AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

A CALIFORNIA COURT OF APPEAL HAS HELD THAT THE BOARD OF EQUALIZATION ERRED IN ITS ASSESSMENT OF SALES TAXES ON SALES OF SOFTWARE TRANSFERRED VIA TANGIBLE MEDIA PURSUANT TO A TECHNOLOGY TRANSFER AGREEMENT

SUMMARY

On October 8, 2015, the California Court of Appeals, Second Appellate District issued its decision in *Lucent Technologies, Inc. v. State Board of Equalization*, Docket No. B257808, a case which involves facts identical to those in *Nortel Networks Inc. v. State Board of Equalization* 191 Cal. App. 4th 1259 (2011), and in which it held, like *Nortel Networks Inc.*, that the Board of Equalization's assessment of sales taxes in connection with a sale of software transferred via magnetic tapes and compact discs under the terms of a technology transfer agreement (or "TTA") was erroneous.

DETAILS

Background

Lucent Technologies, Inc. ("Lucent"), a New Jersey headquartered telecommunications equipment manufacturer, was formed February 1, 1996, when AT&T Corporation ("AT&T") spun-off its Network Services Division that was responsible for manufacturing telecommunication industry switches. These switches were used by telecommunications companies to connect their land-based and wireless telecommunication and data networks. Each switch was operated by a computer, which, in turn, was run by two types of software – one switch-specific and the other generic in nature. AT&T and Lucent designed the software that operates the switches. The software was copyrighted and embodied in at least one of eighteen different patents held by AT&T/Lucent.

CONTACT:

ATLANTIC:

JONATHAN LISS, Tax Senior Director
215-636-5502 / jliss@bdo.com

JEREMY MIGLIARA, Tax Senior Director
703-770-0596 / jmigliara@bdo.com

CENTRAL:

ANGELA ACOSTA, Tax Senior Director
248-688-3313 / aacosta@bdo.com

NICK BOEGEL, Tax Senior Director
414-615-6773 / nboegel@bdo.com

JOE CARR, Tax Principal
312-616-3946 / jcarr@bdo.com

MARIANO SORI, Tax Partner
312-616-4654 / msori@bdo.com

RICHARD SPENGLER, Tax Senior Director
616-776-3687 / rspengler@bdo.com

NORTHEAST:

JANET BERNIER, Tax Principal
212-515-5405 / jbernier@bdo.com

MATTHEW DYMENT, Tax Principal
617-239-4130 / mdyment@bdo.com

SOUTHEAST:

ASHLEY MORRIS, Tax Senior Director
919-278-1963 / amorris@bdo.com

SCOTT SMITH, Tax Senior Director
615-493-5629 / ssmith@bdo.com

SOUTHWEST:

TOM SMITH, Tax Partner
918-281-4080 / tasmith@bdo.com

GENE HEATLY, Tax Senior Director
214-665-0716 / gheatly@bdo.com

WEST:

ROCKY CUMMINGS, Tax Partner
415-490-3130 / rcummings@bdo.com

PAUL MCGOVERN, Tax Senior Director
714-913-2592 / pmcgovern@bdo.com

AT&T/Lucent had contracted with its telephone company customers to: (i) sell switches; (ii) provide instructions for installing and using them; (iii) develop and copy the software needed to operate them; and (iv) grant the right to copy the software for use with their switches. The software was provided to its customers on magnetic tapes or compact discs. The Board of Equalization conducted a sales tax audit covering the period January 1, 1995, through September 30, 2000, and assessed AT&T/Lucent $24,773,185.38 for the total amount related to software licensed under the customer contracts. AT&T/Lucent paid the assessed sales tax and filed a claim for refund, which the Board denied. AT&T/Lucent sued the Board for a refund of the tax paid in Los Angeles Superior Court. The Superior Court concluded that the contracts constituted non-taxable TTAs under California law, notwithstanding the fact that the software was transferred to customers using tangible media, and granted AT&T/Lucent's motion for summary judgment. The Board appealed the Superior Court decision to the California Court of Appeals and the Court of Appeals affirmed the lower court's decision.

The Court of Appeals' Decision

In its decision, the Court of Appeals addressed the following two questions: (i) whether the software was tangible personal property, the sale of which is taxable in California, rather than a sale of intangible property, the sale of which is not taxable in California; and (ii) whether the contracts qualify as TTAs, the sale of which is not taxable in California.

Is the Sale a Taxable Sale of Software Tangible Personal Property?

