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 1-916-322-4530
www.cdtfa.ca.gov

GAVIN NEWSOM
Governor

AMY TONG
Secretary, Government Operations Agency

NICOLAS MADUROS
Director

June 13, 2024

To Whom It May Concern:

The California Department of Tax and Fee Administration will be hosting a second workshop to discuss 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:

June 27, 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 507 695 335#. 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 August 9, 2024. 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

Scope

The California Department of Tax and Fee Administration (Department) will host a second workshop to discuss and receive input on technology transfer agreements (TTAs). The topics for discussion include: recommendations of the interested parties, concepts, which include rebuttable presumptions and an auditable safe harbor, other specific TTA topics, and any other TTA related topics raised by the participants.

Background

General

California imposes a sales tax measured by a retailer's gross receipts from the retail sale of tangible personal property (TPP) inside this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, § (RTC) 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. (California Code of Regulations, title 18, section (Regulation or Reg.) 1700, *Reimbursement for Sales Tax*.) It is presumed that all gross receipts are subject to the 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 6091.)

When sales tax does not apply, use tax is imposed upon the consumer, measured by the sales price of TPP purchased from a retailer for storage, use, or other consumption in California, unless specifically exempted or excluded from taxation by statute. (RTC 6201.) However, every retailer "engaged in business in this state" 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 California use tax that they fail to collect from their customers and remit to the Department. (RTC 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 6006.) 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 6011, 6012.) TPP is personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (RTC 6016.)

The TTA statutes

In 1993, subdivision (c)(10) was added to RTC 6011 and 6012 to specify the measure of tax when intangible property is transferred with TPP pursuant to a TTA. (Stats. 1993, ch. 887 (Assem. Bill No. (AB) 103 (1993-94 Reg. Sess.).) The TTA statutes 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." (RTC 6011, subd. (c)(10)(D) and 6012, subd. (c)(10)(D).)

The TTA statutes further provide 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. (RTC 6011, subd. (c)(10)(A) and 6012, subd. (c)(10)(A).) If

there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, TPP transferred under a TTA by using the price at which the TPP or like TPP was previously sold, leased, or offered for sale or lease, to third parties for a separate price. (RTC 6011, subd, (c)(10)(B) and 6012, subd. (c)(10)(B).) The TTA statutes also provide that in the absence of previous sales, leases, or offers to sell or lease, TPP or like TPP, to third parties for a separate price, the taxable measure is equal to 200 percent of the cost of materials and labor used to produce the TPP. (RTC 6011, subd. (c)(10)(C) and 6012, subd. (c)(10)(C).)

Regulation 1507

Regulation 1507, *Technology Transfer Agreements*, was originally adopted in 2002 to implement and interpret the TTA statutes and incorporate the California Supreme Court's holding in *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197 (*Preston*). Regulation 1507 defines the term TTA, explains the application of tax to transactions involving TTAs, and provides several examples illustrating transactions that do and do not constitute a TTA. Example 3 in Regulation 1507 provides that when a company leases a tangible device for a monthly charge and requires the lessee to pay separate charges each time it uses a patented process related to technology embedded in the internal design, assembly, or operation of the device, the separate charges are not made pursuant to a TTA and are part of the rentals payable for the lease of the device.

Nortel

In *Nortel Networks, Inc. v. State Board of Equalization* (2011) 191 Cal.App.4th 1259 (*Nortel*), the Second District Court of Appeal held that "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. The court held that the copyrighted prewritten software Nortel transferred to Pacific Bell on tangible storage media (disks, magnetic tapes, or cartridges) was exempt from 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 Technologies, Inc. v. State Board of Equalization* (2015) 241 Cal.App.4th 19 (*Lucent*), the Second District 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 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' and hence not in itself essential or physically useful to the later use of the intangible personal property." (*Lucent*, p 33.) The court held that the contrary provisions of subdivision (f)(1) of Regulation 1502 are not sanctioned by California's sales tax law. (*Lucent*, p. 34.) The court held that the transmission of Lucent's copyrighted prewritten software 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, and that the price of the blank tangible storage

media used to transmit the software was what was subject to tax under the TTA statutes. (*Lucent*, pp. 36 and 42.)

Interested Parties Meetings

During its meeting on March 30, 2016, the State Board of Equalization (BOE), the Department's predecessor, authorized staff to begin working on amendments to Regulation 1507 to clarify the requirements to establish that an agreement for the transfer of non-custom software[1] on tangible storage media, such as tapes or discs, is a software TTA, in accordance with the holding in *Lucent,* and clarify the measure of tax when software is transferred under a software TTA.

The BOE held an interested parties meeting on June 30, 2016, to discuss its initial proposed amendments to Regulation 1507, which were distributed with an Initial Discussion Paper. During the meeting, interested parties raised many questions and expressed their concerns with the proposed amendments. There appeared to be a general consensus among interested parties that the proposed amendments were not sufficient to properly codify *Lucent*. Most of the concerns expressed during the first interested parties meeting were reiterated in written comments the interested parties submitted to the BOE subsequent to the interested parties meeting.

After considering the written comments following the June 30, 2016, interested parties meeting, the Department distributed another discussion paper and held an interested parties meeting on November 5, 2019, to discuss a second draft of proposed amendments to Regulation 1507. Again, interested parties expressed concern with the proposed amendments, and no regulatory language was agreed upon.

Initial TTA Workshop

On January 31, 2024, the Department held a TTA workshop 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. 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 second 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 Initial TTA Workshop

Following the initial TTA workshop, the Department received written submissions from the Silicon Valley Leadership Group Tax Committee (SVLG), the Software Finance and Tax Executives Council (SoFTEC), CTIA, which is a trade association for the wireless communications industry, the California Taxpayers Association (CalTax), and Brendan Timmons. (Exhibits 1-5.) Several of the submissions expressed appreciation to the Department for holding

[1] Non-custom software refers to software that is not a custom computer program or programming as defined in RTC section 6010.9 and Regulation 1502.

the workshop and the submissions from CTIA and SVLG recommended that the Department host a second workshop in which the Department could explain its preliminary thoughts on the comments made during the initial workshop and in the written submissions following the workshop. The written submissions also included specific recommendations for the Department to consider prior to proposing any amendments to Regulation 1507 as further summarized below.

SVLG

SVLG said that the TTA regulations should place a great importance on the ease of administration, including the ability of taxpayers to correctly comply, and the ability of the Department to complete audits using less time and resources. SVLG said it would be helpful if the TTA regulations had examples, particularly of more common transactions, including those involving mergers and acquisitions. SVLG said that a rebuttable safe harbor provision could be helpful in easing the overall administration of the TTA statutes, particularly in the case of more routine transactions. SVLG also suggested that in circumstances where a vendor charges tax on less than the full selling price, the Department should consider developing an exclusion certificate for such transactions to insulate the vendor from potential liability, since the vendor would not be able to control or even know whether the purchaser used the product in a manner consistent with treatment as a TTA. (See Exhibit 1.)

SoFTEC

SoFTEC discussed whether transactions involving the transfer of hardware with embedded software are TTAs. First, SoFTEC said that in the embedded software context, the right to make and sell a product is generally not implicated. Second, SoFTEC provided background information on federal patent and copyright law, including the doctrine of patent exhaustion and the distinction between selling a copy of copyrighted software and granting a license to use copyrighted software. (See Exhibit 2.) SoFTEC said that if patented hardware with a copy of copyrighted and/or patented embedded software is sold, the transaction results in the exhaustion of the transferor's patent rights, the property transferred would not be subject to any patent interest of the transferor, and such a transaction would not fall within the definition of TTA. Also, the buyer becomes the owner of the copy of the embedded software. The buyer may make copies of that software as a necessary incident to its use with the hardware without infringing the copyright (17 U.S.C 117(a)(1)), and no copyright of the transferor is licensed to the transferee under federal law. So, the transaction is not a TTA because it did not result in the assignment or license of any right "to use a process that is subject to the patent or copyright interest" of the transferor. SoFTEC also said that in many cases where the set of coded instructions of the software is "hard wired," consists of so-called "microcode" or "firmware," or is stored in so-called "read only memory" (ROM), the making of a copy of the software as a necessary incident to its use is not required. Finally, SoFTEC said that in some cases an embedded software transaction might provide the transferee (1) with the right to use a patented process with respect to both the hardware and software and (2) with a license to make copies of the software incident to its use. However, the value of the right to copy and use the software within the hardware environment would be de minimis. (See Exhibit 2, pp. 1-4.)

SoFTEC also provided examples of software transactions and its analysis and conclusions as to whether each transaction is a TTA. SoFTEC concluded that the sale of a copy of copyrighted and patented computer application software transferred on disk with a perpetual license to copy and use the software is not a TTA because it does not give the purchaser any rights to make and sell products, the perpetual license of a copy of the software should be treated as a sale of the software for California sales and use tax purposes, and the value of the purchaser's right to make copies of the software to use it in a computer is de minimis. SoFTEC concluded that the sale of a copy of copyrighted and patented industrial manufacturing application software on a physical storage medium that when loaded causes equipment to make products that would infringe the seller's patent if sold without authorization, along with licenses to make and sell the products and to copy and use the software on the equipment, is a TTA because it includes a license to use the software to make and sell a product. SoFTEC concluded that a purchase of all the assets of a business is a TTA when it transfers patented and copyrighted software that the business developed for use in its business and/or for the sale of copies to customers, along with an assignment of all substantial rights in the software, including an assignment of the patent and copyright. SoFTEC also concluded that the sale of a smartphone covered by the seller's patents and copyrights with copyrighted and patented software embedded at the time of the sale, subject to a perpetual license to make copies of the software as necessary to use the smartphone, is not a TTA because it's an example of the type of embedded software transaction discussed earlier. (See Exhibit 2, pp. 5-7.)

