STATE OF MICHIGAN
DEPARTMENT OF LABOR & ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

Nintendo of America
Petitioner,

v

MTT Docket No. 312284

Department of Treasury
Respondent.

Tribunal Judge Presiding
Jack L. Van Coevering

CORRECTED FINAL OPINION AND JUDGMENT

This matter was heard before Administrative Law Judge Thomas A. Halick, who issued a Proposed Judgment of Summary Disposition on December 20, 2006. No exceptions or written arguments to the Proposed Judgment have been filed. The Tribunal, pursuant to Section 26 of the Tax Tribunal Act, as amended by 1980 PA 437, has given due consideration to the case file, and adopts and incorporates by reference the findings of fact and conclusions of law in the Proposed Judgment as the final decision of the Tribunal.

IT IS ORDERED that the taxes, interest, and penalties are as set forth in the Proposed Opinion and Judgment as adopted by this Final Opinion and Judgment.

This Opinion & Judgment resolves all pending claims in this matter and closes this case.

MICHIGAN TAX TRIBUNAL

Entered: February 28, 2007

By: Jack Van Coevering

* * *

STATE OF MICHIGAN
STATE OFFICE OF ADMINISTRATIVE HEARINGS AND RULES

Nintendo of America, Inc
Petitioner,

v

Michigan Department of Treasury,
Respondent.

Michigan Tax Tribunal
(Nonproperty Tax)
MTT Docket No. 312284

Administrative Law Judge Presiding
Thomas A. Halick

PROPOSED ORDER GRANTING RESPONDENT'S
MOTION FOR SUMMARY DISPOSITION

PROPOSED ORDER DENYING
PETITIONER'S MOTION FOR SUMMARY DISPOSITION

On April 28, 2006 Respondent and Petitioner each filed a Motion for Summary Disposition and each requested oral argument.

Upon review of the motions, the Stipulation of Facts, oral arguments, and relevant cases and statutes, it is determined that this case shall be disposed of under MCR 2.116(C)(10). Judgment is also appropriate under MCR 2.116(A) based on the "Joint Stipulation of Facts" ("Stip") consisting of 41 paragraphs, which is in the Tribunal's file.

Standard for Motion under MCL 2.116(C)(10)
In the absence of an applicable Tax Tribunal Rule, the Michigan Court Rules apply. Tax Tribunal Rule 111(4); 1996 AACS R 205.1111(4). A motion under MCR 2.116(C)(10) tests the factual support for a claim. The court must consider the pleadings, affidavits, depositions, admissions, and other documentary evidence submitted by the parties. Summary disposition should be granted if there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. *Corley* v *Detroit Board of Education*, 470 Mich 274; 681 NW2d 342 (2004). When determining a motion for summary disposition pursuant to MCR 2.116(C)(10), the trial court must give the benefit of reasonable doubt to the nonmovant and determine whether a record might be developed that would leave open an issue upon which reasonable minds could differ. *Mount Carmel Mercy Hosp* v *Allstate Ins Co*, 194 Mich App 580, 585; 487 NW2d 849 (1992). Furthermore, it is appropriate in this case to render judgment as a matter of law based on the agreed-upon stipulation of facts. MCR 2.116(A).

Summary of Stipulated Facts

Petitioner, Nintendo of America, Inc., ("NOA") is in the business of distributing electronic video home entertainment, including home video game software, hardware and accessories. Petitioner operates under a licensing agreement[1] with its parent company, Nintendo Company, LTD ("NCL"), which grants Petitioner an exclusive license in the Western Hemisphere to make, use and sell all forms of the "inventions" covered by the patents, patents pending, technology, and related technical developments of NCL. Under the agreement, NCL licensed to Petitioner all rights in the Western Hemisphere to the trademarks, copyrights, and mask work rights owned or licensed by NCL related to the video game products, consumer electronics, or any other commercial products or activities of NCL or NOA. Petitioner is required to obtain trademark and copyright registrations and to protect and defend the trademarks and copyrights.

The revenues in question arose from the distribution of copyrighted game software (also referred to as "game cartridges") manufactured in Japan by NCL. Petitioner received the completed game cartridges from NCL, which included modifications resulting from its contractual "localization services." Petitioner is compensated under a separate contract for its localization services and those amounts are not at issue here.

