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SALES AND USE TAXES

Nortel, Lucent, and Taxing Embedded Software in California Under a Technology Transfer Agreement

The significant open substantive question going forward is the position the Board of Equalization will adopt in light of Nortel and Lucent on the embedded software issue.

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As consumer products become more high tech, the line between computers and traditional devices has blurred. Even basic products, such as toothbrushes, alarm clocks, doorbells, smartphones, cameras, home security systems, printers and copiers now include technical software that enables new functionality options for the device. As a general principle, tangible personal property, but not intangibles or services, is subject to California Sales and Use Tax.[1] Software "embedded" into a product has value distinct from the value of the rest of the device and that distinct (intangible) value is not subject to sales tax. On the heels of two recent taxpayer victories in the California Court of Appeal relating to taxation of software, this article discusses current developments on how to treat such embedded software for California sales (and use) tax purposes.

On a foundational level, California sales tax is imposed on all retailers who sell or lease "tangible personal property" in California.[2] Similarly, use tax is imposed on the storage, use, or other consumption in California of "tangible personal property" purchased from any retailer.[3] Tangible personal property is defined as personal property that may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses.[4]

Conversely, a sale or transfer of "intangible" personal property is not subject to sales or use tax.[5] Intellectual property, which includes a license to use information under a copyright or patent, is a non-taxable intangible.[6] In a transaction that involves sales of tangible personal property bundled with services, the transaction is subject to a "true object" test under which the entire transaction is either taxable or not taxable.[7] However, in a transaction where tangibles and intangibles are bundled together and cannot be separated, courts have analyzed the overall sale to determine whether the tangible aspect is "essential" or "physically useful" to the intangible portion.[8]

California's Technology Transfer Act Provisions

The story of California's legislative technology transfer act provisions begins with a 1992 administrative decision by the California State Board of Equalization (Board). In 1992, the Board decided a petition for redetermination filed by Intel Corporation (Intel) regarding an agreement between Intel and Burroughs Corporation in which Intel transferred a license to use its patents in the process of manufacturing integrated circuits.[9] The contract was for a single, lump-sum amount and did not distinguish between the price of the tangible personal property being transferred and the right to use the license.

The Board determined that two types of property had been transferred, one being of taxable personal property, and the other of nontaxable intangible property. The Board concluded that tax applied only to the value attributable to the tangible elements, and used a determination of the material costs, fabrication labor, and a markup for overhead and profit of 100% of the costs of materials and labor. The value attributable to the intangible elements was not subject to tax.

In 1993, and in the aftermath of *Intel*, the California Legislature enacted several statutory provisions governing technology transfer agreements (TTA) now found in California Revenue and Taxation sections[10] 6011 and 6012 (the TTA statutes).[11] These provisions pertain to the transfer of intellectual property and provide rules requiring a separation of the values of the tangible and intangible property for sales and use tax purposes. As amended, subdivision (c)(10) of both sections 6011 and 6012 provides that a TTA is 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.[12]

The TTA statutes also amended the definitions of "sales price" and "gross receipts" to exclude the "amount charged" for intangible property sold under a TTA, if the TTA separately states a "reasonable

price" for the tangible property. If there is no separately stated price, the TTA statutes provide a formula based on the price at which the tangible personal property was sold, leased or offered for sale to third parties, or in the absence of previous sales, 200% of the cost of materials and labor used to produce the tangible property. The remaining amount charged under the TTA is for the (nontaxable) intangible property transferred.[13]

The author of the TTA statutes (Assembly Member Charles Quackenbush) stated the legislation was intended to implement the Board's *Intel* decision.[14] While the Board initially agreed the proposed TTA statutes were consistent with its practices, subsequent amendments before enactment concerned the Board. While the Board never formally opposed the TTA legislation, the Board expressed concern the language in the statutes under some of the later proposed amendments was broader than the Board's interpretation.

Specifically, the Board was concerned the proposed TTA statutes "were somewhat broader" than provided under its interpretation and would encompass any transaction involving an agreement that licenses patents or copyright interests; whereas under the Board's interpretation of existing law, only specific licenses of patent and copyright interests were excluded from the scope of the sales price and gross receipts.[15] Those concerns were not addressed by the Legislature. Indeed, *Preston*, the first major California Supreme Court decision that addressed the TTA statutes after their enactment, emphasized the Legislature was "undoubtedly aware" that the language exempted "any" patent "or" copyright transfer from taxation, notwithstanding the Board's concerns.[16]

The *Nortel* and *Lucent* Court of Appeal Decisions

Two major California Court of Appeal decisions have addressed the issue of how to treat and value software in a TTA. The first is the 2011 decision in *Nortel Networks Inc.*[17]

Nortel Networks Inc. (Nortel) manufactured and sold telephone switching equipment in California to Pacific Bell Telephone Company (Pacific Bell). Each switch processed telephone calls and handled features such as conference calling, call waiting, and voice mail. A switch for a dense urban area such as downtown Los Angeles is large enough to fill a bowling alley or small auditorium. A switch is hardware, comprised of computer processors, frames, shelves, drawers, circuit packs, cables and trunks.[18] Income from sales of switch hardware was undeniably subject to sales tax by California and was not in dispute between the parties. The dispute, and the question before the court, was whether sales tax can be imposed on the software that Nortel licensed to Pacific Bell to operate the switching equipment.

