Cite as Det. No. 93-270, 13 WTD 385 (1994).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In The Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 93-270
. . .	)	Registration No. . . .
	)	Document Nos. . . .
	)	Audit Nos. . . .

[1] RULE 257: B&O TAX -- RETAIL SALES TAX/USE TAX -- WARRANTY V. MAINTENANCE V. "MIXED" AGREEMENTS -- CONTRACT -- CONSTRUCTION -- INTENT OF THE PARTIES. Under current case law, in construing whether a taxpayer has entered into a warranty, maintenance, or "mixed" contract, one must use the "context rule" in construing the legal effect of the contract; i.e., one must look to all circumstances surrounding the making of the contract and subsequent conduct of the contracting parties to aid in determining their intent, and such extrinsic evidence should be considered even if the language is plain and unambiguous. Held: Contract, which on its face provided that customer might receive preventative maintenance and upgrades only at seller-taxpayer's option, held to be a maintenance contract when totality of circumstances surrounding the contract were reviewed.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

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NATURE OF ACTION:

Petition concerning the classification of a contract as a warranty, maintenance, or "mixed" agreement.

FACTS:

Bauer, A.L.J. -- The taxpayer's business records were audited for the period January 1, 1986 to June 30, 1992. As a result, [assessments were issued] . . . .

The taxpayer manufactures hand-held . . . [computerized] devices and software. The device and software is sold to public and private [businesses] . . . . The information collected on the device can be downloaded to mainframe computers for billing purposes.

The taxpayer offers several support packages [to the purchasers of these devices], the most comprehensive of which is its [Program X]. That program is outlined in its applicable service policy. [Program X] contains a full range of service and maintenance functions to be performed under this agreement.

The auditor determined that the taxpayer's [Program X] did not require the taxpayer to perform preventative maintenance. Thus, he concluded that [Program X] was a warranty agreement rather than a maintenance agreement. This conclusion was based on the following language in the ". . . Service Policy," which was incorporated by reference into the . . . Service Agreement:

> [Taxpayer] reserves the right to incorporate Engineering changes to . . . equipment that will result in improved product performance and/or reliability. The installation of such changes, whether through normal service cycles or on-site visits, will be the sole determination of [Taxpayer]. The [Taxpayer's] Client Service Representative will notify the client of any on-site Engineering changes planned and the respective installation schedule. Periodically, [Taxpayer] may perform preventative maintenance on designated equipment. Such service will be scheduled and communicated via the Client Service Representative. . . .[1]

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[1] A later version (3/93), in effect at the time of the hearing, provided:

> . . . In addition to diagnosing, isolating and repairing the specific equipment problem cause, under [Program X], hardware items returned for repair routinely undergo a process of full refurbishment that includes burn-in and testing. Refurbishment also includes the automatic incorporation of all appropriate product updates. . . . Periodically, [Taxpayer] may perform preventative maintenance on designated equipment. Such service will be scheduled and communicated through the Client Service Representative.

[Emphasis added.]

TAXPAYER'S EXCEPTIONS:

The taxpayer protests the classification of the its [Program X] as a warranty agreement rather than a maintenance agreement, which classification resulted in the taxpayer's objection to the following portions of the assessment:

1. Schedule IV: Additional "manufacturing for commercial or industrial use" B&O taxes . . . under WAC 458-20-134 (Rule 134).

2. Schedule VIII: Additional B&O taxes under the service classification . . . under WAC 458-20-257 (Rule 257).

3. Schedule XIII: Additional use and B&O service taxes . . . under WAC 458-20-178 (Rule 178), Use Tax, and WAC 458-20-257 (Rule 257).

4. Schedule X: Additional retail sales taxes and local taxes on items shipped into Washington . . . under WAC 458-20-102 (Rule 102).

