Cite as Det. No. 04-0284, 24 WTD 269 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 04-0284
. . .	)	
	)	Registration No. . . .
	)	Refund Request
	)	Audit Letter Ruling of March 11, 2004
	)	Docket No. . . .

RULE 197, RULE 155: RETAIL SALES TAX – PREPAID CONTRACT FOR HOURS OF UNSPECIFIED SERVICES – REFUND OF RETAIL SALES TAX. A taxpayer who purchases a prepaid service contract for a set number of hours of computer services, under which it may use the hours for either retail or non-retail services, and is charged retail sales tax on the entire sales price, may not obtain a refund of retail sales tax when it actually uses some or all of the prepaid hours for non-retail services.

Prusia, A.L.J. – A taxpayer who purchased a discount prepaid service contract under which it could choose from a smorgasbord of professional and retail computer services, and was charged retail sales tax on the full prepayment, appeals the denial of its request for refund of the retail sales tax it paid on the contract, contending it is entitled to refund because it used only non-retail services. . . . We conclude the taxpayer is not entitled to a refund. We deny the petition. [1]

ISSUES

[1] Did the taxpayer pay retail sales tax in excess of that properly due? If a seller of a prepaid contract for hours of service, which can be used for retail and/or professional services at the option of the buyer, collects retail sales tax on the full contract price, under what circumstances, if any, can a buyer who uses the hours for non-retail services obtain a refund of retail sales tax paid on the contract?

. . .

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

FINDINGS OF FACT

. . . Taxpayer purchased a computer system, including customized software, from [Seller] in the mid-1990's. . . . . Since purchasing the computer system, Taxpayer has purchased all computer hardware from other vendors, has used its own personnel for installing and maintaining hardware, and has used [Seller] for customized software upgrades and consulting services.

[Seller] offers customers a variety of services, some of which the Department classifies as professional services, and some of which it classifies as retail services subject to retail sales tax. Taxpayer purchases its [Seller] services under a standard [Seller] prepaid discount service contract. For a single monthly fee, payable in advance, [Seller] agrees to provide the customer a certain number of hours of service per month. The customer may use its hours for any of the professional and retail services [Seller] offers. If the customer does not use all of the hours in one month, the surplus hours carry forward into the next month. [Seller] charges all prepaid contract customers retail sales tax on the entire prepayment. After the services are rendered, [Seller] gives the customer a listing of the services it actually provided the customer during the month, but does not attempt to categorize the services as professional services or retail services. . . .

Taxpayer . . . requested the refund directly from [Seller].

After receiving Taxpayer's refund request, [Seller] requested a ruling from the Department's Taxpayer Information and Education section (TI&E) on the taxability of each service [Seller] provided, as well as the taxability of its prepaid service contracts. The request letter . . . explained how the prepaid service contracts work, and added that customers receive a significant reduction in the effective hourly rate for [Seller] services if they take such services under a non-specific prepaid service contract.[2]

. . . TI&E issued [Seller] a letter ruling. The ruling stated how each of the services [Seller] had listed, standing alone, was subject to tax. The ruling also stated as follows, in pertinent part, regarding the prepaid service contracts:

> *Are the general, non-specific, prepaid service contracts subject to retail sales tax/retailing B&O tax or to service and other activities B&O tax?*
> Because these contracts provide a mixture of activities that are not determined and are likely to include retail services, the general, non-specific, prepaid service contracts are subject to retail sales tax and retailing B&O tax. The sales tax collected on the prepaid

[2] [Seller's] request stated that that the prepaid service contracts offer the customer a number of prepaid hours of service for the following month, any of [Seller's] various services could be applied to discharge the obligation, at the time of billing the type of services that would be delivered was unknown, retail sales tax was charged on the full amount of each prepaid contract monthly installment, and [Seller] informed the customer after delivery, and in an after-the-month summary, which services the customer had actually used.

> contracts should be reported at the time it is billed (if [Seller is] filing by an accrual method) or at the time it is collected from the customer (if filing on a cash basis).
>
> *How do sales tax or service and other activities B&O tax apply if there is no delivery receipt or reconciliation of work performed provided to the customer?*
> As noted above, the contract should be billed as a retail sale (and have sales tax added to the invoice.) Whether or not a delivery receipt or reconciliation is provided is not an issue.

After receiving the TI&E ruling, [Seller] denied Taxpayer's refund request.

