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California Sales Taxation of Computer Software

Ronald B. Schrotenboer

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Applying old laws to new technology often results in substantial uncertainty and controversy. Such is the case with the application of sales and use tax laws to transfers of computer software. State sales taxes\(^1\) are imposed on transfers of "tangible personal property." Transfers of intangible personal property are exempt from sales taxes. Further, most sales and use tax laws do not tax service transactions;\(^3\) however, fabrication of tangible personal property is taxable.\(^4\) Because of the uncertainty as to whether computer software constitutes tangible or intangible property, and to whether the development of a computer program constitutes a "service," there has been much controversy and uncertainty over

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\(^1\) State sales taxes are imposed on sellers in return for the privilege of selling tangible personal property at retail within the state. See, e.g., CAL. REV. & TAX. CODE § 6051 (West 1970). Use taxes are imposed on any person who uses tangible property in the state. See, e.g., CAL. REV. & TAX. CODE § 6201 (West 1970). The use tax is complementary to the sales tax and applies in situations where the sales tax does not. See CAL. REV. & TAX. CODE § 6401 (West 1970) The purpose of the use tax is to prevent discrimination against in-state businesses from out-of-state sellers who do not have to pay sales tax. Because sales and use taxes are so closely related, this article will use the term "sales" tax to cover both sales and use taxes, except where the differences between the taxes produce different results. See, e.g. infra notes 47-51.

\(^2\) See, e.g., CAL. REV. & TAX. CODE § 6051 (West 1970) ("For the privilege of selling tangible personal property at retail a tax is hereby imposed on all retailers . . . from the sale of all tangible property sold at retail in this state. . . .")

\(^3\) See, e.g., CAL. ADMIN. CODE tit. 18, R. 1501 (1972) [hereinafter cited as Sales Tax Reg.] ("Persons engaged in the business of rendering services are consumers, not retailers, of the tangible personal property which they use incidentally in rendering the service.").

\(^4\) See, e.g., CAL. REV. & TAX. CODE § 6006(f) (West 1970) ("Sale" includes "[a] transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer."). See also, Intellidata Inc. v. State Board of Equilization, 139 Cal. App. 3d 594, 188 Cal. Rptr. 850 (1983) (Payment to service bureau for keypunching services was taxable as payment for fabrication of punched cards).
whether, and in what situations, sales tax applies to transfers of computer software.

After discussing the case history of sales taxation of computer software, this Article will discuss current California sales tax law regarding computer software and its application to specific transactions. Throughout the discussion of current California law, ideas for structuring and documenting transactions to reduce or avoid sales tax will be presented.

I. Case History of Computer Software Sales Taxation

Computer software is a combination of tangible and intangible elements. The intangible elements include the function, internal design, and algorithms of the program. These intangible elements of software must be expressed on some tangible form, however, such as a diskette, tape, read-only-memory or random-access-memory, in order to be used by the computer. Because software has both tangible and intangible elements, questions have arisen whether software should be treated as tangible or intangible property for sales tax purposes.

Because sales tax applies only to sales of tangible personal property, sales tax administrators, as may be expected with any potential new source of revenues, have treated computer software as tangible personal property. But, because the value of a computer program (the intellectual content) is so much greater than the value of the tangible medium in which the program is contained and because computer programs can be transferred by a variety of different means so that any particular tangible medium is only incidental, taxpayers have argued that computer software is intangible property and thus not taxable.

Until 1983 all of the courts which dealt with the tangibility issue held that computer software was intangible property. The first in this line of cases was District of Columbia v. Universal Computer Associates. The case involved application of personal property tax to a computer and two computer programs, one prewritten and one custom, purchased with the computer. District of Columbia per-

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5. This Article uses the term "computer software" synonymously with "computer program." CAL. REV. & TAX. CODE § 6010.9(c) (West 1970) defines a computer program to mean "the complete plan for the solution of a problem such as the complete sequence of automatic data-processing equipment instructions necessary to solve a problem and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs."

personal property tax law applied to the programs only if the programs were tangible personal property.

Two aspects of the programs had significance to the court. The first was that the punched cards on which the programs were stored were of insignificant value. The court found that Universal Computer Associates paid IBM for the intangible value created by IBM's intellectual effort in creating the program stored on the punched cards, not for the cards themselves. Secondly, the court noted that computers can be programmed by means other than punched cards, *i.e.* electronic tapes, disks or directly by a programmer. Also, once the computer program was read into the computer, the punched cards could be destroyed without effecting the performance of the computer. Thus, the court stated that "what rests in the machine then, is an intangible — ‘knowledge’ — which can hardly be thought to be subject to a personal property tax."  

The holding of *Universal* was followed in *Commerce Union Bank v. Tidwell,* the first sales tax case to consider whether computer software constitutes tangible personal property. In *Commerce Union Bank* the taxpayer purchased operating system software and applications software on punch cards and magnetic tapes. The sole issue involved was whether the computer software constituted tangible personal property, which would render the purchases taxable under the Tennessee sales and use tax law.

The court noted that the information contained in the programs could be loaded into a buyer’s computer by several different methods. It could be programmed manually by a programmer, it could be loaded by remote terminal with the information transmitted by telephone, or it could be programmed by punch cards, magnetic tapes or disks containing the programs. Thus, what was created and sold was information. The magnetic tapes were only a method of transmitting these intellectual creations from the originator to the user. It was merely incidental that these intangibles were transmitted by the tangible reel of tape that was not retained by the buyer.

The court distinguished the sale of a phonograph record from the sale of a computer program tape because the phonograph record remained in the possession of the purchaser and the purchaser had

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7. *Id.* at 618.
8. 538 S.W.2d 405 (Tenn. 1976).
9. Computer software is generally licensed to the user rather than sold. Thus, the user is a licensee with restricted rights in the software rather than an owner or buyer. For simplicity, in this Article the term "buyer" will include "licensee," the term "seller" will include "licensor," and "sale" will include "license."
no other viable method of bringing the music into this home. In contrast, the court found that with a computer program the tape was only one method of transmitting the information to the buyer. Consequently, the court held that computer software was intangible personal property not subject to sales tax.

Since these cases, each court which considered the question found that sales tax did not apply to computer software transactions\(^\text{10}\) until two cases were decided one day apart in August of 1983, *Treasury Comptroller v. Equitable Trust Co.*\(^\text{11}\) and *Chittenden Trust Co. v. King.*\(^\text{12}\) In both cases the courts found that prewritten programs transferred on magnetic tape were tangible personal property subject to sales tax.

In *Equitable Trust* the taxpayer principally argued that the court conceptually should sever the program contained on the magnetic tape from the tangible tape itself. The argument was that the transaction should be viewed as (1) the transfer of intangible knowledge or information, and (2) the delivery of a tangible tape. The court determined that in order to separate the transfer it would be necessary to adopt the principle that the buyer's predominant purpose for a transaction controls the classification of the acquisition as either tangible or intangible. The court declined to do so. It noted there was no question that the services involved in the transfer did not predominate and that any intellectual effort rendered in the past in developing the programs was now embodied in the products for sale, the copies of the program. Although the value of the blank tape was insignificant compared to the price paid for the program, severing the intangible knowledge would run contrary to the legislative policy embraced in the definition of "price," which included the

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\(^{10}\) State v. Central Computer Servs., Inc., 349 So. 2d 1160 (Ala. 1977); First Nat'l Bank v. Bullock, 584 S.W.2d 548 (Tex. Civ. App. 1979); First Nat'l Bank v. Department of Revenue, 85 Ill. 2d 84, 421 N.E.2d 175 (1981); James v. Tres Computer Sys., 642 S.W.2d 347 (Mo. 1982); Maccabess Mut. Life Ins. Co. v. State, 122 Mich. App. 660, 332 N.W.2d 561 (1983). See also, Bullock v. Statistical Tabulating Corp., 549 S.W.2d 166 (Tex. 1979) (Keypunching services not taxable fabrication of property because true object is not data processing cards, but the purchase of processed data, an intangible); Janesville Data Center, Inc. v. Department of Revenue, 84 Wis. 2d 341, 267 N.W.2d 656 (1978) (same).


full retail sale price without any deduction for cost of materials, labor or service costs, or any other expense. Further, the court found that the act of severing the program from the tape was no different from the process of extracting information, pictures and sound from books, motion pictures, films, video display disks, phonograph records and music tapes — all of which are considered to be tangible. Transfers of such property escape taxation only if there is a statutory exclusion or exemption.

