Cite as Det. No. 99-345, 19 WTD 618 (2000)

BEFORE THE 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. 99-345
. . .	)	Registration No. . . .
	)	FY. . . /Audit No. . . .

[1] RULE 118; RCW 82.04.290: SERVICE B&O TAX -- LEASE VERSUS LICENSE TO USE REAL ESTATE – COMPUTER EQUIPMENT CO-LOCATION SERVICE. Income from providing space for customers solely to locate their equipment on taxpayer's secure premises or to pair the co-location with a range of internet-access services is subject to service B&O tax where the taxpayer retains control over the space and how its customers are permitted to use it.

[2] RULES 107, 138, 155, & 257; RCW 82.32.070: RETAIL SALE -- USE/DEFERRED SALES TAX -- CANNED SOFTWARE -- COMPUTER TELEPHONE SUPPORT SERVICES -- COMPUTER TRAINING -- WARRANTY -- MAINTENANCE -- MIXED AGREEMENTS -- SEGREGATION OF CHARGES. Charges for mixed services to canned software are subject to use/deferred sales tax. Software maintenance includes "extended warranty" of installed software; annual software releases to fix "bugs"; new codes, security records, and tables; written documentation on the changes made, including installation instructions; and testing and distribution of system software upgrades. These services include both warranty and maintenance services. Under Rules 107 and 257, mixed agreements are taxed as maintenance agreements, subject to sales or use tax. Where payments are not adequately segregated, the combined charge will be subject to use/deferred sales tax.

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

Taxpayer petitions for correction of assessment of Selected Business Services business and occupation ("B&O") tax on a portion of its business receipts which it believes is received for the rental of real estate. The taxpayer also protests assessment of deferred sales/use tax on a contract with a vendor who provides maintenance and support services, contending the charges were for warranty services, not taxable services. An additional warranty issue was appealed but subsequently withdrawn by the taxpayer for lack of documentation.[1]

HISTORY OF THE CASE:

Johnson, A.L.J. -- . . . ("the taxpayer") is engaged in the business of providing local Internet access, software development, LAN connections, space for the location of its customers' hardware, and other Internet- and communications-related services. Its records were audited by the Department of Revenue ("Department") for the period from December 11, 1995, through September 30, 1997. The commencement date matched the date on which the taxpayer began operating in its current form.

The taxpayer is located in a Washington building which offers sophisticated communications access, furthering its ability to provide high-speed Internet access to its customers. Taxpayer explains that its presence in this sophisticated building has prompted several of its customers to request that the taxpayer provide them with space in the building for the customers' equipment.

The taxpayer states its agreements have evolved during the four years the company has been in this business. It contends an increasing number of its customers began to request the co-location/rental arrangements and that these arrangements were memorialized in various agreement forms. Often the customer wanted space only, and the taxpayer was not obligated to furnish any of its Internet access or data transmission services.

The taxpayer states it accommodates its customers with various types of agreements. The terms used by the taxpayer in its agreements are used inconsistently; and "services" sometimes refers to co-location/equipment placement only, while other times "services" means Internet/communications access services and "rental space" means the co-location space.

The Audit Division reviewed what the taxpayer argues was an early version of its agreements. This contract provided for a range of services to be performed by the taxpayer. Monthly billings for services, including co-location, were for a flat amount. The taxpayer provided with its petition a redrafted, blank agreement dated after the audit period, which specifically provides for designated space as a part of the arrangement. Taxpayer also states its billings now separate out amounts it contends are attributable to rent.

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

In support of this, it provided copies of several types of agreements. All were dated outside the audit period, although some were negotiated while the audit work was still in progress. They include:

(1) a 1998 renewal of a December 1996 agreement, which requires two equal payments, one for "service", or Internet access, and one for "rental space", for equipment.

(2) Another, with strikeouts and underscores, is an October 1997 agreement for co-location ("services") for $3,000 per month, replacing a $6,000 figure marked by strikeouts. It is unclear whether this agreement was actually for both components of the taxpayer's services, but it appears to show either that only the space was acquired or that separate agreements were created for space and for communications access.

(3) A 1998 contract page was provided to show the taxpayer contracted with that customer for access, or "service", and for "rental space" for two separate fees.

(4) Another agreement provides for co-location space "service" beginning January 1, 1998.

