STATE OF CALIFORNIA

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November 22, 2024

To Whom It May Concern:

The California Department of Tax and Fee Administration will be hosting a third workshop to discuss and receive input on technology transfer agreements. (See enclosure for additional information.) We invite you to participate in this workshop and present any suggestions or comments that you may have on this issue. Accordingly, a workshop is scheduled as follows:

December 9, 2024
Room SE 235 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 559 987 467#. You are also welcome to submit your written suggestions or comments to me at the address or fax number in this letterhead or via email at BTFD-BTC.InformationRequests@cdtfa.ca.gov by January 20, 2025. Copies of the materials you submit may be provided to others; 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 workshop or presenting their suggestions or comments.

Thank you for your consideration. We look forward to your participation. Should you have any questions, please feel free to 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
Technology Transfer Agreements Workshop III Paper

Technology Transfer Agreements Workshop III

Scope

The California Department of Tax and Fee Administration (Department) will host a third workshop (Workshop III) to discuss and receive input on technology transfer agreements (TTAs). Generally, over the past two workshops, interested parties and Department staff have coalesced around three main proposals: 1) a "safe harbor" provision that is rebuttable by the Department; 2) for transactions where the intangible rights are not specifically bargained for as part of that transaction, a rebuttable presumption that the entire charge in the transaction represents the retail value of the tangible personal property (TPP) transferred; 3) a rebuttable presumption for embedded software. At Workshop III we will discuss and receive input on these proposals and any other TTA related topics raised by the participants.

Background

For background on TTAs, including a summary of prior interested parties meetings and the Initial TTA workshop on January 31, 2024, please see the "Background" in the *Technology Transfer Agreements Workshop II* paper.

Second TTA Workshop (Workshop II)

On June 27, 2024, the Department held Workshop II to provide participants the opportunity to discuss and provide input on key issues to inform the Department's efforts to draft a discussion paper for consideration at a future interested parties meeting. During the workshop, there was a broad discussion of TTAs, including TTAs where software is transferred, determining the measure of tax when a TTA exists, and the use of intermediaries in the supply chain.

Additionally, participants discussed the Department's concepts (outlined in the *Technology Transfer Agreements Workshop II* paper). These included a "sheltered" harbor provision that would have allowed taxpayer's transferring software bundled with hardware under a TTA to exclude a percentage of the transaction from the taxable measure if they could prove that the hardware transferred was no more than 40 percent of the taxpayer's cost in the transaction. The participants initially discussed how to determine the value of such hardware in the easiest way possible. This included leveraging cost of goods sold principles. In addition, there was discussion around two rebuttable presumptions. One rebuttable presumption, generally for consumer transactions, would presume that for consumer transactions the cost of the TPP plus markup would equal or exceed the entire retail selling price of the transaction. The discussion centered around how to define such transactions and what a taxpayer would need to rebut this presumption. The second rebuttable presumption would be for transactions involving certain types of embedded software. This would generally apply where the only software in the hardware is not meant to be accessed or modified by the consumer. For these transactions as well the cost of the TPP plus markup would be presumed to equal or exceed the entire retail selling price of the transaction. Discussion around this concept centered around how embedded software would be defined.

At the conclusion of the workshop, there was a general consensus that the discussion was productive, and several attendees expressed interest in, and recommended, a third workshop to further the effort. At the conclusion of the workshop, the Department welcomed attendees to submit written comments to provide additional input on the discussion topics and TTAs in general.

Written Comments Received After the Second TTA Workshop

Following Workshop II, the Department received written submissions from the Silicon Valley Leadership Group Tax Committee (SVLG); the California Taxpayers Association (CalTax) and the SVLG jointly; CTIA, which is a trade association for the wireless communications industry; and the Software Finance and Tax Executives Council (SoFTEC). (Exhibits 1-4.) Several of the submissions expressed appreciation to the Department for holding the workshop and the submissions from SVLG, CalTax and SVLG, and SoFTEC recommended that the Department host a third workshop.

SVLG

SVLG wrote to follow up on its representative's statement at Workshop II that they would provide information regarding the inclusion of indirect labor costs in cost of goods sold (COGS) calculations. SVLG explained that COGS is calculated based on IRC Section 263A which requires businesses to capitalize certain costs that would normally be expensed. SVLG further explained that COGS includes direct, indirect and mixed service costs. Direct costs include the direct labor and materials costs that are integral to the property or product being produced including worker salaries and production materials and/or costs of acquiring the property. Indirect costs include all costs that are not defined as direct but directly benefit the property being produced or sold or are incurred because of its production or resale such as employee benefits, rent, taxes, interest, quality control costs, supervision salaries, and insurance. Mixed service costs are indirect costs related to the business's administrative and service departments which cannot be written off as expenses. SVLG said that adjustments to COGS in income tax audits generally result in their increase, and, therefore, higher income taxes for that year.

SVLG summarized its submission by stating that, "yes," some indirect labor expenses are included in COGS for income tax purposes. SVLG made the disclaimer that its explanations were only for the purpose of validating the possible use of COGS with respect to the application of the TTA statutes (Rev. & Tax Code (RTC) §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)). SVLG also stated that it is likely that in many cases the calculation of COGS might be greater than appropriate for applying the TTA statutes because of the significant amount of indirect expenses, whether indirect labor or other indirect expenses, that are included in COGS for income tax purposes. (Exhibit 1.)

CalTax and SVLG

CalTax and SVLG stated that their key objectives were for TTA regulations to place great importance on the ease of administration and to not stray from the *Nortel* and *Lucent* decisions. They recommended that the regulations include several examples of transactions that qualify and that do not qualify and expressed support for incorporating a safe harbor in the regulation.

CalTax and SVLG stated that, pursuant to *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 (*Preston*), the Board of Equalization's *Intel Corporation* memorandum opinion is a touchstone for the TTA statutes and informs the proper application of tax to transactions that meet the statutory TTA definition. They also stated that, pursuant to *Preston* and *Lucent Technologies, Inc. v. State Board of Equalization (2015) 241 Cal.App.4th 19 (Lucent)*, TTAs are always mixed transactions, not bundled transactions, because the two transfers are readily separable, and, therefore, the physical usefulness test is inapplicable to TTA transactions. They also state that, pursuant to

Lucent, software and rights to copy and use software are both intangible personal property that must receive separate, nontaxable treatment when a TTA exists. They stated that, therefore, subparagraph (c)(10)(B) of the TTA statutes can be effectively used to determine the value of the TPP component of a TTA, and that under the plain language of the TTA statutes, it should be used before subparagraph (c)(10)(C).

CalTax and SVLG stated that the TTA exclusion is informed by, but not controlled by, federal patent and copyright law. They state that the California Legislature expanded on federal law, that, for example, a "process subject to [a] copyright interest" is not articulated in federal law, but is excluded from tax under the TTA statutes. Therefore, they state that federal law does not limit the exclusion from tax, citing *Nortel Networks, Inc. v. State Board of Equalization (2011) 191 Cal.App.4th 1259 (Nortel)*. Specifically, they state that the right to use the information embodied in a licensed software program is sufficient to establish a TTA and that federal rules pertaining to the transfer of patent or copyright interests and when infringement does or does not occur are not controlling as to whether a TTA exists, citing *Lucent*.

With regard to the concept of a rebuttable presumption for consumer transactions, CalTax and SVLG do not agree that a distinction should be drawn based on whether the transaction is a business or consumer transaction and suggest examples of nonqualifying transactions should be included. They state that the examples of "consumer transactions" on page 8 of the second workshop discussion paper could be examples of transactions that do not qualify as a TTA. They also state that the purchaser's intent – as a business or consumer - is not relevant, but it is relevant whether the documentation indicates that the parties bargained for the transfer of both tangible and intangible personal property.

With regard to the concept of a rebuttable presumption for transfers involving embedded software, CalTax and SVLG reiterate that subparagraph (c)(10)(B) of the TTA statutes is preferred to subparagraph (c)(10)(C) when a reasonable separately stated price for TPP is not made. They also state that for purposes of subparagraph (c)(10)(C) because the TTA statutes were intended to codify and implement *Intel*, the 100-percent markup must be fully inclusive of both overhead and profit. They also state that the existence of a TTA does not depend on whether the intangible software was embedded in TPP or delivered through electronic or load-and-leave mechanisms. Software and the rights to copy and use software are always intangible, and that TTA treatment should be unaffected by the type or types of software at issue (e.g., firmware, middleware, operating, application, etc.).