Petitioner used "authorized retailers" (such as K Mart, Walmart, etc.) to distribute copyrighted game software to end users, but did not have written contracts with the retailers. However, retailers were subject to Petitioner's "Retail Marketing Program" which requires them to perform certain advertising, promotion, and marketing activities. During oral argument, Petitioner's counsel affirmed that the each authorized retailer acquired game cartridges from NOA, but there is no license agreement between NOA and the retailer. Counsel for Petitioner stated that the retailer received "games on a per unit basis" but that the retailers do not "own" a copy of the game cartridge, which is offered to consumers through the retailer at a price determined by Petitioner. TR 29. Counsel presumed that games that are not sold by the retailer would be returned to Petitioner.

The revenues at issue in this case are amounts that Petitioner received from "end-users" of the videogame cartridges. Petitioner's counsel characterized the distribution of the video game cartridges as a transaction between NOA and the end-user, with the retailer acting as a "conduit."

Respondent audited Petitioner for the tax years at issue and determined that the receipts at issue were not royalties and added them back to the tax base, resulting in issuance of the subject assessment for Single Business Tax. In response to Respondent's Request for Admissions, Interrogatories, and Request for Production of Documents, Petitioner produced a letter from Respondent's auditor dated August 13, 2001, which states as follows:

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1 Joint Stipulated Exhibit 2, "Consolidated and Restated Agreement Regarding Intellectual Property Rights Between Nintendo Co., Ltd. and Nintendo of America, Inc." (the "Agreement"). See, Stip, paragraph 18.

> …I had initially indicated to you that revenue (the gross profit thereof) received from software game sales would be excluded from the Michigan tax base. After reviewing this issue, our department has interpreted that this provision of the statute only applies to original developers of software and to resellers.

That letter further stated:

> You had previously indicated that all Nintendo game cartridges purchased by Nintendo of America are purchased from Nintendo of Japan and that these games are resold in their original form. Therefore, this section of the statute does not apply to your situation and no subtraction from the tax base was made for this income during these tax years.

Respondent's auditor based the assessment on the belief that Petitioner "purchased" game cartridges from the parent company (Nintendo of Japan), and "resold" them unaltered. It was determined that the receipts from sales to consumers were sales[2] and not "royalty" income; and therefore, there was no statutory basis for subtracting such amounts from the tax base. Respondent assessed Petitioner for additional tax for tax years ending March 1991, 1992, 1993, 1994, and 1997. The taxes and interest at issue are set forth in paragraph 40 of the Joint Stipulation of Facts. No penalty was assessed.

Although the amounts at issue are revenues that Petitioner receives *from the retailers* (TR 26), it is critical to note that at oral argument Petitioner's counsel stated, "We have treated that as a conduit, but the receipt – the dollar – exact dollar amounts at issue are not received from the end users directly. They are received through retailers." TR 25. Counsel also stated that the retailer acts as an agent of Petitioner for purposes of collecting revenue from the end-user and remitting it to Petitioner. Therefore, for purposes of these cross motions for summary disposition, based on the undisputed facts and legal argument, the transactions shall be analyzed as a transfer of video game cartridges from Petitioner to "end-users" (retail consumers) who pay consideration to the retailer, which acts as a "conduit" to pass the consideration to Petitioner.

The Single Business Tax Act ("SBTA")

The Single Business Tax has been variously described in case law and the tax law literature as a "consumption-type value added tax" or a "modified value added tax." *Trinova* v *Michigan Department of Treasury*, 498 US 358 (1991); Haughey, The Economic Logic of The Single Business Tax, 22 Wayne L Rev 1017, 1021-1022 (1976). The SBT is not an income tax. The tax base calculation uses an additive method whereby the taxpayer starts with federal taxable income (profit) then adds and subtracts certain amounts to create a value added tax base. In general, royalty expense is "added back" to the extent deducted when calculating federal taxable income.

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2 See historical notes to MCLA 208.7(1) for the definition of "sales" in effect for the relevant tax years prior to 2000 PA 477.

