Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice-Chair
Honorable Betty T. Yee
Senator George Runner
Honorable John Chiang

Date: March 9, 2012

From: Jeffrey L. McGuire, Deputy Director
Sales and Use Department (MIC 43)

Subject: Business Taxes Committee – March 20, 2012
Technology Transfer Agreements – Study Update
and Request for Interested Parties Process

Staff would like to provide an update on the software technology transfer agreement (TTA) study with Industry that the Board approved at the August 23, 2011 meeting. Staff is also requesting Board approval to begin an interested parties process to discuss whether it is necessary to amend Regulation 1507, Technology Transfer Agreements, to explain when an agreement involving the transfer of software on tangible storage media qualifies as a TTA (hereafter software media TTA) and how tax applies to the sale of tangible personal property transferred in a software media TTA.

Study Update
Revenue and Taxation Code sections 6011 and 6012 provide that, if the TTA does not separately state a reasonable price for the tangible personal property, and there is no like transaction with third parties to establish the reasonable retail fair market value of the tangible personal property, then the retail fair market value of the tangible personal property transferred in a TTA is equal to 200 percent of the cost of the materials and labor used to produce the tangible personal property subject to tax when sold at retail. (Rev. & Tax. Code, §§ 6011, subd. (c)(10), 6012, subd. (c)(10).) Because it may be a difficult task to determine the retail fair market value of tangible personal property using this method, staff requested and the Board approved a study in cooperation with Industry to determine the feasibility of developing an optional percentage to estimate the retail fair market value of tangible personal property transferred in a software media TTA.

Information on software media TTAs has been placed on the BOE website. In addition, on November 9, 2011, a letter was sent to approximately 300 prospective participants and interested parties informing them of the study and providing contact information for additional information regarding participation in the study. At this time, only one company has contacted staff to indicate an interest in participating in the study. Although the participant could provide valuable information, staff does not believe it would be appropriate to establish an industry standard based on one company’s data.
Staff is in the process of contacting some individual companies to find out if there are specific reasons why they do not want to participate in the study. Based on discussions with those contacted so far, it appears companies are reluctant to open their books without specifics on the information that will be reviewed. Staff’s letter to participants requests general information (such as records to determine per-unit costs) so that staff can gain an understanding of how product costs are accounted for in the software industry. Staff intends to send a follow-up letter to encourage participation in the study and try to address Industry’s identifiable concerns.

Regulation 1507
In Nortel, the Court of Appeal invalidated a sentence in Regulation 1507 that excluded the “transfer of prewritten software” from TTA qualification. Following the decision, the regulation was amended to delete this sentence. However, the regulation has not been amended to clarify when an agreement for the transfer of non-custom software on tangible storage media qualifies as a TTA or how tax applies to sales of tangible personal property transferred in a TTA involving software on such media. For this purpose, staff is requesting Board authorization to begin an interested parties process to discuss whether clarifying amendments are necessary. In the absence of an effective study or the submission of other sufficient data, however, the clarifying amendments would not include an optional percentage to estimate the retail fair market value of tangible personal property transferred in a software media TTA because staff does not have sufficient data upon which to recommend a reasonable percentage at this time.

If you have any questions, please feel free to contact me.

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Kristine Cazadd, Executive Director