CalTax and SVLG recommend the Department adopt a safe harbor percentage for the value of a TTA sold with TPP that a taxpayer could elect to rebut if the value of the intangible personal property exceeds the safe harbor percentage. They state that a safe harbor percentage would provide certainty and clarity for both taxpayers and the state and that the ease of administration of a safe harbor would harmonize the statutory language, legislative intent, impact to the State budget, and reduction of compliance, audit, controversy and administrative expenses for both the Department and taxpayers. They state that they "welcome" the creation of a safe harbor presumption of 20% and believe it would be permissible and would, in many cases, be claimed in lieu of documenting what would be a significantly higher percentage of the value. They suggest that to rebut the 20% safe harbor, the COGS of the TPP as reported on the income tax return of the seller of the TTA could be used.

CalTax and SVLG commented on the importance of the innovation economy to the overall California economy and tax base, citing Silicon Valley as a major global hub for high technology companies and biotechnology and other advanced technology company headquarters located throughout California. They stated that the TTA statutes were enacted to help technology companies to thrive in California. Finally, CalTax and SVLG requested that the Department consider holding one more workshop, that the Department discuss its views on the interested party submissions and comments, and that the Department discuss its concerns about potential abuses or challenges of administering the TTA statutes. (Exhibit 2.)

CTIA

CTIA stated that the rebuttable presumption regarding embedded software is incorrect and invalid. It states that it adds requirements to the TTA statutes that do not exist in the statutes themselves, including an element based on the necessity of the copyright interest or intent to transfer the patent interest, both of which, CTIA argues, are contrary to *Lucent*. CTIA further states that patented software can *only* be transferred with the intent that the patent interest be embodied in the software transferred. CTIA also stated that a presumption that a transferor would assign or license its valuable patented and/or copyrighted software without charging any amount for the right to use such software would be arbitrary, capricious and/or without rational basis. CTIA also states that the transfer of a single patent interest is sufficient to constitute a TTA.

CTIA states that an auditable safe harbor is a great idea, but the audit should be limited to determining whether the transaction is a TTA Transaction. They state that the amount subject to the safe harbor would be deemed the amount charged under the TTA for the intangible personal property, which would not be subject to tax and that the remaining amount charged under the TTA would be deemed to represent the retail fair market value of the TPP subject to tax. CTIA stated that it was concerned that if a taxpayer availing itself of the safe harbor were also audited as to the value of the TPP being transferred, the amount of additional work required of a taxpayer in such an audit would discourage the use of the safe harbor. They also stated that it was unclear what type of financial information a taxpayer would have to produce in such an audit. CTIA suggested that the Department and interested parties work together to arrive at a mutually agreeable percentage that would ease the overall administration of the TTA Statutes while, at the same time, incentivize taxpayers to avail themselves of the safe harbor, and that the audit should be limited to determining whether the transaction is a TTA Transaction. (Exhibit 3.)

SoFTEC

SoFTEC stated that its members assert that federal law surrounding transfers of interests in copyright and patents play a central role in determining what copyright or patent interests, if any, have been transferred from one party to another in a putative TTA, and that these limitations on patent and copyright interests will greatly reduce the tax administration complexity.

SoFTEC states that it strongly disagrees with comments suggesting that the Department "avoid TTA regulations that would place auditors in the position of needing specialized knowledge of intellectual property law…" It states that a determination of whether interests in copyrights or patents have been transferred cannot be made without reference to federal law. SoFTEC states that *Preston*, *Nortel*, and *Lucent* used federal law as a guidepost in analyzing whether such federally created rights were transferred.

As to the first part of the definition of a TTA, assignments or licenses to make and sell a product that is subject to the transferor's patent or copyright interest, SoFTEC states whether a *sale* resulted in the assignment or license to the purchaser of any patent or copyright interest is inherently a matter of federal law and that federal law is clear such sales do not result in any such assignment or license. SoFTEC states that under the patent exhaustion and copyright first sale doctrines, purchasers take title to the article of TPP free and clear of any patent or copyright interest of the transferor and that such transactions would not fall within the definition of a TTA. It further states that the exhaustion doctrines apply to sales, not leases or licenses, but that the definition of "sale" under the Sales and Use Tax Law includes a lease, and, therefore, the Department could have regulatory authority to conclude that lease and licenses of TPP exhaust the lessor's or licensor's patent or copyright interests in the property.

As to the second part of the definition of a TTA, assignments or licenses to use a process that is subject to the transferor's patent or copyright interest, SoFTEC states that it is not possible to apply this part of the definition to copyright interests under federal law because interests protected by the Copyright Act are narrow and are restricted to copying, making derivative work, and distribution of copies to the public and similar rights. SoFTEC states that only patent holders can control how patented processes are used. SoFTEC reiterates that the purchaser would not take the property subject to any patent interest of the seller and the transaction would not fall within the definition of TTA.

SoFTEC also states that transfers of "information" protected by trade secret law are outside the TTA statutes' scope and that agreements for the transfer of other "information," unless protected by patent or copyright law, will not qualify as TTAs. They also state that they are skeptical that the TTA statutes apply to consumer transactions or transactions involving embedded software. SoFTEC summarized that the legislature's inclusion of the words "patent" and "copyright," signals that the TTA statutes wholesale incorporate these two bodies of federal law into the California sales and use tax regime and that application of the exhaustion doctrines will reduce the number of transactions that would be eligible for TTA treatment and significantly reduce the tax administration complexity. (Exhibit 4.)

Discussion

The Department appreciates the oral and written comments it has received. In addition, Legal staff met with members of Caltax, SVLG, and CTIA in order to further understand their written submissions and determine how their submissions may lead to a workable regulation on the matter. After the above submissions and the follow-up informal meeting, the Department would like to host a Workshop III to focus on the following topics.

<u>Recommendations from Interested Parties</u>

The Department is open to further input on the suggestions, recommendations, and responses provided by the interested parties in Exhibits 1-4.

Concepts

Auditable Safe Harbor

Following the Initial TTA workshop, the Department received specific recommendations from industry groups to implement a safe harbor (rebuttable or otherwise) that would allow taxpayers to treat a certain percentage of the total amount charged under a TTA as the value of the intangible property transferred under that TTA. The Department received similar recommendations in the past, including in written comments following the interested parties meeting on November 5, 2019. This approach could ease the overall administration of the TTA statutes, especially in routine transactions.

Following Workshop II, a recommendation was made, and discussions held on a precertification process on a product-by-product basis that would allow taxpayers to obtain treatment similar to a safe harbor for TTA transactions. This process would allow a taxpayer to elect 20 percent of the total amount charged under a TTA as the value of the intangible property transferred under that TTA. Under this approach, if a taxpayer taking the election becomes pre-certified, the burden would shift to the Department upon audit to show that the value of the TPP transferred as part of the TTA exceeds 80 percent of the total amount charged for the TTA. If a taxpayer taking the election is not pre-certified, the burden would remain with the taxpayer to establish upon audit that: (1) a TTA exists and (2) the value of TPP transferred as part of the TTA does not exceed 80 percent of the total charge (i.e., 40 percent cost to the taxpayer, plus 100 percent markup). In this regard, a taxpayer may support the cost of TPP by showing that, for example, materials and labor used to produce the TPP reported for income tax or other accounting purposes does not represent more than 40 percent of the total amount charged under that TTA.[1]

Where a taxpayer contends the value of the intangible personal property transferred under a TTA is greater than 20 percent, this election provision would not preclude taxpayers from using the methods set forth in subdivision (c)(10)(A)-(C) of Sections 6011 and 6012 to derive such value.

The Department seeks input on the following language:

(3) For all transactions not subject to the rebuttable presumptions in subdivisions (1) and (2) of this regulation [note these would be the two rebuttable presumptions, discussed below], a taxpayer may elect to exclude from the gross receipts or sales price 20 percent of the total amount charged under a TTA as the amount charged for intangible personal property transferred with TPP in that TTA. If such election is made, a taxpayer must substantiate upon audit that a TTA exists and that the gross receipts or sales price attributable to the TPP transferred as part of the TTA does not exceed 80 percent of the total amount charged for the TTA under a method set forth in subdivisions (c)(10)(A)-(C) of Sections 6011 and 6012.

[1] If the cost of labor and materials equals 40 percent of the total amount charged, then the fair retail value of the TPP would be 80 percent of the total amount charged pursuant to RTC 6011 and 6012, subdivision (c)(10)(C), and the remaining 20 percent would be for the intangible. Accordingly, cost of labor and materials of 40 percent would be the minimum to support the use of a 20 percent safe harbor upon audit.

