STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

Wisconsin Dept. of Revenue,
Plaintiff/Petitioner
vs.
Microsoft Corporation,
Defendant/Respondent

DECISION AND ORDER

Case No. 17 CV 2214

This is an appeal of Petitioner's (DOR) taxing Respondent (Microsoft) under Wis. Stat. § 71.25(9). The decision by Wisconsin Tax Appeals Commission (Commission) reached the conclusion, contrary to the DOR, that no taxes were owed by Microsoft. The sole legal issue is interpretation of Wis. Stat. § 71.25(9)(d) and (df). The standard of review was recently addressed by the Wisconsin Supreme Court in ***Tetra Tech EC, Inc. v. Wisconsin Dept. of Revenue,*** 2018 WI 75 (2018) and the companion cases o ***Wisconsin Bell, Inc. v. LIRC,*** 2018 WI 76 (2018) and ***Dept. of Workforce Development v. LIRC,*** 2018 WI 77 (2018). Four justices agreed on the relevant conclusion, but not the rationale. [1] For purposes of this decision, Justices Kelly, Ziegler, Roggensack, and Gableman all agree that the previous deference analysis is changed as stated in section III of the opinion: ending the practice of deference to administrative agencies' conclusions of law but applying "due weight" in considering its arguments, per Wis. Stat. § 227.57(10). "Pursuant to Wis. Stat. § 227.57(10), we will give 'due weight' to the experience, technical competence, and specialized knowledge of an administrative agency as we consider its arguments." ***Tetra Tech*** ¶ 108.

Further, the recent opinion does not change the standard of reviewing findings of fact made by the Commission: the substantial evidence test. "Under the substantial evidence standard, the test is whether, taking into account all of the evidence in the record, reasonable minds could arrive at the same conclusion as the agency. ***Kitten v. State Dep't of Workforce Dev.***, 252 Wis. 2d 561, 569, 644 N.W.2d 649, 652 (2002) (internal citations and quotations omitted). To be upheld, the findings do not need to reflect a preponderance of the evidence as long as the agency's conclusions are reasonable. **Id.**

I. Statutes and related Admin. Code

Wis. Stat. § 71.23 imposes a franchise tax on a corporation's "Wisconsin net income." That income is apportioned based on sales within and outside of Wisconsin. (cite omitted). The relevant statute is § 71.25(9)(d) (2007- 2008) as it existed for the four fiscal tax years at issue:

[1] This is from fn 4 of the decision: "Justice Rebecca Bradley joins the opinion in toto. Chief Justice Roggensack joins Sections I., II.A.1., II.A.2., II.B.,and III. Justice Gableman joins Paragraphs 1-3, Sections I.,II. (introduction), II.A. (introduction), II.A.1., II.A.2.,II.A.6., II.B., and III., and the mandate, although he does not join Section II.A.6. to the extent that the first sentence ofParagraph 84 implies a holding on constitutional grounds. Therefore, this opinion announces the opinion of the court with respect to Sections I., II.A.1., II.A.2., II.B., and III." Subsection III is the most salient and states the majority ruling.

July 1, 2005 ending June 30, 2006 through June 30, 2009. Wis. Stat. §71. 25(9)(d) provides in relevant part as follows:

> Except as provided in pars. (df)... , sales other than tangible personal property , ... are in this state if the income-producing activity is performed in this state.

The Wisconsin Administrative Code Tax § 2.39(6)(c)(7) in effect provided that gross receipts from the sale of intangibles includes the licensing or use of intangible property.

The DOR argues Wis. Stat. § 71.25(9)(df) is applicable and provides in relevant part as follows:

1. Gross receipts from the use of computer software are in this state if the purchaser or licensee uses the computer software at a location in this state. [2]
2. Computer software is used at a location in this state if the purchaser or licensee uses the computer software in the regular course of business operations in this state, for personal use in this state, or if the purchaser or licensee is an individual whose domicile is in this state.

These provisions are derived from a uniform law, the UDITPA (Uniform Division of Income for Tax Purposes Act). That Act provides at "**Section 17.** Sales, other than sales of tangible personal property, are in this state if:(a) the income-producing activity is performed in this state."

