Software Finance & Tax Executives Council

www.softwarefinance.org

Via Email

December 7, 2009

Mr. Bruce Johnson
Chairman
Issue Resolution Committee
Streamlined Sales Tax Governing Board

Re: Petition for Resolution and Reconsideration of The Governing Board's May 12, 2009 Decision Adopting Interpretative Opinion 2009-01

Dear Chairman Johnson:

Petitioner, Software Finance and Tax Executives Council ("SoFTEC") submits this letter to present points and authorities in support of its petition for resolution and reconsideration of the Governing Board's May 12, 2009 decision adopting Interpretative Opinion 2009-01. A copy of SoFTEC's petition for resolution and reconsideration is available on the Governing Board's website.[1] A copy of the Governing Board's Interpretative Opinion 2009-01 is appended to the Streamlined Sales and Use Tax Agreement (September 30, 2009 version) ("SSUTA") at page 164.[2] [3] SoFTEC's January 11, 2008 request for interpretation does not appear to be publically available on the Governing Board's website; hence, a copy is attached. The Governing Board's May 12, 2009 Interpretative Opinion adopts the recommendation of the Compliance Review and Interpretations Committee ("CRIC"). [4]

Questions Presented:

1. Whether a sale of a software license upgrade, unaccompanied by a transfer of computer software or other tangible personal property is a sale involving "intangible property."
2. Whether the Governing Board's conclusion that a sale of intangible software license upgrades should be treated the sale as a sale of "tangible personal property" is arbitrary or otherwise contrary to law.

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[1] *Petition For Resolution and Reconsideration Of The Governing Board's May 12, 2009 Decision Adopting Interpretative Opinion 2009-01*

[2] *SSUTA*, September 30, 2009, p. 164 .

[3] Because the Interpretative Opinion 2009-01 is the subject of a petition for resolution and reconsideration, SoFTEC asserts that it is not a final Interpretative Opinion of the Governing Board and, therefore, it is premature and inappropriate for it to be appended to the SSUTA. For this reason, SoFTEC objects to its attachment to the SSUTA unless and until the Governing Board overrules the instant petition.

[4] *CRIC*, January 15, 2009 .

Statement of the Facts:

The basic fact pattern that underlies this request for interpretation involves two separate and distinct transactions. In the first transaction, a customer acquires from a vendor a license to use computer software, along with a copy of the software's object code. The license authorizes the customer to make 500 copies of the software for use in the customer's business. The software is configured in such a way that it will not permit the making of more than 500 copies unless and until the customer enters a special alphanumeric code or "key." Once the key is entered, the software will permit the customer to make a specified number of additional copies of the software. After the customer acquires the software and the 500-copy license, its business expands and it needs to make more copies of the software for use in its business. The customer contacts the software vendor and, as part of a separate transaction, pays a license fee and acquires an alphanumeric key, which is delivered verbally over the telephone. The customer enters the key into software and is able to make additional copies of the software.

Software vendors use flexible licensing in a variety of ways in addition to restrictions on copying. For instance, a vendor might restrict the software to use on a computer of a specified operating capacity. If the customer wants to migrate the software to a computer with a greater operating capacity, it must obtain the right to do so from the software vendor. The right to operate the software on a larger computer typically is transferred by delivering an alphanumeric key to the customer, which, once entered, will permit the software to operate on the larger computer.

Another common fact pattern involves server software that allows a fixed number of concurrent users. If the customer needs to allow additional concurrent users, it must obtain a license from the software vendor. The vendor facilitates the transfer of rights permitting additional concurrent users of the software by delivering to the customer an alphanumeric key that will allow additional concurrent users of the software.

There are myriad other fact patterns used in the software industry whereby the vendor restricts usage of its software. The common theme underlying these facts patterns is that when the customer needs additional rights to use the software, no further copies of the software are delivered to the customer. The vendor merely is allowing the customer additional rights to use the copy of the software that it already has.

Summary of Arguments:

The Governing Board, in its Interpretative Opinion, found:

> The Agreement defines "tangible personal property" as" personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses" and "includes electricity, water, gas, steam, and prewritten computer software." Although no physical software or other tangible personal property is distributed in the fact pattern, the additional license to use the

> software is the essence of the transaction, not the alphanumeric code. The alphanumeric code merely facilitates the additional use of the software. [5]

These findings are consistent with SoFTEC's initial request for interpretation and should not be disturbed. Clearly, on the facts presents, no software or other tangible personal property is transferred to the customer in the second transaction.