(A) Precertification. A taxpayer will be regarded as pre-certified for the 20 percent election if it submits to the Department all of the documents set forth in subdivision (3)(b) or (3)(c) at least 15 calendar days prior to the due date of the return in which the election will be made. Where a taxpayer is pre-certified, it will be rebuttably presumed that the gross receipts or sales price of the TPP transferred as part of the TTA does not exceed 80equ percent of the total amount charged for the TTA. The rebuttable presumption will only apply to transactions involving the sale, use, or lease of products identified through subdivision (3)(B) or (3)(C) below.

(B) Precertification Documents.

1) A description of the taxpayer's business.

2) A schedule of products sold in the regular course of business for which the taxpayer will take the 20 percent election. This schedule must include a product description, a general category of assets to which the product belongs, the sale or lease price per unit, and a general description of software and/or other intangible personal property contained in the product.

3) Taxpayer's statement made under penalty of perjury that:

    i. The products identified in the schedule of products will be transferred pursuant to a TTA as defined under subdivisions (c)(10) of sections 6011 and 6012, and the cases interpreting those sections, *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.

    ii. The taxpayer holds a patent or copyright interest in the intangible personal property transferred with products identified in the schedule of products.

    iii. Based on taxpayer's internal cost information or valuation study, a copy of which shall be provided to the Department upon request, the gross receipts or sales price of the TPP transferred as part of the TTA does not exceed 80 percent of the total amount charged for the TTA under a method set forth in subdivisions (c)(10)(A)-(C) of Sections 6011 and 6012.

4) If the taxpayer makes a sale for resale to another person who will make retail sales of a product identified in the schedule of products, the taxpayer must provide a list of persons that are authorized to assign or license to another person the right to make and sell product or to use a process that is subject to the taxpayer's patent or copyright interest (Authorized Persons).

(C) Precertification Documents for Authorized Persons.

1) A description of the taxpayer's business.

2) A schedule of products sold in the regular course of business for which the taxpayer will take the 20 percent election. This schedule must include the name of the wholesaler from whom the product was purchased for resale, a product description, a general category of assets to which the product belongs, the sale or lease price per unit, and a general description of software and/or other intangible personal property contained in the product.

3) Taxpayer's statement made under penalty of perjury that:

   i. The products identified in the schedule of products will be transferred pursuant to a TTA as defined under subdivisions (c)(10) of Sections 6011 and 6012, and the cases interpreting those sections, *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.

   ii. The taxpayer holds a patent or copyright interest in the intangible personal property transferred with products identified in the schedule of products.

(D) A taxpayer's precertification remains in effect until revoked or revised in writing, or until there is a material change to the gross receipts or sales price attributable to the TPP transferred as part of the TTA under a method set forth in subdivisions (c)(10)(A)-(C) of Sections 6011 and 6012.

Rebuttable Presumption that for Non-Bargained-For Transactions the Price Charged for the Transaction is Equal to the Value of the Transferred TPP

The concept for this presumption is to address situations where TPP is transferred with a patent or copyright interest but there is no evidence that the patent or copyright interest was bargained-for as part of the transaction and the value of such interests are not readily identifiable. The intent of this presumption would be to provide ease of administration and certainty so that retailers of general consumable items (e.g., coffee machines, general office supplies, etc.), to consumers or businesses, do not have to determine the value of such interest.

In response to interested party comments expressing concern that the presumption should not make a distinction based on whether the transaction is to a business or consumer, we note that the language has been revised to focus on whether any copyright or patent interests were specifically negotiated as part of the sale. As such, there is no longer a distinction with respect to whether the transaction is with a business or a consumer. For example, proposed language could include:

> (1)(A) For non-bargained-for transactions it shall be rebuttably presumed that the value of the TPP generally equals the amount charged for the TTA transaction. This presumption may be rebutted by providing:
>
> 1. Documentation, contemporaneous with the sale, showing that any intangible copyright or patent interests were bargained-for as part of the transaction; and
>
> 2. Documentation establishing that the value of the TPP as determined by Sections 6011/6012, subdivision (c)(10)(A)-(C), is less than the amount charged for the transaction.
>
> (B) For purposes of this paragraph a "non-bargained-for" transaction includes but is not limited to, agreements where there is no evidence that the intangible copyright or patent interest were specifically bargained-for as part of the transaction.

The Department intends to include examples as to when the presumption does and does not apply, and how to rebut the presumption. Examples of transactions where this presumption does not apply could include:

- Company X sells computers and offers optional patented software licenses. If a customer elects to purchase the software license, Company X installs the software on to the computer prior to delivery. Company X's invoices show that the purchaser has opted for the patented software and separately lists the price for the software. Company X's transfers of patented software are bargained-for, and the presumption does not apply.
- Company X sells point-of-sale (POS) systems to other businesses. Company X also offers licenses for copyrighted software that enable the POS systems to connect to the internet and store sales data from multiple locations. Company X's invoices state that the selling price of POS systems includes the right to use the copyrighted software. Company X's transfers of the copyrighted software are bargained-for, and the presumption does not apply. Software that is not downloaded by the end user, but used by them on a cloud-based platform housed outside of California would not be considered a transfer of software.

Examples of transactions where this presumption does apply and may be rebutted could include:

- Company X sells digital clocks that come with copyrighted software that enables the clocks to display weather, news, and play music from the internet. The sales invoice states a lump-sum price of $100 for the clock. At the time of sale, the consumer does not have any options to select the software that comes with the clock. Company X's transfers of the copyrighted software are non-bargained-for transactions, and it is rebuttably presumed that the value of the TPP (the clock) equals or exceeds the entire sales price of the property.

  Company X could rebut this presumption with any document, contemporaneous with the sale of the clock, stating the sales price of the clock includes the right to use the copyrighted software. Company X could also rebut this presumption with documentation establishing that the value of the TPP as determined by Sections 6011/6012, subdivision (c)(10)(A)-(C), is less than the amount charged for the transaction.

The Department seeks input on how to best define the scope of transactions subject to this presumption and thoughts on how to best define non-bargained-for transactions.

Rebuttable Presumption Regarding the Transfer of TPP with Embedded Software Only

The concept for this presumption is to address situations in which TPP is transferred with embedded software, but the transfer does not include the transfer of a copyright or patent interest in any other software. Similar to the above presumption, the intent would be to provide ease of administration and certainty to retailers with regard to transactions in which intangible interest is not specifically bargained for or readily identifiable. In this case, however, the presumption would focus on the type of TPP transferred and not the negotiation between the parties to the transaction. As such, it may have a largely duplicative effect to the presumption for non-bargained for transactions, and may be considered as an alternative.

In response to interested party comments expressing concern that this presumption seeks to limit the scope of what constitutes a TTA, we note that the presumption would assume that the transaction constitutes a TTA and would only relate to the value of the TPP transferred. In response to interested party concerns related to valuation, we note that the current proposal excludes transactions in which the measure is established pursuant to subdivisions (b)(1)(A) or (b)(1)(B) of Regulation 1507. In addition, we note that there would not be any presumption as to the value of any intangible rights in embedded software, but rather in the value of the TPP transferred. For example, proposed language could include:

> (2)(A) In a technology transfer agreement involving the transfer of tangible personal property with embedded software, which does not include the transfer of a copyright or patent interest in any other software and for which the gross receipts or sales price of the tangible personal property is not established pursuant to subdivision (b)(1)(A) or (b)(1)(B) of Regulation 1507, the combined cost of materials and labor used to produce the tangible personal property is rebuttably presumed to be equal to or greater than 50 percent of the stated sales price of the tangible personal property.
>
> (B) For purposes of this paragraph embedded software is software that is built or integrated into tangible personal property, including firmware, when it is manufactured that a purchaser is not intended to alter, replace, or otherwise access and that without which the tangible personal property cannot be purchased.
>
> (C) Examples of tangible personal property subject to the presumption include:
>
> - Home appliances
> - Electronic toys
> - Speakers and headphones
> - Implantable medical devices
> - USB drives and other similar digital storage devices

The Department seeks further input on how to best define the scope of transactions subject to this presumption, and how to define embedded, hardwired, and/or preloaded software for purposes of the presumption.

<u>Other TTA Topics</u>

The Department seeks input on the following other TTA topics:

- How to determine if a separately stated price is reasonable under RTC 6011/6012 (c)(10)(A)
- How to calculate 200 percent of the cost of materials and labor used to produce TPP under RTC 6011/6012 (c)(10)(C)
- Whether RTC 6011/6012 (c)(10)(C) applies to sales of TPP purchased for resale, rather than produced by the retailer.

- Whether a taxpayer could avail itself of a process to seek a higher percentage than the 20 percent discussed above in the safe harbor provision on a product-by-product basis. Given ease of administration concerns, what would that process look like, and what must a taxpayer provide to the Department to obtain such percentage.