5. Schedule XI: Additional use/deferred sales taxes . . . .

6. Schedule XII: Additional use/deferred sales taxes . . . .

In objecting to the Department's classification of [Program A] as a warranty contract, the taxpayer contends the Department auditor erred by relying on the bare language of the service policy alone without considering the extrinsic evidence surrounding the negotiations of the contract and the taxpayer's actions in carrying out the contract. As support for this assertion, the taxpayer cites Berg v. Hudesman, 115 W.2d 657, 801 P.2d 222 (1990), which recently adopted the "context rule" in construing contracts.[2]

The taxpayer argues that all circumstances surrounding the making of the contract between the taxpayer and its customers when offering the service should be considered. The taxpayer conveyed to its customers that they would receive periodic maintenance and upgrades as a part of the overall contract. Although the word

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[2] The taxpayer also relies on three additional cases which followed Berg, which cases will not be further discussed herein: Scott Galvanizing, Inc. v. EnviroServices, Inc., 120 W.2d 573, 844 P.2d 428 (1993); Harris v. Ski Park Farms, Inc., 120 W.2d 727, 844 P.2d 1006 (1993), and Nationwide Mutual Fire Insurance Company v. Watson, 63 Wash. App. 139, 816 P.2d 1262 (1991).

"may" appears ambiguous as to the taxpayer's duty to perform this service, the intent of the parties entering into this agreement was the performance of this service on a periodic basis. The actions of the taxpayer subsequent to the making of these contacts support this claim.

As support for the above assertions, the taxpayer has provided a multitude of documents[3] indicating that such service was indeed regularly and routinely performed - both when products came in for repair (an average of every eleven and a half months) and when the taxpayer made field visits to the customer utilities - and that the program was represented to its customers as including routine periodic maintenance and upgrades.

Specifically, over and above its "Baseline Support" program (its mere warranty "repair when broken" program), [Program A] actually provided the repair of normal wear and tear, total refurbishment to "like new" condition, the incorporation of engineering change orders and product improvement, and the routine replacement of cracked cases and displays. [Program A] also provided on-site troubleshooting at no charge.

The taxpayer emphasizes that [Program A] has always been a reflection of its perceived "partnership" with its customers in getting the best and most reliable service out of its product, and that the periodic maintenance and upgrades in the program furthers this goal. Finally, the taxpayer has now amended the language in its service policy to avoid any future confusion in its intent, the new language now providing[4]:

> In addition to diagnosing, isolating and repairing the specific equipment problem cause, under [Program A], hardware items returned for repair routinely undergo a process of full refurbishment that includes preventative servicing, burn-in, testing and the automatic incorporation of all appropriate product updates. In order to ensure that all appropriate equipment receive adequate preventative service, clients may arrange through the Client Service

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[3] Including invoices, office and technician SOP (standing operating procedure) manuals, field change orders routinely ordering upgrades and retrofits of equipment under the program, and [Program A] "sales pitch" slides and documents used during the audit period.

[4] The taxpayer had never perceived the previous language to indicate a restriction on preventative maintenance, since it had always intended to perform preventative maintenance and never used the existing language to decline to do so.

> Representative for the periodic refurbishment of equipment not otherwise serviced annually.

[Emphasis added.]

ISSUE:

The sole issue for resolution is whether the taxpayer's [Program A] contract, including oral representations and actual performance, created an ongoing duty by the taxpayer to perform routine service and maintenance, thereby properly classifying the contracts as service agreements or mixed agreements, taxable as retail sales.

DISCUSSION:

Rule 257 provides that warranty agreements are service taxable. Accordingly, persons providing services under a warranty agreement are retail sales/use taxable on the materials they purchase which become a part of the required repairs or services.

Maintenance agreements, on the other hand, are pre-paid retail sales, subject to the retailing B&O tax and retail sales tax. Persons performing services under maintenance agreements sold by them are not subject to retail sales or use tax on materials they purchase which become a part of the required repairs or services. They are, instead, entitled to give their suppliers resale certificates.

If agreements contain warranty provisions and also include actual specific performance provisions, they are "mixed agreements" which are taxable the same as a maintenance agreement and not as a warranty agreement.

If the agreement here at issue is a "maintenance" or "mixed" agreement, then the parts consumed during the maintenance agreement would not be subject to the retail sales/use tax. Retailing B&O, and not the higher service B&O tax classification, would be appropriate.