However, the Governing Board, based on these findings, concluded, without citation to any provision in the SSUTA or to any other law or authority, "[t]he additional license to use the software should be treated the same as the original purchase of the software license."[6]

SoFTEC asserts, based on the Governing Board's finding that "no physical software or other tangible personal property is distributed in the fact pattern," its conclusion that "the additional license to use the software should be treated the same as the original purchase of the software" is arbitrary, capricious or otherwise contrary to law.

The Committee's focus should be on the use by the Governing Board in its Interpretative Opinion of the words "should be treated the same as." There is no basis in the SSUTA or other law for conflating two separate and distinct transactions involving subject matter of a completely different nature and character. The effect of the Governing Board's Interpretative Opinion is to include intangible property within the SSUTA's definition of "tangible personal property." Such an interpretation constitutes an unwarranted expansion of the definition of "tangible personal property" and has far reaching implications outside the fact patterns presented. Last, the Governing Board's conclusion is contrary to express provisions in the Copyright Act providing that ownership of a copyright is distinct from ownership of any material object in which the work might be embodied.[7]

The Committee should recommend to the Governing Board that its May 12, 2009 Interpretative Opinion 2009-01 be reconsidered. The Committee should also recommend to the Governing Board that it adopt an Interpretative Opinion consistent with SoFTEC's proposed interpretation.

[5] *SSUTA*, September 30, 2009, p. 165, ll. 34-39.
[6] *Id*, at ll. 39-40.
[7] *Title 17, U.S.C., §202*.

Argument:

1. **A sale of a software license upgrade, unaccompanied by a transfer of "computer software" or other "tangible personal property" is a sale involving "intangible property."**

Distinguishing Between Tangible and Intangible Personal Property:

A. Generally:

Although there is no uniform definition for personal property, most jurisdictions statutorily define personal property as any type of property that is not land or an interest in land.[8] Personal property is divided into two general categories: tangible personal property and intangible personal property. Black's Law Dictionary defines tangible personal property as: "[c]orporeal personal property of any kind; personal property that can be seen, weighed, measured, felt, or touched, or is in any other way perceptible to the senses."[9] Black's Law Dictionary defines intangible personal property as "property that lacks a physical existence."[10]

The common law definition of tangible personal property is generally uniform throughout the United States and conforms to Black's definition: all of the cases reviewed cite Black's definition, or some variation of it.[11] Indeed, the SSUT definition of "tangible personal property" is consistent with Black's definition. Many jurisdictions have not adopted an express definition for intangible personal property. Instead, the term is typically defined in contrast to tangible personal property, or by example. Generally, intangible personal property is defined as property that is a right rather than a physical object: it is not itself intrinsically valuable, but it derives its value from what it represents or evidences.[12]

Examples of tangible personal property include goods, chattels, and property of a movable nature. Intangible personal property consists of property such as contracts, future interests, or any property that cannot be touched or felt and that does not take up space.

B. Copyrights are Intangibles:

One of the fact patterns included with this petition involves the sale of a right to make copies of computer software unaccompanied by a simultaneous transfer of a copy of the computer program from which additional copies are to be made. It cannot be disputed that such a transfer involves a copyright and that copyrights are a category of "intangible property."

First, as a matter of law, a computer program is eligible for protection under the Copyright Act.[13] Second, a right to make copies of a copyrighted computer program is a

[8] *E.g.*, 51 Ca. Jur. *Property* § 25 (2009).
[9] *Black's Law Dictionary* 574 (3rd Pocket ed. 2006).
[10] *Id.* at 573.
[11] *E.g., Salenger Realty Corp. v. Grosjean*, 194 La. 470, 474 (1940); *Mount Manfield Television, Inc. v. Vermont Commissioner of Taxes*, 336 A.2d 193 (VT 1975).
[12] *Heather Preston v. State Board of Equalization*, 25 Cal.4th 197 (2001).
[13] *Title 17, U.S.C., §117.*

copyright. [14] Third, a copyright is an 'intangible."[15] Thus, insofar as the facts implicated in this petition include a sale solely of rights to make copies of computer software, they involve transfers of intangible property and do not involve sales of "computer programs" or other "tangible personal property."

