STATE BOARD OF EQUALIZATION
LEGAL DIVISION - MIC 82
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Tele: (916) 324-3828
FAX: (916) 323-3387

June 22, 1995

Ms. L--- L---
Director of Corporate Taxes
S--- A--- I--- C--- (S---)
XXXXX --- --- Drive
--- ---, California XXXXX-XXXX

RE: SY -- XX-XXXXXX
Software Licenses

Dear Ms. L---:

Assistant Chief Counsel Gary J. Jugum has referred your letter to him dated February 22, 1995, to me for a response. I apologize for the delay.

According to your letter, the majority of S---'s contracts are with the United States, but about 30% of its total business consists of sales to commercial customers. You ask how sales tax applies to four separate scenarios.

OPINION

1. "S--- has a commercial customer which is subject to sales and use tax. The customer has requested under our proposed contract that we license 2 different pieces of canned software and sublicense the software to them in substantially the same form as we acquire.

   "One of the canned software licenses is called C--- with XYZ and requires a yearly license charge. The first payment consists of a primary license charge and an annual license charge. The annual license charge applies yearly thereafter, The annual license charge is approximately 15% of the primary license charge. Under the terms of the licensing agreement, if the annual license charge is not

paid, the customer must discontinue use of the product and return all copies to XYZ. The primary license charge must be paid again to use the product."

You conclude that such an arrangement constitutes a lease of the software under Regulation 1502(f)(1)(A). You ask if S--- may elect to pay tax to XYZ up front rather than collect tax from its commercial customer. We note first of all that this agreement would constitute a lease only if S--- were required to return the original canned programs and all copies to XYZ if the annual fee were not paid (you indicate only the copies must be returned). If S--- may keep the original, there is an outright sale. Also, the amount S--- charges its transferee does not determine the nature of the relationship as a sale or lease.

Although your letter does not say so, it appears that S--- is leasing the software from XYZ and transferring that same software to S---'s customer. That is, we assume that S--- transfers the actual software media which it obtained from XYZ and not a copy. (In this scenario, we assume that your reference to the customer returning all "copies" if the annual license fee is not paid means such copies as S---'s customer may make under the terms of the license agreement plus the original media which it received from S---.)[1] As we have assumed that the actual media is transferred, however, we conclude that the transfer to the customer is a sub-lease for the purposes of the use tax. (Reg. 1660(c)(5).)

Because we have concluded that S--- is the sublessor of the actual tangible personal property it leases from XYZ, Regulation 1660(c)(5) provides that the sublease is subject to use tax measured by the sub-rental payments unless S--- elects to pay XYZ up front use tax measured by the rentals payable under the prime lease. Unless it makes a timely election to pay use tax to XYZ on such basis, its sublease of the property is a taxable continuing sale subject to use tax measured by the rentals payable under the sublease. (Annot. 330.2170 (4/13/90). Sales and Use Tax Annotations are excepts from previous Board Staff opinion letters and serve as guides to Staff positions.)

2. "S--- has a commercial customer which is subject to sales and use tax. The Customer has requested under our proposed contract that we also license a different piece of canned software and sublicense the software to them in substantially the same form as we acquire. One of the licenses called A--- is with a distributor of S--- A--- S---, Inc. (SASI). The distributor has been granted the right to market and support the A--- software in substantially the same form as received. S--- is considered the licensee and our customer is considered the sublicensee.

[1]If, however, S--- were instead to retain the original media which it received from XYZ and transfer a copy to its customer, S--- would be using the tangible personal property obtained from XYZ and not leasing it. As a result, the transfer to S--- of the original media would be a taxable retail sale under Section 6006(g)(5) and S---'s transfer of the copy to its customer would also be subject to tax, because the software transferred to the customer (the media on which S--- copied the software) would not be the same media that S--- acquired from XYZ. (Reg. 1502(f)(1)(A).)

"The distributor is aware of the sublicense to our customer. This license and sublicense is a nonexclusive, nonassignable, and nontransferable license to use the program. The program can only be used on one computer where the program is installed.

"The license term is referred to as a lease agreement which shall be for an initial period of 12 months. License (and sublicensee) shall have the right, by continuing its lease agreement payments (referred to as maintenance fees) to extend the term for two additional 12 month periods under the same terms and conditions. Thereafter, the license is automatically renewed for consecutive 12 month periods unless either the licensee or distributor gives notice to the other party of the intent to terminate or renegotiate the agreement at least 60 days prior to the anniversary date. If within the 3 year period mentioned above, the license is terminated for any reason, licensee is to de-install the program from the computer on which it is installed and either certify to SASI that the program was destroyed or return the program to the distributor.

