STATE OF CALIFORNIA

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION
TAX POLICY BUREAU
651 BANNON STREET, SUITE 100, SACRAMENTO, CA 95811
PO BOX 942879, SACRAMENTO, CA 94279-0092
1-916-309-5397 • FAX 1-916-322-2958
www.cdtfa.ca.gov

GAVIN NEWSOM
Governor

NICOLAS MADUROS
Secretary, Government Operations Agency

TRISTA GONZALEZ
Director

July 10, 2025

Dear Interested Party:

Enclosed is the Discussion Paper on the proposed amendments to Sales and Use Tax Regulations 1502, Computers, Programs, and Data Processing, and 1507, Technology Transfer Agreements, and new Sales and Use Tax Regulation 1507.1, Software Technology Transfer Agreements. We invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

July 24, 2025
Room SE 245 at 10:00 a.m.
May Lee State Office Complex
651 Bannon Street, Sacramento, CA

You may also 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 709 872 432#. You are also welcome to submit your written suggestions or comments, including any proposed regulatory language, to me at the address or fax number in this letterhead or via email at BTFD-BTC.InformationRequests@cdtfa.ca.gov by August 14, 2025. Copies of the materials you submit may be provided to other interested parties; 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 meeting or presenting their suggestions or comments.

If you are interested in other Business Taxes Committee topics, refer to the CDTFA webpage at http://www.cdtfa.ca.gov/taxes-and-fees/business-taxes-committee.htm for copies of discussion papers and calendars of current and prior issues.

We appreciate your consideration and look forward to your participation. Should you have any questions, please 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

AO:rsw

Enclosures
Software Technology Transfer Agreements Discussion Paper

DISCUSSION PAPER
Software Technology Transfer Agreements

Issue

Whether the California Department of Tax and Fee Administration (Department) should adopt amendments to Sales and Use Tax Regulations 1502, Computers, Programs, and Data Processing, and 1507, Technology Transfer Agreements, and new Sales and Use Tax Regulation 1507.1, Software Technology Transfer Agreements, through the regular rulemaking process. The amendments and new regulation implement, interpret, and make specific Revenue and Taxation Code (RTC) sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10) (Technology Transfer Agreement (TTA) statutes) and clarify the application of tax to transactions involving the sale and use of software, consistent with the Court of Appeal's opinions in *Nortel*[1] and *Lucent*.[2]

Background

California imposes sales tax on retailers and sales tax applies to a retailer's gross receipts from the retail sale of tangible personal property (TPP) in this state, unless specifically exempted or excluded from tax. (RTC section 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. (Reg. 1700, Reimbursement for Sales Tax.) It is presumed that all gross receipts are subject to 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 section 6091.)

When sales tax does not apply, use tax applies to the sales price of TPP purchased from a retailer for storage, use, or other consumption in California, unless specifically exempted or excluded from tax. (RTC sections 6201, 6401.) Consumers are generally required to report and pay the use tax on their taxable purchases to the state. (RTC sections 6452, 6452.1.) However, every "retailer engaged in business in this state" as defined in RTC section 6203 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 use tax that they fail to collect from their customers and remit to the Department. (RTC sections 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 section 6006.) In general, a "retail sale" or "sale at retail" means a sale of TPP for a purpose other than resale in the regular course of business. (RTC section 6007.) 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 sections 6011, 6012.) TPP means personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (RTC section 6016.)

[1] *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1295.
[2] *Lucent Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19.

Custom and Prewritten Computer Programs

Under RTC section 6010.9, charges for the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program, other than a basic operational program (as defined in RTC section 995.2) are not subject to sales or use tax, even if the custom computer program is transferred on tangible storage media. Subdivision (a) of RTC section 6010.9 provides that "storage media" includes punched cards, tapes, discs, diskettes, or drums on which computer programs may be embodied or stored. Subdivision (b) of RTC section 6010.9 provides that "computer" does not include tape-controlled automatic drilling, milling, or other manufacturing machinery or equipment. Subdivision (c) of RTC section 6010.9 provides that the term "computer program" means the complete plan for the solution of a problem, such as the complete sequence of automatic data-processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs. Subdivision (d) of RTC section 6010.9 further provides that the term "custom computer program" means a computer program prepared to the special order of the customer and includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer. The term does not include a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the prewritten or "canned" program was initially developed on a custom basis or for in-house use. Modification to an existing prewritten program to meet the customer's needs is custom computer programming only to the extent of the modification. Charges for a canned or prewritten computer program are not excluded from tax under RTC section 6010.9.

Regulation 1502

Regulation 1502 prescribes the application of tax to computer programs and implements, interprets, and makes specific RTC section 6010.9. As relevant here, subdivision (b) of Regulation 1502 defines the terms "computer," "program," "custom computer program," "prewritten program," and "storage media." Subdivision (b)(3) provides that a "computer" is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment of the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment. Subdivision (b)(10) provides that a "program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. Subdivision (b)(4) provides that a "custom computer program" is a computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those

services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer. Subdivision (b)(9) provides that a "prewritten program" is a program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product. Subdivision (b)(13) also provides that "storage media" includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

Subdivision (f)(1) of Regulation 1502 provides that prewritten programs may be transferred to the customer in the form of storage media or by listing the program instructions on coding sheets. In some cases, they are usable as written; however, in other cases, it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched. Subdivision (f)(1)(A) of Regulation 1502 clarifies that tax applies whether title to the storage media on which the program is recorded, coded, or punched passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of TPP. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property. Subdivision (f)(1)(B) of Regulation 1502 also clarifies that 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 includable 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.

In addition, subdivision (f)(1)(D) of Regulation 1502 clarifies that 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 TPP, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer's computer except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer (load-and-leave method). If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of TPP used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

Subdivision (f)(2) clarifies that tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated. However, charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated or the modifications to the prewritten program result in the creation of a new program that qualifies as a custom program. Otherwise, the charges are taxable as part of the sale of the prewritten program.

The Technology Transfer Agreement Statutes

The TTA statutes were added to the Sales and Use Tax Law (SUTL) (RTC section 6001, et seq.) in 1993 to specify the measure of tax when intangible personal property is transferred with TPP pursuant to a TTA. (Stats. 1993, ch. 887 (Assem. Bill No. (AB) 103 (1993-94 Reg. Sess.).) Subdivision (c)(10)(D) of the TTA statutes provides that TTA means 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.

Subdivisions (c)(10)(A) through (C) of the TTA statutes further provides 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. If the 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 value of the TPP subject to tax. The remaining amount charged under the TTA is for the intangible personal property transferred. If the 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 for 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 TTA is for the intangible personal property transferred.

Regulation 1507

Regulation 1507 was originally adopted in 2002 to implement, interpret, and make specific the TTA statutes and incorporate the California Supreme Court's holding in *Preston*.[3] Subdivision (a)(1) of Regulation 1507 provides that TTA means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.)[4] that assigns or licenses a copyright interest in TPP for the purpose of reproducing and selling other property subject to the copyright interest. A TTA also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the

[3] *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197.
[4] In *Preston*, the California Supreme Court held that the assignment or license of a copyright requires a "writing," but that the writing need not mention the word "copyright." (*Preston*, p. 214.)

right to use a process subject to a patent interest. A TTA does not mean an agreement for the transfer of any TPP manufactured pursuant to a TTA, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to TTA.

