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EXTERNAL ALERT

Microsoft Corp. v. Franchise Tax Board: California Court of Appeal Reverses Trial Court in Microsoft's Favor and Applies Cost of Performance Sourcing to Royalties

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Overview

On December 18, 2012, the California Court of Appeal for the First Appellate District ("Court of Appeal") issued its decision in Microsoft Corp. v. Franchise Tax Board1 ("Microsoft") reversing a lower court decision in favor of the Franchise Tax Board ("FTB"). In this case, Microsoft challenged the FTB's sales factor treatment of royalties paid by original equipment manufacturers ("OEMs") for licensing the right to replicate and install Microsoft's software programs ("OEM royalties"). The Court of Appeal concluded that, for Microsoft's tax years ended June 30, 1995 and June 30, 1996, OEM royalties should be treated as sales other than sales of tangible personal property ("TPP"), and sourced to the State of Washington under the costs of performance ("COP") rules in Cal. Rev. & Tax. Code ("CRTC") Section 25136.[2] As discussed below, this decision provides guidance for taxpayers concerned with the proper sales factor treatment of receipts from licensing the right to replicate and install software.[3]

Factual Background on Microsoft's OEM Royalties

During the years in question, in exchange for a royalty, Microsoft's licensing agreements permitted OEMs to replicate and install Microsoft software on computer systems that were to be sold by the OEM. Microsoft granted no ownership interest to the OEMs.

Microsoft contended that OEM royalties were from the license of intangible property; therefore, they should be sourced under Section 25136 (i.e., sourced to the state where the greater proportion of the income producing activity occurred, based on COP). Approximately 99.5% of the direct costs to generate OEM royalties occurred outside California with the majority occurring in Washington State.[4] The only income-producing activity that occurred within California during the years at issue was related to the development of plaintiff's PowerPoint product. Therefore, Microsoft sourced OEM royalties to Washington under the COP method, and excluded them from its California sales factor numerator. The FTB argued that OEM royalties were from the license of TPP because Microsoft's software products (often delivered to the OEM on a gold master disk to facilitate replication) constituted TPP. Under the rules for sourcing sales and licenses of TPP contained in Section 25135, the FTB argued that OEM royalties from property delivered to the OEM purchasers in California must be included in the sales factor numerator.

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[1] *Microsoft Corp. v. Franchise Tax Board,* No. A131964 (Cal. Ct. App., Dec. 18, 2012).
[2] All references to "Section" herein are to CRTC, unless otherwise provided. All references to "Regulations section" herein are to Cal. Code Regs., tit. 18, unless otherwise provided.
[3] In tax years beginning on or after January 1, 2011 and before January 1, 2013 where an election has been made under Section 25128.5, and for all tax years beginning on or after January 1, 2013, Section 25136 has been amended to incorporate market sourcing rules for taxpayers apportioning income using a single sales factor apportionment formula.
[4] *Microsoft Corp.,* No. A131964, at p. 8.

Court of Appeal Decision

The Court of Appeal held that the Trial Court "erred in concluding that the OEM licenses pertained to the licensing of tangible personal property."[5]

The Court of Appeal framed the issue in Microsoft as "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." With this issue in mind, the Court of Appeal turned to California's sales and use tax law, the unpublished Board of Equalization ("BOE") decision in *Appeal of Adobe Systems, Inc.* ("*Adobe*"),[6] and relevant federal tax law definitions, to support treating Microsoft's OEM royalties as receipts from the license of intangible property, and not from the license of TPP.

First, the Court of Appeal examined the treatment of intangible property under California's sales and use tax law. The court noted the treatment of technology transfer agreements ("TTA's") under sections 6011(c)(10) and 6012(c)(10) of the sales and use tax law which provide that payments for the right to reproduce are not subject to sales and use tax because they are the transfer of an intangible right. Based on that, the court noted that "granting the right to replicate and install – [is] best understood as involving an intangible property right."[7] Further, highlighting the relevance of congruent treatment between California's sales and use tax law and its corporation tax law, the court stated:

> …it appears California sales and use tax law would treat the OEM licenses as intangible property… while California sales tax 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.[8]

Next, the Court of Appeal considered the unpublished BOE decision in *Adobe.* Briefly, *Adobe* concerned whether a California headquartered taxpayer had properly sourced royalties from licensing the right to replicate and install software on computer manufacturers' equipment. In that case, the SBE concluded that "[Adobe's] royalties from the licensing contracts constitute gross receipts from the licensing of intangible personal property"[9] That could be sourced to California where the majority of the taxpayer's costs of performance were incurred. Though an "unpublished" BOE decision,[10] the Court of Appeal found *Adobe* to be an "informative" administrative interpretation.[11] The Court of Appeal pointed out the FTB had taken an inconsistent position in *Adobe* (presumably because the taxpayer was headquartered in California), stating:

> "We find it troubling, however, that defendant appears to have advocated a position in *Adobe* that is directly contrary to the position it advances against plaintiff in the present case… the inconsistency suggests a result-orientated bias based on the domicile of the taxpayer."[12]

Finally, the Court of Appeal looked to federal tax law for guidance on how to classify Microsoft's OEM royalties. The court found that, under federal law, "intangible property"

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[5] *Microsoft Corp.,* No. A131964, at p. 18.
[6] *Appeal of Adobe Systems, Inc*., 1997 Cal. Tax Lexis 257 (Cal. St. Bd. of Equal., 1997). (Unpublished).
[7] *Microsoft Corp.,* No. A131964, at p. 11.
[8] *Id*. at 12.
[9] *Id*. at 16.
[10] As an unpublished BOE decision, *Adobe* is not citable as a controlling precedent.
[11] *Id*. At 16.
[12] *Id*. at 17.

incudes franchises, licenses and contracts, as well as copyrights and literary, musical or artistic compositions.[13]

The Court of Appeal held that "in sum, the trial court here erred in concluding that the OEM licenses pertained to the licensing of tangible personal property. Accordingly, the computation of the sales factor … improperly included the gross receipts plaintiff obtained from these licenses."[14]

The FTB also argued that Microsoft was not entitled to a refund because it had not proven the correct amount of tax owed with respect to income derived from the California-based PowerPoint program, or its keyboard and mouse sales to California customers. With respect to PowerPoint sales, the court found that the PowerPoint product was bundled with the other software and that the royalty for that software was not separately stated and the revenue not separately accounted for in its business records. The court noted that "California permits the taxpayer to rely on its own accounting methods in determining its items of income" so that Microsoft was not required to allocate the royalties to the different bundled products for purposes of sourcing the revenue. As a result, "the entire amount of the royalties received from the OEM license for the bundled software must be excluded from the numerator of the sales factor."[15] With respect to receipts from hardware sales, the court remanded that issue to the trial court for a determination of the "amount of tax owed by plaintiff based on income derived solely from the sales of its keyboard and mouse devices."[16]

Contacts

If you have questions regarding this decision or other California franchise or income tax matters, please contact any of the following Deloitte Tax professionals or your primary Deloitte Tax multistate tax contact.

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[13] *Id*. (Citing 26 U.S.C. § 963(h)(3)(B); 26 C.F.R. § 1.861-18(b)(1)(i), (c)(2)(i)
[14] *Id.* at 18.
[15] *Id* at 18. The court also noted that the royalties derived from PowerPoint were *de minimis*.
[16] *Id.* at 18