The Department also welcomes participants' comments or suggestions on any other TTA related topic not specifically discussed above.

Summary

We invite you to participate in a second TTA workshop to be held on December 9, 2024. We welcome any comments and suggestions, including proposed regulatory language from you on the TTA topics discussed above. We further invite you to provide your written suggestions or comments on those topics by January 20, 2025.

Delivered electronically to BTFD-BTC.InformationRequests@cdtfa.ca.gov

SILICON VALLEY
LEADERSHIP GROUP

August 9, 2024

Aimee Olhiser, Chief
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Business Tax and Fee Division
California Department of Tax and Fee Administration
450 N Street
Sacramento, CA 95814

SUBJECT: Comments in Response to the second California Department of Tax and Fee Administration's Workshop on Technology Transfer Agreements with regard to using Cost of Goods Sold (COGS) in relevant calculations

During the workshop on Technology Transfer Agreements (TTAs) on June 27, I agreed to provide some information regarding the inclusion of indirect labor costs in cost of goods sold (COGS) calculations.

For income tax purposes, COGS is reported on IRS Form 1125-A and Schedule V of FTB Form 100. For any taxable year, COGS are essentially the value of beginning inventory to which are added purchases, cost of labor, section 263A costs and other costs, from which are subtracted the value of inventory at the end of the year.

For income tax purposes, COGS is calculated based on IRC Section 263A "UNICAP" rules that require businesses to capitalize the direct and indirect costs associated with producing, acquiring, and maintaining their inventory. Because the process requires capitalizing certain costs that would normally be expensed, implementing Section 263A increases taxable income. The Section 263A regulations prescribe a variety of methods that taxpayers can use to identify and allocate additional Section 263A costs, including certain simplified methods for producers and resellers.

In a little more detail, for income tax purposes COGS includes direct, indirect and mixed service costs.

Producers' direct costs include the direct labor and materials costs that are integral to the property or product being produced. Examples include worker salaries and production materials. For resellers, direct costs are the costs of acquiring the property.

Indirect costs include all costs that are not defined as direct but directly benefit the property being produced or sold or are incurred because of its production or resale. Costs such as employee benefits, rent, taxes, interest, quality control costs, supervision salaries, and insurance are all considered indirect costs.

Mixed service costs are types of indirect costs related to the business's administrative and service departments. These departments are not directly involved in the manufacturing process, but they do indirectly support the overall function of the business. Some of these costs can be written off as expenses (such as selling, distribution, marketing, and advertising expenses; administrative and general expenses unrelated to development or construction; R&D expenses; and amortization and depreciation), but others may need to be allocated to production activities and capitalized.

It is worth noting that if adjustments are made to COGS during an income tax audit, in most cases the adjustments would increase COGS. This is because to increase COGS an expense of a taxpayer that would otherwise be currently tax deductible would be added to COGS. So, instead of being currently tax deductible and reducing current year taxable income (and income tax), the expense would be added to COGS and eventually would reduce taxable income in the year that the inventory is sold, which might be later than the current year. The consequence of this timing difference is that income tax auditors would have no incentive to make audit adjustments that would decrease COGS, rather than to increase COGS, because higher COGS for a given tax year would mean higher income taxes for that year.

In a one-word response to the request for information about whether some indirect labor expenses are included in COGS for income tax purposes, the answer is "yes."

As a disclaimer, the COGS regulations are very complex and this summary above is for the purpose of validating the possible use of COGS with respect to the application of Sections 6011(c)(10) and 6012(c)(10) of the California Revenue and Taxation Code (RTC). In particular, Section 6011(c)(10)(C) and Section 6012(c)(10)(C) base their calculations of taxable tangible personal property on the cost of materials and labor. It is likely that in many cases the calculation of COGS might be greater than appropriate for applying the TTA statutes because of the significant amount of indirect expenses, whether indirect labor or other indirect expenses, that are included in COGS for income tax purposes.

Best regards,

Dan Kostenbauder
Vice President, Tax Policy
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Delivered electronically to BTFD-BTC.InformationRequests@cdtfa.ca.gov

August 9, 2024

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SUBJECT: Joint Comments from CalTax and SVLG in Response to the second California Department of Tax and Fee Administration's Workshop on Technology Transfer Agreements

The California Taxpayers Association (CalTax) and the Silicon Valley Leadership Group (SVLG) Tax Committee would like to thank you for the opportunity to provide comments and suggestions regarding the taxation of technology transfer agreements (TTAs) following the workshop held on June 27, 2024. We sincerely appreciate the opportunity to have an open dialogue between the Department and stakeholders.

The comments addressed in this letter represent mutual agreement that our two organization's members have agreed to, and are reflective of the views of the business tax community at large. CalTax and SVLG are submitting comments jointly because we believe it would be helpful to the CDTFA to have the perspective of our member companies who represent both innovation economy companies as well as a more general part of the business community as you develop regulations that will bring much-needed clarity and certainty to this important issue.

Key Objective

The revisions to Regulation 1507, Technology Transfer Agreements, should place great importance on the ease of administration to both taxpayers and the Department but should not stray from the decisions of *Nortel* and *Lucent*.

For ease of compliance, as expressed by industry both verbally and in writing, we strongly recommend the amendments to Regulation 1507 include several examples of

transactions that qualify as a TTA and examples of transactions that would not qualify. In addition, we are in favor of incorporating a safe harbor in the regulation.

Specific Comments

<u>Technology Transfer Agreement (TTA) definition</u>

California Revenue and Taxation Code Sections 6011(c)(10)(D) and 6012(c)(10)(D) define a TTA as "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."

The California Supreme Court in *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 ("*Preston*") provides an authoritative overview of the legislative history relevant to the exclusion from tax for TTAs set forth in the TTA statutes. *Preston* makes clear that the Board of Equalization's ("Board") *Intel Corporation* memorandum opinion ("*Intel*") is a touchstone for the TTA statutes, which were enacted to codify and implement *Intel*. (*Preston* at p. 222.) In light of *Preston*'s emphasis on the significance of *Intel* as an interpretive guide, consideration must be given as to how *Intel* informs the proper application of tax to transactions that meet the statutory TTA definition.

<u>TTAs involve two separate and distinct transactions, each of which receives a separate and distinct tax treatment.</u>

Intel makes clear that TTAs involve two transfers: (1) a transfer of tangible personal property ("TPP") and (2) a transfer of intangible personal property — or as the *Preston* court put it: TTAs involve "two separate and distinct transactions for tax purposes." (*Preston* at p. 216.) In other words, TTAs are always mixed transactions, not bundled transactions, because the two transfers are readily separable. (See *ibid*.) This is also why the physical usefulness test is inapplicable to TTA transactions. As explained by the court in *Lucent Technologies, Inc. v. State Bd. of Equalization* (2015) 241 Cal.App.4th 19 ("*Lucent*"), the physical usefulness test only applies to non-TTA transactions where the transfer of tangible and intangible personal property is inextricably intertwined. (*Lucent* at p. 36.) Software and rights to copy and use software are both intangible personal property that must receive separate, nontaxable treatment when a TTA exists. (*Lucent* at pp. 25 & 30.)

Accordingly, any suggestion that subparagraph (c)(10)(B) cannot effectively be used to determine the value of the TPP component of a TTA involving intangible software must be rejected. The notion that secondary markets of like TPP could be unreliable because the value of the related software is too intertwined with the TPP constitutes a misguided attempt to revive the inapplicable physical usefulness concept under another guise.

The *Lucent* opinion is clear that, when a TTA exists, the TPP and intangible components are not intertwined (inextricably or otherwise) because TTAs are always mixed, not bundled, transactions. When subparagraph (c)(10)(B) is used to determine the value of

the TPP in a TTA, per the plain language of the TTA statutes, the remainder of the selling price is the full value of the intangible property. In other words, under the plain language of the TTA statutes, the use of subparagraph (c)(10)(B) does not result in overvaluing of the intangible component. It should also be noted that the TTA statutes mandate that subparagraph (c)(10)(B) is to be used for allocation purposes whenever possible before resorting to subparagraph (c)(10)(C).

The TTA exclusion is informed by, but not controlled by, federal patent and copyright law.