Subdivision (b)(1) of Regulation 1507 prescribes the general application of tax to TTAs. It provides that tax applies to amounts received for any TPP transferred in a TTA. Tax does not apply to amounts received for the assignment or licensing of a patent or copyright interest as part of a TTA. The gross receipts or sales price attributable to any TPP transferred as part of a TTA shall be:

> (A) The separately stated sale price for the TPP, provided the separately stated price represents a reasonable fair market value of the TPP;
> (B) Where there is no such separately stated price, the separate price at which the TPP or like (similar) TPP was previously sold, leased, or offered for sale or lease, to an unrelated third party; or
> (C) If there is no such separately stated price and the TPP, or like (similar) TPP, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor to produce the TPP. "Cost of materials" consists of those materials used or otherwise physically incorporated into any TPP transferred as part of a TTA. "Cost of labor" includes any charges or value of labor used to create the TPP whether the transferor of the TPP contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the TPP shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer's normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

Subdivision (b)(2) of Regulation 1507 provides that tax applies to all amounts received from the sale or storage, use, or other consumption of TPP transferred with a patent or copyright interest, where the transfer is not pursuant to a TTA. Subdivision (b)(3) of Regulation 1507 provides that tax applies to the sale or storage, use, or other consumption of artwork and commercial photography pursuant to a TTA as set forth in Regulation 1540, Advertising Agencies, Commercial Artists and Designers.

Nortel

In *Nortel*, the Court of Appeal held that "Not every software program qualifies as a TTA: Only 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 in 2011. The court held that the copyrighted prewritten software programs Nortel transferred to Pacific Bell on tangible storage media (disks, magnetic tapes, or cartridges) were not subject to 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*, the 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 [copyrighted] 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.'" (*Lucent*, p 33.) The court held that the contrary provisions of subdivision (f)(1) of Regulation 1502 are not sanctioned by the SUTL and must give way to the TTA statutes in situations where they both may apply. (*Lucent*, pp. 34 and 39.) The court also held that the transmission of Lucent's copyrighted prewritten software programs 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. (*Lucent*, p. 36.).

In addition., the court held that the value of the tangible storage media used to transmit the copyrighted software was what was subject to tax under the TTA statutes. (*Lucent*, p. 42.) The court held that TPP is to be valued in one of three ways under the TTA statutes. (*Ibid*.) The court also affirmed the trial court's use of the price that Lucent had charged third parties for blank tangible storage media to establish the taxable value of the tangible storage media used to transmit the copyrighted software under the TTA statutes. (*Ibid*.) However, the court did not apply the valuation rules to any TPP other than tangible storage media, and the value of other TPP may not be readily available in many situations.

Interested Parties Meetings

The Department's predecessor, the State Board of Equalization (BOE), held an interested parties meeting on June 30, 2016, to discuss its proposed amendments to Regulation 1507 to address *Nortel* and *Lucent.* The Department also held an interested parties meeting on November 5, 2019, to discuss its proposed amendments to Regulation 1507 to address *Nortel* and *Lucent.* During both meetings, interested parties raised many questions and expressed their concerns with the proposed amendments, and no regulatory language was agreed upon.

Department's TTA Workshops

The Department held TTA workshops with the interested parties on January 31, 2024, June 27, 2024, and December 9, 2024. The meetings provided participants the opportunity to have a broad discussion about TTAs and provide input on key issues regarding TTAs that include the transfer of software on tangible personal property (software TTAs) to inform the Department's efforts to draft new regulatory language that is consistent with *Nortel* and *Lucent* for consideration at a future interested parties meeting. During the workshops, there was a broad discussion of software TTAs, how to determine the measure of tax when a TTA exists, and the use of

intermediaries in the supply chain. There was also a discussion of several topics to clarify the application of tax to software TTAs, including:

- A "sheltered" safe harbor provision that would allow a retailer transferring copyrighted or patented software bundled with hardware under a TTA to exclude 20 percent of the transaction from tax if they could prove that the hardware transferred was no more than 40 percent of the retailer's cost in the transaction;
- How to determine the value of such hardware in the simplest way possible, including leveraging cost of goods sold principles;
- A rebuttable presumption that for consumer transactions the cost of the TPP plus markup would equal or exceed the entire retail selling price for the transaction;
- A second rebuttable presumption that the cost of the TPP plus markup would equal or exceed the entire retail selling price for transactions where the only software in the hardware is embedded software that is not meant to be accessed or modified by the consumer; and
- How to define the term "embedded software."

Following each workshop, the Department also received written submissions from several interested parties with their further suggestions and recommendations for the new regulatory language.

Discussion

The Department appreciates all the participants' efforts, comments, concerns, and suggestions made during the TTA workshops and in the written comments that followed. The Department has thoroughly considered the input provided by the interested parties that participated in the BOE's interested parties meetings and the Department's TTA workshops. The Department has carefully reviewed and reconsidered the provisions of subdivision (f)(1) of Regulation 1502 after taking *Lucent* into consideration. The Department has carefully reviewed and reconsidered the provisions of subdivision (b) of Regulation 1507 after taking the discussions during the TTA workshops into consideration, including the discussions about how to determine the value of TPP transferred under a TTA in the simplest way possible. The Department has also carefully reviewed and reconsidered the historical software TTA issues after taking *Nortel*, *Lucent*, and the discussions during the TTA workshops into consideration, including the discussions about how to determine the value of hardware transferred under a software TTA, the safe harbor provision, and the presumptions.

The Department is now proceeding with the informal rulemaking (or interested parties) process to discuss draft regulatory language that the Department is considering proposing to adopt to make the sales and use tax regulations consistent with *Nortel* and *Lucent*, and help retailers determine the value of TPP transferred under a TTA in the simplest way possible. Similar to the TTA workshops, the interested parties process provides a forum for informal discussion and allows the opportunity for participants to provide their oral and written comments and concerns, along with any recommendations they may have, including changes to the new regulatory language. The focus of the interested parties meeting process will be to draft amendments to subdivision (f)(1) of

Regulation 1502 (Exhibit 1) to clarify the application of tax to the sale and use of prewritten software programs, draft amendments to subdivision (b) of Regulation 1507 (Exhibit 2) to clarify how to determine the cost or value of TPP transferred under a TTA, and a draft of new Regulation 1507.1 (Exhibit 3) to clarify the application of tax to software TTAs, as further discussed below.

Proposed Amendments to Regulation 1502

The Department determined that subdivision (f)(1) of Regulation 1502 correctly provides the general rule that tax applies to the sale or lease of the storage media or coding sheets on which or into which prewritten (canned) programs have been recorded, coded, or punched. This is because the TTA statutes do not exclude or exempt TPP, such as storage media or coding sheets, from tax. However, the Department is concerned that the second sentence in subdivision (f)(1)(A) of Regulation 1502 may be overly broad and inconsistent with the general rule in subdivision (f)(1) because the sentence refers to the temporary transfer of a program, rather than the temporary transfer of storage media on which a program is recorded, coded, or punched. Therefore, the Department is proposing to amend the second sentence in subdivision (f)(1)(A) to refer to storage media on which a program is recorded, coded, or punched, rather than a program.

