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January 6, 1992

Mr. T--- -, V--- M---
 Tax Manager
 S--- D--- R--- C---
 XXXX --- Drive
 ---, --- XXXXX-XXXX

SZ --- XX-XXXXXX

Dear Mr. ---:

This is in reply to your September 25, 1991 letter regarding the application of sales and use tax to your charges for computer software. You provided the following facts.

“SDRC Software Products Marketing Division, Inc., (hereinafter referred to as SPMD) markets a comprehensive mechanical computer aided engineering software system called I--- (I--- D--- E--- A--- S---), which spans a broad range of applications including solid modeling, finite element modeling and analysis, computer-aided testing, drafting and manufacturing. SDRC’s software products are sophisticated tools used by an engineer to analyze and simulate a product’s performance in a manufacturing process at the conceptual stage prior to prototype development or manufacturing. The Company’s software products run on the leading computer platforms (such as --- Corporation, D--- E--- Corporation, A--- C---, Inc., S--- M---, S--- G---, Inc. and H--- Corporation) including mainframes, super mini-computers and engineering workstations.

“SPMD world headquarters are located in M---, ---. SPMD maintains “sales offices” in --- ---, --- --- and --- ---, California. The salespeople in these offices will visit California customers and solicit purchase orders from them. All orders for the Company’s software are approved in Ohio and the software is shipped from Ohio to our California customers via common carrier. No stock of software is maintained in our California offices.

“The I--- program which SPMD licenses is an application program. An application program permits a computer to perform specific tasks. In contrast to operations or “system” programs which are fundamental and necessary to the functioning of the hardware itself. The I--- system is modular, allowing the design engineer to acquire only the portion of the system which fits his

requirements with no performance penalty and to add additional modules as his needs expand.

“When transferring engineering technology to its end user customers, SPMD has decided (for safety and control purposes) to embody SPMD’s technology on magnetic media and ship the media to the end user customer (as opposed to transmitting it via phone lines). It is important to note at this point that an end user customer does not generally receive magnetic media with only the I--- modules which he has licensed. Depending on the platform upon which the Company’s programs will be executed, the entire I--- program is embodied on from one to six magnetic media cartridges. If a customer licenses the I--- Solid Modeling module on a platform which requires three magnetic cartridges to embody the entire I--- program, the customer will receive the one magnetic cartridge which contains the I--- Solid Modeling module. In all likelihood, other I--- modules will be embodied on this one magnetic cartridge. The customer, however, will not be able to access those other modules because of the password security system utilized by the Company. The magnetic media, even encoded, is virtually worthless unless the end user customer is supplied by SPMD with the passwords necessary to access the desired programs.

“Prior to shipping computer software to an end user customer, the end user customer must execute the Company’s standard Master License Agreement (“MLA”). A copy of SPMD’s current standard MLA is attached as Exhibit I for your review. The MLA is comprised of the following schedules: the Licensed Software Designation Agreement, Standard Annual Software License, the Standard Extended Term Software License, Maintenance and Support Schedule and the Training Service schedule. Each of these schedules with the exception of the Training Service Schedule will be discussed later in more detail. The end user customer is granted a non-exclusive, non-transferable license to use the software only on the computer system designated by the customer. Once the MLA is executed by the customer and approved by SPMD, magnetic media, embodying the entire I--- program (or a portion thereof) is shipped to the end user customer. The customer is also sent the passwords which allows him to access the specific modules licensed for a given number of simultaneous users (sometimes referred to as ‘seats’) as specified on the Licensed Software Designation Agreement.

“The MLA also states that, ‘Additional SDRC software may be ordered from time-to-time by Customer’s execution of a supplemental Licensed Software Designation Agreement referencing the MLA Agreement Number cited above, and upon execution by SDRC of such supplemental Licensed Software designation Agreement, such future orders shall be governed by the terms and conditions referenced herein.’ Clearly state, the end user customer signs one MLA. Additional software may be ordered by executing a supplemental Licensed

Software Designation Agreement. However, additional orders are governed by the terms and conditions of the MLA.

