STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
XEROX CORPORATION AND XAC, LLC f/k/a AMICI, INC.	:	DETERMINATION DTA NOS. 821914 AND 821915
for Revision of Determinations or Refund of Sales and Uses Tax under Articles 28 and 29 of the Tax Law for the Period June 1, 2006 through July 21, 2006.	:	

Petitioners, Xerox Corporation and XAC, LLC, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 2006 through July 21, 2006.

On May 9, 2008 and June 4, 2008, respectively, petitioners, appearing by Hodgson Russ LLP (Timothy P. Noonan, Esq., of counsel), and the Division of Taxation, appearing by Daniel Smirlock, Esq. (James Della Porta, Esq., of counsel), waived a hearing and submitted the matters for determination based on documents and briefs to be submitted by October 29, 2008, which date began the six-month period for issuance of this determination. After due consideration of the documents and arguments submitted, Joseph W. Pinto, Jr., Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioner XAC, LLC's sale of a software program, which it developed by itself for self-use, to Xerox Corporation as part of a bulk sale was properly determined to be taxable as a sale of tangible personal property.

FINDINGS OF FACT

The parties executed a stipulation containing 12 numbered paragraphs containing facts that have been incorporated into the findings below. In addition, petitioner submitted 13 proposed findings of fact which have been incorporated into the facts below, except proposed findings of fact 4, 5 and 12, which have been modified to better reflect the record and eliminate irrelevant or immaterial facts.

1. Petitioner XAC, LLC f/k/a/ Amici, Inc. (Amici) provided electronic legal document storage and management services for law firms and large corporations. Using Amici's online document management system, Amici's clients (consisting mainly of law firms or in-house attorneys of large corporations) could store, access, manage, organize and search millions of pages of documentation related to specific cases or litigation they were working on.

2. This document management system operated exclusively online, accessed by Amici's clients through a password-enabled web interface.

3. In order to provide this service, Amici designed and developed its own software programs to operate the online document management system. The software was used to convert the legal documents provided by Amici's clients for storage on the system into readable and searchable formats and also enabled the provision of the web interface, through which clients could access the system.

4. The software was developed internally by Amici solely for use in operating the online document management system. Amici did not sell the software or offer it for sale in the ordinary course of its business.

5. The value of the software might have been less if Amici had ever tried to sell the software separately. As indicated in the affidavit of Michael Lindburg, the former managing

director at Amici, the utility of Amici's software depended on the presence of large volumes of litigation documents and a base of legal clients with a need to understand and manage the information content contained in those documents. The software had little utility without a client database with voluminous litigation documents. Moreover, the value of Amici at the time of the company's acquisition by Xerox was contingent upon the existence of Amici as a going concern which operated such a database.

6. Amici listed the software as "software development costs" in an asset account on its books, and it was reflected not as an income generating asset but as an intangible whose balance sheet value totaled roughly $246,000.00.

7. Petitioner Xerox Corporation (Xerox) is the world's leading document management technology and services enterprise, providing a broad portfolio of offerings to the document industry.

8. On July 21, 2006, Xerox purchased substantially all of the assets of Amici for approximately $174 million.

9. The purchase of Amici's assets was part of an overall Xerox business strategy to expand its document management offerings. It planned to continue Amici's business essentially intact.

10. Since Xerox purchased all of Amici's assets, included in the sale was Amici's software. The software comprised $8,074,700.00 of the total purchase price, determined based on a valuation completed by a valuation firm. The valuation method employed by the firm was the "royalty savings method." This valuation method analyzed the software market value - - not as a distinct commodity - - but as a measure of what a company would save by owning, rather

than paying rent or royalties for use of the same software. This type of valuation was necessarily based on the assumption that the software was being used as part of a going concern.

11. Since acquiring Amici's assets, Xerox has operated the online document management system in the same manner as Amici had, and it has used the software exactly as Amici had used it.

