

**M e m o r a n d u m****120.0563**

To: Mr. Fred Berkey, Supervising Tax Auditor  
--- --- District Office

September 30, 1988

From: John Abbott, Tax Counsel

Subject: A--- S---, Inc. – SR -- XX-XXXXXX  
Computer program source code – license of copyrighted programs

In your August 18, 1988 memorandum to Legal, you write that your office is currently auditing A--- S---, and the taxpayer has requested a legal opinion on one disputed item in the audit. Typically, A--- encodes its prewritten computer programs on a master (ROM BIOS) chip, and transfers the master chip to its customer together with a license to reproduce identical copies of the master chip. The customer incorporates the copied chips into its own products. For each chip so copied and sold as a part of the customer's product, the customer pays A--- a license fee or royalty payment. Both the master chip and the copies are encoded in computer-readable (binary) object code. You agree with the taxpayer that these transactions are nontaxable transfers of copyrighted computer programs under Regulation 1502(f)(1)(B) since the customer acquires the copyrighted object code for the purpose of reproducing it and distributing it to third parties. The customer is not the end user of the program.

The issue in disagreement concerns some related transactions. In certain situations, A--- also furnishes to those customers the computer program's human-readable source code in addition to the license of the master chip. The source code in other source materials furnished by A--- allows the licensee to make modifications to the master chip's object code before reproducing the chip. You note that paragraph 10(B) of A---'s standard software license agreement provides in part: "Licensee shall have no right to sell, license, sublicense, disclose or provide access to the source materials without the prior written consent of the licensor." Instead of a per-chip license fee, A--- charges a one-time flat fee for the customer's license of the source code.

Your view is that the amount which A--- charges for the source materials is taxable under Regulation 1502(f)(1)(B) as a site licensing fee for a prewritten program transferred in tangible form. Your reason is that while the copyrighted object code for the program is reproduced and sold to third parties, the source code for that program is not. Rather, the customer uses the source code to modify the object code, and is specifically prohibited by the source code license from transferring the source code.

You also enclosed with your memo a letter from Mr. Joseph P. Powers, Attorney for A---, dated July 15, 1988 and addressed to your attention at our --- --- office. In summary, Mr. Powers' contention is that since A--- has licensed its licensees to reproduce or copy the chip's object code for A---'s computer programs, the transfer of the source code for the same program should likewise be regarded as nontaxable under subdivision (f)(1)(B).

### Opinion

Our opinion is that tax does not apply to A---'s charges for its license of the source code and other source materials to its licensees. Our view is that the exclusion from tax provided by subdivision (f)(1)(B) embraces both the source code version of that program and the object code version. Subdivision (f)(1)(B) does not contemplate that the license fees or royalty payments made to the licensor will only be excluded if the object code is reproduced exactly by the licensee and sold to end users of the program. If the object code is modified by the licensee for purposes of copying and distribution to third parties, the exclusion will nevertheless apply. The licensee accomplishes this modification by gaining access to the source code, making the modifications in the source code, and then translating the source code modifications into the computer-readable object code.

In this situation, we think the licensee who receives the source code and other source materials has received information which will enable the licensee to make the modifications, and the storage media on which the information is encoded would be incidental to this transaction. As long as the licensee acquires the right to reproduce and distribute copies of the program in object code format, and does not acquire a site license for the object code, it makes no difference that he does not also have this right with respect to the source code.

JA:jb