Nortel and Pacific Bell had entered into licensing agreements, found to be TTAs, giving Pacific Bell the right to use Nortel's software programs in the switches. There were two types of licensed software. First, there were three prewritten operator workstation programs that connected customers to operators, data center programs that connected customers to directory assistance, and switch-connected programs that allowed switches to communicate. Second, there were switch-specific programs (SSPs) that operated the switch and enabled it to process telephone calls.

Each SSP was unique, was created for a particular switch, and could not be used to operate any other switch. Nortel copyrighted its SSPs and the SSP itself incorporated one or more processes that were subject to and implemented Nortel's interests in between 200 and 500 patents on inventions related to switches. Nortel's licensing agreements forbid Pacific Bell from giving a copy of the SSP to third parties.[19]

The foundation for the SSPs was a basic code, and creating a new unique SSP for a specific Pacific Bell location using the basic code as a foundation required some 400 hours of work. The completed SSP was shipped to Pacific Bell on discs, magnetic tapes, or cartridges, collectively known as "storage media." The cost of producing the storage media was negligible ($54,604). The licensing agreement allowed Pacific Bell to copy the software from the storage media and load it into the operating memory of a switch's computer hardware.

Upon audit, the Board determined that Nortel owed $32,054,936.62 of sales tax, $29.2 million of which was attributable to the SSPs, and $2.3 million to the prewritten operator workstation, data center, and switch-connection programs. Nortel paid the disputed amounts and then filed a suit for refund after exhausting its administrative remedies.[20]

The Board and Nortel disagreed on how to apply the TTA statutes and the extent to which the value of the software should be excluded from sales (or use) tax. As discussed above, the legislation broadly defines a TTA 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."[21] If intangible property such as software is transferred under a TTA, the TTA statutes exempt the intangible property from taxation under a variety of methods, depending in part upon whether a separate charge is stated.

The California Sales and Use Tax Law recognizes that, because charges for services are generally not subject to sales tax, the design, development or creation of a custom computer program to the special order of a customer is not subject to sales tax.[22] However, a "canned" or prewritten computer program that is held or existing for general or repeated sale is taxable.[23]

The Board argued Nortel's basic code was canned or prewritten, such that the licensing of that program to Pacific Bell would be taxable. The trial court had rejected this argument, finding, in the words of the statute,[24] the basic code is not a computer program because it is not "the complete plan for the solution of a problem."[25] On appeal, the Board's principal argument was that its Regulation 1507, Technology Transfer Agreements, provided the TTA statutes do not apply to an agreement for the transfer of "prewritten software."[26] Thus, the Board's argument in *Nortel* largely turned on its own regulation and whether Regulation 1507 properly applied to the TTA statutes.

It is an established legal principle that an administrative agency, such as the Board, may not promulgate a regulation that is inconsistent with the governing statute, or that alters, amends, enlarges, or impairs the scope of the statute.[27] Applying this principle, the Court of Appeal rejected the Board's argument and concluded that to the extent Regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, Regulation 1507 exceeded the scope of the Board's authority and was invalid. The Court of Appeal held the TTA statutes broadly encompass "*any* agreement" and do not exclude the licensing of a prewritten program "that is subject to [a] patent or copyright interest."[28]

On April 27, 2011, the California Supreme Court denied the Board's Petition for Review in *Nortel*, thus bringing finality to that litigation. Soon thereafter, on May 27, 2011, the Board issued a news release announcing that the Board intended to amend its Regulation 1507, consistent with *Nortel,* that sales tax does not apply to interests in patents and copyrights transferred with prewritten (or canned) software in a TTA.[29] The news release also stated the changes required by *Nortel* do not affect the way sales tax is applied to the typical off-the-shelf retail sale of canned, mass-marketed software because the typical retailer does not hold any copyright or patent interests in the software (which prevents the agreement from qualifying as a TTA under the statutes).[30]

Thus, after *Nortel*, the Board's position was that if a taxpayer holds patent or copyright interests in non-custom software and makes retail sales of the software on tangible media, a portion of the proceeds from the retail sales of the software may be excluded from gross receipts subject to sales tax. If one purchases non-custom software on tangible media in a transaction that is subject to use tax from a retailer who holds patent or copyright interests in the software, then a portion of the price one pays for the software may be excluded from the sales price of the software that is subject to use tax. However, under *Nortel*, an agreement for the sale or purchase of non-custom software on tangible storage media may qualify as a TTA when the agreement for the sale or purchase also assigns or licenses the right to make and sell a product or the right to use a process that is subject to a patent or copyright interest.[31]

The protracted *Nortel* litigation should have provided a significant degree of resolution regarding the scope of the TTA statutes, but that was not the case. *Nortel* was followed by the 2015 Court of Appeal decision in *Lucent Technologies*[32] where, as the trial court observed: "One could almost substitute the names of the plaintiff and the monetary amounts and the facts would be essentially the same" as in *Nortel.*[33] Similarly, the Court of Appeal in *Lucent* observed that it[34] previously had held in *Nortel* "that an almost identical transaction satisfied the requirements of California's technology transfer agreement statutes."[35]