(5) A 1998 agreement and 1999 change order provide for "service", the co-location of two equipment cabinets, which expanded to three with the change order.

(6) A 1998 contract with a school district provided for co-location "services" and for the customer to purchase both maintenance and back-up services from the taxpayer.

The taxpayer also provided four invoice copies to supplement those cited in the audit report. Three of the additional invoices were dated during the audit period and billed customers for "access/space/power". The fourth invoice accompanies Contract (3), the October 1997 agreement that provides for the initial setup of the customer's server and first month's "Server Colocation Access/Space/Power" charge.

The Audit Division concluded no rental arrangement was created under the taxpayer's agreements during the audit period and that bifurcation of a portion of its Internet service income as tax-exempt rental income was not required. The report stated:

> [The taxpayer] controls the access to this secured facility. The customer has no exclusive dominion or control to the occupancy of this room. The room also contains the servers of other [taxpayer] customers, so there is no exclusivity. Also, the provisions in your Internet Access and Server Co-Location agreement do not contain language necessary for Landlord-Tenant relationship.
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> The predominate nature of [taxpayer's] business is providing internet access. [The taxpayer] provides its customers with a single contract in its Internet Access and Server Co-Location agreement. You charge a monthly lump sum to customers for access to the Internet which includes the co-location service. The co-location service is merely a component of an array of Internet services you offer to customers by providing different levels of Internet access. Therefore, the server co-location is an additional Internet service that benefits the customer's server to be accessed at higher speeds on the Internet.

(Brackets supplied.)

In concluding the relationship was a taxable license to use real estate, the Audit Division also found persuasive the fact that the taxpayer provided the heat, air conditioning, lighting and a guarantee of backup power. The taxpayer disagrees with this conclusion for two reasons: it argues the conclusion fails to accurately reflect its business and contends the auditor did not review later agreements which more clearly offered services separate from rentals of dedicated location spaces. The taxpayer concedes the earlier contracts did not clearly segregate what it contends was, throughout the corporation's existence, a clear rental relationship from that of its activity as service provider. However, the taxpayer argues the later agreements convey to the customer exclusive possession and use of an assigned space which is available to the customer at all times, even when bundled with its other service, providing Internet/communications access. The later agreements designate a specific space and require thirty days' notice to terminate. They further state the space is provided "for customer's own use", denying that the taxpayer has any responsibility to "monitor or police" the use or any responsibility for the actions of the customer or any of the customer's designees.

The taxpayer explained the agreements are usually long-term arrangements for one year or more, in part because it would be very expensive for the customers to move their equipment, even if another sophisticated building were available. The taxpayer states its customers rent spaces of designated racks which are seven feet high and are one of several industry-standard widths, including one width which can contain locking cabinets. All racks are numbered and the customer receives a specific numbered space or set of racks, which it perceives as its own space. No one else has access to the space or the right to touch other customers' equipment. Taxpayer contends the auditor was also biased by the knowledge that no customer could enter the premises without the taxpayer's security officers. It argues the escort's primary function is to provide security both to the accessing customer and for the equipment of absent customers, as well as to ensure that any breakdown in equipment is immediately addressed. The taxpayer argues this shows that all of its customers have the right of exclusive possession, which is underscored by the escort's presence in the room. Its attorney cites WAC 458-20-118 and ETA 232.08.118 and contends the taxpayer's customers receive rights that exceed those granted to monthly parking customers, whom the Department has conceded lease real estate if a specific space is designated in the arrangement.

The taxpayer also claimed it had been required by many customers to include in its contracts proof that it had a right to lease space to them, usually in the form of a statement that the taxpayer had received from the building owner the right to sublease space in its quarters, so that the customers could be assured that they would not lose their space once they had moved in. The taxpayer believes this is evidence of the customers' belief that they were renting a specific space for a long term.

The taxpayer also protests a portion of the deferred sales/use tax assessed on Schedule 7 of the assessment. The amount is attributable to its . . . support agreement, which involves an annual payment of approximately $6,000. The Audit Division concluded this agreement was subject to sales tax as a maintenance agreement, pursuant to WACs 458-20-257 and 458-20-155, based on

a finding that the contract provided for software maintenance, . . . access, advance replacement of hardware and technical support necessary for customers' self-maintenance of the product.