Intel discusses transfers of patent and copyright interests without explicit reference or citation to federal law. Thus, even if the exclusion provided under the TTA statutes may be implicitly understood to be informed by federal law, the TTA exclusion is not ***controlled by*** federal law. The California Legislature was free to, and in fact did, expand notions from federal law to enact a broad exclusion from tax. For example, while the concept of using a “process subject to [a] copyright interest” is not articulated in federal law, the value of the right to use such processes is nevertheless excluded from tax under the plain language of the TTA statutes. This is why *Intel*, and the appellate courts that have construed the TTA statutes describe the intangible personal property in a TTA to include a “license to use information” that is under (or “subject to”) a patent or copyright interest. (See *Intel*; *Preston* at pp. 216-219; *Nortel Networks, Inc. v. State Bd. of Equalization* (2011) 191 Cal.App.4th 1259 (“*Nortel*”) at p. 1269; *Lucent* at p. 30.)

In other words, the fact that a copyright interest may be predicated on federal law does not mean that federal law limits the broad nature of the exclusion from tax enacted by the Legislature. As the *Nortel* court succinctly explained, for a TTA to exist, “All that is required is that the licensed right be ’subject to’ the patent or copyright.” (*Nortel* at p. 1276.) Thus, no doubt should exist that the right to use the information embodied in a licensed software program is sufficient to establish a TTA.

Moreover, specific federal rules pertaining to the transfer of patent or copyright interests and when infringement does or does not occur are not controlling as to whether a TTA exists. This is why the *Lucent* court emphatically rejected the Board’s arguments that a TTA could exist only if “meaningful” or “more than ‘conventional’” rights were transferred to a licensee who can also establish that an infringement would have occurred but for the license purchased. (*Id*. at pp. 37-41.)

Concepts the CDTFA seeks input on related to the valuation of TPP transferred in a TTA

Rebuttable Presumption that for Consumer Transactions the Price Charged for the Transaction is Equal to the Value of the Transferred TPP

The Department seeks input on how to best define a consumer transaction. The Department lists some potential ways or combination of ways to define a consumer transaction.

We do not agree that a distinction should be drawn based on whether the transaction is a business or consumer transaction. Rather we suggest that the regulation include examples of "Transactions that would not qualify as a TTA." The four examples provided by the Department and referred to as "consumer transactions" on page eight of the "Technology Transfer Agreements Workshop II" document, could be included with the examples of transactions that do not qualify as a TTA. In short, it is not relevant whether the purchaser's intent was to purchase for business or personal use. However, because TTAs always involve two separate and distinct transactions, it is relevant whether the contemporary documentation indicates that the parties bargained for the transfer of both tangible and intangible personal property.

Rebuttable Presumption Regarding Intellectual Property Rights Transferred with Embedded Software

The CDTFA would like assistance in addressing situations where software is hardwired or embedded in machinery or equipment when it is manufactured, and it is not known if a copyright interest is needed for such software to function or if the software provided embodies patent interests the seller intends to transfer to the buyer.

The Department refers to RTC 6011/6012 (c)(10)(C) as potentially the answer to this question but seeks input on how to best define the scope of the transactions subject to this presumption, and how to define embedded, hardwired and/or preloaded software for the purposes of the presumption.

As noted above, subparagraph (c)(10)(B), not subparagraph (c)(10)(C), is the preferred TTA allocation methodology when a reasonable separately stated price for TPP is not made. In the event secondary markets for like TPP do not exist and subparagraph (c)(10)(C) becomes relevant, it is important to remember that, pursuant to the *Preston* court, *Intel* is a touchstone to the proper interpretation and application of this allocation method.

Intel is clear that the 100-percent markup the Board used to determine the taxable measure of the TPP transferred (e.g., engineering notes, data base tapes, test tapes, etc.) was fully inclusive of both "overhead and profit." In other words, the Board determined that a 100-percent markup on the cost of direct labor and materials was sufficient to fairly allocate a reasonable retail value to the TPP transferred in the transactions at issue in *Intel*. The Legislature decided to apply this same 100-percent markup approach to ***all*** TTA transactions when subparagraph (c)(10)(C) of the TTA statutes is applicable (i.e., when neither a separately stated price for intangibles nor like sales of TPP exist for allocation purposes). Because the TTA statutes were intended to codify and implement *Intel*, the statutory 100-percent markup set forth in subparagraph (c)(10)(C), when applicable, must also be fully inclusive of both overhead and profit.

Moreover, because the physical usefulness test is inapplicable to TTAs, it is also certain that the existence of a TTA does not depend on whether the intangible software was delivered through being embedded in TPP or through electronic or load-and-leave mechanisms. Software and the rights to copy and use software are always intangible. (*Lucent* at pp. 25 & 42.) For this reason, provided all the requirements for establishing a TTA have been met, TTA treatment should be unaffected by the type or types of software at issue (e.g., firmware, middleware, operating, application, etc.). As discussed above, according to *Intel*, *Nortel*, and *Lucent*, all that is required to establish a TTA is the existence of a "license to use information" that is under (or "subject to") a patent or copyright interest.

Safe Harbor

We recommend the CDTFA adopt a safe harbor percentage for the value of a TTA sold with TPP that a taxpayer could elect to rebut if the value of the intangible personal property exceeds the safe harbor percentage. A safe harbor percentage would provide certainty and clarity for both taxpayers and the state. The ease of administration of a safe harbor would accomplish the goals of harmonizing the statutory language, legislative intent, impact to the State budget, and reducing compliance, audit, controversy and administrative expenses for both CDTFA and taxpayers.

As technology becomes ever-more persistent in our economy, it is likely that the amounts of intangible property transferred will be greater in the future. By putting in a safe harbor percentage of 20%, taxpayers would be able to apply the safe harbor in lieu of documenting what would in many cases be a significantly higher percentage of the value. The ease of administration of a safe harbor would benefit all parties and likely result in a significantly reduced amount of administration and controversy.

When subparagraph (c)(10)(A) and (c)(10)(B) do not apply, and specifically for relying on (c)(10(C), we welcome the creation of a safe harbor presumption of 20% that a taxpayer could rebut and believe it would be permissible considering the Department has approved safe harbors in other cases. If the taxpayer wants to rebut the 20% safe harbor, we suggest that the cost of goods sold (COGS) of the tangible personal property (TPP) as reported on the income tax return of the seller of the TTA could be used to calculate the 100-percent markup in determining the value of the TPP.

California Tax and Economic Policy

We would like to add a brief comment regarding how important the innovation economy is to the overall California economy and tax base. Obviously, Silicon Valley is a major global hub for high technology companies, but there are companies in biotechnology and other advanced technologies located throughout California. The TTA statutes were enacted by the Legislature to help encourage technology companies to thrive in California. In view of this general policy objective of the TTA statutes, we encourage the

CDTFA to develop regulations in the spirit of the TTA statutes, while obviously being consistent with their statutory language.

Request for Third Workshop

We request that CDTFA consider holding one more workshop to discuss the issues addressed in this letter along with any other issues that are in need of further clarification. In addition, it would be very helpful if CDTFA could discuss or describe its views on some of the suggestions made during the first two workshops and submissions received after them. It would also be helpful if CDTFA could discuss or describe its greatest concerns about potential abuses or challenges of administering the TTA statutes.

Best Regards,

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Sales Tax Consultant
California Taxpayers Association

Dan Kostenbauder
Vice President, Tax Policy
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August 9, 2024

Via Email to: BTFD-BTC.InformationRequests@cdtfa.ca.gov

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Re: Response to the CDTFA's TTA Workshop Paper Circulated on June 13, 2024

Dear Ms. Olhiser:

On behalf of CTIA and its members, thank you for organizing the January 31 and June 27, 2024, technology transfer agreement ("TTA") workshops. Our members found both workshops excellent as the exchange of viewpoints by the various speakers was very informative and beneficial.

Accepting your kind invitation to provide additional written comments and suggestions, CTIA and its members provide the following responses to two of the concepts discussed in the TTA Workshop paper attached to your June 13, 2024, letter (the "TTA Workshop Paper II").

CONCEPT NO. 2: Rebuttable Presumption Regarding Intellectual Property Rights Transferred with Embedded Software.

Here's is why Concept No. 2 is incorrect and invalid. [1]

A. <u>The CDTFA's Proposed Presumption Is Invalid Because It Adds Requirements to the TTA Statutes that Do Not Exist in the Statutes Themselves</u>.

The CDTFA provides the following explanation for this proposed presumption to be included in Regulation 1507, *Technology Transfer Agreements* ("Regulation 1507"),[2] as to be amended following these very productive workshops and any subsequent interested parties meeting(s) ("Amended Regulation 1507"):

> The intent of this presumption is to address situations in which software is hardwired[3] or embedded in machinery or equipment

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[1] The below analysis is not inclusive. Were this proposed presumption included in a draft of Amended Regulation 1507 or were it to be promulgated as part of Amended Regulation 1507, we respectfully reserve the right to make these and any and all additional arguments to show its invalidity through the interested parties process, in any judicial proceeding, and/or in any other appropriate setting or forum.