The Department determined that, in accordance with *Lucent*, the provisions of subdivision (f)(1)(B) of Regulation 1502, which provide that tax applies to the entire amount charged to the customer for storage media or coding sheets on which or into which prewritten (canned) programs have been recorded, coded, or punched, must give way when software is transferred pursuant to a software TTA (as discussed further below). Therefore, the Department is proposing to add "Except as provided in Regulation 1507.1" (discussed below) to the beginning of subdivision (f)(1)(B) to limit subdivision (f)(1)(B) accordingly.

The Department determined that subdivision (f)(1)(D) of Regulation 1502 correctly provides that 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. However, the transaction is not taxable because the prewritten program is being transferred electronically by remote telecommunication, and it's not relevant that the prewritten program is being transferred from the seller's place of business. Therefore, the Department is proposing to amend subdivision (f)(1)(D) to clarify that the prewritten program is being transferred electronically and delete the text about the software being transferred from the seller's place of business to avoid confusion.

The Department is also concerned that subdivision (f)(1)(D) of Regulation 1502 may be overly broad and inconsistent with the general rule in subdivision (f)(1). This is because it indicates that the sale or lease of an electronically transferred program would be taxable if the purchaser obtains possession of any TPP in the transaction, rather than TPP on which the program is recorded, coded, or punched. This is also because it indicates that the sale of a prewritten program by the load-and-leave method is taxable if the seller transfers title to or possession of storage media in the transaction, rather than storage media on which the program is recorded, coded, or punched. Therefore, the Department is proposing to amend subdivision (f)(1)(D) to refer to TPP and storage

media "on which the program is recorded, coded, or punched" to make it consistent with subdivision (f)(1). The Department is also proposing to add a clarifying example to subdivision (f)(1)(D) to illustrate that if Company X sells a customer a computer and a license to electronically download and use a prewritten program, the sale of the license to electronically download and use the prewritten program is not taxable.

Proposed Amendments to Regulation 1507

The Department determined that Regulation 1507 is generally consistent with the TTA statutes and *Preston*. However, the Department is concerned that the first sentence in subdivision (b)(1) may be overly broad because it provides that tax applies to amounts received for any TPP transferred in a TTA without regard to whether any exclusions or exemptions apply. Therefore, the Department proposes to add "unless otherwise exempt or excluded" to the end of the first sentence in subdivision (b)(1) to limit it accordingly.

The Department determined that subdivision (b)(1)(C) of Regulation 1507 is generally consistent with the provisions in subdivision (c)(10)(C) in the TTA statutes, which provide that under specified circumstances the retail fair market value of TPP transferred in a TTA shall be equal to 200 percent of the cost of materials and labor used to produce the TTP. However, interested parties that participated in the TTA workshops indicated that it would simplify the process for retailers if they could calculate the combined cost of materials and labor used to produce TPP by adding the cost of direct materials and direct labor which must be attributed or allocated to the cost of producing the TPP under generally accepted accounting principles. Also, the Department agreed that the cost of direct materials and direct labor, which must be attributed or allocated to the cost of producing TPP under generally accepted accounting principles, should equal or reasonably approximate the combined cost of materials and labor used to produce the TPP under subdivision (b)(1)(C) of Regulation 1507. Therefore, the Department is proposing to reformat the second and third sentences in subdivision (b)(1)(C) of Regulation 1507 as subdivisions (b)(1)(C)(i) and (b)(1)(C)(ii), respectively, and add new subdivision (b)(1)(C)(iii) to provide that:

> For purposes of this subdivision, a taxpayer may calculate the combined cost of materials and labor used to produce TPP by adding the cost of direct materials and direct labor which must be attributed or allocated to the cost of producing the TPP under generally accepted accounting principles. For example, Company A makes a tangible product. Company A's books and records, kept in accordance with generally accepted accounting principles, document that to produce the finished product in a form suitable for retail sale, Company A incurred $125 in direct material costs and $175 in direct labor costs. Company A may calculate the combined cost of material and labor used to produce the tangible product by adding the $125 cost of direct materials and $175 cost of direct labor ($300).

Finally, Regulation 1540, Advertising Agencies, Commercial Artists and Designers, clarifies the application of tax to transfers of finished art pursuant to a TTA and subdivision (b)(3) of Regulation 1507 provides a cross-reference to Regulation 1540 to avoid confusion. The Department is proposing to adopt new Regulation 1507.1 to clarify the application of tax to

software TTAs. The Department also determined that it is necessary to add a similar cross-reference to new Regulation 1507.1 to subdivision (b)(3) of Regulation 1507 to avoid confusion. Therefore, the Department is proposing to add subdivision (b)(3)(A) to Regulation 1507 to provide that tax applies to the sale or storage, use, or other consumption of a prewritten program transferred on TPP pursuant to a TTA as set forth in Regulation 1507.1, Software Technology Transfer Agreements, and renumber the current text of subdivision (b)(3) as subdivision (b)(3)(B).

Proposed New Regulation 1507.1

The Department is proposing to adopt new Regulation 1507.1 because the Department determined that it is necessary to further clarify the application of tax to software transactions and establish presumptions to help taxpayers and the Department determine whether there is a software TTA, and the value of hardware transferred under a software TTA. Subdivision (a) of new Regulation 1507.1 defines "computer" and "storage media" so that they have the same meaning as set forth in Regulation 1502 to ensure that new Regulation 1507.1 is consistent with Regulation 1502. Subdivision (a) defines "custom software," "prewritten software," and "software" so that they respectively have the same meaning as "custom computer program," "prewritten program," and "program" as set forth in Regulation 1502 to ensure that new Regulation 1507.1 is consistent with Regulation 1502. Subdivision (a) also provides that "software technology transfer agreement" or "software TTA" means a TTA as defined in Regulation 1507, Technology Transfer Agreements, that includes the transfer of copyright or patent interests in software transferred on TPP (e.g. a computer or storage media), as specified in *Nortel*, and *Lucent* to ensure that new Regulation 1507.1 is consistent with Regulation 1507, *Nortel*, and *Lucent*.

Also, after further consideration and refinement, the Department included presumptions for bargained-for software and non-bargained-for software in subdivision (d) of new Regulation 1507.1 (discussed below), rather than the presumptions for consumer and embedded software transactions discussed during the TTA workshops. Therefore, subdivision (a)(1) of new Regulation 1507.1 clarifies that "bargained-for software" means patented and/or copyrighted prewritten software transferred on TPP that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in for consideration. It shall be rebuttably presumed that prewritten software is bargained-for software if the retailer provides an invoice, receipt, or other document to the purchaser, contemporaneous with the sale or license of the software, showing that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in the software for a consideration. The Department may rebut the presumption by establishing that the prewritten software was non-bargained-for software. For example:

> Company X sells computers, and optional licenses to use different types of patented and/or copyrighted prewritten software (e.g., accounting, wording processing, etc.). If a customer elects to purchase a computer and one or more optional software licenses, Company X installs the licensed prewritten software on the customer's computer prior to delivery. Also, Company X's invoice shows that the customer opted for such software license(s) and separately lists the price for the license(s).

Therefore, the optional patented and/or copyrighted prewritten software is presumed to be bargained-for software.

