

Cite as Det. No. 18-0109, 38 WTD 189 (2019)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 18-0109
)	
...)	Registration No. . . .
)	

[1] RCW 82.04.050(8)(a); RCW 82.04.192(3)(b)(xiv); WAC 458-20-15503(303)(n): RETAIL SALE – DIGITAL AUTOMATED SERVICES – HOSTING – MERE STORAGE EXCLUSION. Software hosting and data hosting services are retail sales of digital automated services, and not excluded as the “mere storage” of software and data, where customers use the host’s servers to store and run their software and manipulate their data.

[2] RCW 82.04.050(8)(b): RETAIL SALE – SERVICES PROVIDED EXCLUSIVELY IN CONNECTION WITH DIGITAL AUTOMATED SERVICES. Help desk and other IT support services provided exclusively in connection with software hosting and data hosting digital automated services are included in the retail sale of digital automated services.

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.

Eckholm, T.R.O. – A provider of software and data hosting services, in conjunction with help desk and other information technology (IT) support services, protested an assessment of retail sales tax on its receipts from these services. The taxpayer asserted that the transaction meets the definition of a “bundled transaction,” [and] should be taxed as a non-retail service under statutory exclusions in RCW 82.08.190(4). The Department concludes that the software and data hosting services are retail digital automated services (DAS) under RCW 82.04.050(8)(a) and that the IT support services provided exclusively in connection with the software and data hosting DAS were included in the retail sale of DAS under RCW 82.04.050(8)(b). The Department denies the taxpayer’s petition.¹

ISSUES

1. Are software and data hosting services, where customers use the host’s servers to store and run their software and manipulate their data, digital automated services (DAS) under RCW

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

82.04.050(8)(a), or are they excluded as the “mere storage” of software and data under RCW 82.04.192(3)(b)(xiv) and WAC 458-20-15503(303)(n)?

2. Are help desk and other IT support services, provided exclusively in connection with software and data hosting DAS, included in the retail sale of DAS under RCW 82.04.050(8)(b)?

FINDINGS OF FACT

. . . was a Washington medical partnership practice that also provided software and data hosting and IT support services when doing business as . . . (the taxpayer). This review relates to the tax assessment on income from hosting and IT support services. A separate assessment related to its medical practice is not at issue. The taxpayer administratively dissolved on . . . 2015.²

The Department of Revenue (Department) Audit Division audited the taxpayer’s records for the period of January 1, 2011, through October 31, 2014 (audit period). The taxpayer reported its receipts from its services under the service and other activities business and occupation (B&O) tax classification. The Audit Division reclassified those receipts under the retailing B&O tax classification and assessed retail sales tax.³ The taxpayer disagreed with the tax liability related to its software and data hosting and IT support services, and sought review of the associated assessment in the amount of \$. . . , composed primarily of retail sales tax.⁴

The taxpayer operates a data center where it houses its servers and other equipment. The taxpayer’s servers store, host, and back-up software and data for its customers. The taxpayer explained that a portion of its servers is dedicated for use by each customer. The taxpayer stated that it does not sell or license software to its customers but that its services include installing a customer’s software and installing patches and upgrades to a customer’s software. The customers remotely access their data and operate their software through a private network connection. The taxpayer’s servers provide processing capacity and access memory that allow a customer to analyze and transform its own data, and manipulate and use its own software. The taxpayer also provides help desk and other professional IT support services, as well as installation, repair and maintenance of computer hardware. In exchange for these services, the taxpayer charges a non-itemized monthly fee ranging from \$. . . to \$

Agreement for Services

The taxpayer requires its customers to enter into a “Data Hosting and Support Services Agreement” (Agreement). The taxpayer provided a sample Agreement that it described as representative of its customer agreements except for the provision of two full time equivalent

² The taxpayer has numerous tax reporting accounts but reports all tax liabilities under tax registration number

³ The taxpayer asserted that the Audit Division did not ask for records or agreements and was unwilling to discuss the issues involved. The Audit Division responded that its email messages and communication log illustrate that it repeatedly requested records and information related to its data center and IT services, and the taxpayer never provided a number of records or information requested.

⁴ Document No. . . . included assessments of retail sales tax of \$. . . , retailing business and occupation (B&O) tax of \$. . . , a credit of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . and interest of \$. . . , for a total amount of \$

(FTE) employees dedicated to serving that customer. The Agreement refers to the customer in the Agreement as “Clinic” and describes the services the taxpayer agrees to provide, as follows:

2. Services. During the term of this Agreement, [the taxpayer] shall provide application support services in connection with Clinic’s license and use of the . . . suite, including all required equipment located at the Data Center, infrastructure, and personnel support required for such services (collectively, “Services”). . . .

