

Alert 10-173

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Dechert: The Pennsylvania Supreme Court Holds That 'Canned' Software is Tangible –Is This the End of the Battle on the Taxation of Software in Pennsylvania?

Earlier this week, the Pennsylvania Supreme Court issued its long-awaited decision in *Dechert*¹, upholding the Commonwealth Court's determination that canned computer software is tangible personal property, and that licenses of such software are subject to Pennsylvania sales and use tax. The Supreme Court's decision demonstrated an extreme display of deference by the court to the statutory interpretations adopted by the state's administrative agencies. This deference sets a troubling precedent for future tax cases in which taxpayers are disputing the Department of Revenue's statutory interpretations.

Dechert involved a taxpayer that had licensed canned computer software. This software had in some cases been delivered on discs or other tangible media, and in other cases was delivered electronically. The taxpayer argued that the amounts it paid for the licenses were payments for the use of copyrighted software – a form of intangible intellectual property. In contrast, the Commonwealth argued that canned software was tangible personal property, based on the 2005 decision of the Pennsylvania Commonwealth Court in *Graham Packaging*.²

The Pennsylvania sales tax statute defines tangible personal property as "corporeal personal property."³ Although the statute does not provide a definition of "corporeal," it does include a list of examples of items that fall within the scope of tangible personal property. The list does not include computer software. Nonetheless, the Pennsylvania Supreme Court did not find the fact that canned computer software was excluded from the list to be persuasive.

Instead, the court was influenced by the wording of a statement of policy issued by the Department of Revenue after the 1997 repeal of the statutory provisions taxing "computer programming services." In that statement, the Department explained that the sale of canned computer software "remains" subject to tax after the repeal. The court found that the use of the word "remains" implied that, as of the time of the 1997 repeal, the Department viewed canned software as having been subject to Pennsylvania sales and use tax both before and after the repeal.⁴

Ultimately, the Pennsylvania Supreme Court concluded that when courts are interpreting statutes, the interpretations rendered by the administrative agency charged with administering the statute are afforded substantial deference. As a consequence, the Supreme Court chose to defer to the Department of Revenue's interpretation of the definition of tangible personal property.

This conclusion is troubling for taxpayers not only because the Supreme Court arguably

misunderstood the true nature of the software, but also because it shows an excessive amount of deference to the Department's interpretation of taxing statutes. Essentially, the court concluded that when it's too close to call, the Department gets the benefit of the doubt. The Department is likely to exploit this deference in future cases.

Although the holding in *Dechert* is likely to be disappointing for most companies making software purchases in Pennsylvania, it may not be the last battle over the Commonwealth's sales tax treatment of electronically delivered software. As *Dechert's* counsel in this matter, we are considering filing a motion for reconsideration. The motion is expected to note that the court's rationale—deference to the Department's interpretation of the statute—does not apply to electronically delivered canned software, which, prior to *Graham Packaging*, was always characterized by the Department as not being tangible personal property.

In addition, the motion is expected to highlight the significant uniformity problem that would be created if the court's decision were to apply to electronically delivered software. Currently, it is the Department of Revenue's position that other electronically delivered products, like books and music, are not tangible personal property. However, based on the statute, the Department has no authority to treat some electronically delivered data as tangible while not treating other electronically delivered data as tangible, with the distinction based merely on the type of data being delivered, or the way in which the data is expected to be used by the purchaser.

Finally, *Dechert* may actually benefit some Pennsylvania taxpayers by opening up some refund opportunities and filing positions. For example, purchasers of software may be able to include these tangible assets in their property factor denominator for corporate tax purposes. Also, software producers may be able to take advantage of the franchise tax manufacturing exemption. Even taxpayers producing and purchasing custom software may have potential refund opportunities and filing positions based on the court's analysis.

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For more information on *Dechert* and its significance for your company, please contact the authors of this article, or the Reed Smith lawyer with whom you normally work.

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1. *Dechert LLP v. Commonwealth*, 12 MAP 2008 (7/20/2010).
 2. *Graham Packaging Company, LP v. Commonwealth of Pennsylvania*, 882 A2d 1076 (9/15/2005).
 3. 72 P.S. § 7201(m).
 4. 61 Pa. Code § 60.19.

→ [Michael A. Jacobs](#)
Partner
Philadelphia
+1 215 851 8868

→ [Kaitlin A. McKenzie-Fiumara](#)
Associate
Philadelphia
+ 1 215 851 8875

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