[2] Cal. Code Regs., tit. 18, § 1507.

[3] We do not understand the meaning of the word "hardwired" in the context of the TTA Workshop Paper

> when it is manufactured. In these situations, it is not readily known ***if a copyright interest is needed for such software to function*** or if the software provided embodies patent interests ***the seller intends to transfer*** to the buyer.

(TTA Workshop Paper II, at p. 8, bold and italics added.)

Whether or not "a copyright interest is ***needed*** for [hardwired or embedded] software to function" is not a requirement found anywhere in the TTA Statutes.[4] All that is required is an agreement under which the "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." (§§ 6011(c)(10)(D) and 6012(c)(10)(D);[5] *Lucent Technologies, Inc. v. Board of Equalization* (2015) 241 Cal.App.4th 19, 31 [193 Cal.Rptr.3d 323] (*Lucent*) ["A technology transfer agreement is 'any agreement under which' (1) 'a person who holds a patent or copyright interest' (2) 'assigns or licenses to another person the right to make and sell a product or to use a process' (3) 'that is subject to the patent or copyright interest.' [Citation]."].) "Need" plays no role in this analysis.

Likewise, the proposed requirement that the patented software transferred embodies the "patent interests the seller ***intend[ed]*** to transfer to the buyer" is found nowhere in the TTA Statutes.[6] Again, all a taxpayer needs show is that the transferor "assign[ed] or license[d]" the patented software for the purposes stated in sections 6011(c)(10)(D) and 6012(c)(10)(D). "Intent" also plays no role in this analysis.

Even if intent were relevant or was an element in the TTA analysis – which it is not – the patented software transferred embodies the patent interest the assignor or licensor intended to transfer. Here is why:

Software is patented if it embodies the assignor or licensor's patent(s). (See *Lucent*, *supra*, 241 Cal.App.4th at p. 27 ["AT&T and Lucent (collectively, AT&T/Lucent) designed the software . . . that runs the switches they sell. That ***software*** . . . ***embodies***, implements, and enables at least one of 18 different patents held by AT&T/Lucent. . . ." Bold and italics added.]; *id*., at p. 37 ["[the] ***software embodied*** some portion of AT&T/Lucent's patents." Bold and italics added.]; *id*. ["AT&T/Lucent also transferred a portion of its patent rights when it granted the telephone companies licenses to use the processes ***embodied*** in its ***software***, and the companies' resulting products – which, again, required the use of that software – were consequently 'subject to' those patents." Bold and italics added]; *id*., at p. 36 ["the undisputed evidence indicates that AT&T/Lucent's computer software was . . . patented."].) Therefore, if an assignor or licensor transfers software that is patented, the assignor or

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II, and the workshop paper provides no definition. We use this term simply because the workshop paper uses it. We do not concede that software is or can be "hardwired" – whatever that means – in machinery or equipment.

[4] The "TTA Statutes" refer to Revenue and Taxation Code sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

[5] "Sections 6011(c)(10)(D) and 6012(c)(10)(D)" refer to Revenue and Taxation Code sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

[6] By using the terms "seller" and "buyer," the TTA Workshop Paper II does not address the much more common TTA situation in which the holder of a patent interest does not sell (*i.e.*, assign) but ***licenses*** the right to use its patent interest.

licensor could only have intended to assign or license the patent interest(s) that are embodied in the patented software so transferred. The transferor could have had no other intent.

The attempt to add these proposed requirements to the TTA Statutes is reminiscent of another attempt to contradict, alter, amend, and/or impair the scope of these statutes. The State Board of Equalization ("Board"), the CDTFA's predecessor with respect to sales-and-use tax matters, in former Regulation 1507, subdivision (a)(1) excluded from the definition of a TTA those agreements that transferred prewritten software.[7] *Nortel Networks Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259 119 Cal.Rptr.3d 905] ("*Nortel*") held that this portion of Regulation 1507, subdivision (a)(1) was invalid:

> The Board exceeded its authority by excluding all prewritten computer programs from the definition of a TTA, even the licensing of a prewritten program "that is subject to [a] patent or copyright interest." (§§ 6011, subd. (c)(10)(D), 6012, subd. (c)(10)(D).) By doing so, the Board altered or impaired the scope of the TTA statutes. If the Legislature did not want the TTA statutes to apply to prewritten—but copyrighted or patented—computer programs, it would have expressly excluded prewritten programs, as it did in section 6010.9. ***To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, the regulation exceeds the scope of the Board's authority and does not effectuate the purpose of the TTA statutes: It is, for these reasons, invalid.***

(*Nortel*, *supra*, 191 Cal.App.4th at 1278, bold and italics added.)

For the very same reasons the proposed presumption conflicts with the TTA Statutes and does not effectuate their purpose. If promulgated, it would, we respectfully submit, be found invalid. (See *id*.)

B. <u>A Presumption That There Is No Consideration for the Transfer of Valuable Patented and/or Copyrighted Software, Whether Embedded or Not, Is Arbitrary, Capricious and/or Without Rational Basis</u>.

Even assuming *arguendo* that the proposed presumption is consistent and not in conflict with the TTA Statutes and is reasonably necessary to effectuate their purpose[8] – which, as shown above, it is not – we respectfully submit it would be declared invalid under either the "arbitrary, capricious or without

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[7] The portion of former Regulation 1507, subdivision (a)(1) held to be invalid provided as follows: "A technology transfer agreement also does not mean an agreement for the transfer of prewritten software . . . ."

[8] See *Nortel*, *supra*, 191 Cal.App.4th at 1278; *GMRI, Inc. v. California Dept. of Tax & Fee Administration* (2018) 21 Cal.App.5th 111, 123-124 [230 Cal.Rptr.3d 183] ("'[N]o regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute.' [Citations.].")

rational basis" standard of review or, if this proposed presumption does not implicate the CDTFA's rulemaking power, the less rigorous standard of review applicable to interpretative regulations.[9]

A presumption that a transferor would assign or license its valuable patented and/or copyrighted software without charging any amount for the right to use such software would be, at the very least, arbitrary, capricious and/or without rational basis.

That such valuable patent and/or copyright interest is in the form of patented and/or copyrighted software "hardwired or embedded in machinery or equipment when it is manufactured" (TTA Workshop Paper II, at p. 8) makes no difference. It would be arbitrary, capricious and/or without rational basis to presume that in a TTA Transaction[10] "[t]he amount charged for intangible personal property [patented and/or copyrighted software] transferred with tangible personal property [per the workshop paper, machinery or equipment into which such software is hardwired or embedded] in any technology transfer agreement"[11] is zero.

For these reasons, we respectfully submit that the proposed presumption, if included as part of Amended Regulation 1507, would be invalid under either the "arbitrary, capricious or without rational basis" standard of review or the lesser standard of review applicable to interpretive regulations.

C. The Presumption Is Contrary to *Lucent*.

This proposed presumption contravenes *Lucent* in several ways.

First, the "copyright interest is needed" language is a reformulation of the "but for" argument the Board unsuccessfully advanced in *Lucent*:[12] In *Lucent*,

> the Board urges that the technology transfer agreement statutes are inapplicable unless and until the taxpayer makes "a prima facie showing that it was more likely than not that, ***absent the right-to-use licenses in the agreements***, [its] customers would have infringed on

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[9] Where the CDTFA, in the exercise of its substantive rulemaking power, makes a regulation, the standard of review is "arbitrary, capricious or without rational basis." (See, e.g., *Culligan Water Conditioning, Inc. v. State Board of Equalization* (1976) 17 Cal.3d 86, 92 [130 Cal.Rptr. 321, 550 P.2d 593].) Where, however, a regulation merely interprets a statute and does not implicate the exercise of a delegated lawmaking power, the CDTFA's interpretation "commands a commensurably lesser degree of judicial deference." (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 11 [78 Cal. Rptr. 2d 1, 960 P.2d 1031].)

[10] "TTA Transaction" refers to a transaction in which an amount is charged for intangible personal property such as patented and/or copyrighted software transferred with TPP in an agreement that qualifies as a TTA under sections 6011(c)(10)(D) and 6012(c)(10)(D).

[11] Revenue and Taxation Code sections 6011, subdivision (c)(10)(A) and 6012, subdivision (c)(10)(A).

[12] The amendments to Regulation 1507 proposed in 2019 would also have required a taxpayer to prove that, but for the transfer of a patent or copyright interest pursuant to a TTA, the "assignee or licensee . . . would not otherwise have either that transferred interest or a substantially equivalent interest." (Discussion Paper circulated by the CDTFA on Oct. 18, 2019, at p. 16.) As discussed in the text, such a "but for" argument had been previously rejected by *Lucent*. (*Lucent*, *supra*, 241 Cal.App.4th at pp. 40-41.)

