

**STATE BOARD OF EQUALIZATION**

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

September 21, 1990

Mr. M--- M---
W--- & F---
XXX --- Avenue
--- ---, California XXXXX-XXXX

Re: A--- S--- Incorporated
SY – XX-XXXXXX

Dear Mr. M---:

This is in response to your letter dated August 28, 1990 regarding the application of sales or use tax to the sale of certain computer software programs and other items.

A--- S--- Incorporated develops applications computer software programs. The software, which is sold to original equipment manufacturers (OEMs), consists of two components: a common "kernel" which is identical for all users regardless of the hardware, and a device-implementation portion which is unique for each type of hardware upon which the program will operate.

A--- licenses this software to OEMs under license agreements for sale along with hardware the OEMs sell to their customers. A--- usually develops the entire kernel while the device implementation is developed either entirely by A---, entirely by the OEM, or jointly. Both the kernel and the device implementation, if any, provided by A--- may be in source program and/or object program format.

The kernel and the device implementation generally become part of the operating system software of the hardware and reside in a hard-wired control board inserted into the hardware which is sold by the OEM. The charge for the A--- software is not separately stated in the charge made by the OEMs to their customers for the hardware which include the A--- software.

Under the license agreements, the OEMs pay A--- the following fees: 1) royalties related to the hardware items containing the software sold or distributed by the OEM, and these royalties may include any up-front advance and may be calculated under a variety of formulae; 2) a

non-recurring engineering fee for services, if any, provided by A--- in developing a device implementation; 3) a source license fee, if applicable, when A--- provides some or all of its software in source program format; and 4) a fee for distribution to end users of documentation provided by A--- in excess of a certain number of free copies.

Under the license agreement, A--- provides to OEMs with updates to the kernel component of the software. Sometimes these updates are provided for no additional charge and other times for a fee after an initial period. A--- sometimes agrees to provide the OEMs up to a certain number of person hours of technical assistance at no additional charge to familiarize the OEMs' personnel with the operations of the software and to help the OEMs develop their device implementations. A--- also provides certain documentation of the software to the OEMs in connection with the license agreements at no additional charge in order to facilitate the development and use of the software by the OEMs.

The programs are delivered by A--- under the license agreements on tangible personal property such as diskette, magnetic tapes, or erasable programmable read-only memory. A federal copyright attaches to all programs, including software updates, delivered by A--- to the OEMs. The OEMs are entitled to make and use a limited number of copies of the software for internal purposes of the OEM.

Discussion

We agree that no sales or use tax applies to royalty payments or license fees or to any source license fee paid under the license agreement as relates to payments made for the right to reproduce and sell the copyrighted program. (Reg. 1502(f)(1)(B).) This is true regardless of the manner or formula for determining those royalty payments and license fees and regardless of whether the copyright program is transferred by way of a source program and/or an object program format. This is also true regardless of whether the OEM modifies the program and regardless of whether it is delivered in the form of systems software or hard-wired board which would be inserted into the OEM's hardware.

We agree that sales and use tax does not apply to non-recurring engineering fees paid by an OEM to A--- with respect to services rendered by A--- to develop software which is not part of a sale of tangible personal property. (Reg. 1502(g).)

We agree that sales and use tax does not apply to fees for software updates provided by A--- to an OEM under a license agreement when a copyright attaches to those updates and they are transferred solely in order for the OEM to sell copies of those updates.

We note that sales or use tax will apply to a small portion of the items provided by A---. Since you have not inquired about these, perhaps you realize they are subject to tax. You

state that the OEM is permitted to make and use a limited number of copies of the software for internal purposes of the OEM. I assume this means that the OEM has a right to copy the software for purposes of functional use by the OEM. The portion of the charge made by A--- which is attributable to this right of the OEM is subject to sales or use tax since this use does not come within the provisions of subdivision (f)(1)(B) of Regulation 1502 which provide that tax does not apply to transfers of copyrighted software which are transferred solely for the purpose of copying the software for sale. You also state that A--- charges a fee for distribution to consumers of documentation in excess of a certain number of free copies. This charge is subject to sales or use tax.

If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:wak
2474C

bc: --- --- District Administrator

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1020 N STREET, SACRAMENTO, CALIFORNIA
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(916) 445-5550

January 17, 1991

Mr. M--- M---
Law Offices of W--- & F---
A Professional Corporation
XXX --- Avenue
--- ---, California XXXXX-XXXX

Re: A--- S--- Incorporated
SY – XX-XXXXXX

Dear Mr. M---:

This is in response to your letter dated January 3, 1991. In a letter dated September 21, 1990, I responded to your previous inquiry regarding the application of sales or use tax to A---'s sale of certain computer software. All software was federally copyrighted, and the purchasers acquired the right to sell the software after further development. You ask for the following clarification of my letter:

“The first sentence in the second paragraph of the Response indicates that A--- develops applications software programs. As indicated in the Letter, A--- in fact develops applications and systems computer software programs. We would like your assurance that the characterization of A---'s business or of any software involved in its licensing arrangements with its OEMs is systems rather than applications software in no way changes the conclusions set forth in the Response.”

“The first sentence in the fourth paragraph of the Response indicates that the kernel and the device implementation generally become part of the operating system software of the hardware and reside in a hard-wired control board inserted into the hardware which is sold by the OEM. The Letter indicates that the kernel and the device implementation become part of the operating system software of the hardware or resided in a hard-wired control board inserted into the hardware which is sold by the OEM. We would

like your assurance that the correction of this fact in no way changes the conclusions set forth in the Response.

In my letter, I stated:

“We agree that no sales or use tax applies to royalty payments or license fees or to any source license fee paid under the license agreement as relates to payments for the right to reproduce and sell the copyrighted program. (Reg. 1502(f)(1)(B)). ...This is also true regardless of whether it is delivered in the form of systems software or hard-wired board which would be inserted into the OEMs hardware.” (Emphasis added.)

As indicated in the second sentence quoted above, the nontaxable conclusion of the first sentence quoted above applies also to systems computer software (that is, in addition to application software) as well as to software which will reside in a hard-wired control board (that is, in addition to software transferred by disk, etc.). Thus, the characterization of the subject software as systems rather than applications software does not alter the conclusions set forth in my September 21, 1990 letter nor does the fact that the subject software may become part of the operating systems software or reside in a hard-wired control board.

If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:wak
0111E

bc: --- --- District Administrator