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POTENTIALLY DISRUPTIVE CALIFORNIA SALES TAX DECISION

On April 27, 2011, the California Court of Appeal's decision in *Nortel Networks Inc. v. State Board of Equalization* became final.[1] This significant decision held that the license of software transferred on tangible storage media constitutes a "technology transfer agreement" ("TTA")—and thus is at least partially exempt from California sales and use tax—if the software is subject to a copyright or patent interest.[2] The court's exempt TTA holding extends to licenses of prewritten or "canned" software transferred on tangible storage media, shattering the long-standing position of the State Board of Equalization ("SBE") that the entire "gross receipts" or "selling price" from sales of such software is subject to tax.

In light of *Nortel*, taxpayers should re-evaluate their California sales tax collection and remittance and use tax payment practices to determine (1) whether claims for refund should be filed, and (2) the proper measure of tax on future sales and purchases of software.

SALES AND USE TAX IMPLICATIONS OF TECHNOLOGY TRANSFER AGREEMENTS

A TTA is statutorily defined as "any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest."[3] An SBE regulation excluded an agreement for the transfer of prewritten software from the definition of a TTA, but the court in *Nortel* invalidated this portion of the regulation.[4] The amount charged for intangible personal

1 119 Cal. Rptr. 3d 905 (Cal. Ct. App. 2011), *petition for review denied*, California Supreme Court, No. S190946, April 27, 2011.

2 *Id.*

3 Cal. Rev. & Tax. Code §§ 6011(a)(10)(D), 6012(a)(10)(D).

4 Cal. Code Regs. tit. 18, § 1507(a)(1); *Nortel Networks Inc.*, 119 Cal. Rptr. 3d at 919.

property transferred with tangible personal property pursuant to a TTA is excluded from the measure of California sales and use tax.[5]

SUMMARY OF *NORTEL V. STATE BOARD OF EQUALIZATION*

In *Nortel*, the taxpayer licensed two types of software programs to Pacific Bell: (1) a switch-specific program ("SSP") that enabled a hardware switch to process telephone calls and (2) prewritten operator workstation programs, data center programs, and switch-connection programs ("Canned Software").[6] Nortel copyrighted its SSP and Canned Software, and both the SSP and Canned Software incorporated—and implemented—Nortel patents.[7]

The SSP and Canned Software were transferred to Pacific Bell on tangible storage media (disks, magnetic tapes, and cartridges); the software license allowed Pacific Bell to copy the software from the storage media and load it into the operating memory of a switch's computer hardware.[8] The software license gave Pacific Bell the right to use Nortel's patented processes embedded in the software to produce and sell telephonic communications.[9]

Nortel charged Pacific Bell $401.9 million for the licenses and, following an audit and SBE hearing, paid sales tax of roughly $32 million.[10] Of this amount, $29.7 million was tax attributable to the SSP, and $2.3 million was tax attributable to the Canned Software.[11] The parties stipulated that the cost of materials and labor used to produce the tangible storage media was $54,604.[12]

The Superior Court held the SSP license was a TTA, but in reliance on Regulation 1507(a)—which expressly excluded prewritten software from the definition of a TTA—held the Canned Software license was not a TTA.[13] The Superior Court declined to invalidate the Regulation insofar as it excluded canned software from the definition of a TTA because to do so "would irreconcilably conflict with section 6010.9, rendering a nullity that section's inclusion of canned or prewritten computer programs."[14]

The Court of Appeal affirmed the Superior Court judgment granting Nortel a refund of sales tax paid on its SSP license, observing that the SSP license met each of the three independent definitions of a TTA under Regulation 1507.[15] The Court of Appeal then turned to the Canned Software. Relying on the breadth of the TTA statutes (which apply to "any" written agreement), the Court of Appeal concluded that Regulation 1507(a)(1)'s exclusion of canned or prewritten software from the definition of a TTA was invalid, and that any transfer of a software program that is subject to a patent or copyright is a TTA.[16] Accordingly, the Court of Appeal reversed the Superior Court judgment and granted the taxpayer's claim for refund of sales tax paid on the license of the Canned Software.