Company X sells point-of-sale (POS) systems (e.g., registers, terminals, kiosks, etc.) to other businesses with licenses to use patented and/or copyrighted prewritten software that enables the devices in the POS systems to connect to each other through the internet and store sales data from multiple devices in one place. If customers purchase POS systems with the licenses, Company X installs the licensed prewritten software on the customers' POS systems prior to delivery. Also, Company X's invoices state that the retail selling price of the POS systems includes the right to use such prewritten software. Therefore, the patented and/or copyrighted prewritten software is presumed to be bargained-for software.

Company X enters into a master agreement (MA) to lease computers to Company Y with licenses to use patented and/or copyrighted prewritten software that is necessary to operate the computers during the term of the lease. Company X installs the software onto all the computers leased under the MA prior to delivery and the MA expressly provides that Company X grants Company Y right-to-use licenses for the prewritten software on all the computers leased under the MA. Therefore, the patented and/or copyrighted prewritten software is presumed to be bargained-for software.

Subdivision (a)(4) of new Regulation 1507.1 clarifies that "non-bargained-for software" means prewritten software transferred on TPP that the retailer did not separately or specifically agree to sell or license intangible copyright or patent interests in. It shall be rebuttably presumed that software transferred on TPP is non-bargained-for software, unless the retailer maintains a copy of an invoice, receipt, or other document provided to the purchaser, contemporaneous with the transaction, showing that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in the software. For example:

Company X sells digital clocks that come with pre-installed patented and/or copyrighted prewritten software that enables the clocks to display the time and weather and play music from the internet, and the software is not optional. Company X's sales invoices state a lump-sum price of $100 for the clocks, the sales invoices do not mention the pre-installed prewritten software, and Company X does not provide any other sales documents to its customers as part of the sales of the clocks. Therefore, the pre-installed patented and/or copyrighted prewritten software is presumed to be non-bargained-for software.

Company X sells coffee making machines (coffee makers) that come with patented and/or copyrighted prewritten software that was embedded in the coffee makers at the time of manufacture. The embedded prewritten software enables the coffee makers to display the time and enables users to set the coffee makers to make coffee at specific times and/or at various strengths. Company X's sales invoices state a

> lump-sum price of $100 for the coffee makers, the sales invoices do not mention the embedded prewritten software, and Company X does not provide any other sales documents to its customers as part of its sales of the coffee makers. Therefore, the embedded patented and/or copyrighted software is presumed to be non-bargained-for software.

In addition, subdivision (a)(5) of new Regulation 1507.1 provides that "optional software" means patented and/or copyrighted software that a purchaser is not required to purchase as a condition of the sale of the TPP on which the software is transferred as part of a software TTA. This is because the Department is proposing to clarify the application of tax to optional bargained-for software in subdivision (e)(1) of new Regulation 1507.1 (discussed below).

Subdivision (b) of new Regulation 1507.1 incorporates the software exclusions in subdivision (f) of Regulation 1502 to ensure that new Regulation 1507.1 is consistent with Regulation 1502. Subdivision (b) clarifies that the software exclusions apply to a transaction before the TTA provisions in Regulations 1507 or 1507.1. It also clarifies that tax applies to all amounts received from the sale or storage, use, or other consumption of prewritten software transferred on TPP, as provided in subdivisions (f)(1)(A), (B), and (C) of Regulation 1502, where the transfer of the software is not pursuant to a TTA to ensure that new Regulation 1507.1 is consistent with Regulation 1502.

Subdivision (c) of new Regulation 1507.1 incorporates the provisions of subdivision (b) of Regulation 1507 to ensure that new Regulation 1507.1 is consistent with Regulation 1507. Subdivision (c)(1) provides that tax applies to amounts received for any TPP transferred in a software TTA and tax does not apply to amounts received for the assignment or licensing of intangible copyright or patent interests in software transferred on TPP as part of a software TTA, as provided in subdivision (b)(1) of Regulation 1507. Subdivision (c)(2) also provides that, except as further provided in Regulation 1507.1, the gross receipts or sales price attributable to any TPP transferred as part of a software TTA shall be determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507.

Subdivision (d) of new Regulation 1507.1 establishes the presumptions for bargained-for software and non-bargained-for software. It provides that it shall be rebuttably presumed that bargained-for software was transferred pursuant to a software TTA. It also provides that it shall be presumed that:

- Non-bargained-for software was not transferred pursuant to a software TTA;
- The value of the TPP on which non-bargained-for software is transferred equals or exceeds the amount charged for the TPP with the non-bargained-for software; and
- Tax applies to all amounts received from the sale or storage, use, or other consumption of non-bargained-for software, as provided in subdivision (b).

This is because there is an agreement to sell or license intangible copyright or patent interests in bargained-for software (as defined above) that is sufficient to raise the rebuttable presumption that

the bargained-for software was transferred pursuant to a software TTA. However, there is no agreement to sell or license intangible copyright or patent interests in non-bargained-for software as defined above.

Subdivision (e) of new Regulation 1507.1 clarifies the application of tax to bargained-for-software transactions. Subdivision (e)(1) clarifies how the provisions of subdivision (c)(10)(A) of the TTA statutes apply to optional bargained-for software transferred on TPP consistent with subdivision (b)(1) of Regulation 1507. It provides that when a retailer transfers optional bargained-for software to a purchaser on TPP pursuant to a software TTA, and the retailer separately states the price for the optional bargained-for software from a reasonable price charged for the TPP, including any other prewritten software on the TPP:

> (A) Tax does not apply to the separately stated amount charged for the optional bargained-for software; and
>
> (B) Tax applies to the reasonable separately stated amount charged for the TPP, including any other prewritten software on the TPP, unless the retailer establishes that the gross receipts or sales price attributable to the TPP is less than that amount pursuant subdivision (b)(1)(A), (B), or (C) of Regulation 1507 or subdivision (e)(2) of Regulation 1507.1 (discussed below).
>
> For example, Company X sells computers for a separately stated reasonable price of $1,000, and optional licenses to use different types of bargained-for software (e.g., accounting, wording processing, etc.) for an additional separately stated price. If customers elect to purchase computers and one or more optional software licenses, Company X installs the licensed bargained-for software on the customers' computers prior to delivery. Also, Company X's invoices show that the customers opted for such software license(s) and separately lists the price for the license(s). Therefore, tax does not apply to the separately stated charges for the optional software licenses and tax does apply to the separately stated $1,000 charge for the computers, including any other prewritten software on the computers, unless Company X establishes that the gross receipts or sales price attributable to the computers is less than that amount pursuant subdivision (b)(1)(A), (B), or (C) of Regulation 1507 or subdivision (e)(2) of this regulation.