The Board also requested the court overrule the *Nortel* decision, but the Court of Appeal rejected this request and succinctly stated: "the Board gives us no good reason to depart from this authority, even if we could."[36] Perhaps this sentiment of having the same case before it again entered into the trial court's finding that the Board's position in *Lucent* was not "substantially justified" and awarding to Lucent $2,625,469.87 in reasonable litigation costs, as well as the Court of Appeal's decision to affirm that award.[37]

Lucent involved agreements under which AT&T and Lucent (collectively Lucent) sold telephone companies switches used to connect telephone and data networks, copies of copyrighted and patented software recorded on tapes and discs, and licenses granting the telephone companies the right to copy the software onto the switches' hard drives and the right to use the software. Lucent conceded sales tax was owed on the switches themselves and the written instructions on how to install and run the switches (i.e., the tangible personal property transferred under the agreements). Just like Nortel, Lucent disputed the (nearly $25 million in) sales tax assessed by the Board on (1) the computer software sent to the telephone companies using tapes and compact discs; and (2) the licenses to copy and use that software on the switches.[38]

Following its previous analysis in *Nortel*, the *Lucent* Court of Appeal found the agreements constituted TTAs because Lucent transferred copyrighted and patented interests in the software, so the portion of the transaction dealing with the software and the licenses to use it were not subject to sales tax. The *Lucent* court also added to the holding in *Nortel* by expressly limiting portions of Regulation 1502, which the Board relied on for its position that the TTA statutes only protected the transfer of a "meaningful" patent and copyright interest.[39]

Despite the broad language in the TTA statutes, the Board's Regulation 1502, subdivisions (f)(1) and (f)(1)(B) provided that sales tax applied to the storage media and all license fees included in the sale or lease of a prewritten (or canned) computer program unless the "license fees . . . are made for the right to

reproduce or copy" a copyrighted program "in order for the program to be published and distributed for a consideration to third parties."[40] The Court of Appeal rejected the Board's argument and stated the TTA statutes included no such requirement and "refer simply to the assignment or licensing of 'a patent or copyright interest.'"[41]

On January 20, 2016, the California Supreme Court denied the Board's petition for review in *Lucent.*

The Board's Response to *Lucent* (and *Nortel*)

Once the *Lucent* decision became final, the Board began to consider plans for implementing the decision. A March 18, 2016 Memorandum ("Memo") to the five members of the Board from the Board's Chief Counsel proposed several recommendations for consideration at the March 2016 Board meeting.

The Memo emphasized that *Lucent* found the facts there were virtually identical to those in *Nortel* and argued that *Nortel "*did not apply the TTA statutes to software that was embedded in a device at the time of manufacture or preloaded on a device prior to delivery to a consumer."[42] Further, the Memo also pointed out that *Lucent* did not apply the TTA statutes to a process that was embedded in a device at the time of manufacture.[43] Rather, according to the Board, *Lucent* only applied to software transmitted on tangible storage media that is "wholly collateral to the subsequent use of the licenses regarding that software."[44]

The Memo concluded that when "read together," *Nortel* and *Lucent* primarily hold that:

- The TTA statutes apply when the *holder* of the copyright to non-custom copyrighted software transfers a copy of the software on tangible storage media, the right to reproduce or copy the copyrighted software, and the right to make and sell the "products" that the buyer could not legally make without using a copy of the copyrighted software.
- The TTA statutes also apply when the *holder* of a patent that is embodied, implemented, and enabled by non-custom software transfer a copy of the software on tangible storage media with the right to make and sell a product that is subject to the patent or to use a patented process that is embodied, implemented, and enacted by the software.
- When there is a software TTA (as described above), the measure of tax is limited to the amount charged for the storage media used to transfer the non-custom software as determined under the TTA statutes and does not include charges for the licenses to copy and use the software; under the TTA statutes, the storage media is deemed to be blank for purposes of the Sales and Use Tax Law,

> notwithstanding the physical alterations to the storage media caused by placing the software on the storage media.[45]

The Memo then made two recommendations to the Board for implementing *Lucent* (and *Nortel*). The first recommendation was for the Board to amend its Regulations 1502 and 1507 to clarify (1) the requirements to establish that an agreement for the transfer of non-custom software on tangible storage media is a software TTA; (2) the measure of tax when software is transferred under a software TTA; and (3) the measure of tax when storage media on which software is placed is sold at retail in a non-TTA transaction.[46]

The second recommendation implicitly involved the treatment of embedded and pre-loaded software. The Memo repeated its prior position that *Lucent* did not apply the TTA statutes to software that was embedded in a device at the time of manufacture or preloaded on a device prior to delivery to a consumer.[47] The Memo reasoned *Lucent*'s "analysis indicated that when the TTA statutes do *not* apply, tax applies to the sale of non-custom software on a tangible device that is essential or physically useful to the purchaser's subsequent use of the software, such as a computer, car or coffeemaker."[48]

However, the Memo went on to recognize that *Lucent* had "used language . . . that could be interpreted as suggesting that a holder-retailer's sale of a device, along with the right to copy copyrighted software from the device's hard drive or other tangible storage media into the RAM of the device, could be sufficient to constitute a software TTA."[49] Accordingly, the Memo suggested the Board may wish to address how to apply *Lucent* to sales of devices with storage components that contain embedded or pre-loaded copyrighted software.[50]