SoFTEC also provided its industry proposal for amendments to Regulation 1507. The proposed amendments delete the requirement for a TTA to be evidenced by a writing and change "process" to "production process." They incorporate the doctrine of patent exhaustion, the distinction between sales and licenses of copies of software for copyright purposes, and they treat perpetual and "stated period" software licenses as sales for both purposes. They establish that the value of the right to make copies of a computer program as an incident to the use of the program is de minimis. They recognize that four specific transactions are TTAs: (1) any assignment of a patent or copyright interest, together with TPP, that results in the transfer of all substantial rights in the patent or copyright from the assignor to the assignee; (2) licenses of copyright interests necessary for the licensee to make and sell a product subject to the copyright; (3) licenses of the right to use a patented production process; and (4) transfers between related parties of copyright interests in computer software together with TPP. They also appear to exclude all other licenses of a copyright interest from the definition of TTA. (See Exhibit 2, pp. 8-9.)

CTIA

CTIA recommended that Regulation 1507 expressly state that the terms TTA and TTAs and the provisions of the TTA statutes themselves are to be broadly construed. CTIA recommended that Regulation 1507 should expressly state that software, the right to use such software, and/or software right to use assignments or licenses are and will always be intangibles based on the holdings in *Preston*, *Nortel*, and *Lucent*, and legislative history. CTIA recommended that Regulation 1507 expressly state that an agreement transferring embedded or pre-loaded software can qualify as a TTA, regardless of whether it is transferred on TPP that is essential or physically useful to the use of the software, based on the holdings in *Preston*, *Nortel*, and *Lucent*. CTIA said example 3 in Regulation 1507 deals with patented technology embedded in TPP, not embedded software, and recommended that the Department revise example 3 or add a new example to clarify that an agreement that assigns or licenses the right to use embedded or preloaded software, rather than embedded technology, can be a TTA. CTIA also said that the first workshop paper's reliance on *Nortel* regarding embedded software is misplaced. (See Exhibit 3, pp. 1-9.)

CTIA said that amendments to Regulation 1507 should establish a preponderance of the evidence standard for establishing the existence of a TTA. They should clarify that an agreement can be a TTA even if it does not expressly state that patent or copyright interests are being transferred or it only transfers a single patent or copyright based on the holdings in *Preston*, *Nortel*, and *Lucent.* They should clarify that declarations are sufficient to establish a copyright interest in software or that software is subject to a patent based on the holdings in *Lucent*. They should also expressly state that the TTA statutes do not require a showing that, but for the right-to-use assignments or licenses in a TTA, the assignee or licensee would be infringing on the transferor's patent or copyright interests because the court disagreed with that argument in *Lucent*. (See Exhibit 3, pp. 9-14.)

Lastly, CTIA provided consistent responses to some of the topics raised in the initial TTA workshop paper. CTIA said that the TTA statutes can apply to any agreement that meets the requirements to be a TTA, including an agreement that transfers embedded software or a three-party or four-party agreement. CTIA also said that the separately stated price for TPP in an arm's-length transaction should be considered reasonable and the Department should have the burden to establish that it's not reasonable. (See Exhibit 3, pp. 14-16.)

CalTax

CalTax said that the courts determined that the TTA statutes were written broadly in *Nortel* and *Lucent* and the guidance provided by those cases should be implemented without creating new limitations. CalTax recommended that the regulatory definition of TTA mirror its statutory definition, rather than limit its statutory definition. CalTax recommended adding language to Regulation 1507 that allows taxpayers to consider 25 percent of a TTA to be intangible personal property, thus creating a safe harbor with a rebuttable presumption that would allow a taxpayer to prove a higher percentage. CalTax said the safe harbor percentage was necessary to address issues establishing the cost of the labor and materials used to produce TPP and reasonable because some TTAs have a higher percentage of intangible personal property. CalTax said the TTA provisions should not be limited to business-to-business transactions because the TTA statutes do not include such a limitation. CalTax also said that it would be improper to create a subjective list of items of

TPP that can qualify to be part of a TTA based on the items' perceived importance, rather than follow the guidance provided in the statute and court cases. (See Exhibit 4.)

Brendan Timmons

Brendan Timmons said that the Department should clarify what is meant by "the assignment or license of the right to use a process subject to a patent interest" in the definition of a TTA, particularly regarding licenses to use software embedded in medical devices. (See Exhibit 5.)

Discussion

The Department appreciates the oral and written comments it has received and after considering the suggestions and recommendations, the Department would like to host a second TTA Workshop to focus on the following topics.

Recommendations from Interested Parties

The Department is open to further input on the suggestions, recommendations, and responses provided by the interested parties in Exhibits 1-5, including:

- The amendments to Regulation 1507 recommended by CTIA, CalTax, and SoFTEC, and suggested by SVLG.
- CTIA's responses to the topics raised in the initial TTA workshop paper.
- The 25 percent (25%) safe harbor recommended by CalTax and rebuttable safe harbor suggested by SVLG (as discussed in more detail below).
- SVLG's suggestion to develop a TTA exclusion certificate.
- CTIA's and Brendan Timmons' comments regarding licenses to use embedded software, rather than other embedded technology, and SoFTEC's analysis and conclusions regarding embedded software transactions.

Concepts

The Department seeks input on the following concepts 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 intent of this presumption is so that retailers of goods to consumers or businesses purchasing general consumable items (e.g., coffee machines), where they did not intend for the patent or copyright interest to be specifically bargained for and where the value of such interests are not readily identifiable as part of the transaction, do not have to determine the value of such interest. Further, based on a review of the original legislative intent of AB 103, it was intended to provide certainty to business taxpayers in the tax treatment of TTAs. This may be interpreted to indicate that the focus of the TTA provisions was for business-to-business transactions.

Thus, a rebuttable presumption could provide that for certain consumer transactions the value of the TPP generally equals the amount charged for the TTA transaction. This presumption may be rebutted by showing that the value of the TPP, as determined by RTC 6011/6012 (c)(10))(A)-(C), is less than the amount charged for the TTA transaction.

The Department seeks input on how to best define a consumer transaction. Some potential ways or combination of ways to define a consumer transaction would be as follows:

- An agreement where TPP is primarily sold for its functional purpose.
- An agreement where the seller has little intangible copyright or patent interests in the property being sold. For example, a retailer sells TPP which includes the right to use software embedded in the product, but the retailer does not have the rights to further sub-license the copyright or patent interest to the purchaser. In other words, the value of the intangible is likely minimal.
- An agreement where there is no evidence that the patent or copyright interest is specifically bargained for or valued as part of the transaction.
- An agreement where there is no evidence the purchaser intends to monetize the patent or copyright interest it receives.

Rebuttable Presumption Regarding Intellectual Property Rights Transferred with Embedded Software

The intent of this presumption is to address situations in which software is hardwired or embedded in machinery or equipment 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.

Thus, a rebuttable presumption could provide that with regards to a TTA involving the sale of TPP containing hard-wired or embedded software, the value of the TPP generally equals the total amount charged for the transaction, as determined pursuant to RTC 6011/6012, subdivision (c)(10)(C). That is, it is presumed that 200 percent of the cost of materials and labor used to produce the TPP is generally equal to the total amount charged. This presumption may be rebutted by showing that the value of the TPP, as determined pursuant to RTC 6011/6012 (c)(10)(A)-(C), is less than the amount charged. The Department seeks 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.

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.

An auditable safe harbor (a shelter harbor) could allow a taxpayer to treat a certain percentage (e.g., 20 percent) of the total amount charged under a TTA as the value of the intangible property transferred under that TTA. Upon audit, the taxpayer may support this by showing that the cost of the materials and labor used to produce the TPP reported for income tax or other accounting purposes does not represent more than a certain percentage (e.g., if the shelter harbor provision is 20 percent, then the cost of materials and labor used to produce the TPP, would need to be less than 40 percent) of the total amount charged under that TTA.[1] Where a taxpayer contends the value of the intangible property transferred under a TTA is greater than the shelter harbor percentage, the taxpayer could use the methods set forth in subdivision (c)(10)(A)-(C) of RTC 6011/6012 to derive such value instead of using the shelter harbor.

The Department seeks input on whether there should be a shelter harbor and whether the TTA statutes lend themselves to supporting a shelter harbor. If so, the Department also seeks input on a reasonable shelter harbor percentage, taking into consideration issues such as, but not limited to:

- A higher percentage runs the risk of a taxpayer taking the shelter harbor for transactions involving intangible property with a value significantly less than the shelter harbor percentage. This would potentially cause significant audit adjustments for taxpayers who avail themselves of this provision.
- A lower percentage would discourage taxpayers from using the shelter harbor, which would not serve the goal of easing the administration of the TTA statutes.
- The Department recognizes that the TPP at issue will vary by industry and seller and in turn, the value of the intangible property at issue will vary. Given that variation, how should the Department balance the potential administrative benefits of a shelter harbor against the benefits of more accurately valuing the TPP in particular transactions.

<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.

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

[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.

Summary

We invite you to participate in a second TTA workshop to be held on June 27, 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 August 9, 2024.

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

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

March 15, 2024

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

Re: Technology Transfer Agreement Workshop on January 31, 2024

Dear Chief Olhiser,

The Silicon Valley Leadership Group Tax Committee commends the CDTFA for holding the recent workshop to discuss and receive input on technology transfer agreements. In this regard, we urge the CDTFA to hold another workshop before completing any draft regulations to provide taxpayers with some preliminary reactions of the CDTFA to the discussion at the working group and written comments submitted per CDTFA's request for written comments by March 15. Having another working group session would provide taxpayers with the opportunity to provide additional comments more focused on considerations related to the CDTFAs preliminary views about TTA regulations.

A key objective that the CDTFA and taxpayers both share is that TTA regulations should place great importance on the ease of administration. The ability of taxpayers to correctly comply with TTA regulations and for both taxpayers and the CDTFA to complete audits in a timely way with less time and resources should be a priority. In this regard, it would be good to avoid TTA regulations that would place auditors in the position of needing specialized knowledge of intellectual property law or transfer pricing.

In furtherance of the ease of administration, it would be helpful if TTA regulations had examples, particularly of more common transactions, including those involving mergers and acquisitions.