The court then reviewed the cases that had concluded that software was intangible property. The court rejected the reasonings of the various cases. The court rejected the statement in *Universal Computer Associates* that a program loaded into computer memory is knowledge. It found that what rests in the program memory is not "knowledge," but rather machine instructions. Further, the court stated that taxability of a prewritten program copy should not be determined by whether the buyer stores the program in memory or whether the buyer's computer memory is large enough to hold the whole program.

The court next considered *Commerce Union Bank* and rejected its additional reasons for intangibility. The court saw no merit to the argument that the program could be transferred by alternative means, such as telephone transmission or direct programming. Alternative methods had no significance over actual facts. Further,


15. The court later in its opinion says: "because a taxable transaction might have been structured in a nontaxable form, it does not thereby become nontaxable." 464 A.2d at 255. The Vermont Supreme Court in *Chittenden Trust* makes the same comment: "It may well be that the Bank could have procured, by way of telephone or personal service, the same programming information so as to avoid a use tax. To base the tax consequences on how it could have been structured 'would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred.' [citation omitted] This we will not do. The bank must accept the consequence of its choice to purchase the program in the form of a tape." 465 A.2d at 1102. The South Carolina Supreme Court in *Citizens and So. Sys. Inc. v. South Carolina Tax Comm'n*, also said: "We agree with the Supreme Court of Vermont... which held the bank had to accept the consequences of its choice to purchase the computer program in the form of a magnetic tape. ..." 280 S.C. 138, 311 S.E.2d at 719 (1984).

California also has decided that the form of a transaction governs sales taxation. In *Simplicity Pattern Co. v. State Board of Equalization*, 27 Cal. 3d 900, 167 Cal. Rptr. 366 (1980), the California Supreme Court rejected the argument for nontaxability that a sale of assets could have been structured as an exchange of stock which would have avoided tax. The court stated "The fact is, however, that here there was a different arrangement whereby plaintiff's subsidiary made a taxable sale of tangible personal property. It is perhaps an inevitable, but neither unique nor unconstitutional, consequence of applying revenue measures to sophisticated commercial arrangements that tax consequences sometimes vary according to
the fact that the program copy was not retained was not determinative. Intangibility, the court stated, should not be determined by the extent of use. After all, a book which is read only once remains tangible personal property.

Throughout its opinion the court makes reference to books, records, and films. No one contests that sales of these items do not escape taxation. Thus, the court reasoned, why should prewritten software transferred on magnetic tape escape taxation. The court took judicial notice that technology exists for producing a copy of a movie film on disk, of a phonograph record on tape, and of a book on microfiche. Moreover, a phonograph record does not become intangible because it is a reproduction of artistic effort, so a tape containing a prewritten program does not lose its tangible character because its content is a reproduction of intellectual effort. Because the court could discern no legally significant difference for sales tax purposes between the prewritten computer program on magnetic tape and music on a phonograph record, the court held that sales tax applied to the transactions.

The Vermont Supreme Court in *Chittenden Trust*, although not discussing all the previous cases, nevertheless reached the same conclusions as *Equitable Trust*. The court rejected the taxpayer's attempt to distinguish a computer program tape from other taxable personal property such as films, video tapes, books, cassettes, and records. In each case, the value of the property lay in its ability to store and later display or transmit its content. The court concluded a computer software tape is no different.

Only one related case has been decided since *Equitable Trust* and *Chittenden Trust* turned the tide toward taxation. The South Carolina Supreme Court, following the decisions in these two cases, reached the same result.\(^{16}\) Legislatures also have enacted laws recently which specifically include prewritten computer software as property subject to sales tax.\(^{17}\) Thus the trend is now toward tasa-

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\(^{17}\) See MINN. STAT. § 297A.02.3(a) (effective July 1, 1983) ("Sale" also includes the transfer of computer software, meaning information and directions which dictate the function
tion of prewritten programs transferred in a tangible form. Nevertheless, as discussed below, there are methods of structuring transfers of software to avoid sales tax.

II. CALIFORNIA SALES TAXATION OF PREWRITTEN COMPUTER SOFTWARE

A. History

In 1972 the California State Board of Equalization (the "State Board") issued a regulation covering Automatic Data Processing Services and Equipment. The regulation states that sales of prewritten computer programs on tangible media are subject to sales tax. The basis for application of tax is that the transfer of title or possession of tangible personal property, including property on which or into which information has been recorded or incorporated is a sale subject to tax. Tax, once it is applicable, applies to the entire amount charged to the customer including present or future license fees or royalty payments. This regulation regarding sales taxation of prewritten computer programs was never challenged in court.

However, in 1980 the California Supreme Court in Simplicity Pattern Co. v. State Board of Equalization considered whether film negatives and master recordings were tangible personal property subject to sales tax. In Simplicity Pattern the taxpayer made the same arguments for intangibility that had been made in the sales tax cases for computer software. The Supreme Court rejected the arguments. The taxpayer argued that the property was not tangible because the buyer's primary interest was not in the physical object, but rather in the right to exploit the intellectual products they embodied. The court considered that the negatives and master recordings might be treated as partially tangible. However, it found that when tangible property is transferred the amount subject to tax is the full amount received without any deduction for amounts paid for the property's intellectual or other intangible components. Further, the court found that the property was not transferred to be performed by data processing equipment and which are sold without adaptation to the specific requirements of the purchaser. This type of computer software, whether contained on tape, discs, cards, or other devices, shall be considered tangible personal property; TENN. CODE § 67-6-102 (13)(B) (1982); ARK. STAT. § 84-1903.5(a).

19. Id. § 1502 (c)(1) (1972).
22. Id. at 906.
solely for its intellectual content because the property was physically useful in the production of audio and visual educational aids. Neither was the sale of the property incidental to the transfer of services. Thus, the court found that the film negatives and master recordings were tangible personal property and that tax was due on their entire value without reduction for any intellectual content.  

Following the decision in *Simplicity Pattern* and passage of a provision which specifically states that custom programs are not taxable (thereby strongly implying prewritten programs are taxable), California law now is fairly settled that transfers of prewritten programs in tangible form are subject to sales tax. Nevertheless, there are methods by which prewritten computer software may be transferred with reduced or no sales tax.

**B. Electronic Transmission**

If a computer program is transferred by electronic transmission, sales tax does not apply. In that situation there is no transfer of tangible personal property; thus, there is no basis on which to impose sales tax. In the past the State Board required that all property under a software acquisition contract had to be electronically transmitted in order to avoid sales tax. Practical problems of transmission arose concerning the transfer of manuals and documentation for the program. In some situations, the seller would electronically transmit the program, but would deliver manuals and other documentation in a tangible form. Until April 1984 the State Board asserted tax on the entire consideration paid because any tangible property transferred provided the basis for tax on all payments under the acquisition contract.

In April 1984 the State Board changed its position so that now taxation of the manuals and documentation is incidental to the taxation of a computer program. Thus, if the program is transferred

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23. Id. at 912. In 1975, after the years in issue in the case, the California legislature passed Revenue and Taxation Code Section 6362.5 which provides that sales tax on master tapes or master records embodying sound applies only to the costs for producing the tangible elements of the master record or master tape.


25. The Note, *Software and Sales Tax: The Illusory Intangible* states that electronic transmission of software could be taxed as the remote fabrication of tangible property. 63 B.U.L. REV. 181, 210-11 (1983). The State Board has decided that electronic transmission of a computer program does not result in the fabrication of tangible personal property. Letters from the State Board Sales Tax Counsel to the Author (Feb. 11 and Apr. 12, 1982).

26. Letter from the State Board Sales Tax Counsel to the Author (Feb. 8, 1982).

27. Letter from the State Board Sales Tax Counsel to the Author (May 11, 1984).
by electronic transmission, then no sales tax is due even though the manual and other documentation are delivered in a tangible form. The transfer of tangible documentation in connection with the program does not convert the nontaxable transfer into a taxable one. Conversely, if the program is transferred in a tangible form, then the full amount is taxable.\(^2\)

If a separate charge is stated for the tangible documentation, then that amount is taxable, even though the program is electronically transmitted. The State Board treats the transaction as the sale of two different items; one of the items (the documentation) is taxable, while the other (the program) is nontaxable.\(^2\)

One uncertain situation is where preliminary versions of a pro-

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State Board also decided the same in a taxpayer appeal handled by the Author determined on Apr. 16, 1984.