“SPMD generates revenue by licensing its technology based on its accessibility. If an end user customer licenses the entire I--- program for numerous simultaneous users, the license fee could easily be hundreds of thousands of dollars. Alternatively, an end user customer could license one module of the I--- program for one simultaneous user and the license fee could be a couple of thousand dollars. Since license revenue is generated by SPMD based upon the technology which has been made accessible to the end user customer, it is not possible to assign a fixed and constant value of each magnetic media upon which the I--- program has been embodied.

“When an end user customer licenses the I--- computer software, the customer can obtain either an annual license or a perpetual (i.e., an extended term) license. An annual license allows the end user customer access to the I--- technology for a one year period. A perpetual license grants the end user customer the right to use the I--- technology forever (on the computer hardware equipment specified by the customer). When a customer obtains a perpetual license, the will frequently also obtain maintenance and support (‘M&S’) services. M&S services are defined in the MLA but, in general, the purchase of M&S services entitles the end user customer to receive (1) hotline telephone support services), (2) updates and extensions or amendments of user documentation (i.e., manuals), (3) new versions of the licensed programs which encompass improvements, extensions and other changes which SPMD, in its discretion, deems to be logical improvements or extensions of the original licensed programs and, (4) corrections to user documentation and/or program code if there are any material variances between the licensed program(s) performance and the user documentation. M&S services are optional. The M&S service agreement cannot be for less than one year nor more than three years in duration. M& S services are provided as part of an annual license without additional charge.”

You went on to provide the following situations:

“(1) A customer who has previously obtained a perpetual license also purchases 12 months of M&S service. The M&S fee is due at the beginning of the period of coverage. At this point, no tangible or intangible property has been received by the customer. In month three of the M&S service period, the Company releases a new version of the I--- program licensed by the customer. New magnetic media embodied with the new technology along with new user documentation (i.e., manuals) are sent from Milford to the end user customer. No additional fees are charged to the end user customers. The customers are given new passwords to access the appropriate computer program modules for a specified number of simultaneous users.

“(2) A customer executes SPMD’s MLA and initially obtains a perpetual license for the I--- Drafting module for two simultaneous users. At that time, the customer receives a tape which embodies the engineering technology and a manual. Eight months later the customer decides to expand to four simultaneous users. The customer executes a new Licensed Software Designation Agreement. Upon receipt and acceptance of the Licensed Software Designation Agreement, SPMD issues the customer new passwords which will allow four simultaneous users access to the licensed I--- Drafting module. No additional tapes or manuals will be sent to the customer. The customer is charged a fee for the addition of the two simultaneous users.

“(3) A customer executes SPMD’s MLA and initially obtains a perpetual license for the I--- Drafting module. At that time, the customer receives a tape which embodies the engineering technology and a manual. After a period of three months, the customer would like to add the I--- Solid Modeling module. Assume the I--- Solid Modeling module is embodied on the same magnetic media as the I--- Drafting module previously sent to the customer. As in Example 2, the customer executes a new Licensed Software Designation Agreement. The customer will receive new passwords which will allow the user access to the Solid Modeling module. No additional tapes will be sent to the customer. An additional manual will be sent to the customer. The customer is charged a fee for access to the additional I--- module.

“(4) A customer who has obtained an annual license for an I--- module and at the end of the period renews for an additional period of one year. The customer will receive new passwords. No additional tapes or manuals will be sent to the customer. The customer is charged an annual license fee.”

You understand that tax applies to your charges in situation (1); however, you asked whether tax applies to charges in situations (2) through (4). One of your California customers claims that the charges are nontaxable, because no tangible personal property was transferred. In support of its position, the customer cites Sales and Use Tax Regulation 1502, subdivision (f)(1)(D), which provides in relevant part:

“The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media in the transaction.”

The quoted subdivision provides that charges are nontaxable when the purchaser does not obtain possession of any tangible personal property. Under the facts you provided, you have transferred possession of tangible personal property and make a charge for the customer’s

increased use of the property. The quoted subdivision of Regulation 1502 pertains to situations where a contract provides solely for a transfer of information by remote telecommunications such as a facsimile transmission. We believe that the fees in each of the situations you describe are subject to tax.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

Ronald L. Dick
Senior Tax Counsel

RLD:sr