12-2574
TAX TYPE: SALES & USE TAX
TAX YEAR: 04-01-08 – 02-28-11
DATE SIGNED: 7-28-2014
COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO
EXCUSED: D. DIXON

BEFORE THE UTAH STATE TAX COMMISSION

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| TAXPAYER,<br>Petitioner,<br><br>v.<br><br>TAXPAYER SERVICES DIVISION OF THE UTAH STATE TAX COMMISSION,<br><br>Respondent. | **INITIAL HEARING ORDER**<br><br>Appeal No. 12-2574<br><br>Account No. #####<br>Tax Type: Sales & Use<br>Tax Period: 04/01/08 - 02/28/11<br><br>Judge: Chapman |

**Presiding:**
Kerry R. Chapman, Administrative Law Judge

**Appearances:**
For Petitioner: REPRESENTATIVE-1 FOR TAXPAYER, Representative (by telephone)
REPRESENTATIVE-2 FOR TAXPAYER, Representative (by telephone)
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General
RESPONDENT, from Taxpayer Services Division

## STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on December 11, 2013.

On May 26, 2011, TAXPAYER ("TAXPAYER" or "taxpayer") submitted a refund request to Taxpayer Services Division ("Division"), in which it requested a refund of both sales tax it had paid to sellers and use tax that it had self-accrued. The refund request was for the period April 1, 2008 through February 28, 2011. Only that portion of the claim concerning self-accrued use tax is at issue in this appeal.[1] The amount of

1 The refund claim also included a request for a refund of $$$$$ of sales tax that the taxpayer paid to sellers. For this portion of the claim, the Division issued a Dismissal Notice, which the taxpayer appealed. The dismissal of this portion of the refund claim was designated as *USTC Appeal No. 12-2315* and is not at issue in the instant case.

the taxpayer's refund claim for self-accrued use tax was $$$$$.

On September 27, 2012, the Division issued a Statutory Notice ("Notice") in which it considered the taxpayer's refund claim for $$$$$ of use tax that it had self-accrued for the period April 1, 2008 through February 28, 2011.[2] In the Notice, the Division informed the taxpayer that it was denying a portion of the use tax claim, specifically denying $$$$$ of the $$$$$ claim. Thus, the Division agreed to refund the remaining portion of the claim, which amounted to $$$$$ of self-accrued use tax.

Of the $$$$$ amount that the Division denied, the taxpayer stated at the hearing that it has decided to withdraw its refund claim for $$$$$ of this amount. Remaining at issue is approximately $$$$$ of use tax the taxpayer self-accrued on transactions that it claims to be either nontaxable or exempt from taxation. The taxpayer has segregated the transactions remaining at issue into the following categories or transactions:

1) Exemption - Manufacturing Replacement Parts. The taxpayer self-accrued use tax on purchases of replacement parts that it uses in the manufacturing process at its manufacturing facility in CITY, Utah. The taxpayer manufactures (X) that are used in the aerospace industry and sells these (X) to customers that incorporate them into aircraft and military vehicles. The taxpayer admitted that these transactions concern items that have a useful life of less than three years and recognizes that the exemption only applies to items with an economic life of three or more years. However, the taxpayer asks the Commission to consider that one of the Division's former employees, NAME, had verbally informed the taxpayer some years ago that the law requiring replacement parts to have an economic life of three or more years might be changing to eliminate this

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2 The Statutory Notice indicates that the refund period at issue is April 1, 2008 through June 31, 2010 (even though June only has 30 days). However, at the hearing, both parties agree that the taxpayer's refund request was for the period April 1, 2008 through February 28, 2011 and that the Division's Statutory Notice denied refunds for transactions that occurred after the June 2010 date referenced in the notice. (The last transaction still at issue occurred in August 2010). Accordingly, the refund period at issue in this appeal is considered to be April 1, 2008 through February 28, 2011.

requirement. The taxpayer did not provide any further information about the replacement parts at issue. The use tax associated with these transactions totals approximately $$$$$.

The Division contends that Utah law limits the manufacturing exemption to items that have an economic life of three or more years. Because the taxpayer admits that the replacement parts for which it seeks a refund do not have an economic life or three or more years, the Division contends that the taxpayer properly self-accrued use tax on these items.

2) <u>Nontaxable Service – Bundled Software Maintenance Charge</u>. The taxpayer stated it self-accrued $$$$$ of use tax on $$$$$ of "bundled" charges for software maintenance that included both taxable software upgrades and nontaxable maintenance services. As a result, the taxpayer contends that this transaction is partially nontaxable. The taxpayer admitted that it could not identify which portion of this transaction was subject to taxation and which portion was exempt. However, it believes that it would be appropriate to refund at least a portion of the $$$$$ of tax it accrued on this invoice item.

The Division asserts that Utah law provides that a bundled transaction that includes items and/or services that are both taxable and nontaxable is fully subject to taxation when the nontaxable portion of the transaction cannot be identified. Because the taxpayer has not provided information to show what portion of the bundled transaction is nontaxable, the Division contends that the taxpayer properly self-accrued use tax on the entire charge.

