BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 98-195
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 155: B&O TAXES – SERVICE & OTHER ACTIVITIES – CANNED SOFTWARE – PAYMENTS -- ORIGINAL EQUIPMENT MANUFACTURER. Payments for licensing rights from an original equipment manufacturer to the owner of copyrighted software programs are subject to B&O taxes under the service and other activities tax classification.

[2] RULE 194: B&O TAXES – SOFTWARE – ROYALTIES/LICENSING FEES – APPORTIONMENT. Amounts received for the payment of software royalties or licenses are allocated to the domicile of the software owner and are not apportioned.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

A computer software development company protests the reclassification of software license fees from the manufacturing business and occupation (B&O) tax classification to the service and other activities tax classification. [1]

FACTS:

Okimoto, A.L.J. -- . . . (Taxpayer) is a computer software development company based in . . . , Washington. Taxpayer's books and records were examined by the Audit Division (Audit) of the Department of Revenue (Department) for the period January 1, 1989 through June 30, 1993. An amended audit report resulted in additional taxes and interest owing of $. . . and Document No. . . .

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

was issued in that amount on October 7, 1994. Taxpayer protested the entire assessment and it remains due.

Schedule V: To Reclassify Royalty Fees

In this schedule, Audit reclassified royalty fees received from Original Equipment Manufacturers (OEM) for their right to make and sell copies of software developed by Taxpayer. Taxpayer had been reporting this income under the manufacturing B&O tax classification. Audit reclassified this income to the service and other activities B&O tax classification.

Taxpayer explained during the hearing that it initially designs and develops canned computer software for sale throughout the world. The process of creating the product culminates in a master disk. Once the master is created, Taxpayer's marketing and sales force markets the computer software program to distributors and OEMs at trade shows or through individual visitations.

Taxpayer further explained that it licenses its software to both retail customers and OEMs. Audit agreed that licenses made to retail customers were subject to manufacturing and retailing B&O taxes and retail sales tax. Audit made no adjustment on these reported transactions. Taxpayer argues that licenses sold to retail customers are the same as licenses sold to OEMs. Taxpayer described the two licensing scenarios as follows.

Retail Customers:

If a retail purchaser agrees to purchase Taxpayer's canned software, the customer and Taxpayer enter into a signed contract. For retail customers, Taxpayer copies the program onto a disk and packages it with a manual. Both are enclosed in a shrink-wrapped box. Taxpayer then ships the package to retail customers located in and outside the State of Washington. Taxpayer invoiced the retail purchaser for each shrink-wrapped box and reported that amount under the manufacturing and retailing B&O tax classifications and as sales subject to retail sales tax. Audit made no adjustment on these transactions.

Original Equipment Manufacturers:

Taxpayer's major accounts are OEMs. In this case, Taxpayer does not supply individual sets of duplicated software to its OEM customers. Instead, it delivers only one copy of the master disk to the OEM. Using the supplied master disk, the OEM makes additional copies of Taxpayer's canned computer software programs and combines them with printed manuals. The OEM is responsible for printing the manuals in conformance with Taxpayer's specifications. In addition, both the software and manuals incorporate Taxpayer's trademarks, copyrights, and warranty provisions. The software is then installed into the hardware and sold by the OEM to retail customers as a combined hardware and software computer system. Taxpayer receives a negotiated royalty per copy of software sold by the OEM. The amount varies depending on the volume of licenses purchased by each OEM.

Taxpayer first argues that the amounts received from the OEM are for the rental of tangible personal property, i.e. the master disk, and therefore exempt from tax if located outside the state. Taxpayer states in its petition:

> This master disk is placed in the hands of our customers for their use in copying the disk in salable form. The disk itself, containing intellectual property, is tangible personal property. The ownership of this property is always retained by the taxpayer. The taxpayer avails itself of a number of contractual rights to safeguard its interest in this property, including the right to examine its customers[’] business records to insure compliance with licensing restrictions, as well as verifying the number of copies made and distributed.
>
> Excise Tax Bulletin 324 addresses the issue of patent rights. We perceive a significant difference between that and the "rights" granted by the taxpayer. It is our contention that the taxpayer's income is generated by the actual use of its tangible personal property at locations outside the State of Washington. The use of the property is the act which gives rise to the income. In most cases, the income is derived on a price per unit basis. If the customer doesn't have the property to copy, there would be no income. In this sense, the use by the customer of the taxpayer's property is more akin to a rental of personal property than anything else.

Second, Taxpayer argues that its OEM fees should be taxed under the manufacturing tax classification as originally reported. It sees no difference between licenses sold by supplying the master disk to OEMs and licenses sold by supplying shrink-wrapped products. Taxpayer maintains that the substance of the transaction remains the same in either case, the transfer of licenses to use a canned computer program.

Finally, Taxpayer states that even assuming that licensing income is taxable under the service and other activities B&O tax classification, Taxpayer argues that it should be entitled to apportion the income pursuant to WAC 458-20-194 (Rule 194).

Taxpayer points out that:

> Under the various contracts with its customers, the taxpayer agrees to participate in sale marketing with individual clients and in trade shows around the world. Taxpayer's employees also make regular visits to the customers to verify compliance with licensing restrictions, and to "audit" the customer records to verify the number of copies made and distributed. These functions are more than incidental to the generation of income. They are, in fact, a necessary and major influence on the continuation of the income in question.