28. The letter states "we conclude that written documentation transferred as part of the transfer of a computer program for a lump-sum charge should be taxable only to the extent the program itself is taxable. If the program itself is not taxable because the vendor has not transferred any tangible personal property, then the transfer of written documentation in connection with the program should not convert a nontaxable transaction into a taxable one."

29. The letter states "If there are separately stated charges for documentation, however, these charges would be taxable even if the transfer of the program itself is nontaxable. This is because the separate charges for the documentation would constitute either a transfer of tangible personal property produced or printed to the special order of a customer, or the transfer of a publication."

Although the Author is unaware of any regulation or ruling that electronic transmission will avoid sales tax in any other state, unless a state has a specific statute stating that transfers of computer programs regardless of form are taxable, no tax should apply in other states. Minnesota's sales tax statute which specifically taxes canned computer programs covers electronic transmission of software, according to an employee of the Minnesota Department of Revenue. The rationale for exemption in California is that no tangible property is fabricated. This rational should exempt tax in other states where the transfer of tangible personal property is necessary for sales tax to apply.

In Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976), the court in fact states at 408:

It does not appear that appellee has attempted to tax computer programs purchased by appellant which were transmitted to its computer from outside the state by way of telephone lines. That method of transmission, without question, constitutes the purchase of intangible personal property.

Moreover, the recent cases which tax transfers of prewritten software imply that tax would not be due if the programs were transmitted electronically. The court in Equitable Trust Co., stated:

Equitable's argument has merit, if the direct input by keyboard, without documentation, alternative (a service transaction) or the electronic transmission, without documentation, alternative (no tangible carrier) is the form of the transaction under consideration. 464 A.2d at 261.

Since the court keyed heavily on the tangible tape, it is logical that if there were no tangible tape the court would have decided that no sales tax applied. An unanswered question is how other states will treat the transfer of tangible documentation when the program is electronically transmitted.
gram are delivered in a tangible form to the buyer, but the final version is delivered by electronic transmission. In some situations a buyer will want to test a program to make sure it performs as it is supposed to. Thus, preliminary test versions will be delivered.30 Because electronic transmission can be a difficult and time consuming process, sellers of software may deliver preliminary versions of the program in a tangible form. The final version of the software, however, which is the version which the buyer will use in his business, is transmitted electronically. In this situation the State Board may argue that because tangible property containing a version of the program was delivered to the buyer, sales tax applies.

However, the final version is the version which the buyer uses and for which the buyer makes payments to the seller. This is particularly true in a software publishing agreement. The software publisher is acquiring the computer program in order to make copies to sell to the publisher's customers. Only the final version of the software is used to make copies to be sold to customers. Typically, a software publishing agreement will provide royalty payments (either a percentage of receipts or a fixed amount per copy) to the seller based on the number of copies of the software sold by the publisher. Only copies of the final version generate royalties, and thus payments are only made for that version of the software. If the buyer never received the final version, then no payments would ever be made to the seller. Thus, the consideration is only for the electronically transmitted copy, not for the preliminary versions transferred in a tangible form, and thus no sales tax should apply to the payments.

Further, the rationale that documentation and user manuals are incidental to the software also should apply to preliminary versions. Preliminary versions of the software are transferred in order to test the software to make sure it operates correctly and has all the features the buyer desires. Thus, similar to documentation and end user manuals, preliminary versions are incidental to the final version that is desired by the buyer, and no amount should be subject to tax.

Finally, if sales tax is assessed in this situation, the payment should be allocated only to the various items of tangible property

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30. Delivery of preliminary test versions to the buyer indicates that the transaction is the development of a custom computer program. If the program were prewritten, then no preliminary test versions would be necessary. See infra text accompanying notes 97-100 (concerning custom computer programs). However, preliminary test versions may be transferred where there are only modifications to a prewritten program which do not result in a custom program.
received in the transaction.\textsuperscript{31} The transfer of the tangible property under a contract in which intangible property is also transferred should not result in taxation of payments for the intangible property.\textsuperscript{32} Because the preliminary versions have minor value to the buyer and the buyer desires the final version, only a small portion of the payments should be allocated to the tangible preliminary versions.

In order to avoid any argument with the State Board that computer software in tangible form is transferred to the buyer, all versions of the software, including preliminary versions, should be delivered to the buyer by electronic transmission. No program code in tangible form should be delivered.

If a buyer or seller wishes to transmit the computer program electronically, the software acquisition agreement should contain specific provisions that the computer program will be transmitted electronically and that no part of the program will be transferred in a tangible form.\textsuperscript{33} Because of the State Board's change of position with respect to documentation, it no longer is necessary in California to require that the documentation also be transmitted. However, if there is not much difficulty in doing so, documentation should also be electronically transmitted.\textsuperscript{34} If there is no requirement for electronic transmission in the software acquisition agreement, the State Board auditors will assume the program was

\textsuperscript{31} An allocation between taxable and nontaxable items is required in a number of sales tax regulations. See Sales Tax Reg. § 1602(b) (If a package contains both food products and nonfood products and more than 10% of the retail value of the complete package represents the value of nonfood merchandise, a segregation must be made and the tax is measured by the retail selling price of the nonfood merchandise); Sales Tax Reg. § 1588 (fertilizer which is used to grow human food is nontaxable. If fertilizer is mixed with insecticide, then the price allocable to the fertilizer is not taxable); Sales Tax Reg. § 1521 (a lump-sum construction contract which includes the furnishing and installation of materials, fixtures and machinery requires allocation of the price to the various items); Sales Tax Reg. § 1595(b) (tax applies only to that portion of the gross receipts of the sale of a business that is attributable to the transfer of tangible personal property held or used in the course of activities requiring the holding of a seller's permit). See also California Board of Equalization v. Advance School, Inc., CCH CALIFORNIA TAX REPORTS ¶ 60-439.14 (N.D. Ill. 1980) (Court required an allocation of lump-sum fees between tangible property sold and services performed).

\textsuperscript{32} See infra text accompanying notes 73-89.

\textsuperscript{33} A provision such as the following could be used: "Manner of Delivery. All deliverable items will be transmitted by Author or Author's agent to publisher electronically via telephone at Author's expense. Author will not deliver any of the deliverable items in any tangible medium unless specifically agreed to by publisher in writing. Upon either party's reasonable request, Author and publisher will execute certificates attesting that such items were transmitted electronically."

\textsuperscript{34} Electronic transmission of documentation may be necessary to avoid sales tax in states other than California. See supra note 29.
transferred in a tangible form and thus is taxable.\textsuperscript{35}

In addition, the buyer or seller (whoever is obligated to pay tax) should obtain written statements from its employees and the other party stating that the program was transmitted electronically on a certain day. Evidence of electronic transmission will be harder to obtain when an audit starts, if the employees who handled the transmission have changed employment. Further, contemporaneously-produced evidence more easily will persuade an auditor that electronic transmission occurred. Any additional proof of electronic transmission also should be retained. If a third party is engaged for the transmission, invoices or statements should be obtained evidencing the electronic transmission.

C. \textit{Out-of-State Duplication}

Because sales taxation of software focuses on the tangible medium which contains the computer program, not using the tangible medium in California will also avoid sales tax, without having to transmit the software electronically to the buyer. Under this method the California buyer purchases the software on a tangible medium, but has the medium delivered to an office of the buyer outside of California. The out-of-state office then duplicates the software and any documentation onto a blank medium.\textsuperscript{36} The duplicate medium is then brought into California for use by the buyer. The original medium is left outside of California as a backup or destroyed, but is never used in California.

Payments made to the seller are not subject to California sales or use tax because the tangible property delivered by the seller, and to which the payment relates, is not used in California and the sale is not a California sale.\textsuperscript{37} Even though the software is used in California, no tax applies because the tangible property is not used in California.

The tax consequences do not change even if the seller is located in California. Sales tax law excludes from tax receipts where the

\textsuperscript{35} The Author is currently involved in a sales tax audit where no electronic transmission was required in the acquisition agreement, but the computer program was actually electronically transmitted. In this situation the auditor has assessed tax, although the issue is on appeal.