Under the SBTA, a firm's labor, capital, and profit (entrepreneurial skill) are elements of "value added" that are included in the tax base. Whereas an income tax imposes tax on profits derived from the economy, the SBT is based upon a resources consumed principle. The rationale being that a firm engaged in business activity consumes resources and government services regardless of whether it earns a profit. Examples of "value added" attributable to the firm's use of capital are: depreciation expense, dividends paid, interest expense, and all royalties paid. MCL 208.9 [definition of "tax base"]. A firm that uses or exploits intellectual property in the course of its business activity often pays a royalty to the holder of the rights to the intellectual property. For example, a manufacturer of a product may pay a royalty to the person who holds the patent to that product.

In general, the SBTA imposes tax on the firm that consumes the capital. The firm that receives royalty income is not taxed on that income, but rather the royalties are part of the payor's tax base. *Mobil Oil Corporation, infra,* at 477; also *Town & Country Dodge, Inc* v *Department of Treasury*, 420 Mich 226, 235; 362 NW2d 618 (1984); *Detroit Lions, Inc* v *Department of Treasury*, 157 Mich App 207, 214; 403 NW2d 812 (1986); and *Field Enterprises* v *Department of Treasury*, 184 Mich App 151, 154; 457 NW2d 113 (1990), lv den 437 Mich 1020 (1991).

The SBTA does not define the term "royalty," but in *Mobil Oil* v *Department of Treasury*, 422 Mich 473; 373 NW2d 730 (1985), the Supreme Court looked to dictionary definitions.

> The Random House College Dictionary defines "royalty" as: compensation or portion of the proceeds paid to the owner of a right, as a patent or oil mineral right, for the use of it…an agreed portion of the income from a work paid to its author, composer, etc., usually a percentage of the retail price of each copy sold…a royal right, as over minerals, granted by a sovereign to a person or corporation…the payment made for such a right. [The Random House College Dictionary (rev ed), p 1150.]

The court also cited the following:

> Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an inventor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property…In mining and oil operations, a share of the product or profit paid to the owner of the property. [Black's Law Dictionary (5th ed), p 1195.]

Mobil Oil held that an operator-lessee under an oil and gas lease paid a *royalty* equal to 1/8 of the gross oil and gas production to the landowner (lessor of the oil and gas rights). Under the oil and gas lease, Mobil acquired the right to enter land and remove oil and gas, for which it paid a royalty based on the amount produced. This was an exclusive right in that neither the lessor nor any other person had the right to exploit the oil and gas during the term of the lease.

The Supreme Court quoted dictionary definitions that a royalty is "compensation paid to the *owner* of a right…for the use of it," (emphasis added.) However, it has been held that the dictionary definitions used in *Mobil Oil* are not "all encompassing" definitions for SBTA purposes. *Zenith Data Systems* v *Dep't of Treasury*, 218 Mich App 742, 747 (1996).

In *Mobil Oil*, the transaction was described as a "mixture of various elements and thus difficult to characterize in a consistent conceptual manner." Applying the holding and definitions adopted in *Mobil Oil*, and in consideration of the the appellate cases cited above and in Respondent's brief, the payments for video games by end-users, especially in the absence of a licensing agreement, are not "royalties" as that term is used in the SBTA.

Legal Analysis

The legal issue is: Whether amounts that Petitioner received as consideration pursuant to transactions with end-users of copyrighted game software constitute "royalties" that are deducted from the tax base under MCL 208.9(7)(c).

The relevant statute states that when calculating the SBT tax base, the taxpayer shall:

> (7) Deduct the following, to the extent included in arriving at federal taxable income:
>
> ***
>
> (c) All royalties except for the following:… MCL 208.9(7)(c)

There is no licensing agreement between Petitioner and the retailer or between Petitioner and the consumer (end-user). This fact is strongly supports Respondent's position in this case that the amounts in question are not royalties.

Petitioner cites *Field Enterprises* v *Dep't of Treasury*, 184 Mich App 151; 457 NW2d 113 (1990), for the proposition that a formal license agreement is not necessary for a royalty to exist. Nevertheless, in *Field* the payments were made under an exclusive, limited television syndication license agreement. Field Enterprises was a television station that paid "royalties" to Twentieth Century Fox Television Corporation for the exclusive right to broadcast episodes of the television show M*A*S*H pursuant to a "limited television exhibition license." The license had a six-year term, prohibited Field Enterprises from sublicensing or copying the episodes, and granted to Field Enterprises the exclusive right to broadcast (display) the shows in its area. The right to display the copyrighted work publicly is one of the exclusive rights of copyright under 17 USC 106. Fox retained all right, title, and interest in the episodes.