C. Other Software License Upgrades are Intangibles:

The facts underlying this petition also include sales of license upgrades that do not involve transfers of copyrights. Other license upgrades include the right to migrate software to a computer with larger capacity and to increase the number of concurrent users. Indeed, on the facts presented here, at the time of the initial transfer of the computer software, the vendor only provided limited rights and restricted by contract the type of computer on which the software could be loaded or the number of concurrent users permitted. The vendor also placed within the software itself, not only a method of enforcing these license restrictions, but also a mechanism for relaxing them in the future. Even though the right to run software on a particular machine and the right to a given number of concurrent users are not copyrights, they are no less intangible property.[16]

As noted above, an intangible generally is defined as property that is a right rather than a physical object. Clearly, the right to use software on a particular machine and the right to a given number of concurrent users are rights transferred under the fact patterns outlined in the statement of facts. Nothing else is transferred from the vendor to the customer under the facts. Clearly, the subject matter of the hypothetical transactions is intangibles under the common meaning of the legal term.

D. Software License Upgrades are Not "Computer Software":

The SSUTA defines "computer software" as "a set of coded instructions designed to cause a "computer" or automatic data processing equipment to perform a task."[17] Under the facts presented here, the set of coded instructions was transferred to the purchaser at the time of the first transaction, at a time prior to the sale of the upgrade rights. No computer software was transferred to the purchaser at the time of, or in connection with, the sale of the license upgrade rights.

E. The Governing Board Correctly Found That No Computer Software Or Other Tangible Personal Property Was Transferred At The Time Of Sale Of The License Upgrades:

As was shown above, the software license upgrades at issue are neither "computer software" nor "tangible personal property" as those terms are defined in the SSUTA. The Governing Board's finding to this effect is correct and should not be disturbed.

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[14] *Title 17, U.S.C., §106(1).*
[15] *Black's Law Dictionary*, 809 (6th ed, West, 1990).
[16] Federal copyright law only grants the owner of a copyright certain enumerated rights. The rights to run software on a particular size computer and permit a given number of concurrent users of software are not among them. *17 U.S.C., Section 106(1)-(6).*
[17] *SSUTA*, September 30, 2009, p. 122, ll. 9-10.

2. The Governing Board's Conclusion That A Sale Of Intangible Software License Upgrades Should Be Treated The Sale As A Sale Of "Tangible Personal Property" Is Arbitrary Or Otherwise Contrary To Law

After finding that the transactions involved in the hypothetical fact patters did not involve either "tangible personal property" or "computer software" (a species of "tangible personal property"[18]) it concluded that the purchase of the software license upgrades "should be treated the same as original purchase of computer software." The Governing Board cited no provision of the SSUTA, or any other source of law, as support for this conclusion and SoFTEC asserts that there is none. Because there is no legal support for the Governing Board's conclusion, it is arbitrary and capricious. In addition, SoFTEC asserts that the Governing Board's conclusion is contrary to the Copyright Act. Last, SoFTEC asserts that the Governing Board's conclusion represents an unwarranted expansion of the SSUTA's definition of "tangible personal property" that has far reaching consequences outside the narrow fact patterns set forth in its request for interpretation. For these reasons, the Governing Board's conclusion is contrary to law.

A. There Is No Legal Authority For The Governing Board's Conclusion:

In its Interpretative Opinion, the Governing Board cites no provision of the SSUTA or any other law for its conclusion that the "[t]he additional license to use the software should be treated the same as the original purchase of the software license." The reason the Governing Board cites no authority for its conclusion is because there is none. There is no provision of the SSUTA, no state or federal statute or rule or regulation, no judicial decision nor rule of statutory construction supporting the conclusion that would support the Governing Board's conclusion.