Subdivision (e)(2) of new Regulation 1507.1 further clarifies the application of subdivisions (c)(10)(A)-(C) of the TTA statutes to bargained-for software transferred on TPP because the taxable value of TPP on which bargained-for software is transferred can fluctuate, and it may be difficult for businesses to determine the taxable value of TPP on a transaction-by-transaction basis. Subdivision (e)(2) provides that when a retailer transfers bargained-for software to the purchaser on TPP pursuant to a software TTA, and the retailer does not separately state the price charged for the bargained-for software from a reasonable price charged for the TPP, including any non-bargained-for software on the TPP, or the bargained-for software is not optional, the retailer may elect to pay or collect tax on a taxable percentage of the total amount charged for the bargained-for software and the TPP, including any non-bargained-for software on the TPP, if:

(A) The taxable percentage is 80 percent or more and the taxable percentage was pre-certified to the Department in accordance with subdivision (f) (discussed below); or

(B) The taxable percentage is less than 80 percent and the Department pre-certified the taxable percentage as provided in subdivision (g) (discussed below); or

(C) The retailer can substantiate upon audit that bargained-for software was in fact transferred on the TPP and that the retail selling price attributable to the TPP, including any non-bargained-for software on the TPP, as determined in accordance with subdivision (b)(1)(B) or (C) of Regulation 1507, does not exceed the taxable percentage.

(D) For example:

(i) Company X purchases USB flash drives in a form suitable for retail sale from an unrelated third-party for $5 each. Company X may use its purchase invoices as documentation to substantiate the retail selling price attributable to the USB flash drives under subdivision (b)(1)(B) of Regulation 1507.

(ii) Company X purchases laptop computers in a form suitable for retail sale from an unrelated third-party for $500 per laptop. Company X may use its purchase invoices as documentation to substantiate the retail selling price attributable to the laptop computers, including any non-bargained-for software on the computers, under subdivision (b)(1)(B) of Regulation 1507.

(iii) Company X also makes desktop computers. Company X's books and records kept in accordance with generally accepted accounting principles document that, to produce the finished desktop computers in a form suitable for retail sale, Company X incurred $100 in direct material costs and $200 in direct labor costs. Therefore, Company X may use those costs to substantiate that the retail selling price attributable to the computers, including any non-bargained-for software on the computers, is $600 (($200 + $100) x 200% = $600) under subdivision (b)(1)(C) of Regulation 1507.

The Department further clarified the provisions for taxpayers to pre-certify a nontaxable percentage of 20 percent to the Department discussed during the TTA workshops. The Department made the provisions more flexible so that they permit a seller to pre-certify a taxable percentage of 80 percent or more for itself and its authorized retailers. The Department also included those provisions in subdivision (f) of new Regulation 1507.1.

Subdivision (f)(1) provides that a seller may elect to pre-certify a taxable percentage of 80 percent or more for specific TPP (product) on which bargained-for software is transferred. It also provides that:

- The seller must submit all the information required by subdivision (f)(3) to the Department in good faith to elect to pre-certify a taxable percentage of 80 percent or more for a product.

- The information required by subdivision (f)(3) must be submitted to the Department before the seller or an authorized retailer may use the pre-certified percentage as provided in subdivision (e)(2)(A) (discussed above).

Subdivision (f)(2) of new Regulation 1507.1 provides that if a seller submits the information required by subdivision (f)(3) in good faith, the Department will rebuttably presume that the retail selling price of the product on which bargained-for software is transferred does not exceed the seller's pre-certified percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product. The rebuttable presumption will only apply to the sale, use, or lease of the specific product identified in the information required by subdivision (f)(3)(B) of this regulation.

Subdivision (f)(3) of new Regulation 1507.1 requires a seller to submit the following information to the Department:

(A) A general description of the seller's business.

(B) A description of the product sold in the regular course of the seller's business and the bargained-for software transferred on the product, and the seller's pre-certified taxable percentage of 80 percent or more for the product.

(C) The seller's statement made to the best of seller's knowledge that bargained-for software will be transferred on the product pursuant to software TTAs and based on the seller's cost information or valuation study, documentation of which may be requested by the Department, the retail selling price of the product without the bargained-for software does not exceed the seller's pre-certified taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product, as determined in accordance with subdivision (b)(1)(A), (B), and (C) of Regulation 1507.

Subdivision (f)(3) also provides that a seller may elect to pre-certify a taxable percentage of 80 percent or more for multiple products on which bargained-for software is transferred by submitting a schedule containing the information required by subdivision (f)(3)(B) for each product and a single seller's statement for the products in substantially the same form as required by subdivision (f)(3)(C).

Subdivision (f)(4) of new Regulation 1507.1 clarifies that in the absence of evidence to the contrary, a seller will be presumed to have submitted the information required by subdivision (f)(3) in good faith if the seller's information is complete and otherwise appears valid on its face. Also, subdivision (f)(5) of new Regulation 1507.1 provides that a seller's precertification for a product remains in effect and applies to sales or leases of the product until revoked or revised in writing by the seller, or until there is a material change to the retail selling price attributable to the product as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507. A material change occurs when the retail selling price of the product without the bargained-for software, as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507, exceeds the seller's pre-certified taxable percentage of total amount charged for

the bargained-for software and the product, including any non-bargained-for software on the product.

Subdivision (f)(6) of new Regulation 1507.1 clarifies how a seller may authorize other retailers to use its pre-certified taxable percentage. It provides that a seller that submits the information required by subdivision (f)(3) to pre-certify a taxable percentage of 80 percent or more for a product that it sells for resale in the regular course of business may also submit a statement or schedule authorizing other retailers to elect to use the seller's pre-certified taxable percentage when they sell the product with the bargained-for software pursuant to software TTAs. A seller may authorize each retailer by name or may state that all persons that will make retail sales of such product pursuant to a software TTA are authorized retailers. A seller may only authorize retailers to elect to use the seller's pre-certified taxable percentage for a product if the seller also authorizes the Department in writing to disclose the following information to the retailer when necessary to determine the correct amount of tax due on sales or leases of the product:

- The information the seller submitted about the product pursuant to subdivision (f)(3)(B).
- The seller's written statement or schedule authorizing the retailer to elect to use the seller's pre-certified taxable percentage.
- The seller's revocation or revision of its precertification for the product pursuant to subdivision (f)(4).
- A material change in the retail selling price attributable to the product described in subdivision (f)(4).

Subdivision (f)(6) also provides that if a seller submits a statement or schedule authorizing a retailer to elect to use the seller's pre-certified taxable percentage for a product on which bargained-for software is transferred, the Department will rebuttably presume that the retailer's selling price for the product does not exceed the authorizing seller's pre-certified percentage of 80 percent or more of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product, while the seller's precertification is in effect.

Finally, the Department determined that it may be necessary to establish procedures for the Department to pre-certify a taxable percentage of less than 80 percent for a product on which bargained-for software is transferred in rare circumstances. Therefore, the Department included subdivision (g) in new Regulation 1507.1 to further clarify the provisions discussed during the TTA workshops.

Subdivisions (g)(1) and (2) of new Regulation 1507.1 provides that a seller may submit a written request for the Department to pre-certify a taxable percentage of less than 80 percent for a product on which bargained-for software is transferred. The Department will only pre-certify a taxable percentage of less than 80 percent for a product if:

- The seller submits all the information required by subdivision (f)(3) to the Department and the cost information or valuation study the seller used to determine that the retail selling price of the product without the bargained-for software does not exceed the seller's

requested taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product, as determined in accordance with subdivision (b)(1)(A), (B), or (C) of Regulation 1507; and

- The Department determines in its sole discretion that the retail selling price of the product on which bargained-for software is transferred does not exceed the seller's requested taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product.

