Cite as Det. No. 95-164, 15 WTD 152 (1996).

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. 95-164

RULE 227; RCW 82.04.050, RCW 82.04.290: B&O, USE TAX -- CABLE -- RENTAL -- CONVERTERS. A cable television company's receipts from the rental of remote control units and standard converters are taxable under the retailing classification. Addressable converters which descramble the company's signal for premium channels are for the premium service and receipts labeled as "rental" for these converters are taxed under the service and other activities classification. The taxpayer owes deferred sales/use tax on purchases of addressable converters since they are not for resale.

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.

NATURE OF ACTION:

A cable television company protests the reclassification of income from rental of converters and remote control devices.[1]

FACTS:

Pree, A.L.J.-- The taxpayer provided cable television services in Washington. The taxpayer offered its customers the use of its converters and remote controls for an additional fee. The taxpayer required customers to use its addressable converters to

[1]Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

descramble some of its premium channels. The taxpayer charged its customers retail sales tax on the "rental" fees for the remote controls, standard converters, and the addressable (descrambler) converters. It reported the revenue under the retailing category of the business and occupation (B&O) tax. The taxpayer then remitted the sales tax that it collected to the Department.

The taxpayer's records were examined for the period January 1, 1990 through March 31, 1994, disclosing taxes and interest owing. An assessment was issued on August 12, 1994.

The remote control units (remotes) allowed customers to control their television sets (power, volume, channel, etc.) from their viewing position without physically touching the units that the remotes controlled. The customers could buy or rent remotes from vendors other than the taxpayer.

Converters served two functions. First, standard converters allowed customers with older television sets to view more than the thirteen channels that the television sets were built to receive. Customers with newer, cable-ready sets did not need these converters. Second, customers receiving some premium channels needed to descramble the taxpayer's signal with addressable converters to view the programs.

Customers could rent standard converters from the taxpayer or purchase or rent them from other vendors. The taxpayer allowed customers to descramble its signal only with addressable converters rented from the taxpayer.[2]

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[2] The taxpayer indicated that customer contracts and correspondence during the audit period regarding the use of converters were not available. One of the taxpayer's affiliates mailed a document to this ALJ's residence labeled, "Your Local Cable Company's Revised Policies and Practices". Section 7 of that document provides in part:

> . . . that converters with descrambling capabilities should only be obtained from us. In fact, should you see advertisements for cable converters that have descramblers in them (so called "pirate boxes" or black boxes"), you should understand that these devices may be illegal to sell or use, unless authorized by us. Because of the need to protect our scrambled services, we will not authorize the use of any converter/descramblers not provided by us.

The taxpayer charged its customers retail sales tax on the fees that it designated as rental for remotes and converters (both standard and addressable) and reported the revenue under the retailing category of the B&O tax remitting the sales tax collected to the Department. The taxpayer did not pay retail sales tax or use tax when it purchased any of these items. The taxpayer contends that the converters and remotes were acquired for resale because they were rented to others.

The Audit Division reclassified the revenue from the rentals of the converters and remotes to the service and other activity classification of the B&O tax, assessing use tax on these items. The Audit Division allowed no credit for the retail sales tax remitted explaining that the taxpayer chose not to refund the tax to its customers who paid the tax in trust for the state.

The Audit Division also assessed use tax on converters that the taxpayer received after the taxpayer's vendor agreed to repair defective converters at no charge to the taxpayer. The taxpayer states that an entire model line of these converters were defective and returned them to the manufacturer for repairs under warranty. The same manufacturer sells the taxpayer millions of converters. According to the taxpayer, the figures used by the auditor were merely internal journal entries to account for how many converters were returned. The taxpayer paid nothing for the repairs. It only kept track of the ones returned to make sure that it got the same number back. The auditor explained that the taxpayer had not verified that retail sales or use tax had been paid on the converters.

Use tax was also assessed on digital music equipment for an audio service provided to customers through the use of special devices. They were originally used in restaurants for background music. The taxpayer estimated their value at $100 - 150 each. Unlike the other converters, the taxpayer encouraged its customers to purchase these units, but many were rented as well.