If the CDTFA were able to include a safe harbor approach in TTA regulations, it could be helpful in easing the overall administration of TTA statutes, particularly in the case of more routine transactions. Taxpayers would definitely want the presumption to be rebuttable because it is realistic to assume that the level of safe harbor that might be acceptable to the CDTFA would be far lower than appropriate in certain circumstances. On the other hand, taxpayers recognize that a higher safe harbor level could lead to significant revenue loss without some limitation to prevent transactions involving a de minimis amount of value from patents or copyrights to be eligible for safe harbor treatment. We would also suggest that a reasonable safe harbor would probably be used in many transactions in which the value of the intellectual property component involved is higher than the safe harbor amount because it would not be worth the additional time and effort to establish a marginally higher level for the value of the intellectual property.

In circumstances where a vendor charges tax on less than the full selling price, we would suggest that the CDTFA consider developing an exclusion certificate for such transactions in order to insulate the vendor from potential liability since the vendor would not be able to control or even know whether the purchaser used the product in a manner consistent with treatment as a TTA.

The Silicon Valley Leadership Group looks forward to working with the CDTFA in the development of regulations regarding TTAs.

Best regards,
Dan Kostenbauder
Vice President, Tax Policy
Silicon Valley Leadership Group
24680 North First Street
San Jose, CA 95131
669-319-2852

TECHNOLOGY TRANSFER AGREEMENTS
AND EMBEDDED SOFTWARE

Statutes:

The definition of Technology Transfer Agreement (TTA) is:

(D) For purposes of this paragraph, "technology transfer agreement" 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.

Cal. Rev. and Tax Code §6011(c)(10)(D).

The federal Copyright Act (Title 17, U.S.C.) confers on the owner of copyright the exclusive rights to do and to authorize any of the following:

(1) to reproduce the copyrighted work in copies or phonorecords;

(2) to prepare derivative works based upon the copyrighted work;

(3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;

(4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;

(5) 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, to display the copyrighted work publicly; and

(6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

17 U.S.C. §106.

The federal Patent Act (title 35, U.S.C.) provides as follows:

§271. Infringement of patent

(a) Except as otherwise provided in this title, whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefor, infringes the patent.

Discussion:

Generally, the Copyright Act confers upon the owner of the copyright the right to make copies of computer programs and distribute them to the public. The Copyright Act does not bestow upon the copyright owner any exclusive rights regarding the *use* of computer programs.

The Patent Act protects the patent owner against the unauthorized making, using or selling the patented invention.

This discussion addresses the phrase in the TTA definition that includes within the definition an "agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to .... *to use a process that is subject to the patent or copyright interest*. [Italic added.] The focus is on when transactions involving so-called "embedded software" will come withing this part of the TTA definition.

In the embedded software context, which involves the transfer of hardware with software embedded in it, generally, the other part of the TTA definition that includes the transfer of "the right to make and sell a product" is not implicated.

In the embedded software context, the software is embedded in the hardware transferred to the transferor. Elements of both the hardware and the software may be protected by patent law. The copy of the computer software also is protected by copyright law. Any patent on the hardware and software would protect the patentee against unauthorized use of both the hardware and the software while the copyright on the software would protect against unauthorized copying of the software and distribution of the copies.

However, in the typical embedded software transaction, the exclusive right to distribute copies of computer programs to the public is not transferred. The only exclusive right, if any, that might be transferred in the typical embedded software transaction might be a limited right to make copies. In some cases, the software may be of a type that requires the making a copy of the software from a copy stored in the memory of the hardware to the random access memory (RAM). From the new copy of the software in the RAM, the set of coded instructions of the software can be read and executed by the central processing unit (CPU) of the hardware. The making of this copy is necessary for the use of the software. Without the transfer of the right to make such copies, the transferee would be unable to use the software without infringing the copyright.

In many cases, where the set of coded instructions of the software is "hard wired," consists of so-called "microcode" or "firmware," or stored in so-called "read only memory (ROM), the making of a copy of the software as a necessary incident to its use is not required. In some cases, such software can be updated using so-called "flash updates." The ability to update such software does not require the making of any copy of the computer program by

the transferee. Under these circumstances, no exclusive right under the copyright act is transferred. In these cases, no right to use a process subject to the transferor's copyright interest is assigned or licensed.

In some cases, the copy of the software is "sold" (as opposed to "licensed") along with the hardware. In cases where the copy of the software is "licensed" the transferor retains title to the software and gives the licensee the right to "use" the software. In cases where the copy of the embedded software is "sold" and title to the copy of the software passes, no violation of the copyright owner's exclusive right to copy occurs when the transferee makes copies of the software as a necessary incident for its use. See 17 U.S.C. § 117(a)(1). In such cases, no copyright interest of the transferor is licensed to the transferee.

In some cases, an embedded software transaction might provide the transferee (1) with the right to use a patented process with respect to both the hardware the software and (2) with a license to make copies of the software as an incident to its use. In such cases, care must be taken to allocate separately the selling/purchase price between the patent interests and the copyright interest.

Because the major benefit to the transferee of the embedded software is its use within the hardware's environment, the license of the right to make copies of the software as a necessary incident to its use should be *de minimis*. If the transfer of the copy of the software did not include the right to make such copies, the transfer of such rights likely would be implied by law. Without such copying rights, the transferee would be deprived not only of the value of the software, but also the value of the hardware in which the software is embedded. Where transfers of the right to make copies of software as a necessary incident of its use is of *de minimis* value, such transfers should be ignored under the doctrine of *de minimis non curat lex*.

In analyzing whether a transaction is a TTA under the part of the definition that includes transfers of the right "to use a process that is subject to the patent or copyright interest," attention must be paid to the patent exhaustion doctrine. Under this doctrine, which governs whether a transaction results in the transfer of patent rights to a transferee, if a patented product is *sold* to the buyer, the patent holder is said to have "exhausted" the patentee's patent rights in the product. If the sale of the hardware and/or the embedded software exhausts the patentee's patent rights, then the patentee retains no rights to restrict the transferee's use of the patented processes. In such a case, the property transferred would not be subject to any patent interest of the transferor. Such a transaction would not fall within the definition of TTA.

Thus, if:

(1) patented hardware
(2) together with copyrighted and/or patented software embedded in the hardware
(3) are transferred such that

(4) the transaction resulted in the exhaustion of the transferor's patent rights and
(5) the value of any right to copy the software is *de minimis*,

then the transaction is not a TTA because it did not result in the assignment or license of any right "to use a process that is subject to the patent or copyright interest" of the transferor.

TECHNOLOGY TRANSFER AGREEMENTS & SOFTWARE

EXAMPLES

I. Software Sold on Tangible Storage Media:

A. Computer Application Software: Perpetual License

FACTS: Software developer D has a copyrighted and patented software program. D markets and sells copies of the software to both consumers and businesses that facilitates word processing on a desktop computer. D delivers the copies of the software on a disk that allows the software to be copied and installed on purchasers' desktop computers. The end user license agreement ("EULA") has no term limit and, under the terms of the license, D retains title to the copy of the software. The EULA gives purchasers of copies of the software the right to make copies only as needed to permit the software to be use on a computer, such as by copying from the disk to the computers' hard drives and from the hard drives to the computers' random access memory (RAM) so the set of coded instruction representing the software can be read by the computers' central processing units (CPUs). The EULA does not give purchasers any rights to make and/or sell copies of the software.

CONCLUSION: The transaction is not a technology transfer agreement.

REASONING: While the transaction involved the sale of both tangible personal property (the disk) and intangible property (the software), for a transaction to be a technology transfer agreement (TTA), it must transfer either the right to (a) make or sell a product that is subject to a patent or copyright interest of the transferor or (b) use a process that is subject to patent or copyright interest of the transferor. Under the facts, purchasers of copies of the software receive no rights to make or sell copies of the software so the first part of the TTA definition is not met.

Under the facts of the example, D retains no rights to restrict further use of any process that is subject to the D's patent or copyright interest. Key to this conclusion is the perpetual nature of the license agreement. For purposes of the California sales and use tax, a perpetual license of a copy of computer software is treated as a sale of the copy. Because the transaction is treated as a sale of the copy, all the transferor's patent and copyright interests in the copy are treated as having been exhausted. In addition, because the transfer right to make copies of the software only for purposes of enabling use of the software in a computer is of *de minimis* value, such transfer is ignored for purposes of the TTA definition.

B. Industrial Manufacturing Application Software:

FACTS: Software developer S has a copyrighted and patented software program. The software is of a type that when loaded into specialized manufacturing equipment, it causes the manufacturing equipment to make products that, if sold without authorization from S, would

infringe S's patent. S transfers a copy of the software to manufacturer M on a physical storage medium. The transfer of the copy of the software is accompanied by a license agreement that gives M the right to both use the software to make the products and sell them. M also receives rights under the license to make copies of the software only by copying it from the storage media into the manufacturing equipment and further copies as needed to enable its use in the equipment. M does not receive any license to make copies of the software and resell them.

CONCLUSION: The transaction is a TTA.

RATIONALE: Because the license gives M the right to use the software to make a product and sell it, the transaction is a TTA.

II. Transfer of Software as Part of a Purchase of All the Assets of a Business:

FACTS: Company A seeks to buy company B. The transaction will be structured as a purchase of all the assets of company B. B's assets include patented and copyrighted software that B developed for use in its business and/or for the sale of copies to customers. The asset sale agreement includes the transfer of all B's physical assets to A together with an assignment of all substantial rights in the software, including an assignment of the patent and the copyright. After the transaction is complete, A records the assignment of the patent with the U.S. Patent Office and the transfer of ownership of the copyright with the U.S. Copyright Office.

CONCUSION: The transaction is a TTA.

RATIONALE: The transaction included the sale of both tangible personal property (B's physical assets) and intangible property (B's patents and copyrights in the software). An assignment of all substantial rights to a patent or copyright results in the transfer of all rights under the patent or copyright including rights to make and sell products and to use any process that is subject to the patent or copyright.

