STATE OF CALIFORNIA

120.0520

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
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July 20, 1993

Mr. J--- -. G---
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C--- & L---
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Dear Mr. G---:

This is in reply to your April 20, 1993 letter regarding the application of sales tax to charges for licensing of computer software under the following facts you provided:

> "A computer software company ("Company") generally licenses its copyrighted object-oriented database management and development tool software programs (hereinafter "programs" or "software") in machine readable object code to third party licensees. The same basic programs and development tools are licensed to all licensees, although after the license agreement is executed such programs may be "fine tuned" by Company's consultants to maximize effective use by the licensee.
>
> "Company provides instructional and operational manuals and other reference documentation (hereinafter "documentation" or "documentary materials") pertinent to such programs. Charges for such documentary materials are separately stated.
>
> "At the option of the licensee, Company provides Standard Technical Support Agreements (hereinafter "maintenance agreements"), which involve the provision of technical assistance via telephone or electronic mail and the provision of software upgrades in most cases. Maintenance agreements for some product platforms do not include upgrades; in these instances, upgrades are available for a separate charge.

"In some cases "on-site technical assistance" is also provided for a separate charge over and above the fee for the maintenance agreement. On-site technical assistance involves technical assistance by Company's technical support staff and advisory consulting, and does not involve manipulation or modification of the licensed software. Charges for such services are separately detailed on Company's invoices.

"Company engages in business with two general types of licensees: (1) licensees who use Company's programs solely for internal data processing operations or to develop software applications or combine Company's programs with other software products which are in turn used internally by the licensee ("licenses for internal use"), and (2) VARs. In no case do licensees use Company's programs for both of the above purposes.

"VARs generally use Company's programs (or program development tools) to develop, market and sublicense application programs which include, as a component part, Company's programs or portions of Company's program. Under Company's Standard Value Added Reseller Agreement ("Agreement"), a copy of which is attached, the VAR agrees to act as a non-exclusive value added reseller for Company in a specified sales territory for the term of the agreement. Pursuant to the agreement Company grants the following non-exclusive licenses to VARs:

(a) A license to operate Company's programs and program development tools within the territory for purposes of the VAR's internal use, development of programs of which Company's programs are component parts ("hybrid programs" or "application programs") and providing support services to customers.

(b) A license to market, distribute, and sublicense, by itself and through authorized sub-distributors, Company's programs and program development tools as part of an embedded in the VAR's hybrid program. This license includes a license to copy Company's programs in conjunction with copying the hybrid programs for purposes of distributing and sublicensing such hybrid programs.

(c) A license to operate Company's programs for the sole purpose of demonstrating the operation and capabilities of the VAR's hybrid programs to prospective subdistributors and sublicensees. See Agreement, section 3.1."

Given this information, you ask that we confirm your understanding that the transfers of the programs by the Company to the VARs are not sales for resale. We agree. The transfer by the Company is not a sale for resale, because the VARs do not sell the actual software received from the Company nor do they physically incorporate the software into tangible personal property sold by the VARs. Rather, the VARs make a use of the software by retrieving data from the software and incorporating the data into other software produced by the VARs. (Cf. Simplicity Pattern Company v. State Board of Equalization (1980) 27 Cal.3rd 900.)

Sales and Use Tax Regulation 1502, Computers, Programs, and Data Processing, provides the application of sales tax to charges for pre-written programs at subdivision (f)(1). Subdivision (f)(1)(B) of the regulation 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 in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental."

We agree with your analysis that the premise of subdivision (f)(1)(B) is that the true object of the transaction is the transfer of the intangible federal copyright and that the subdivision applies to transactions where the copyrighted program is transferred for the purpose of a VAR incorporating the copyrighted program into a hybrid program which the VAR publishes and distributes for a consideration to third parties.

You asked whether Section 3(1)(a) of the Agreement would cause tax to apply to all or part of the Company's license fee. Yes, since Section 3.1(a) of the Agreement grants a license to the VAR to make internal use of the programs, tax applies to the portion of the license fee attributable to such use.

Very truly yours,

Ronald L. Dick
Senior Staff Counsel

RLD:ph