The facts underlying the request for interpretation would not support the deployment of any common law theory, such as "step transaction,"[19] "sham transaction,"[20] or "no economic substance"[21] that would authorize conflating two separate transactions involving subject matter of a different nature and character and treating them the same. On the facts presented, the purchasers were motivated to upgrade their software license by changes in their business, not to avoid payment of sales taxes on software. One can imagine many factual scenarios where a purchaser may seeks to avoid payment of sales taxes on a product, like computer software, that is susceptible of division into separate components, some of which might fall within a state's sales tax imposition statute and some that might fall outside the imposition. States have tools at their disposal, such as those described above, to combat such attempts at tax avoidance when they have supporting facts. But such facts are not present in the instant case. There is no basis for interpreting the definitions of "tangible personal property" and "computer software" as incorporating those common law doctrines in a blanket fashion.

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[18] The SSUTA definition of "tangible personal property" specifically provides that prewritten computer software is included within the definition. *SSUTA*, September 30, 2009. P. 117, ll. 23-25.
[19] E.g., *Associated Wholesale Grocers v. United States*, 927 F.2d 1517 (10th Cir. 1991)
[20] E.g., *Knetsch v. United States*, 364 U.S. 361 (1960).
[21] E.g., *Frank Lyon Company v. United States*, 435 U.S. 561 (1978).

Sales taxation always focuses on the form of the sale and the four corners of the transaction. On the facts presented, there is no basis for deviating from the four corners of the transaction and determining that the sale was of something different than that described in the sales agreement. Here, the subject matter of the sales agreements is intangible property rights, not tangible personal property and there is no basis for the Governing Board to find that the two are the same.

Because there is no legal support for the Governing Board's conclusion, it is arbitrary and capricious and the Governing Board should reconsider it.

B. The Governing Board's Conclusion is Contrary to the Copyright Act:

Prewritten computer software is a unique product composed of tangible and intangible components. The tangible component is the copy of the set of written instructions delivered to the customer in form of a disk, tape or other medium, or delivered electronically. The intangible components include the federally created copyrights that forbid the making of copies of the software unless authorize by the owner of the copyright.

The very nature of prewritten computer software provides the vendor with the unique ability to precisely control the way in which customers use the product. Vendors impose these controls using contract law to transfer to the customer only specific rights to use the software. The vendor can enforce the contractual control by building into the software the ability to prevent the customer from using the software in violation of the contractual restrictions. These contracts, or licenses, give rise to intangible property rights owned by the vendor that can later be convey to the purchaser.

The point of this discussion is that the copy of the software and the intangible right to the software can be separated from each other and conveyed to a purchaser *seriatim* as the needs of the purchaser change over time. With respect to separating a copy of software from the copyrights to the software, federal law controls. Specifically, Section 202 of the Copyright Act provides as follows:

> Ownership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied. Transfer of ownership of any material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object; nor, in the absence of an agreement, does transfer of ownership of a copyright or of any exclusive rights under a copyright convey property rights in any material object. [22]

Thus, federal law mandates separation of the copyright from the material object in which the copyrighted work is embodied. Transfer of either the material object or the copyright does not result in the transfer of the other absent an agreement.

[22] *Title 17, U.S.C., §202.*

The effect of the Governing Board's ruling is to treat the sale of a right to make copies of prewritten computer software, a copyright under federal law, as a sale of a copy of the software. Such a ruling is contrary to the plain language of the Copyright Act providing that a transfer of a copyright interest does not convey any rights to any material object on which the copyrighted work might be embodied.

C. The Governing Board's Conclusion Represents An Unwarranted Expansion Of The SSUTA's Definition Of "Tangible Personal Property" And Has Far Reaching Consequences Outside The Narrow Fact Patterns Set Forth In The Request For Interpretation:

As demonstrated above, the effect of the Governing Board's interpretation is to treat a sale of intangibles as a sale of "tangible personal property." Until this interpretation, the scope of the SSUTA's definition of "tangible personal property" was appropriately limited to the contours of the common law definition of the term. However, now we know that under the SSUTA definition intangibles are to be treated the same as tangibles. Intangibles is a broad class of property and includes not only copyrights and contract rights, but also stock, bonds, patents, trademarks, franchises; the list goes on and on. The interpretation has far reaching consequences for the tax bases of the states that have adopted the SSUTA definition. Transactions that were not taxable before because they were thought to involve intangibles are suddenly taxable because they now must be treated the same as a sale of "tangible personal property" without a single word from the state's legislature. The uncertainty that this ruling creates is profound and contrary to the stated purpose of the SSUTA.[23]

While the intangibles involved here are copyrights, rights to use software on different machines and rights to concurrent use of software, the interpretation is not so limited. We can see the Interpretative Opinion having consequences with respect to sales of other literary works protected by the Copyright Act. Consider a sale of a right to reprint a newspaper or magazine article. The sale of the reprint right must be "treated the same as" the original sale of the newspaper or magazine under the Governing Board's ruling.