IMPACT OF *NORTEL*

All software sold for consideration is virtually certain to be copyrighted and in most cases also subject to one or more patent interests, meaning *Nortel* inevitably will have a significant negative fiscal impact on the State of California. In its Petition for Review to the California Supreme Court, the

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5 Cal. Rev. & Tax. Code §§ 6011(a)(10)(A), 6012(a)(10)(A).

6 119 Cal. Rptr. 3d at 909.

7 *Id*. at 909, 919.

8 *Id*. at 910-11, 919.

9 *Id*. at 911.

10 Combined Respondent's Brief and Cross-Appellant's Opening Brief at 31, *Nortel Networks Inc.*, 119 Cal. Rptr. 3d 905 (No. B213415), 2010 WL 677409.

11 *Nortel Networks Inc.*, 119 Cal. Rptr. 3d at 911.

12 *Id.*

13 *Id*. at 918.

14 *Id.* (quoting the Superior Court decision, quotation marks omitted).

15 *Id*. at 917. Regulation 1507 defines a TTA as a written agreement that assigns or licenses: (1) a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest, (2) a patent interest for the right to manufacture and sell property subject to the patent interest, or (3) the right to use a process subject to a patent interest.

16 *Nortel Networks Inc.*, 119 Cal. Rptr. 3d at 918-19.

SBE claimed that the expected revenue loss from sales of canned software alone would be more than $300 million per year.[17] Although the SBE is bound to follow the *Nortel* decision, given California's budget crisis, the SBE is expected to distinguish and limit the *Nortel* holding in any way it can.

On May 27, 2011, the SBE issued a news release announcing that, in accordance with *Nortel*, it has authorized an amendment removing the exclusion of canned or prewritten software from the definition of a TTA in Regulation 1507.[18] The news release also provides insight as to how the SBE plans initially to respond to *Nortel*. First, the SBE appears to be taking the position that, despite the broad holding of *Nortel*, the mere sale of patented or copyrighted software is not a TTA. According to the news release, the transferor must be the holder of the patent or copyright interest being transferred. Second, the SBE is taking the position that the taxable tangible personal property transferred pursuant to a TTA is the software itself, not merely the storage media that contains the software. The news release is only the initial response from the SBE, and additional positions and action limiting *Nortel*'s reach will undoubtedly be forthcoming.

One should expect aggressive pushback from the SBE on *Nortel*-based refund claims and future sales and use tax returns that rely on *Nortel* to materially reduce the amount of sales or use tax paid. In particular, the SBE will likely take tough audit positions on taxpayer allocations of "gross receipts" or "sales price" to nontaxable copyright or patent interests, and it will no doubt try to distinguish *Nortel* in future cases involving the taxability of sales of software. As a more permanent fix, the SBE may seek "curative" and possibly retroactive legislation and adopt "clarifying" regulations limiting *Nortel*'s reach, for example, regulations that address how to allocate gross receipts or sales price between taxable tangible personal property and exempt intellectual property. Affected parties should consider submitting comments on any proposed draft regulations relating to TTAs. While the dust settles, expect the SBE to delay paying refund claims pending further guidance from the courts or the Legislature.

While *Nortel* broadly states that any transfer of a software program that is subject to a patent or copyright qualifies as a TTA, the court's analysis of the taxability of the SSP reveals that the TTA statutes and regulations likely require more. A careful reading of the TTA statutes, regulations, and related case law (including but not limited to *Nortel*) reveals there is a fair degree of subtlety involved in determining the types of transfers that qualify as TTAs. The SBE has already taken the position that *Nortel* "does not affect the way sales tax is applied to the typical off-the-shelf retail sale of canned, mass-marketed software because the typical retailer does not hold a patent or copyright interests in the software."[19] The SBE may try to further limit the types of software sales that qualify as TTAs.

PROTECTIVE REFUND CLAIMS

Still, the broad holding of *Nortel* encourages taxpayers to file protective claims for refund of sales and use tax paid on software licenses for all periods not barred by the statute of limitations. Less certain, however, is how taxpayers should handle future sales and purchases of software in California. Taxpayers must decide whether to (1) continue to treat sales and purchases of software transferred on tangible storage media as subject to California sales and use tax, but file protective refund claims, (2) treat such sales as TTAs, allocating the "gross receipts" or "sales price" of such software licenses between the nontaxable intangible copyright and patent interests and the taxable tangible personal property, or (3) fashion some modified approach. There is no single simple answer, and both primary options have their downsides.

