SOFTWARE: TANGIBLE OR INTANGIBLE?
ERRIS PROMOTIONS LTD AND OTHERS V COMMISSIONER OF INLAND REVENUE

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**Introduction**

The legal nature of computer software has long been problematic. Is it goods or is it services? Is it tangible property or intangible property? Is it a chose in possession or a chose in action? One might argue that none of these traditional distinctions are relevant or accurate for software. However, in at least the common law countries we are stuck with the rule that “All personal things are either in possession or in action. The law knows no tertium quid between the two.”

Ascertaining the correct legal nature of software can be important in a number of legal contexts but perhaps the two most common are taxation and sale of goods. Indeed, two cases used by proponents of the contrary views on the legal nature of software come from these two areas of law. The first is a 1994 decision of the Louisiana Court of Appeal in *South Central Bell Telephone Co v Barthelemy* (a property tax case) where the Court decided software was tangible property. The second is the 1996 English Court of Appeal case, *St Albans City and District Council v International Computers Ltd* (a sale of goods case) where Sir Iain Glidewell concluded that computer programs as such, being intangible instructions, were not goods.

More recently, the New Zealand High Court has considered the question again (in an income tax case) and decided “software (including source code)” is intangible property.

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1 *Colonial Bank v Whinney* (1885) 30 Ch D 261 at 285 per Fry LJ
2 643 So (2d) 1240 (1994)
3 [1996] 4 All ER 481
Facts

In *Erris Promotions Limited and Others v The Commissioner of Inland Revenue*\(^4\) the owners of software of claimed high value sought a tax advantage by claiming depreciation deductions from the software assets. The Commissioner of Inland Revenue disallowed the depreciation claims on the basis that the software was not allowable depreciable property under the Tax Administration Act 1994.

Some 420 investors in a joint venture called ACTONZ purchased six software packages in the late 1990s. One of these, called BACCIS, was valued at $450,000,002. Investors bought units in the joint venture in the expectation of sharing certain tax advantages and possible revenue from licensing the software. The Commissioner claimed that the valuations were grossly inflated, the software purchases were shams and the investment arrangement was one for tax avoidance. The Court ultimately agreed, but these issues will not be traversed in this article.

The six software packages pre-existed and were purchased from different owners, but all transactions involved similar legal documentation. This typically comprised a sale and purchase agreement including a schedule for progressive payments of the purchase price; a deed of debt recording that the vendors in each sale had financed the purchase; and a deed securing the vendors’ loan, which contained a non-recourse provision under which the vendors’ only remedy for default of payment by ACTONZ was repossession of the software. In each sale and purchase agreement the purchase price was allocated between three “assets”; (i) software (including the source code), (ii) intellectual property, including the copyright, (iii) other property, essentially the physical representations of the software. “Intellectual property” and “other property” in each case was valued in the agreements at $1. The rest of the purchase price (essentially all) was allocated to the software, including the source code.

The ACTONZ investor information memoranda advised that the depreciation allowances on all the software packages would be divided equally among all investment units in the joint venture. It was stated that an investment of $300,000 based on tax advantages alone, assuming no sales of software, would return an investor his original investment plus $239,000 within 2-3 years. Independent tax opinions and software valuations were provided to investors. *Erris Promotions Ltd* was representative of the investors. It invested $15,000 in 1999 to purchase 1 unit. ACTONZ allocated a loss per unit of $150,933.70 for the tax year ended 31 March 1999. *Erris* claimed the full allowance for that tax year with the result that it effectively paid no income tax. Without the benefit of the depreciation allowance it would have paid over $49,000 in income tax.

\(^4\) [2004] 1 NZLR 811
Arguments and Decision

The Plaintiffs’ argument was that taxpayers who both own and use software as a business asset have a right to depreciate it and claim a deduction against gross income. The Commissioner on the other hand argued that all the Plaintiffs attempted to depreciate was software source code and that because the code was intangible property it was not depreciable – it did not fall within those limited forms of intangible property which could be depreciated under the Act.

The depreciation provisions in the Act defined “depreciable property” to “not include –

... (iv) Intangible property other than depreciable intangible property.”

“Depreciable intangible property” was defined in the Act to mean “intangible property of a type listed in Schedule 17”, along with some other qualifications. Schedule 17 in its list of depreciable intangible property included as paragraph 6,

“the copyright in software, the right to use the copyright in software, or the right to use software.”

The Plaintiff’s primary argument was that software (including the source code) is tangible property and therefore the inconvenient Schedule 17 restrictions on the types of intangible property which were depreciable were not relevant. The Act did not define either tangible property or intangible property. The Judge accepted evidence for the Commissioner that software is a set of instructions in coded form that controlled computer hardware; its source code is the form in which the programmer writes the software that is subsequently converted to machine code for supply and actual execution on computers. He agreed with the analogy between source code and the text of a novel. He agreed that the only property in literary works was copyright as provided under the Copyright Act. (In the New Zealand Act “literary work” is defined to include "a computer program"). The software code and the media on which it happened to be stored was not to be confused – software is a message and not the medium. Essentially, source code is information. Source code cannot be touched and therefore does not come within the dictionary definitions of “tangible”. Source code as a set of instructions was no more than ideas expressed in logical form. This was intellectual property and therefore intangible.