Our imagination is limited but there are sure to be consequences for other types of transactions involving a later sale of an intangible right that has some connection to a prior sale of tangible personal property. The Governing Board's Interpretative Opinion gives state sales tax auditors license to apply retroactively a sales tax imposition statute, confined to sales of tangible personal property, to sales of intangibles.

[23] *SSUTA*, September 30, 2009, Sec. 102.

Conclusion:

For the reasons stated above, the Issue Resolution Committee should recommend to the Governing Board that its Interpretative Opinion 2009-01 be reconsidered and that the relief prayed for in the petition be granted.

Respectfully submitted:

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Cc: Erica Mani
Tom Gillaspie
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Streamlined Sales Tax Governing Board, Inc.
Compliance Review and Interpretations Committee

INTERPRETATION/DEFINITION REQUEST

Complete each section

1. Name(s) of Requestor(s): Software Finance & Tax Executives Council

2. Contact Person:

Name Mark Nebergall
Address 1150 17th St., NW,
Suite 601
Telephone (202) 331-9533
Email mnebergall@softwarefinance.org

3. Agreement Section(s) involved: Definitions of "Tangible Personal Property" and "Computer Software

4. Statement of Background Facts (be succinct)**:** Purchaser acquires prewritten computer software under a license that limits its ability to use the software in one of three ways: (1) the license only permits the purchaser to make a set number of copies, (2) the license only permits a set number of users to use the software concurrently, or (3) the license only permits the purchaser to load the software onto a computer with a specified computing power. If the purchaser wants to make additional copies of the software, allow additional users to use the software concurrently, or to migrate the software to more powerful computer, it must upgrade the license and pay an additional license fee. Once the fee is paid, the seller provides the purchaser by telephone with an alphanumeric code which, when entered into the computer, permits the making of additional copies of the software, permits additional concurrent users, or causes the software to function on the more powerful machine. The seller delivers no additional software to the purchaser.

5. Issues: Does a software license upgrade (as opposed to an upgrade of the software itself) constitute "tangible personal property" or "computer software" where the only thing delivered to the purchaser is an alphanumeric code.

6. Proposed Interpretation: A software license upgrade (as opposed to an upgrade of the software itself) does not constitute "tangible personal property" or "computer software" where the only thing delivered to the purchaser is an alphanumeric code .

7. Is expedited consideration requested? X **No** ____**Yes**

8. Date this Request is submitted: January 11, 2007

Submit to: Scott Peterson, Executive Director
Streamlined Sales Tax Governing Board, Inc.
4205 Hillsboro Pike, Suite 305
Nashville, TN 37215

MEMORANDUM IN SUPPORT OF SOFTEC'S REQUEST FOR INTERPETATION OF THE DEFINITIONS OF "TANGIBLE PERSONAL PROPERTY" AND "PREWRITTEN COMPUTER SOFTWARE"

This memorandum is submitted in support of the request for interpretation of the definitions of "tangible personal property" ("TPP") and "computer software" in the Streamlined Sales and Use Tax Agreement ("Agreement"). This interpretation request is submitted in accordance with Section 902 of the Agreement and Rules 902 and 903.2 of the Rules and Procedures.

The Software Finance and Tax Executives Council (SoFTEC) believes that an upgrade of a software license that does not involve the delivery of any additional computer software to the purchaser is a transaction involving intangible personal property and does not involve either "computer software" or "tangible personal property" as those terms are used in the Agreement. It is important to distinguish between a license upgrade, which typically will only require the delivery of an alphanumeric code or "key" and a software-upgrade which will require the delivery of additional software object code which enhances or changes the functionality of the software. A software upgrade will allow the software to cause the computer onto which it is loaded to perform more and/or different functions. By contrast, a license upgrade permits broader distribution through or use in the purchaser's business of the software's existing functionality or capability and does not require the delivery of any additional software code.

