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LEGAL ALERT

December 19, 2012

California Court Finds in Favor of Microsoft, Upholds Costs of Performance

On December 18, 2012, the California Court of Appeal ruled that receipts from the right to replicate software are sourced as sales "other than tangible personal property." In reversing the trial court, the Court of Appeal upheld the taxpayer's use of costs of performance sourcing. *Microsoft Corporation v. Franchise Tax Board*, Case No. A131964, Cal Ct. App. (1st App. Dist.). Sutherland State and Local Tax (SALT) attorneys represented Microsoft in the appeal.

Background

The issue in *Microsoft* was whether royalties received for the right to replicate and install software on original equipment manufacturers' (OEM) computers constitute receipts from the sale of tangible or intangible property for purposes of California's franchise tax. This characterization is important because California includes receipts from the sale of tangible personal property in the sales factor numerator if the property is delivered or shipped to California customers. However, receipts from intangibles are included in the sales factor numerator only if the greater proportion of the taxpayer's income-producing activity is performed in California, based upon costs of performance. California has not defined "tangible property" or "intangible property" for purposes of its franchise tax.

Characterization of Receipts from Replicating Software

The trial court ruled for the State and determined that the OEM royalties constituted receipts from the sale of tangible personal property because they constituted receipts from computer software products, which the trial court found to be tangible. The Court of Appeal determined that the right to replicate software is different than the right to use software: "While we appreciate that computer software purchased by an end-user consumer may be characterized as tangible property, our inquiry does not end there. As plaintiff clarifies in its reply brief, 'the issue in this case is not whether software itself is tangible or intangible property, but whether the right to replicate and install software is a tangible or intangible property right.'" Op. at p. 9. The Court of Appeal thereafter held that the OEM royalties constituted the license of an intangible right.

In reaching this conclusion, the Court of Appeal relied upon several California sales and use tax authorities (including the California Supreme Court's decision in *Preston v. Franchise Tax Board*, California's technology transfer agreement statutes, and California's regulations governing the replication of copyrighted software). The Court of Appeal noted that although such "cases and regulations are not controlling as to the outcome of this franchise tax case, we find them to be relevant. In particular, we see no rational justification for treating licenses to replace software as *intangible* in the context of sales taxation, while treating these very same licenses as *tangible* in the context of franchise taxation." The Court of Appeal also rejected the Franchise Tax Board's (FTB) attempt to "selectively rel[y] on pre-*Preston* California sales tax cases" while dismissing *Preston* and the software regulations "on the ground that they concern sales tax and have 'no relevance' to corporate franchise taxation," noting that the FTB's approach was "inconsistent." Op. at p. 14.

FTB's Inconsistent Positions

The Court of Appeal was also disturbed by the FTB's inconsistent position regarding *Appeal of Adobe Systems, Inc.,* 1997 Cal.Tax Lexis 257, an unpublished decision of the State Board of Equalization (BOE). *Adobe* presented the same characterization and sourcing issues associated with OEM transactions as was presented to the Court of Appeal. However, the FTB took the *opposite* litigation position in *Adobe* to the position that it took in the *Microsoft* case and advocated that *Adobe's* royalties constituted gross receipts from the licensing of intangible property. The BOE agreed and held that such receipts should be attributed to California for purposes of determining the taxpayer's California sales factor because Adobe's costs of performance were largely incurred within California. At trial, the Superior Court judge would not allow Microsoft's counsel to cite to or rely on the *Adobe* decision because it was an unpublished decision.

The Court of Appeal held that the *Adobe* opinion was "informative" and stated that: "[w]e ***find it troubling...that [the FTB] appears to have advocated a position in Adobe that is directly contrary to the position it advances against plaintiff in the present case. Unfortunately, the inconsistency suggests a result-orientated bias based on the domicile of the taxpayer."***
Op. at 16 (footnotes omitted; emphasis added).

Federal Tax Law

The Internal Revenue Code provides rules for characterizing software transactions, including the right to replicate software. For instance, Internal Revenue Code section 936 defines "intangible property" to include copyrights. And, U.S. Treasury Regulation sections 1.861-18(b)(1)(i) and (c)(2)(i) define "copyright rights" to include the right to copy software. The Court of Appeal was asked to consider these federal tax characterizations of software transactions on the grounds that doing so would align with global standards and promote consistency with other jurisdictions. The Court of Appeal rejected this suggestion, noting that such policy measures were more appropriately directed to the State legislature. However, Microsoft argued, and the Court of Appeal agreed, that federal law is helpful in determining how to characterize royalties from OEMs.

Costs of Performance and Burden of Proof

Having reversed the trial court on the characterization of Microsoft's OEM royalties, the Court of Appeal next addressed whether Microsoft had met its burden of proof regarding the application of the costs of performance methodology. The Court of Appeal rejected the FTB's contention that Microsoft failed to provide adequate evidence of the location of its costs of performance. Specifically, the FTB argued that the revenues attributable to PowerPoint software (which was developed in California) undermined the taxpayer's position that 99.5% of its costs were outside of California.

The Court of Appeal found that "California permits the taxpayer to rely on its own accounting methods in determining its items of income" and that "[r]egardless, in our view the percentage of income attributable to PowerPoint qualifies as de minimus." Op. at 18. The Court of Appeal further noted that revenues attributable to hardware "constitute approximately six percent of its income" and remanded the case to the trial court to "determine the amount of tax owed by plaintiff based on income derived solely from the sales of its keyboard and mouse during the taxable years at issue." Op. at pp. 18-19.

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