III. Transfer of Technology, Non-Exclusive License:

Company I manufactures and sells computer chips. I has developed proprietary patented and copyrighted processes and software that aid in the manufacture of the of its computer chips. I's computer chip products are so successful that its dominate market position has caught the attention of anti-trust regulators. I seeks to license the production of its computer chips to a competing third-party, A. I and A enter into a licensing agreement that permits A to manufacture chips using I's patented and copyrighted designs. As part of the licensing agreement, I transfers to A blueprints, paper designs, prototypes, computer chip samples and other tangible personal property needed by A to manufacture the competing chips.

CONCLUSION: The transaction is a TTA.

RATIONALE: The transaction includes the transfer of both tangible personal property (the blueprints, paper designs, prototypes, computer chip samples and other tangible personal property needed by A to manufacture the competing chips) together with patent and copyright licenses need to make and sell the computer chips and also transfers the right to uses processes that are covered by I's patents and copyrights.

IV. Sale of a Smartphone with Embedded Software:

Company X designs and markets to both businesses and consumers so-called "smartphones." The smartphones are covered by patents and copyrights owned by X. The smartphones include many copyrighted and patented software programs that are embedded in the hardware at the time of the sale of their sale. Many aspects of the smartphones' hardware are patented. X sells the smartphones subject to a perpetual license of the embedded software. The license of the software includes the right to make copies of the software as necessary to use the smartphone.

CONCLUSION: The sale of the smartphones are not TTAs.

RATIONALE: The transactions under which the smartphones are sold include both tangible personal property (the smartphone hardware) and intangible property (the patented hardware and the copyrighted and patented software). The transactions do not convey any rights to smartphone purchasers to make and sell smartphones. The sale of the smartphone exhausts any patent rights X had in the hardware. The transfer of the smartphone's software subject to a perpetual license to use any patented processes or make copies necessary to the use of the smartphone, under California sale tax law, is to be treated as the sale of the copy of the software, and, for TTA purposes, exhausts X's patent and copyright interests in the copy of the software.

INDUSTRY PROPOSAL

SALES AND USE TAX REGULATIONS-1507

TECHNOLOGY TRANSFER AGREEMENTS

Proposal: Add a new subparagraph to subsections (1) and (2) of section (a) of Regulation 1507 as follows:

(a) Definitions.

(1) (A) "Technology transfer agreement" means any 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 any ~~written~~ agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or any ~~written~~ agreement that assigns or licenses the right to use a production process subject to a patent interest.

(B) 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.

(2) (A) An agreement for the transfer of any tangible personal property that either exhausts the transferor's patent interest or constitutes a "first sale" under the Copyright Act, or both, in the tangible personal property is not a "technology transfer agreement." For purposes of the section, if a copy of a computer program is transferred together with tangible personal property then

(i) the transfer of a perpetual right to make copies of a computer program as an incident to the use of the computer program is treated as a "first sale" of a copy of the computer program,

(ii) the transfer of a right to make copies of a computer program as an incident to the use of the computer program for a stated period is treated as a "first sale" of a copy of the computer program for the duration of the transfer,

(iii) the transfer of a perpetual right to use a copy of a computer program is treated as the exhaustion of the transferor's patent interest in the copy of the computer program and

(iv) the transfer of a right to use a copy of a computer program for a stated period is treated as the exhaustion of the transferor's patent interest in the copy of the computer program for the duration of the transfer.

(2) (A) "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.

(B) Right to copy as an incident of use of software: The value of the transfer of the right to make copies of a computer program as an incident to the use of the computer program is *de minimis*.

(C) Assignments: Any assignment of a patent or copyright interest, together with tangible personal property, that results in the transfer all substantial rights in the patent or copyright from the assignor to the assignee is a "technology transfer agreement."

(D) Not all licenses of a copyright interest are within the definition of "technology transfer agreement" for purposes of this section. Only licenses of copyright interests necessary for the licensee to make and sell a product without infringing the licensor's copyright interest will be within the definition of "technology transfer agreement." A license of a right to use a computer program is not a license of a copyright interest for purposes of this definition of "technology transfer agreement." An agreement that licenses a patent interest is not a "technology transfer agreement" unless it licenses the right to use a production process that is subject to licensor's patent interest.

(D) Transfers between related parties of copyright interests in computer software together with tangible personal property are Technology Transfer Agreements.

March 15, 2024

Aimee Olhiser, Chief
Tax Policy Bureau
Business Tax and Fee Division
California Department of Tax and Fee Administration
Tax Policy Bureau
450 N Street, Sacramento, CA 95814
PO Box 942879, Sacramento, CA 94279-0092

Re: Suggestions and Comments to Contemplated Amendments to Regulation 1507

Dear Ms. Olhiser:

On behalf of the members of CTIA®, the trade association for the wireless communications industry, who participated in the January 31, 2024, Technology Transfer Agreement Workshop, we extend our appreciation for coordinating such an insightful event.

Accepting your kind invitation to provide written comments and suggestions following the workshop, set forth below are ideas for the California Department of Tax and Fee Administration ("**CDTFA**") to consider as it contemplates amending Regulation 1507, Technology Transfer Agreements[1] ("**Regulation 1507**") to, among other things, implement the holdings of *Nortel Networks Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259 [119 Cal.Rptr.3d 905] ("***Nortel***") and *Lucent Technologies, Inc. v. Board of Equalization* (2015) 241 Cal.App.4th 19 [193 Cal.Rptr.3d 323] ("***Lucent***").

Before circulating a new set of proposed amendments to Regulation 1507, however, on behalf of our members, we would like to join the other attendees of the January 31 workshop who recommended that the CDTFA host a follow-up workshop. If a second workshop were agreeable to the CDTFA, then at this second workshop, (i) it could provide its thoughts on the comments and suggestions made at the January 31 workshop and in subsequent written submissions, and (ii) participants could provide feedback to the CDTFA.

Here, then, are recommendations for the CDTFA to consider as it contemplates amending Regulation 1507[2]:

I. AMENDED REGULATION 1507 SHOULD EXPRESSLY STATE THAT "TECHNOLOGY TRANSFER AGREEMENTS" ARE TO BE *BROADLY* CONSTRUED.

To place an audit, an administrative proceeding, or a court case involving Revenue and Taxation Code sections 6011, subdivision (c)(10) and 6012, subdivision (c)(10)[3] (the "**TTA Statutes**") in the proper

[1] Cal. Code Regs., tit. 18, § 1507.

[2] We respectfully recommend that our suggestions for language that should be included in any amended version of Regulation 1507 ("**Amended Regulation 1507**") should also be included in those section(s) of the CDTFA Audit Manual dealing with technology transfer agreements.

[3] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

context, it is essential that Amended Regulation 1507 start with a declaration that "technology transfer agreements" (sometimes "**TTA**" or "**TTAs**"), as defined in sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D), are to be ***broadly*** construed.

Sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D) ***broadly*** define a "technology transfer agreement" 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." (Bold and italics added.) The California Supreme Court in *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 [105 Cal.Rptr.2d 407, 19 P.3d 1148] ("***Preston***") and the Court of Appeal in *Nortel* support such a broad interpretation:

- Sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D) "***broadly*** define a 'technology transfer agreement . . . .'" (*Preston*, *supra,* 25 Cal.4th at p. 213, bold and italics added.)
- "The Legislature ***broadly*** defined 'technology transfer agreement' to encompass the transfer of *any* copyright interest . . . ." (*Id.*, at p. 215, italics in original, bold and italics added.)
- "A TTA is ***broadly*** defined . . . ." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1269, italics in original, bold and italics added.)
- "The TTA statutes ***broadly*** encompass '*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.'" (*Id.*, at p. 1277, citation omitted, italics in original, bold and italics added.)

Including in Amended Regulation 1507 examples of agreements that qualify as TTAs would be helpful. These examples should make clear that no particular set of words is required for an agreement to qualify as a TTA. As long as the agreement provides, ***expressly or inferentially***, that 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 assignor or licensor' patent or copyright interest, the agreement is a TTA.

II. <u>AMENDED REGULATION 1507 SHOULD EXPRESSLY STATE THE TTA STATUTES THEMSELVES ARE TO BE *BROADLY* CONSTRUED</u>.

Lucent made this point: "Indeed, the [TTA] statutes' legislative history indicates that the Board warned the Legislature of how ***broadly*** the statutes could be ***construed***, and the Legislature enacted the statutes anyway." (*Lucent*, *supra*, 241 Cal.App.4th at p. 39, citation omitted, bold and italics added.)

III. <u>AMENDED REGULATION 1507 SHOULD EXPRESSLY STATE THAT SOFTWARE, THE RIGHT TO USE SUCH SOFTWARE, AND/OR SOFTWARE RIGHT-TO-USE ASSIGNMENTS OR LICENSES ARE, AND WILL ALWAYS BE, INTANGIBLES</u>.

A. <u>Our Proposed Language Is Supported by Case Authority</u>.

Preston, *Nortel*, and *Lucent* make clear that software, the right to use such software, and/or software right-to-use assignments or licenses are, and will always be, intangibles:

- The California Supreme Court noted that in *Intel*,[4] the decision of the State Board of Equalization ("**Board**") that the TTA Statutes sought to codify, the Board "***broadly*** defined 'intangible property' as 'the ***license to use*** the information under the copyright *or* patent.'" (*Preston*, *supra,* 25 Cal.4th at p. 216, italics in original, bold and italics added. See *id*. at pp. 216-217 ["To implement *Intel*, Assembly Bill No. 103[[5]] borrowed *Intel*'s ***broad definition of intangible property*** and exempted any transfer of such property from taxation." Bold and italics added].)
- "We conclude that the software licensed by Nortel is exempt from sales tax under the [TTA Statutes] . . . ."] (*Nortel*, *supra*, 191 Cal.App.4th at p. 1264.)
- Intangible personal property "is generally defined as property that is a 'right' rather than a physical object." (*Id.,* at p. 1269. See also *Navistar Internat. Transportation Corp. v. State Bd. of Equalization* (1994) 8 Cal.4th 868, 875 [35 Cal.Rptr.2d 651, 884 P.2d 108] ["[I]ntangible property (citation omitted) . . . is generally defined as property that is a 'right' rather than a physical object.").
- "Intellectual property is an intangible right . . . ." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1269.)
- "Intangible property includes a license to use information under a copyright or patent." (*Id*.)
- "Here, Nortel licensed the right to copy the diskette containing the SSP [Switch-Specific Program] onto Pacific Bell's switch, making this a valid license of a copyrighted interest under the TTA statutes." (*Id.,* at p. 1275.)
- "Pacific Bell . . . made continuous use of the ***intangible*** information contained on the disk, information that was necessary to run the switch. Pacific Bell's ability to use the information contained in the SSP was an ***intangible personal property right***." (*Id.,* at p. 1276, bold and italics added.)
- *Nortel* held that "the manufacturer was responsible for paying sales taxes only on the tangible portions of the transaction (the equipment and instructions), but not the ***intangible portions (the software and rights to copy and use it***)." (*Lucent*, *supra*, 241 Cal.App.4th at p. 25, bold and italics added.)
- "[T]he manufacturer's decision to give the telephone companies copies of the software on magnetic tapes and compact discs (rather than over the Internet) ***does not turn the software itself or the rights to use it into 'tangible personal property'*** subject to the sales tax, . . ." (*Id*., at p. 26, bold and italics added.)

