Assignment of Receipts from the Sale of Computer Software

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The Problem

The type of software from which receipts are derived may determine the numerator assignment rules to be applied, sale of tangible property as compared to sales of other than tangible property, and the method of delivery of the software may influence the assignment rules to be applied.

Computer software generally is of two distinct types. First, there is what is commonly called "canned software," and then, second, there is custom software. Canned software is a computer program that is written for use by anyone. Typical types of canned software include word processing programs, spreadsheets and games, applications we have on our home computers and that we use at work.

The second type of software is what is commonly referred to as custom software. Custom software is written specifically for an individual customer and is designed to meet the specific needs of the customer. Major businesses frequently will have software programs designed to meet their specific needs.

At the Franchise Tax Board we have an electronic office system called PASS which is used from our audit process through the resolution of controversies. It includes a number of canned software programs, some of which have been modified for our specific needs, but its unique characteristics involve the installation of firewalls to limit access to data to the appropriate level. So, for example, an auditor cannot access material in legal files unless they are assigned to the case, and no one other than members of our settlement bureau can access anything involving settlements. Access is also limited to individuals based upon their need to know, so only people assigned to a case and their supervisors or managers can typically access the files related to a case.

Custom Software

The assignment of receipts derived from custom software is typically treated as arising from providing services. Under traditional UDITPA such receipts are assigned on the basis of the location of income producing activity, with the place where the predominance of the income producing activity takes place having all the receipts assigned there.

Several states have abandoned the all or nothing assignment rule but still use income producing activity as the means of determining assignment but do it on a proportional basis.

More recently, particularly with the use of sales factor only assignment, more states are going to some variation of the benefits received or location of the customer.

If assignment is made pursuant to the location of the income producing activity, whether under the traditional UDITPA approach of the predominant location, or on a proportional basis, there will be audit issues in determining where the income producing activity occurs. Using FTB's PASS experience as a guide, there was a team of the developer's employees who were working at FTB headquarters for several years. I do not know specifically how the receipts from the contract were assigned, but clearly there were income producing activities at FTB' s California headquarters, but I also suspect there were income producing activities occurring at the headquarters of the provide.

With respect to sourcing based on the benefits received or location of the customers, issues arise when the customer is a multijurisdictional taxpayer that may utilize the software in a variety of locations. In such instances, is the place of assignment (a) the headquarters of the customer, (b) the office that contracted for the service, (C) where the bill is sent, or (d) the place where the software is in fact employed? Using the FTB's PASS example it is clear that the headquarters, the office that contracted for the design of the system, and where the bills were sent were all in California. The PASS system, however, is used by all of FTB's audit offices which include sites in New York, Chicago and Houston as well as in California. Will the provider have the information to make an assignment based upon where the programs or used and the benefits are received? California has attempted to address this issue in its regulations by creating a cascade of assignment rules which establishes an order or priority for assignment. If assignment cannot be made by a method than it is made by the next alternative until the assignment can be made.

It also bears mentioning that for sales and use tax purposes, a 2011 California appellate court decision indicates that the distinction between canned software and custom software is unimportant. *Nortel Networks v. State Board of Equalization,* 191 Cal App 4th 1259.

Canned Software

The question of the assignment of receipts arising from canned software may turn upon the nature of the contract between the provider and the purchaser and the manner of delivery. California currently has pending at the Court of Appeal a case, *Microsoft Corporation v. Franchise Tax Board*, Court of Appeal, First District, A131964, which illustrates some of the issues that arise. The years involved are 1995 and 1996 so the facts are dated and do not fully reflect how the industry may have evolved.

Microsoft produces the Disk Operating Systems that are used by most non-Apple computers. In addition, their word processing, spreadsheet, and presentation programs are frequently industry standards and they also have a variety of games and other software programs that are present on most non-Apple personal computers.

The software programs may be marketed separately or grouped together as packaged "offices." During the years at issue there were several methods of distribution. First, the software was sold through third-party retail outlets. You and I can go to Costco, Compuserve or any other number of outlets and buy a set of disks and install the software on our computers.

Second, customers could buy a computer from companies such as Dell, Hewlett-Packard, etc. on which the software was already installed. Such companies are commonly referred to as original equipment manufacturers (OEM’s).

Third, customers can go to the neighborhood computer geek who would install the software requested or needed on the computer or would build a computer and install the software as part of the computer purchased from them. For purposes of the litigation these were viewed as OEM sales.

Fourth, Microsoft enters into agreements with large businesses for the use of their software products throughout the business. These are referred to as enterprise sales.

The litigation focused on the assignment of OEM sales. All retail sales were treated as a sale of tangible personal property and were assigned on a destination basis. No issues were raised with respect to the assignment of enterprise sales.

The receipts from OEMs arise in two distinct ways.

First, with respect to large computer manufacturers Microsoft shipped the manufacturers a "Golden Disk" which could be copied onto the hard drives of the computers being manufactured. The agreement with the manufacturer is categorized as a license authorizing the installation of the software on the computers being manufactured with a payment being made generally on a per installation basis. The license agreements granted no ownership rights to the licensee. The purchaser of a computer then received an end user license agreement (EULA) which then would then execute and return to Microsoft. The EULA's or the means by which the purchaser of a computer would receive patches and updates to the software from Microsoft.