\textsuperscript{36} Because the State Board has determined that documentation is incidental to a software program, it is probably not necessary that the documentation be duplicated. However, since the program is being duplicated, one can avoid any challenge by the State Board if the documentation is also duplicated and only the duplicate documentation is brought into California.

\textsuperscript{37} Letter from the State Board Sales Tax Counsel to the Author (June 8, 1984) [hereinafter cited as June 8 letter].
tangible property is required by contract to be shipped, and is shipped, to a point outside California by facilities operated by the seller, or by delivery by the seller to a carrier for shipment to the out-of-state point. Thus, the seller is not subject to any sales tax on the transaction.

California will only subject to tax the cost of the blank duplicate medium which is brought into California because that is the only tangible property used in California and its cost (as a blank) is the only payment by the buyer for that tangible property. If a third party duplicates the original medium, the payment for these costs will also be subject to California tax as fabrication labor.

Naturally, the duplication should occur in a state which has no sales or use tax or exempts prewritten programs from sales and use tax. Otherwise, tax in that state would apply to payments by the buyer to the seller for use of tangible property (the duplication of the property).

If this method of acquisition is used, the software acquisition agreement should state that the tangible medium containing the program is to be delivered to the buyer's out-of-state office and that no tangible property is to be delivered to the buyer in California. Statements from employees should be obtained shortly after duplication of the program stating that the program was received in the out-of-state office directly from the seller, that it was duplicated in that office and that only the duplicate medium was sent to California. If a third party is used to duplicate the software, invoices should be retained to prove the out-of-state duplication. As with electronic transmission, contemporaneously produced evidence more easily will convince an auditor, particularly if the evidence conforms with requirements for delivery set forth in the software acquisition agreement.


39. June 8 letter, supra note 37. If the duplicate medium is purchased outside of California, the payment for the medium will be subject to California use tax, but California will allow a credit for any sales tax paid to another state. Cal. Rev. & Tax. Code § 6406 (Deering 1975).


41. Alaska, Delaware, Montana, New Hampshire and Oregon do not have any sales or use tax.

42. A provision such as the following may be used: "The Author shall deliver all deliverable items to publisher's office in __________. Author will not deliver any of the deliverable items in any tangible medium to publisher in California, unless agreed to by publisher in writing."
D. **Software License: Sale or Lease?**

A “sale” for sales tax purposes is defined to include a lease of tangible personal property in any manner or by any means whatsoever for a consideration, except for certain specified exclusions which are not relevant to software transactions.\(^43\) A sale is defined to include a lease of tangible property in order to prevent the avoidance of sales tax by transferring only the use of the property rather than transferring full ownership. Generally, there is no distinction between property sold or leased for sales tax purposes; however, in some situations there is an important difference between a true lease and a sale.

1. **Tax Differences Between a Sale and Lease**

Sales tax is an accrual tax.\(^44\) A seller may not pay sales tax on a cash basis nor on an installment basis. Thus, sales tax has to be paid at the time a sale is completed, even though payment is not received from the buyer until later. If payment is not received later from the buyer, the seller will be allowed a bad debt deduction.\(^45\)

If a transaction is a lease, however, tax is reported and paid during the period in which the lessor receives the lease payments from the lessee.\(^46\) Thus, if a transaction is a lease, the taxpayer can defer the tax over the period for which rentals are received, rather than paying the full tax at the inception of the transaction.

The tax resulting from a lease is a use tax imposed on the use of the tangible property by the lessee.\(^47\) The lessor is required to collect the use tax from the lessee at the time the rental payments are received. The lessee is not relieved from liability for the use tax until he is given a receipt for the tax by the lessor or the tax is paid to the state.\(^48\) If the lessee is not subject to use tax (for example, the lessee is the United States government), then sales tax applies to the

\(^{43}\) CAL. REV. & TAX. CODE § 6006(g) (Deering 1984). See also Sales Tax Reg. § 1502(f)(1) (1972) (provides that sales tax applies to a lease of a prewritten computer program).

\(^{44}\) See Sales Tax Reg. § 1641(c) (1970).

\(^{45}\) CAL. REV. & TAX. CODE §§ 6055, 6203.5 (Deering 1975). See also Sales Tax Reg. § 1642 (1980).

\(^{46}\) Sales Tax Reg. § 1660(c)(1) (1984). See also CAL. REV. & TAX. CODE § 6457 (Deering 1975). If a sale is made with contingent payments, so that at the time of sale the full price is not known, the State Board collects the tax as payments are made. Thus, tax is payable at the same time as a lease, even though the transaction is a sale. The State Board allows this because it is the only administrative way to handle the tax on contingent payments.


lessor. The amount of sales tax is measured by the rental payments.\textsuperscript{49}

That the tax under a lease is a use tax is important with respect to which party is legally obligated to pay the tax. If the transaction is a true lease and the lessor fails to collect the use tax from the lessee, the state may assess and collect the tax from the lessor. Even if the lease agreement does not require the lessee to pay or reimburse the lessor for the tax, the lessor has a legal right to require the lessee to reimburse him for the use tax paid to the state.\textsuperscript{50} However, if the transaction is a sale rather than a true lease, the legal obligation for the tax is on the seller/lessor. Unless sales tax is collected at the time of the transaction, or there is an agreement that the lessee/buyer must pay any sales tax, the seller may not later require the lessee/buyer to reimburse him for the sales tax.\textsuperscript{51} If the lessor/seller in a transaction which is not a lease wants to shift the economic burden of the tax to the lessee/buyer, the seller must provide in the agreement that any sales or use tax is to be paid by the lessee/buyer. If any sales tax is later assessed against the lessor/seller, the lessor/seller will have a contractual right to require the lessee/buyer to reimburse him.

Whether a transaction is a sale or a lease also makes a difference if the transaction is the first transaction of the seller/lessor. California use tax applies only if tangible personal property is purchased from a “retailer.”\textsuperscript{52} A retailer is defined to include every seller who makes a retail sale\textsuperscript{53} and is further defined to include any person making more than two retail sales of tangible personal property in any twelve month period.\textsuperscript{54} A “seller” is specifically defined to include “every person engaged in the business of selling tangible personal property of a kind the gross receipts from the retail sale of which are required to be included in the measure of sales tax.”\textsuperscript{55} Finally, a “retail sale” is “a sale for any purpose other than resale in the regular course of business in the form of tangible personal prop-

\textsuperscript{49} Sales Tax Reg. § 1660(c) (1981). A lesor who leases tangible personal property in substantially the same form as acquired by the lessor may elect to pay use tax measured on his purchase price at the time of purchase. In such a case use tax is not due on the rentals received by the lessor. See Sales Tax Reg. § 1660(c)(2) (1981). A lessor may elect to pay tax on the purchase price if the purchase price is substantially less than the rentals under the lease.\textsuperscript{50}


\textsuperscript{53} Id. § 6015(a) (West 1970).

\textsuperscript{54} Id. § 6019 (West 1970).

\textsuperscript{55} Id. § 6014 (West Cum. Supp. 1984).
Putting all the definitions together, a retailer is either a person engaged in the business of selling tangible personal property or a person who makes more than two retail sales of tangible personal property during any twelve month period.

If property is purchased for use in California from a person who is not a "retailer," use tax will not apply and the person, because he is not a "retailer," will not be subject to sales tax. If the purchase is from a person who has not previously made any sales, the purchase is not from a retailer. A ruling from the California State Board of Equalization Sales Tax Counsel ("Sales Tax Counsel") states that

when a purchaser makes a purchase from a seller who has not previously made sales the purchaser cannot be said to have made the purchase from a 'retailer.' The purchaser's liability cannot be contingent upon subsequent acts by the seller which will be unknown to the purchaser. The purchaser cannot be reasonably be held to ascertain from the seller who... may be out-of-state whether he makes additional sales within the twelve months following.57

Thus, if a California user acquires software from an out-of-state seller and the sale is the first sale made by the out-of-state seller, the purchase will not have been made from a retailer and California use tax will not apply to the transaction. Because the seller is located out-of-state, neither will any sales tax apply.