[4] *Intel Corporation* (June 4, 1992) [1993-1995 Transfer Binder] Cal.Tax Rptr. (CCH) paragraph 402-675, page 27,873 ("***Intel***").

[5] Assembly Bill No. 103 ("**AB 103**") eventually became the TTA Statutes.

- A TTA within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D) "can exist when the only intangible right transferred is the right to copy software onto tangible equipment." (*Lucent*, *supra*, 241 Cal.App.4th at p. 26.)
- "As we conclude above, the fact that placing a computer program on storage media physically alters that media ***does not thereby transmogrify the software itself into tangible personal property***; the media is tangible, ***the software is not***." (*Lucent*, *supra*, 241 Cal.App.4th at p. 42, bold and italics added.)[6]

B. Our Proposed Language Is Also Supported by Legislative History.

The legislative history of the TTA Statutes also supports our recommendation that Amended Regulation 1507 expressly declare that software, the right to use such software, and/or software right-to-use assignments or licenses are, and will always be, intangibles for purposes of the TTA Statutes.

During the enactment process, the Board warned the Legislature that if the TTA Statutes were enacted, they would exclude from tax software transferred:

> In the case of a sale of ***computer software***, there usually is a licensing agreement which provides that the buyer may use the program only under certain conditions. The provisions of AB 103 could be interpreted to apply in this situation as the ***right [to] use a process***, i.e., the program. If this were true, the retailer of the ***software*** could segregate a portion of the program sales price as a sale of ***intangible*** personal property.

(State Board of Equalization Legislative Bill Analysis of AB 103, dated August 17, 1993, at pp. 3, 4, bold and italics added. A copy of this analysis is attached as Exhibit B to the CDTFA's Discussion Paper on Proposed Amendments to Regulation 1507, *Technology Transfer Agreements*, distributed on October 18, 2019.)

Notwithstanding the Board's expressed concerns quoted above, the Legislature enacted the TTA Statutes into law:

> The Legislature enacted the TTA statutes over the Board's objections. The Board warned the Legislature that the language covering licenses to "use a process" could mean the right to use a ***computer program***; this interpretation would ***exempt software licensing agreements*** that limit the buyer to conditional use of the program. This, in turn, would reduce state tax revenues. Despite the Board's

[6] CDTFA publication, titled "Software Technology Transfer Agreement," made available on the CDTFA website on or about September 11, 2023, states in part: "In order to establish that an agreement qualifies as a TTA, the taxpayer must be able to document that the retailer of the ***non-custom software sold in tangible form*** held patent or copyright interests in the software, and transferred the patent or copyright interests to the purchaser of the software under the terms of the agreement." Bold and italics added. This statement seems to us to be incorrect. As discussed, software is, and will always be, ***intangible*** for purposes of the TTA Statutes.

> concerns, the Legislature enacted the TTA provisions with the language to which the Board objected.

(*Nortel*, *supra*, 191 Cal.App.4th at pp. 1269-70, bold and italics added.)

IV. <u>AMENDED REGULATION 1507 SHOULD EXPRESSLY STATE THAT AN AGREEMENT TRANSFERRING *EMBEDDED* OR *PRELOADED* SOFTWARE *CAN* QUALIFY AS A TTA</u>.

A. <u>The TTA Statutes Leave No Doubt that an Agreement Transferring Patented and/or Copyrighted Software Embedded or Preloaded in TPP *Can* Be a TTA</u>.

As shown above, sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D) ***broadly*** 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." Bold and italics added.

Thus, ***any*** agreement under which the holder of a patent or copyright interest in software ***embedded*** or ***preloaded*** in tangible personal property ("**TPP**") (i) assigns or licenses to another person the right to use such embedded or preloaded software to make and sell a product (ii) or to use a process embodied by such embedded or preloaded software (iii) that is subject to the patent and/or copyright interest, is a TTA within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

Here is why:

- The first requirement of sections 6011, subdivision (c)(10)(A) and 6012, subdivision (c)(10)(A) that intangible personal property be transferred with TPP is met:[7] Intangible personal property (the embedded or preloaded software and the right to use it) is transferred with TPP (for example, the equipment or device into which the software is embedded or preloaded).
- The second requirement of sections 6011, subdivision (c)(10)(A) and 6012, subdivision (c)(10)(A) that such intangible and tangible property be transferred in a TTA is met if the agreement under which the holder of the patent or copyright interest in the software embedded or preloaded in the equipment or device (i) assigns or licenses to another the right to use such embedded or preloaded software to make and sell a product (ii) or to use a process embodied by such embedded or preloaded software (iii) that is subject to the assignor or licensor's patent and/or copyright interest. Such an agreement squarely meets the definition of a TTA as set forth in sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).
- The only thing left is to ascertain what part of the amount charged under the TTA is for the TPP, which is subject to tax, and for the intangible personal property, which is not. (*Lucent*, *supra*, 241 Cal.App.4th at pp. 31-32 ["[A] taxpayer who enters into a contract that qualifies as a technology transfer agreement is required to sort the tangible

[7] The full text of the relevant portion of sections 6011, subdivision (c)(10)(A) and 6012, subdivision (c)(10)(A) is as follows: "The amount charged for intangible personal property transferred with tangible personal property in any technology transfer agreement" is not subject to sales or use tax if the requirements of the TTA Statutes are satisfied.

personal property from the intangible, and to pay sales tax on the tangible personal property that is transferred but not on '[t]he amount charged for [the] intangible personal property transferred.'"]. See sections 6011, subdivision (c)(10)(A), (B), and (C), and 6012, subdivision (c)(10) (A), (B), and (C).)

B. *Nortel* and *Lucent*, Too, Leave No Doubt that an Agreement Transferring Patented and/or Copyrighted Software Embedded or Preloaded in TPP Can Be a TTA.

First, *Nortel* and *Lucent* confirm a technology transfer agreement is "***any*** agreement" that meets the requirements of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D). (E.g., *Nortel*, *supra*, 191 Cal.App.4th at p. 1277; *Lucent*, *supra*, 241 Cal.App.4th at p. 31, bold and italics added.)

- This definition covers the transfer of patented and/or copyrighted software in external storage media and then uploaded onto the equipment or the device, as in *Nortel* and *Lucent*. (*Nortel*, *supra*, 191 Cal.App.4th at pp. 1259-1279; *Lucent*, *supra*, 241 Cal.App.4th at pp. 19-45.)
- This definition also covers the transfer of patented and/or copyrighted software that is embedded or preloaded in the equipment or a device and then transferred in the equipment or the device itself.

That an agreement assigning or licensing the right to use embedded or preloaded software can be technology transfer agreement within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D), is plainly seen when the words "embedded or preloaded" are substituted for "prewritten"[8] in the *Nortel* opinion:

- "The TTA statutes do not restrict agreements transferring an interest in [embedded or preloaded] software. Instead, they apply to 'any agreement.'" (*Nortel*, *supra*, 191 Cal.App.4th at p. 1277.)
- "Because the TTA statutes cover '***any*** agreement' that involves the sale or license of copyrighted materials or patented processes, the Board cannot exclude [embedded or preloaded] software that is subject to a copyright or patent, thereby creating an exception that the Legislature did not see fit to make. (*Id*., bold and italics added.)
- "The Board exceeded its authority by excluding all [embedded or preloaded] computer programs from the definition of a TTA, even the licensing of a[n] [embedded or preloaded] program 'that is subject to [a] patent or copyright interest.'" (*Id*., at p. 1278.)
- "To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA [embedded or preloaded] 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." (*Id*.)

[8] In *Nortel*, Taxpayer Nortel Networks Inc. ("**Nortel**") challenged the validity of the provision in Regulation 1507, subdivision (a)(1) that had excluded from the definition of a TTA "an agreement for the transfer of ***prewritten software*** . . . ." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1277, bold and italics added.)

Second, the fact that the equipment or the device might be "essential" or "physically useful" to the use of the patented and/or copyrighted software embedded or preloaded therein is of no moment if the agreement transferring such software is a TTA within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

Here is why:

Prior to the enactment of the TTA Statutes, the "default rule" was (a) if a transaction involved both a taxable (tangible) and a not-taxable component, (b) if the not-taxable component of that transaction was an intangible, and (c) if the taxable tangible component and the not-taxable intangible component were "inextricably intertwined" rather than "readily separable," then . . .

- If the tangible component of the transaction was "essential" or "physically useful" to the subsequent use of the intangible component, the entire transaction was subject to tax. (See e.g., *Lucent*, *supra*, 241 Cal.App.4th at p. 31.)
- If the tangible portion of the transaction was not "essential" or "physically useful" to the subsequent use of the intangible component, no part of the transaction was subject to tax. (See e.g., *id*.)

"This default rule is thus an all-or-nothing affair; depending on the centrality of the tangible personal property to the subsequent use of the intangible personal property, either the entire transaction is taxable or it is not." (*Id*.)

