

PUBLICATION

Spotlight on New Jersey: Software Licensing and Income Tax Nexus AccuZIP and Quark

September 08, 2009

In consolidated cases, the New Jersey Tax Court ruled that software license agreements and related activities did not give New Jersey income taxing jurisdiction over two sellers of prewritten software. *AccuZIP, Inc. v. Division of Taxation*, No. 005744-2003 (August 13, 2009) and *Quark, Inc. v. Division of Taxation*, No. 004692-2002 (August 13, 2009). In doing so, the court distinguished software licensing from trademark licensing and economic presence nexus addressed in *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (2006), cert. denied, 551 U.S. 1131 (2007).

Software Licensing Arrangements

From its offices in California, AccuZIP sold pre-written computer software on CD-ROMs to business customers in New Jersey and nationwide. AccuZIP's mailing software helped its customers qualify for lower postage rates. Customers were solicited via advertisements in national trade magazines and AccuZIP's website. Customer orders were placed exclusively by telephone, email or fax, and the CD-ROMs were shipped from California by common carrier. Technical support for customers was provided from California. AccuZIP had no employees, offices, or contractors in New Jersey. Customers were required to agree to a license agreement under which AccuZIP retained title to the CD-ROMs.

Quark also sold pre-written desktop publishing software on CD-ROMs to New Jersey customers along with hardcopy tutorial guides, reference manuals, and user guides. Quark had a New Jersey employee working out of his home office. This employee solicited orders for sales of Quark's software. The employee's activities in New Jersey were confined to those protected from income taxation by federal Public Law 86-272 (15 U.S.C. §§ 381 et seq.) Quark also required its customers to agree to a license agreement.

Sellers of Tangible Personal Property or Licensors of Intangibles?

Relying on federal Treas. Reg. § 1.861-18, the New Jersey Tax Court first disagreed with the Division of Taxation (Division) and found that AccuZIP and Quark were sellers of tangible personal property in the form of CD-ROMs containing prewritten computer software and not licensors of intangible property. In addition, AccuZIP's and Quark's revenues were from single sales of prewritten software and updates, not from any resale or royalties. Their intellectual property was not displayed in New Jersey. Thus, AccuZIP and Quark were not generating income from the use of their intangible personal property in New Jersey. Based on these factors, the Tax Court distinguished AccuZIP and Quark from the licensor in *Lanco*.

Next, the court rejected the argument of the Division that retention of title to the software under a license agreement was the ownership of property in New Jersey. The court reasoned that, under federal copyright law and the license agreements, AccuZIP and Quark retained ownership of copyrighted intellectual property; but buyers of the prewritten software received ownership of the physical property for their use.

The Multistate Tax Commission's (MTC) "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 (2001)" provides that "licensing . . . of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trade marks, .

. . are not protected activities under P.L. 86-272." New Jersey has not adopted this MTC Statement, but the Division argued it should apply since the Division agrees with the MTC Statement and New Jersey is a "Sovereignty Member" of the MTC (but is not a regular or "Compact Member" that has enacted the Multistate Tax Compact). Without ruling on the validity of the MTC's interpretation, the court rejected the Division's argument using the following rationale:

- First, the Division could not informally adopt a rule or regulation per *Metromedia, Inc. v. Director, Div. of Taxation*, 97 N.J. 313 (1984); and
- Even if the Division properly adopted the MTC Statement, the Tax Court stated AccuZIP and Quark were selling tangible personal property not licensing, based on Treas. Reg. § 1.861-18(a)(3).

Quark's home office employee handed out "demo disks" to potential customers so they could "play around with the software." The Court held this activity was also protected by P.L. 86-272 because the "demo disks" had no value, were pre-sale activity, and served no independent business function other than the solicitation of orders.

The Court also rejected the Division's argument that the "significant economic presence test" of *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W.Va. 2006), *cert. denied*, 551 U.S. 1141 (2007), should be applied.

If you would like to discuss these consolidated cases and how they may impact the taxation of your business activities in New Jersey or other states, particularly if those activities involve or include licensing of software or other intellectual property, please contact one of the attorneys in our Tax Department.