California Supreme Court denies review of *Lucent*, BOE addresses refunds

Overview

On January 20, 2016, the California Supreme Court denied the California State Board of Equalization's (BOE) petition for review[1] of *Lucent Technologies, Inc. v. Board of Equalization,*[2] a California Court of Appeals ruling involving the sales and use tax treatment of switch-specific software programs.

In response to the California Supreme Court's denial of review, Randy Ferris, Chief Counsel of the California State BOE, issued a Chief Counsel Memorandum (Chief Counsel Memo) discussing the following topics: (1) the BOE's interpretation of the holdings set forth in *Nortel*[3] and *Lucent*, as well as their application under three different scenarios; (2) the BOE Legal Department's recommended approach to implementing the *Lucent* holding; and (3) the BOE's potential approach to addressing the California sales and use tax treatment for embedded and pre-loaded software under *Lucent*.[4] Moreover, during a BOE meeting held on March 30, 2016, the BOE heard oral testimony from the BOE Legal Department Staff regarding the BOE Legal Department's recommended approach to implementing the *Lucent* holding (BOE Meeting).

This Tax Alert incorporates information from our previous Alert involving the *Lucent* case,[5] summarizes the recent Chief Counsel Memo and BOE Meeting, as well as provides some related taxpayer considerations.

Summary of Chief Counsel Memo

In accordance with the holdings set forth in both *Nortel* and *Lucent*, the Chief Counsel Memo outlines three different factual scenarios, along with the BOE's recommended sales and use tax treatment under each scenario.

First, the BOE indicates that under a fact pattern similar to *Lucent*, where a holder transfers software on tangible media with a right to make or use a product under a software technology transfer agreement (TTA), the measure of [sales] tax would be on the value of the tangible media used to transfer the software.[6] Second, the BOE indicates that where the software is transferred by a non-holder retailer, the transaction would not be considered a software TTA, and the full retail selling price would be subject to state sales tax. Third, the BOE indicates that where a holder retailer is not the exclusive seller, the non-holder retailer's selling price for the same item would be the taxable measure.[7]

In addition, the Chief Counsel Memo discusses two potential approaches for determining the sales and use tax treatment of embedded and pre-loaded software under the *Lucent* holding: (1) the BOE can issue a notice explaining that the *Lucent* decision is only dispositive with respect to software transmitted on tangible storage media, and is not dispositive with respect to embedded or pre-loaded non-custom software; or (2) the BOE can rely on suggestive language used in the *Lucent* decision to clarify that the *Lucent* case may apply to embedded or pre-loaded non-custom software, or both, but individual retailers of devices must establish that (i) they are a holder; (ii) any software is copied at least once; and (iii) the right to copy is transferred in a written software TTA.[8]

BOE Meeting[9]

On March 30, 2016, the BOE discussed potential rulemaking and other possible administrative actions necessary to properly implement the holding set forth in *Lucent.* As such, the BOE heard oral testimony from the BOE Legal Department Staff on the recommendations that the BOE Legal Department had set forth earlier in the Chief Counsel Memo.

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[1] *Lucent Technologies, Inc. v. Board of Equalization*, 2016 Cal. LEXIS 483 (Cal., Jan. 20, 2016).
[2] *Lucent Technologies, Inc. v. Board of Equalization*, 241 Cal. App. 4th 19 (October 8, 2015); modified and rehearing denied by *Lucent Technologies, Inc. v. Board of Equalization*, 2015 Cal. App. LEXIS 986 (Cal. App. 2d Dist., Nov. 3, 2015).
[3] *Nortel Networks, Inc. v. Board of Equalization*, 191 Cal. App. 4th 1259 (January 18, 2011).
[4] Chief Counsel Memorandum, Cal. BOE (Mar. 18, 2016), available here.
[5] This Multistate Tax Alert from October 16, 2013 is available here.
[6] Chief Counsel Memorandum, Cal. BOE (Mar. 18, 2016) at page 5, available here.
[7] *Id*.
[8] *Id*. at page 6
[9] *See* Board of Equalization Meeting Webcasts, March 29-30, *available at* http://www.boe.ca.gov/meetings/pubmeet16.htm (last visited Apr. 14, 2016).

During oral testimony, the BOE Legal Department Staff made three recommendations to the BOE board members,[10] which mirrored the BOE Legal Department's earlier recommendations from the Chief Counsel Memo:

1. Make amendments to California Code of Regulations, tit. 18, section (CCR) 1507 to clarify the requirements to establish an agreement for the transfer of software on tangible media under a software TTA in accordance with the primary holding in *Lucent*;
2. Clarify the measure of tax [due] when software is transferred under a software TTA; and
3. Make conforming amendments to 18 CCR section 1502, Computer Programs. Data. Processing.

The BOE Legal Department Staff also recommended that the BOE issue a notice stating that the *Lucent* decision is only dispositive with respect to software transmitted on tangible storage media that is wholly collateral to the subsequent use of the licenses regarding the software; as well as notify interested parties about topics, such as the tax treatment of embedded or pre-loaded software.[11]

Lastly, the BOE voted to authorize its staff to begin processing refund claims for taxpayers with facts similar to *Lucent*—for example, for the existence of a software TTA between an exclusive holder retailer and purchaser licensee, pursuant to which software was transferred on tangible storage media and could be verified. In this instance, the taxable measure would be limited to the retail fair market value of the blank storage media used to transfer the software.[12]

Note, while the *Lucent* case specifically dealt with the transfer of software, taxpayers should be aware that a TTA may encompass other copyrighted or patented interests embedded in tangible property traditionally regarded as taxable (e.g., tooling[13] and artwork[14]). This is because the California statutes and administrative regulations pertaining to TTAs recognize that gross receipts attributable to certain intangible rights developed and licensed by a seller are not subject to California sales and use tax, even when the buyer is also paying for a tangible element of the product.[15]

Considerations

Although the holding in *Lucent* applies specifically to software TTAs between a holder of copyright interests or patent rights and a licensee for software transferred on tangible media, the BOE has suggested other potential situations in which a TTA may exist (i.e., transfers of equipment with embedded or pre-loaded software), and is now scheduled to begin reviewing TTA-related refund claims.[16] Accordingly, taxpayers may want to consider whether there are any California sales and use tax refund opportunities available for years open under the statute of limitations for tax paid on software, or other copyrighted or patented interests, embedded or pre-loaded in tangible personal property.

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[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Petition of Intel Corp.*, Cal. State Bd. of Equalization, No. Sy GH 26-624781-010 (Jan. 18, 1994).
[14] *Preston v. State Bd. of Equalization*, 25 Cal. 4th 197 (2001).
[15] Cal. Rev. & Tax. Code §§ 6011(c)(10), 6012(c)(10); Cal. Code Regs. tit. 18, § 1507.
[16] *See* Cal. Rev. & Tax. Code §§ 6902, 6902.3 (generally the statute of limitations in California is three years following the month on which the overpayment of tax was made). Thus, taxpayers may want to consider whether to file a refund claim with the State of California to prevent transactions from falling outside of the statute of limitations.

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