

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for)
 4 Redetermination and Claims for Refund)
 4 Under the Sales and Use Tax Law of:)
 5 LUCENT TECHNOLOGIES, INC.) Account Number: SR OHB 99-851511
 6 Petitioner) Case ID's 317049, 317677, and 89002416490
) Alpharetta, GA

7 Type of Business: Telephone and networking equipment

8 1st claim period: 09/01/96 – 08/31/97 (89002416490)

9 Audit and 2nd claim period: 02/01/96 – 09/30/00 (317049, 317677)

10 <u>Item</u>	<u>Disputed Amount</u>
11 Disallowed claimed nontaxable sales	\$51,695,576 ¹
12 Tax as determined:	\$30,521,955.40
12 Adjustment - Sales and Use Tax Department	- 1,277,798.56
12 - Appeals Division	- 478,778.40
13 Proposed redetermination	\$28,765,378.44 ²
13 Less concurred	- 24,588,040.48
14 Balance, protested	<u>\$ 4,177,337.96</u>
15 Proposed tax redetermination	\$28,765,378.44
15 Interest through 3/31/05 (tax paid in full 3/29/05)	<u>17,945,049.76</u>
16 Total tax and interest	\$46,710,428.20
16 Payments	-34,388,537.62
17 Balance Due	<u>\$12,321,890.58</u>

18 This matter was previously scheduled for Board hearing on March 24, 2010, but was postponed
 19 at petitioner's request to provide additional time for its representatives to gather documents and file an
 20 opening brief.

21 UNRESOLVED ISSUE

22 **Issue:** Whether adjustments are warranted to the amount of disallowed recorded nontaxable
 23 sales. We recommend no further adjustment.

25 _____
 26 ¹ Petitioner protests certain sales in four of the six strata tested by the Department. We have computed a percentage of
 27 disputed to disallowed sales in each sample and then computed the amount for each stratum that remains in dispute
 (\$8,491,895 for stratum 3, \$20,804,038 for stratum 4, \$16,707,464 for stratum 5, and \$5,692,179 for stratum 6). The
 28 disputed amount is significantly less than the amount in dispute shown in the D&R because the D&R regarded the total
 amount disallowed for each of the four strata to be in dispute.

² This amount is net of a concurred credit of \$7,567.28, which represents the allowed portion of petitioner's claim for
 refund for the period September 1, 1996, through August 31, 1997 (explained under the heading Resolved Issue).

1 Petitioner is a developer, manufacturer, and installer of telephone and networking equipment
2 and related software and maintenance. Petitioner obtained its seller's permit effective February 1,
3 1996, which is the beginning of the audit period. Prior to that date, petitioner was a wholly-owned
4 subsidiary of American Telephone and Telegraph (AT&T).

5 The Sales and Use Tax Department (Department) segregated petitioner's recorded nontaxable
6 sales into six strata, testing strata 2 through 6 (it did not test stratum 1, which consisted of sales less
7 than \$100.00).³ The Department reviewed random samples of sales between \$100.00 and \$200,000.00
8 (strata 2, 3, and 4), reviewed a one-year block sample of sales between \$200,000 and \$1 million
9 (stratum 5), and reviewed all sales greater than \$1 million (stratum 6). The Department found errors in
10 each of the five strata tested and established a separate audit item for each stratum. Petitioner protests
11 specific sales disallowed in strata 3, 4, 5, and 6 (the three disallowed transactions the D&R
12 recommends be accepted as nontaxable are not discussed further). Several types of transactions
13 remain in dispute, most of which relate to license fees petitioner charged its California customers for
14 the right to use petitioner's copyrighted software (RTU software transactions) in order to access a
15 public switch telephone network.

16 RTU Software

17 The RTU software transactions involve petitioner's 5ESS®-2000, which is a software-based
18 digital switching system located in the central office (CO) of a public switch telephone network that
19 has the capability to support multiple applications. Petitioner contends that charges for the RTU
20 software were from nontaxable sales of custom computer software because the software in each CO is
21 unique, incorporating the various communications services requested by individual consumers served
22 by that particular CO.⁴ Petitioner believes that this case is substantially identical to that of an
23 unrelated taxpayer, Nortel Networks, Inc. (Nortel), which resulted in litigation in which the superior
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27 ³ Petitioner reported its taxable sales based on its recorded accrued sales tax, and the Department was not able to readily
28 trace claimed nontaxable and exempt sales to recorded figures. Therefore, the Department tested recorded nontaxable sales.