The Board first argued that, logically, AT&T/Lucent's placement of the software on tangible media (i.e., magnetic tapes and CDs), physically altered/changed the transaction from a non-taxable sale of intangible property to a taxable sale of tangible personal property. The court disagreed with the Board for two reasons. First, California courts on multiple occasions have held that choosing to transfer software on tangible media in conjunction with a granting of a license to copy or use that software where the tape or disc merely represent a convenient storage medium to transfer the copyrighted content does not establish a taxable transaction. Second, ascribing sales tax consequences to the manner in which a software program is transferred when the method of transfer is secondary to the ultimate use of the software and easily manipulated by the seller and end-user would lead to an absurd result. That is, if the court accepted the Board's argument that the software at issue was tangible property, AT&T/Lucent would be liable for nearly $25 million in sales tax, rather than $0, simply because it or the customer chose to transfer the software on tangible media rather than electronically (e.g., e-mail or Internet).

The Board also advanced the following four other reasons in support of its position that the software at issue is tangible personal property – each of which the court rejected:

- The sale of software on physical media is a transaction subject to sales tax as per *Navistar Internat. Transportation Corp. v. State Board of* Equalization, 8 Cal. 4th 868 (1994), and *Touche Ross & Co. v. State Board of Equalization*, 203 Cal. App. 3d 1057 (1998), which the court found to be inapplicable because those cases addressed the sale of computer software for its own sake and not in conjunction with the concurrent sale of intellectual property rights.
- The exclusion of the type of sale at issue from the exceptions to sales tax for certain types of transactions involving the sale of software found under Cal. Rev. & Tax Code §§ 6010.9 (relating to the service of creating custom software) and 6377.1 (relating to software necessary to operate equipment used to stimulate economic development as part of California's enterprise zone program), implies that the sale at issue is taxable; otherwise, these two sections would be superfluous. The court found each statutory provision to be contextually distinct and neither rendered a nullity by its decision.
- Likely in an attempt to get the court to follow Louisiana law, Louisiana courts treat software as tangible personal property, which the court found to be at odds with California law, and, therefore, lacked even persuasive value.
- The court should overturn precedent that dictates a ruling against it, which the court was hesitant to do because the issue was a statutory one that the legislature has the power to alter, the court was bound by California Supreme Court precedent, and the potential for the absurd result noted above.

Do the Contracts Qualify as Nontaxable Technology Transfer Agreements (TTAs)?

The Board next argued that even if the software itself is not tangible personal property, the AT&T/Lucent transactions with customers are taxable because: (i) the underlying contracts do not satisfy the statutory elements of a TTA; and (ii) the nontaxable intangible aspect of the each transaction is essential or physically useful to the tangible portion of the transaction. The court did not entertain the Board's argument with respect to the latter point because the court found that the AT&T/Lucent contracts met each of the requirements needed to qualify as nontaxable TTAs. First, the software was copyrighted and patented. Second, AT&T/Lucent granted its customers a license to reproduce its software. Third, the products sold by AT&T/Lucent customers were subject to the licensor's copyright or patent interest. Here, the court pointed out that its earlier decision in *Nortel Networks Inc.* was directly on point.

Similar to the issue of whether the software is tangible personal property, the Board advanced several arguments in support of its position that the contracts did not meet the requirements for a TTA, including AT&T/Lucent transferred insufficient rights, and the TTA statutes require prima facie evidence showing that it was more likely than not that, absent the right-to-use license agreements, its customers would have infringed on AT&T/Lucent's patent or copyright interests when using the software. Also, similar to the other issue, the court systematically rejected each of the Board's arguments.

BDO INSIGHTS

- *Lucent Technology, Inc.*, like *Nortel Networks Inc*., is a huge win for taxpayers and tremendous loss for the State of California. Amounts in each of these decisions were enormous, but the refund claims pending before the Board on these issues, as well as those that may be filed as a result of the publication of this decision, could be devastating for an already strapped California budget.
- The Court of Appeals took a page from the majority opinion and Justice Scalia's concurring opinion in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) when it wrote, "[c]ourts are especially hesitant to overturn prior decisions where, as here, the issue is a statutory one that our Legislature has the power to alter." The Board foresaw the potential for a material degradation of the tax base when the TTA statutes were proposed by the California legislature in 1993, and asked that they not be enacted. Will the legislature make statutory changes whereby this exemption will no longer be available?
- After this second loss on an identical issue as that which was decided in the *Nortel Networks, Inc*., the Board will now be faced with deciding how they will treat these transactions in current and future audits assuming no further legislative changes are made or the Board prevails on an appeal to the California Supreme Court.