. . . Taxpayer petitioned the Department's Appeals Division, protesting the . . . TI&E letter ruling to [Seller]. The petition stated that since the early 1990's, Taxpayer has provided its own procurement, installation, and maintenance, and replacement of computer hardware. It has used [Seller] only to provide training, customization of software, and telephone support of the computer software, none of which activities are subject to retail sales tax.

The Appeals Division referred the . . . petition to the Audit Division for its decision whether to grant the refund request and refund the taxes directly to the taxpayer.

. . . [T]he Audit Division denied Taxpayer's refund request. The denial letter summarized the history of the request, and gave the following reason for the final denial of the request:

> I then again reviewed the billing documents in detail. The vast majority of the services provided by [Seller] to [Taxpayer] appear to be services exempt from the retail sales tax. But even if all of the services provided by [Seller] were exempt from retail sales tax, it is not possible at the time of billing by [Seller] to determine with certainty, which services will be used by you. When a contract calls for both retail and non-retail activities the sales tax applies to the entire billing, unless a segregation of the services between retail and non-retail activities occurs in the billing. (This issue was discussed by the Board of Tax Appeals in Docket No. 50237). . . . [The 2003 TI&E] letter affirmed this concept and stated that the tax is due at either the time of billing or at the time of payment, depending on [Seller's] accounting system.
>
> **CONCLUSION:**
> Based on [the TI&E] letter, your petition for refund of retail sales tax is denied, as the sales tax was correctly charged.

. . . Taxpayer again petitioned the Appeals Division, protesting the Audit Division's final denial of the petition for refund.

The refund period is July 1998 through August 2002. The amount of refund requested is $ . . . . The petition sets out the same reasons for granting the refund request that Taxpayer stated in its [earlier] petition.

ANALYSIS

. . . The retail sales tax is levied on each retail sale in this state. RCW 82.08.020. Charges for the sale of computer hardware and canned software are subject to retail sales tax, as are charges for maintenance agreements or service contracts which require the specific performance of repairing, cleaning, altering, or improving them on a regular or irregular basis, to ensure their continued satisfactory operation. WAC 458-20-155 (Rule 155); WAC 458-20-257 (Rule 257).

In contrast, [many] personal or professional services are not considered retail sales and, therefore, ordinarily are not subject to sales or use tax. *See* RCW 82.04.040, .050; WAC 458-20-138 (Rule 138); WAC 458-20-224 (Rule 224). Rule 155 also provides that information services are taxable under the service and other business activities classification.

A contract to perform work pursuant to a single contract for a single, lump-some billing will be taxed according to the primary nature of the activity. Det. No. 89-433A, 11 WTD 313 (1992). This principle results in retail sales tax applying to some services that would not, standing alone, be subject to retail sales tax. However, the Department has allowed taxpayers to report income from lump-sum contracts under more than one tax classification, when the contract is one to perform a variety of activities with different tax classifications, and the values assigned to the various activities are negotiated or otherwise determined in advance. *Ibid.;* Det. No. 98-012, 17 WTD 247 (1998); Det. No. 89-43A, 8 WTD 5 (1989).

In this case, the [Seller] contract allowed the customer to require [Seller] to perform a variety of activities with different B&O tax classifications. Had [Seller] billed for the services after providing them, had it kept records of the precise nature of the services performed, and had it separately billed for the various categories of service, [Seller] could have reported the revenues under different tax classifications. Det. No. 98-012, *supra*; Det. No. 89-396, 8 WTD 143 (1989). It is the documentation requirement in this context (billing after performance) that the Board of Tax Appeals (BTA) addressed in the decision the Department's auditor cited in his . . . letter to Taxpayer. That decision is *Harvey v. Department of Rev.*, BTA Docket No. 50237 (1997). In *Harvey*, the vendor had failed to separately account for or bill for the services, and the BTA held that later oral testimony and affidavits of recollected facts were insufficient to show, with a reasonable degree of objective certainty, the breakdown between retail and service activity.[3]

Taxpayer's situation differs from those addressed in the above decisions, in that it involves prepayment of a contract by a buyer for a variety of activities with potentially different tax classifications, and a refund request by the buyer after the seller reported and paid tax under a single B&O tax classification, consistent with how the transaction was structured. In addition to the documentation requirements discussed in the above decisions, there are refund issues. RCW 82.32.060 addresses excess payment of tax and refunds, and WAC 458-20-229 (Rule 229) sets out refund/credit procedures. Refund issues raised by the facts in this case include the following. Can Taxpayer request the refund, or must [Seller] request it? Since the vendor and the customer

[3] While BTA decisions are not binding on the Department as precedent with anyone except the named taxpayer, this case provides useful clarification and analysis with regard to the issue.

structured the transaction as a retail sale, are the vendor and customer now bound by the form they chose? Does the Department have authority to grant a refund in this circumstance?