The Memo also recommended that "at a minimum," the Board issue a notice explaining that *Lucent* is only "dispositive" with respect to software transmitted on tangible storage media "wholly collateral" to the subsequent use of the license regarding that software, and is not "dispositive" with respect to embedded non-custom software and preloaded non-custom software.[51] In addition, the Memo presented the Board with the option of modifying the Board's regulations to clarify that *Lucent* may apply to embedded or preloaded non-custom software or both, but that individual retailers of devices must establish that (1) they hold copyright or patent interests in embedded or pre-loaded software; (2) the devices copy the software at least once in order to utilize the software; and (3) they are transferring the right to copy the software in a written software TTA.[52] The Memo states that in other situations, retailers must report tax on the entire charge for the device, including the embedded and pre-loaded software under "the general default rule of *Lucent.*"[53]

Legal staff presented its recommendations in the Memo at the March 2016 Board meeting, including the necessary regulatory amendments to address *Lucent* (and *Nortel*). Staff explained the amendments should address transactions in three scenarios: (1) exclusive holder-retailers; (2) non-exclusive holder-retailers; and (3) non-holder retailers.[54] However, none of the substantive actions recommended in the Memo were acted upon at the March 2016 Board meeting.[55] Instead, upon unanimous motion, the Board referred the implementation of *Lucent* to the Board's Business Tax Committee, authorized staff to issue a special notice that would specify what is dispositive with respect to *Lucent*, and referred the non-dispositive fact patterns of *Lucent* to the Business Tax Committee interested parties process.[56]

Following an interested parties meeting on June 30, 2016, to discuss amendments to Regulation 1507, on August 24, 2016, the Board issued the Special Notice regarding *Lucent.*[57] As discussed above, the Board repeated its position that *Lucent* did not address how sales and use tax applies "to the typical off-the-shelf retail sales of canned, mass-marketed software on tangible storage media."[58] The Board also repeated its position that the holding in *Lucent* "does not address the application of tax to embedded non-custom software or pre-loaded non-customer software, which were not at issue in *Lucent.*"[59]

According to the Board, the *Lucent* court "indicated"[60] that storage media is "wholly collateral" to the buyer's use of the software license "if the storage media is only being used to transmit the software to the buyer so that it can be copied and used in conjunction with a computer or computers, and the storage media is not essential or otherwise physically useful to the buyer's subsequent use of the software."[61] The Special Notice further stated that in addition to the June 30, 2016 meeting, other interested parties meetings will be held to continue the Regulation 1507 discussion and to discuss confirming amendments to Regulation 1502 and the application of tax to embedded non-custom software and pre-loaded non-custom software.[62]

Board staff had stated at the March 2016 Board Meeting there were "roughly" 900 pending administrative claims for refund pending, about one-third of which set forth a specific refund amount, and about two-thirds of which did not.[63] The August 2016 Special Notice states that existing claims for refund filed with the Board and based upon software transactions that are "similar" to the software TTA in *Lucent* are now ready to be processed if Board staff can verify they were: (1) between an exclusive holder-retailer, such as Lucent, and a licensee, such as the telephone companies involved in Lucent's software TTAs; and (2) pursuant to which software was transmitted to the licensee on tangible storage media that was wholly collateral to the licensee's use of the licenses regarding that software, such as the tapes and discs used to transfer Lucent's software.[64] On these two points, the Special Notice states that Board staff recently clarified that an exclusive holder-retailer's agreement is similar to the software TTA in *Lucent* if the

agreement assigns or licenses the right to reproduce or copy non-custom software, subject to the exclusive holder-retailer's copyright or patent interest, that is transmitted on wholly collateral storage media.[65]

Looking Forward

As this article went to press, on October 18, 2016, the Board rescheduled the next (and the second) interested parties meeting on technology transfer agreements for January 10, 2017 (previously scheduled for November 1, 2016). The Board also rescheduled distribution of its second discussion paper on that subject to December 2, 2016 (previously scheduled for October 21, 2016). Finally, the Board stated it is reevaluating the concept of basing the application of the tax on whether the seller is an "exclusive holder-retailer" or a "holder-retailer," which is a distinction previously made by the Board in its March 2016 Memo.[66]

An immediate issue for the Board to address is not only the anticipated new filings of claims for refund based on *Lucent* (and/or *Nortel*), but the resolution of a large existing inventory of the "roughly 900" refund claims which have not yet been acted upon. As a first step, and consistent with the Board's position that the "holding" in *Lucent* (or *Nortel*) does not apply to embedded software, in August 2016, the Board issued questionnaires (Form BOE-196-Q) to taxpayers with pending claims for TTA refunds. The questionnaire sets forth a series of questions for retailers and a set of questions for buyers. The retailer questions ask if the retailer was the holder of copyright or patent interests, and the buyer questions ask if the software was purchased from the holder of a copyright or patent interest.

