STATE OF CALIFORNIA

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Director

January 17, 2024

To Whom It May Concern:

The California Department of Tax and Fee Administration will be hosting a workshop to discuss and receive input on technology transfer agreements. (See enclosure for additional information.) We invite you to participate in this workshop and present any suggestions or comments that you may have on this topic. Accordingly, a workshop is scheduled as follows:

January 31, 2024
Room TBD at 10:00 a.m.
450 N Street, Sacramento, CA

You may join us on your computer or mobile app through Microsoft Teams or by calling 1-916-535-0987 and then entering the phone conference identification number 766 176 162#. You are also welcome to submit your written suggestions or comments to me at the address or fax number in this letterhead or via email at BTFD-BTC.InformationRequests@cdtfa.ca.gov by March 15, 2024. Copies of the materials you submit may be provided to others; therefore, please ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others who may be interested in participating in the workshop or presenting their suggestions or comments.

Thank you for your consideration. We look forward to your participation. Should you have any questions, please feel free to contact Business Taxes Committee team member Robert Wilke at 1-916-309-5302.

Sincerely,

Aimee Olhiser

Aimee Olhiser, Chief
Tax Policy Bureau
Business Tax and Fee Division

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Enclosures
Technology Transfer Agreements Workshop Paper

Technology Transfer Agreements Workshop

Scope

The California Department of Tax and Fee Administration (Department) will be hosting a workshop to discuss and receive input on technology transfer agreements (TTAs). The topics for discussion are TTAs (including TTAs where software is also transferred), determining the measure of tax when there is a TTA, the use of intermediaries in the supply chain, and any other TTA related topics raised by the participants.

Background

General

California imposes a sales tax measured by a retailer's gross receipts from the retail sale of tangible personal property (TPP) inside this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code (RTC) 6051.) While the sales tax is imposed upon the retailer for the privilege of selling TPP at retail in California, the retailer may collect sales tax reimbursement from the customer if the contract of sale so provides. (California Code of Regulations, title 18, section (Regulation or Reg.) 1700, *Reimbursement for Sales Tax*.) It is presumed that all gross receipts are subject to the tax until the contrary is established, and the burden of proving that a sale of TPP is not a sale at retail is upon the person who makes the sale unless they accept a resale certificate from the purchaser. (RTC 6091.)

When sales tax does not apply, use tax is imposed upon the consumer, measured by the sales price of TPP purchased from a retailer for storage, use, or other consumption in California, unless specifically exempted or excluded from taxation by statute. (RTC 6201.) However, every retailer "engaged in business in this state" that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the Department, and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Department. (RTC 6203, 6204; Reg. 1684, *Collection of Use Tax by Retailers*.)

A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of TPP for a consideration. (RTC 6006.) In general, gross receipts and sales price mean the total amount for which TPP is sold, without any deduction for, among other things, the cost of the property sold and the cost of any services that are a part of the sale. (RTC 6011, 6012.) TPP is personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (RTC 6016.)

The TTA statutes

Subdivisions (c)(10) were added to RTC sections 6011 and 6012 in 1993 to specify the measure of tax when intangible property is transferred with TPP pursuant to a TTA. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.).) The TTA statutes define a TTA as "any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." (RTC 6011, subd. (c)(10)(D) and 6012, subd. (c)(10)(D).)

The TTA statutes further provide that sales price and gross receipts do not include the amount charged for intangible personal property transferred with TPP in any TTA, if the TTA separately states a reasonable price for the TPP. (RTC 6011, subd. (c)(10)(A) and 6012, subd. (c)(10)(A).) If

there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, TPP transferred under a TTA by using the price at which the TPP or like TPP was previously sold, leased, or offered for sale or lease, to third parties for a separate price. (RTC 6011, subd, (c)(10)(B) and 6012, subd. (c)(10)(B).) And, in the absence of previous sales, leases, or offers to sell or lease, TPP or like TPP, to third parties for a separate price, the TTA statutes provide that the taxable measure is equal to 200 percent of the cost of materials and labor used to produce the TPP. (RTC 6011, subd. (c)(10)(C) and 6012, subd. (c)(10)(C).)

