STATE BOARD OF EQUALIZATION
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September 2, 1992

Mr. [T]
[C]
XXX --- ---
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Dear Mr. [T]:

This is in reply to your June 23, 1992 letter regarding the application of sales and use tax to a software licensing agreement. You provided the following explanation:

> "Our clients develop and publish video games. The games are currently manufactured and distributed on floppy disks. Our clients are interested in issuing non-exclusive licensing agreements for their products to persons who would be granted the right to convert and, to the extent necessary, modify the video games to be compatible with computer/interactive entertainment formats such as IBM and IBM compatible CD-ROM's. With respect to the above, our clients ('licensors') would supply to the licensees object code masters for the licensed games, and mechanical art or film for all components necessary to complete the licensed products, with the exception of CD-specific instructions, which would be produced by the licensee. With respect to the sale and distribution of the licensed products, the licensee shall pay the licensor royalties equal to a percentage of net sales."

Given this information, you asked the following specific questions:

> Are video games taxable as video cassettes (i.e. tax on rental receipts) or software or as tangible personal property?

We assume that you asking whether the ultimate rentals of such video games for private use are subject to Revenue and Taxation Code sections 6006, subdivision (g)(7) and 6010, subdivision (e)(7) which provide generally that tax applies to rentals and leases of videocassettes, videotapes, and videodiscs measured by the rental receipts and preclude the lessor from paying tax measured by cost. Yes, we believe that the video games you describe would qualify for that tax treatment.

Are the royalties and/or fixed amounts paid for a software license agreement subject to sales/use tax?

Yes, generally, the transfer of software for a consideration is subject to tax. However, tax does not apply to royalty payments or license fees paid 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. That is true regardless that a tangible copy of the program is transferred with the granting of such right and that the licensee may modify the program. Any storage media used to transmit the program is merely incidental. (Sales and Use Tax Reg. 1502, Computers, Programs, and Data Processing, subd. (f)(l)(B).)

Is the transfer of information from one storage media (i.e. floppy disk) to a different storage media (i.e. cd rom) taxable?

A charge for converting data from one physical form of recordation to another form is subject to tax. (Reg. 1502, subd. (d)(l).)

How does tax apply when a master game is sold or licensed for duplication purposes for ultimate resale to the end-user?

We believe the response to the second question above answers this.

What is the tax application for related tangible personal property transferred with the storage media (game) mechanicals, film, etc.?

Although the charge for the storage media may be nontaxable as discussed in response to the second question, tax would apply to the portion of the charge attributable to the transfer of the mechanical art and film.

We hope this answers your questions; however, if you need further information, feel free to contact me directly.

Very truly yours,

Ronald L. Dick
Senior Tax Counsel

RLD:sr