The issue litigated in *Field* was whether the payments were “royalties” or “rent.” The court concluded that the payments were “royalty” for SBT purposes. That case involved a business-to-business transaction in which Field used the copyrighted material in its business activity of operating a commercial broadcast television station and derived income from that activity. In our present case, the transactions are essentially retail sales to consumers who purchased a copy of a video game that was subject to federal copyright protections. It has not been established that a license of any type exists between the end-user and Petitioner and there is no indication that the consideration paid at the retail level is a royalty. Respondent aptly points out that a consumer may purchase any number of goods at a retail store that are subject to copyright protections, such as books, recorded music, movies, and art, and yet this does not transform the transaction from a typical retail sale to a “license” involving a royalty payment for SBT purposes.

The essential attributes of the licensing arrangement in *Field* are both factually and legally distinguishable from our present case where no such licensing agreement exists between Petitioner and the end-user, and where the end-user acquires a copy of a game cartridge in a retail transaction.

Petitioner also cites *Zenith Data Systems* v *Dep’t of Treasury*, 218 Mich App 742; 555 NW2d 264 (1996); however, in that case the Tax Tribunal had held that signed “license agreements” existed between Zenith Data Systems Corporation and its customers. The Tribunal’s hearing officer found in the Proposed Judgment that 80% of the sales were made to the United Stated Air Force. There is no indication in the Tribunal’s decision that any of the sales were made to consumers at the retail level. (Although the Court of Appeals stated that some of the customers were “individuals” the facts do not indicated whether they acquired the software by retail purchases or how they used the software.) Zenith acquired copyrighted software, modified it, and licensed it to its customers pursuant to signed licensing agreements.

In *Zenith*, the court of appeals held that dictionary definitions used in *Mobil Oil* “were used in the context of determining whether oil and gas royalties constitute royalties for SBTA purposes” and were not “all-encompassing” definitions for all cases. Therefore, the particular factual and legal context of the present case must be carefully considered in light of the relevant appellate cases. *Zenith* interprets *Field* and *Detroit Lions* v *Dep’t of Treasury*, 157 Mich App 207; 403 NW2d 812 (1986), as requiring a court to consider the “nature of the transaction” and not to exalt any particular fact as determinative. In *Zenith*, the court held that the nature of the transaction was a licensing agreement that produced non-taxable, royalty income for the taxpayer. The taxpayer, Zenith Data Systems, acquired copyrighted computer software from copyright owners who created or acquired substantial rights in the software. Zenith Data Systems modified and adapted the acquired software to suit the needs of its customers. Zenith Data Systems held a copyright in the modifications it made to the software, in addition to the rights it acquired from its licensors. Zenith then entered into its own “licensing agreements with the end users for the use of the modified software... [and] also contract[ed] with distributors who distribute the computer software to end users." *Id*, 742. The court's decision was premised on the finding that a valid "end-user licensing agreement" had been entered into between Zenith Data Systems and the "end-user," which stated that the "software is a proprietary product and is protected by copyright laws. It is licensed (not sold) for use on a single machine, and is licensed only on the condition that you agree to the terms of this END USER LICENSE AGREEMENT." The court placed significance on the fact that Zenith held a proprietary interest in the modifications it made to the software, although they did not have "a proprietary interest in the entire computer software package." *Zenith*, p 748. As in *Detroit Lions*, the *Zenith* decision reaffirmed that the overall "nature of the transaction" must be considered.

