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Nortel is Now Final: Most Software is Now Exempt from California Sales Tax; State Board of Equalization Expected To Fight Refund Claims

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Last week, the California Supreme Court denied the California State Board of Equalization's petition for review of the Court of Appeal decision in *Nortel Networks, Inc. v. State Board of Equalization*, holding that a license of prewritten software falls within California's sales and use tax exemption for transfers of intangible property pursuant to a technology transfer agreement (TTA).[1]

The *Nortel* case has broad implications for the taxation of prewritten software in California. The longstanding position of the State Board of Equalization ("SBE") has been that all sales of prewritten software are subject to the sales tax. However, the SBE must now review every software license on a case-by-case basis-even canned mass-market software-to determine whether the software is subject to a patent or copyright and, thus, covered by the TTA exemption. In the SBE's own words, under the Court of Appeal's ruling, which is now final, "sales of software programs, such as Windows 7 operating system, Microsoft Word, Quicken or TurboTax, will be subject to claims of exclusion from tax."[2]

Based on the SBE's longstanding position, many companies have been collecting California sales or use tax on all of their sales or licenses of prewritten computer software. Since most computer software is subject to copyright and/or involves patented processes, taxpayers who sell prewritten computer software and have been collecting California sales or use tax on such sales should consider filing claims for refund. Additionally, customers who have paid California sales or use tax on purchases or licenses of prewritten software should work with vendors to file claims for refund.

Pursuant to Revenue and Taxation Code sections 6011(c)(10)(D) and 6012(c)(10)(D), California sales tax does not apply to the amount charged for intangible personal property transferred in a TTA. A TTA 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."

The SBE has issued regulations that exclude agreements for the transfer of prewritten software from the definition of a TTA. As a consequence, the SBE argued that the software being licensed by Nortel was

prewritten software and, therefore, subject to sales tax. The Court of Appeal rejected the SBE's argument that the software at issue was in fact "prewritten," noting that the Board's own definition of prewritten software required that such software be "held or existing for general or repeated sale or lease." The software being licensed by Nortel could only be used with a specific piece of hardware and, thus, could not be held for general or repeated sale or lease.

The Court of Appeal held that Nortel's software licenses to Pacific Bell qualified for the exemption for transfers of intangible property pursuant to a TTA. The court noted that a licensing agreement qualifies as a TTA if (1) the holder of a patent or copyright assigns or licenses to another person "the right to make and sell a product" that is subject to the patent or copyright interest, or (2) the holder of a patent assigns or licenses "a process" that is subject to the patent.

Just as significant, the Court of Appeal also determined that the SBE exceeded its authority when it issued a regulation excluding all prewritten computer programs from the definition of a TTA. The relevant statute states that licenses of software that are subject to patent or copyrights qualify for the TTA exemption-regardless of whether the software is prewritten. The court stated that if the legislature did not want the TTA exemption to apply to prewritten computer programs, it would have expressly excluded them and, therefore, the SBE's regulation improperly narrowed the scope of the TTA statute.

Even though *Nortel* is now final, we expect that the SBE will continue to resist applying the TTA exemption to prewritten software.[3] At a minimum, we expect that the SBE will set high evidentiary standards for taxpayers to establish that their software is subject to a patent or copyright.[4] Reed Smith has extensive experience on this issue and has developed methods to show that software is, indeed, subject to patent or copyright.

For more information on the *Nortel* case and other sales tax cases pending in California, contact the authors of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's California tax practice, visit www.reedsmith.com/catax.

Reed Smith's state and local tax practice is comprised of more than 30 lawyers across seven offices nationwide. The practice focuses on state and local audit defense and refund appeals (from the administrative level through the appellate courts), as well as planning and transactional matters involving income, franchise, unclaimed property, sales and use, and property tax issues.

1. Court of Appeal of California, Second District, No. B213415, January 18, 2011, *petition for review denied*, California Supreme Court, No. S190946, April 27, 2011.

2. *Nortel Networks, Inc. v. State Board of Equalization,* Petition for Review, p. 10.

3. The State Board of Equalization has until July 26 to petition the United State Supreme Court for review of the California Supreme Court's denial. 28 USC 2101(c); U.S. Supreme Court Rule 13. However, we believe that if the SBE were to file such a petition, it is highly unlikely that the petition would be granted, because the issues raised in the *Nortel* case are limited to the interpretation and application of state law.

4. We expect the SBE to take a hard line on refund claims, despite the fact that it has previously stated that "software programs sold or leased that are neither patented nor copyrighted are virtually nonexistent." *Nortel Networks, Inc. v. State Board of Equalization*, Petition for Review, p. 9.