How best to process pending and additional anticipated *Nortel/Lucent* refund claims involving retailers is an especially challenging issue. Such issues of "ease of administration" and the idea of "centralized" processing of refunds were the subject of discussion at the March 30, 2016 Board Meeting.[67] The distinction the Board makes on the question sets for retailers and buyers raises questions regarding how refunds can be made at a practical level depending on whether the retailer paid sales tax or the buyer paid use tax. Use tax is imposed on the retailer or the purchaser.[68] In contrast, sales tax is imposed only upon retailers.[69] Under California Sales and Use Tax Law and the *Loeffler* decision, the retailer is the taxpayer, not the consumer.[70]

Accordingly, only retailers are legally authorized to file and prosecute a sales tax refund action against the Board. Where a retailer has collected excess sales tax reimbursement from its customers, the retailer

must either refund the excess collections to the customers from whom they were collected, or remit the excess amounts to the Board.[71] Thus, to the extent the TTA claims for refund are limited to refunds of *sales* tax, only the retailers would be authorized to file the claims and receive the refunds, and those refunds would be conditioned on the retailers returning the refund to the customers from whom it was collected.

In other words, even though a telecommunications company may have paid the sales tax to the Board on its purchases from a retailer of software, only the retailer (such as Lucent in the *Lucent* case) could actually file and pursue the refund action. This requirement is a substantial impediment to an efficient distribution of the TTA refunds because a retailer typically has minimal incentive to pursue a refund claim to obtain a refund which the retailer then cannot keep and which it is obligated to return to its customers.

A possible option to facilitate an efficient distribution of refunds is to allow a buyer to obtain the refund directly. There is some precedent for such an approach. Following the Court of Appeal's 2008 decision in *Dell*,[72] the parties (i.e., the Board, the retailer (Dell and others) and the purchasers (Dell and others' customers)) agreed to settlement terms under which the Board administered a direct refund process for purchases of optional service contracts.[73] Under the settlement agreement, a customer who paid sales tax could file a refund claim directly with the Board and receive a refund, and the retailer was entirely excluded from the process.[74]

However, in 2014, six years after *Dell*, the California Supreme Court decided *Loeffler* and reiterated that under the tax code it is the retailer—and not the consumer/customer—that is the taxpayer, and that only the taxpayer can file a claim with the Board seeking a refund of overpaid sales tax.[75] The Supreme Court acknowledged the inherent problems with this refund structure: "Of significance to the present case, we also recognized that under existing procedures, 'the retailer is the only one who can obtain a refund from the Board,' but observed that because the retailer cannot retain the excess tax amount for itself, but must undertake some procedure to make refunds to customers, it may have no particular interest in pursuing a tax refund. Similarly the *Board* may lack incentive to examine returns on its own initiative to determine whether retailers have remitted excess taxes to it—that is, whether taxes have been *overpaid.* We observed that the Board 'is very likely to become enriched at the expense of the customer to whom the amount of the excessive tax actually belongs.'"[76]

Because consumers cannot directly pursue refund claims from the Board alone, they are left with the unenviable options of either trying to work with retailers informally to do so outside litigation by, among myriad options, entering into joint defense and/or assignment of rights agreements (with the same

disincentive concerns at play for retailers that were noted by the *Loeffler* court) or by suing their retailers—and joining the Board as a party to these actions—to seek refunds from the Board to the retailers conditioned on an appropriate refund back to the consumers.[77] Permitting consumers direct access to the refund process in these unique circumstances should be warranted.[78]

Legislation certainly could expressly allow for direct refunds by buyers, but that approach has been tried before and without success—specifically, in each of the last four years. In 2013, Assembly Bill ("AB") 1412 proposed a streamlined refund process that would have authorized retailers to assign the right to receive a sales and use tax refund if the amount was greater than $50,000.[79] The Senate Appropriations Committee sent AB 1412 to the Senate Floor as a bill with insignificant revenue costs, but the bill never proceeded further.[80]

In 2014, another version of the bill proposed the same $50,000 threshold for a direct refund payment to the customer, but also authorized retailers to assign the right to file a claim for refund (not just the right to receive the refund payment directly).[81] This added complexity purportedly increased administrative costs and eventually the bill was placed on the Senate Appropriations Committee's suspense file.[82]

In 2015, Senate Bill ("SB") 640 was introduced as a legislative response to the 2014 *Loeffler* decision.[83] SB 640 dropped the refund threshold from $50,000 in previous proposed legislation to $1,000, but maintained that retailers could assign both the right to the direct refund and the right to file the claim for refund.[84] The Board estimated the administrative costs to implement the bill could exceed $1,000,000,[85] and the author ultimately withdrew the bill before its first hearing in the Assembly Appropriations Committee.[86] In 2016, SB 640 was reset for hearing, but was never voted out of the Assembly Appropriations Committee.[87]

Process aside, the significant open substantive question going forward is the position the Board will adopt in light of *Nortel* and *Lucent* on the embedded software issue. The Board has never expressly defined embedded software in the Sales and Use Tax context, though there is much history involving the Board on the embedded software issue in the context of property tax valuation and taxation.[88] Instead, the Board recently uses the term "embedded" software in the Sales and Use Tax context to broadly describe software that is "embedded in a device at the time of manufacture or preloaded on a device prior to delivery to a consumer."[89]

