Apart from simply causing California Code Regulation §1507 to be amended, the Nortel decision is likely to have a direct and profound change on purchases of prewritten software (also referred to as “canned” or “off the shelf” software) in California. At the same time, the changes brought on by the Nortel decision have created an environment filled with both uncertainty and opportunity for state and local tax practitioners in California. This article provides background information regarding the relevant law, explains what has changed, and provides guidance for practitioners on how to take advantage of the current opportunities that may only be available in the short term.

I. TECHNOLOGY TRANSFER AGREEMENTS DEFINED & THEIR APPLICATION

California Revenue and Taxation Code §§6011(c)(10)(D) and 6012(c)(10)(D) define a “technology transfer agreement” to mean “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.” For purposes of the computation of sales tax, the statutes exclude amounts charged that are sourced to intangible personal property from both “sales price” and “gross receipts” in any technology transfer agreement, even if tangible personal property is transferred along with the intangible personal property. The retail fair market value of the tangible personal property transferred in a technology transfer agreement is taxable.

1 E.A., C.P.A., M.S.T; Assistant Controller - Tax, University of Miami; California State University Northridge, B.A., 2005; California State University Northridge, M.S.T., 2012; The author would like to thank Robert J. Johnson, Managing Director, and John H. Schneider, Senior Manager State & Local Tax - U.S. Indirect Tax KPMG LLP for their input.

2 Nortel Networks, Inc., v. State Board of Equalization, 119 Cal.Rptr.3d 905 (2011)
§§6011(c)(10)(D) and 6012(c)(10)(D) were enacted in 1993 and together these sections of the California Revenue and Taxation Code are referred to as the technology transfer agreement statutes.

In a 2001 decision, the California Supreme Court interpreted the technology transfer agreement statutes broadly. The court found in Heather Preston v. State Board of Equalization, 25 Cal. 4th 197 (2001) that the technology transfer agreement statutes excluded from taxation amounts that an artist received in exchange for transferring the right to reproduce her artwork in a particular object. Because she transferred her intangible property (copyrighted artwork in this case), the contracts she entered into were found to constitute technology transfer agreements and, apart from the retail fair market value of the tangible personal property transferred along with the intangible personal property, were exempt from tax for sales tax purposes. Due to the rights transferred in software licensing agreements, many software licenses qualify as technology transfer agreements under this statutory criteria.

II. THE VALUATION OF TANGIBLE PROPERTY IN TECHNOLOGY TRANSFER AGREEMENTS

The technology transfer agreement statutes provide that amounts charged for intangible personal property transferred with tangible personal property are excluded from tax if a reasonable price for the tangible personal property is separately stated. If the technology transfer agreement does not separately state a price for the tangible personal property, then comparable sales of similar tangible property will guide the valuation of the taxable amount of the tangible property transferred. Using this approach, the remainder amount charged under the technology transfer agreement is deemed the value of the intangible personal property transferred.

But, if the technology transfer agreement does not separately state a price for the tangible personal property, and comparable sales data that would help determine the value of the tangible property are not available, then the statutes provide that the retail fair market value of the tangible property transferred is equal to 200% of the cost of materials and labor used to produce the tangible personal property subject to tax. Of course, the remaining amount charged under the technology
transfer agreement is still deemed to be for non-taxable intangible personal property.

III. CALIFORNIA CODE REGULATION §1507

Between 2002 (when California Code Regulation §1507 was adopted) and 2011, the California State Board of Equalization’s position was that technology transfer agreements did not include agreements for the transfer of prewritten software. Thus, prior to 2011, Regulation 1507 stated, “a technology transfer agreement also does not mean an agreement for the transfer of prewritten software”.

However, this provision was found to be invalid with the decision in Nortel Networks, Inc., v. State Board of Equalization, 119 Cal.Rptr.3d 905 (2011). In Nortel, the court found that the Board was attempting to narrow the application of technology transfer agreement statutes. The court decided that the Board of Equalization did not have the authority narrow a statute by regulation. Consequently, the revised language in Regulation 1507 only provides that transfers of tangible property are taxable, and the exclusion for prewritten software has been removed.

IV. NORTEL, AND WHY IT MATTERS

In Nortel, Nortel Networks, Inc. (“Nortel”), a telecommunications firm, sold switches to Pacific Bell, and the facts of the case showed that software used to operate the switches was transferred in a separate transaction on CDs and tapes. Although there was no question as to whether tangible property (tangible media containing software) was transferred, the court found that Nortel also transferred intangible personal property rights to Pacific Bell. Therefore, the court viewed the situation differently than the Board of Equalization and felt that the question before them was whether the transactions between Nortel and Pacific Bell actually represented technology transfer agreements. Although Nortel initially lost, on appeal the court found that the transfers constituted technology transfer agreements, and therefore were exempt from sales tax. What this means for practitioners today is that the
repercussions of Nortel may be as far-reaching as possibly exempting most purchases of software, even if prewritten computer programs are delivered via tangible media.

V. THE DISTINCTION BETWEEN SOFTWARE RESELLER V. COPYRIGHT HOLDER

Since a technology transfer agreement is between a copyright-holder and the user of intangible property, the tax result of the purchase of software made from a reseller of software is different. Let’s examine two scenarios. In the first, ABC Corp creates and owns a software package, and a consumer purchases a license directly from ABC Corp, the purchase is (for simplicity’s sake) nontaxable. Bear in mind that under current law purchases of software are not taxable if the software is delivered electronically as opposed to on tangible media. Refer to Cal. Code Reg. §1502 for more information.

