


STATE BOARD OF EQUALIZATION

LEGAL DIVISION - MIC: 82
 450 N STREET, SACRAMENTO, CALIFORNIA
 (P. O. BOX 942879, SACRAMENTO, CA 94279-0082)
 TELEPHONE: (916) 322-2976
 FAX: (916) 323-3387

JOHAN KLEHS
 First District, Hayward

DEAN F. ANDAL
 Second District, Stockton

ERNEST J. DRONENBURG, JR.
 Third District, San Diego

BRAD SHERMAN
 Fourth District, Los Angeles

KATHLEEN CONNELL
 Controller, Sacramento

April 29, 1996

E. L. SORENSEN, JR.
 Executive Director

Mr. D--- L. W---
 K--- P--- M--- L---
 --- --- Center
 --- ---, CA XXXXX

**Re: S--- C--- Operation
 SR -- XX-XXXXXX**

Dear Mr. W---:

This is in response to your letter dated February 6, 1996 regarding the application of tax to the sale of a computer source code and related materials. I note that you wrote a letter dated November 6, 1995 in which you described substantially the same fact pattern as that set forth in your more recent letter. However, in your previous letter, you did not identify the parties involved in the transactions. Staff Counsel Warren Astleford sent a response to you dated November 30, 1995.

You state that you are writing to request our advice under Revenue and Taxation Code section 6596. In order for a taxpayer's failure to make a timely return or payment to come within the provisions of section 6596, the taxpayer must have reasonably relied on the Board's written advice provided in response to a written request for advice that disclosed all relevant facts, including the identity of the parties. Since you did not identify the parties to the transaction in your previous letter, the November 30, 1995 opinion sent to you by Mr. Astleford in response to your previous letter does not come within the provisions of section 6596. Although you identify the parties in your more recent letter, it appears that the transaction at issue has already taken place. Therefore, any nonpayment of taxes due prior to receipt of this letter would not be based on this letter and therefore would not come within section 6596.

You state that S--- C--- Operation (SCO) is a software manufacturer that has purchased certain property from N---, Inc., a Delaware corporation that is also in the software developing and manufacturing business. You explain that some of the property was in California at the time of the purchase, although the majority of the property was located in another state. You characterize the property as a source code, duplication copies, consumer copies, and software documentation. You state:

“The purchase price of all the property acquired is approximately X.X million shares of SCO stock, plus the assumption of certain liabilities. This was paid in a lump sum. The contract provides for [N---] to retain royalties, which are contingent on future sales volumes by SCO, up to a maximum of \$XX million.

“The key technology asset being purchased is one source master code and an in-process development of a new version of the code. These elements are collectively referred to as the ‘source code’ in this ruling request. Except as noted below under ‘retained rights of N---,’ SCO acquired all rights to the source code, which will be developed further and be incorporated into SCO’s software products for duplication and sale (including software licensing characterized as sales for tax purposes). SCO will therefore use copies of the source code in research and advanced development and for duplication in California and in other jurisdictions.

“The source code, except working copies, is presently maintained on a unique computer in another state. The code includes the source master and an essential control mechanism which maintains a history of bug fixes and developments to the master, the ‘source code control.’ For technological and business reasons it would be difficult to move this code to a different location at this time because of the risk to the source code control’s archive capability which is crucial to controlling the future development effort. Given this sensitive nature of the source code, SCO intends to leave the code in its present location for an extended period of time and at least 91 days, after closing. When this code has to be accessed, it will be done remotely from the computers in other locations including California....

“Virtually all of the source code is protected under federal copyrights, although some elements with little value may not be covered.

“Because of the need to have a full copy of the source code in a development center in another country, a copy will be transmitted by telecommunications from the state where the source code resides, through a router and telecom switch in California, to a foreign country. The router (an electronic switching device with a processor) will be owned by SCO; the computer in the foreign country will be owned by SCO or by its foreign subsidiary.

“Currently, a valuable part of the source code is still being developed by N---, and will be completed some months after closing. Under the purchase agreement, N--- is completing the development on behalf of SCO and the two parties are sharing in the cost. The research and development effort, and SCO’s purchase of this code, is for the purpose of duplication and sale. It is possible the

development effort will fail such that the code is not duplicated; however, in such a case it would have minimal use and value.

