California – Software agreements qualify as sales tax exempt technology transfer agreements

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In brief

On a motion for summary judgment, a California trial court held that written software agreements qualified as technology transfer agreements (TTAs) exempt from sales and use tax. The Board of Equalization raised several arguments that would have shifted to taxpayers the burden of proving certain facts in order to satisfy required elements of a TTA. However, the court found that the taxpayers were able to provide sufficient evidence and ruled that software licensed by the taxpayers were exempt from sales tax under the TTA statutes as a matter of law. The decision highlights what factual support the BOE may demand of taxpayers, and what factual support is actually required by the courts. [*Lucent Technologies, Inc. v. State Board of Equalization*, Los Angeles Superior Court, No. BC402036 (9/27/13)]

In detail

Facts

During the 1995 – 2000 tax periods at issue, AT&T Corp. and Lucent Technologies, Inc. (Taxpayers) were global suppliers of products and services supporting various telecommunication services. Taxpayers manufactured and sold switching equipment, which allowed customers to provide telecommunication services to end customers. The switches required software, which Taxpayers provided pursuant to written agreements.

Taxpayers filed for a refund claim for sales and use tax paid on amounts relating to the written agreements described above because they were exempt technology transfer agreements. The Board of Equalization (BOE) denied the refund, and Taxpayers filed a complaint with a trial court. The trial court ruled in favor of Taxpayers on a motion for summary judgement for the reasons set forth below.

California's treatment of technology transfer agreements

California generally exempts from sales and use tax intangible personal property transferred with tangible personal property in any technology transfer agreement. A 'technology transfer agreement' is 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."

2011 Nortel decision

The court recognized that the 2011 appellate court decision in *Nortel Networks, Inc. v. California State Board of Equalization* addressed a nearly identical issue and was controlling. In *Nortel,* a taxpayer designed, manufactured, and sold switches pursuant to written agreements. The BOE asserted that such agreements involved

prewritten software and therefore could not qualify as exempt technology transfer agreements, relying on a regulation stating that TTAs do not include an agreement for the transfer of prewritten software. The appellate court found that the TTA statute encompasses *any* agreement without a restriction regarding prewritten software. Accordingly, the court ruled that the regulation was an invalid extension of authority and found that the BOE could not exclude prewritten software from the definition of a technology transfer agreement. Click here for our summary of the *Nortel* decision.

Computer code as a physical medium is irrelevant

The BOE argued that software has a physical presence due to physical transformations in storage mediums. The court did not disagree that physical transformations may occur, but found doubtful that this fact would make a difference in its decision. The role of storage media is not essential to the software reproduction process. Storage media is merely a convenient means used to transmit software. Accordingly, the BOE did not establish the existence of a material fact to avoid summary judgement.

Taxpayers do not have to prove copyright or patent infringement

The BOE argued that Taxpayers failed to adequately support their assertion that their written agreements were subject to patent or copyright interests. The BOE suggested that Taxpayers should prove whether violations of each license agreement would constitute patent and copyright infringements. The court found that such inquiries were beyond the scope of its analysis, stating that "this is not a patent or copyright infringement case."

Specifying the precise patent or copyright interest for every agreement is not required

The BOE asserted that Taxpayers should specify, for *each* agreement, the ownership of the precise patent or copyright interest licensed to the customer. The court found that general evidence provided by Taxpayers supporting such interest was sufficient to transfer the burden of proving otherwise to the BOE, which failed to disprove that such interests existed.

Licensed software exempt from sales tax

The court recognized that the facts at issue were essentially the same as those presented in *Nortel*. In the absence of the BOE raising a triable issue of material fact, the court ruled in favor of Taxpayers' motion for summary judgement and found that the software licensed by Taxpayers were exempt from sales tax under the TTA statutes as a matter of law.

Proceedings in this case will continue for the limited purpose of determining whether Taxpayers are entitled to prejudgement interest.

The takeaway

As a procedural matter, this ruling was in response to Taxpayers' motion for summary judgement. To avoid the court ruling in favor of Taxpayers' motion, the BOE advanced several arguments in an effort to create a triable issue of material fact. The BOE generally didn't challenge the legal test for qualifying for a TTA, but rather challenged the factual support that the Taxpayers were required to provide in order to satisfy those requirements.

Although the result in *Lucent* doesn't change the treatment of TTAs as set forth in *Nortel*, the *Lucent* decision is instructive in detailing the BOE's efforts to shift the burden of proof back to Taxpayers. The decision highlights what factual support the BOE may demand of taxpayers, and what factual support is actually required by the courts.

Let's talk

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