Subdivisions (g)(3) and (4) of new Regulation 1507.1 provide that the Department's precertification for a product remains in effect and applies to sales or leases of the product until revoked or revised in writing by the Department, or until there is a material change in the retail selling price attributable to the product as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507. A material change occurs when the retail selling price of the product without the bargained-for software, as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507, exceeds the Department's pre-certified taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product. If the Department pre-certifies a taxable percentage of less than 80 percent for a product pursuant to a seller's request and the seller sells the product for resale in the regular course of business, the seller may authorize other retailers to elect to use the Department's pre-certified taxable percentage for the product if the seller complies with all the requirements of subdivision (f)(6) of new Regulation 1507.1.

Summary

We welcome any comments, suggestions, and input from interested parties regarding this issue. We also invite interested parties to participate in the July 24, 2025, interested parties meeting. The deadline for interested parties to provide their written submissions regarding this discussion paper will be August 14, 2025.

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

Current as of 07/03/25

Text of Proposed Amendments to California Code of Regulations

Title 18. Public Revenues

Division 2. California Department of Tax and Fee Administration-- Business Taxes

Section 1502. Computers, Programs, and Data Processing

Regulation 1502. Computers, Programs, and Data Processing.

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. “Program” is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. “Subdivision” includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. “Problem” means and includes any problem that may be addressed or resolved by a program or subdivision; and the “problem” addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. “Problem” further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property (cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are

performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for date entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 “Mailing-Services.”)

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) “Processing of customer-furnished information” means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) “Processing of customer-furnished information” does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics

furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. “Additional copies” are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor

cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of <u>storage media on which</u> a program <u>is recorded, coded, or punched</u>, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) <u>Except as provided in Regulation 1507.1, tax</u>~~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 includable 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.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer program generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

(D) The sale or lease of a prewritten program is not a taxable transaction if the program is transferred electronically 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 on which the program is recorded, coded, or punched, such as storage media, in the transaction. For example, if Company X sells a customer a computer and a license to electronically download and use a prewritten program, the sale of the license to electronically download and use the prewritten program is not taxable. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer's computer except when the seller transfers title to or possession of storage media on which the program is recorded, coded, or punched or the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable.

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

(1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).

(2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).

(3) Consulting services (e.g., study of all or part of a data processing system).

(4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).

(5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).

(6) Providing technical help, analysts, and programmers, usually on an hourly basis.

(7) Training Services.

(8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)

(9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016, Revenue and Taxation Code.

Text of Proposed Amendments to California Code of Regulations

Title 18. Public Revenues

Division 2. California Department of Tax and Fee Administration-- Business Taxes

Section 1507. Technology Transfer Agreements

Regulation 1507. Technology Transfer Agreements.

(a) Definitions.

(1) "Technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to technology transfer agreement.

Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce and sell tangible personal property subject to Company X's copyright interest in the artwork. Company X's transfer of artwork and a copyright interest to Company Y constitutes a technology transfer agreement. Company Y's sales of tangible personal property containing reproductions of Company X's artwork do not constitute a technology transfer agreement.

Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) its patent interests to sell widgets and the process used to manufacture such widgets to Company Y. Company X's transfer of its patent interests to Company Y constitutes a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any widgets that it manufactures does not constitute a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement.

Example No. 3: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the use, application or manipulation of the medical device. Company X charges a monthly

rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device to Company Y to perform the separately patented process is not a technology transfer agreement and tax applies to the entire rentals payable for the medical equipment. Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.

(2) "Copyright interest" means the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission. For purposes of this regulation, an "original work of authorship" includes any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.

(3) "Patent interest" means the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material. "Process" means one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest.

(4) "Assign or license" means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement.

(b) Application of Tax

(1) Tax applies to amounts received for any tangible personal property transferred in a technology transfer agreement, unless otherwise exempt or excluded. Tax does not apply to amounts received for the assignment or licensing of a patent or copyright interest as part of a technology transfer agreement. The gross receipts or sales price attributable to any tangible personal property transferred as part of a technology transfer agreement shall be:

(A) The separately stated sale price for the tangible personal property, provided the separately stated price represents a reasonable fair market value of the tangible personal property;

(B) Where there is no such separately stated price, the separate price at which the tangible personal property or like (similar) tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party; or,

(C) If there is no such separately stated price and the tangible personal property, or like (similar) tangible personal property, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor used to produce the tangible personal property.

(i) "Cost of materials" consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a technology transfer agreement.

(ii) "Cost of labor" includes any charges or value of labor used to create the tangible personal property whether the transferor of the tangible personal property contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the tangible personal property shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer's normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

(iii) For purposes of this subdivision, a taxpayer may calculate the combined cost of materials and labor used to produce tangible personal property by adding the cost of direct materials and direct labor which must be attributed or allocated to the cost of producing the tangible personal property under generally accepted accounting principles. For example, Company A makes a tangible product. Company A's books and records, kept in accordance with generally accepted accounting principles, document that to produce the finished product in a form suitable for retail sale, Company A incurred $125 in direct material costs and $175 in direct labor costs. Company A may calculate the combined cost of material and labor used to produce the tangible product by adding the $125 cost of direct materials and $175 cost of direct labor ($300).

(2) Tax applies to all amounts received from the sale or storage, use, or other consumption of tangible personal property transferred with a patent or copyright interest, where the transfer is not pursuant to a technology transfer agreement.

(3) Specific Applications.

(A) Tax applies to the sale or storage, use, or other consumption of a prewritten program transferred on tangible personal property pursuant to a technology transfer agreement as set forth in Regulation 1507.1, *Software Technology Transfer Agreements*.

(B) Tax applies to the sale or storage, use, or other consumption of artwork and commercial photography pursuant to a technology transfer agreement as set forth in Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6011 and 6012, Revenue and Taxation Code; *Preston v. State Board of Equalization* (2001) 25 Cal. 4th 197, 105 Cal. Rptr. 2d 407.

Proposed Text of California Code of Regulations

Title 18. Public Revenues

Division 2. California Department of Tax and Fee Administration-- Business Taxes

Section 1507.1. Software Technology Transfer Agreements

(A new regulation to be added to the California Code of Regulations)

Regulation 1507.1. Software Technology Transfer Agreements.

(a) Definitions. For purposes of this regulation, the following terms have the following meanings:

(1) "Bargained-for software" means patented and/or copyrighted prewritten software transferred on tangible personal property that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in for consideration. It shall be rebuttably presumed that prewritten software is bargained-for software if the retailer provides an invoice, receipt, or other document to the purchaser, contemporaneous with the sale or license of the software, showing that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in the software for a consideration. The Department may rebut the presumption by establishing that the prewritten software was non-bargained-for software. For example:

(A) Company X sells computers, and optional licenses to use different types of patented and/or copyrighted prewritten software (e.g., accounting, wording processing, etc.). If a customer elects to purchase a computer and one or more optional software licenses, Company X installs the licensed prewritten software on the customer's computers prior to delivery. Also, Company X's invoice shows that the customer opted for such software license(s) and separately lists the price for the license(s). Therefore, the optional patented and/or copyrighted prewritten software is presumed to be bargained-for software.