“In addition to the source code above, there are several working copies of the source code, which are used in research and development and to make duplication masters. The working copies may contain a portion or entire duplication of the source code as needed and exist in multiple languages, formats, and hardware platforms. These working copies were delivered to SCO in California in several ways: some copies have already been delivered for due diligence purposes and will be retained by SCO after closing; some are on computer equipment to be delivered to California; and some will be made from the source code brought into California by SCO after closing....

“Under the contract, N--- has retained a worldwide royalty free license to use all of the technology, for internal purposes and in limited resale activities not in competition with SCO’s sales. This represents a retained interest in N--- and is not a transfer.

“In addition to the above copies of the code, there are copies used by contract duplicators in making copies for sale. These are inherently different from, although derived from the source code. There is no comparable sales price of the duplication copies, and they can be reproduced from the source code. Thus, the purchase price allocable to the duplication copies is equal to the cost to make replacement copies. It was not practical to have the duplication companies destroy or return to N--- the duplication copies. SCO therefore purchased these copies and effectively took delivery of them in California, although they remain in the hands of the duplicators.

“There are also consumer inventory copies held by the duplicators for N---, including numerous copies that SCO purchased for resale.

“With respect to N---’s inventory copies and user manuals that SCO purchases for resale, SCO will provide N--- with a resale certificate.

“Further, SCO holds some consumer copies which it has purchased or received from N--- during due diligence for purposes of evaluation.

“Software related documentation includes portions of code in human readable form, notes of engineers, flow charts, schematic drawings and so on, some of which is in paper form and some of which is in electronic format. The documentation will be used by SCO employees in research and advanced development. Complete original documentation will be delivered by N--- to SCO in the other state (the location of the source code). In addition, there are copies of

portions of the documentation in California and in a few other states. These portions of the software documentation are used in conjunction with the research and development of the software being performed in each of those locations. In addition to the original copies in the other state, SCO has received in California copies of some of these documents.

“Other than noted above, SCO will not take delivery of software documentation in this state. Copies of the documentation will instead be made out of state and transmitted by modem or fax into California as needed during the first 91 days.”

DISCUSSION

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property inside this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) A sale means any transfer of title or possession of tangible personal property for a consideration. (Rev. & Tax. Code § 6006(a).) In the absence of an agreement to the contrary, title to property generally passes no later than the time when a seller completes its responsibilities with respect to physical delivery of the property. (Cal. U. Com. Code § 2401.) Where sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for storage, use or other consumption in California. (Rev. & Tax. Code §§ 6201, 6401.) The taxable gross receipts or sales price includes all amounts received with respect to the sale, with no deduction for the cost of the materials, service or expense of the retailer passed on to the purchaser unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011, 6012.)

We understand that SCO purchased software in tangible form which was located in various places throughout the United States. This software consists of the source master code which was located on the unique computer outside this state as well as working and duplication copies located both inside and outside California. You state that SCO uses copies of this software in research and advanced development and for duplication in California and other jurisdictions. We understand this to mean that SCO purchased the source code from N--- and will modify or expand it for purposes of copying and selling the modified program (or portions thereof) to others.

Subdivision (f) of Regulation 1502 (copy enclosed) explains the application of tax to sales of software. As relevant to SCO, subdivision (f)(1)(B) of Regulation 1502 provides:

“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 does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for*

the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.” (Emphasis added.)

You state that virtually all of the source code is protected under federal copyrights, but that a part of the source code “may not be covered.” Tax does not apply to N---’s sale of the source master code provided a federal copyright attaches to the software, or to the transfer of a tangible copy of the program transferred concurrently with the granting of the right to reproduce or copy the software for the purpose of copying and selling, and not for other use. If SCO obtained the source code and a tangible copy of the program concurrently with the granting of such a right, tax does not apply to the concurrent transfer of that copy because we would consider the transfer of that copy to be incidental to the granting of the right to copy and sell the program.