Second, with respect to smaller companies, Microsoft would enter into an agreement with third party authorized disk replicators, Delivery Service Providers (DSP's) to produce multiple packages of the software which were then given to the smaller companies who would break apart the packages and install the individual systems on computers. Microsoft's agreement was with the DSP's and it received payments from them with respect to the copies of the software that was reproduced and sold in packages to the smaller OEM's. Again an EULA would be executed by the ultimate purchaser of the software\computer.

On Microsoft's original California returns the receipts from the OEM's were assigned to the billing address of the licensee. The licensee might actually install the software somewhere else but Microsoft did not have information as to where that installation occurred.

Claims for refund were filed based upon treating the payments received under the licenses as receipts arising from the licensing of intangible property which should be assigned on the basis of income producing activity. Microsoft alleges that the majority of the income producing activity both in terms of writing the software programs and maintaining the copyrights and licenses occurred in Washington. Microsoft treated all the software as a single package.[1]

[1] Factually Microsoft did not distinguish income producing activity by individual software product or distinguish receipts arising from tangible property such as keyboards and mice. With respect to one of the individual software products, PowerPoint, development occurred in California.

Section 17 of UDITPA provides that sales, other than the sales of tangible personal property, are assigned to the state of the pre-dominate income producing activity. MTC Regulation IV.17.(4)(B)(b) provides that

> Gross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; . . .

The primary question involved in the Microsoft case is whether the receipts from licensing the software products constitute receipts from the licensing of intangible property or tangible property. The trial court concluded that the receipts from the licensing agreements arose from licensing tangible personal property. It based its conclusion on the following:

> First, a number of state courts have concluded that computer software is tangible personal property – it is knowledge recorded in a physical form which has physical existence, takes up space on the tape, disk or hard drive
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>> *South Central Bell Telephone Co. v. Barthelemey* (La., 1994), 643 So. 2nd 1240; *Andrew Jergens Company v. Wilkins* (Ohio, 2006) 848 N.E. 2nd 499; *South Central Utah Telephone Association v. Utah State Tax Commission* (Utah, 1997); *Wal-Mart Stores Inc. v. Mobile,* (Ala, 1996) 696 S. 2nd 290; *Hasbro Industries, Inc. v. Norberg* (RI, 1985) 487 A. 2nd 128; *Graham Packaging Co, .L.P. v. Commonwealth* (Pa, 2005) 882 A 2nd 1076.
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> Second, California courts have determined for sales and use tax purposes that a transfer of physical property even when the true object is an intangible right is the sale of tangible property.
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>> *Simplicity Pattern Co. v. Board of Equalization,* (1980) 27 Cal 3rd 900 (film negatives); *A & M Records v. State Board of Equalization*(1988) 204 Cal App. 3rd 358 (master recordings); *Capitol Records, Inc. v. State Board of Equalization*(1984) 158 Cal. App. 3rd 582 (master recording types). The computer software are inextricably intertwined with the disks. *Citizens and Southern Systems Inc. v.South Carolina Tax Commission,* (S.C., 1984) 311 S. E. 2nd 717; *Comptroller of the Treasury v. Equitable Trust Co.* (Md. 1983) 464 A. 2nd 248. *Penn. & W.Va. Supply Corp. v.Rose* (W.V. 1988) 368 S.E. 2nd 101.
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> Third, the treatment of canned software, as distinguished from custom software, for sales and use tax purposes is to classify it as tangible property.
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>> *Navistar International Transportation Corp. v. State Board of Equalization* (1994) 8 Cal 4th 868; *Touche Ross & Co. v. State Board of Equalization,* (1988) 203 Cal App 3rd 1057; See Also, Hellerstein & Hellerstein 3rd Edition13.06[3][a]
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> Fourth, a decision of the Nebraska Supreme Court treats computer software the same way.
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>> *American Business Information v. Egr* (2002) 650 N.W. 2nd 251.

The taxpayer argues that computer software is by definition intangible property and therefore the receipts should be assigned on the basis of income producing activity, which we predominately performed in Washington. An issue not address under this analysis is whether it is the historic income producing activity or the activities of the current year. There is an unpublished California Board of Equalization in *Appeal of Adobe Systems, Inc,* (1997) where the Board of Equalization sustained assessments of the Franchise Tax Board based upon the predominant income producing activity occurring in California. In that case the issue was presented in the same manner as in *Microsoft.* The taxpayer also relies upon classification of software for purposes of the Internal Revenue Code. IRC Reg. 1.482-(4)(b, IRC Section 936(h)(3)(B), IRC Reg. 1.861-18, and IRC Section 197(d)(1)(C)(iii)

Alternatively an argument can be made under Section 18 of UDITPA, in order to fairly reflect the taxpayer's business activities the receipts from licensing software should be assigned on a market basis. This would be consistent with the general purpose of the sales factor, the use of income producing activities duplicates the property and payroll factors, and the means of delivery should not give rise to a different result. An example of the same application to similar property is found in the assignment of receipts from the exhibition of motion picture films. Similar to software the value of motion pictures lies in the thoughts contained on the film. The viewer of a motion picture in a movie theatre does not buy the film, the viewer only pays for the right to view it. To the extent the viewer buys a DVD or other medium the viewer is buying tangible property that has value because of its intellectual content.

The *Microsoft* case will probably be argued before the Court of Appeal in San Francisco on October 1, with a decision likely by the end of the year.