

Life After *Lucent*: Administering California's Technology Transfer Agreement Law

California law imposes a sales tax on retailers for the privilege of selling tangible personal property (TPP), absent a specific exemption or exclusion.¹ The tax is based upon the retailer's gross receipts from TPP sales in California.

Sales tax does not apply, however, to the amount charged for *intangible* personal property transferred with TPP in any "technology transfer agreement" (TTA), as specified. (Revenue and Taxation Code (R&TC) Section 6012(c)(10)(A).) A TTA, in turn, is defined as any agreement under which a person holding a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process subject to the patent or copyright interest. (R&TC Section 6012(c)(10)(D).)

Origins of the TTA Law

California's TTA Law traces its origin to a 1992 decision by the State Board of Equalization (BOE). The case involved Intel Corporation (Intel), which had entered into a contract in which it licensed to another company a process for producing integrated circuits. As part of this contract, Intel transferred written information, instructions, schematics, database tapes, and test tapes. The issue raised in this case was whether the sales tax should apply to the entire transfer price or only to the amount attributable to the tangible items transferred. The BOE concluded that:

[I]n agreements of this type there are for sales and use tax purposes, two transfers. One is the [TPP] which may consist of engineering notes, manuals, schematics, database tapes, drawings and test tapes. The second is the sale of intangible property which consists of the license to use the information under the copyright or patent.

(In the Matter of the Petition of INTEL CORPORATION for Redetermination under the Sales and Use Tax Law, p. 2)

The following year, AB 103 (Quackenbush), Chapter 887, Statutes of 1993, was signed into law, with the stated purpose of "clarifying" the Sales and Use Tax Law consistent with the BOE's

¹ TPP is personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.

decision in *Intel*. In its staff analysis of AB 103, however, the BOE cautioned that AB 103's language could be construed more expansively than intended. Specifically, the BOE analysis noted:

The purpose of the [BOE's] decision in the Intel case was to make certain the application of tax to technology transfer transactions, which involve the licensing of copyright and patent interests in a product to be manufactured for sale – transfers which generally had not in practice been subject to the tax prior to the time the [BOE] issued its opinion. It is our understanding that the author's intent is to clarify the application of tax on transactions such as Intel's. However, with the proposed definition of [a] technology transfer agreement, other transfers of patented processes could be exempted.

To this end, the BOE analysis noted several scenarios under which a "problem in interpretation" could arise, including the following:

In the case of a sale of computer software, there usually is a licensing agreement which provides that the buyer may use the program only under certain conditions. The provisions of AB 103 could be interpreted to apply in this situation as the right [to] use a process, i.e., the program. If this were true, the retailer of the software could segregate a portion of the program sales price as a sale of intangible personal property.

Since enactment, the TTA Law has indeed generated disagreements over its proper scope and interpretation. Most recently, the TTA Law was subject to litigation in the case of *Lucent Technologies, Inc.*, discussed below.

The *Lucent* Decision

In *Lucent Technologies, Inc. v. Board of Equalization* (2015) 241 Cal.App.4th 19, the Court of Appeal applied the state's TTA Law to a case in which a manufacturer sold telecommunications equipment to nine different telephone companies, which in turn used the equipment to provide telephone and Internet services to their customers. In these transactions, the telephone companies paid for: (1) the equipment, (2) written instructions for using the equipment, (3) a copy of the computer software used to operate the equipment, and (4) the right to copy that software onto the equipment's hard drive and thereafter use the software. (*Lucent, supra*, 241 Cal.App.4th at p. 25.)

The Court concluded that the BOE had improperly assessed sales tax in these transactions on both: (1) the computer software sent to the telephone companies on tapes and compact discs and (2) on the licenses to copy and use that software. (*Id.* at 32.)

Specifically, the Court held that the manufacturer's decision to provide copies of the software on magnetic tapes and compact discs (rather than over the Internet) did not turn the software or the rights to use it into taxable TPP. (*Id.* at 26.)

In addition, the Court held that the underlying transactions met the statutory definition of a TTA. (*Id.* at 36.) The Court began its analysis by noting the undisputed evidence indicating that

Lucent's computer software was both copyrighted and patented. (*Id.*) The Court also held that the second and third elements of a TTA were met. Specifically, the Court noted that Lucent had transferred a portion of its copyright interest in its software when it granted the telephone companies a license to reproduce the copyrighted work. (*Id.* at 37.) Finally, the Court found that the resulting products (i.e., the telephone products the telephone companies sold to their customers) were "subject to" this copyright interest. (*Id.*)

On January 20, 2016, the California Supreme Court denied the BOE's petition for review, allowing the Court of Appeal's decision in *Lucent* to stand. In light of this decision, the State faces a host of issues with possibly far-reaching policy and budgetary implications depending upon the breadth of the TTA Law's application.

The BOE Regulatory Process – Implementing *Lucent*

During its March 30, 2016 board meeting, the BOE discussed potential rulemaking and other possible administrative actions necessary to implement the *Lucent* decision. BOE Members voted to refer implementation of *Lucent* to the Business Tax Committee (BTC) interested parties process. The BOE Members also authorized staff to issue a special notice² (released August 2016) to taxpayers about the decision and the BTC interested parties process.

On June 30, 2016, a BTC interested parties meeting was held to discuss proposed amendments³ to Sales and Use Tax Regulation 1507, *Technology Transfer Agreements*. The amendments were intended to clarify the definition of a software TTA (in accordance with the holding in *Lucent*) and to clarify the measure of tax when software is transferred under a software TTA. Interested parties were asked to provide written responses to the proposed amendments by July 15, 2016.

Subsequent interested parties meetings were planned to continue discussion on Regulation 1507, conforming amendments to Sales and Use Tax Regulation 1502, *Computers, Programs, and Data Processing*, and the application of tax to embedded or pre-loaded non-custom software.⁴ However, the second interested parties meeting planned for January 10, 2017 was cancelled and has not yet been rescheduled.

Notwithstanding this ongoing regulatory process, the BOE has the authority to process timely, valid claims for refund if they are based upon transactions similar to the fact pattern in *Lucent*. Specifically, staff must verify that the claims relate to a software TTA:

- 1) That is between an exclusive holder-retailer, such as Lucent, and a licensee, such as the telephone companies involved in Lucent's software TTAs; and,
- 2) Pursuant to which software was transmitted to the licensee on tangible storage media that was wholly collateral to the licensee's use of the licenses regarding that software, such as tapes and discs used to transfer Lucent's software.

² <http://www.boe.ca.gov/pdf/L468.pdf>

³ <http://www.boe.ca.gov/meetings/pdf/1507IDPweb061716.pdf>

⁴ Additional interested parties meetings set for August 12, 2016, and October 21, 2016, were also postponed.

In August 2016, the BOE's Audit Determination and Refund Section sent approximately 1,000 surveys to taxpayers that had filed claims for refund related to TTAs. Returned surveys indicating the claim closely fits the fact pattern in *Lucent* have been referred to BOE field offices so staff can contact taxpayers and verify the claim for further processing. Refund claims that were not referred to field offices will continue to be held in abeyance pending the conclusion of the regulatory process.

Focus of Hearing

This informational hearing will focus on: (1) a general overview of the *Lucent* decision, (2) a status update on the BOE's current regulatory rulemaking efforts to implement the decision, and (3) the potential budgetary implications of the decision for the state's General Fund.