(B) Company X sells point-of-sale (POS) systems (e.g., registers, terminals, kiosks, etc.) to other businesses with licenses to use patented and/or copyrighted prewritten software that enables the devices in the POS systems to connect to each other through the internet and store sales data from multiple devices in one place. If customers purchase POS systems with the licenses, Company X installs the licensed prewritten software on the customers' POS systems prior to delivery. Also, Company X's invoices state that the retail selling price of the POS systems includes the right to use such prewritten software. Therefore, the patented and/or copyrighted prewritten software is presumed to be bargained-for software.

(C) Company X enters into a master agreement (MA) to lease computers to Company Y with licenses to use patented and/or copyrighted prewritten software that is necessary to operate the computers during the term of the lease. Company X installs the software onto

all the computers leased under the MA prior to delivery and the MA expressly provides that Company X grants Company Y right-to-use licenses for the prewritten software on all the computers leased under the MA. Therefore, the patented and/or copyrighted prewritten software is presumed to be bargained-for software.

(2) "Computer" has the same meaning as set forth in Regulation 1502, Computers, Programs, and Data Processing.

(3) "Custom software" has the same meaning as "custom computer program" as set forth in Regulation 1502.

(4) "Non-bargained-for software" means prewritten software transferred on tangible personal property that the retailer did not separately or specifically agree to sell or license intangible copyright or patent interests in. It shall be rebuttably presumed that software transferred on tangible personal property is non-bargained-for software, unless the retailer maintains a copy of an invoice, receipt, or other document provided to the purchaser, contemporaneous with the transaction, showing that the retailer separately or specifically agreed to sell or license intangible copyright or patent interests in the software. For example:

(A) Company X sells digital clocks that come with pre-installed patented and/or copyrighted prewritten software that enables the clocks to display the time and weather and play music from the internet, and the software is not optional. Company X's sales invoices state a lump-sum price of $100 for the clocks, the sales invoices do not mention the pre-installed prewritten software, and Company X does not provide any other sales documents to its customers as part of the sales of the clocks. Therefore, the pre-installed patented and/or copyrighted prewritten software is presumed to be non-bargained-for software.

(B) Company X sells coffee making machines (coffee makers) that come with patented and/or copyrighted prewritten software that was embedded in the coffee makers at the time of manufacture. The embedded prewritten software enables the coffee makers to display the time and enables users to set the coffee makers to make coffee at specific times and/or at various strengths. Company X's sales invoices state a lump-sum price of $100 for the coffee makers, the sales invoices do not mention the embedded prewritten software, and Company X does not provide any other sales documents to its customers as part of its sales of the coffee makers. Therefore, the embedded patented and/or copyrighted software is presumed to be non-bargained-for software.

(5) "Optional software" means patented and/or copyrighted software that a purchaser is not required to purchase as a condition of the sale of the tangible personal property on which the software is transferred as part of a software technology transfer agreement.

(6) "Prewritten software" has the same meaning as "prewritten program" as set forth in Regulation 1502.

(7) "Software" has the same meaning as "program" as set forth in Regulation 1502.

(8) "Software technology transfer agreement" or "software TTA" means a technology transfer agreement as defined in Regulation 1507, Technology Transfer Agreements, that includes the transfer of copyright or patent interests in software transferred on tangible personal property (e.g. a computer or storage media), as specified in *Nortel Networks Inc. v. State Bd. of Equalization* (2011) 191 Cal.App.4th 1259, and *Lucent Technologies, Inc. v. State Bd. of Equalization* (2015) 241 Cal.App.4th 19.

(9) "Storage media" has the same meaning as set forth in Regulation 1502.

(b) Software Exclusions.

(1) Tax does not apply to license fees or royalty payments that are made for the right to reproduce or copy software to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties as provided in subdivision (f)(1)(B) of Regulation 1502.

(2) The sale or lease of prewritten software is not a taxable transaction if the software is transferred electronically or installed by the seller on the customer's computer as provided in subdivision (f)(1)(D) of Regulation 1502.

(3) Tax does not apply to the sale or lease of custom software as provided in subdivision (f)(2) of Regulation 1502.

(4) When applicable, the software exclusions in subdivision (f) of Regulation 1502 shall be applied to a transaction before the provisions in Regulation 1507 or this regulation.

(5) Tax applies to all amounts received from the sale or storage, use, or other consumption of prewritten software transferred on tangible personal property, as provided in subdivisions (f)(1)(A), (B), and (C) of Regulation 1502, where the transfer of the software is not pursuant to a technology transfer agreement.

(c) General Application of Tax to Technology Transfer Agreements.

(1) As provided in subdivision (b)(1) of Regulation 1507:

(A) Tax applies to amounts received for any tangible personal property transferred in a software technology transfer agreement, unless otherwise exempt or excluded.

(B) Tax does not apply to amounts received for the assignment or licensing of intangible copyright or patent interests in software transferred on tangible personal property as part of a software technology transfer agreement.

(2) Except as provided in this regulation, the gross receipts or sales price attributable to any tangible personal property transferred as part of a software technology transfer agreement shall be determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507.

(d) Presumptions for Bargained-for and Non-Bargained-for Software.

(1) It shall be rebuttably presumed that bargained-for software was transferred pursuant to a software technology transfer agreement.

(2) It shall be presumed that:

(A) Non-bargained-for software was not transferred pursuant to a software technology transfer agreement;

(B) The value of the tangible personal property on which non-bargained-for software is transferred equals or exceeds the amount charged for the tangible personal property with the non-bargained-for software; and

(C) Tax applies to all amounts received from the sale or storage, use, or other consumption of non-bargained-for software, as provided in subdivision (b)(4) of this regulation.

(e) Specific Application of Tax to Bargained-for Software.

(1) When a retailer transfers optional bargained-for software to a purchaser on tangible personal property pursuant to a software technology transfer agreement, and the retailer separately states the price for the optional bargained-for software from a reasonable price charged for the tangible personal property, including any other prewritten software on the tangible personal property:

(A) Tax does not apply to the separately stated amount charged for the optional bargained-for software; and

(B) Tax applies to the reasonable separately stated amount charged for the tangible personal property, including any other prewritten software on the tangible personal property, unless the retailer establishes that the gross receipts or sales price attributable to the tangible personal property is less than that amount pursuant subdivision (b)(1)(A), (B), or (C) of Regulation 1507 or subdivision (e)(2) of this regulation.

For example, Company X sells computers for a separately stated reasonable price of $1,000, and optional licenses to use different types of bargained-for software (e.g., accounting, wording processing, etc.) for an additional separately stated price. If customers elect to purchase computers and one or more optional software licenses, Company X installs the licensed bargained-for software on the customers' computers prior to delivery. Also, Company X's invoices show that the customers opted for such software license(s) and separately lists the price for the license(s). Therefore, tax does not apply to the separately stated charges for the optional software licenses and tax does apply to the separately stated $1,000 charge for the computers, including any other prewritten software on the computers, unless Company X establishes that the gross receipts or sales price attributable to the computers is less than that amount pursuant subdivision (b)(1)(A), (B), or (C) of Regulation 1507 or subdivision (e)(2) of this regulation.