Note how carefully the Board and Board staff's current position on embedded software is couched in terms of semantics. Staff states in its March 2016 Memo that "the *Lucent* court did not *apply* the TTA statutes to software that was embedded in a device at the time of manufacture or preloaded on a device

prior to delivery to a consumer";[90] that the "the *Lucent* decision is *not dispositive* as to transactions involving embedded or preloaded software";[91] and that embedded software "was not at issue in *Lucent*" so the Board "is *under no legal obligation*" with respect to taking a position on embedded software.[92] The Board then states in its August 2016 Special Notice that the *Lucent* "court's *holding* does not address the application of tax to embedded non-custom software."[93]

How should one read and apply *Lucent* and *Nortel?* Witkin explains: "The *ratio decidendi* is the principle or rule that constitutes the ground of the decision, and it is this principle or rule that has the effect of a precedent. It is therefore necessary to read the language of an opinion in the light of its facts and the issues raised, to determine (a) which statements of law were necessary to the decision, and therefore binding precedents, and (b) which were arguments and general observations, unnecessary to the decision, i.e., dicta, with no force as precedents."[94] In other words, not all factual differences automatically call for different legal results. What matters is the *ratiodecidendi* of a decision and how it applies to other sets of facts.

As a simplified example, no one could dispute that the fact *Dell, Inc. v. Superior Court* involved a Dell computer as compared to, for instance, an HP or Microsoft computer, is not legally significant to the court's decision and its *ratio decidendi* there regarding the sales tax treatment where a computer and service contract were sold at the same time. Is the fact that *Nortel* stated the computer programs at issue there were "not embedded"[95] legally significant to the *ratio decidendi* of the *Nortel* and *Lucent* decisions?

The authors think not. "The principle of the case is found by taking account (a) of the facts treated by the judge as *material*, and (b) his decision as based on them."[96] Nothing in the opinions suggests the embedded/nonembedded "fact" was material in *Nortel* or *Lucent.* Indeed, *Nortel* only mentioned the computer programs at issue there were "not embedded" in the next to the last paragraph of its 20-page decision.[97] The Court of Appeal in *Lucent* squarely held that the type of tangible personal property transferred with a TTA does not control whether the TTA statutes apply.[98]

Even the Board concedes there is favorable "suggestive language in *Lucent*" on embedded software.[99] And *Nortel*, citing to *Preston*, explained, "[t]he *lone trigger* for this [TTA] exemption is the presence of a technology transfer agreement. In other words, these provisions exclude the value of a patent or copyright interest from taxation whenever a person who owns a patent or copyright transfers that patent or copyright to another person so the latter person can make and sell a product embodying that patent or copyright."[100]

It is well known the Legislature "enacted the TTA statutes over the Board's objections."[101] It is also well known that the Board "warned the Legislature of how broadly the statutes could be construed, and the Legislature enacted the statutes anyway."[102] Statutes are to be read "with a view to promoting rather than defeating the[ir] general purpose"[103] and the Board, and taxpayers, need look no further than the TTA statutes themselves for authority that establishes embedded software is within the scope of the TTA statutes. Nothing in *Nortel* or *Lucent* suggest the TTA statutes should be read otherwise.

The TTA statutes define a TTA 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."[104] Under the TTA statutes, among the other requirements, an agreement is a TTA if the buyer/licensee/assignee either (1) "make[s] and sell[s] a product . . . subject to the patent or copyright interest" or (2) "use[s] a process that is subject to the patent or copyright interest."[105] Nowhere do the TTA statutes distinguish embedded software from other types of software. All that appears on the face of the TTA statutes is whether the buyer/licensee/assignee makes a product or uses a process subject to the licensor/assignor's patent or copyright interests.

The fact the Board has delayed recognizing the exempt nature of embedded software is itself puzzling. The pendency of both *Lucent* and/or *Nortel* did not justify such a delay when the Board concluded that neither case even involved embedded software. Perhaps the delay was caused by the Board's hope that on a broader policy level, one or both of those cases would hold the TTA statutes, in general, were to be read as narrow in scope, and such that a narrow reading would then justify a position the Board could then apply to tax embedded software, even in a TTA.

However, both cases held precisely the opposite and stand for a broad and expansive reading of the TTA provisions. Recall that *Nortel* litigated the issue of whether the Board by regulation could impose a limitation upon TTA statutes—whether their scope was limited only to custom (and not canned) software—when that limitation which was not found anywhere in the language of those statutes. In rejecting the Board's proffered canned/custom distinction, *Nortel* clearly held the Board may not impose such limitations where they are not found in the TTA statutes themselves.

Exactly the same situation holds true for the so-called "embedded" issue, which is no more than yet another attempt by the Board to administratively limit application of the TTA statutes where the proposed limitation is not found in those statutes—in this case an "embedded" instead of a "canned" limitation. To add further complication, unlike the Board's canned/custom limitation argued in *Nortel*, such an "embedded" limitation is not even found in or supported by a regulation of the Board. As in the case of the

failed canned/custom distinction, one need look no further than the TTA statutes themselves for the answer to the Board's question on how to treat embedded software. Both of the TTA code sections state succinctly in subsection (10)(A) there is an exemption for "[t]he amounts charged for *intangible personal property transferred with tangible personal property* in any technology transfer agreement, if the technology agreement separately states a reasonable price for the tangible personal property."[106]

The statutes do not limit or put conditions upon the type of intangible transferred, and they do not limit or put conditions upon the type of tangible personal property transferred. They simply need to be transferred "with" each other. Echoing the Court of Appeal's thinking in *Lucent*, the Board should not "engraft a [embedded] limitation on statutes that appears nowhere in their text . . . ."[107]

[1] Cal. Rev. & Tax. Code §§ 6051, 6006.