⁴ It is undisputed that petitioner holds the copyright to both the code and object codes for all software at issue.

1 court found that the software at issue was custom computer programming because it was uniquely
2 programmed for each switch application.⁵

3 Despite petitioner's characterization of the software as unique to each switch, we find that the
4 program and modules were preexisting and homogeneous. The software was not prepared for the
5 special order of each customer. Petitioner provided preexisting modules and entered the necessary
6 data into the software to configure the switch. Thus, we find that the software was prewritten software
7 rather than custom software, and the license fees for use of the software were subject to tax.

8 Petitioner requests relief from any tax and interest due, contending that it reasonably relied on
9 the Department's prior written advice when it did not charge tax or tax reimbursement on the RTU
10 software transactions. Although petitioner has not submitted the requisite statement under penalty of
11 perjury setting forth the basis of its claim for relief and we thus lack authority to recommend relief
12 under Revenue and Taxation Code section 6596, we have considered whether relief would be
13 warranted if properly requested.

14 Petitioner contends that in prior audits of its predecessor, AT&T, the Department regarded the
15 same types of transactions as nontaxable.⁶ This is not correct. The Department did regard certain
16 software transactions as nontaxable in the audit of AT&T for the period July 1, 1992, through
17 December 31, 1994. However, in the following audit, for the period January 1, 1995, through
18 December 31, 1999, the Department regarded the disputed transactions as taxable sales of pre-written
19 software.

20 The software at issue was determined not to be custom software in the audit of AT&T for the
21 period January 1, 1995, through December 31, 1999. AT&T disputed that finding, based on part of
22 reliance on the prior audit. We found several bases for finding that relief was not warranted. For
23 example, the software could well have been custom computer software during the July 1, 1992,
24 through December 31, 1994 audit period, and evolved into pre-written software for the following
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26 ⁵ The *Nortel* decision is a trial court decision of one judge, not a published precedential appellate decision by a panel of
27 appellate justices. Thus the Board is not bound by the *Nortel* decision. Moreover, we note that the Board has since
28 appealed the *Nortel* decision.

⁶ Petitioner is the legal successor to AT&T and may obtain relief if it actually relied on advice to AT&T, and if that reliance
was reasonable

1 period. That is, it is not unusual that, at a given point in the development of software to accomplish a
2 specific task, the software must be customized for each individual user, and that with time the software
3 developer has created a library of prewritten code that makes the creation of a pre-written software
4 package possible, even for users with different circumstances. Thus, petitioner could well have
5 provided software for digital switching that qualified as custom software during the earlier audit
6 period, and then by the later audit period, was providing pre-written software for the same purpose.
7 We concluded that it appeared that the facts and circumstances in the earlier audit period were different
8 than during the later audit period, and thus concluded that AT&T could not obtain relief based on
9 reasonable reliance on the prior advice. For this reason and others, we found that AT&T could not
10 have reasonably relied on the prior advice to avoid paying the tax due on its later sales of prewritten
11 software. On August 6, 2008, the Board upheld this finding. We conclude that petitioner likewise
12 cannot rely on the results of the AT&T audit for the period July 1, 1992, through December 31, 1994,
13 to avoid paying the tax due on its sales of prewritten software during the present audit period.

14 Petitioner alternatively contends that the contracts by which it transferred the RTU software
15 qualify as technology transfer agreements (TTA's), and that charges for intangible personal property
16 transferred as part of such agreements are excluded from the sales price. Petitioner, citing *Preston v.*
17 *State Board of Equalization* (2002) 25Cal.4th 197, argues that these transactions satisfy all four
18 elements of a TTA because: 1) petitioner's contracts were written agreements, 2) it held a copyright
19 interest in all of the software covered under the RTU software transactions; 3) the agreements were
20 licenses that gave petitioner's customers the right to use the software; and 4) petitioner's customers
21 used the copyrighted software on the 5ESS®-2000 switches at issue. Petitioner also states that the
22 superior court in *Nortel* found nearly identical transactions to be nontaxable TTA's. Further, petitioner
23 asserts that, to the extent California Code of Regulations, title 18, section (Regulation) 1507 provides
24 that sales of prewritten software are not sales of TTA's, Regulation 1507 is invalid because it is
25 inconsistent with Revenue and Taxation Code section 6011.