12. Prior to the July 21, 2006 sale, Xerox timely filed form AU-196.10, Notification of Sale, Transfer, or Assignment in Bulk (Bulk Sale filing). Upon review of the Bulk Sale Filing, the Division of Taxation (Division) issued a Notice of Determination, dated September 11, 2006, to XAC, LLC, and a Notice of Determination to Xerox Corporation, dated September 18, 2006, for the sales tax applicable to the amount of the purchase price attributable to the software. The Division also asserted a small amount of sales tax on other aspects of the transaction described in the Bulk Sale Filing, but following a conciliation conference in the Bureau of Conciliation and Mediation Services, these amounts were cancelled, as reflected in conciliation orders dated July 20, 2007.

13. The total amount of sales tax asserted by the Division in the notices of determination for the sale of the software as part of the bulk sale was $645,976.00 plus interest and is the only amount remaining in dispute herein.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) provides that the receipts from every retail sale of tangible personal property is subject to sales tax except as otherwise provided in Article 28. A retail sale is defined as a sale of tangible personal property to any person for any reason. (Tax Law § 1101[b][4].) Tangible personal property is defined as corporeal personal property of any nature including prewritten computer software, whether sold as part of a package, as a separate component or

otherwise, and regardless of the medium by which it is conveyed to a purchaser. (Tax Law § 1101[b][6].) Prewritten computer software is defined in Tax Law § 1101(b)(14), in part, as follows:

> Computer software [including prewritten upgrades thereof] which is not software designed and developed by the author or other creator to the specifications of a specific purchaser.

B. From this statutory scheme, it follows that computer software, other than that specifically excluded by the definition in Tax Law § 1101(b)(14), is subject to sales tax as tangible personal property when it is the subject of a retail sale.

The Tax Law was amended in 1991 to explicitly include prewritten computer software as tangible personal property subject to state and local sales and use taxes and to define that term. (L 1991, ch 166.) In a letter from James W. Wetzler, Commissioner of Taxation and Finance, to Governor Mario M. Cuomo, dated June 6, 1991, commenting on Assembly Bill No. 8491, the commissioner noted that sections 154 through 159 of the Bill amended "various provisions of Article 28 of the Tax Law to include pre-written software in the definition of tangible personal property, thus rendering such software subject to the . . . sales tax. . . . Pre-written software is software other than software designed and developed to the specifications of a specific purchaser (commonly called 'custom software')." (Governor's Bill Jacket, L 1991, ch 166.)

C. A careful reading of the pertinent language in Tax Law § 1101(b)(14) indicates that prewritten computer software was meant to include *all* computer software. The exception noted in the latter part of the first sentence provides that software designed and developed to the specifications of a specific purchaser is not prewritten computer software.

The section is not ambiguous and must be construed according to its plain terms and each word in the statute must be given its appropriate meaning, and sense brought out of the words used. (Mr. Kinney's Cons Laws of NY, Book 1, Statutes § 94.)

Here, the only exception mentioned in the first sentence of Tax Law § 1101(b)(14) (which is the only part pertinent to the instant matter) is for software designed and developed to the specifications of a specific purchaser. The software designed and developed by Amici to operate the online document management system was developed internally solely for its own use. Therefore, the software was not designed and developed to the specifications of a "*purchaser*," as required by the plain terms of the statute and, by definition, constituted prewritten software. As such the Division properly determined it to be taxable.

The language of Tax Law § 1101(b)(14) indicates that both canned and custom software may be considered prewritten software if they are not designed and developed by the author or other creator to the specifications of a specific purchaser. The software in issue was indeed customized, but it was not designed to the specifications of a specific purchaser. Its ultimate sale to Xerox was merely the sale of a commodity, prewritten computer software, which had not been designed and developed to the specifications of Xerox.

D. A Technical Services Bureau Memorandum (TSB-M-93[3]S) issued by the Division included the same analysis set forth above. However, it also included a segment on bulk sales which extended the definition of prewritten software. It stated:

> When a seller of business assets in bulk, as part of the bulk sale, sells software, such software is subject to tax even if it was deemed to be exempt software when purchased by the seller.

