Cite as Det. No. 98-213, 19 WTD 777 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 98-213
	)	
. . .	)	Registration No. . . .
	)	FY . . ./Audit No. . . .
	)	

[1] RULE 155; RCW 82.04.290: SERVICE B&O TAX -– SOFTWARE -– ROYALTY v. SALES – OEM. Payments made by Original Equipment Manufacturers (OEMs) and resellers for the right to reproduce and distribute copyrighted software programs are "in the nature of royalties" and subject to B&O taxes under the service and other activities tax classification.

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, 1990 through March 31, 1994. An audit report resulted in additional taxes and interest owing of $ . . . and Document No. FY . . . was issued in that amount on December 14, 1994. Taxpayer paid the assessment and now petitions for a refund.

Taxpayer explains its business activities in its petition as follows:

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

> [Taxpayer] is a developer and manufacturer of document management software. The Company's software is a standard product (i.e., not custom) that can be licensed in a prepackaged manner or licensed on a "golden master site license" basis where either the end user customer or the reseller or OEM customer duplicates and distributes the software. The tangible personal property associated with a software transaction consists of the computer code residing on the media in which it is conveyed. [Taxpayer] licenses it's standard software directly to both end user customers and to Resellers and Original Equipment Manufacturers (OEMs) to be reproduced and sold to end users. Both the end user customers and the resellers and OEMs then pay the company based upon the number of software units they license.

Schedules II & V: To Reclassify OEM Revenue from Manufacturing to Service

In these two schedules Audit reclassified license fees received from Original Equipment Manufacturers (OEMs) and resellers 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. Citing WAC 458-20-155 (Rule 155), Audit considered this income to be "in the nature of royalties for the reproduction, use, and reuse of patented systems and technological components of hardware or software. . ." and reclassified this income to the service and other activities tax classification.

Taxpayer explained during the hearing that it designs and develops canned computer software for sale. The process of creating the product culminates in a master disk. Once the master is created, Taxpayer licenses the software code to OEMs, resellers and to end-users of the canned software. Taxpayer states that Audit agreed that licenses made to retail end-users of canned software were subject to manufacturing B&O tax and retailing and retail sales tax. Audit accepted these transactions as reported. Taxpayer argues that licenses sold to OEMs and resellers are the same as licenses sold to retail end-users and should be taxed the same. Taxpayer described the licensing scenarios as follows.

Sales to End-users:

If an end-user agrees to purchase a license to use Taxpayer's software program, the end-user can be given a software package consisting of shrink-wrapped software disks and manuals, or can be given a site license. With a site-license, the customer is only given one disk with the right to reproduce the program on a specified number of computers. The end-user pays more depending on the number of computers licensed to use the program. In addition, end-users can also acquire the program without any disks by downloading the software directly from a public forum such as CompuServe, the Internet or an electronic bulletin board. In this case, the end-user pays Taxpayer a license fee for being allowed to download and use the software. Taxpayer invoiced these end-users directly and reported the sales under the manufacturing and retailing and retail sales tax classifications. Audit made no adjustment on these transactions.

Original Equipment Manufacturers and Resellers:

Taxpayer explains in its supplemental memo that:

> The Company also licenses the same software to resellers and Original Equipment Manufacturers ("OEM's"). Resellers are licensed to market the software to end users and may reproduce the software similar to a customer who has a site license that pays based upon the number of units reproduced. Per the standard reseller agreement section 4.7 (Exhibit 3), the reseller may as stated in 4.7.1. sell individually packaged goods or as stated in 4.7.2 sell it in a non-packaged form which could consist of reproducing it electronically. The reseller then pays a fee based upon the number of units they have licensed to end users regardless of the medium that the code was delivered just like site licenses to end users. OEM's are licensed to include or use the Company's product as an additional component of their product (hardware or software) which is marketed for resale. The OEM's pay based upon the number of units reproduced and licensed. The sale by the reseller or OEM to the end user is a sale of tangible property, with the reseller OEM's classifying their revenue as retail/wholesale.

Taxpayer argues that all of the above software transactions are the same and should be considered a sale of tangible personal property taxable under the manufacturing, retailing and wholesaling tax classifications. Taxpayer stresses in its petition that:

> The tangible property sold represents the computer code not the disk or medium of transmission. This point is most clear in a case where the customers received no disk or CD, but directly downloads the software ("tangible personal property") directly from a public forum such as CompuServe or the Internet or from a vendor electronic bulletin board and pays the vendor a license fee to do so.

Taxpayer further argues:

> . . . the nature of the transaction, license of tangible property, does not change as a result of licensing prewritten software to end users or to resellers and OEM's. The WAC 458-20-155 does not contemplate the change in the nature of the asset from tangible to intangible when the recipient of the software changes from end user to intermediate marketer and therefore, the Company does not believe that reclassification from Retail/Wholesale to Service is appropriate. [Taxpayer] can find no legal evidence to substantiate the State's position that licensing for use vs. distribution justifies a change in the nature of the transaction from Retail/Wholesale to Service.

ISSUE:

Are payments received by the copyright owner and made by OEMs and resellers for the right to reproduce and distribute copyrighted software programs subject to B&O taxes under the service and other activities tax classification?

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 added.)

RCW 82.04.080. Consequently, royalties are considered part of 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).