The Sales Tax Counsel ruling goes on to state, however, that the situation is different where the question is whether the seller owes sales tax. In that situation when a third sale is made, the seller knows that he has made three sales in a twelve month period and is in a position at that time to make a return and payment of sales tax on the gross receipts from all of the sales, including the initial sale.

The granting of possession of tangible personal property by a lessor to a lessee or to another person at the direction of lessee is a continuing sale in California by the lessor for the duration of the lease with respect to any period of time the leased property is situated in California.58 The State Board interprets this to mean that a lessor, upon entering into his first lease transaction, is engaged in the business of selling tangible personal property because the lease is deemed a continuing sale in California for the duration of the lease.

56. Id. § 6007 (West 1984).
In the lease situation the State Board says that the Sales Tax Counsel ruling with respect to the first sale from a seller does not apply. The seller is a retailer from the beginning of the lease transaction. Therefore, any purchase, including the first purchase (lease), is from a retailer. Consequently, use tax would apply with respect to the first lease of property from an out-of-state lessor.

2. Determining Whether a Transaction is a Sale or Lease

Although the question whether a transaction is sale or lease is important in certain situations, there is very little authority on how this determination should be made. A sale is defined to include a transaction “whereby the possession of property is transferred but the seller retains title as security for the payment of the price.” Further, regulations state that where a contract is designated as a lease which binds the lessee for a fixed term, and the lessee is to obtain title at the end of the term upon completion of the required payments or has the option to purchase the property for a nominal amount, the contract will be regarded as a sale under a security agreement from its inception and not as a true lease. Further, the option price will be regarded as nominal if it does not exceed $100.00 or 1% of the total contract price, whichever is the lesser.

Software is often transferred to a user under a license agreement. Under the license agreement the user is often restricted in his use of the software. For instance, the software licensee may be restricted from transferring the software to others, from using the software on other than a designated central processing unit, from disclosing any confidential information relating to the software, or the license may only be for a specific period of time.

Sales tax law defines lease to include rental, hire and license. Thus, a software license is specifically subject to sales tax if tangible property is transferred. However, it is not clear when a software license is a “lease” or actually a “sale.”

For federal income tax purposes the transfer of software is a sale rather than a license if the transferor transfers “all substantial rights.” But for sales tax purposes it may not be necessary for the

59. This is the position of the auditor in a sales tax audit currently being handled by the Author. The Sales Tax Counsel also confirmed this position in a telephone conversation.
63. See Pickren v. United States, 378 F.2d 595 (5th Cir. 1967); Liquid Paper Corp. v.
agreement to transfer "all substantial rights" in order for a license to constitute a "sale." Because sales tax focuses heavily on the tangible property, the State Board may look to whether there is a sale or lease of the tangible medium on which the software is transferred. If the buyer acquires title to the tangible medium the license should most fairly be interpreted as a sale under the current law. If the buyer (licensee) only has a right to use the tangible medium for a period of time and then must return the tangible medium, the license should be interpreted as a lease. Thus, there may be a sale of the program for sales tax purposes, because the tangible copy is owned by the buyer, even though there is no sale for federal income tax purposes because not all substantial rights were transferred.\(^4\)

In most license agreements, the parties do not focus on the tangible medium containing the software because its value and use are incidental to the computer program. Thus, the agreement may be silent as to the ownership of the tangible medium. Consequently, the question remains whether the license is a sale or a lease.

If the buyer obtains "all substantial rights" in the software for federal income tax purposes, and there is no limitation in the agreement on the buyer's rights to the tangible medium, the transfer should most fairly be treated as a "sale" for sales tax purposes. The transfer of "all substantial rights" necessarily means the seller may not obtain the tangible property back from the buyer, unless the buyer defaults under the agreement or upon the happening of a specified event. Any defaults or reversion must be in the nature of conditions subsequent or a security interest.\(^6\) Sales tax law specifically states that a sale reserving title as a security interest is a sale and not a lease.\(^6\) Because "all substantial rights" means, therefore, that the retained rights in the seller are similar to a security interest,

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United States, 1983-1 U.S.T.C. ¶ 9305 (Cl. Ct. 1983); Taylor-Winfield Corp. v. Commissioner, 57 T.C. 205 (1971). In order to transfer all substantial rights, the transfer, among other things, must be exclusive, must be for the remaining useful life of the property, and the transferee must have the right to prevent unauthorized disclosure.

\(^{64}\) In a taxpayer appeal handled by the Author, a State Board hearing officer, in a decision dated March 11, 1982, found that a software license was a "sale," even though restrictions on the licensee's use of the software prevented the transfer of "all substantial rights".

\(^{65}\) Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Cl. Ct. 1967) ("Moreover, clauses in an agreement permitting termination by the grantor upon the occurrence of stated events or conditions will not prevent the transaction from being considered a sale; such clauses are uniformly treated as conditions subsequent, similar to provisions in realty conveyances calling for a reversion of title previously vested."); United States Mineral Products Co. v. Commissioner, 52 T.C. 177, 195 (1969) ("the right of petitioner to terminate upon certain conditions subsequent did not constitute the retention of 'substantial rights' ").

\(^{66}\) See supra note 60.
the transfer of all substantial rights to software in a license agreement also should be a "sale" for sales tax purposes.

If the parties wish a transaction to be a sale, they should specify in the license agreement that the buyer is obtaining title to the tangible medium transferred. Conversely, if the parties wish a transaction to be a lease, the license agreement should require the buyer to return the tangible medium to the seller shortly after the buyer has made a copy of the software.

E. Sale for Resale

Property purchased for resale is not subject to California sales and use tax.\textsuperscript{67} Thus, a retailer of goods does not pay sales tax on its purchase of inventory. Because sales tax focuses on tangible property, these resale rules produce unexpected results when applied to software.

Software is often developed by individuals and small companies who have technical programming skills but often lack the resources and skill to market the software successfully. Thus, programmers often contract with software publishing companies to market their software. The software publisher will purchase the computer program and will resell copies of the program to software dealers and end-users.

One might expect that the sale to the software publisher would be a sale for resale. However, the State Board focuses on the tangible property transferred. If one tangible copy of the program is transferred, the software publisher will make and sell copies from that copy. The State Board takes the position that the duplication is a taxable use of the program so that the tangible copy of the program is not resold.\textsuperscript{68} Thus, tax applies to the sale to the publisher and also the sale to the publisher's customer.\textsuperscript{69}

Often a software publishing agreement will provide compensation to the programmer as a percentage of the receipts of the pub-

\textsuperscript{67} \textsc{Cal. Rev. & Tax. Code} § 6007 (West Supp. 1984) ("A 'retail sale' or 'sale at retail' means a sale for any purpose other than resale. . . .").

\textsuperscript{68} Report of State Board hearing officer dated March 11, 1982, in a taxpayer appeal handled by the Author. \textsc{Cal. Rev. & Tax. Code} § 6009 defines a use to include "the exercise of any right or power over tangible personal property incident to the ownership of that property."

\textsuperscript{69} Sales Tax Reg. § 1501 (1972) states "the transfer to a publisher of an original manuscript by an author thereof for the purpose of publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of his creation." Thus, tax does not apply to book authors who sell book manuscripts to publishers, but sales tax applies to software authors who sell computer software to software publishers. The State Board rejects any argument that Sales Tax Reg. § 1501 applies to computer programs.
lisher. Thus, double taxation occurs because the sale of a copy of the computer program by the publisher is subject to tax and then a percentage of that amount is subject to tax a second time when it is paid to the programmer.

If the programmer made copies of the program and transferred each copy to the publisher, then since each tangible copy is resold and not used by the publisher to make copies, each sale is a sale for resale. In this situation, payments to the programmer are exempt from sales tax. Where it does not matter which party does the duplication, sales tax can be avoided by agreeing that the programmer do it. If the parties decide that the programmer will duplicate the software, this arrangement should be spelled out in the software acquisition agreement.