Regulation 1507

Regulation 1507, *Technology Transfer Agreements*, was originally adopted in 2002 to implement the TTA statutes and incorporate the California Supreme Court's holding in *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197. Regulation 1507 defines the term TTA, explains the application of tax to transactions involving TTAs, and provides several examples illustrating transactions that do and do not constitute a TTA. Example 3 in Regulation 1507 provides that when a company leases a tangible device for a monthly charge and requires the lessee to pay separate charges each time it uses a patented process related to technology embedded in the internal design, assembly, or operation of the device, the separate charges are not made pursuant to a TTA and are part of the rentals payable for the lease of the device.

Nortel

In *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1259 (*Nortel*), the Second District Court of Appeal held that "the transfer of a program that is subject to a patent or copyright is a TTA." (*Nortel*, pp. 1277-1278.) The court invalidated the part of Regulation 1507 that provided that a TTA does not mean an agreement for the transfer of prewritten software (*Nortel*, p. 1278), and that language was subsequently deleted from the regulation. The court held that the copyrighted prewritten software Nortel transferred to Pacific Bell on tangible storage media (disks, magnetic tapes, or cartridges) was exempt from sales tax under the TTA statutes because the software was "not embedded in the hardware at the time of manufacture," and "the licenses gave Pacific Bell the right to reproduce the copyrighted material on its computers." (*Ibid*.) The court also granted Nortel's claim for a refund of the sales tax paid on the charges for the licenses to copy and use the prewritten software. (*Ibid*.)

Lucent

In *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19 (*Lucent*), the Second District Court of Appeal held that software is not TPP and that placing software on tangible storage media does not thereby transmogrify the software itself into TPP. (*Lucent*, p. 33 and 42.) The court held that "the transmission of software using a tape or disc in conjunction with the grant of a license to copy or use that software does not yield a taxable transaction because the tape or disc is 'merely ... a convenient storage medium [used] to transfer [the] copyrighted content' and hence not in itself essential or physically useful to the later use of the intangible personal property." (*Lucent*, p 33.) The court held that the contrary provisions of subdivision (f)(1) of Regulation 1502 are not sanctioned by California's sales tax law. (*Lucent*, p. 34.) The court held that the transmission of Lucent's copyrighted prewritten software on tangible storage media (tapes and compact discs) as part of a transaction granting a license to copy and use that software did not transform that software into TPP subject to sales tax, and that the price of the blank tangible storage

media used to transmit the software was what was subject to tax under the TTA statutes. (*Lucent*, pp. 36 and 42.)

Interested Parties Meetings

During its meeting on March 30, 2016, the State Board of Equalization (BOE), the Department's predecessor, authorized staff to begin working on amendments to Regulation 1507 to clarify the requirements to establish that an agreement for the transfer of non-custom software[1] on tangible storage media, such as tapes or discs, is a software TTA, in accordance with the holding in *Lucent,* and clarify the measure of tax when software is transferred under a software TTA.

The BOE held an interested parties meeting on June 30, 2016, to discuss its initial proposed amendments to Regulation 1507, which were distributed with the Initial Discussion Paper. During the meeting, interested parties raised many questions and expressed their concerns with the proposed amendments. There appeared to be a general consensus among interested parties that the proposed amendments were not sufficient to properly codify *Lucent*. Most of the concerns expressed during the first interested parties meeting were reiterated in written comments submitted by the interested parties to the BOE subsequent to the interested parties meeting.

After considering the written comments following the June 30, 2016, interested parties meeting, the Department distributed another discussion paper and held an interested parties meeting on November 5, 2019, to discuss a second draft of proposed amendments to Regulation 1507. Again, interested parties expressed concern with the proposed amendments.