But this is only the ***pre-TTA Statutes default rule***. (*Id*.)

In 1993, the Legislature enacted the TTA Statutes. The TTA Statutes set up a new, special rule that excludes from the definition of "sales" and "gross receipts" the amount charged for intangible personal property transferred with TPP pursuant to a TTA. (See §§ 6011, subd. (c)(10), 6012, subd. (c)(10); *Preston, supra,* 25 Cal.4th at p. 212; *Lucent*, *supra*, 241 Cal.App.4th at p. 31.)

In a TTA transaction, the taxable tangible component (e.g., equipment or device) and the not-taxable intangible component (e.g., patented and/or copyrighted software) are not "inextricably intertwined."[9] Rather, they are "mixed transactions"[10] in which the transfer of the tangible component is "readily separable" from the transfer of the intangible component. (See *Preston*, *supra,* 25 Cal.4th at p. 216 ["The Board held that [the] agreements [in *Intel*] created ***two separate and distinct transactions for tax purposes***. The first transaction involved the transfer of tangible personal property and was subject to sales tax. The second transaction involved the nontaxable transfer of intangible property." Bold and italics added.)

[9] The "essential" or "physically useful" test applies only if the tangible and intangible components are ***inextricably intertwined***. (*Lucent*, *supra*, 241 Cal.App.4th at pp. 30-33.)

[10] "[A] ***mixed transaction*** involving separately identifiable transfers of tangible and intangible property [is] distinguishable from a bundled sale of ***intertwined property***." (*Dell, Inc. v. Superior Court* (2008) 159 Cal.App.4th 911, 929 [71 Cal.Rptr.3d 905], bold and italics added, citations omitted.)

Thus, under the TTA Statutes, it is no longer an all-or-nothing affair. If the contract transferring intangible personal property with TPP qualifies as a TTA, then only the amount charged for the TPP is subject to tax. (*Lucent, supra*, 241 Cal.App.4th at pp. 31-32 ["Instead of sales tax liability attaching to ***all or none*** of the transaction," in a TTA transaction a taxpayer pays tax only on the amount charged for the TPP that is being transferred but not on the amount charged for the intangible component. Bold and italics added.].)[11]

It does not matter, therefore, that in a TTA transaction the equipment or device in which the patented and/or copyrighted software is embedded or preloaded might be "essential" or "physically useful" to the subsequent use of the software. As long as the elements of the TTA Statutes are met, the essential or physically useful test does not apply, and the amount charged for assigning or licensing the right to use the embedded or preloaded software is not subject to tax.[12]

Third, in its briefings to the Court of Appeal in *Lucent*, the Board did not distinguish between software on external storage media, such as the discs and tapes involved in *Nortel* and *Lucent*, and software that had been embedded or preloaded in equipment or a device.[13] Thus, the Board presented sub silentio the issue of embedded or preloaded software in the *Lucent* appeal. *Lucent*, however, did not limit its holding to external storage media; its holding therefore can be seen to apply to ***both*** (i) external storage media and (ii) embedded or preloaded software.

C. Regulation 1507, Subdivision (a)(1), Example No. 3 Should Be Revised – or a New Example Added – to Make Clear that an Agreement that Transfers Embedded or Preloaded Software Is a TTA If the Requirements of the TTA Statutes Are Satisfied.

1. Example No. 3 Should Be Revised or a New Example Added to Regulation 1507, Subdivision (a)(1) that Says a TTA Transaction *Can* Involve the Transfer of Embedded Software.

Regulation 1507, subdivision (a)(1), Example No. 3 ("**Example 3**"), to the extent here relevant, deals with patented technology embedded in the internal design, assembly or operation of a medical device,

[11] See also *Lucent*, *supra*, 241 Cal.App.4th at p. 36 ("The Board alternatively contends that, even if AT&T/Lucent's computer software is not itself tangible personal property, the transactions between AT&T/Lucent and the telephone companies are still subject to the sales tax ***in their entirety*** because the contracts underlying them do not amount to technology transfer agreements and thus fall under the default '***all-or-nothing***' rule . . . . The unspoken premise of the Board's argument is that the switches, documentation, software, and licenses are all inextricably intertwined, and thus not subject to the rule that independently assesses taxability for each 'readily separable' component of a transaction. . . . [But] "even if we assume these components are inextricably intertwined, the transaction is still not subject to the sales tax ***in its entirety*** because the contracts between AT&T/Lucent and the telephone companies ***meet the statutory definition of technology transfer agreements***." Bold and italics added.

[12] Although there is discussion in *Lucent* about whether a tape or a disc is "essential" or "physically useful" to the later use of the software (*id*., at p. 33), *Lucent* did ***not*** apply the essential-or-physically-useful test because the contracts at issue in *Lucent* were TTAs within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D). Therefore, the tangible and intangible components of the *Lucent* transactions were ***not*** inextricably intertwined, and, because they were not inextricably intertwined, the essential-or-physically-useful test was not triggered. The Court merely suggested that if it were to apply the test – ***which it did not*** – the Board would still lose because "California courts have on multiple occasions held that the transmission of 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' and hence not in itself essential or physically useful to the later use of the intangible personal property." (*Lucent*, *supra*, 241 Cal.App.4th at p. 33.)

[13] The Board argued that "[w]hen a consumer purchases a Dell computer, for example, that consumer is either explicitly or implicitly authorized to use Dell's ***patented processes*** and its ***pre-loaded***, copyrighted software utilities. Similarly, when a consumer purchases a tablet, e-reader, or smartphone, that consumer is implicitly or explicitly authorized to use the copyrighted software and patented hardware ***contained therein***." (Appellant's Opening Brief, at p. 30, bold and italics added.)[13]

not with embedded or preloaded software. Nevertheless, for purposes of clarity, and for the reasons discussed above, we respectfully suggest that Example 3 should be revised – or a new example added to Regulation 1507, subdivision (a)(1) – that makes clear an agreement that assigns or licenses the right to use embedded or preloaded ***software*** can be a TTA if it otherwise meets the statutory definition provided by sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

2. The TTA Workshop Paper's Reliance on *Nortel* Regarding Embedded Software Is Misplaced.

The CDTFA's January 17, 2024, Technology Transfer Agreements Workshop Paper (the "**TTA Workshop Paper**"), at page 2, under the "*Nortel*" heading, states in pertinent part:

> The [*Nortel*] court held that the copyrighted prewritten software Nortel transferred to Pacific Bell on tangible storage media (disks, magnetic tapes, or cartridges) was exempt from 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."

Bold and italics added.

To be sure, the *Nortel* opinion, in the part dealing with Nortel's switch-specific programs (SSPs), did refer to "an example given by the Board in regulation 1507, subdivision (a)(1), . . ." involving "a medical device that uses a separate patented process external to the device: . . ," i.e., Example 3. (*Nortel*, *supra*, 191 Cal.App.4th at pp. 1276.) The Court then noted that Nortel's patented processes for making telephone calls, the SSPs (the switch-specific programs), and the prewritten programs were all ***external*** to the switch equipment; they are not embedded in the hardware. (*Id*., at pp. 1276, 1278.)

Because Nortel's patented processes and the software into which those processes were embodied were ***external*** rather than embedded in the equipment (*id*., at pp. 1276, 1278), (i) Nortel had no need to challenge the validity of Example 3, and (ii) the *Nortel* court had no occasion to consider the validity of Example 3 to the extent it applied to embedded software assigned or licensed pursuant to an agreement that otherwise met the requirements of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

V. PROVING THE ELEMENTS OF THE TTA STATUTES.

We respectfully recommend that Amended Regulation 1507 should include the following regarding what a taxpayer needs to show – and does not need to show – to satisfy the requirement of the TTA Statutes.

A. The TTA Statutes Should *Not* Be Strictly Construed Against a Taxpayer. Rather, the Preponderance-of-the-Evidence Standard Applies to TTA Cases.

The TTA Statutes provide an exclusion from tax, not an exemption. (See *Lucent*, *supra*, 241 Cal.App.4th at p. 31 ["In 1993, our Legislature enacted the technology transfer agreement statutes and thereby set up a special rule for technology transfer agreements by ***excluding*** them from the definition of 'sales' and 'gross receipts.'" Bold and italics added.]. See also sections 6011, subdivision (c) ["'[s]ales price' ***does not include*** any of the following: . . ." bold and italics added"]; and 6012, subdivision (c) ["'[g]ross receipts' ***do not include*** any of the following: . . ." bold and italics added].)[14]

Because the TTA Statutes do not provide a tax exemption, they should ***not*** be strictly construed against a taxpayer. (Cf. *Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235 [139 Cal. Rptr. 3d 825, 274 P.3d 446] ["[S]tatutes granting tax exemptions must be strictly construed against the taxpayer, 'resolving any doubts in favor of the [taxing agency] (Citation omitted).'"]

Instead, a taxpayer in a TTA case need only establish the elements of the TTA Statutes by a ***preponderance*** of the evidence. (See *Paine v. State Bd. of Equalization* (1982) 137 Cal.App. 3d 438, 442 [187 Cal.Rptr. 47] ["The taxpayer must affirmatively establish the right to a refund of the taxes by a ***preponderance*** of the evidence . . . ." Bold and italics added]; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 745 [180 Cal.Rptr. 479] ["Honeywell has not established by ***preponderance*** of the evidence that it has paid excessive tax . . . ." Bold and italics added.]

To eliminate any doubt on this subject, Amended Regulation 1507 should make clear that in a TTA case the preponderance-of-the-evidence standard applies.

B. A TTA Need Not *Expressly* State a Patent or Copyright Is Being Transferred.

Amended Regulation 1507 should state that an agreement qualifies as a technology transfer agreement under sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D) even if it does not expressly state that patent or copyright interests are being transferred. As long as the intent to transfer such patent or copyright interests can be inferred, that is sufficient. As stated by *Nortel*:

> Nortel's licensing agreements with Pacific Bell do not expressly reference any patents or copyrights. The Board contends that the absence of such references means that the agreements are not TTA's. ***Neither the TTA statutes nor the Preston case requires that a TTA expressly reference a patent or copyright***. (See *Preston, supra*, 25 Cal.4th at p. 214 [absence of any reference to a copyright is "irrelevant"].) All that is required is that the licensed right be "subject to" the patent or copyright. (§§ 6011, subd. (c)(10)(D), 6012, subd. (c)(10)(D).)

