

Cite as Det. No. 15-0314, 35 WTD 451 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund and)	<u>D E T E R M I N A T I O N</u>
Correction of Assessment of)	
)	No. 15-0314
)	
...)	Registration No. . . .
)	

[1] RULE 15501; RULE 15502; RCW 82.04.050; RCW 82.04.290; RCW 82.08.190: RETAIL SALES TAX – BUNDLED TRANSACTIONS – COMPUTER SOFTWARE MAINTENANCE AGREEMENT – HELP DESK – TECHNICAL SERVICES – COMPUTER HARDWARE AND SOFTWARE INSTALLATION, REPAIR AND MAINTENANCE. Although sales of stand-alone computer software maintenance agreements are generally taxable under the services and other activities B&O tax, this applies only to agreements where all of the services provided qualify under the services and other activities B&O tax classification. Taxpayer’s sales of tangible personal property, accompanied by a service consisting of installation, repair, cleaning, altering, or improving of the hardware or software, are subject to retail sales tax on the entire sale price, inclusive of tangible personal property consumed in the activity and/or labor and services rendered.

[2] Rule 15502(7)(d); RCW 82.08.190: RETAIL SALES TAX – BUNDLED TRANSACTIONS – DE MINIMIS EXCLUSION. The *de minimis* provisions of RCW 82.08.190 and Rule 15502(7)(d) apply to sales for a single non-itemized price, and do not apply to charges for separately stated line items. Instead, each line item is taxed according to the nature of the activity.

[3] Rule 15002; RCW 82.04.050, RCW 82.04.29001; RCW 82.04.050; RCW 82.04.290: RETAIL SALES TAX – CUSTOMIZATION OF PREWRITTEN COMPUTER SOFTWARE – CUSTOM AND ROUTINE INSTALLATION OF PREWRITTEN COMPUTER SOFTWARE. Customization of prewritten computer software is generally subject to services and other activities B&O tax and includes custom installations, but does not include routine installations, which are subject to retail sales tax. Taxpayer was liable for uncollected retail sales tax because it did not separately state charges for customization of software and custom installations, and failed to maintain and present suitable records to show that its activities were custom installations and/or services rendered to customize software.

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.

LaMarche, A.L.J. – A computer service provider petitions for correction of an assessment and a refund, arguing that the Department erred when reclassifying certain separately stated charges as retail sales. Petitioner alleges that the charges were *de minimis* relative to the business’s primary activity of providing help desk and consulting services, or were in relation to network-based services not subject to retail sales tax. Because the Department reclassified only line items on Taxpayer’s own invoices that indicated retail sales activity, and because Taxpayer has not shown that the activities should be classified differently, we deny the petition.¹

ISSUES

1. Under RCW 82.04.050, WAC 458-20-15501 (Rule 15501), and WAC 458-20-15502 (Rule 15502), are certain sales pursuant to a maintenance agreement subject to retail sales tax?
2. Do the *de minimis* provisions of [RCW 82.08.190 and] Rule 15502(7)(d) apply to the sales at issue?
3. Do the sales at issue qualify for treatment as customization of computer software under RCW 82.04.050(2), RCW 82.04.29001, and Rule 15002(7)(a)(v)?

FACTS

[Taxpayer] provides help desk services and information technology consulting and support, and also sells, installs, cleans, and repairs computer hardware and software, including virus removal.

The Audit Division (Audit) of the Department of Revenue (Department) conducted an audit of Taxpayer’s business activities for the period of January 1, 2010 through March 31, 2014 (Audit Period). Audit found that Taxpayer had charged retail sales tax for its sales of computer hardware and software, but did not charge sales tax for its installation, cleaning, and repair services, which it separately stated by line item on its invoices. Audit concluded that these activities (Disputed Activities) were retail sales, and reclassified them from service and other activities to the retailing classification. Audit issued an assessment on October 21, 2014 totaling \$² Taxpayer paid the balance of \$. . . in full on November 17, 2014, and filed an appeal.