Support for the State Board's position can be found in Simplicity Pattern. In Simplicity Pattern the taxpayer also argued that the transfer of the negatives and master recordings were for the purpose of resale. The Supreme Court held that the sale was not for resale. The Supreme Court cited Sales Tax Regulation Section 1525 which states that "tax applies to the sale of tangible personal property to persons who purchase it for the purpose of use in manufacturing, producing or processing tangible personal property and not for the purpose of physically incorporating it into a manufactured article to be sold." The court found that neither the film strip negatives nor the master recordings were to be incorporated physically into any of the audio-visual aids sold to customers. Rather the parties had stipulated that the property was for "preparation of master film strip negative, master and tape and printing proofs" and that "copies were made . . . from the 'negative' or 'master' production versions." Since the primary purpose of selling the film negatives and master recordings was to use them in manufacturing the final product rather than to incorporate them into that product, their sale did not escape tax as a sale for resale. Such an argument would apply equally to the transfer of a master copy of a software program to be used by a software publisher to make copies of the program for sale to distributors and customers.

F. Copyright Licenses

Although the transfer of the master copy of the computer program to the software publisher may not be a sale for resale, never-
theless, most of the payments made by the publisher to the software programmer should not be subject to sales tax. When a programmer transfers software to a publisher, the programmer also transfers a copyright or grants a copyright license to the publisher.\textsuperscript{73} Without the copyright the software publisher would not have the right to make copies of the program, but would have only the rights of an owner to use the one program copy.\textsuperscript{74}

In \textit{Michael Todd Co. v. County of Los Angeles},\textsuperscript{75} the California Supreme Court considered whether personal property tax assessed on film negatives of the copyrighted motion picture entitled "Around the World in 80 Days" was proper. The taxpayer argued that personal property tax was being assessed on the copyright on the film negatives. The Court stated that the taxpayer's copyright was a statutory copyright which exists solely by virtue of Federal law and that the "taxpayer's copyright is intangible property wholly distinct from any property interest that plaintiff may have in the material object copyrighted."\textsuperscript{76} The court determined that personal property tax may be levied only on tangible property and certain specified types of intangible property. All other intangible property is exempt from personal property taxation.\textsuperscript{77} Accordingly, the Supreme Court stated that "'[plaintiff's] copyright in the motion picture and the negatives may not be subjected to \textit{ad valorem} property taxation under the present constitutional and statutory law of this state. Indeed, copyrights are among the intangible rights and privileges which, as observed in \textit{Roehm} . . . 'have never been taxed as property in this state during its entire existence. . .'"\textsuperscript{78} "Further, the court found that the legal right to make copies of copyrighted material derives from the copyright statute alone and has never been deemed an attribute of the ownership of that material or of the

\textsuperscript{73} The Computer Software Copyright Act of 1980 confirms that computer programs may be protected by Federal copyright. See 17 U.S.C. §§ 101, 107. Except as provided in 17 U.S.C. §§ 107 through 118, an owner of a copyright has, among other things, the exclusive rights to do and to authorize others (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. 17 U.S.C. § 106 (1983).

\textsuperscript{74} See 17 U.S.C. §§ 106, 117.

\textsuperscript{75} 57 Cal. 2d 684, 371 P.2d 340, 21 Cal. Rptr. 604 (1962).

\textsuperscript{76} Id. at 689.

\textsuperscript{77} See \textit{Roehm v. County of Orange}, 32 Cal. 2d 280 (1948) ("Emanating from a Legislature vested with the power to exempt from taxation all kinds of personal property, it [Rev. and Tax. Code Section 111] makes immune from taxation all intangible property not included in the statutory definition").

\textsuperscript{78} 57 Cal. 2d at 691.
Consequently, the copyright to a software program is intangible personal property distinct from any tangible copy of the software. Because California sales tax only applies to transfers of tangible personal property, transfers of a copyright (intangible property) are not subject to California sales tax.

The State Board, however, defies this concept and considers all payments under a software publishing agreement as payments for the tangible software and not for any intangible copyright, and thus will subject all the payments to tax. The State Board bases its position on Simplicity Pattern where the Supreme Court held that film negatives and master recordings were intangible personal property and that tax was due on their entire value. The full amount received was taxable without any reduction for the property's intellectual or other intangible components.

Nevertheless, the concept that sales tax does not apply to payments for a copyright license does not separate the intellectual com-

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79. *Id.* at 691-92. *See also* Rev. Rul. 80-327, 1980-2 C.B. 53 (amounts paid for printing plates and rights to print and sell books had to be allocated between the plates and the rights. The rights to print were separate from the plates. Investment tax credit was allowable only for the tangible plates but not for the intangible copyright). Because the right to copy is not an attribute of the ownership of the material, there necessarily has to be a transfer of another property right separate from the tangible property, namely the copyright. Consequently, there is a transfer of two items of property.

80. Taxation of a copyright with respect to book publishers does not occur because the Sales Tax Reg. § 1501 (1972) exempts from taxation the transfer of a manuscript from an author to a publisher. Because the State Board does not assess tax on tangible property being transferred, they further do not assess tax on the copyright that is also transferred.

81. *See* Sales Tax Reg. § 1502(f)(1) (1981) ("Tax applies to the entire amount charged to the customer. Where consideration consists of license fees or royalty payments, all license fees or royalty payments, present or future, whether for a period of minimum use or for extended periods, are includable in the measure of tax").

In a letter to the Author dated Aug. 23, 1984, the State Board Sales Tax Counsel essentially stated that sales tax applies to copyrights. The situation covered by the letter was where a software owner licenses a copy of a software program to a particular user for the user's internal business use. The user, because he is obtaining one copy of the software, pays the price for the one copy. After evaluating the software and using it in its business, the user determines that it would like to incorporate the software into a product which the user sells and to sell a copy of the software with the product. The user then returns to the seller to request only a license to copy the software and distribute copies of the software. Even though no tangible property is transferred under the copyright license, and the copyright license is separate from the payment for the first copy, the State Board Sales Tax Counsel stated that sales tax applies to the copyright license. The letter states that the second license is an integral part of the transaction and the payments received under the copyright license are taxable because they are additional payments for the use of the original tangible property.

As a result of further discussions with the Author, the Sales Tax Counsel reconsidered its position, but in a letter dated December 26, 1984 the Sales Tax Counsel declined to change its position.
ponent included in a tangible copy of the software from the tangible copy. Rather, excluding tax on a copyright license merely recognizes that two separate items of property are acquired: one of which is tangible and therefore taxable, and one of which is intangible and therefore not taxable. The copyright is separate property distinct from any tangible copy of the copyright work. For example, a blank floppy diskette costs less than $5.00. A copy of a software program on a floppy diskette such as Lotus 1-2-3 costs approximately $300.00. However, an exclusive license to copy and market Lotus 1-2-3 would cost vastly more than $300.00. The $300.00 tangible copy of the software program would be the cost of the tangible diskette which includes the value of intellectual content. Thus, based on Simplicity Patterns, sales tax applies to the full value of the tangible program copy (the $300.00 rather than the $5.00 value for the blank diskette). Thus, there is no deduction for the intellectual component included in the tangible copy of the computer program. The copyright license, however, which is separate intangible property from the physical copy of the software should not be subject to tax.

In the recent case of Capitol Records, Inc. v. State Board of Equalization however, the court did consider the copyright issue. In Capitol Records the taxpayer purchased master tapes and paid production companies to produce master tapes for use in making phonograph records in exchange for royalties. The issue was whether use tax imposed on purchases of master tapes from outside California was proper.

The court discussed at length and then rejected the taxpayer’s arguments that the exemption in California Revenue and Taxation Code Section 6362.5 was retroactive, and that the State Board acted unreasonably or discriminatorily against the recording industry. Only briefly at the end of the opinion did the court discuss the copyright issue.

The taxpayer contended that the license fees it paid for the right to reproduce and market musical recordings were payments for intangible rights and were not subject to sales tax. The court stated that the argument was premised on the technological possibility of using previously manufactured prerecorded tapes to produce a new master and the theoretical possibility that a licensee would purchase the right to manufacture and distribute the artist’s

82. See supra notes 73-79 and accompanying text.
83. Lotus 1-2-3 is a trademark of the Lotus Development Corporation.
performance and not the copy tape which embodied the performance. The court rejected the taxpayer's argument because the record did not reveal a separate purchase of intangible rights. The court held that the State Board correctly imposed tax on the total value of the license agreements.

Although *Capitol Records* appears to consider the copyright issue, the case did not involve the acquisition of a copyright. The period for which tax was assessed was April 1, 1968 through March 31, 1971. The Second Recording Act of 1971, effective for recordings fixed after February 14, 1972, accorded copyright protection for the first time to sound recordings. Prior to February 15, 1972, there were no copyrights in sound recordings. Consequently *Capitol Records* does not hold that sales or use tax applies to payments for the acquisition of a copyright.