In this case, it has been stipulated that Petitioner provided services in the development of the videogames, which resulted in "modifications to the game software at issue." Stip.12. It was also stipulated that Petitioner is compensated for these services under a separate contract with its parent, Nintendo Co., Ltd. That agreement is attached to the Stipulation of Facts as Stipulated Exhibit 1, which provides that, "All intellectual property rights shall be and remain the sole property of NCL and, to the extent required, shall be held by NOA in NOA's name for the benefit of NCL." Confidential Agreement for Contract Services, page 3, paragraph 5.1 [Emphasis added]. While expressly retaining ownership to all intellectual property, NCL assigns certain intellectual property rights to NOA "to the extent required" pursuant to the agreement. Furthermore, an express "work for hire" clause exists that prevents NOA from acquiring copyright ownership in any original works covered by the agreement. Therefore, the agreement provides that the modifications resulting from Petitioner's localization services are not the property of Petitioner merely by virtue of Petitioner's participation in creating those modifications. Petitioner creates the modifications as a service to NCL and for NCL as its contractor. Petitioner has no rights in the modification, except to the extent that Petitioner acquires such rights by assignment (after creation) from NCL, which retains ownership in the rights. Petitioner is compensated for its services that result in the creation of intellectual property (modifications) at "cost plus 10%" pursuant to paragraph 6.1 of the agreement. The rights that Petitioner has in the copyrighted games are distinguishable from that portion of the "proprietary rights" that Zenith held by virtue of its modifications made to the copyrighted software that it licensed to its customers. Zenith received royalties directly from the licensing of the software to its customers and Zenith held a proprietary right in its modifications to the software. In our present case, although NCL assigned all rights to the trademarks and copyrights in the videogames to Petitioner, this fact alone does not support the conclusion that Petitioner receives royalties from its sale or distribution of the games to end-users, where there is no license between Petitioner and the end-users.

In this case, Petitioner argues that a valid "end user license agreement" exists between it and the "end-users." It is concluded that Petitioner has not demonstrated the existence of a license agreement. The term "end-user license agreement" ("EULA") is recognized in numerous federal cases. For example, in *Davidson & Associates v Jung*, 422 F3d 630, 634-635 (2005) the court described one type of EULA as follows:

> …a user must first install the game onto a computer and agree to the terms of the End User License Agreement ("EULA") and Terms of Use ("TOU"), both of which prohibit reverse engineering. At the end of both the EULA and TOU, Blizzard includes a button with the text, "I Agree" in it, which the user must select in order to proceed with the installation. Users are also required to enter a name and the CD Key during installation of Battle.net and Blizzard games. *Davidson & Associates v Jung*, 422 F3d 630, 634-635 (2005).

In that case, the EULA provided in part:

> YOU SHOULD CAREFULLY READ THE FOLLOWING END USER LICENSE AGREEMENT BEFORE INSTALLING THIS SOFTWARE PROGRAM. BY INSTALLING, COPYING, OR OTHER WISE USING THE SOFTWARE PROGRAM YOU AGREE TO BE BOUND BY THE TERMS OF THIS AGREEMENT. IF YOU DO NOT AGREE TO THE TERMS OF THIS AGREEMENT, PROMPTLY RETURN THE UNUSED SOFTWARE PROGRAM TO THE PLACE OF PURCHASE OR CONTACT BLIZZARD ENTERTAINMENT CUSTOMER SERVICE ··· FOR A FULL REFUND OF THE PURCHASE PRICE WITHIN THIRTY DAYS OF THE ORIGINAL PURCHASE.
>
> This software program (the "Program"), any printed materials, any on-line or electronic documentation, and any and all copies and derivative works of such software program and materials are the copyrighted work of Blizzard Entertainment.. . .Subject to that Grant of License hereinabove, you may not, in whole or in part, copy, photocopy, reproduce, translate, *reverse engineer*, derive source code, modify, disassemble, decompile, create derivative works based on the Program, or remove any proprietary notices or labels on the Program without the prior consent, in writing, of Blizzard. *Davidson & Associates* v *Jung*, 422 F3d 630, 635 (2005).

In *Davidson*, the agreement both incorporated protections that exist under federal copyright law, and also imposed additional restrictions specific to the agreement. Under those facts the court found that a valid licensing agreement existed between the licensor and the consumer, which restricted the consumer's use of the computer program beyond the copyright protections.

The following describes another type of end user licensing agreement:

> A "clickwrap" agreement appears when a user first installs computer software obtained from an online source or attempts to conduct an Internet transaction involving the agreement and purports to condition further access to the software or transaction on the user's consent to certain conditions there specified; the user 'consents' to these conditions by 'clicking' on a dialog box on the screen, which then proceeds with the remainder of the software installation or Internet transaction. Kevin W. Grierson, Annotation, *Enforceability of "Clickwrap" or "Shrinkwrap" Agreements Common in Computer Software, Hardware, and Internet Transactions,* 106 ALR 5th 309 n. 1 (2003).