Under Rule 257, maintenance agreements are

> . . . agreements which require specific performance of repair, cleaning, altering, or improving tangible personal property on a regular or irregular basis to ensure its continued satisfactory operation.

In 4 WTD 393 (1987), the distinction between warranty and maintenance agreements was discussed. In that case, the taxpayer sold emissions testing equipment. The taxpayer gave a limited warranty along with the equipment, and a further contract which

contained the following service provisions: (1) taxpayer was to install the equipment and "supply complete service, including labor and repair [parts]," (2) taxpayer agreed to respond to service calls within a "two hour period: each working day," and (3) supply a quality assurance check for each piece of equipment for each month.

The Administrative Law Judge (ALJ) in that case held the agreement to be a maintenance agreement rather than a warranty agreement, reasoning that

> . . . even though the contract may contain some language indicative of a warranty, it also requires the specific performance of inspection, cleaning, servicing, altering, or improving the property on a regular or periodic basis.

Moreover, the ALJ reasoned that the quality assurance checks, with calibration and assistance of installation are not ". . . [duties] contingent upon breakdowns as in the case of a true warranty. Rather, they are specific requirements of the contract 'without regard to the operating condition of the property.'. . ."

In this case, the bare language of the [Program A] service policy indicates that preventative maintenance and upgrading would occur only at the taxpayer's discretion. Reliance on the bare language of a contract, however, is no longer sufficient in construing it. The Washington Supreme Court, in Berg v. Hudesman, supra., recently held that circumstances under which a contract was made should be used as an aid in determining the parties' intent in entering into a contract.

Under the rationale of this case, extrinsic evidence should be considered even if the language is plain and unambiguous. Extrinsic evidence relating to the entire set of circumstances, including subsequent conduct of the contracting parties, should be used as an aid in interpretation.

> . . . Interpretation is the process whereby one person gives a meaning to the symbols of expression used by another person. . . . Construction of a contract determines its legal effect. "Construction . . . is a process by which legal consequences are made to follow from the terms of the contract and its more or less immediate context . . . ." The cardinal rule with which all interpretation begins is that its purpose is to ascertain the intention of the parties . . . . Determination of the intent of the contracting parties is to be accomplished by viewing the contract as a whole, the subject matter and objective of the contract, all circumstances surrounding the contract, and

> the reasonableness of respective interpretations advocated by the parties.

[Berg, supra., at 663 and 667, citations omitted.]

Using the "context rule" set forth by Berg to construe the [Program A] contract, we have reviewed the evidence supplied by the taxpayer. This evidence was presented to demonstrate the intent and understanding of the parties in entering into the agreement. We find that, based on the sales material and [Program A] presentation slides normally used by the taxpayer, customers certainly would have rightfully expected, and were legally entitled, to receive at least irregular maintenance and upgrades under this program. A review of the taxpayer's various internal SOPs, field change orders, site visit reports, and actual invoices indicate that such periodic maintenance and upgrades were in fact actually and routinely performed for its [Program A] customers. The fact that the taxpayer's service policy has been amended to clarify this intent, with no additional charge to its customers, is further evidence of the taxpayer's intent in this matter.

We therefore hold that the intent of the parties in the [Program A] contracts here at issue was that preventative maintenance, upgrades and other services beyond its warranty provisions would be performed, albeit perhaps irregularly. Accordingly, because the [Program A] contracts as construed contained not only warranty provisions, but also specific performance provisions (in the way of upgrades, periodic maintenance, replacement of worn cases and handholds, periodic troubleshooting visits, etc.), these agreements are "mixed agreements" which are taxable the same as maintenance agreements and not as warranty agreements.

DECISION AND DISPOSITION:

The taxpayer's petition is granted. The Audit Section will adjust the Schedules listed under the Taxpayer Exceptions section to be consistent with [Program A] being a mixed agreement, taxable under the Retailing classification of the B&O tax and retail sales tax.

DATED this 30th day of September 1993.