(*Nortel*, *supra*, 191 Cal.App.4th at p. 1276, bold and italics added. See also *Preston*, *supra,* 25 Cal.4th at p. 214 ["The absence of the word 'copyright' in most of the Agreements is irrelevant. Although an

[14] To be sure, *Preston*, *Nortel*, and *Lucent* used words such as "exemption" and "exclusion" interchangeably. We submit, however, that they used these words in a conversational, rather than in a technical, sense. The question whether the TTA Statutes provide an exclusion, or an exemption was not presented in any of these cases. Had it been, we believe these courts would have held the TTA Statutes provide an exclusion, not an exemption, because sections 6011, subdivision (c)(10) and 6012, subdivision (c)(10) identify charges that are not included in – *i.e.*, excluded from – the definition of "sales price" and "gross receipts," as discussed in the text, above.

assignment or license of a copyright requires a 'writing' (17 U.S.C. § 204(a)), the writing need not mention the word 'copyright.'" Footnote and case citations omitted.].)

C. An Agreement that Transfers Only a Single Patent or Copyright Right Can Qualify as a TTA.

"[T]here would appear to be no limit on how narrow the scope of licensed [copyright] rights may be and still constitute a 'transfer' of ownership, as long as the rights thus licensed are 'exclusive.'" (*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.) A TTA "can exist when the only intangible right transferred is the right to copy software onto tangible equipment, . . ." (*Id.,* at p. 26.)

Amended Regulation 1507 should therefore state it is sufficient if an agreement transfers only a single patent or copyright right to qualify as a TTA under sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

D. No Documentation Needed to Establish a Copyright Interest.

Amended Regulation 1507 should state that no documentation, much less a certificate of registration from the U.S. Copyright Office, is needed to prove that a person holds a copyright interest in the software being transferred pursuant to a TTA.[15]

In *Lucent*, no documentation was presented to the court to establish that Taxpayers AT&T Corp./Lucent Technologies Inc. ("**AT&T/Lucent**") held a copyright interest in the software they were transferring. Instead, a witness testified by way of a sworn declaration that, based on his personal knowledge, all software at issue was subject to AT&T/Lucent's copyright interests.

This evidence was sufficient: "[T]he undisputed evidence indicates that AT&T/Lucent's computer software was copyrighted . . . ." (*Lucent*, *supra*, 241 Cal.App.4th at p. 36.) *Lucent* then rejected the Board's contentions that more was required:

> "The Board argues that AT&T/Lucent's evidence on this point was provided through the declaration[] of [a] person[] without personal knowledge, but th[is]

[15] A CDTFA publication, titled "Software Technology Transfer Agreement," published on or about September 11, 2023, appears to (mistakenly) advise to the contrary:

> In order to establish that an agreement qualifies as a TTA, the taxpayer must be able to ***document*** that the retailer of the non-custom software sold in tangible form held . . . copyright interests in the software, and transferred the . . . copyright interests to the purchaser of the software under the terms of the agreement. . . . [I]n the case of a copyright, the retailer must be able to provide a ***certificate from the U.S Copyright office*** or other reasonable and satisfactory ***documentation*** to establish original ownership or authorship of the copyrighted work. If the retailer obtained the . . . copyright interests from another party, the retailer must be able to provide written ***documentation*** to show that it held the . . . copyright interests at the time of sale. If you are the purchaser of the software seeking a refund, you will still be required to provide written ***documentation*** establishing that the retailer held the patent or copyright interests at the time of the sale.

> declaration[] specifically state[s] to the contrary. The Board further argues that AT&T/Lucent . . . offered only [a] conclusory declaration[] that the software was copyright . . -protected, yet these arguments are beside the point because there is no dispute that the software was a copyrighted work . . . . ***Nothing in sections 6011 or 6012 requires any greater granularity of proof than was established here.***"

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

E. <u>No Need to Establish Which Patent Claim(s) the Software Embodied When There Is No Dispute that the Software is Subject to the Transferor's Patent Interest</u>.

Amended Regulation 1507 should state that for an agreement to qualify as a TTA, the assignor or licensor of software need not establish which patent claims the software embodied if the CDTFA fails to adduce evidence to dispute that the software embodied some portion of the transferor's patents.

In *Lucent*, the Board had argued that AT&T/Lucent's agreements did not qualify as TTAs because, among other things, taxpayers "submitted conclusory declarations that simply announced that their software was 'subject to' their patents, but without identifying any specific claim in any patent, or explaining how any such claim should be construed." (Appellant's Opening Brief, at p. 17.)

Lucent rejected this argument: "[T]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***." (*Lucent*, *supra*, 241 Cal.App.4th at p. 37, bold and italics added.)

F. <u>A Transferor Need *Not* Show that "But for" the Assignment or License the Transferee Would Infringe on the Transferor's Patent and/or Copyright Interest</u>.

Amended Regulation 1507 should expressly state the TTA Statutes do not require a showing that, but for the right-to-use assignments or licenses in a TTA, the assignee or licensee would be infringing on the transferor's patent or copyright interests. Rather, all that needs to be shown is that the requirements of a TTA, as set forth in sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D), have been met, as was the case in *Preston*, *Nortel*, and *Lucent*.

In *Lucent*, the Board made this "but for" argument:

> [T]he 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 [the taxpayer's] patent or copyright interests when using the acquired software."

(*Lucent*, *supra*, 241 Cal.App.4th at p. 40, bold and italics added.) *Lucent* 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.

(*Id*.)

> 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.)

(*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 omitted); [ii] of implied oral license (citation omitted); [iii] of equitable estoppel (citation omitted); [iv] of exhaustion (citation omitted); [v] of the uncopyrightability of ideas and processes (citations omitted); and [vi] of fair use (citation omitted) and the ***patent defenses*** [i] of exhaustion (citation omitted); [ii] of implied license (citation omitted); and [iii] of equitable estoppel (citation omitted). 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 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 and italics added.)

VI. TTA WORKSHOP TOPICS

Here are our responses to some of the TTA Workshop Topics raised in the TTA Workshop Paper:

TTAs

CDTFA Topic: "How should the TTA statutes apply to the sale or use of TPP (e.g., machinery, equipment, hardware, household items, electronic devices, vehicles, etc.) transferred with intangible rights (including transactions where software is also transferred)?" (TTA Workshop Paper, p. 3.)

Response: It depends on whether the transfer of intangible rights, including the transfer of software, are transferred with TPP in an agreement that is a technology transfer agreement within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D). If they are, then under *Preston*, *Nortel*, and *Lucent*, the amounts charged for the intangible personal property, including the software being transferred, are not subject to tax under the TTA Statutes.

* * * * *

CDTFA Topic: "TPP may contain various types of software, including firmware, basic operational software, and application software. Additionally, some software is updated to the latest version when the TPP is connected to the internet or other networks. What are the circumstances when software transferred on TPP would be considered transferred pursuant to a TTA?" (TTA Workshop Paper, p. 4.)

Response: As discussed extensively above, if software transferred on TPP is pursuant to an agreement that is a TTA under sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D), the software should be considered transferred pursuant to a TTA. As to updates, the CDTFA Topic does not provide sufficient information to allow for an educated response other than to say that one would likely look to the TTA to see what, if anything, it says about updates.

* * * * *

CDTFA Topic: "How do you determine whether a copyright or patent interest is transferred to the consumer when they purchase TPP with software?" (TTA Workshop Paper, p. 4.)

Response: No response at this time.

* * * * *

CDTFA Topic: "For clarity, should the Department set forth a definition of embedded software to identify when the software is or is not considered to be transferred pursuant to a TTA?" (TTA Workshop Paper, p. 4.)

Response: This question seems to (impermissibly) assume that there could be instances where embedded software might ***not*** be considered transferred pursuant to a technology transfer agreement even though such an agreement qualifies as a TTA under sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D).

As discussed extensively above, if embedded software is transferred pursuant to an agreement that is a TTA within the meaning of sections 6011, subdivision (c)(10)(D) and 6012, subdivision (c)(10)(D), then that embedded software will ***always*** be transferred pursuant to a TTA, regardless of how the CDTFA might define embedded software.

* * * * *

Measure of Tax

CDTFA Topic: "Subdivisions (c)(10)(A) provide that the TTA may separately state a reasonable price for the TPP. How should the Department determine that the separately stated price for the TPP is reasonable?" (TTA Workshop Paper, p. 4.)

Response: If the CDTFA determines that the transaction is an arm's-length transaction, then the burden falls on the CDTFA to establish that the separately stated price is not reasonable.

* * * * *

Other CDTFA Topics on Measure of Tax: No response at this time

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Use of Intermediaries in the Supply Chain

CDTFA Topic: "A buying company purchases TPP containing copyrighted or patented software from the original holder and then resells or leases the TPP to related entities, which are the end users. Does the result change if the original holder transferred the copyright or patent interest directly to the related entity of the buying company that is the end user?" (TTA Workshop Paper, p. 5.)

CDTFA Topic: "An authorized retailer, not the original holder, sells TPP containing copyrighted or patented software." (TTA Workshop Paper, p. 5.)

Response: Although the CDTFA hypotheticals provide no information about the applicable terms and conditions of the underlying technology transfer agreements, these transactions can be, and often are, TTA transactions that meet the requirements of the TTA Statutes.

In addition, three-party or four-party transactions contemplated by the TTA Workshop Paper are not uncommon.

Professor Raymond T. Nimmer, in his book *The Law of Computer Technology*, at § 8:15 notes that "***[s]oftware leases*** . . . are ***common elements*** of three-party and four-party hardware lease transactions, providing a critical element to the hardware lease – the software-driven ability to productively use the leased computer." (*Id*., bold and italics added.)