Agreement, page 3.

[. . . (Software)] is software used by many health care organizations for electronic medical record and practice management.⁵ The taxpayer specializes in providing hosting and support services in connection with [Software]. The “Data Center,” referenced above, is the physical location where the taxpayer houses the “System.” Agreement, page 2. The Agreement defines the “System” as “the electronic information system described in this Agreement through which Clinic’s Protected Health Information may be hosted. . . .” *Id.* The taxpayer stated that the System is essentially its servers.

The Agreement continues to describe the Services, as follows:

The Services shall consist of those specific services described in Exhibit A hereto, which Exhibit is incorporated by reference. [The taxpayer] may also provide other services upon Clinic’s request, including those services listed in Exhibit A as additional services (collectively, “Additional Services”). In connection with the Services, [the taxpayer] shall make the System available 24 hours per day, seven days per week, 365 days per year, subject to the System Performance Standards set forth in Exhibit E. [The taxpayer] shall provide the technical support for resolution of issues related to the Services and System as set forth in Exhibit A.

Agreement, page 3. Exhibit A of the Agreement, details the scope of services the taxpayer agrees to provide to Clinic:

Information Technology Full Outsource Solution

Service Level: 2.0 FTE⁶

[The taxpayer] will provide Clinic with the full scope of IT services required to;

- Maintain a healthy server infrastructure
 - Pro-active system monitoring
 - Regular maintenance and application of system updates, backups and downtime prevention measures
 - Routinely work to optimize data center performance and security
- Provide responsive helpdesk and on-site support

⁵ See . . . (last visited April 18, 2018).

⁶ The footnote in original regarding customer-specific FTE (full time equivalent) staff services is not included in this excerpt.

- Full software and hardware [desktop / laptop / tablet / thin] client support / break-fix
- Access to our helpdesk ticketing system
- 30 min response during production hours 7:30-5:30 / 60 mins during after-hours
- F/T Technicians stationed within greater [town] area
- Provide IT Leadership
 - Guidance for: Future technologies and updates, IT strategies, and ROI opportunities
 - communicated via regularly scheduled meetings
- Provide project management
 - Clinic and [the taxpayer] will agree on scope, complexity and time line of projects. Projects will be billed [the taxpayer's] usual and customary amount for additional services. Project updates to be given across the length of the project including any situation that would cause the project time line to change.
- Advise Regarding IT purchasing
- Exceptions
 - [Software] application support, workflows, customizations and processes shall be maintained by the clinic in house [Software] system managers⁷
 - [The taxpayer] has the capacity and desire to provide this support at an additional hourly rate.
 - Anomalous / Complex Microsoft Support Cases
 - Technical support from the above vendors is not free. In very rare cases it's required to open a trouble ticket with a potential cost of up \$. . . / incident. Any such technical support expense will be passed through to Clinic at cost.
 - Home Network Issues
 - This agreement does not guarantee support for Clinic user home or other offsite network connections, including; hotel, Wi-Fi hot spots and cellular broadband.
 - A reasonable effort will always be made to assist the end-user.

Agreement, Exhibit A.⁸

The Agreement also provides that the taxpayer must maintain the security of the Data Center and the System. *See* Agreement, pages 8-9, paragraph 10, "Security Obligations." The taxpayer agrees to make the System available for use by Clinic's end user 24/7 every day of the year, subject to the "System Performance Standards" described in Exhibit E of the Agreement, which include the following:

Availability Level. [The taxpayer] will make the System available at least 99.8% of the time this Agreement is in effect. This availability refers to an access point on [the

⁷ The taxpayer explained at the hearing that these Clinic responsibilities are reflected in the provision in Exhibit B to the Agreement requiring Clinic to "provide a qualified super user capable of managing Tier 1 application issues within [Software]."

⁸ The text and format of Exhibit A is produced as it appears in the original except for omission of the original footnote identified in footnote 6 and added bracketed terms "[the taxpayer]" and "[Software]". Term "[desktop / laptop / tablet / thin]" bracketed in original.

taxpayer's] provider's backbone network (. . .).⁹ It does not apply to the portion of the circuit that does not transit the hosting provider's (i.e. [the taxpayer's]) backbone (. . . etc.). Clinic is responsible for its own connectivity and Internet access. For purposes of the Uptime Service Level, the System is considered to have "System Unavailability" when the System is unavailable for use by Clinic's end users. . . .

Exhibit B of the Agreement requires Clinic to "provide a qualified super user capable of managing Tier 1 application issues within [Software]." The Agreement defines three tiers of support:

Tier 1 (T1) – basic support / onsite: changing passwords, adding users, basic break-fix etc.