26 We note first that petitioner has mischaracterized the decision in *Nortel*. The court found that
27 Regulation 1507 is valid, and did *not* find that the transactions at issue in that case were nontaxable
28 TTA's. As prewritten software, the RTU software transactions are excluded from the definition of a

1 TTA in Regulation 1507. Since the decision in *Preston* did not concern prewritten software (or any
2 software all), it is not applicable here. We find that petitioner's RTU software transactions did not
3 qualify as TTA's.

4 Other transactions

5 Petitioner asserts that three of the remaining disputed transactions were nontaxable sales for
6 resale of materials to Pacific Bell, which petitioner contends was a leasing entity who provided a resale
7 certificate under the name "SBC Leasing Affiliates." Petitioner has not explained how or why a resale
8 certificate issued by SBC Leasing should be regarded as a resale certificate issued by Pacific Bell, nor
9 can we discern any such reason from the record. Thus, we find that the SBC Leasing resale certificate
10 does not support petitioner's contention that the three sales were nontaxable sales for resale. In
11 addition, we find that the evidence suggests that the resale certificate provided by petitioner was not
12 taken timely, and thus would not relieve petitioner of the tax applicable to these transactions even if it
13 were from the proper party.

14 Petitioner contends that the disputed sale to Network Services/Telsave, was also a nontaxable
15 sale for resale of materials. In support, petitioner has provided a multi-jurisdictional sales tax
16 exemption certificate dated December 15, 1995, listing the permit number TU HQ 35-100767 (an
17 account number for the Emergency Telephone Users Surcharge program). We find that the resale
18 certificate provided is not valid because it lacks two of the elements essential for a valid resale
19 certificate: 1) a valid seller's permit number for the purchaser and 2) a description of the property to be
20 purchased for resale. Also, the Department found no evidence in its records that Network
21 Services/Telsave was in the business of reselling any tangible personal property. Thus, there is no
22 basis to conclude that this sale was a nontaxable sale for resale.

23 Petitioner contends that four sales to Western Wireless should be excluded from tax because:
24 petitioner shipped the property to the customer from outside California, with title passing outside
25 California at the point of shipment, and because the customer's emailed response to an XYZ letter
26 indicates that none of the items at the Fairfield warehouse would have been used in CA."

27 While the sale is not subject to sales tax because title passed to Western Wireless outside this
28 state, it is undisputed that the property was delivered to the customer in this state, and therefore is

1 presumed to have been sold for use in California. As such, the transaction is subject to use tax, absent
2 an applicable exemption or exclusion. We understand petitioner to be arguing that the transaction
3 qualifies for exclusion from use tax because the only use of the property in this state was for the
4 purpose of subsequently transporting it outside California, and the property was thereafter used solely
5 outside this state. However, while petitioner provided an email apparently referring to the property at
6 issue here with the explanation that none of the items would have been used in this state, the email
7 does not have sufficient information in it to stand alone for the proposition that the property at issue
8 here was never functionally used in California and was shipped outside of the state, including, for
9 example, bills of lading or other evidence to establish that the property ever left this state after
10 delivery.

11 For 10 other transactions disallowed in the audit, the customer provided a response to an XYZ
12 letter indicating that it had been audited by the Board and had paid the applicable tax directly to the
13 Board as a result of the audit. However, the property at issue was sold for delivery to GTE and Pacific
14 Bell in California, and the response on which it relies was issued by Verizon, rather than either of the
15 two customers at issue. Accordingly, the response is not evidence that the customers involved paid the
16 tax. Also, while we are constrained from revealing taxpayers' confidential information, we have
17 reviewed the evidence and have concluded that the transactions at issue herein have not been assessed
18 against any other taxpayer, either on a projected or actual basis. Accordingly, we find that the
19 evidence does not support this contention.