Furthermore, there is a major difference between software and master tape recordings. Computer software is represented in tangible medium in digital form (a string of zeros and ones), whereas master tapes contain an analog of the music. Any copy of a software program can be used to make copies and each copy made will be identical to the original. There is no degradation in quality upon making a copy because the software is in digital form. Such is not the case with music and film masters. There the master, as an item of tangible property, is more valuable than any tangible copy made from the master. There is a degradation in making copies of music on records or film on tape. Although *Michael Todd* found that property tax could not be assessed upon a copyright, it stated the value of the tangible master has greater value when the owner of the master also has the copyright to the master. Such a position may be applicable to master music tapes and master films, but it does not apply to software. Since each software copy is identical and can be used as a master, and each copy, including a master copy, can be used for its program content rather than only for making copies, each tangible copy has no more value when one owns the copyright than if one does not.

In *Capitol Records* the court rejected the taxpayer's premise that previously manufactured prerecorded tapes could be used to

85. *Id.* at 602.
86. *Id.* at 603.
87. Some microcomputer software is distributed with copy protection of the diskette in order to physically prevent a user from copying the software in violation of the copyright holder's copyright. Thus, these copies would be difficult to use as master copies. However, it is possible to overcome any copy protection scheme, so that any copy-protected software could be copied, albeit with some effort and expense.
produce a new master and that it was therefore theoretically possible for a licensee to purchase a license to reproduce without a copy tape. But unlike music tapes, copies of software are identical with one another in quality; and beyond being theoretically possible, in practice a copy is used sometimes as a master for other copies. Further, it is theoretically possible to license a copyright without transferring a copy. For example, software is often purchased for internal use by software publishing companies or original equipment manufacturers (OEMs). After using the software in its business, the publisher or OEM may ask for a copyright license. A copyright license then can be entered into without transferring any copy of the software. In addition, because any software copy can be used as a master copy, a copyright licensee could acquire a tangible copy from one person and acquire the copyright license from another person. Consequently, the payments for a right to copy and market software should be nontaxable as payments for an intangible and the result in *Capitol Records* should not apply to software.

A software acquisition agreement between a software publisher and a programmer generally will not have separately stated charges for the copy of the program and the copyright. But even though there is no express segregation of the price, a conceptual segregation should be made. Contrary to the position of the State Board, the transfer of intangible property should not be subject to sales tax merely because it is included in the transfer of separate tangible property. Moreover, it is not difficult to determine the value of the copy of the software transferred to the publisher. Since the software publisher resells copies of the software (identical with the copy received), one can easily determine the value of one copy of the software, exclusive of the value of the copyright.

Furthermore, such a separation of taxable property from nontaxable property is often required in various sales tax regulations, and in fact, was made in *Simplicity Pattern*. In *Simplicity Pattern* a whole business which included the master recordings and film negatives was transferred for stock of the buyer in a nontaxable asset for stock acquisition. The stock received by the seller had to be allocated among the various assets, and sales tax was assessed only on certain items. Because the price is often allocated between taxable and nontaxable items where a lump-sum price covers both the taxable and nontaxable items, the lack of an allocation of the payments in the software acquisition agreement between the copyright and

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89. *See also* Sales Tax Reg. § 1595(b) (1980).
the tangible copy should not result in sales tax on acquisition of the copyright license.

III. CALIFORNIA TAXATION OF CUSTOM COMPUTER PROGRAMS

A. History

In addition to the provisions discussed in II above, Sales Tax Regulation Section 1502 also imposed sales tax on the transfer of a custom computer program if the custom computer program was transferred in the form of punch cards, tape, disk, drum, or other similar forms.\(^9^0\) Tax did not apply, however, to the transfer of a custom program in the form of written procedures such as instructions listed on coding sheets.

The distinction that the State Board had made with respect to custom computer programs was a distinction between the performance of services and the fabrication of tangible personal property. Sales tax did not apply to the performance of services, but charges for fabrication of tangible personal property were subject to sales tax.\(^9^1\) The purpose for taxing fabrication labor was to prevent taxpayers from purchasing materials and then separately paying a service fee (claiming it is not taxable) to have a product made from the materials. Thus, for example, a person who purchased fabric and paid a tailor to make a suit would have to pay tax on the fee to the tailor. As a result, the person who bought a suit from the rack was not in any worse sales tax position.

In issuing the sales tax regulation for custom programs, the State Board considered that if a custom program were transferred in a machine-readable form, the taxpayer wanted the physical property on which the program was transferred. The taxpayer would use the tangible machine-readable form of the program for loading the program into the computer. Thus, there was fabrication of property for the taxpayer subject to tax.\(^9^2\) On the other hand, if the program were transferred in a human-readable form, the State Board treated the tangible property as incidental to the service of producing the program. In this latter situation, sales tax was not due.

The imposition of tax on custom programs in machine-reada-

\(^9^0\) Sales Tax Reg. §§ 1502(0)(2) (1972).

\(^9^1\) CAL. REV. & TAX. CODE § 6006(b) (West 1971). See also Sales Tax Reg. § 1502(e)(2) (1972).

The decision in favor of General Business Systems provided the impetus for the California legislature in 1982 to pass a law clarifying that development of a custom computer program is not subject to sales tax even though the program is transferred on a tangible medium. Specifically, in Section 4 of Assembly Bill 2932, the legislature stated that the act was declaratory of, and not a change in, existing law.

By specifically stating that sales tax does not apply to the transfer of custom computer programs, but not addressing the transfer of prewritten programs, the legislature implied that sales tax properly applied to transfers of prewritten computer programs. The legislature was well aware of the State Board's position with respect to both prewritten and custom programs; the definition of a custom computer program specifically excludes a prewritten computer program. Thus, the history of the act effectively precludes any argu-

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94. Id. The three recent cases in which courts of other states found sales tax applied deal with prewritten programs. By contrast in all cases which dealt with custom computer programs courts have found the transactions nontaxable. Generally the rationale was that the program was intangible property. See District of Columbia v. Universal Computer Assoc., Inc., 465 F.2d 615 (D.C. Cir. 1972); James v. Tres Computer Sys., 642 S.W.2d 347 (Mo. 1982). In Maccabees Mut. Life Ins. Co. v. Department of Treasury, 122 Mich. App. 660, 332 N.W.2d 561 (1983), however, the court found that the custom programs were a personal service, and therefore were not taxable.
96. "The Legislature finds and declares that sales and service of custom computer programs, as defined in Section 6010.9 of the Revenue and Taxation Code, other than basic operational programs, are service transactions not subject to sales or use taxes under any existing state law. The use of any storage media in the transfer of custom computer programs is only incidental to the true object of the transaction, which is the performance of a service. Therefore, the Legislature . . . declares that Section 2 of this act is declaratory of, and not a change in, existing law."
ment that the transfer of a prewritten computer on a tangible medium is not subject to sales tax in California.

B. Defining a Custom Program

Although sales tax does not apply to transfers of custom computer programs in any form, it is not always easy to determine when a program is a custom computer program. A custom computer program is defined in Revenue and Taxation Code Section 6010.9 as "a computer program prepared to the special order of the customer and includes those services represented by separately stated charges for modification to an existing prewritten program which are prepared to the special order of the customer." A custom computer program by definition does not include a canned or prewritten program which is defined as a program "which is held or existing for general or repeated sale or lease, even if the prewritten or canned program was initially developed on a custom basis or for in-house use." Further, modification to an existing prewritten program to meet a customer's need is custom computer programming only to the extent of the modification. The State Board has not issued regulations to define further when a program is a custom computer program.

The prototypical situation is where a company determines a need for a particular type of computer program and requests that a programmer develop the program for its need. In order to show that the program is a custom computer program, the agreement with the programmer should be labelled a "custom computer program development agreement." Furthermore, the agreement should state that the programmer is providing services to develop the program for the special order of the buyer. If the contract merely states that the customer is purchasing a particular computer program and does not specify that it is a development, tax will not apply automatically. Nevertheless, the seller and the buyer will have to produce extrinsic evidence to satisfy the State Board that the program was a custom computer program.