WAC 458-20-155 (Rule 155) is the regulation explaining the tax applications of software and related services. It states in part:

> SERVICE: Persons who charge for providing information services or computer services (other than retailing or wholesaling as defined above) are subject to the service and other activities classification of business and occupation tax measured by the gross income of such business. This includes charges for custom program development, charges for on-line information and data, and charges in the nature of royalties for the reproduction, use, and reuse of patented systems and technological components of hardware or software, whether tangible or intangible. (Underlining added.)

Rule 155 clearly states that "charges in the nature of royalties for the reproduction, use, and reuse of patented systems and technological components of … software, whether tangible or intangible" are taxed under the "catchall" service and other activities B&O tax classification. The basis for this lies in RCW 82.04.290 which provides that all business activities that are not taxed under a specific tax classification are taxed under the service and other activities tax classification.

[2] The B&O tax rate on royalty income was reduced by legislation enacted in Chapter 331, Laws of 1998. The new rate became effective July 1, 1998.

Although Taxpayer contends that the payments it receives are for tangible personal property (i.e. the computer code or canned program) and not for royalties, we disagree. First, we note that ownership of a copyrighted object entails both ownership of the material object and derivative intangible copyrights. The ownership interests are separate and divisible[3]. Furthermore, the extent of copyrights obtained by a purchaser is determined solely by the terms of the contract between the owner and purchaser. Consequently, even though two purchasers may acquire the identical copyrighted material object, the actual rights related to that material object may vary considerably.

The term "royalty" is not defined in the Revenue Act. Absent a contrary definition in a statute, words are given their ordinary and common meaning, which can be found in dictionaries. John H. Sellen Constr. v. Department of Rev., 87 Wn.2d 878, 558 P.2d 1342 (1976). Black's Law Dictionary defines the term "royalty" 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).

We believe the compensation received by Taxpayer from OEMs is "in the nature of royalties" pursuant to Rule 155. This can be seen by examining the rights and responsibilities of each party under the contract.

Section 2.1 of Taxpayer's "OEM License Agreement" grants the OEM a nonexclusive, nontransferable license to:

> (a) use and reproduce the Program in the Territory to embed the Program, in object code only, as part of the OEM Product in such a way that it allows a Customer to use the Program command and functions only through the OEM Product interfaces;
>
> (b) reproduce and directly or through Resellers distribute and license the Program solely as an embedded part of OEM Product, to Customers in the Territory pursuant to a license agreement meeting the requirements set forth in Section 2.4 of these License Term and Conditions;
>
> (c) reproduce and incorporate information from the Documentation into OEM's documentation for the OEM Product, provided the use of such information is not misleading, inaccurate or incomplete, and distribute such OEM Product documentation; and
>
> (d) use the [Taxpayer] Marks to promote and identify the OEM Product.

[3] The Copyright Act of 1976, 17 U.S.C. Sec. 202.

While Section 2.1 describes the intangible rights received by the OEM, Section 2.2 describes the tangible personal property received. It states:

> Upon receipt of the prepaid license fee described in Section 5 of the OEM License Agreement, [Taxpayer] shall deliver to OEM a reproducible master copy of the Program, in object code form, and the Documentation in both electronic and paper form.

In exchange for the above licenses and the deliverables, the OEM agrees to pay Taxpayer the following compensation under Section 3.

> 3.1 License Fees. OEM shall pay [Taxpayer] upon execution of the Agreement, the prepaid license fee amount specified in Section 5 of the OEM License Agreement. In addition, OEM shall pay [taxpayer] the unit license fee specified in the OEM License Agreement of the applicable Program for each Workstation on which a Customer is authorized to use the OEM Product containing such Program (a "Workstation License"). [Underlining added.]

Under the contract, the OEM is required to pay Taxpayer (as copyright holder) both a prepaid license fee and a unit license fee specified in the OEM License Agreement based on the number of units licensed to end-users. This compensation falls within the common and ordinarily understood definition of a royalty, and we so find.

Although Taxpayer sees no distinction between a license to reproduce canned software acquired by OEMs and resellers, and a license to use the canned software acquired by end-users, we again disagree. The sale or transfer of a copyrighted object consists of both the tangible personal property containing the copyrighted item and the bundle of copyrights related to them. Each is separately identified and can be treated differently for purposes of taxation. See generally, Nimmer on Copyrights, sec. 8.12 (1997).

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, ETA 520.04.211, and ETA 573.04.224. In Taxpayer's case, it is clear that when Taxpayer licenses its canned software to end-users, whether through a single disk and documentation or through a multiple site-license, the true object of the end-user is to acquire and utilize the material canned computer software program to run the end-user's computer. The medium, whether it is in the form of tangible disks, pre-installation in an OEM product, or downloaded from an Internet site is immaterial. In each of these situations, the "true object" of the end-user is to obtain the material tangible software program to run its computer. The Department has consistently taxed these sales or licenses of canned computer software under the manufacturing B&O and retailing and retail sales tax classifications. See, WAC 458-20-155. In contrast, however, the OEM contract clearly provides that the OEM is primarily acquiring a license to reproduce and

distribute canned software as part of a bundled product to end-users and resellers. Although the OEM does receive some tangible personal property, i.e. a reproducible master copy, this tangible copy is only incidental to the intangible right to reproduce and re-license the product. It is not the "true object" of the transaction. Instead the "true object" of this transaction is the right to reproduce and distribute copies of Taxpayer's computer program. This is an intangible right and is in the nature of a royalty. Accordingly, we find that the fixed fee per copy payments made by the OEM to Taxpayer constitutes a payment in the nature of a royalty and is taxable under the service and other activities tax classification pursuant to Rule 155.

DECISION AND DISPOSITION:

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

Dated this 15th day of December, 1998.