20 Petitioner's last contention is an objection to the audit methodology in connection with two
21 specific transactions, one of which was not assessed as taxable. The remaining transaction was a sale
22 of materials to Octel Communications for \$58,776. Petitioner asserts that the inclusion of this
23 transaction in the tested sample is inconsistent with the agreed-upon sampling method because the
24 samples were to be tested on a line-item basis, whereas the amount included as taxable in this
25 transaction is the entire invoice amount.

26 Here, the Department found that, while the invoice shows two line items for \$33,586 and
27 \$25,190, the data file supplied by petitioner showed only one line item for a total of \$58,776. The
28 Department speculates that the two line items on the invoice show as one line item in the data file

1 because the same product description is shown for both lines. The Department has concluded that,
2 since the samples were drawn based on the data petitioner provided and there is no duplication in the
3 strata, no adjustment is warranted. Based on our review of the record, we concur. The Department has
4 assessed tax on both line items, in the aggregate. Petitioner has not established that either of the line
5 items is not subject to tax, and we find there is no basis to recommend an adjustment.

6 **AMNESTY**

7 The amnesty interest penalty is not applicable in this case because petitioner filed a timely
8 amnesty application and paid the amnesty-eligible tax and a portion of the interest by May 31, 2005.

9 **RESOLVED ISSUE**

10 Petitioner's August 13, 1998, claim for refund for the period September 1, 1996, through
11 August 31, 1997, was resolved in the audit. The claim was based on the grounds that petitioner had
12 erroneously collected and remitted tax in connection with nontaxable charges to its customer, ICG
13 Access Services. The Department investigated this claim for refund during the audit and allowed a
14 \$7,567.28 of the claimed overpayment in the audit. Since petitioner agrees with the amount allowed in
15 the audit, this claim for refund has been resolved.

16 **OTHER DEVELOPMENTS**

17 None.

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19 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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Statistical Sample
Strata 2, 3, & 4

Transactions Examined	Sales for resale
Confidence level	80%
Confidence interval, combined evaluation	27.9880%
Total number of items in the population	Stratum 2 - 62,163 Stratum 3 - 27,564 Stratum 4 - 3,773
Number of items randomly selected for the test	Stratum 2 - 400 Stratum 3 - 401 Stratum 4 - 325
Number of errors found	Stratum 2 - 17 Stratum 3 - 5 Stratum 4 - 15
Whether stratification was used, and if so what was stratified	Stratum 1 - less than \$100* Stratum 2 - \$100 to \$3,000 Stratum 3 - \$3,000 to \$50,000 Stratum 4 - \$50,000 to \$200,000 Stratum 5 - \$200,000 to \$1 million Stratum 6 - over \$1 million
Average dollar value of population	Stratum 2 - \$826 Stratum 3 - \$11,484 Stratum 4 - \$83,929
Dollar value of remaining errors	Stratum 2 - \$ 9,285 Stratum 3 - \$ 38,790 Stratum 4 - \$1,362,095
Dollar value of sample	Stratum 2 - \$ 330,360 Stratum 3 - \$ 4,605,002 Stratum 4 - \$27,276,994
Percentage of error	Stratum 2 - 2.81% Stratum 3 - 0.842% Stratum 4 - 4.9875%
Were XYZ letters sent	Yes
Number of XYZ letters sent	Unknown**
Percentage of XYZ letters sent in relation to number of questioned items	Unknown**
Number of responses to XYZ letters received	Unknown***
Percentage of responses to XYZ letters received in relation to the number of XYZ letters sent	Unknown***
Number of responses to XYZ letters received accepted as proof of valid exempt/nontaxable sales	Unknown***
Percentage of responses to XYZ letters received accepted as proof of valid exempt/nontaxable sales	Unknown***
Number of responses to XYZ letters treated as taxable	Unknown***
Percentage of responses to XYZ letters treated as taxable	Unknown***

* Stratum 1 was not tested; for stratum 5, the Department tested a block sample, the year October 1, 1999, through September 30, 2000, and it reviewed all sales in stratum 6 on an actual basis. Accordingly, statistical samples were tested for strata 2, 3, and 4 only.

** The audit did not list or indicate the number of XYZ letters sent to petitioner's customers.

*** The audit did not list or indicate the number of XYZ letters received.