**STATE BOARD OF EQUALIZATION**
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

June 12, 1991

Ms. C--- L. T---
C---, Inc.
XXXXX --- Boulevard, Suite XXX
---, California XXXXX

Re: C--- M--- P---, Inc.
SR – XX-XXXXXX

Dear Ms. T---:

This is in response to your letter dated May 3, 1991 regarding the application of sales tax to a sale of computer software from C--- to B--- T---, Inc. (BTI). You state:

> "Enclosed please find a contract between our corporation and another California corporation for custom software development which will allow our current software to be integrated into their computers for them to sell as an option to their customers. Until the final product is delivered in the form of a magnetic tape, they will not be receiving anything tangible from us.
>
> "Please also consider that they will charge sales tax to their customers each time they sell a copy of the software."

The contract between C--- and BTI provides that C--- will sell certain programs in tangible form to BTI as set forth in Exhibits A and B to the contract. My understanding of these exhibits is that C--- will provide its preexisting software program under Exhibit A and modify it for BTI as specified in Exhibit B. BTI will pay C--- $X00,000 (plus pre-approved hardware expenditures) which payments are characterized under section 3.1 of the contract as development fees. Additionally, BTI will pay C--- license fees per unit as specified in Exhibit D. I assume these license fees relate to sales of copies by BTI of the software that is provided by C---. Section 5.2(c) provides that C--- will perform ongoing changes to the software subject to payment by BTI on a time and materials basis as specified in Exhibit C. Section 9.1 of the contract indicates that portions of the software transferred to BTI are protected by copyright.

My understanding of the primary purpose of the contract is to obtain certain software together with the right to sell copies of that software, which sales would otherwise be in violation of the copyright held by C---. However, I note that in section 2.2 of the contract BTI also acquires the right to use the software itself for purposes of processing customer data and for marketing.

Discussion

Sales and Use Tax Regulation 1502, a copy of which is enclosed, covers the application of sales tax to computer programs. Subdivision (f) (1) (B) states:

> "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."

Under this provision, no sales or use tax applies to royalty payments or license fees paid under the license agreement as relates to payments made for the right to reproduce and sell a copyrighted program. Section 9.1 of the contract is somewhat ambiguous on the question of copyright in that it states that portions of the program are protected by copyright. For purposes of this opinion, I assume that a federal copyright attaches to the transferred software within the meaning of subdivision (f) (1) (B) of Regulation 1502. Based on this assumption, no sales or use tax applies to amounts received by C--- for the right acquired by BTI to copy the software and sell the copies.

There are two types of payments involved in this contract, a $X00,000 fee divided into 4 payments of $XX,000 (plus other approved charges) and a license fee which I understand to be based upon the number of units of copies sold by BTI. As discussed above, payments for the right to sell copies of the software are not subject to sales or use tax. However, as noted above, the contract gives BTI the right to use the program for its own internal consumption. Unless otherwise exempt (as discussed below), the portion of the charge made by C--- which is attributable to this right of BTI to use the program transferred to BTI in tangible form is subject to sales or use tax since this use does not come within the nontaxable provisions of subdivision (f) (1) (B) of Regulation 1502.

The license fees which are based upon the number of copies sold by BTI are not subject to tax since they all relate to the right of BTI to sell copies of the program. However, the $300,000 payment relates to all rights received by BTI. The portion of this $300,000 payment attributable to BTI's right to use the program itself is subject to tax unless exempt as discussed below. Also included in the payments characterized as development fees are preapproved hardware expenditures. If BTI obtains title to or possession of the hardware, these charges for hardware are entirely subject to sales tax notwithstanding any other discussion herein. If these charges are merely reimbursement to C--- for its overhead expenditures when purchasing hardware necessary for this project, tax applies to these fees in the same manner as tax applies to the other development fees (i.e., the portion attributable to the right of BTI to use the software for other than copying for sale of the copies is subject to tax unless exempt as discussed below).

Charges for custom computer programs are not subject to sales or use tax. (Rev. & Tax. Code § 6010.9). The term "custom computer programs" is defined in subdivision (b) of Regulation 1502. If the software is a custom computer program under this provision, then that software would not constitute a sale or purchase of tangible personal property and the charges for the software would therefore not be subject to sales or use tax. However, as noted above, it is my understanding that C--- starts with a program that does not constitute a program custom designed for BTI and then performs modifications to that program. If this is the case, then subdivision (f) (2) (B) of Regulation 1502 sets forth the application of tax:

> "However, charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as services part of the sale of the prewritten program.
>
> "When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program if the price of the prewritten program was 50% or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, was more than 50% of the contract price to the customer."

The $X00,000 charge to BTI does not appear to separately state the charge for modification. Thus, whether the program is regarded as a custom computer program depends upon whether the portion of the $X00,000 charge attributable to custom programming is more than $XY0,000. If the charge so attributable is over $XY0,000, then the entire charge for that program is not subject to sales or use tax. If the program does not qualify as a custom computer program, then, as discussed above, the amount of the $X00,000 charge which is attributable to BTI's right to use the program as opposed to BTI's right to sell copies of the program is subject to sales tax.

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

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl
Enclosure