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Impact of the *Lucent* Decision

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Overview

- The *Lucent* decision on the tangibility of software transferred on tapes and disks expressly hinges on application of the physical usefulness test as applied to sale of software on external storage media in Technology Transfer Agreements (TTAs), where the external storage media is not physically useful post-sale and thus is merely "convenient."
- The issue in which attorneys and CPAs have expressed the most interest is whether the *Lucent* decision can be extended to the software that is embedded in the internal storage media found in electronic products, from cars, planes, and computers to cell phone devices, appliances, and toothbrushes.
- Unlike the "convenient" external storage media (magnetic tapes) in *Lucent*, "essential" internal storage media (containing embedded software) is necessarily physically useful post-sale.
- Because internal storage media is always physically useful post-sale, in the case of a sale made pursuant to a TTA of equipment containing software embedded in its internal hardware, application of *Lucent*'s physical usefulness test necessarily leads to a conclusion that the software in such cases must be treated as TPP for purposes of the TTA allocation.

General Rules for Non-TTA Sales of Software on Media

- The general rule for software stored on storage media in physical form has been and remains that, because it can be seen, measured, and perceived, it constitutes TPP for sales and use tax purposes, and that its sale is therefore fully taxable.
- BOE Regulation 1502 applies in non-TTA cases:
  - PREWRITTEN (CANNED) PROGRAMS. ....Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.
- Rev. & Tax. Code, § 6016
  - "Tangible personal property" means personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.
- *Searles Valley* (2008) held that electricity is TPP.
- *Navistar* (Supreme Court, 1994) and *Touche Ross* (1988) held that a transfer of a prewritten program stored on physical media constitutes a transfer of tangible personal asset.

The Pre-TTA Physical Usefulness All-or-Nothing Test for Mixed Sales of TPP and IP Rights

- *Simplicity Pattern* (Supreme Court, 1980)
  - ". . . a sale does not become nontaxable whenever its principal purpose is to transfer the intangible content of the physical object being sold."
  - ". . . completed film negatives and master recordings were tangible personal property for sales tax purposes . . . . Though valued in part for their intellectual content, they also were physically useful in the manufacturing process. Their value as physical objects permitted measuring the tax on their sale by the price received for their entire worth."
- *Navistar* (Supreme Court, 1994), held that physical usefulness in a manufacturing process is not a prerequisite to the imposition of sales tax on items valued in part for their intellectual content.

TTA Statutes, 1993, Allocation Approach

- "Technology transfer agreement" means 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.
- The TTA Statutes were enacted in 1993 to implement the BOE's decision in *In the Matter of Petition of Intel* (1992).
- The BOE warned the Legislature in its 1993 Legislative Bill Analysis that the proposed TTA exemption may be broader than intended by the author.

TTA Decision on Physical Usefulness Test

- *Preston* (Supreme Court, 2001)
  - ". . . the tangible artwork was physically useful and essential in the ultimate production of books and rubber stamps incorporating the copyright in the artwork. Without the physical artwork, the contracts were essentially 'worthless.'"

Proposed Amendment to § 6010.9 in 2013 California State Budget Bill

- In May 2013, as part of the California State Budget Bill, the Legislature considered amending § 6010.9 to explicitly state that computer programs stored on physical media are TPP, but did not enact the amendment.
- Clarify Sales Tax on Software
  - Governor proposed trailer bill language that clarified that software delivered on media (such as disc, tapes, or other storage devices) is tangible personal property and subject to the state's sales tax provisions.
  - The clarification consists of an amendment to the RTC and non-codified language in the bill indicating that the language is declaratory of existing law.
- Senate: No action on TBL.
- Assembly: Adopted TBL.

Key Holdings in *Nortel*

- The court invalidated one sentence in Regulation 1507 which provided that a TTA does not include an agreement for the transfer of prewritten software, as inconsistent with the statute.
- The court also stated: "Pacific Bell made little use of the tangible disk containing the program, which was simply copied onto its computers, but it made continuous use of the intangible information contained on the disk, information that was necessary to run the switch."

Background to the *Lucent* Litigation

- Taxpayers sold telephone companies switches and software that were recorded on external storage media, mainly magnetic tapes, together with the right to copy the software onto switches and then only "use" the software to run the switches, but not otherwise reproduce or sell the software to third parties. Telephone companies used the equipment and software to provide telephone and Internet services to their customers.
- The BOE argued that software transferred on storage media was TPP under § 6016's scientific test, and therefore the computer programs physically stored on the tapes constituted TPP.
- Taxpayers argued that similar issues had been decided in *Nortel*, that the only TPP transferred was the storage media and documentation, and that the intangible transferred was the right to use the software subject to taxpayer's patent or copyright interests.

Lucent Key Holdings

- The court rejected the BOE's argument under § 6016 because, "First and foremost, it is inconsistent with precedent. As detailed above, when tangible and intangible property is inextricably intertwined, whether the property is subject to the sales tax turns on whether the tangible property is 'essential' or 'physically useful' to the subsequent use of the intangible personal property."
- The court applied the default all-or-nothing rule from the pre-TTA decisions to determine whether the external storage media was "essential" or "physically useful" to the purchaser's subsequent, post-sale use of the licensed or assigned patent or copyright interests.
- The court acknowledged that the TTA Statutes set up a special allocation rule for TTA transactions, but still applied the physical usefulness test, asking whether the external storage media was necessary to the subsequent, post-sale use of the licensed copyright interests.
- Based upon the above analysis, the court held that the tapes and discs were merely convenient storage media used to transfer the copyrighted content and hence not in and of themselves essential or physically useful to the later use of the licensed copyright interests; therefore, the transmission of the software using physical media as part of a transaction granting a license to copy and use that software did not transform that software into TPP, and only the storage media itself was taxable.

Impact of the *Lucent* Decision

- On the issue of external storage media (generally convenient) vs. internal storage media (essential as always physically useful), the *Lucent* decision has created uncertainty regarding the proper tax treatment of purported TTA transactions involving internal storage media, i.e., embedded software and preloaded software.
- Potential lawsuits:
  - Consumers or retailers may attempt to file lawsuits against the BOE for refund of sales or use taxes.
  - Consumers may also attempt to file class actions against retailers. In class actions brought by consumers who paid sales tax reimbursement, the BOE is afforded protection by the Supreme Court in *Loeffler*.

Amending Regulations 1507 and 1502

- The Supreme Court denied the Board's Petition for Review *Lucent* in January of 2016.
- During the interested parties meeting on March 30, 2016, the Board authorized staff to begin working on amendments to Regulations 1507 and 1502.
- The Initial Discussion Paper on Regulation 1507 was issued on June 17, 2016, and an interested parties meeting was held on June 30, 2016.
- The next interested parties meeting has been postponed while further revisions are considered.