N--- has transferred copies on storage media in addition to the single copy necessary to transmit the program for purposes of copying and selling. Thus, N--- has not only sold a program with the incidental transfer of necessary tangible personal property; it has also sold tangible personal property for use as a manufacturing aid. The sale of such additional tangible personal property is not incidental to the transfer of the source code. Further, since N--- has also transferred software documentation, manuals, or other tangible personal property in addition to the necessary incidental transfer of a copy of the source code, tax applies to the sale of that property, as explained below. (See Navistar International Transportation Corp. v. State Board of Equalization (1994) 8 Cal.4th 868.) In the absence of a separately stated price for the sale of such property, tax applies to the fair retail value of the property transferred. (See Rev. & Tax. Code § 6012(c)(10)(C).)

Sales tax applies to the charge for any software that was located inside California at the time of N---’s sale to SCO. (Rev. & Tax. Code §§ 6051, 6006(a), 6010.5; Cal. U. Com. Code § 2401.) Where sales tax does not apply, use tax applies to the use of software purchased by SCO outside California which is first functionally used inside this state, or which is brought into California within 90 days after purchase unless the software is stored outside this state one-half or more of the time during the six-month period immediately following its entry into this state. (Reg. 1620(b)(3).) Prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California. (Id.)

The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business to or through the purchaser’s computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. (Reg. 1502(f)(1)(D).) It is our understanding

that after the close of the transaction, a copy of the source code was transmitted to a foreign country by telecommunications from the state where the source code resides through a router and telecom switch located in California, and that California was only a link in the electronic routing of the source code. If our understanding of the circumstances is correct, then as long as no tangible personal property was purchased for use in California, the transfer of the source code through California via remote telecommunications was not subject to tax.

You next state that a portion of the source code will be completed at the joint cost (and effort) of N--- and SCO some time after the closing of the proposed transaction. If the costs of completing the source code are not part of the gross receipts from or the sales price on the transaction, meaning that SCO and N--- have agreed to jointly perform additional programming-type activities wholly separate from the sale of the source code and related materials, we would regard N--- as providing custom programming services to SCO wholly separate from its sale of the source code and related materials to SCO. In such a case, tax would not apply to N---'s charges for its programming services. (See Regs. 1501; 1502(f)(2)(B).)

With respect to the retained rights of N---, it is our understanding that the sales agreement between N--- and SCO provides that N--- will retain the right to use and sell (on a limited basis) the source code and that SCO is not selling tangible personal property or software licensing to N---. Under these facts, tax does not apply to N---'s retention of the limited sale and use rights of the source code.

As discussed above, where SCO's purchase consists of the purchase of software subject to a federal copyright for purposes of copying and selling that program (or portions thereof) to others, we would regard the necessary transfer of a copy of the software, transferred concurrently with the granting of the right to reproduce the software, as property transferred incidentally to the nontaxable transfer of the copyrighted software; therefore, tax would not apply. Tax also would not apply to the sale of any consumer inventory copies and/or user manuals or software documentation purchased for resale by SCO provided the property would not be used by SCO prior to its resale to a customer. (Rev. & Tax. Code § 6007, Reg. 1668.) With respect to consumer copies and software documentation transferred to SCO in tangible form inside California or purchased for use in California and used by SCO employees, tax applies, as explained above.

I note that we have not been provided with copies of contracts relevant to the transaction about which you inquire. It is possible that, if we were to review copies of relevant contracts, we might find that certain facts differ from what we currently understand the facts to be based on the information you have provided. A change in the factual circumstances might change our legal analysis and conclusions regarding the transaction at issue.

Please note that each time a person writes us to ask a question, we consider the question and provide the necessary analysis. Even if we have just written to the person as an unidentified taxpayer and then the identical request comes in identifying the taxpayer, that second request

must be processed as a new opinion request. Thus, when the sole purpose of a second letter is to identify the taxpayer for purposes of coming within section 6596, the additional workload of answering two letters when one response would have been sufficient greatly affects our efficiency. Further, letters coming within section 6596 are never "retroactive" to the date of any other correspondence; therefore, if you identify your client in your first letter, you will be more likely to receive a timely section 6596 letter on which your client can rely.

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

Sincerely,

Kelly W. Ching
Staff Counsel

KWC:cl

Enclosure (Reg. 1502)

cc: Mr. Robert Nunes (MIC:40)
--- District Administrator