Detail of the Disputed Activities is derived from a three-month sample of Taxpayer’s sales invoices, and is set forth on Workpaper A of the Audit Report. *See* Audit Report, Workpaper A, and auditor’s notes in APS Com Log. The items in dispute appear as separately stated line items on Taxpayer’s sales invoices, and show a description of each activity in most cases, and the amount of time spent and charge for each activity. *Id.* The Disputed Activities include installation of computer hardware and software; virus/malware removal; installing computer

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

² The assessment issued on October 21, 2014, Document No. . . . , totaled \$. . . , comprising \$. . . retail sales tax, \$. . . retailing [B&O] tax, a credit of \$. . . for service and other activities B&O tax, interest of \$. . . , and a 5% assessment penalty (substantial underpayment penalty) of \$

software updates; repair, maintenance, and cleaning of both computer hardware and software; physical set up of work stations; packing of equipment for delivery; patching of phone lines; and testing of internet routers. *Id.*

Taxpayer contends that it is a professional service provider of Information Technology (IT) consulting and helpdesk services, and that Audit erroneously flagged and reclassified certain line items on Taxpayer's invoices based on terms Taxpayer listed in its line item notations—such as “install” or “repair.” Taxpayer argues that the line item notations do not completely or accurately capture all of the services it provided, and that any retail activity is *de minimis* with respect to the overall transactions, which were primarily professional services not subject to sales tax.

Taxpayer further argues that the majority of its software installations require custom modifications to make the software work on each customer's computer network or computer system. On July 22, 2014, Audit sent an email to Taxpayer that adjustments were possible if Taxpayer could show that certain sales were installations of customized software. *See* Audit Report, APS Com Log, July 22, 2014. However, Taxpayer never provided such proof of customized installations to the Department.

Audit responds that because Taxpayer's invoices clearly broke out the time involved for each line item, it was reasonable to assert retail sales tax on each retail activity, regardless of whether it was the primary activity or not.

ANALYSIS

1. Sales pursuant to a maintenance agreement

Sales of help desk and network system technical support services are generally subject to B&O tax [pursuant to] RCW 82.04.220, under the services and other activities classification. RCW 82.04.290(2); Rules 15501 and 15502.³ However, the sale of or charge made for installation, repair, cleaning, altering, or improving of tangible personal property, including computers and computer systems, for consumers is subject to retail sales tax. The term “retail sale” includes “the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to” those activities. RCW 82.04.050(2)(a) (emphasis provided); Rule 173; Rule 15501.⁴

³*See also* the Department's Quick Reference Guide, Taxability of IT Products and Services When Sold as a Package, <http://dor.wa.gov/docs/pubs/industspecific/quickrefchartitservices.pdf> (last accessed November 9, 2015).

⁴ In its petition, Taxpayer seeks to make a distinction between “computer” and “computer systems” or “computer networks” under RCW 82.04.215 and Rule 15501. Taxpayer makes this distinction in support of its argument that its services [with] regard to computer systems and computer networks are not subject to retail sales tax. Taxpayer refers in particular to Rule 15501(1)(a) which states that the term “computer” does not include any “computer software or peripheral devices.” However, the distinction has no bearing on our discussion here of retail sales tax liability. As we will discuss, sales of computer software can be classified as retail sales under RCW 82.04.050(6) and Rule 15502, and installation of computer hardware, including internal and external peripheral devices, can be classified as retail sales under RCW 82.04.050(2)(a) and Rule 15501(5).

The sale of prewritten computer software to a consumer, regardless of the method of delivery to the end user, is also subject to retail sales tax. RCW 82.04.050(6)(a); Rule 15502(3).

Although sales of stand-alone computer software maintenance agreements are generally taxable under the service and other activities B&O tax, this applies only to agreements where all of the services provided qualify under the services and other activities B&O tax classification [RCW 82.04.290; RCW 82.08.190;] Rule 15502(7)(d)(i). That is not the case here.

Here, Taxpayer's sales of tangible personal property accompanied by a service consisting of installation, repair, cleaning, altering, or improving of the hardware or software, are subject to retail sales tax on the entire sale prices, inclusive of tangible personal property consumed in the activity and/or labor and services rendered. RCW 82.04.050(2)(a); [Rule 15502(7)(d)(i)].

Although Taxpayer engaged in the kinds of professional services contemplated under Rule 15502(7)(d)(i), Taxpayer also engaged in activities that are subject to retail sales tax, such as installation of computer hardware and software; virus/malware removal; installing computer software updates; repair, maintenance, and cleaning of both computer hardware and software; physical set up of work stations; packing of equipment for delivery; patching of phone lines; and testing of internet routers. RCW 82.04.050(2) and (6).

Because Taxpayer collected sales tax only on the tangible personal property portion of each sale, it failed to collect retail sales tax on the entire sale price, which is inclusive not only of the tangible personal property sold, but also of the other tangible personal property consumed in the activity and/or labor and services provided. RCW 82.04.050(2). Therefore, Taxpayer is liable for the uncollected sales tax. RCW 82.08.050(3).