The taxpayer argues the upgrades are only a "throw-in"; instead, it believes the reason for purchasing the protection is to obtain access to . . . technicians, a nontaxable service. It contends the system is widely recognized to be unreliable, making this access a necessity for customers who cannot afford long or multiple breakdowns.

Taxpayer also alleges the auditor erroneously focused on the fact that "upgrades" are covered under the agreement. It contends what it receives are "bug" fixes, not upgrades. As an example, it argues it would be required to separately purchase what it believes are true "upgrades", which it characterized as new versions of the software and that what the contract actually grants are repairs of after-discovered "bugs" which cause the existing software to malfunction or fail. The taxpayer believes [the software manufacturer] is required to meet its obligations under the contract to ensure that the covered programs function correctly, which means it must provide the customers with fixes for bugs as the bugs are discovered and repaired. Consequently, it argues the Audit Division is obligated to exempt from sales tax an unstated value attributable to the latter function.

ISSUES:

[1] Is a landlord-tenant relationship exempt from B&O tax created where a provider of services also grants to its customers specific spaces on which the customers can locate and access their own computer equipment?

[2] Must the Department bifurcate the tax treatment of a maintenance contract covering warranty protection for, maintenance of, and upgrades for canned software?

DISCUSSION:

[1] WAC 458-20-118 (Rule 118) provides, in part, that

> Amounts derived from the sale and rental of real estate are exempt from taxation under the business and occupation tax. However, there is no exemption of amounts derived from engaging in any business wherein a mere license to use or enjoy real property is granted.
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> LEASE OR RENTAL OF REAL ESTATE. A lease or rental of real property conveys an estate or interest in a certain designated area of real property with an exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control and occupancy during the term of the lease or rental agreement. An agreement will not be construed as a lease unless a relationship of "landlord and tenant" is created thereby.

. . .

> LICENSE TO USE REAL ESTATE. A license grants merely a right to use the real property of another but does not confer exclusive control or dominion over the same. Usually, where the grant conveys only a license to use, the owner controls such things as lighting, heating, cleaning, repairing and opening and closing the premises.

In Det. No. 96-173, 18 WTD 1 (1999), cited by the taxpayer, the Department considered a seemingly-similar situation and concluded it was a rental of real estate. In that case, lessees received a designated area which was identified by a number in the agreement. However, the Administrative Law Judge in that case was also persuaded the situation represented a special type of situation, a "leased department" under WAC 458-20-200. That Rule is intended to address the unique facts present when a retailer of goods, such as a department store, or personal services, such as a beauty salon, leases portions of its space to persons essentially operating as independent contractors under the umbrella of the leasing business. Examples included in the rule are hairdressers working in a salon or a paint department in a hardware store. The lessees are independents but may, in addition, receive a wide variety of services from the lessor. In 18 WTD 1, the variety of services was so great it actually included, in some cases, staffing by the lessor of the lessees' spaces, in addition to the normal services used by leased-department operators, such as bookkeeping.

This taxpayer's situation presents a close case but contains more of the factors discussed in Det. No. 92-213ER, 13 WTD 108 (1993). As in that case, this taxpayer has repeatedly argued that the test to determine whether an occupant has a lease, rather than a license, is whether the occupant is granted the rights of exclusive possession and control over the property. While we agree that this is a proper test, we do not agree that the taxpayer's customers received such rights with respect to the assigned "racks".

Factors considered in 13 WTD 108 which are relevant in the taxpayer's case include:

Restrictions on the Customers' Control of Activities. Taxpayer controls what the customers can do in the space. They are not permitted to access others' spaces, despite the fact that the spaces are normally not locked off or protected by anything other than the presence of taxpayer's security personnel. While the taxpayer asserts it does not dictate the content of what its customers send through its communication lines, it does control what activities the customers are allowed to perform in the space; and only activities related to the communications abilities, functionality, and servicing of the customers' equipment occur in the space.

Restrictions on the Customers' Control of Lighting and Heating. As noted in 13 WTD 108, the taxpayer's customers do not control such things as lighting and heating or the very-important air and ventilation systems needed for such fragile equipment. 13 WTD 108 quotes Rule 118, which provides that usually "where the grant conveys only a license to use, the owner controls such things as lighting [and] heating."

