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California Trial Court Grants Summary Judgment in *Lucent*, Concluding that Switching Software Qualified for Sales Tax Exemption

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Overview

In *Lucent Technologies, Inc. et al. v. State Board of Equalization*,[1] the Los Angeles Superior Court recently granted the taxpayer's (Lucent Technologies, Inc., "Lucent") motion for summary judgment, ruling that Lucent's license of switch-specific software programs ("SSP") was not subject to California sales tax because the license qualified as a technology transfer agreement ("TTA").[2] The court further agreed with the taxpayer that *Nortel Networks, Inc. v. State Board of Equalization*[3] is controlling and supports the taxpayer's position.[4] In *Nortel*, the California Court of Appeal held that Nortel's license of SSPs and certain related prewritten programs to a regional phone company met the definition of a TTA and was thus exempt from California sales tax, even though the SSPs were delivered on tangible storage media and were not "custom" software.[5]

The *Lucent* case is not yet final, as there is an issue regarding prejudgment interest that the court has scheduled to hear on November 18, 2013. There is also the possibility that the State Board of Equalization ("SBE") may decide to appeal the court's decision. However, taxpayers may wish to consider the *Nortel* holding as well as the *Lucent* court's reasoning and findings in analyzing whether sales or purchases may qualify as TTAs.

In this Tax Alert we summarize the Los Angeles Superior Court's decision regarding Lucent's motion for summary judgment.

Background

Lucent manufactured and sold switches to its telephone company customers. These switches allowed the customers to provide telephone calling and other services to telephone users. The switches consisted of the computer processor frames (or cabinets), shelves, drawers, circuits, packs, cables, trunks, and other items of hardware. No two switches were alike. Each switch was operated by an SSP that was uniquely created for that switch to enable the switch to perform the particular functionalities desired by the telephone company customers. The SSPs drew upon the Lucent basic code, only a portion of which was used by each telephone company customer, depending of the desired functionalities. The basic code was integrated with the customer's specifications pursuant to instructions unique to each switch. Lucent downloaded the desired aspects of the basic code onto storage media consisting of nine-track or digital audio tape. Pursuant to written agreements, the tapes were shipped to the customer's switch location, and the basic code and the instructions were loaded onto the switch hard drive.

Lucent moved the trial court for summary judgment, arguing that there was no triable issue of fact with respect to: (1) whether the written agreements are TTAs, and (2) the amount to be refunded. Lucent argued further that the decision of the Court of Appeals in *Nortel* supports its position and is controlling.[6]

In response, the SBE moved the trial court for summary judgment, arguing that the court should not follow *Nortel*, but should instead follow *Navistar International Transportation Corp. v. State Board of Equalization*,[7] which

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[1] *Lucent Technologies, Inc. et al. v. State Board of Equalization*, (Super. Ct. L.A. County, Sept. 27, 2013, No. BC402036).
[2] *Lucent*, slip. op. at 12.
[3] *Nortel Networks, Inc. v. State Board of Equalization,* 191 Cal. App. 4th 1259 (2011).
[4] *Lucent*, slip. op. at 12.
[5] *Nortel*, 191 Cal. App. 4th at 1279. Our External Tax Alert dated May 3, 2011, summarizing *Nortel* is accessible at:
https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_CA_050311.pdf.
[6] *Lucent*, slip. op. at 3.
[7] *Navistar International Transportation Corp. v. State Board of Equalization*, 8 Cal. 4th 868, 881 (1994) (holding that the manuals and designs sold by Navistar International Transportation were tangible personal property subject to sales tax, and not intangible property). The fact that Navistar International Transportation developed a computer program in-house for its own use did not make the software a custom computer program exempt from tax when it was sold.

addressed the issue of the tangibility of software.[8] Furthermore, the SBE disputed the sufficiency of the evidence in support of Lucent's motion, which the SBE asserted created a triable issue of material fact.[9]

Summary of the Trial Court's Ruling in *Lucent*

The court concluded that *Nortel* "is directly on point" and that the "software licensed by Lucent is exempt from sales tax under the TTA statutes as a matter of law."[10] The court then determined that there "is no triable issue of material fact on this point."[11]

Regarding the question of whether Lucent had presented sufficient evidence in support of its motion for summary judgment with respect to the amount to be refunded, Lucent calculated the maximum value of tangible personal property (i.e., the storage media and documentation transferred with the software pursuant to the written agreements) using the valuation method set forth in Cal. Rev. & Tax. Code §§ 6011(c)(10)(B) and 6012(c)(10)(B). Lucent then calculated the sales tax applicable to the value of the storage media and documentation and subtracted that amount from the total erroneously assessed tax amount that had included sales tax on software licensed by Lucent. After factoring in an adjustment to reflect a slight overstatement of the refund amount, the Court accepted Lucent's calculation and concluded: "There is . . . no triable issue of fact with respect to the amount of the refund due Lucent."[12]

Based on the foregoing, the court granted Lucent's motion for summary judgment.[13] Also, the court addressed an additional issue raised by Lucent regarding Lucent's right to prejudgment interest. The court determined that this issue had not been briefed and, accordingly, set the hearing for November 18, 2013 to address the issue.[14]

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If you have questions regarding the *Lucent* summary judgment decision or pertaining to other California sales tax matters, please contact any of the following Deloitte Tax professionals.

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[8] *Lucent*, slip. op. at 11.
[9] *Lucent*, slip. op. at 13.
[10] *Lucent*, slip. op. at 12.
[11] *Id.*
[12] *Lucent*, slip. op. at 13.
[13] *Id.*
[14] *Id.*