(2) When a retailer transfers bargained-for software to the purchaser on tangible personal property pursuant to a software technology transfer agreement, and the retailer does not separately state the price charged for the bargained-for software from a reasonable price charged for the tangible personal property, including any non-bargained-for software on the tangible personal property, or the bargained-for software is not optional, the retailer may elect to pay or collect tax on a taxable percentage of the total amount charged for the bargained-for software and the tangible personal property, including any non-bargained-for software on the tangible personal property, if:

(A) The taxable percentage is 80 percent or more and the taxable percentage was pre-certified to the Department in accordance with subdivision (f); or

(B) The taxable percentage is less than 80 percent and the Department pre-certified the taxable percentage as provided in subdivision (g); or

(C) The retailer can substantiate upon audit that bargained-for software was in fact transferred on the tangible personal property and that the retail selling price attributable to the tangible personal property, including any non-bargained-for software on the tangible personal property, as determined in accordance with subdivision (b)(1)(B) or (C) of Regulation 1507, does not exceed the taxable percentage.

(D) For example:

(i) Company X purchases USB flash drives in a form suitable for retail sale from an unrelated third-party for $5 each. Company X may use its purchase invoices as documentation to substantiate the retail selling price attributable to the USB flash drives under subdivision (b)(1)(B) of Regulation 1507.

(ii) Company X purchases laptop computers in a form suitable for retail sale from an unrelated third-party for $500 per laptop. Company X may use its purchase invoices as documentation to substantiate the retail selling price attributable to the laptop computers, including any non-bargained-for software on the computers, under subdivision (b)(1)(B) of Regulation 1507.

(iii) Company X also makes desktop computers. Company X's books and records kept in accordance with generally accepted accounting principles document that, to produce the finished desktop computers in a form suitable for retail sale, Company X incurred $100 in direct material costs and $200 in direct labor costs. Therefore, Company X may use those costs to substantiate that the retail selling price attributable to the computers, including any non-bargained-for software on the computers, is $600 (($100 + $200) x 200% = $600) under subdivision (b)(1)(C) of Regulation 1507.

(f) Precertification to the Department.

(1) A seller may elect to pre-certify a taxable percentage of 80 percent or more for specific tangible personal property (product) on which bargained-for software is transferred.

(A) The seller must submit all the information required by subdivision (f)(3) of this regulation to the Department in good faith to elect to pre-certify a taxable percentage of 80 percent or more for a product.

(B) The information required by subdivision (f)(3) must be submitted to the Department before the seller or an authorized retailer may use the pre-certified percentage as provided in subdivision (e)(2)(A) of this regulation.

(2) If a seller submits the information required by subdivision (f)(3) of this regulation in good faith, the Department will rebuttably presume that the retail selling price of the product on which bargained-for software is transferred does not exceed the seller's pre-certified percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product. The rebuttable presumption will only apply to the sale, use, or lease of the specific product identified in the information required by subdivision (f)(3)(B) of this regulation.

(3) A seller shall submit the following information to the Department:

(A) A general description of the seller's business.

(B) A description of the product sold in the regular course of the seller's business and the bargained-for software transferred on the product, and the seller's pre-certified taxable percentage of 80 percent or more for the product.

(C) The seller's statement made to the best of seller's knowledge that bargained-for software will be transferred on the product pursuant to software technology transfer agreements and based on the seller's cost information or valuation study, documentation of which may be requested by the Department, the retail selling price of the product without the bargained-for software does not exceed the seller's pre-certified taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product, as determined in accordance with subdivision (b)(1)(A), (B), and (C) of Regulation 1507.

(D) A seller may elect to pre-certify a taxable percentage of 80 percent or more for multiple products on which bargained-for software is transferred by submitting a schedule containing the information required by subdivision (f)(3)(B) for each product and a single seller's statement for the products in substantially the same form as required by subdivision (f)(3)(C).

(4) In the absence of evidence to the contrary, a seller will be presumed to have submitted the information required by subdivision (f)(3) of this regulation in good faith if the seller's information is complete and otherwise appears valid on its face.

(5) A seller's precertification for a product remains in effect and applies to sales or leases of the product until revoked or revised in writing by the seller, or until there is a material change to the retail selling price attributable to the product as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507. A material change occurs when the

retail selling price of the product without the bargained-for software, as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507, exceeds the seller's pre-certified taxable percentage of total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product.

(6) A seller that submits the information required by subdivision (f)(3) to pre-certify a taxable percentage of 80 percent or more for a product that it sells for resale in the regular course of business may also submit a statement or schedule authorizing other retailers to elect to use the seller's pre-certified taxable percentage when they sell the product with the bargained-for software pursuant to software technology transfer agreements.

(A) A seller may authorize each retailer by name or may state that all persons that will make retail sales of such product pursuant to a software technology transfer agreement are authorized retailers.

(B) A seller may only authorize retailers to elect to use the seller's pre-certified taxable percentage for a product if the seller also authorizes the Department in writing to disclose the following information to the retailer when necessary to determine the correct amount of tax due on sales or leases of the product:

(i) The information the seller submitted about the product pursuant to subdivision (f)(3)(B).

(ii) The seller's written statement or schedule authorizing the retailer to elect to use the seller's pre-certified taxable percentage.

(iii) The seller's revocation or revision of its precertification for the product pursuant to subdivision (f)(4).

(iv) A material change in the retail selling price attributable to the product described in subdivision (f)(4).

(C) If a seller submits a statement or schedule authorizing a retailer to elect to use the seller's pre-certified taxable percentage for a product on which bargained-for software is transferred, the Department will rebuttably presume that the retailer's selling price for the product does not exceed the authorizing seller's pre-certified percentage of 80 percent or more of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product. while the seller's precertification is in effect.

(g) Precertification by the Department.

(1) A seller may submit a written request for the Department to pre-certify a taxable percentage of less than 80 percent for a product on which bargained-for software is transferred.

(2) The Department will only pre-certify a taxable percentage of less than 80 percent for a product if:

(A) The seller submits all the information required by subdivision (f)(3) to the Department and the cost information or valuation study the seller used to determine that the retail selling price of the product without the bargained-for software does not exceed the seller's requested taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product, as determined in accordance with subdivision (b)(1)(A), (B), or (C) of Regulation 1507; and

(B) The Department determines in its sole discretion that the retail selling price of the product on which bargained-for software is transferred does not exceed the seller's requested taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product.

(3) The Department's precertification for a product remains in effect and applies to sales or leases of the product until revoked or revised in writing by the Department, or until there is a material change in the retail selling price attributable to the product as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507. A material change occurs when the retail selling price of the product without the bargained-for software, as determined in accordance with subdivisions (b)(1)(A), (B), and (C) of Regulation 1507, exceeds the Department's pre-certified taxable percentage of the total amount charged for the bargained-for software and the product, including any non-bargained-for software on the product.

(4) If the Department pre-certifies a taxable percentage of less than 80 percent for a product pursuant to a seller's request and the seller sells the product for resale in the regular course of business, the seller may authorize other retailers to elect to use the Department's pre-certified taxable percentage for the product if the seller complies with all the requirements of subdivision (f)(6) of this regulation.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6011 and 6012, Revenue and Taxation Code; *Nortel Networks Inc. v. State Bd. of Equalization* (2011) 191 Cal.App.4th 1259; and *Lucent Technologies, Inc. v. State Bd. of Equalization* (2015) 241 Cal.App.4th 19.