II. Commission Findings and Decision

Microsoft and all involved Original Equipment Manufacturers (OEMs) are out-of-state companies. Microsoft sells software licenses to OEMs and not the software itself, which Microsoft retains. OEMs make and/or assemble the hardware and preinstall Microsoft software used in computers, laptops and the like. OEMs determine how to configure the software on the hardware. OEMs decide what to charge for their products, including preinstalled software. Microsoft does not participate in that pricing. OEMs service any software support. The software license to the OEMs provides (1) the right to make a copy of the software and preinstall it on computers; (2) the right to make a copy of Microsoft software for recovery media for backups; and (3) the right to distribute Microsoft software preinstalled on customers per the terms of the EULA (End User License Agreement) drafted by Microsoft. However, the EULA explicitly states that Microsoft is not a party to it: only the OEM and end user are parties. The license does not allow modifying or making derivative works, nor does it include a general right to copy the product at will. Installation is by one of 2 methods: (1) a physical "Golden Disk" the OEM uses to copy software onto hard drives or (2) a third-party "back up disk" bundled with the OEM products.

OEMs pay[3] Microsoft for the licenses to use software. The purchasers from the OEMs pay nothing to Microsoft. The OEMs' payment is not tied to the price the OEMs charge its

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[2] Perhaps worth noting, though not determinative, is another subsection of § 71.25(9) relates to sales of tangible personal property and uses the term "a" user or purchaser. (See subsection (b) 1.) When a related statute uses different terms, it is presumed the legislature meant a different interpretation. (CITATION OMITTED)

[3] The Commission dubbed these payments "royalties."

customers. Some license agreements require a minimum payment in exchange for a discount from Microsoft. In general payments were based on a per copy or per system basis. In the per copy method, the OEM pays royalties for the number of copies it makes, even if those computers with the software installed are never sold. On the per system basis, the OEM pay based on the number of particular models the OEM assembled, even if not loaded with the software and even if those models are never sold. As stated above, none of the end user pays Microsoft anything. The Commission determined that for purposes of subsection (df), the OEMs are the purchasers or licensees, not the end users, reversing the DOR. Because that sales activity all occurred outside Wisconsin, it provided an exception to imposing the tax. Thus, no tax was owed.

III. Analysis

The Commission's findings of fact were largely undisputed and reasonable. It is the application of the law to those facts that is the focus of this review. Microsoft derives no revenue from the relevant Wisconsin transactions. Microsoft pays taxes on the money received from the OEMs, but not to Wisconsin. The OEMs receive revenue from Wisconsin customers and report that revenue, which is taxed. This court applies the de novo standard and, when applicable, the "due weight" standard to the Commission, as required per ***Tetra Tech*** to interpret Wis. Stats. § 71.25(9)(d) and (df).

As urged by Microsoft and the Commissioner, subsection (d), Commission, is controlling and subsection (df) is irrelevant. According to this argument, the bundle of rights are simply classic intangibles and not software. Because Microsoft sold no licenses in Wisconsin, there is no taxable event.

DOR would have the court "look through" the OEM to the end users and apply subjection (df) as the controlling law. Subsection (df) 1. Relies on "gross receipts" from the "use" of the software in Wisconsin by the licensee/purchaser. Taxation only applies of there are gross receipts and use by the same person/entity. The OEMs cannot use the software. This entire line of argument essentially begs the question of who is a licensee or purchaser. In various forms, the DOR argues the end user is the real licensee or purchaser. The Commission rejected those arguments. This court does so as well.

A. The end users are the true "purchasers" or "licensees" per DOR

This would fundamentally add to the meaning of " the" licensee/purchaser something like this: "or any subsequent purchasers or sub-licensees of the software." DOR argues it is the commission that read into the statute by holding that only the ORIGINAL purchasers qualify. The commission determined that the plain language of the statute should be interpreted to mean the OEMs are the purchasers/licensees and no subsequent purchasers or licensees so qualify. The DOR's argument as to intellectual property and sublicenses omits an important qualifier. A sublicense is typically treated as if it is an agreement with the original licensor, *unless the license agreement provides otherwise*. (emphasis added) ***Rhone Poulenc Agr., S.A. v. DeKalb***

Genetics Corp., 283 F3d 1323, 1332 n. 7 (Fed. Cir. 2002). Here, the license agreement (EULA) expressly provides that Microsoft plays no part in the software support, sales, or pricing except to enforce its intellectual property rights. Thus, intellectual property law compels the result the Commission reached, on a de novo review.