Generally, for a valid EULA to exist, the user must first read the terms of the agreement on the outside of the packaging before opening it, and then consent by opening the package on which the Agreement is printed. Or, the user must accept the terms of the agreement by clicking "I accept" prior to using the product. The federal circuit courts have held that shrinkwrap and clickwrap agreements are valid and enforceable contracts. *AH Siedle v Nat'l Ass'n of Sec Dealers, Inc,* 248 F Supp2d 1140, 1143 (2003); *Management Computer Controls, Inc v Charles Perry Const, Inc,* 743 So2d 627, 631-32 (1999); *ProCD, Inc v Zeidenberg,* 86 F3d 1447, 1449 (1996). It has been held that shrinkwrap and clickwrap contract disputes are examined by applying general contract principles. *ProCD, Inc,* 86 F3d at 1449. For example, MCL 400.2204 provides that "[a] contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." "A vendor, as master of the offer, may invite acceptance by conduct and may propose limitations on the kind of conduct that constitutes acceptance. A buyer may accept by performing the acts the vendor proposes to treat as acceptance." *ProCD, Inc.,* 86 F3d at 1452. A shrinkwrap contract is an agreement that takes effect when a customer removes the plastic or cellophane wrapping from a product. *ProCD, Inc* v *Zeidenberg,* 86 F3d 1447, 1449 (1996). A shrinkwrap license arises from language printed on the packaging that is visible to the consumer, which states that by opening the packaging or wrapper, the user agrees to the terms of the license. *Specht* v *Netscape Commc'n Corp,* 306 F3d 17, 22 n. 4 (2002).

Petitioner does not claim that it receives royalties paid by the *retailer* pursuant to a license agreement. Rather, Petitioner claims that the end user (retail consumer) pays a royalty, pursuant to a license agreement created by language contained in the instruction booklet that accompanies the game. The instruction booklet is not available to the end-user until after he or she acquires it from the retailer and opens the package. The outside of the package does not include a notice of the alleged license agreement. Typically, a "shrinkwrap" license arises when the consumer reads language on the outside of the package and consents to the terms of the license by opening the package. Another form of EULA, the "clickwrap" license, arises when the user is required to affirmatively consent to the terms by "clicking" "yes" before the first use of the software. No such agreement arises in this case.

The language in the instruction booklet accompanying Petitioner's games is included as Exhibits F and G to the Stipulation of Facts:

> IMPORTANT
>
> WARNING: Copying of any Nintendo game is illegal and is strictly prohibited by domestic and international copyright laws. “Back-up” or “archival copies” are not authorized and are not necessary to protect your software. Violators will be prosecuted.
>
> This Nintendo game is not designated for use with any unauthorized copying device. Use of any such device will invalidate your Nintendo Product warranty. Nintendo (and/or any Nintendo licensee or distributor) is not responsible for any damage caused by the use of any such device. If use of such device causes your game to stop operating, disconnect the device carefully to avoid damage and resume normal game play. If your game ceases to operate and you have no device attached to it, please contact your local authorized Nintendo retailer.
>
> The contents of this notice do not interfere with your statutory rights.
>
> The rental of this game without permission of Nintendo or its licensees is strictly prohibited.
>
> For further information or assistance, please contact:
>
> Nintendo Consumer Assistance Hotline…Or your local authorized Nintendo dealer.

Nothing in the above “notice” purports to create a license between the end-user and Nintendo of America, Inc, but rather is a “warning” and a “notice.” The warning applies to the existence of prohibitions under federal copyright laws, including prohibitions upon copying or renting the game. The warning regarding “unauthorized copying devices” informs the consumer that use of such devices will void the product warranty. There is no provision regarding the payment of a royalty as a condition of using the game. There is no provision in the agreement that the consideration paid to acquire possession and use of the game is a “royalty.” The language of the notice informs the consumer that he or she is prohibited from renting the game to another without permission from “Nintendo or *its licensees*.” The only reference to a “licensee” refers to a person other than the consumer.

The parties did not stipulate to the existence of a licensing agreement between Petitioner and the end-user. However, they stipulated as follows:

> 30. End users acquire the right to use game software with authorized hardware and accessories. Pursuant to the language contained within the instruction booklet accompanying the game software, the end user is restricted from copying, re-selling, renting, and using the game software with unauthorized components....