In the second scenario, ABC Corp is a software reseller. In other words, ABC Corp is authorizes to sell license for the software, but is not the copyright holder itself. Assuming that the software is delivered on tangible media, the purchase is subject to sales tax. The reason that the transaction is not exempt from tax is because the transaction between the software reseller and the consumer fails to qualify as a technology transfer agreement.

VI. ARE THE TECHNOLOGY TRANSFER STATUTES INHERENTLY DISCRIMINATORY?

We have distinguished that a purchase of software may be taxable or nontaxable based on whether the seller is the copyright holder, and therefore it seems that copyright holders have a competitive advantage in the marketplace as compared to resellers. Certainly, if a consumer of a large and expensive

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3The value of the tangible personal property may be small as compared to the total charge for the software. In reality, it depends on how the Board of Equalization decides to respond to the difficult issue of valuing tangible personal property in the real world. It is doubtful that the BOE would agree to a 15- or 20-cent value assigned to the cost of the CD that is used to transfer software to the purchaser.
software package has the option to pay sales tax or avoid tax based on rather elementary tax planning, he will most certainly prefer to make his purchase through the copyright holder. The implication is that holders of copyrights such as the Oracles, Microsofts, and SAPs of the world are treated favorably as compared to software resellers such as Dell, CDW, and Amazon.com.

The Equal Protection Clause of the U.S. Constitution, U.S. Const. amend. XIV, §1, provides that no state can “den[y] to any person within its jurisdiction the equal protection of the laws.” As discussed in *Stephanie Nordlinger v. Kenneth Hahn*, 225 Cal. App. 3d 1259 (1990), separate classifications of taxpayers are both appropriate and sometimes necessary, but the Equal Protection Clause forbids states from treating persons differently who are in all relevant respects alike. The next logical question to consider is whether the technology transfer agreement statutes violate the Equal Protection Clause. However, the answer is a *prima facie* “no” because there is certainly a difference between copyright holders and resellers – namely, that copyright holders hold copyrights, and resellers do not.

This distinction may be enough to warrant a legitimate classification under the Equal Protection Clause and does not seem inherently suspect. As stated in the *Lenhausen v. Lakeshore Auto Parts Co.*, 410 U.S. 356 (1973) decision, the states have large leeway in making classifications and drawing lines in which their judgment produces reasonable systems of taxation. The immediate question involving technology transfer agreements is in sharp contrast to the situation in *MCI Telecommunications Corporation v. Limbach*, 68 Ohio St.3d 195, 198, 625 N.E.2d 597 (1994), in which Ohio was attempting to treat the telephone company differently than its competitors even though both were in the same class of taxpayers and owned the same property. In *Nordlinger*, the U.S. Supreme Court found that California’s Proposition XIII had a legitimate state interest, since it promoted stable home values and helped older citizens with their property tax liabilities. Similarly, it is possible that a similar state interest for encouraging innovation and promoting the acquisition of copyright could be demonstrated.

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4Approved by California voters on June 6, 1978, Proposition XIII restricts annual increases of assessed value for real property not to exceed 2% per year. Since its passage, Prop XIII continues to impact public finance by limiting the State’s ability to collect revenue from property tax. Therefore, annual budgets are highly dependent on less stable revenue sources such as sales and income (largely influenced by capital gains) tax.
The court noted in the Nortel decision that the California Legislature enacted the technology transfer agreements statutes over the Board's objections that the enactment would cause a decrease in sales tax revenues. Despite the Board's concerns, the Legislature enacted the technology transfer agreement provisions with the language to which the Board objected. This perhaps indicates that the preference given to copyright holders may be sourced to a state interest of promoting innovation in industry.

VII. DEALING WITH UNCERTAINTY, AND A RECOMMENDATION TO PRACTITIONERS

Though it does not seem that the technology transfer agreement statutes violate the Federal Equal Protection Clause, it is unclear whether the outcome is fair and sustainable to all players in the software marketplace in California over the long term. After all, both the copyright holders and software resellers make money by selling software. Therefore, challenges to the technology transfer agreement statutes based on the principles of state uniformity clause provisions may be coming. Of course, the law could also be changed to tax all purchases of software, regardless of method of delivery, bringing California into conformity with other states that have adopted a similar position. However, the prudent state and local tax practitioner should not overlook the opportunity to file refund claim requests under the Nortel decision if their client’s software purchases meet the statutory criteria to qualify as technology transfer agreements. If in the long term the state is losing too much revenue and the Board can gain the ear of the Legislature, the technology transfer agreement statutes may also be repealed. It is in the client’s interest to file refund requests even though there is uncertainty in this area of the law and exactly how the Board will respond to taxpayer refund claims. The alternative of not filing refund requests for software purchases that qualify as technology transfer agreements is that the refund opportunity is permanently lost with the expiration of the three-year rolling statute of limitations that applies to sales tax filings in California. Just as it is better to have loved and lost than to have never loved at all, filing refund requests concerning software purchases even when tangible media was received is
worth a shot even if it does not result in a 100% recovery of tax.