[2] Cal. Rev. & Tax. Code § 6051.

[3] Cal. Rev. & Tax. Code § 6201.

[4] Cal. Rev. & Tax. Code § 6016.

[5] *Dell, Inc. v. Superior Court*, 159 Cal. App. 4th 911, 921 (2008) ("California applies sales and use tax to tangible personal property but not to intangible property and services.")

[6] *Preston v. State Bd. of Equalization*, 25 Cal. 4th 197, 216-19 (2001).

[7] *Id.* at 209.

[8] *Id.* at 211-12. *See also Lucent Technologies v. Board of Equalization*, 241 Cal. App. 4th 19, 31 (2015).

[9] *Petition of Intel Corporation for Redetermination under the Sales and Use Tax Law,* Memorandum Opinion, June 4, 1992.

[10] All statutory references herein are to the California Revenue and Taxation Code.

[11] Stats. 1993, ch. 887.

[12] Cal. Rev. & Tax. Code §§ 6011(c)(10)(D), 6012(c)(10)(D).

[13] Cal. Rev. & Tax. Code §§ 6011(c)(10)(B) & (C), 6012(c)(10)(B) & (C).

[14] Assembly Floor Concurrence in Senate Amendments, Bill Analysis of AB 103, at 1 (Aug. 17, 1993).

[15] Senate Floor, Bill Analysis of AB 103, at 2-3 (Aug. 17, 1993). For example, the Board was expressly concerned the TTA statutes would exclude from taxation many transactions "such as licenses of photographs, film strips or other artwork" that were otherwise subject to taxation before the TTA statutes. *Id.*

[16] *Preston*, 25 Cal. 4th at 218. Accordingly, *Preston* applied the TTA statutes to an artist who entered into written agreements to provide artwork for use as book illustrations and rubber stamp designs.

[17] *Nortel Networks Inc. v. Board of Equalization*, 191 Cal. App. 4th 1259 (2011).

[18] *Id.* at 1265.

[19] *Id.* at 1265-66.

[20] *Id.* at 1266-88.

[21] Cal. Rev. & Tax. Code §§ 6011(c)(10)(D), 6012(c)(10)(D).

[22] Cal. Rev. & Tax. Code § 6010.9; *see also Navistar Internat. Transportation Corp. v. State Bd. of Equalization*, 8 Cal. 4th 868, 881 (1994).

[23] Cal. Rev. & Tax. Code § 6010.9(b); Cal. Code Regs. tit. 18 ("Regulation"), § 1502(b)(4), (9) and (10).

[24] Cal. Rev. & Tax. Code § 6010.9(c).

[25] After the trial court's findings, but before the case was heard by the Court of Appeal, the Board rewrote its regulation to re-define the "problem" in the statute in a manner the *Nortel* court characterized as an unpersuasive and "very tardy 'Hail Mary' pass after the last whistle blew and the fans were filing for the exits." *Nortel*, 191 Cal. App. 4th at 1272.

[26] *Id.* at 1277.

[27] *Id.* at 1276-77.

[28] *Id.* at 1277 (emphasis in original).

[29] Press Release, State Board of Equalization, *Nortel* Case Does Not Affect Sales Tax On Off-The-Shelf Software (May 27, 2011).

[30] *Id.*

[31] California State Board of Equalization, *Software Technology Transfer Agreements*, http://www.boe.ca.gov/sutax/stta.htm.

[32] *Lucent Technologies v. Board of Equalization*, 241 Cal. App. 4th 19 (2015).

[33] *Id.* at 37.

[34] Both *Nortel* and *Lucent* were decided by the Court of Appeal, Second District, Division Two.

[35] *Lucent*, 241 Cal. App. 4th at 25.

[36] *Id.* at 40.

[37] *Id.* at 28.

[38] *Id.* at 26-28.

[39] *Id.* at 39.

[40] *Id.*

[41] *Id.* at 38.

[42] Memorandum from the Chief Counsel of State Board of Equalization on Implementation of the *Lucent* Decision ("Memo") at 4 (Mar. 18, 2016). The Memo cited to *Nortel*: "As with the SSP, the prewritten programs are contained on storage media external to the switch hardware, and are loaded onto the switch computers; they are not embedded in the hardware at the time of manufacture." *Nortel*, 191 Cal. App. 4th at 1278.

[43] Memo at 4.

[44] *Id.* at 2.

[45] *Id.* at 5.

[46] *Id.* at 7.

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.* at 8.

[52] *Id.* at 7.

[53] *Id.*

[54] Transcript of March 30, 2016 Board of Equalization Meeting, Item M1, Other Chief Counsel Matters, at p. 6 ("March 30 Board Meeting Transcript").

[55] 2016 Minutes of the State Board of Equalization, Item M1, Other Chief Counsel Matters (Mar. 30, 2016).

[56] *Id.*

[57] State Board of Equalization Special Notice, *Lucent* Court Case: *Lucent*'s Charges for Software on Storage Media as Part of a Technology Transfer Agreement are Not Subject to Tax (Aug. 24, 2016) ("Special Notice"), http://www.boe.ca.gov/pdf/L468.pdf.