The language in the warning does not strictly prohibit the consumer from using the game with "unauthorized components" but warns that the game is not designed for use with unauthorized components and sets forth a consequence for doing so, that is: voiding the warranty.

Assuming, *arguendo*, that a valid "EULA" existed between the end user and Petitioner, it does not necessarily follow that the amounts in question are royalties under *Zenith,* or any other case cited by Petitioner. In *Zenith*, by analogy to federal income tax law, it was held that a corporation in the business of developing, manufacturing, or producing computer software received royalty income pursuant to licensing agreements with its customers. In *Zenith*, petitioner licensed its computer software to "governmental agencies, businesses, and individuals for their own use and to dealers for distribution to others." *Id*, 742. Except for the vague reference to "individuals for their own use," the licensees were either businesses or governmental agencies. The factual record at the Tribunal level does not include facts pertaining to the individuals who acquired the software or how they used the software, but it is clear that a written licensing agreement existed with all customers.

The case law indicates that the Tribunal must consider the nature of the entire transaction and all relevant circumstances, none of which are necessarily determinative. It is relevant to consider whether the person paying the royalty acquires and uses the copyrights in its business activity, as opposed to being a consumer not engaged in business activity. *Twentieth Century Fox* v *Treasury,* MTT Docket No. 289152 (2004).

The Tribunal concludes that *Columbia Associates*, *LP* v *Treasury*, 250 Mich App 656; 649 NW2d 760, lv den 467 Mich 925; 656 NW2d 520 (2002), is closely on point. That case held that cable television subscribers did not acquire any rights to use the programming in order to derive income, but merely had the right to view the copyrighted programming. The subscription payments were not from funds or proceeds derived from the use of network programming. In our present case, the amounts paid by end-users are similar in that they are not a portion of revenues that the consumer derives from its use of the game. The amounts are consideration paid as a part of a typical retail sale. The facts and law point to the conclusion the payments are not royalties for SBT purposes.

In *H.H. Cutler Company* v *Department of Treasury*, MTT Docket No. 250864, the Tribunal held that amounts received by a manufacturer from sales of "logo-bearing clothing" to mass merchandisers and retailer sellers were not royalties. H.H. Cutler manufactured clothing emblazoned with logos, trademarks, and copyrighted images, such as Nike, Disney, NFL, etc., and sold the clothing at the wholesale level. The amounts in question were not paid by consumers at the retail level but were payments from the retailers to the manufacturer. The retailers obtained rights to advertise the logo-bearing clothing, display it, and resell it. The taxpayer, H.H. Cutler, restricted its customers from using the logos in their advertising or store posters and charged a separate fee for the clothing and for the rights to the intangibles. The taxpayer argued that it granted its customers the right to use the logos, which established a "license relationship with its customers" and that an "unwritten license agreement" existed, which included specific restrictions upon the right to use, display, advertise, and sell the products. *H.H. Cutler, supra*. H.H. Cutler further imposed "geographic and class of trade restrictions on use and resale." *Id.* The parties stipulated that such restrictions existed. The Tribunal held that the manufacturer did <u>not</u> receive royalties from its wholesale customers because the customers did not pay the manufacturer for permitting them to use the protected logos, but the wholesalers and large retailers simply resold the products that bore the protected logos. It was the manufacturer that affixed the logos to the clothing pursuant to licensing agreements with holders of the rights to the logos. The Tribunal found that the *manufacturer had no written contracts or licensing agreements with its customers*, and did not retain exclusive ownership over the logo-bearing clothing. It was concluded that the "nature of the transaction…did not justify a conclusion that a royalty is involved." *Id*.

In the present case, it is determined that Petitioner does not receive royalty income in return for its distribution or sales of video games under these facts where no licensing agreement is proven to exist between Petitioner and the "end-user" who acquires a video game cartridge in a sale at retail. Clearly, there is no agreement between Petitioner and the end-user that the consideration paid is a royalty. This opinion should not be interpreted to support the proposition that royalties necessarily result where a valid end-user licensing agreement exists, such as a shrinkwrap license, in the context of a retail transaction. The treatment of the amounts in question does not turn solely upon the existence of a valid EULA, which would require, among other matters, a factual determination regarding the end-user's assent, and his or her legal capacity to enter a licensing agreement (which questions would be implicated in cases of sales to minors). Rather, the focus is upon the nature of the transaction as a whole, which in this case, Petitioner has characterized as a transaction between itself and the "end user" (consumer) with the retailer acting as conduit.