2. *De minimis* Provisions

Activities that consist of sales of prewritten computer software for a single non-itemized price that includes a retail component, such as upgrades and updates of prewritten software, along with a professional service component, such as help desk services, . . . are properly classified as retail sales, unless the retail activities are *de minimis*. [RCW 82.08.190;] Rule 15002(7)(b)(ii). However, if charges are separately stated within a prewritten computer software maintenance agreement and invoice, then each activity is taxed according to the nature of the activity. *Id.*

Here, contrary to Taxpayer's assertion, the *de minimis* provisions of [RCW 82.08.190 and] Rule 15502(7)(d) do not apply to the Disputed Transactions, because those transactions are separately stated line items, showing the time and charge for each activity. *Id.* Therefore, the Disputed Transactions are not sales for a single non-itemized price, and the *de minimis* rule does not apply. Instead, because the charges for the professional service component(s) and the retail component(s) on the invoices were separately stated, each activity is taxed according to the nature of the activity. [RCW 82.08.190,] Rule 15502(7)(d).

3. Customization of software

The term “retail sale” does not include the sales of or charges made for “the customization of prewritten computer software.” RCW 82.04.050(6)(a)(i)-(ii); Rule 15502(7)(b). Gross income obtained from the customization of prewritten software is taxed under the service & other activities B&O tax classification under RCW 82.04.290(2) and 82.04.29001(2). *See also* Rule 15502(2)(a) & (7)(a)(iii); Det. No. 15-0034, 34 WTD 492 (2015).

“Customization of prewritten computer software” is any alteration, modification, or development of applications using or incorporating prewritten computer software for a specific person. [RCW 82.04.050(6);] Rule 15502(7)(a). Customization of prewritten computer software includes custom installations, but does not include routine installations. [RCW 82.04.050(6);] Rule 15502(7)(a)(v).⁵

Routine installation of prewritten computer software is treated as a retail sale that includes charges for labor and services in respect to the installation. Rule 15502(7)(b)(ii). “Routine installation” means the process of loading program files and installation files onto a computer, including the process of “clicking through” dialog boxes to install prewritten software, and does not require any specialized knowledge or skills. “Custom installation,” on the other hand, generally requires programming by a programmer to integrate customized elements of prewritten computer software. RCW 82.04.050(2); RCW 82.04.29001; Rule 15002(7)(a)(iv).

Customization of prewritten software is not considered a retail sale, and is taxable under the services and other activities B&O tax classification, so long as there is a reasonable separately stated charge on an invoice or other statement of the price given to the purchaser. RCW 82.04.29001; Rule 15502(7)(a)(iii).

Here, Taxpayer argues that most of its installations were not routine and involved customization of the prewritten software for each customer’s unique computer system or network. However, Taxpayer has not shown that it separately stated charges for customization of software, or that it separately stated charges for custom installations. Every person who is liable for any tax that the state of Washington imposes must keep and maintain, for five years, the kinds of complete and adequate records the Department needs to determine that person’s tax liability, RCW 82.32.070; WAC 458-20-254 (Rule 254), and must make records available to the Department that an “ordinary, prudent business person would keep, such as ‘general ledgers, sales journals, cash receipts journals, bank statements, check registers, and purchase journals, together with all bills, invoices, cash register tapes, and other records or documents of original entry supporting the books of account entries.’” [RCW 82.32.070;] Rule 254(3)(c); Det. No. 14-0106, 33 WTD 402 (2014). “The burden of maintaining proper records rests with the taxpayer.” Det. No. 01-193, 21 WTD 264 (2002).

The Audit Division’s July 22, 2014 email explained to Taxpayer that proof of custom installations and/or proof of services rendered to customize software could reduce its tax liability, and Taxpayer was given the opportunity to provide such proof. However, Taxpayer has not come forth with such proof.

⁵ Rule 15502(7) goes into much detail and gives guidance in regard to customized software and custom installations.

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In conclusion, because the Disputed Transactions consisted of retail sales under RCW 82.04.050 were separately stated on the invoices, and Taxpayer has not shown that any of the activities or sales were sales of customized software or custom installations, we conclude that Taxpayer has not shown that the Department erred when it reclassified the Disputed Transactions as retail sales of services. Because Taxpayer failed to collect sales tax due on the transactions, Taxpayer is liable for the uncollected sales tax. RCW 82.08.050(3). Accordingly, we deny the petition.

DECISION AND DISPOSITION

We deny the petition.

Dated this 17th day of November, 2015.