B. OEM is an agent of Microsoft per the DOR.

1. Common law agency

A common law agency relationship is created by mutual consent. (CITE OMITTED) There is no dispute about that. The key question is whether OEMs were "acting on behalf" of Microsoft with Microsoft retaining control of the OEMs. Microsoft had no control over OEMs loading the software at all, let alone pricing or selling it. The OEMs serviced the software once sold to end users. Microsoft doesn't warranty the software. In short, once Microsoft sells to the OEMs, Microsoft is done and has no control over the OEMs subsequent actions.

2. Intellectual Property law and agency

DOR cites a tax and patent case: ***Federal Laboratories, Inc., v. Commission of the Internal Revenue,*** 8 T.C. 1150, 1157 (1947). First, the Wisconsin tax code was not in issue. In that case, the petitioner bought rights under a patent from Coffman and claimed the purchase was a "sale" of the patent itself, as opposed to a "license." The tax court held the petitioner received a sublicense and not the patent itself because their agreement allowed Coffman to retain title of all patents. This case stands for the proposition of looking to the agreement to determine the nature of the relationship. While Microsoft clearly retains ownership of its software, the agreement keeps Microsoft out of any further involvement with that software once the OEM has it. As stated above, this does not create an agency relationship, but quite the opposite.

3. "Market place realities" create an agency relationship

DOR would have the court "follow the money" and view the OEMs as a conduit, at best, for purposes of sales tax. First, this is a policy decision which this court does not make. Second, Microsoft's only receipts come from the OEMs. While the OEM sales undoubtedly benefit Microsoft by encouraging them to sell more software to OEMs, an agency relationship does not exist thereby. According to The Restatement (Third) Agency, the performance of a duty created by contract, while benefiting a party to that contract, does not create an agency relationship unless the other elements of agency exist. § 1.01. cmt. G. (2006). As stated above, those elements are not present, because Microsoft lacked the degree of control necessary to create an agency relationship over the OEMs.

C. The court should look to the statutes as repealed and replaced after the relevant years, per DOR.

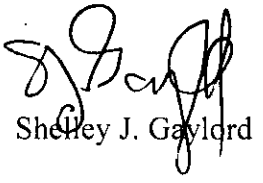
DOR argues the court should look to *subsequent* legislation in interpreting the relevant statutes. Wis. Stat. § 71.25(9) was amended and repealed subsection (d). That left subsection (df) unchanged and added subsection (dj). However, it is applicable to tax years beginning on or

after January 1, 2009. Thus it did not apply to any of the relevant tax years, which all started well before that date. But there are further persuasive arguments to deny application of the revised statute. First, we do not look beyond the language of the statute as it existed, unless it is ambiguous. ***State ex rel. Kalal v. Circuit court for Dane Cty.***, 2004 WI 58, 271 Wis. 2d 633. The DOR does not explicitly argue the statute is ambiguous, making extrinsic sources such as subsequent legislation, irrelevant. Second, even if the statute were ambiguous, the DOR is essentially arguing for retroactive application. Yet nothing in the subsequent legislation indicates such retroactivity should apply. Wis. Stat. s. 990.04 and ***Lands' End, Inc. v. City of Dodgeville,*** 2016 WI 64, 370 Wis. 2d 500 provide that "a statute is presumptively prospective unless the statutory language clearly reveals either expressly or by necessary implication an intent" to apply retroactively. Note 9. Generally, procedural or remedial statutes are applied retroactively, unless it would impair vested rights. Note 10. The subsequent legislation is neither procedural nor remedial and the general rule of prospective application applies here. Third, this court would still have to interpret subsection (df) as done above, and subsection (dj) which provides in relevant part: except as provided in par. (df), gross receipts from the use or license of intangible property, including license are sales in this state if the licensee or purchaser used the intangible property etc. So we are back to either using subsection (df) or interpreting who is the purchaser/licensee.

IT IS ORDERED, judgment for Microsoft. This is a final order for purposes of appeal.

Dated August 13, 2018.

BY THE COURT



Shelley J. Gaylord

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During the years at issue, Wisconsin transitioning from a 3 factor apportionment fraction taking into account payroll, property and sales to a single factor of sales. Wis. Stat. § 71.25(6)(b)-(d).