STATE BOARD OF EQUALIZATION
(916) 445-6493

January 21, 1988

Mr. A--- C. R---
Law Offices of --- & ---
A Professional Corporation
XXX --- ---
--- ---, CA XXXXX-XXXX

A--- S---, Inc. – SR -- XX-XXXXXX
P--- software – ROM and EPROM circuit boards
Included in computer hardware

Dear Mr. R---:

In your November 5, 1987 letter to me, you relate that on behalf of your client, A--- S---, Inc., you request several opinions of us which relate to the license by A--- S--- of P--- software delivered to its customers on ROM or EPROM printed circuit boards, and then incorporated by those customers into their computer hardware.

Since we are prepared to agree with the opinions you have requested, and since we conclude that you have correctly stated the applicable sales and use tax principles involved with respect to A--- S---' activities, I have merely quoted below with approval relevant excerpts from your letter.

The facts you relate in your letter are set out below:

> "A--- is engaged in the business of developing and licensing computer programs used in computer workstations, laser printers, typesetters and other computerized raster output devices to print integrated text and graphics for high quality word processing, printing and publishing applications. The Company's principal product, the P--- language interpreter (the 'P--- software'), is typically implemented by a customer in Read Only Memory ('ROM') or Erasable Programmable Read Only Memory ('EPROM') form on a printed circuit board which is contained in a workstation, printer or other raster output device to control a printer…. A--- licenses the P--- software to computer, printer and typesetter manufacturers who incorporate copies of the software in their hardware products for distribution to end users.

"A--- specially develops a version of the P--- software for each manufacturer customer. The P--- software version created by A--- for computer systems of one manufacturer customer are generally incompatible and will not function with the computer systems of another manufacturer. The foregoing remains true even when the version is quite similar to that developed by A--- for another customer. This is because the operational rules of a computer will cause it to reject and not function with any object code which does not conform to the computer's specifications in every detail. The essence of A---'s business is to create a version of the P--- software for each manufacturer customer which enables the manufacturer's hardware to print or cause to be printed the desired graphics. In fact, A--- frequently develops several versions of the P--- software for different computer systems offered by that customer. This customization also involves compiling the P--- software itself into object code suitable for operations on the customer's computer system(s). A federal copyright attaches to each P--- software version created by A---.

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"A--- frequently delivers its software to customers by telephonic transmission. However, when A--- delivers a tangible copy of the P--- software, A--- typically delivers a version in the form of object code on a prototype EPROM suitable for operation on the customer's computer system, although delivery could be made by way of other media, such as tapes or diskettes. The delivery is made pursuant to a license agreement (the 'License Agreement') between A--- and the customer which gives the customer the right to republish the customer's P--- software version as part of the customer's hardware (workstation, printer or typesetter) which is then sold to third parties. The License Agreement provides for a per copy royalty to be paid to A--- (generally after a substantial development fee has been exhausted) as each piece of hardware containing a copy of the customer's P--- software version is sold.

"Under the License Agreement, A--- reserves the right to license the P--- software version it has developed for one customer to other entities. However, given the myriad of operating systems, CPU combinations and object code formats, it is an unusual case for the P--- software version developed for one A--- customer to be operational on another customer's computer system. Moreover, the translation process which is correct for one customer's computer system is rarely correct for another computer system. In those rare instances where A--- is able to relicense a version of the P--- software it has developed, there is usually some apparent overlap in the development of the two computer systems in question, such as a common printer engine. For the foregoing reasons, A--- is in most cases unable to license the same P--- software version to anyone other than the customer for whom that version was originally developed.

"Following the license of a P--- software version, A--- may provide maintenance and enhancement services to the licensee which improve the software. Although the maintenance upgrades and enhancements provided to a customer may be unique to the customer's computer system, A--- retains the right to relicense those upgrades and enhancements.

"A--- has also prepared a user manual (the 'Manual') for use in conjunction with its P--- software. A Manual is provided free of charge to each licensee with delivery of the P--- software version. The Manual is not revised for each licensee. This is because the Manual simply describes the rules for writing programs for any P--- software developed by A---."

I have also quoted below the opinions you request, and this will confirm that we agree that sales or use tax does not apply to the transactions for the reasons you have indicated in your request. You write as follows:

"A. Where a P--- software version specially developed by A--- for a customer is delivered by A--- to that customer (the 'First Time Transferee'), the delivery is exempt from Tax as the sale of a custom computer program pursuant to [Revenue and Taxation Code] Section 6010.9 as long as pre-written P--- software versions will not function on the First Time Transferee's computer system. The foregoing remains true:

"(a) even where those pre-written versions may have varying degrees of source and object code similarity with the versions developed specially by A--- for the First Time Transferee, and despite (b) the reservations by A--- in the License Agreement (pursuant to which the P--- software is transferred) of the right to relicense and deliver that version to a customer other than the First Time Transferee, or (c) the delivery by A--- to the First Time Transferee without charge of one or more copies of the Manual.

"B. Regardless of whether an A--- P--- version is custom software under Section 6010.9, Tax does not apply to development fee or royalty payments received under any License Agreement with a customer for that software since the payments under the License Agreement are made for the right to republish copyrighted software for sale to third parties. No tax is due for Manuals delivered without charge pursuant to the License Agreement.

"C. The delivery of any modification, enhancement or upgrade (each of the foregoing is referred to herein as an 'update') of a P--- software version to a First Time Transferee which modified the Transferee's existing P--- software version is exempt from the Tax under Section 6010.9 as either a custom modification of the P--- software version or as a custom computer program as long as pre-written A--- updates will not function on the First Time Transferee's computer system. The foregoing remains true even where one or more of those pre-written updates may

> have varying degrees of similarity with the update specially developed by A--- for the First Time Transferee's computer system.
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> "Even if an update is not custom software, where a federal copyright attaches to the update, its delivery is exempt from tax where its transfer to a customer is solely for republication to third parties by a customer as part of the customer's hardware under a License Agreement."

You correctly note that proposed amendments to Regulation 1502(f)92)(B), dated October 14, 1987, provide that no tax applies to license agreements for the transfer of P--- versions to which a federal copyright attaches, where the customer will republish and sell the software as part of its hardware. These proposed amendments, while not yet formally adopted, reflect the Board's view of how tax applies to software license agreements under current law.

Sincerely,

John Abbott
Tax Counsel

JA:jb