. . .

Tier 2 (T2) – intermediate support: call escalation – system not functioning as it is designed, i.e. can't open charts, system errors, etc. . . .

Tier 3 (T3) – Advanced concepts: back-end database support, terminal server – CCC form configurations, system performance tuning, MS OS, Print servers, Terminal services, WAN and 3rd party VPN connections, Redundant systems, backups/restores, etc. . . .

Agreement, Exhibit A (ellipses in original).

The taxpayer designates its installation of software and software updates, and maintenance/repair of computer hardware as retail IT support services and the rest of its IT support services as "non-retail." The taxpayer indicated that it does not offer its non-retail support services separate from its retail services and that it offers its non-retail services exclusively in connection with its retail services, as represented by the Agreement.

Reliability of Trouble Ticket Log

The taxpayer provided a log of the sample Agreement customer's helpdesk service requests, or "trouble tickets," for a five-month period between March 1, 2013, and July 29, 2013 (Log). The taxpayer indicated that the two dedicated technicians (the two FTE employees) under this customer's agreement were on-call to respond to trouble ticket requests for roughly 1600 hours during this period. The Log includes 176 entries. The taxpayer indicated that each entry includes an amount of time the taxpayer spent on the trouble ticket and that total time indicated on the Log for the 176 entries is approximately 146 hours. The taxpayer highlighted 43 of the Log entries that it asserts involved retailing activities, such as installing prewritten software (including patches or updates), repair and maintenance of computer hardware, and upgrading RAM. The taxpayer indicated that the total amount of time for the 43 highlighted Log entries is approximately 37.5 hours. The taxpayer asserts that for the remaining 1562.5 hours, the technicians were engaged in non-retail services, such as monitoring network systems, maintaining vendor relationships, planning new projects or making themselves available as standby support.¹⁰ The taxpayer did not

⁹ A "backbone" is "a part of computer network that interconnects various pieces of network, providing a path for the exchange of information between different LANs or subnetworks. A backbone can tie together diverse networks in the same building, in different buildings in a campus environment, or over wide areas. Normally, the backbone's capacity is greater than the networks connected to it." https://en.wikipedia.org/wiki/Backbone_network (last viewed November 21, 2017).

¹⁰ We note that the taxpayer provides these characterizations of retail versus non-retail services. Some of these "non-retail" services may actually be retail services

provide any evidence supporting the taxpayer's activities during the 1562.5 hours it asserts were spent on non-retail activities. The taxpayer indicated that the Log contains only the trouble tickets and does not include the other services that the taxpayer provided under the Agreement.

....

ANALYSIS

Washington imposes retail sales tax on each retail sale in this state and retailing business and occupation (B&O) tax on gross proceeds of sales. RCW 82.04.250; RCW 82.08.020. The retail sales tax is "to be collected by the seller" and is "deemed to be held in trust by the seller until paid to the [D]epartment." RCW 82.08.050(2). If a seller fails to collect the retail sales tax as required, the seller is "personally liable to the state for the amount of the tax." RCW 82.08.050(3).

1. Software and data hosting.

The term "retail sale" encompasses sales and services, including the "installing, repairing, cleaning, altering, imprinting, or improving tangible personal property of or for consumers. . . ." RCW 82.040.050(2)(a). Therefore, the term "retail sale" includes [the routine] installing or uninstalling [of prewritten] computer software, including software upgrades and updates. *Id.* See WAC 458-20-15502(7)(b).

Sales of digital automated services (DAS) to consumers are also retail sales, as provided in RCW 82.04.050(8)(a).¹¹ DAS means "any service transferred electronically that uses one or more software applications." RCW 82.04.192(3)(a). "Transferred electronically" means: "obtained by the purchaser by means other than tangible storage media. It is not necessary that a copy of the product be physically transferred to the purchaser. So long as the purchaser may access the product, it will be considered to have been electronically transferred to the purchaser." RCW 82.04.192(8). See WAC 458-20-15503. The Department's administrative rule governing the taxation of digital products . . . clarifies the meaning of "transferred electronically:"

Generally, this means the product is transferred using the public internet, a private network, or some combination. However, it is not necessary that the product be delivered to the purchaser. As long as the purchaser may access the product, it will be considered to have been electronically transferred to the purchaser. . . .

WAC 458-20-15503(102).

The taxpayer provides its customers a package of services it describes as an "Information Technology Full Outsource Solution." See Agreement, Exhibit A. The services described in the

¹¹ RCW 82.04.050(8)(a) provides that "sale at retail" or "retail sale" includes:

- . . . the following sales to consumers of digital goods, digital codes, and digital automated services:
- (i) Sales in which the seller has granted the purchaser the right of permanent use;
 - (ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent;
 - (iii) Sales in which the purchaser is not obligated to make continued payment as a condition of the sale; and
 - (iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sale.