Facts:

The following examples illustrate situations involving software license upgrades:

Example 1: Purchaser acquires from seller a copy of prewritten computer software subject to a license. The license permits the purchaser to make 500 copies of the software for use in the purchaser's business. The software is such that when the 500th copy is made, it will not permit the making of additional copies without entry of a special alphanumeric code or "key." Subsequent to the acquisition of the software, purchaser's business expands and it needs additional copies of the software. Purchaser contacts the seller and, as part of a separate transaction, pays an additional fee and receives the key over the telephone. Purchaser enters the key into the software which now will allow the making of additional copies.

Example 2: Purchaser acquires from seller a copy of prewritten computer software subject to a license. The license permits the purchaser to load the software onto a server that allows purchaser's employees concurrent use of the software. However, the software only will permit access to 500 users at a time. Later, purchaser's business expands and it needs to allow more than 500 users concurrent access to the software on its server. Purchaser contacts the seller and, as part of a separate transaction, pays an additional fee and receives the key over the telephone. Purchaser enters the key into the software which allows additional users concurrent access to the software.

Example 3: Purchaser acquires from seller a copy of prewritten computer software subject to a license. The license only permits the purchaser to load the software onto a computer with a certain data processing capacity. Later, purchaser's business expands and it needs additional data processing capacity. Purchaser buys a computer with added data processing power. However, in order to load the seller's software onto the new computer, it needs to upgrade its license. Purchaser contacts seller and, as part of a separate transaction, pays an additional fee and receives an alphanumeric "key" over the telephone. Purchaser loads the software onto the new computer and enters the key which allows the software to function.

There likely are other fact patterns that involve software keys. The examples above are only designed to illustrate a few of the myriad possible situations where a software key, where no delivery of any additional software code occurs, might be used.

Argument:

The Agreement defines "computer software" as follows:

> **"Computer software"** means a set of coded instructions designed to cause a "computer" or automatic data processing equipment to perform a task.

The alphanumeric code or key that facilitates a software license upgrade is not a set of instructions that causes a computer to perform a task. The "key" is only a mechanism that allows the seller to control the use of its software by the customer. The "key" is merely a bit of data used by the software's preexisting coded instructions that changes some operating parameter.

Nor is the alphanumeric key "tangible personal property." The agreement defines "tangible personal property" as follows:

> **"Tangible personal property"** means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. "Tangible personal property" includes electricity, water, gas, steam, and prewritten computer software.

The alphanumeric codes or keys at issue here have no intrinsic value and merely represent the delivery to the customer of the right to use the software in ways in which the customer previously was restricted. Under the facts presented about, the keys were read to the purchaser's employees over the telephone; but it would make no difference whether the keys were delivered on a piece of paper, in an email message or directly inserted into the purchaser's computers remotely by the seller. Once the key is entered, it is no longer needed and can be discarded.

We assert that the alphanumeric code or key is merely a representation of the delivery to the purchaser of the enhanced license rights and has no intrinsic value of its own, meeting the definition of "intangible personal property." Black's Law Dictionary defines "intangible property" as "property as has no intrinsic and marketable value, but is merely the representative or evidence of value, such as certificates of stock, bonds, promissory notes, copyrights, and franchises" or "property that is a 'right' such as a patent, copyright, trademark, etc.." Here,

delivery of the alphanumeric code or key is merely the mechanism through with the increased license rights are transferred to the purchaser.

In addition, even though in the fact patterns described above the software keys were delivered by telephone, the method of delivery of the keys is not relevant to their essential character as intangible property. It would not matter whether the keys were printed on a piece of paper mailed to the customer, sent by email, retrieved from a website or delivered using some other method.

Last, it would make no difference whether the software to which the keys relate was delivered on disk or electronically; there is no software delivered in the separate "key" transactions described in the fact patterns. Software "keys" are not tangible or intangible depending on how the underlying software was delivered; they are always representative of intangible property rights.

Conclusion:

As has been shown, a software license upgrade, facilitated through the use of an alphanumeric code or key, is not a transaction involving either computer software or tangible personal property. The Governing Board should grant the interpretation request.