AUDIT RISK

Vendors who choose to treat all sales and purchases of software as TTAs in reliance on *Nortel* will likely have happy customers but consequently face a number of risks and

17 Petition for Appeal at 29, *Nortel Networks Inc. v. State Board of Equalization*, No. S190946 (Cal. Feb. 28, 2011), 2011 CA S. Ct. Briefs 90946.

18 News Release, California State Board of Equalization, "Nortel Does Not Affect Sales Tax on Off-The-Shelf Software" (May 27, 2011), *available at* http://www.boe.ca.gov/news/2011/66-11-H.pdf. *See also* Memorandum from Randy Ferris, Acting Chief Counsel, to the Board of Equalization (May 10, 2011), *available at* http://www.boe.ca.gov/meetings/pdf/J1__052511__Regulation__1507.pdf.

19 News Release, California State Board of Equalization, "Nortel Does Not Affect Sales Tax on Off-The-Shelf Software" (May 27, 2011).

issues. Vendors must first consider how to allocate the gross receipts from software sales between the taxable tangible personal property and the nontaxable copyright and patent interests transferred in connection with the license. This allocation is not as simple as one might hope. The TTA statutes and regulations contain specific—and potentially complex—rules for determining what portion of the sales price or gross receipts is attributable to tangible personal property transferred in connection with a TTA.[20] Further, the news release states that the SBE plans to "work with industry" to formulate guidance for allocating the gross receipts or sales price of software transferred in connection with a TTA.[21] The SBE's audit stance is likely to be consistent with such guidance.

Additionally, absent an enforceable agreement with customers allowing a vendor to seek reimbursement for later-determined sales tax liability, penalty (if any), and interest associated with its software sales, the vendor will likely be left "holding the bag" if it is unable to successfully resist an SBE assertion of additional liability. Taxpayers broadly treating all sales and purchases of software as TTAs may find California sales and use tax audits particularly difficult to satisfactorily resolve.

By contrast, software vendors who choose to collect and remit sales tax on software licenses that are arguably TTAs will likely encounter unhappy customers, potentially leading to competitive disadvantages and decreased sales. Aggrieved customers who perceive that a vendor charged more than the correct amount of California sales tax on a transaction may also file suit, alleging that the vendor engaged in unfair competition in violation of California Business & Professions Code Section 17200.[22]

As if these considerations were not enough to make one's head spin, the matter is further complicated by the fact that the current state of affairs is unlikely to endure. The expected severe revenue loss to the state likely will prompt the enactment of "curative" legislation, which may be retroactive. Although any such legislation would presumably restore a degree of certainty in the application of the California sales and use tax law of software, it could also introduce unwelcome additional restrictive changes to the California sales and use tax law. Taxpayers beware.

LAWYER CONTACTS

Jones Day offers in-depth experience in addressing and evaluating complex multidisciplinary issues such as those raised in *Nortel*, particularly in the areas of state and local taxation, issues and appeals, and intellectual property. For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form at www.jonesday.com.

David E. Cowling
Dallas
+1.214.969.2991
decowling@jonesday.com

Roburt J. Waldow
Irvine
+1.949.553.7573
rwaldow@jonesday.com

Justin J. Hepworth
Dallas
+1.214.969.5062
jjhepworth@jonesday.com

20 Cal. Rev. & Tax. Code §§ 6011(a)(10)(A)-(C), 6012(a)(10)(A)-(C); Cal. Code Regs. tit. 18, § 1507(b).

21 News Release, California State Board of Equalization, "Nortel Does Not Affect Sales Tax on Off-The-Shelf Software" (May 27, 2011).

22 While vendors have prevailed in two recent Section 17200 cases involving the collection of sales tax, both cases are currently pending review by the Supreme Court of California. *See Yabsley v. Cingular Wireless, LLC*, 98 Cal. Rptr. 3d 657 (Cal. Ct. App. 2009); *Loeffler v. Target Corporation*, 93 Cal. Rptr. 3d 515 (Cal. Ct. App. 2009). The Courts of Appeal found the customers' lawsuits inappropriate because filing a refund claim by a vendor is a prerequisite to a suit to recover sales tax reimbursement payments.