Agreement center on the taxpayer providing its customers remote access to its servers via the Internet and private network connections, using one or more software applications. The taxpayer's customers store their software and data on the taxpayer's servers, and use the servers' processing capacity and access memory to run their software. The purpose of the software and data hosting services is to allow customers this use of their stored software, including the ability to analyze, transform, and manipulate the data associated with the software stored through this service. The taxpayer's software and data hosting services are DAS subject to retailing B&O tax and retail sales tax. *See* RCW 82.04.050(8)(a); RCW 82.04.192(3)(a).

However, mere storage of digital products and computer software, which includes providing space on a server for web hosting or backing-up data or other information, is excluded from the definition of DAS. RCW 82.04.192(3)(b)(xiv); WAC 458-20-15503(303)(n). Here, the taxpayer is providing more than "mere" data and software storage. As stated above, the taxpayer's software and data hosting services provide CPU capacity and random access memory that enables its customers to run their stored software. Under these circumstances, these services would not qualify for the exclusion under RCW 82.04.192(3)(b)(xiv) and WAC 458-20-15503(303)(n), and constitute DAS under RCW 82.04.192(3).

2. Services provided exclusively in connection with software and data hosting DAS.

A retail sale of DAS includes "any services provided by the seller exclusively in connection with the . . . digital automated services, whether or not a separate charge is made for such services." RCW 82.04.050(8)(b).

The sale of professional services, such as the taxpayer's telephone consulting, help desk services, remote diagnostic services, and other professional services, are generally taxable under the service and other activities B&O tax classification. *See* RCW 82.04.190(2); WAC 458-20-15502(7)(d)(i). Because the taxpayer provides these professional IT services exclusively in connection with its software and data hosting DAS, the services under the Agreement are retail sales under RCW 82.04.050(8)(b). *See* Det. No. 11-0001, 32 WTD 93 (2013) (holding that data processing services, otherwise subject to service and other activities B&O tax, were retail services and subject to use tax under RCW 82.12.020(1)(e)(i) because they were provided exclusively in connection with online property management DAS).

The taxpayer argues that the transaction under the Agreement should be subject to the "bundled transaction" statutes, RCW 82.08.190 and RCW 82.08.195. In general, a bundled transaction is a retail sale of two or more distinct and identifiable products for one non-itemized price, and is taxed as a retail transaction. *See* RCW 82.08.190(1)(a); RCW 82.08.195(1). The taxpayer claims that the transaction meets this definition but is taxed as a non-retail transaction under two exclusions: (1) the retail services are essential to the non-retail services, provided exclusively in connection with the non-retail services, and the non-retail services are the true object of the transaction under RCW 82.08.190(4)(b); and (2) the retail services component of the Agreement is de minimis compared with the non-retail component and taxed as a non-retail service under RCW 82.08.190(4)(c).

The Department recently published Det. No. 15-0328R, 36 WTD 538 (2017), involving facts [very similar] to the facts presented in this review, including a similar agreement and trouble log. In 36 WTD 538, the Department assessed the customer use tax on the monthly payments it made under its agreement because the customer did not pay retail sales tax at the time it made the payments to the IT services vendor. . . . The customer in 36 WTD 538 sought review of the assessment and asserted the same arguments as the taxpayer [does here]. The Department held in 36 WTD 538 that the services agreement constituted a bundled transaction taxable at retail under RCW 82.08.195(1) and the customer failed to establish it qualified for either exclusion under RCW 82.08.190(4)(b) and (c). 36 WTD at 546.

In both cases, the service agreements included similar IT support services but there is a significant difference: In 36 WTD 538, the vendor provided IT support services for a customer that owned its own servers and the vendor did not provide hosting services. In this case, the taxpayer owns the servers and provides IT support services exclusively in connection with its software and data hosting services. Because the vendor in 36 WTD 538 did not provide software and data hosting services like the taxpayer in this case, the services provided under that agreement did not constitute DAS under RCW 82.04.050(8)(b); therefore, the Department applied the bundled transaction analysis. Here, the entire transaction is treated as a retail DAS transaction under RCW 82.04.050(8)(b), as set forth above; therefore, there is no bundled transaction.

. . .

The taxpayer's receipts from its services provided under the Agreement are taxed at retail. The Department denies the taxpayer's petition.

DECISION AND DISPOSITION

The taxpayer's petition is denied

Dated this 23rd day of April 2018.