The taxpayer and the Audit Division agree on portions of the assessment. The taxpayer does not dispute the Audit Division's methodology on Schedules II and IV of the assessment. The Audit Division agrees with the taxpayer regarding asset transactions that it improperly included in an expense sample, such as grip services and postage. These items will be taken out of the sample. The Audit Division will revise the projection from that sample. Finally, the taxpayer now understands that no penalties

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Unless the taxpayer clearly demonstrates that this was not its policy regarding addressable converters, we will consider this document the taxpayer's policy.

were imposed. The reference in the assessment to penalties only applies to future reporting instructions.

ISSUE

Under which tax classification should receipts that the taxpayer designated as rental fees for remotes, converters, and digital music service equipment be taxed?

DISCUSSION:

Excise taxes in Washington are imposed at different rates depending upon the classification of the taxpayer's activity. Retailing activities including the rental of tangible personal property are taxed at the retailing rate. RCW 82.04.250 and RCW 82.04.050(4). Service activities such as providing cable services are taxed at a different rate. See RCW 82.04.290. Persons engaged in several activities, may be taxed under the applicable section for each activity. Chapter 82.04 RCW.

RCW 82.32.300 directs the Department to make and publish rules and regulations necessary to enforce excise taxes. The rules have the same force and effect as the excise tax laws. WAC 458-20-227 (Rule 227) applies to cable television issues. Subsection (2)(a) provides:

> Gross income derived from the charge made for installation and the monthly rental or service fee is subject to tax under the classification service and other activities.

We must determine whether the Audit Division properly taxed the monthly rental for the remotes, converters, and digital music service equipment under the service and other activities classification.

Customers could separately rent remotes and standard converters from the taxpayer. The activity of renting that equipment could be severed from the cable service activity provided by the taxpayer. It wasn't necessary for the customers to rent that equipment from the taxpayer. They could rent or purchase the equipment from others as well. They could, therefore, receive the service without renting the remotes or standard converters from the taxpayer. We find in those situations, that the taxpayer was engaged in the renting of tangible personal property, a retail sale.

If customers rented or purchased the equipment from others, it would be a retail sale. We believe that taxpayers should be treated similarly. The customers who rented the remotes and standard converters wanted the equipment because they were under

no obligation to rent these items to obtain the cable service. Therefore, the taxpayer properly reported the receipts from the rental of standard converters and remotes under the retailing B&O tax classification.[3] The taxpayer properly collected retail sales tax from its customers and remitted the tax to the Department. The taxpayer's purchases of these items were not subject to retail sales tax or use tax because the taxpayer acquired them for resale as rental items.

Customers rented addressable converters only to descramble the taxpayer's premium signals. The taxpayer did not allow customers to use descramblers acquired or rented from others. If they ordered a premium channel which the taxpayer transmitted with a scrambled signal, they had to pay the taxpayer for the addressable converter. The addressable converters had no particular value to the customers. The customers only wanted the unscrambled signal.

We find that the receipts labeled by the taxpayer as rental of addressable converters, were properly part of the cable service, taxable under the service and other activities classification. The addressable converters were not purchased by the taxpayer for resale. Rather the taxpayer purchased them to deliver its premium signals which the taxpayer needed to descramble for its customers. Therefore, the taxpayer's purchases of these converters were subject to deferred sales/use tax.

If receipts for the digital music service equipment were included in the assessment, the Audit Division needs to determine whether or not customers could obtain this equipment from third parties for use to receive the taxpayer's signal. If the taxpayer allowed customers to use equipment acquired from third parties, the rental receipts should be taxed under the retailing classification. If the taxpayer restricted where its customers could obtain the digital music service equipment, the receipts labeled as "rental" should be taxed with the service provided by the taxpayer.

The question regarding the taxability of the warranted converters returned for repair depends on whether the converters were acquired for resale. If the taxpayer acquired standard converters for resale (i.e., to be rented), the receipts would be classified under retailing, no tax would be due. However, if the taxpayer acquired the converters to provide cable service (i.e. addressable converters), the taxpayer would be considered the consumer when it purchased the converters from the vendor. As

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[3] The reference to monthly rental in Rule 227 only applies to equipment rental as a part of the cable service.

the consumer, the taxpayer must verify that it paid retail sales tax on the addressable converters or be subject to use tax.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. The file will be returned to the Audit Division to revise the assessment as discussed above.

DATED this 25th day of August, 1995.