"The license fee is $XX,000 and is due upon installation of the program. The annual renewal fee, referred to as a maintenance fee, is $X,000 and is due for each of the 2 years commencing on the first anniversary date. If after the 3 year period mentioned above, licensee fails to continue its lease agreement payments (maintenance fee), program upgrade and support shall be terminated and distributor has no obligation to reinstate. Licensee is not required to return or destroy the program after this 3 year period."

You ask if S--- pays the $XX,000 upon installation and the $X,000 on the anniversary date and charges its customer $XX,000 upon installation and $X,000 on the anniversary date, may it elect to pay the tax up front and not collect the tax from its customer.

We are of the opinion that, in this case, there is an outright sale to S--- followed by an outright sale by S--- to its customer. During the initial three year period, if the license is not renewed, S--- has the option of either certifying that the program was destroyed or of returning it to the distributor, and after then apparently keeps the program even if the license is terminated. S--- thus obtains possession of the program with no requirement to return it. That is a sale and not a lease. (Reg. 1502(f)(1)(A) & (B); See, e.g., Annot. 330.2320 (7/8/93).) S---'s customer obtains the software on the same basis. Thus, S--- is making an outright sale to its customer. The sale to S--- is a sale for resale and so excluded from tax (§ 6007); its sale to its customer is the taxable retail sale. The measure of tax from that sale is the $XX,000 sales price. With respect to the maintenance contracts, such "maintenance" contracts provide for supplying updates and later releases of the software. As such, they are themselves sales of tangible personal property. (Reg. 1502(f)(1)(C).) Charges for such contracts are subject to tax whether or not they are optional with the customer. (Annot. 120.0550 (5/6/93).) Thus, S---'s charges of

$X,000 are also subject to tax.

3. "If S--- licenses the canned software from XYZ mentioned under item 1 above for its use on a US Government contract that contains a title passage clause, will sales or use tax apply? S--- will not sublicense the program to the government, but use it to evaluate certain criteria."

Under the decision of the Ninth Circuit Court of Appeals in the case of United States v. S.B.E., 683 F.2d 316 (9th Cir. 1982), leases to government contractors are not exempt from tax even though the contractor uses the leased property to perform a contract with the United States and will be reimbursed for the cost of the lease by the United States. The incidence of the tax is on the lessee, and that the lessee may pass such cost on to the United States does not make it a lease to the latter. The charges to S---'s customer are subject to use tax which S--- must collect. (§ 6203(c).)

4. "If S--- licenses the canned software program from distributor mentioned in item 2 above for its use on a US Government contract that contains a title passage clause, will sales or use tax apply? S--- will not sublicense the program to the Government, but use it to evaluate certain criteria."

Here it is not possible to give you a definite answer. The computer industry's use of the word "license" is not synonymous with the word "lease" for sales and use tax purposes. The first problem is whether the software package is being sold to S--- in a transaction in which S--- becomes its owner or instead is being leased to S---, though being "licensed" to S--- in both cases. If the transaction is a lease for sales and use tax purposes, the lease to S--- is taxable for the reasons discussed in our response to Question 3 above. If a sale, we have determined that canned software programs are items of a type that might be purchased for resale to the United States under the Aerospace decision. Whether the sale of a particular software package so qualifies, however, is determined by the interplay between the FAR, the various government agency supplements to the FAR, and by the transfer restrictions contained in the individual software packages themselves.

Under the FAR system, each agency is empowered to issue supplements ostensibly to deal with agency-peculiar procurement situations and needs, provide necessary agency implementation procedures, and displace the agency procurement regulations which had existed before the FAR went into effect. In reality, agencies have issued what amounts to separate regulations which supersede the FAR where they conflict. Some agency supplements provide that if the software displays a legend that it is subject to the restrictions of a provision in a supplement stating title to software remains with the vendor, then title to the software does not pass to the government. Software packages sold subject to such title clauses are not resold to the United States under Aerospace. As a result, S--- must consult the agency supplements and the transfer restrictions in the software packages it is licensing for deviation from the FAR title-passage provisions.

I hope the above discussion has answered your question. If you need anything further, please do not hesitate to write again.

Sincerely,

John L. Waid
Tax Counsel

JLW:sr

cc: --- --- District Office - --