Next Steps

The Department greatly appreciates the input and written comments that interested parties have provided with respect to proposed amendments to Regulation 1507. As previously noted, the Department has given much consideration to the input it has received, and the Department would like to engage in discussions regarding how to best clarify the TTA statutes. However, rather than starting the process with Department proposed amendments, we invite you to participate in a TTA workshop to provide input on key issues to inform the Department's efforts to draft a discussion paper for consideration at a future interested parties meeting.

TTA Workshop Topics

TTAs

How should the TTA statutes apply to the sale or use of TPP (e.g., machinery, equipment, hardware, household items, electronic devices, vehicles, etc.) transferred with intangible rights (including transactions where software is also transferred)?

[1] Non-custom software refers to software that is not a custom computer program or programming as defined in RTC section 6010.9 and Regulation 1502.

- TPP may contain various types of software, including firmware, basic operational software, and application software. Additionally, some software is updated to the latest version when the TPP is connected to the internet or other networks. What are the circumstances when software transferred on TPP would be considered transferred pursuant to a TTA?
- How do you determine whether a copyright or patent interest is transferred to the consumer when they purchase TPP with software?
- For clarity, should the Department set forth a definition of embedded software to identify when the software is or is not considered to be transferred pursuant to a TTA?

Measure of Tax

Once a determination has been made that the TTA statutes apply, how should you determine the measure of tax for the sale, lease, or use of the TPP under subdivisions (c)(10)?

- Subdivisions (c)(10)(A) provide that the TTA may separately state a reasonable price for the TPP. How should the Department determine that the separately stated price for the TPP is reasonable?
- Subdivisions (c)(10)(B) provide that when a TTA does not separately state a price for the TPP, and the TPP or like TPP has been previously sold or leased, or offered for sale or lease, to third parties at a separate price, the price at which the TPP was sold, leased, or offered to third parties shall be used to establish the retail fair market value of the TPP subject to tax. If there is no market for the TPP without software, can this provision be used? If there is a market for the TPP with some software (e.g., firmware and/or operating software) should the full price charged for the TPP with the software be included in the retail fair market value of the TPP?
- Subdivisions (c)(10)(C) provide that when a TTA does not separately state a price for the TPP, and the TPP or like TPP has not been previously sold or leased, or offered for sale or lease, to third parties at a separate price, the retail fair market value shall be equal to 200 percent of the cost of materials and labor used to produce the TPP subject to tax. The remaining amount charged under the technology transfer agreement is for the intangible personal property transferred. Should the cost of materials and labor used to produce the TPP that is subject to tax include overhead? If the retailer purchases the TPP from a third party at wholesale, under this provision is the retail fair market value equal to 200 percent of the cost of the TPP purchased? If there is firmware and/or operational software on the TPP at the time of purchase and the wholesaler does not separately state the price for this software or transfer it pursuant to a TTA, is the software included in the cost of the TPP?
- Are there other circumstances where software should be valued and included in the measure of tax under subdivisions (c)(10)(A-C) in the same manner as the TPP or as part of the TPP?

Use of Intermediaries in the Supply Chain

How should the TTA statutes apply when software is not purchased directly from the original holder? Examples:

- A buying company purchases TPP containing copyrighted or patented software from the original holder and then resells or leases the TPP to related entities, which are the end users. Does the result change if the original holder transferred the copyright or patent interest directly to the related entity of the buying company that is the end user?
- An authorized retailer, not the original holder, sells TPP containing copyrighted or patented software.

Other TTA Related Topics

The Department also welcomes participants' comments or suggestions on any other TTA related topic not covered above.

Summary

We invite you to participate in the January 31, 2024, TTA workshop. We welcome any comments and suggestions, including proposed regulatory language from you on the TTA topics discussed above. We further invite you to provide your written suggestions or comments on those topics by March 15, 2024.

Prepared by the Tax Policy Bureau, Business Tax and Fee Department

Current as of January 17, 2024