A slightly different situation exists where a computer programmer develops an idea for a program and suggests to a software publishing company that the programmer develop the program exclusively for the software publishing company which will then market the program. In this situation, the program should also be a custom computer program. However, the State Board in these situ-

98. Id.
ations may argue that the program was not developed specifically for the software publishing company, but rather was developed for the programmer.

Although the programmer developed the idea for the program, the program nevertheless is prepared exclusively for the special order of the publishing company. Further, even though the programmer develops the idea, the software publisher will often have significant input into the features and user operation of the program.

This type of program also does not meet the definition of a prewritten program. At the time the development contract is entered into, there is no computer program. When the program is finished, it is not held for sale or lease by the programmer for himself or for anyone else. The program is committed for the use of the sole software publisher. Finally, the program is not developed for in-house use.

Treating this transaction as a custom computer program achieves the legislative goal of not taxing programming services. Because the program is not developed at the time of the contract, the major aspect of the transaction is the performance of services. Taxing this transaction would result in tax on the services performed by the programmer.

Modifications to a prewritten program are treated as a custom program and are not taxed if the charges for the modifications are stated separately. Tax will apply to the full payment for a program if modification charges are not stated separately. Although modifications to a prewritten program are nontaxable only if the charge is stated separately, "modifications" can be so great that the program developed is not a modification of a prewritten program, but instead is a custom program. The extreme example is where a customer requests a specific computer program and the programmer uses one standard subroutine that he has prewritten for another program. The buyer may have presumed he was requesting a completely new program and did not realize the programmer would use prewritten code for a standard subroutine. Thus, the parties may not have charged separately for any modifications. It would be unfair to tax the payments for this program development as the purchase of a modified prewritten program.

An otherwise custom program should not be treated as a prewritten program merely because one subroutine was taken from

99. Id.
a previous program. However, the problem arises in determining the point at which modifications of a prewritten program become so great that the new program constitutes a custom computer program. Adding one minor feature to an existing program should be treated as a modification which is taxed unless the charges are stated separately. Adding twenty features to a program that has only two features should generally be treated as developing a custom program.

Sales Tax Regulation Section 1502 provides that if the cost of a program with modifications is twice the cost of the prewritten program without modification, the program is a custom program. This provision is one method of determining when modification becomes so great that the whole program is a custom program. Although this simple definition is helpful, it does not help in all situations.

Suppose a company has developed a program for in-house use or has not yet sold any copies of the program. If there is no prewritten program price, the formula does not work. There is no price to compare to the price actually paid by the buyer for the program with modifications. A helpful addition to this definition would be one which focuses on the program code. Thus, for example, a program which added lines of code (other than comment lines) equal to the number of lines of the existing program would be treated as a custom program. This focus on program code seems appropriate because the more new or different code that is added, the greater the differences will become between the old and the new program. Since the custom computer provision was added to prevent the taxation of services, if the services to be performed to develop the new program are greater than the services represented by the prewritten program, the predominant object of the transaction is the performance of programming services. In these situations, no tax should apply to any of the payments for the program (whether or not stated separately), because the program is a custom computer program rather than a modification to a prewritten program.

IV. CALIFORNIA SALES TAXATION OF SOFTWARE MAINTENANCE

Because errors in a program can be hidden and only discovered later by users, software sellers generally provide maintenance for

their software. Typically, software is sold with a warranty of ninety days to one year. During this period, if any errors or problems occur, the software seller will repair the software without charge. After the initial warranty period, the software buyer may enter into an optional maintenance contract. Under an optional maintenance contract the seller generally provides technical support to the software buyer and will correct any errors discovered in the software. Most software buyers will obtain software maintenance so that the buyer is assured that if any problems occur, they will be corrected. Sometimes, the software seller will also offer software improvements under an optional software maintenance contract. A software seller may develop new features for the software program and then provide them to its optional maintenance customers. Usually major new features are sold separately as new versions of the software.

Sales tax applies to amounts charged for warranties and mandatory maintenance agreements.\textsuperscript{101} Sales tax regulation dealing with optional maintenance contracts and optional warranties, however, provide that the maintenance provider is the consumer of any tangible property used under the contract. Thus, tax applies on sales of tangible property to the maintenance provider and sales tax does not apply to the payments by the customer for the optional maintenance.\textsuperscript{102}

Nevertheless, the State Board says that optional software maintenance contracts are subject to sales tax.\textsuperscript{103} No sales tax regulation or published ruling provides that optional software maintenance is subject to sales tax, and each regulation dealing with optional maintenance contracts and all published sales tax counsel rulings provide that no sales tax is due on other types of optional software maintenance contracts.\textsuperscript{104} The State Board views an optional software maintenance contract as the sale of prewritten software pro-

\textsuperscript{101.} CAL. REV. & TAX. CODE § 6012(b) (West Cum. Supp. 1984) ("The total amount of the sale or license or rental price includes all of the following: (1) Any services that are a part of the sale.") See also Sales Tax Reg. § 1655(c)(2) (1983).

\textsuperscript{102.} Sales Tax Reg. § 1502(k) (1981) (optional maintenance contract for automatic data processing equipment is not taxable); Sales Tax Reg. § 1546(b)(3)(C) (1979) (repair work under an optional maintenance contract is not the sale of parts, but the repairer is regarded as the consumer of the parts and materials furnished); Sales Tax Reg. § 1655(c)(3) (1983) (person obligated under an optional warranty to furnish parts and labor necessary to maintain the property is the consumer of the material and parts furnished). See also 2 Sales Tax Counsel 6874, 490.0680 ¶ 61-764 (1954) and 490.0640 (1965), CCH CAL. TAX REPORTER (1982).

\textsuperscript{103.} Letter from the State Board Sales Tax Counsel to the Author (Feb. 8, 1982).

\textsuperscript{104.} See supra note 102.
grams.\textsuperscript{105} Thus, unless the program is delivered in an intangible form (such as electronic transmission) or unless all the maintenance provided under the contract is custom computer programming, sales tax applies according to the State Board. The State Board holds this position even though the bulk of an optional maintenance contract is the provision of technical services (such as telephone support and on site service of technicians) and the provision of error corrections to fix problems in the program. Such items which are services should not be taxed.\textsuperscript{106}

Further, the State Board does not make any allocation of the price under a maintenance contract to the nontaxable services and the taxable sales of programs.\textsuperscript{107} Yet in other situations where taxable and nontaxable items are combined and sold with a lump-sum price, an allocation is made.\textsuperscript{108} There is no clear reason for the State Board to distinguish these situations from that involving a software maintenance contract.\textsuperscript{109} A bill introduced in 1984 in the California legislature provided that 30 percent of an optional maintenance contract that provides improvements and technical support or error corrections is for the taxable improvements. The bill easily passed the Assembly and Senate, but was vetoed by the Governor.

Consequently, the current situation of full taxation by the State Board continues. A maintenance provider, however, can avoid the economic burden of the tax by charging its maintenance customers for the tax.

\textsuperscript{105} Report of State Board hearing officer dated March 11, 1982, in a taxpayer appeal handled by the Author.

\textsuperscript{106} Although the State Board officially states that all of a software maintenance contract is taxable, in oral testimony before the Legislative Committees dealing with Assembly Bill No. 3459, Feb. 16, 1984 (discussed infra at note 109), the State Board agreed that a portion of optional software maintenance contracts is for services and that it should be nontaxable. The State Board, however, believed that providing error corrections is the sale of a new program and thus should be taxable. Thus, the State Board realizes that it is taxing more than is justified.

\textsuperscript{107} See supra note 103.

\textsuperscript{108} See supra note 31.

\textsuperscript{109} Assembly Bill No. 3459 introduced by Assemblyman Byron Sher. The bill provides that improvements to software are taxable, but that payments for technical support and error corrections are not taxable. If an optional maintenance contract provides prewritten improvements and either or both error corrections or technical support, then 30 percent of the payments under the contract are for the taxable improvements. Thus, the bill recognizes that both nontaxable services and taxable sales of programs are provided under an optional maintenance contract, but only the sale of tangible property is subject to tax while the performance of services is not.
V. CONCLUSION

As shown in this Article, California sales tax law focuses heavily on the tangible medium which contains a computer program. Thus, a premium is placed on the form a software transaction takes. Careful planning and drafting of the documents to reflect a software transaction, and developing the evidence to show the proper form was followed, can prevent sales tax application in California.