[58] *Id.* at 2.

[59] *Id.*

[60] The Board did not go so far as to state this was a holding of the *Lucent* decision.

[61] Special Notice, *supra* note 57, at 2.

[62] *Id.*

[63] March 30 Board Meeting Transcript, *supra* note 54, at p. 14.

[64] Special Notice, *supra* note 57, at 3.

[65] *Id.*

[66] October 18, 2016, Board Business Taxes Committee Material—Revised BTC Calendar—Technology Transfer Agreements (Regs. 1502/1507).

[67] March 30 Board Meeting Transcript, *supra* note 54, at p. 9.

[68] Cal. Rev. & Tax. Code §§ 6201-6203.

[69] Cal. Rev. & Tax. Code § 6051.

[70] Cal. Rev. & Tax. Code §§ 6051, 6902, 6933; *Loeffler v. Target Corp.*, 58 Cal. 4th 1081, 1104 (2014).

[71] Cal. Rev. & Tax. Code § 6901.5; Regulation 1700(b); *Loeffler*, 58 Cal. 4th at 1126.

[72] *Dell, Inc. v. Superior Court*, 159 Cal. App. 4th 911 (2008).

[73] State Board of Equalization, *Dell and SBE Litigation Settlement on Optional Service Contracts-Claim for Refunds*, http://www.boe.ca.gov/info/dell_litigation_settlement.htm.

[74] *See Mohan et al. v. Dell Inc.*, Case Nos. CGC 03-419192; CJC-05-004442, SBE Settlement Agreement (Nov. 30, 2011).

[75] *Loeffler*, 58 Cal. 4th at 1104, 1107.

[76] *Id*. at 1115 (quoting *Javor v. State Bd. of Equalization*, 12 Cal. 3d 790, 801-02 (1974)) (emphasis in original).

[77] *Id.* at 1122-23.

[78] Notably, the *Loeffler* opinion cites to the 2008 *Dell* opinion, although there is no discussion of the subsequent consumer refund claim process that was permitted by the Board following the *Dell* decision.

[79] Assembly Floor, Bill Analysis of AB 1412, at 1 (May 28, 2013).

[80] Complete History of AB 1412, 2013-2014 Legislative Session, https://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=201320140AB1412.

[81] Assembly Committee on Revenue and Taxation, Bill Analysis of AB 43, at 1 (Jan. 10, 2014).

[82] Complete History of AB 43, 2013-2014 Legislative Session, https://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=201320140AB43.

[83] Assembly Committee on Revenue and Taxation, Bill Analysis of SB 640, at 5 (Jul. 10, 2015).

[84] *Id.* at 1.

[85] State Board of Equalization, Bill Analysis of SB 640, at 5 (Jun. 2, 2015).

[86] Complete History of SB 640, 2015-2016 Legislative Session, https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201520160SB640.

[87] *Id.*

[88] *See* Cal. Rev. & Tax. Code § 995; *Hahn v. State Bd. of Equalization*, 73 Cal. App. 4th 985 (1999); *Cardinal Health v. County of Orange*, 167 Cal. App. 4th 219 (2008); Regulation 152 (commonly known as Property Tax Rule 152); Board of Equalization, "Report on Bundled Nontaxable Software-Embedded Software," presented at the January 16, 2014 Property Tax Committee Hearing. The Board states that because the *Lucent* court did not discuss section 995, the decision has no precedential effect with respect to property tax. Memo, *supra* note 42, at 4 fn. 2. *See also King v. State Bd. of Equalization,* 22 Cal. App. 3d 1006, 1010-1011 (1972) (property tax law definitions do not apply to sales tax law).

[89] Memo, *supra* note 42, at 4.

[90] *Id.* at 4 (emphasis added). The same statement is then repeated at p. 7.

[91] *Id.* at 7 (emphasis added).

[92] *Id.* at 8 (emphasis added).

[93] Special Notice, *supra* note 57, at 2 (emphasis added).

[94] 9 Witkin, Cal. Proc. 5th, Appeal, § 509 (2008).

[95] *Nortel*, 191 Cal. App. 4th at 1278.

[96] *Achen v. Pepsi-Cola Bottling Co. of Los Angeles*, 105 Cal. App. 2d 113, 124 (1951); *see also* 9 Witkin, Cal. Proc. 5th, Appeal, § 510 (2008).

[97] *Nortel*, 191 Cal. App. 4th at 1278.

[98] *Lucent*, 241 Cal. App. 4th at 34.

[99] Memo, *supra* note 42, at 7.

[100] *Nortel*, 191 Cal. App. 4th at 1273 (emphasis added) (citing *Preston*, 25 Cal. 4th at 213-14).

[101] *Id.* at 1269.

[102] *Lucent,* 241 Cal. App. 4th at 39.

[103] *Id.* at 41 (citing *People v. Gutierrez*, 58 Cal. 4th 1354, 1369 (2014)).

[104] Cal. Rev. & Tax. Code §§ 6011(c)(10)(D), 6012(c)(10)(D).

[105] *See id.*

[106] Cal. Rev. & Tax. Code §§ 6011(c)(10)(A), 6012(c)(10)(A) (emphasis added).

[107] *Lucent*, 241 Cal. App. 4th at 39.