Hence, the Division made it clear that software sold in a bulk sale loses its identity as software originally designed and developed to the specifications of a specific purchaser and its tax-exempt

status. Petitioner's argument that there was merely a change of ownership and a continued use of the software in similar circumstances which did not alter the customized nature of the software is not consistent with the statute. The facts reveal that a specific value was given to the software in the bulk sale - - one which was determined in accordance with a specific royalty valuation methodology described by Michael Lindberg in his affidavit. Further, the record does not support petitioner's claim that the software was developed and designed to the specifications of Xerox, but it does reflect that Amici developed it on its own for its own business purposes. Given these circumstances, the software transferred by Amici to Xerox in the bulk sale is, by definition, prewritten computer software subject to tax. (Tax Law § 1101[b][14].)

It is noted that the State Tax Commission case cited by petitioner, ***Matter of Economic Information Systems, Inc.*** (May 26, 1987), although presenting similar circumstances to the instant matter, was decided four years prior to the enactment of Laws of 1991 (ch 166), the effect of which was to broaden the types of computer software subject to sales and use tax, specifically the type of software which is the subject of this action. Therefore, it is inapplicable to the facts presented since the statutory scheme under which Amici's computer software is determined to be taxable did not exist in 1987.

Petitioner argues that the ***Economic Information Systems*** matter, and two advisory opinions issued since and discussed below, support its view that the change in ownership of the software did not change its character as tax exempt custom software and that the subsequent sale of the software to an unrelated third party should not have been taxable. This argument fails because the interceding legislation provided the definition of prewritten computer software, and extinguished any precedential value ***Economic Information Systems*** might have held for the instant matter. The self-developed and designed software used by Amici was, by definition,

prewritten computer software and therefore taxable as tangible personal property when sold to Xerox. Petitioner's expansive reading of Tax Law § 1101(b)(14) seeks to create a new exemption that is simply not extant in the current legislation or supported by the legislative history. As more succinctly stated:

> A statutory exemption from the taxing power of the state will never be implied from language which will admit of any other reasonable construction. Mc Kinney's Cons Laws of NY, Book 1, Statutes § 294 .)

The two advisory opinions, decided after the change in the Tax Law, are consistent with the Department's position and support its action herein. In TSB-A-00(18)S, April 21, 2000, the issues revolved around whether certain software was exempt from sales and use tax prior or subsequent to a plan of reorganization; whether the software, determined to be prewritten software, is tax exempt when transferred to a subsidiary and then leased back to the parent; and whether future upgrades to the software is exempt from tax. The Advisory Opinion determined that the transfer of the software to a purchaser for whom it was specifically developed and designed was tax exempt as provided for in Tax Law § 1101(b)(14) both before and after the plan of reorganization; it determined that custom software developed in-house by a company and licensed to customers without consideration did not constitute a "sale, selling or purchase" subject to tax; it determined that a transfer of software from a parent to a subsidiary in exchange for 100 percent of the stock of the subsidiary did not constitute a retail sale and was not taxable; it determined that future upgrades and enhancements of custom software to the specifications of the original purchaser was tax exempt and subsequent sub-licensing from the subsidiary to the parent was exempt as a transfer to a corporation which was a member of an affiliated group under Tax Law § 1115(28) (but specifically noting that the software would lose its character as custom software and become prewritten software if resold to any other person).

The interpretations of the pertinent Tax Law sections in the Advisory Opinion are consistent with the rationale applied to petitioner herein. The Division's positions in the Advisory Opinions are consistent with TSB-M-93(3)S and support the conclusion reached above. It is also noteworthy that the advisory opinions mention circumstances where software that was designed and developed by a company to the specifications of a specific purchaser is subsequently sold to a different purchaser, the software loses its character as custom software and becomes taxable. That situation is closely analogous to the circumstances presented here where software developed by Amici for its own use, i.e., not for sale to a specific purchaser, loses its exempt status when sold to a third party for whom it was not specifically designed and developed. [1]

E. The petitions of Xerox Corporation and XAC, LLC, are denied and the notices of determination dated September 18, 2006 and October 2, 2006 are sustained.

DATED: Troy, New York
April 23, 2009

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE

[1]Generally, the same issues and conclusions were presented and reached in Advisory Opinion, TSB-A-01(6)S, which enhance and support the Division's position and the legislative intent expressed above.