STATE OF CALIFORNIA

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Mr. S--- S---
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Re: [No Permit Number]
Taxation of Computer Software

Dear Mr. S---

I am responding to your letter to Assistant Chief Counsel Gary J. Jugum dated May 19, 1993. You ask about the taxation of computer software in the following situation in the wake of the decision in *Quill v. North Dakota* (1992) 504 U.S. ---, 119 L.Ed.2d 91, 112 S.Ct. ---.

> "Suppose we are an out-of-state company that has no contacts with California. We have no office nor personnel in the state. All of our sales are conducted via mail and telephone solicitations. Next, suppose we conduct two transactions, both involving canned, or off-the-shelf, software. The first transaction is a pure sale: we sell you a copy of the software. The second transaction is a perpetual license agreement where title to the software remains with us but you can use your copy in any way you desire that does not violate any copyright or patent laws. All other aspects of the contract are identical."

Since you are not the taxpayer and are only posing hypothetical facts, this letter does not constitute specific written advice to the taxpayer under Revenue and Taxation Code Section 6596. Rather, it constitutes general comments regarding the applicability of California Sales and Use Tax Law to a set of hypothetical facts.

OPINION

A. Use Tax on Tangible Personal Property

In California, except where specifically exempted by statute, Revenue and Taxation Code Section 6051 imposes an excise tax, computed as a percentage of gross receipts, upon all retailers for the privilege of selling tangible personal property at retail in this state. (Unless otherwise stated, all statutory references are to the Revenue and Taxation Code.) Property is "in this state" if it is physically located within the external limits of California when the sale takes place. (§§ 6010.5, 6017.) Likewise, Section 6201 imposes a use tax in the storage, use, or other consumption in this state of tangible personal property purchased from any retailer for use, storage, or other consumption in this state unless otherwise exempted from taxation by statute.

Please note that the sales tax is imposed upon the retailer for the privilege of selling tangible personal property in this state while the use tax is upon the purchaser who uses, stores, or otherwise consumes such property here. The retailer must collect the use tax from the purchaser if engaged in business in this state. (*Bank of America v. St. Bd. of Equalization* (1962) 209 Cal.App.2d 780, 792, 792-793 [26 Cal.Rptr. 348].) (§ 6303.) Under the Quill decision, a state may not require a mail-order retailer whose only contact with the state is by mail or through common carrier to collect state use tax from the buyer without the approval of Congress.

B. Taxation of Sales of Computer Software.

Regulation 1502(f) discusses the taxation of sales or leases of canned software in pertinent part as follows:

(1) PREWRITTEN (CANNED) PROGRAMS....

* * *

(B) 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 includible in the measure of tax....

Tax applies to the sale or lease of the storage media or coding sheets on which or into which prewritten (canned) software programs have been recorded, coded, or punched.

C. Tax Consequences to K--- Publications.

Under your hypothetical situation, K--- has no offices or sales personnel in California. We assume it also does not contract with persons here either to train its customers in the use of the program or to maintain it. (See, § 6203(b).) In this case, its only contact with California is through the mail.

As to transactions where the software is sold outright, the tangible personal property - i.e., the storage media, is presumably located at K---' place of business when the sale is made. Since the property is located out of state at that time, sales tax does not apply. Under the facts you relate, K--- has no contact with California other than mailing the software to the customer. Under Quill, then, K--- has no obligation to collect California use tax from the purchaser at this time.

The license agreement is different. We assume that at the end of the license, the customer must return the software to K---. Thus, we consider that K--- would be leasing the software to the customers. (§ 6006.3.) A lease of tangible personal property is a continuing sale and purchase unless the property is leased in substantially the same form as acquired by the lessor and sales tax reimbursement or use tax measured by the sales price. Since K--- presumably copies the program onto the storage media sent out with the license, it does not lease it in the same form as acquired. As a result, the license is subject to use tax measured by the rental payments. (Reg. 1660.) Any retailer deriving rentals from a lease of tangible personal property in this state is engaged in business here and so required to collect use tax. (§ 6203(c).)

The policy behind Section 6203(c) is explained in Annotation 220.0140 as follows:

> "The purpose of the addition of subsection (c) to Section 6203 was to require the collection of the use tax by an out-of-state lessor on leases of tangible personal property in this state where the lessor did not otherwise qualify as "engaged in business in this state" under Section 6203(a) or (b). Where the lessor's connection with this state is solely that of leasing tangible personal property, he is responsible for collection of the use tax only with respect to leased property physically located in this state. The mere presence of the leased property in this state does not constitute the requisite nexus with respect to sales in interstate commerce, made by the out-of-state lessor to California customers."

(Sales and Use Tax Annotations are excerpts from staff opinion letters and serve as a guide to staff policy.)

The passage from Quill you quoted reinforces this principle. The Court noted there that Quill licensed software to some of its North Dakota clients, apparently so that those clients could more readily order Quill's products. As you note, the Court held that "'the existence in North Dakota of a few floppy diskettes to which Quill holds title seems a slender thread on which to base nexus.'" (Quill, supra., 119 L.Ed.2d at 108, fn. 8.) Thus, as noted in the annotation, the

retailer does not have nexus with regard to its mail-order sales. Leases are different. A lessor's business is the continuing sale and purchase of leased property in California; the physical presence of property in this state gives the required "nexus" for California to impose a duty to collect use tax.

For your information, I have included a copy of Regulations 1502 and 1660. 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:es

Encs.: Regs. 1502 & 1660