly by the purchaser for its intended purpose (e.g., by downloading from the tapes into the purchaser's hard drive or by duplicating the transferred tapes and then using those duplications in its business) without regard to any additional information, in the form of notes or drawings, provided by the transferor. More importantly, the purpose of the contract was not the transfer to the purchaser of the right to copy the magnetic tapes and sell those copies. Rather, the purchaser sought the magnetic tapes for use in its service business of providing its customers access to its database.

B. Application of tax to technology transfers

In short, the essence of a technology transfer agreement is that the minimal tangible personal property transferred is ancillary to the primary purpose of the agreement, that is, the manufacturing and distribution rights granted to the transferee. In its I--- decision, the Board concluded that agreements of this type involve two types of transfers for purposes of sales and use tax. 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 the intangible property which consists of the license to manufacture and sell the product in question.

The Board concluded that in the absence of a contract price for the tangible elements, the tax applies only to the value attributable to the tangible elements including the cost of

^{1/}If the transferor transferred only the right to copy and sell without transferring any tangible personal property whatsoever, the question considered here would not arise. That is, since there would be no transfer of tangible personal property, there would be no taxable sale of tangible personal property. This question does arise when some tangible personal property is transferred, such as in your situation.

manufacturing the specific tangible properties. This includes material costs, fabrication labor, and a suitable markup for overhead and profit. While suitable markups vary depending on the industry or taxpayer, the markup considered suitable in the I--- case was 100 percent of the cost of materials and labor. The value attributable to the intangible elements transferred under the contract is not subject to tax.

C. The Z--- - ESS contract

Here, the contract includes an exhibit listing "deliverables" from Z--- to ESS. These deliverables are tangible personal property. If the transfer of this property were the primary purpose for the contract and the property were simply for use by ESS as manufacturing aids, then we would regard the contract as a sale of tangible personal property, and all payments made to Z--- under the contract would be taxable. Furthermore, such a sale of tangible personal property would be taxable even if the property included trade secrets or other "intellectual" property.

It appears, however, that the primary purpose of the contract was for the transfer of a license allowing ESS to manufacture and sell reproductions of the Z8, an activity which would otherwise infringe Z---'s federally protected intangible property rights. Based on this understanding, we conclude that only the portion of your charge attributable to the tangible personal property transferred to ESS is subject to tax (calculated as discussed in the second paragraph of section B, above). The remainder of your charge is attributable to the intangible property rights transferred to ESS and is therefore not subject to sales tax because those charges are not regarded as from the sale of tangible personal property.

I hope our delay in responding has not inconvenienced you. If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

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