Respondent argues, and the Tribunal agrees, that the transaction in question has the character of a typical retail sale. For the tax years in question, "Sale" was defined under the STBA as: "…gross receipts arising from a transaction or transactions in which gross receipts constitute consideration: (a) for the transfer of title to, or possession of, property that is stock in trade or other property of a kind which would be properly included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business." MCL 208.7 (in effect for the tax years in question). The amounts in question were paid by the consumer as consideration for a game cartridge, which resulted in a transfer of title or possession of the property that is either "stock in trade" (as Respondent argues); property that would be included in inventory of the taxpayer, or property held for sale to customers. Given the conclusions reached above, it is held that the transactions in question are "sales" of individual copies of the copyrighted games, and that the consideration paid for each copy is not a royalty.

As argued by Respondent, there is a significant distinction between a person who purchases a single copy of a copyrighted product and a person who acquires a copyright right. *Field Enterprises* v *Dep't of Treasury*, 184 Mich App 151; 457 NW2d 113, *lv den* 437 Mich 1020 (1991). In this case, the end-user does not acquire any part of the copyright, but acquires a physical copy of the copyrighted game, subject to restrictions imposed by federal copyright law.

Black's Law Dictionary, as cited in *Mobil Oil*, defines royalties to include amounts *derived from the use* of copyrighted property paid to the owner or holder of the copyrights. Royalties are generally expressed as a percentage of receipts from using the property or an account per unit produced. The person who pays the royalty generally produces income from the exploitation of the copyrighted material (or other rights) and is required by contract (such as a license agreement) to remit a royalty expressed as a percentage of its total sales or as specific amount per unit produced or sold. Our facts are quite distinguishable.

Petitioner claims it is "compensated on a per-unit basis by virtue of the fact that each game cartridge is licensed separately to an end-user." Petitioner's Brief in Support of Summary Disposition, page 10. This position is rejected, chiefly because there is no license agreement between the end user and Petitioner. Although it may be said that compensation is paid on a per-unit basis, the same can be said of any retail sale.

Petitioner argues that based on the restrictive language in the instruction book, "a license arrangement is *implied* between Petitioner and the end user…" Petitioner's Brief in Support of Summary Disposition, page 10 [Emphasis added.]. The Tribunal shall not "imply" the existence of a license in this case where the facts indicate the contrary.

Petitioner cites Black's Law Dictionary for the proposition that the language in question creates a "proprietary license" or a "use-based license," which is defined as an "open source license to which the user assents by acting according to the license's terms, namely, by using, modifying, or distributing the licensed software." Black's Law Dictionary, 8th Ed., p. 939. The Tribunal concludes that there is no license of any kind in this case between Petitioner and the end-user. See, Respondent's Brief in Opposition to Petitioner's Motion for Summary Disposition, page 4. Even assuming that a "use-based" license existed, Petitioner cites no authority for the position that consideration paid pursuant to such an agreement is necessarily a royalty in this context. The Tribunal concludes that under the facts presented the consumer does not pay a royalty to acquire a copy of a copyrighted game cartridge.

JUDGMENT

IT IS ORDERED that Respondent's Motion for Summary Disposition is GRANTED and the taxes and interest as assessed by Assessment No. K886246 are AFFIRMED. No costs to either party.

IT IS FURTHER ORDERED that Petitioner's Motion for Summary Disposition is DENIED. No costs to either party.

IT IS FURTHER ORDERED that the parties shall have 20 days from date of entry of this Proposed Order and Judgment to file exceptions and written arguments with the Tribunal consistent with Section 81 of the Administrative Procedures Act (MCL 24.281). The exceptions and written arguments shall be limited to the matters relating to the motions. This Proposed Order and Judgment, together with any exceptions and written arguments, shall be considered by the Tribunal in arriving at a final order in this matter pursuant to Section 26 of the Tax Tribunal Act (MCL 205.726).

MICHIGAN TAX TRIBUNAL

Entered: December 20, 2006

By: Thomas A. Halick