The Judge then considered the non-binding UK and US cases cited to him by the parties. In St Albans City and District Council v International Computers Ltd the question of whether
software was goods was considered by Sir Iain Glidewell. He concluded that when software was supplied on a disk it was a “good” and subject to the Sale of Goods Act 1979. He considered the programs themselves were “intangible instructions or comments” and therefore not goods and not as such subject to the Sale of Goods Act. Against this Ronald Young J had to consider the Louisiana Court of Appeal decision that software was tangible property in *South Central Bell Telephone Co.* He noted that that decision was based on a statute which (unlike the one before him) did contain a definition of “tangible personal property”. The New Orleans City Code was equated by the Court of Appeal in that case with the Louisiana Civil Code which defined “corporeals” and “incorporeals”. Louisiana has inherited civil law from its French founders. Ronald Young J noted that these definitions were broader than the dictionary definitions. The Code includes as tangible property anything that “is perceptible to any of the senses”. In addition the Judge noted that the Court of Appeal made its decision in respect of “physical recordings of computer software”.

The Judge thus distinguished *South Central Bell* and concluded that computer software source code was intangible property. The only intangible property which the Plaintiffs could depreciate under the Act was the copyright in the software which they themselves had valued at only $1 in their sale and purchase agreements.

**Comment**

Ronald Young J was surely correct. Defining the legal nature of software in terms of the legal nature of the storage medium on which it is supplied to a user has the potential to produce logical absurdities. These days much software is transferred to users over the Internet and not on storage media such as tapes, disks, CDs or semiconductor chips. To say that software when purchased on a disk is tangible or is goods, while software purchased over the Internet is intangible, even when it is in fact the same software, certainly defies logic. The unfair consequences which might have followed in *St Albans* were only avoided by the court forming the view that although there was no transfer of goods and therefore no implication of terms as to quality or fitness for purpose under the Sale of Goods Act, the supply contract was nevertheless of the type where the common law would imply such terms.\(^5\)

The Judge held that source code was a writing and once having formed this view he wanted to accept the only property in source code was copyright. This derived from expert evidence that

\(^5\) In New Zealand this dilemma has now been solved by Parliament exercising its sovereign power to legislate black as white. It simply redefined the meaning of “goods” in various of consumer and commercial legislation under the Consumer Protection (Definition of Goods and Services) Act 2003 - somewhat of a misnomer as the affected legislation is not limited to consumer transactions. A raft of Acts now have a definition of “goods” which expressly includes “computer software”. The Commerce and Fair Trading Acts now have even more far reaching definitions of “goods”, and include “personal property of every kind (whether tangible or intangible)”\(^5\). Whether patentees and copyright owners have anything to fear is not yet known.
was given relating to the decision of the House of Lords on the point in 1774 in the famous case *Donaldson v Beckett*. Prior to *Donaldson v Beckett* there had been a 50 year debate on whether there was any property in writing at common law. The argument against such “literary property” was that writing as a product of the mind was intangible and the *intangible could attract no property rights at common law*. The majority of the Lords agreed with this. This meant that the only property which could subsist in writing was copyright as established by statute. In 1774 this meant the Statute of Anne 1709.

However, there remain difficulties under the common law when the focus is on common law personal property rights, rather than the classifications “tangible” or “intangible”. Software as an intangible still does not fit well within either of the only two forms of personal property recognised by the common law. Unless the only property in software is the copyright which subsists in it (as the Judge decided for source code), it does not fit within all the criteria for a chose in action. It has long been settled that a chose in action is an intangible thing capable of enjoyment only in the last resort by the exercise of a right of action – “a thing … you must bring an action to realise; a thing which you cannot take but must go to law to secure”.\(^6\) Manifestly software on the other hand can be enjoyed and possessed without an action. It seems that it is an intangible in possession.

The trouble is personal property law – whether Roman law or common law - developed in an era when not only was software unknown or unimaginable, but when even intellectual property such as copyright was unknown. It is only in the last few centuries that the law has recognised that property can subsist in any intellectual assets at all (as distinguished from intangibles such as debts). This law has developed in a piecemeal way so that only some species of intellectual assets have the status of property. The law has yet to adequately catch up with other intangibles such as electricity and now software.

It is time to reform the law of personal property to accommodate computer software. The attempt to side step the personal property conundrum by categorising (at least some) software as a service has only led to legal confusion and undesirable international trade implications.\(^7\) The law now needs to recognise a tertium quid between things in possession and things in action.

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6  T Cyprian Williams, “Property, Things in Action and Copyright” (1895) 11 LQR 223