> [the taxpayer's] patent or copyright interests when using the acquired software."

(*Lucent*, *supra*, 241 Cal.App.4th at p. 40, brackets in original, bold and italics added.) The Court of Appeal rejected this argument "for several reasons[:]" (*Id*.)

> First and foremost, a defeat every possible copyright and patent defense requirement appears nowhere in the text of the [TTA] statutes.

(*Lucent*, *supra*, 241 Cal.App.4th at p. 40.)

> Second, and as noted above, such a requirement is flatly inconsistent with our Supreme Court's holding that the licensee's product is "subject to" a copyright interest when that product "is a copy . . . or incorporates a copy of the" copyrighted work, and is "subject to" a patent when that product is made "us[ing]" the patented process. (*Preston, supra,* 25 Cal.4th at pp. 215-216.)[13]

(*Lucent*, *supra*, 241 Cal.App.4th at pp. 40-41.)

> Third, the Board's interpretation would, for all intents and purposes, foreclose any use of the technology transfer agreement statutes. The Board suggests that AT&T/Lucent has not met the Board's proffered new standard because AT&T/Lucent did not refute the possible ***copyright defenses*** of [i] implied license to make a single copy of computer programs [Citation]; [ii] of implied oral license [Citation]; [iii] of equitable estoppel [Citation]; [iv] of exhaustion [Citation]; [v] of the uncopyrightability of ideas and processes (citations omitted); and [vi] of fair use [Citation] and the ***patent defenses*** [i] of exhaustion [Citation]; [ii] of implied license [Citation]; and [iii] of equitable estoppel [Citation]. The Board has not adduced any evidence that these defenses might be at issue in this case; if no evidentiary showing is required, as the Board's argument suggests, then the defenses a taxpayer would have to refute are limited only by the Board's ingenuity and imagination. ***This is a profoundly unsound result. It would turn every taxpayer refund action involving the technology transfer agreement statutes into a full-blown copyright and/or patent trial***. Further, because it would obligate the taxpayer – who by statute bears the burden of establishing its entitlement to a tax exemption (§ 6091) – to refute every possible copyright and patent defense, ***the Board's interpretation would effectively nullify those statutes***. ***This is a result we cannot countenance***. . . . [S]ee *Soukup v. Law Offices of Herbert Hafif* (2006) 39 Cal.4th 260, 286 [46 Cal.Rptr.3d 638, 139 P.3d 30] [declining to adopt an interpretation of a statute

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[13] *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197, 208 [105 Cal.Rptr.2d 407, 19 P.3d 1148] ("*Preston*").

> because "it would require [a party] to identify and address every conceivable statute that might have had some bearing . . . and then prove a negative . . ."].)

(*Lucent*, *supra*, 241 Cal.App.4th at p. 41, bold, italics, and numerals in brackets added.)

Hence, including a requirement that a "copyright interest is needed" is directly contrary to the holding of *Lucent*.

Second, the proposed requirement for a showing that "the [hardwired or embedded] software provided embodies patent interests the seller intends to transfer to the buyer" (TTA Workshop Paper II, at p. 8) is ***irrelevant*** for, among others, the following reasons:

a. Under the patent prong of the TTA Statutes, all a taxpayer needs to show is that the software embodied at least one of the transferor's patents. If it did, then the software is patented. (See *ante*, at pp. 2-3.) Whether the patent embodied in the software is, or is not, the patent interest the transferor intended to transfer is not remotely relevant. The only relevant consideration is that the software transferred embodied one or more of the transferor's patents. If it did, then the taxpayer has met this requirement of the TTA Statutes. (See *Lucent*, *supra*, 241 Cal.App.4th at pp. 27, 36, 37.)

b. The transferor's intent is also entirely irrelevant to ascertaining the amount charged for the patented software. Under the TTA Statutes, the amount charged for the patented software is not dependent on whether "the software provided embodies patent interests the seller ***intend[ed]*** to transfer to the buyer." (TTA Workshop Paper II, at p. 8, bold and italics added.) The only appropriate inquiry is the retail fair market value of the TPP. Once that has been determined, the remaining amount charged under the TTA is for the patented software transferred, whether or not such software embodies the patent interest the transferor intended to transfer. (See §§ 6011, subdivisions (c)(10)(A), (B), (C) and 6012, subdivisions (c)(10)(A), (B), (C).).

Third, the proposed requirement that the patent interest the assignor or licensor "intend[ed] to transfer to the [assignee or licensee]" is the patent interest embodied in the software is a repackaging of the Board's argument in *Lucent* that AT&T/Lucent had to show which claim within each of its patents the software embodied. The *Lucent* court rejected this argument:

> The Board further argues that AT&T/Lucent never established which claim within each of its patents the software embodied and offered only conclusory declarations that the . . . patent-protected, yet these arguments are beside the point because there is no dispute that the software . . . embodied some portion of AT&T/Lucent's patents. ***Nothing in sections 6011 or 6012 requires any greater granularity of proof than was established here***. (Accord, *Preston*, *supra*, 25 Cal.4th at p. 214 ["The absence of the word 'copyright' in most of the Agreements is irrelevant."].

(*Lucent*, *supra*, 241 Cal.App.4th at pp. 36-37.)

Likewise, nothing in sections 6011(c)(10)(D) and 6012(c)(10)(D) requires any greater granularity of proof than to show "the software . . . embodied some portion of [the assignor or licensor's] patents." (*Lucent*, *supra*, 241 Cal.App.4th at p. 37. See also *id*. at pp. 27, 36, 37.) Having to prove (i) what was the patent interest the transferor intended to transfer and (ii) whether that patent interest was in fact the patent interest that was transferred, is precisely the type of granular proof the *Lucent* court said was not required.

Fourth, resolving the questions presented by the proposed presumption – (i) whether the "copyright interest is needed" and (ii) whether the patented and/or copyrighted software "embodies patent interests the seller intend[ed] to transfer to the buyer" – "would turn every taxpayer refund action involving the technology transfer agreement statutes into a full-blown copyright and/or patent trial." (*Lucent*, *supra*, 241 Cal.App.4th at p. 41.) *Lucent* held that this would be "a profoundly unsound result." (*Id*.)

Finally, the TTA Workshop Paper II refers to "patent interests" in the plural. The transfer of a single patent interest, however, is sufficient to create a valid TTA. As noted by our Supreme Court, "there would appear to be no limit on how narrow the scope of licensed [copyright] rights may be and still constitute a 'transfer' of ownership, . . ." (*Preston*, *supra,* 25 Cal.4th at p. 215, cleaned up.) Indeed, "[t]he transfer of a ***single*** copyright right is sufficient." (*Lucent*, *supra*, 241 Cal.App.4th at p. 37.) By extension, therefore, the transfer of a single patent interest is also sufficient.

D. Conclusion.

Based on the foregoing, if Amended Regulation 1507 were promulgated to include the proposed presumption regarding embedded or hardwired software, as outlined in the TTA Workshop Paper II, it would, we respectfully submit, be declared invalid.

CONCEPT NO. 3: Auditable Safe Harbor.

This is a great idea, but the audit should be limited to determining whether the transaction is a TTA Transaction. (See footnote 10, *ante*, page 4.)

For all the reasons articulated in the TTA Workshop Paper II and at the January 31 and June 27 workshops, it would be beneficial both to the CDTFA and the taxpayer community if Amended Regulation 1507 were to include a safe harbor.

A taxpayer availing itself of this safe harbor could, of course, be audited if the CDTFA determines it is appropriate to do so. The audit, however, should be limited to confirming whether the transaction is a TTA Transaction. (See footnote 10, *ante*, page 4.) If the audit confirms that the transaction is indeed a TTA Transaction, then that should be the end of the matter. The amount subject to the safe harbor would be deemed the amount charged under the TTA for the intangible personal property, which amount would not be subject to tax. The remaining amount charged under the TTA would be deemed to represent the retail fair market value of the TPP subject to tax.

We make this recommendation because we are concerned that if a taxpayer availing itself of the safe harbor were also audited as to the value of the TPP being transferred, the amount of additional work required of a taxpayer in such an audit would, we believe, discourage the use of the safe harbor.

Moreover, as the lively discussion at the June 27 workshop demonstrated, it is not at all clear what type of financial information a taxpayer would have to produce in such an audit. The audit would also require a CDTFA tax auditor(s) to devote substantial time and resources to auditing what would likely be a relatively small amount.