Professor Nimmer then describes the same situation presented by the TTA Workshop Paper:

> In the relevant three- or four-party model in which the lessor [e.g., a procurement company ("ProCo")] primarily provides financial, rather than operational, support, the lessor-licensor [the ProCo] acquires a licensed copy from the primary licensor [the original holder] and delivers the copy of the software to the lessee [e.g., the operating company ("OpCo")] as part of a transaction in which the lessor-licensor [ProCo] pays for acquiring the copy and the lessee-licensee [OpCo] uses the software in return for paying a rental fee.

The respective rights that arise in a transaction of this nature are relatively clear:

> The lessee's [OpCo's] contractual commitments run to both the primary licensor [the original holder] and to the lessor-licensor [ProCo] directly: (1) a conditional, possessory relationship exists between the lessor-licensor [ProCo] and lessee-licensee [OpCo] that can be enforced by the lessor's [ProCo's] taking possession of copies of the software as between it and the lessee [OpCo]; and (2) a license exists between the primary licensor [the original holder] and both the lessor [ProCo] and the lessee-licensee [OpCo] that gives conditional use rights to the licensee [OpCo] that can be enforced as can any other license directly against the licensee [OpCo].

(*Id*., bold and italics added.)

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

Sincerely,

Annissa Reed
Annissa Reed
Director
State and Local Affairs

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

March 14, 2024

CalTax Comments in Response to the California Department of Tax and Fee Administration's Workshop on Technology Transfer Agreements

Thank you for the opportunity to provide comments and suggestions regarding the taxation of technology transfer agreements (TTAs) workshop held on January 31, 2024. We applaud the CDTFA for coordinating a workshop where taxpayers and CDTFA staff could come together in an informal setting and discuss TTAs. After many years with no action being taken to implement the precedential Court of Appeal decisions of *Lucent*[1] and *Nortel*[2], this is a step in the right direction.

General Observations

The arguments presented by taxpayers in November 2019, in response to the Department's proposed amendments to Regulation 1507, Technology Transfer Agreements, remain the same. The courts determined that the TTA statutes were written broadly and any regulation that narrows the courts' rulings would be inconsistent with state statute. In addition, the guidance provided in the court cases noted above should be implemented without creating limitations.

Specific Comments

Technology Transfer Agreement (TTA) definition

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."

[1] Lucent Technologies, Inc. v. State Board of Equalization, 214 Cal.APP.4th 19 (2015).
[2] Nortel Networks, Inc. v. State Board of Equalization, 191 Cal.App.4th 1259 (2011)

<u>Recommendation No. 1: Use the TTA Definition in the Statutes</u>

When the regulation is amended, we recommend that the regulatory definition be revised to mirror the TTA statutes. As we stated in our November 25, 2019, letter in response to the proposed amendments to Regulation 1507:

> The narrowing of the application of the TTA statutes to certain limited transactions was something the Legislature considered, as evidenced by the State Board of Equalization's analysis of AB 103 (Quackenbush, 1993). In its analysis, the BOE stated that one of the potential consequences of the bill would be that the "proposed exemption may be more broad than intended" and included several examples of how the TTA statutes could be more broadly interpreted to exclude portions of certain transactions from the sales and use tax. The Department of Finance also highlighted this potential broad application of the language in its enrolled bill report presented to then Governor Pete Wilson. Finance suggested that Governor Wilson veto the bill because of the concern that "this bill may result in a revenue loss due to a likely broader interpretation than currently practiced." The Legislature and the governor received these analyses and decided to pass the legislation with the potential broad language included. As a matter of fact, the *Lucent* court specifically states on page 39 of the opinion, "Indeed, the statutes' legislative history indicates that the Board warned the Legislature of how broadly the statutes could be construed, and the Legislature enacted the statutes anyway." (*Nortel*, supra, 191 Cal.App.4th at p. 1269, 119 Cal.Rptr.3d 905 ["The Legislature enacted the (technology transfer agreement) statutes over the Board's objections"])

<u>Method for determining the retail fair market value of Tangible Personal Property (TPP)</u>

For purposes of establishing the retail fair market value of TPP under a TTA, the statutes provide three methods:

i. The separately stated price of the TPP.

ii. 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 fair market value of the TPP subject to tax. The remaining amount charged under the TTA is for the intangible personal property transferred.

iii. 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 at 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.

However, most transactions do not disclose a separate price or the cost of labor and materials for the TPP, to protect the manufacturer's confidential trade information. Additionally, a separately stated price for transactions of like TPP with unrelated third parties may be unavailable.

Recommendation No. 2 – Create a Safe Harbor

To address the above situation where the cost of labor/materials for TPP is not separately disclosed, CalTax suggests adding language to the regulation that allows taxpayers to consider 25 percent of a TTA to be intangible personal property, thus creating a safe harbor with a rebuttable presumption that would allow a taxpayer to prove a higher percentage. To ensure the effectiveness of this provision, the 25 percent safe harbor would not be subject to audit. In addition, if a taxpayer claims to have a higher percentage, but is unable to provide sufficient proof to satisfy the CDTFA, that taxpayer would be allowed to utilize the safe harbor percentage.

Including a safe harbor in a regulation is not new. An example can be seen in Regulation 1502, where the tax agency added a safe harbor of 50 percent applied to optional software maintenance agreements:

> ***Regulation 1502(f)(1)(C)*** *– 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.*

During the workshop, CDTFA staff expressed concern that taxpayers might abuse a safe harbor provision. An example was given of a taxpayer with intangible property of 5 percent included in a TTA, using the safe harbor. The opposite also can apply. A taxpayer with a higher percentage of intangible property might settle for the 25 percent safe harbor rather than spend valuable time proving the higher percentage. Speculation of taxpayer abuse should not be a reason to dismiss the idea of including a safe harbor in the regulation, since there is no evidence such abuse will occur.

Recommendation No. 3 – Business-to-Business Limitation Should Be Rejected

During the workshop, there was some discussion regarding limiting the TTA provisions to business purposes only, i.e. "B to B" transactions. We do not agree. The TTA statutes do not include such a limitation. Since it does not appear that CDTFA is considering

sponsoring legislative changes to the TTA statutes, a business-to-business limitation in a regulation would be inconsistent with the statute. Therefore, all transactions should be considered in CDTFA's regulations, including business-to-consumer transactions.

Recommendation No. 4 – Do Not Create an Exhaustive List of Qualifications for TTA Eligible Properties

There was some discussion during the workshop as to what type of property should qualify and what should not. An example of an MRI machine qualifying as a TTA vs. a coffee maker not qualifying was used to stress this point. It woud be improper for the CDTFA create a subjective list of items that qualify based on the items' perceived importance rather than follow the guidance provided in the statute and court cases. To do so would create ambiguity and confusion, similar to what happened during the implementation of the "Snack Tax" many years ago, where tax administrators were left developing definitions for taxable foods vs. tax-exempt foods based on what they believed was a snack, i.e. one doughnut vs. a dozen doughnuts, or pork rinds made with real pork vs. artificial pork. The language of the proposed regulation should make it clear as to what qualifies, using specific guidelines and robust examples.

In summary, we agree with Director Maduros' statement that the goal is not to come up with a compromise, but to draft a workable regulation that is consistent with the statute approved by the Legislature and governor.

Thank you for the opportunity to comment. We are making progress and look forward to having a second workshop. If you have any questions, please contact me using the information provided below.

Respectfully submitted,

Joan Armenta-Roberts
Sales Tax Consultant
California Taxpayers Association

From: Brendan Timmons (US)
To: BTFD-BTC Information Requests
Subject: Re: [External] California Technology Transfer Agreement Workshop
Date: Thursday, February 1, 2024 5:29:43 AM

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Thanks for the quick response. Further clarification of this definition below would be helpful. TTA , as you know, is defined as either 1.) the assignment or licensing of copyright interest in TPP to reproduce or sell other property subject to the copyright interest or 2.) assignment or licensing a patent interest for the right to manufacture and sell property subject to the patent interest or 3.) assignment or licensing the right to use a process subject to a patent interest. Often more of the questions I receive are whether or not a transaction would qualify as a TTA under 3. For example, one of my clients has a lot of discussions with customers on tax associated with software embedded on medical devices. The software could or could not be considered to produce something tangible. The medical devices and software are not used for manufacturing TPP.

"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.

Brendan Timmons
PwC | Indirect Tax Senior Manager
Boston | Mobile: (508) 826 9770
PwC US Tax LLP
pwc.com

From: BTFD-BTC Information Requests <BTFD-BTC.InformationRequests@cdtfa.ca.gov>
Sent: Wednesday, January 31, 2024 4:39 PM
To: Brendan Timmons (US) <brendan.p.timmons@pwc.com>
Subject: RE: [External] California Technology Transfer Agreement Workshop

Hi Brendan,

Thank you for your input. I will share with the rest of the CDTFA team working on this issue once we receive additional comments. I think you make a good point and would note that the term "process" is currently defined in Regulation 1507 https://www.cdtfa.ca.gov/lawguides/vol1/sutr/1507.html in subdivision (a)(3). Perhaps, further clarifying that definition is something we will consider.

Thanks again for the suggestion.

From: Brendan Timmons (US) <brendan.p.timmons@pwc.com>
Sent: Wednesday, January 31, 2024 11:02 AM
To: BTFD-BTC Information Requests <BTFD-BTC.InformationRequests@cdtfa.ca.gov>

Subject: [External] California Technology Transfer Agreement Workshop

You don't often get email from brendan.p.timmons@pwc.com. Learn why this is important

To whom it may concern,

Hope this email finds you well.

I attended the California Transfer Agreement Workshop. There was a lot of good discussion. On behalf of my clients the question received most often is around what is meant by "the right to use a process subject to a patent interest" in the definition of technology transfer agreement in the regulation. Many of my clients provide software embedded in tangible personal property (e.g., medical devices) but are not licensing the right to make and sell the product. Defining "process" would help determine if these transactions qualify for a TTA.

Best,

Brendan

Brendan Timmons
PwC | Indirect Tax Senior Manager
Boston | Mobile: (508) 826 9770
PwC US Tax LLP
pwc.com

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