Restrictions on the Customers' Access. As in 13 WTD 108, the taxpayers' customers are limited in their access to their assigned spaces. They must be accompanied at all times by the taxpayer's security personnel, both in order to protect the present customer in the event assistance with power and other types of failure occur and to protect the absent customers from misbehavior. 13 WTD 108 states Rule 118 specifically provides that where the owner controls the opening and closing of the premises, usually the grant conveys only a license.

13 WTD 108 also noted the taxpayer argued access was controlled for security and maintenance purposes. As in that case, we find the fact that just because "there may be valid reasons for the controls and that the restrictions are imposed by the owner of the facility", this does not lessen the fact that "these controls significantly diminish the control the [customers] exercise over their spaces." (Brackets supplied.)

In short, as in 13 WTD 108, we find that the taxpayer did not grant to its customers "absolute right of control" over their assigned spaces; instead, it granted a license to use its space, which was usually coupled with other services. The Audit Division properly concluded that the taxpayer's customers are granted licenses to use the space in the cases where the customers elect to locate their equipment on the taxpayer's premises. Taxpayer's income from such licenses is subject to B&O tax under the "selected business services" category during the period for which that classification was in effect, if the income was inseparable from the array of services provided by the taxpayer. However, as the Audit Division has previously explained, if the contract and accompanying bills provided for the license to place equipment on the taxpayer's premises alone or separately provided and billed for it in conjunction with other services, the license income would be subject to the "service & other" B&O tax category, and an adjustment to the assessment will be granted.

Taxpayer's petition on this issue is denied.

[2] WAC 458-20-257 (Rule 257) provides:

> (a) Warranties . . . are agreements which call for the replacement or repair of tangible personal property with no additional charge for parts or labor, or both, based upon the happening of some unforeseen occurrence, e.g., the property needs repair within the warranty period.
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> (c) Maintenance agreements . . . sometimes referred to as service contracts, are agreements which require the specific performance of repairing, cleaning, altering, or improving of tangible personal property on a regular or irregular basis to ensure its continued satisfactory operation.

Similarly, Rule 155 provides:

> The retail sales tax also applies to all charges to users for the repair, maintenance, alteration, or modification of hardware, equipment, and/or standard, prewritten software or materials.

Pursuant to Rule 257, nonmanufacturer's warranties and manufacturer's warranties not included in the retail selling price of the article being sold are not subject to sales or use tax. In contrast, maintenance agreements are subject to sales or use tax under all circumstances. If an agreement contains both warranty and maintenance provisions, the agreement is subject to sales or use tax.

These agreements are similar to those previously addressed by the Department. In Det. No. 93-158, 13 WTD 302 (1994), we said

> [Contract A provides for] two separately billed services: "system support" and "user support." Taxpayer states that these services are primarily provided over the telephone. Although these amounts are separately stated, the services provided under the two classifications are not separately itemized. Instead, the services under both categories can include telephone assistance, maintenance of system software, provision of emergency password, investigation of software errors, correction of errors in system software, maintenance of programming code, provision of information on new systems, and installation of programming requests required by outside organizations. Taxpayer conceded that Provider A helped it work out "bugs" over the telephone. While some of these services may involve warranty or professional services, because the charges for maintenance services are not adequately segregated, we sustain the auditor's assessment of use/deferred sales tax on the entire agreement.
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> . . . [The customer's contract for] Software Maintenance includes "extended warranty" of installed software; annual software releases to fix "bugs"; new codes, security records, and tables; written documentation on the changes made, including installation instructions; and testing and distribution of system software upgrades. These services include both warranty and maintenance services. Under Rules 107 and 257, mixed agreements are taxed as maintenance agreements, subject to sales or use tax. The auditor's assessment of use/deferred sales tax on this portion of the agreement is therefore sustained.

We sustain the auditor's assessment of deferred sales/use tax on this taxpayer's "mixed" support agreement with its vendor.

DECISION AND DISPOSITION:

Taxpayer's petition is denied in part. However, the taxpayer may provide to the Audit Division within sixty days from the date of this Determination contracts and billings from the audit period showing separate license and service activities. If these are available, that Division will adjust receipts from the "selected business services" to the "service & other" B&O tax category.

Dated this 30th day of December, 1999.