Hence, if Amended Regulation 1507 were to include a safe harbor – and we think it should – we respectfully submit the CDTFA and the taxpayer community work together to arrive at a mutually agreeable percentage that would ease the overall administration of the TTA Statutes while, at the same time, incentivize taxpayers to avail themselves of the safe harbor if, in their view, it makes economic sense to do so. And, as discussed, any audit should be limited to determining whether the transaction is a TTA Transaction.

CONCLUSION.

Again, we thank the CDTFA for organizing these two very productive workshops, preparing and distributing the two TTA Workshop Papers, and considering our comments, concerns, and suggestions.

If you have any questions or if we can be of further assistance, do not hesitate to contact me.

Sincerely,

Annissa Reed

Annissa Reed
Director
State and Local Affairs

Software Finance & Tax Executives Council

www.softwarefinance.org

August 20, 2024

Via Email

Aimee Olhiser
Chief, Tax Policy Bureau
Business Tax and Fee Division
California Department of Tax and Fee Administration
Tax Policy Bureau
Sacramento, California

Re: Further Comments on Technology Transfer Agreements

Dear Ms. Olhiser:

The Software Finance and Tax Executives Council (SoFTEC) is pleased to provide the following additional comments with respect to the CDTFA's continuing dialog with the business community with respect to the tax treatment of technology transfer agreements (TTAs) as they relate to transfers involving computer programs. As reflected in our prior comments, SoFTEC members assert federal law surrounding transfers of interests in copyright and patents play a central role in determining what federally created copyright or patent interests, if any, have been transferred from one party to another in a putative TTA. Below, we reiterate this assertion. These limitations on patent and copyright interests, if incorporated into regulations, will greatly reduce the tax administration complexity, which is our goal.

SoFTEC's members also appreciate the workshops the CDTFA has convened where issues surrounding the application of the TTA statutes to transactions involving computer programs were discussed. We ask that the CDTFA convene additional workshops where the application of federal copyright and patent law are the central topics of the discussion.

SoFTEC is aware of comments submitted by others suggesting the CDTFA, in any proposed regulations, "avoid TTA regulations that would place auditors in the position of needing specialized knowledge of intellectual property law…"[1] SoFTEC strongly disagrees with this position. One cannot make any determination whether interests in copyrights or a patents have been transferred without reference to the federal law that both created interest and controls if and to what extent any transfer has been made. SoFTEC asserts the need for "specialized knowledge of intellectual property law," specifically federal patent and copyright law, cannot be avoided.

Indeed, the California cases, to date, touching on the applicability of the TTA statutes to transactions used federal law as a guidepost in analyzing whether such federally created rights

[1] See Technology Transfer Agreement Workshop, Comments from SVLG, March 15, 2024.

were transferred. The *Preston* case from the California Supreme Court, the first case to involve the TTA statutes, started its analysis with a comprehensive set of citations to provisions of the Copyright Act that govern the creation of copyright interests and their transfer.[2] The two Court of Appeals cases that dealt with application of the TTA statutes to transfers of computer programs, likewise, refer to *Preston's* discussion of the federal creation of copyrights and patents and the federal law surrounding their transfer.[3]

A technology transfer agreement is an "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."[4] This definition can be broken down into two separate parts. The first part includes assignments or licenses <u>to make and sell a product</u> that is subject to the transferor's patent or copyright interest. The second part includes assignments or licenses <u>to use a process</u> that is subject to the transferor's patent or copyright interest.

As to the first part, as we made clear in our initial submission, whether a *sale* of an article of tangible personal property that included patented and/or copyrighted computer programs embedded in the article resulted in the assignment or license to the purchaser of any patent or copyright interest was inherently a matter of federal law. Federal law is clear such sales do not result in any such assignment or license. Under the patent exhaustion and copyright first sale doctrines, purchasers take title to the article of tangible personal property free and clear of any patent or copyright interest of the transferor.[5] Such transactions would not fall within the definition of a TTA.

The exhaustion doctrines apply to sales, not leases or licenses. Consequently, the question is whether the CDFTA has regulatory authority, for purposes of the sales and use tax, to provide that leases and licenses are the equivalent of sales for purposes of the TTA statutes. There could be authority for such a conclusion in the definition of "sale," which includes "any lease of tangible personal property…"[6] A "lease" includes a "license."[7] These statutory definitions, when applied to the TTA statutes, could give the CDTFA regulatory authority to conclude that lease and licenses of tangible personal property exhaust the lessor's or licensor's patent or copyright interests in the property.

The second part of the definition of TTA speaks in terms of assignments or licenses to use a process that is subject to the transferor's patent or copyright interest. Under federal law it is not possible to apply this part of the definition to copyright interests. The interests protested by the Copyright Act which are spelled out are narrow and are restricted to copying of copyright works, making derivative work, and distribution of copies to the public and similar rights. The

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[2] *Preston V. State Board Of Equalization*, 105 Cal.Rptr.2d 407 (2001), 25 Cal.4th 197, 19 P.3d 1148.
[3] *Nortel Networks Inc. V. Board Of Equalization*, 191 Cal.App.4th 1259 (Cal. Ct. App. 2011), 119 Cal. Rptr. 3d 905, and *Lucent Technologies, Inc. v. State Board of Equalization*, 241 Cal.App.4th 19 (Cal. Ct. App. 2015) 193 Cal. Rptr. 3d 323.
[4] Cal. Rev. and Tax Code §6011(c)(10)(D)
[5] *Impression Products, Inc. v. Lexmark International, Inc.*, 581 U.S. ___ (2017) (patent exhaustion), *Kirtsaeng v. John Wiley & Sons, Inc.*, 568 U.S. 519 (2013) (first sale doctrine).
[6] Cal. Rev. and Tax Code §6006(g).
[7] Cal. Rev. and Tax Code §6006.3.

Copyright Act does not give the owner of the copyright any exclusive right to "use" a copyrighted work, such as a computer program. Only patent holders can control how their patented processes are "used."

As with the first part of the definition, if a computer program embedded in an article of tangible personal property includes a patented process, if the article of tangible personal property is "sold," the patentee's interest in the article of tangible personal "exhausts." This same concept might also apply to leases and licenses of the tangible personal property. The purchaser of the tangible personal property would not take the property subject to any patent interest of the seller and the transaction would not fall within the definition of TTA.

Transfers of "information" protected by trade secret law that are not also protected by federal intellectual property law are outside the TTA statutes' scope. In order for "information" to qualify for copyright protection, there must be some independent creation plus a modicum of creativity.[8] Similarly, patent law, unlike copyright law, protects inventions, not information.[9] Transfers of non-copyrightable or patentable "information" inherently are transfers of intangible property. Whether they are subject to the sales or use tax is determined by other aspects of California's sales and use tax law. Agreements for the transfer of other "information," unless protected by patent or copyright law, will not qualify as TTAs.

We also are skeptical the TTA statutes could be construed as applying to consumer transactions. We use the definition of "consumer" from the Uniform Commercial Code as "an individual who enters into a transaction primarily for personal, family, or household purposes."[10] By this definition, consumers do not undertake transactions that give them to right to make and sell a product, activity that inherently is commercial in nature. Consumers thus would not qualify for TTA treatment under the first part of the definition. Likewise, because consumers "buy" their products in transactions that qualify as sales, no patent to copyright interest of the seller passes to the consumer because they "exhaust," failing the second part of the definition.

Also, just because a transaction involving tangible personal property and embedded software might be between two businesses does not automatically mean the transaction is a TTA. If the transaction results the sale of the tangible personal property it would result in the exhaustion of the transferor's patent or copyright interest in it such that it is not possible for the transaction to be a TTA under either part of the definition.

We are sympathetic to the tax administration complexity visited upon the CDTFA by the legislature's inclusion of the words "patent" and "copyright," which wholesale incorporates these two bodies of federal law into the California sales and use tax regime. Most importantly, application of the exhaustion doctrines referenced above go a long way towards reducing the number of transactions that would be eligible for TTA treatment. These limitations on patent and copyright interests, if incorporated into regulations, should significantly reduce the tax administration complexity.

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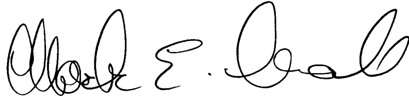
[8] *Feist Publications, Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340 (1991)
[9] 35 U.S.C. § 101.
[10] U.C.C. § 1-201(11).

We hope the CDTFA will schedule another public participation TTA workshop where these copyright and patent issues can be explored in more detail.

We hope you find these comments useful. I can be reached at (202) 486-3725 or mnebergall@softarefinance.org with any questions or requests for additional information.

Respectfully submitted,



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