We will address the second and third refund issues first. . . .

Even if Taxpayer could produce evidence that most or all the services it used were professional services, we would . . . not alter the characterization of the price paid [Seller] in this case. In essence, Taxpayer argues that we should look to the substance, not the form of the transactions at issue. In general, the doctrine of substance over form is not available to a taxpayer to eliminate the tax consequences of a taxpayer's structured form of the transaction. *See, e.g.*, Det. No. 85-112A, 1 WTD 343 (1985), *citing Higgins v. Smith*, 308 U.S. 473 (1940); Det. No. 92-166, 12 WTD 211 (1993); *see also Chevron USA, Inc. v. Department of Rev.*, Docket No. 99-94 (Bd. Tax Appeals 1999), *citing Commissioner of Internal Rev. v. Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) ("This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not."). . . .

The Department is not authorized to refund tax unless it finds that tax was paid "in excess of that properly due." RCW 82.32.060(1).[4] We are unable to make that finding in this case. Because the mix of activities [Seller] would provide was not determined when it sold a contract, retail sales tax was properly collected on the entire payment. As soon as the income proceeded or accrued to [Seller], it became liable for the tax. WAC 458-20-197 (Rule 197).[5] Thus, the tax [Seller] paid was "properly due."

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[4] RCW 82.32.060(1) provides, in pertinent part:

> If, upon receipt of an application by a taxpayer for a refund . . . it is determined by the department that within the statutory period for assessment of taxes, penalties, or interest prescribed by RCW 82.32.050 any amount of tax, penalty, or interest has been paid in excess of that properly due, the excess amount paid within, or attributable to, such period shall be credited to the taxpayer's account or shall be refunded to the taxpayer, at the taxpayer's option.

[5] Rule 197 states, in pertinent part:

> **When tax liability arises.** (1) Gross proceeds of sales and gross income shall be included in the return for the period in which the value proceeds or accrues to the taxpayer. . . .
>
> (2) **Accrual basis**.
>
> (a) When returns are made upon the accrual basis, value accrues to a taxpayer at the time:
>
> (i) The taxpayer becomes legally entitled to receive the consideration, or,
>
> (ii) In accord with the system of accounting regularly employed, enters as a charge against the purchaser, customer, or client the amount of the consideration agreed upon, whether payable immediately or at a definitely determined future time.
>
> (b) Amounts actually received do not constitute value accruing to the taxpayer in the period in which received if the value accrues to the taxpayer during another period. <u>It is immaterial if the act or service for which the consideration accrues is performed or rendered, in whole or in part, during a period other than the one for which return is made.</u> The controlling factor is the time when the taxpayer is entitled to receive, or takes credit for, the consideration.
>
> (3) **Cash Receipts Basis**.
>
> (a) When returns are made upon cash receipts and disbursements basis, value proceeds to a taxpayer at the time the taxpayer receives the payment, either actually or constructively. <u>It is immaterial that the contract is performed, in whole or in part, during a period other than the one in which payment is received.</u> [Emphasis added.]

Had [Seller] structured the contracts differently, such as billing for its services after the fact, or placing the prepayments in trust and accruing the income after it provided the services, or contracting to provide this taxpayer only non-retail services, there would not have been a refund issue. Tax would have been properly due after performance, when it would have been possible to bifurcate the charges, assuming documentation requirements were met. But [Seller] structured the contracts in a manner that made sales tax properly due on the entire charge, and [Seller] and its customer must accept the tax consequences of that choice.

Another barrier Taxpayer has not overcome is the documentation requirement applicable both to bifurcating contracts and establishing entitlement to any refund. The Department does not permit bifurcation of charges unless there is a reasonable basis for determining the value of the various activities performed. Similarly, a taxpayer must provide documentation to support a refund claim. In this case, [Seller] did not even know which of its services were retail and which were not when it provided services to Taxpayer. [Seller] did not separate the charges between retail and service in its records or billings. The evidentiary problem the BTA discussed in *Harvey* would be present if [Seller] now attempted to go back and segregate the services.

For the above reasons, we deny the petition for refund. . . . .

DECISION AND DISPOSITION

Taxpayer's petition for refund is denied.

Dated this 28th day of December, 2004.