ISSUES:

1) Are payments from an OEM to the owner of copyrighted software programs subject to B&O taxes under the service and other activities tax classification?

2) Should amounts received for the payment of royalties be apportioned?

DISCUSSION:

Washington imposes the B&O tax on the privilege or act of engaging in business activities in this state. The tax is measured by applying the rates against the value of the products, gross proceeds of sales, or the gross income of the business as the case may be. RCW 82.04.220. "Gross income of the business" means:

> . . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses. (Underlining ours.) RCW 82.04.080.

Consequently, royalties are considered part of a business' gross income. The service and other activities B&O tax rate is imposed on royalties by RCW 82.04.290(4)[2]. See also Det. No. 92-004, 11 WTD 551 (1992); Excise Tax Advisory 324.04.106\194 (ETA 324).

A "royalty" is defined as:

> Compensation for the use of property, usually copyrighted material . . . expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, ... Black's Law Dictionary, at 1330 (6th ed. 1990).

Although Taxpayer contends that the payments it receives are for the rental of tangible personal property (the master disk) and not for royalties, we must disagree. Taxpayer is in the business of designing, creating, and licensing canned computer software to consumers and distributors. Taxpayer's primary asset consists of the copyrighted software, trademarks, trade names, and logos related to the software, user manuals, and packaging. Under the terms of the software licensing and distribution agreement, Taxpayer is to provide the OEM with copies of its software product and authorize the OEM to "copy, distribute, market, and sublicense end users to use the Software as part of a Bundled Product. . .[3]" Furthermore, the master disks must be updated continuously. Taxpayer stated during the hearing that updates are sometimes required every month. In addition, the OEM's use of the master disks and software programs are both strictly limited. The OEM may not modify or change the software in any manner, the software must be

[2]But see, Chapter 332, Laws of 1998 (effective July 1, 1998) that changed the taxation of software royalty income.
[3]Software Licensing and Distribution Agreement, Sec. 3.1(a)

sold as part of a bundled product and there are restrictions on what programs with which the software can be bundled. Also, the right to reproduce the software normally cannot be transferred.

In return for these rights, the contract provides that the OEM agrees to: "pay [Taxpayer] all royalties and fees specified in this Section and in Exhibit B as required under Section 5.1.[4]" The contract clearly and continuously refers to all payments received as royalties. Nowhere, in the contract does it state that the OEM is renting tangible personal property. On the contrary, the terms of the sample OEM agreement state that the OEM pays Taxpayer: "an amount for each copy of the Software distributed as part of a Bundled Product distributed by OEM Company…[5]" Such an arrangement clearly falls within the definition of "royalty", because it is compensation that the OEM pays on a per-copy-sold basis for the use of Taxpayer's copyrighted properties.

Next, although Taxpayer sees no distinction between licenses sold by supplying a master disk to an OEM and licenses sold by supplying a shrink-wrapped product to a consumer, we again disagree. When determining whether a retail sale of tangible personal property or some other type of property or service has been purchased, the Department has frequently focused on the "true object" of the transaction sought to determine the proper tax classification. Det. No. 89-009A, 12 WTD 1 (1992) (Discount memberships); Det. No. 94-115, 15 WTD 019 (1994) (Food Demonstrations). See also WAC 458-20-211, ETB 520.04.211, and ETB 573.04.224. In Taxpayer's case, it is clear that when Taxpayer licenses its software to consumers, the true object of that consumer is to acquire and utilize the canned software to run the customer's computer. Sales of canned computer software are taxable under the retailing or wholesaling tax classifications. In contrast, however, Taxpayer's OEM contract clearly provides that the OEM is acquiring a license to reproduce and distribute canned software as part of a bundled product. Although the OEM does receive some tangible personal property, i.e. a master copy, this tangible copy is only incidental to the intangible right to reproduce and re-license the product. Accordingly, we find that the OEM pays a royalty based on a fixed fee per copy sold for the intangible right to reproduce or re-license computer software.

Nor can we allow Taxpayer to apportion this income. A copyright is an intangible asset. Similarly, a license to reproduce copyrighted material is intangible property. Intangible property has its situs at the domicile of its owner. In Re Eilerman's Estate, 179 Wash. 1, 35 P.2d 763 (1934). The state in which an intangible property owner is domiciled may impose a tax measured by the value of that property. Det. No. 92-004, 11 WTD at 559; Det. No. 88-233, 6 WTD 59 (1988). Since Taxpayer's domicile is Washington, Washington may and does impose its B&O tax on that income.

Finally, although Taxpayer contends that it is also providing significant services under the contract, we believe any services performed are only incidental to the licensed intangible rights acquired in the contract. In fact, we note that most of the alleged services being performed are primarily to insure that Taxpayer is paid the full amount of royalties due under the licensing agreement.

[4] Software Licensing and Distribution Agreement, Sec. 4.1(d)
[5] Software Licensing and Distribution Agreement, Sec. 5.1

DECISION AND DISPOSITION:

Taxpayer's petition for correction of assessment and refund is denied.

Dated this 25th day of November, 1998.