New York Division of Tax Appeals determines separately stated patent license fees not subject to sales tax

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In brief

On June 19 2014, a New York State Division of Tax Appeals administrative law judge (ALJ) held that patent license fees related to the sale of laser medical devices were not subject to sales tax because the licenses were executed independently from the purchases of the lasers, the license fees were separately stated and reasonable in relation to the total price, and the sales agreement clearly stated that patent rights were not part of the sale of the tangible personal property.

Companies granting rights to perform patented procedures together with the sale of tangible personal property in New York, should evaluate their current sales tax filing position based on the reasoning in this decision. [AMO USA, Inc., New York Division of Tax Appeals, Administrative Law Judge Unit, DTA No. 824550, 06/26/2014]

In detail

AMO USA, Inc. develops, manufactures, and distributes procedures and technologies for corrective eye surgery. AMO developed and patented laser assisted surgical methods to use in performing eye (corneal) procedures (LASIK surgery). AMO sold lasers in New York and collected sales tax from its purchasers on its nonexempt sales. When AMO sold a laser, it also entered into written patent license agreements with the purchaser-operators to perform patented surgical procedures. The procedure license fees were included as a separately identifiable line item on invoices to the purchaser-operators. AMO also sold key cards that were required to be inserted into the laser in order to perform the patented procedures. The cards controlled the number of procedures that could be performed by the laser. Sales tax was charged for sales of cards in New York that were not exempt.

The New York Division of Taxation audited AMO and issued a sales tax assessment for separately stated patent license fees that were charged in connection with lasers sold to AMO's customers (the purchaser-operators) located in New York.

Separate sale of patent license fee

New York generally imposes sales tax on the sale of tangible personal property and specifically enumerated services. Sales tax is not imposed on the sale of intangible personal property. While the New York sales tax laws do not define patents as intangible property, other sections of New York Tax Law define patents in such a manner

Typically, when taxable and non-taxable components are bundled together the entire price may be treated as taxable unless the non-taxable portion

of the transaction is separately stated. Even when certain components are separately stated, the total charge may be taxable if the separately stated items are merely an expense pass-through of the production costs or services in rendered providing the taxable tangible personal property.

Upon audit, the Division assessed sales tax was due on the license fees collected by AMO from purchaser-operators. The Division asserted that the sale of the laser device (and an accompanying key card) implied a right to use and that the license fee was merely an additional cost of the laser system, separately stated to avoid sales tax. The Division maintained that the sale structure was an integrated or step transaction and the patent license and key cards were merely part of the sale of the lasers.

The ALJ disagreed, stating, "The chosen transactional structure respected the discrete identities of the tangible property and intangible property rights that were separately invoiced, indicating that there was no intent to merge the sale of the excimer laser and key cards with the intangible rights conveyed by the patent license."

The Division also argued that the transaction was an indivisible bundled transaction, and that the attempt to break out the patent license fee as a non-taxable item was improper. According to TB-ST-860, a vendor may collect sales tax on only the taxable portion of bundled transactions (i.e., not collect tax on the non-taxable items) if: 1) the taxable and nontaxable items may be purchased separately, (2) the charges are separately stated on the bill and (3) the charges are reasonable in relation to the total charges. The ALJ found that AMO convincingly met all three requirements.

The Division further contended that the licensing of the patents had no independent purpose in the transaction since a number of the patents expired during the audit period. However, after examining the fees and corresponding patents, the ALJ disagreed, finding that the argument that AMO failed to establish a correlation between the license fee amount and the patents was without merit.

ALJ determines patent license fee should not be treated as taxable expense

The Division also asserted that the patent license fees were used as a means to manipulate the taxable portion of the sale by referring to the following three rulings: 1) *Matter of Zagoren* (Tax Appeals Tribunal, May 19, 1994), in which the receipts of tangible personal property could not be broken down into taxable and non-taxable services used in its production and that the charge for design services was not distinct from other charges involved in the production of tangible personal property; 2) *Matter of Artex Systems, Inc. v Urbach* (252 AD2d 750 [1998]), in which professional engineering fees were an integral part of furnishing the tangible personal property and a contractually required expense, and 3) *Matter of Penfold v. State Tax Commission* (114 AD2d 696 [1985]), in which separately charged fees were merely company expenses that could not reasonably be considered a separate service arising from a different transaction. The ALJ determined that AMO's patent license fees did not constitute a sale of tangible personal property, a taxable service, or an item of expense since the fees were agreed to under a separate agreement from the laser device and key cards. Specifically, since AMO owned the patents to protect a valuable intangible right and granted the licenses, the intangible right temporarily transferred was not an expense passed through to customers. Rather, the fee represented compensation for usage of the patent right, independent of the laser devices and key cards sold.

ALJ rejected step transaction doctrine argument that would impose tax

The Division contended that the sale of lasers was an integrated transaction, relying on application of the step doctrine. The federal, judicially created, step doctrine treats a series of several steps as a single transaction when the steps are integrated parts of a single plan. The ALJ noted the step transaction doctrine is usually applied to corporate acquisitions, mergers and liquidations and is "ill-fitting and tenuous" to the transaction at issue. However, applying the end result test, the ALJ stated the individual step of having customers purchase patent licenses was an intended end result, i.e., the protection and preservation of a valuable intangible with the execution of a separate contract.

The takeaway

The New York ALJ granted AMO's petition and canceled the Division's Notice of Determination for sales tax due on the patent license fees. Companies licensing intangible property rights in concert with sales of tangible personal property may benefit by evaluating their current sales tax filing positions in light of this decision.

Let's talk

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