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POTENTIALLY DISRUPTIVE CALIFORNIA SALES TAX DECISION (UPDATED TO REFLECT RECENT DEVELOPMENTS)

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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 largely 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 pre-written 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 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 further 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 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. In its Petition for Review to the California Supreme Court, the SBE claimed that the expected revenue loss from sales of canned software alone would be over $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 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.

On August 9, 2011, the SBE's Tax Policy Division, Sales and Use Tax Department, and the Taxes and Fees Division, Legal Department released an Informal Issue Paper recommending a study be conducted to evaluate the feasibility of developing an optional percentage to estimate the fair market value of tangible personal property transferred in a TTA involving prewritten software.[19] On August 23, 2011, the SBE's Business Taxes Committee sought and received Board approval to conduct this study.

The Issue Paper notes that "a case by case approach to cost accounting, bookkeeping, reporting, and auditing TTAs for sales and use tax purposes is difficult and would impose an administrative burden on taxpayers and the Board." The Issue paper further notes that "establishing or verifying the retail value based on cost may pose difficulties because costs are not always booked by product line or in the same year as the sale. In order to determine the retail value of a particular product, the retailer would need to track all related costs on a per product and per unit basis, without regard to the year the cost was expensed or capitalized." The Issue Paper concludes that the adoption of an optional percentage would save time and provide certainty in the calculations, while protecting taxpayers against claims of unreasonable allocation.

The Issue Paper proposes that SBE staff work with a focus group of industry members who are directly engaged in the sale of prewritten software through qualified TTAs to evaluate the feasibility of developing an optional percentage. If the study concludes that it is feasible to use an optional percentage, the issue would then be addressed through the interested parties' process, providing additional opportunity for involvement.

Affected parties should consider participating in the study as well as 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".[20] 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 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.[21] Further, the news release states 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.[22] 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.[23]

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.

Conclusion

Under the current authority and policy, where a transferor holds a patent or copyright interest and licenses or assigns that interest pursuant to a TTA, the amount paid for the patent or copyright interest should be exempt from California sales and use tax. As with many technical issues, the taxpayer's particular facts and circumstances are critical to the analysis. Companies first must consider whether they have sales or purchases which qualify as TTAs, a potentially difficult task given the unclear guidance provided by *Nortel*. If companies believe they have sales or purchases that qualify as TTAs, they must then determine how to allocate the sales price or gross receipts between the taxable tangible personal property and the nontaxable copyright or patent interest.

The TTA statute and regulations provide a hierarchy for allocating sales price or gross receipts to the taxable tangible personal property, with any remaining amount allocable to the intangible copyright or patent interest. When the TTA provides a separately stated price or the tangible personal property has been previously sold or leased to third parties, that price will be allocated to the tangible personal property. When the TTA does not have a separately stated price and the tangible personal property has not been previously sold or leased to third parties, the price of the tangible personal property will be equal to 200 percent of the cost of such property to the seller. The SBE may judge the reasonableness of any separately stated price for tangible personal property by reference to the cost of such property to the seller.

Companies may find it difficult to identify with particularity the labor and materials costs incurred to produce the tangible personal property sold—a task made more daunting when such costs reasonably can be said to relate to the creation of the nontaxable copyright or patent interest to which the tangible personal property is subject. It is currently unclear how the costs of tangible personal property are to be determined under these circumstances. Even if the identification and classification of development costs as between taxable tangible personal property and nontaxable intangible personal property is feasible, sellers are still faced with the task of allocating their total costs of creating the tangible personal property among the actual individual sales of the product.

Companies should carefully consider the propriety of their cost allocation processes and maintain robust documentation to allow not only for vigorous defense if challenged on audit, but also the means to recompute the allocation using alternative processes if necessary. Jones Day is continuing to monitor the situation and will continue to update our readers as the situation progresses!

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[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.
[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.
[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] Memorandum from Jeffrey L. McGuire, Deputy Director, Sales and Use Tax Department, to the Board of Equalization (Aug. 4, 2011) *available at* http://www.boe.ca.gov/meetings/pdf/TTA-IIP.pdf.
[20] News Release, California State Board of Equalization, Nortel Does Not Affect Sales Tax on Off-The-Shelf Software (May 27, 2011).
[21] Cal. Rev. & Tax. Code §§ 6011(a)(10)(A)-(C), 6012(a)(10)(A)-(C); Cal. Code Regs. tit. 18, § 1507(b).
[22] News Release, California State Board of Equalization, Nortel Does Not Affect Sales Tax on Off-The-Shelf Software (May 27, 2011).
[23] While vendors have prevailed in two recent Section 17200 cases involving the collection of sales taxes, 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.