3) <u>Nontaxable Service – Engineering Services</u>. The taxpayer claims that it improperly self-accrued use tax on a transaction described on the invoice as "professional engineering services." The taxpayer proffered that it self-accrued $$$$$ of use tax on this $$$$$ charge. The taxpayer stated that the entire charge for "professional engineering services" clearly relates to nontaxable services because of its invoice description refers to engineering services. As a result, it claims that the $$$$$ of use tax it paid on this charge should be fully refunded.

The Division claims, however, that the taxpayer did not provide sufficient information about these services for the Commission to determine whether or not they were taxable. As a result, the Division claims that the taxpayer has not met its burden of proof to show that the transaction is not subject to taxation and asks the Commission to deny the refund claim for this transaction

4) Nontaxable Service – COMPANY-1 Transactions. The taxpayer stated that it self-accrued approximately $$$$$ of use tax on four transactions with COMPANY-1 for software maintenance. The taxpayer asserted that these transactions were all bundled transactions that included both taxable items or services and nontaxable items or services. As a result, the taxpayer contends that these transactions are partially nontaxable. The taxpayer admitted that it could not identify which portions of the transactions were subject to taxation and which ones were not. However, it believes that it should get some relief from the approximately $$$$$ of use tax that it accrued on these transactions.

The Division again asserts that Utah law provides that a bundled transaction that includes both taxable and nontaxable items or services is fully subject to taxation when the nontaxable portion of the transaction cannot be identified. Because the taxpayer has not provided information to show what portions of these bundled transactions are nontaxable, the Division contends that the taxpayer properly self-accrued use tax on the entirety of these charges.

5) Nontaxable Services - COMPANY-2. The taxpayer stated that it self-accrued $$$$$ of use tax on a transaction for $$$$$ to acquire the right to access an on-line database provided by COMPANY-2. The taxpayer contends that these taxes should be refunded because charges to access an on-line database are nontaxable. The taxpayer stated that it uses the on-line database to access and retrieve specifications for specific parts. The taxpayer stated that it did not download any software.

The only copy of an invoice proffered by either party was this COMPANY-2 invoice. On this invoice, the item or items that the taxpayer purchased for $$$$$ on September 2, 2009, were described as follows:

(INVOICE REMOVED)

The taxpayer explained the "BOLD" portion of the description stands for "COMPANY-2 on-line data." The taxpayer claims that a transaction for the use of a database is not subject to Utah taxation and asks the Commission to find that it is entitled to a refund of the $$$$$ of use tax it self-accrued on this transaction.

The Division asserts that the use of an on-line database is subject to Utah taxation, if the user is located in Utah. As a result, it asks the Commission to find that the taxpayer properly accrued use tax on the COMPANY-2 transaction.

APPLICABLE LAW

1. Utah Code Ann. §59-12-103 (2010)[3] provides that the following transactions are subject to Utah sales and use tax, as follows in pertinent part:

> (1) A tax is imposed on the purchaser as provided in this part for amounts paid or charged for the following transactions:
> (a) retail sales of tangible personal property made within the state;
> (b)[4] amounts paid for:
> (i) telecommunications service, other than mobile telecommunications service, that originates and terminates within the boundaries of this state;
> (ii) mobile telecommunications service that originates and terminates within the boundaries of one state only to the extent permitted by the Mobile Telecommunications Sourcing Act, 4 U.S.C. Sec. 116 et seq.; or
> (iii) an ancillary service associated with a:
> (A) telecommunications service described in Subsection (1)(b)(i); or
> (B) mobile telecommunications service described in Subsection (1)(b)(ii);
> . . . .
> (k) amounts paid or charged for leases or rentals of tangible personal property if within this state the tangible personal property is:
> (i) stored;
> (ii) used; or
> (iii) otherwise consumed;
> (l) amounts paid or charged for tangible personal property if within this state the tangible personal property is:
> (i) stored;

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3 All cites are to the 2010 version of Utah law, unless otherwise indicated.

4 Subsection (1)(b), as cited, was not in effect for the first portion of the tax period at issue. This subsection went into effect on January 1, 2009. The COMPANY-2 transaction, which occurred after January 1, 2009, is the only contested transaction that could be affected by the cited version of the subsection.

(ii) used; or
(iii) otherwise consumed; and
(m)[5] amounts paid or charged for a sale:
(i) (A) of a product that:
(I) is transferred electronically; and
(II) would be subject to a tax under this chapter if the product was transferred in a manner other than electronically; or
. . . .
(ii) regardless of whether the sale provides:
(A) a right of permanent use of the product; or
(B) a right to use the product that is less than a permanent use, including a right:
(I) for a definite or specified length of time; and
(II) that terminates upon the occurrence of a condition.
(2) . . . .
(d) . . . .
(ii)[6] Subject to Subsection (2)(d)(iii), for a bundled transaction other than a bundled transaction described in Subsection (2)(d)(i):
(A) if the sales price of the bundled transaction is attributable to tangible personal property, a product, or a service that is subject to taxation under this chapter and tangible personal property, a product, or service that is not subject to taxation under this chapter, the entire bundled transaction is subject to taxation under this chapter unless:
(I) the seller is able to identify by reasonable and verifiable standards the tangible personal property, product, or service that is not subject to taxation under this chapter from the books and records the seller keeps in the seller's regular course of business; or
(II) state or federal law provides otherwise; or
. . . .
(iii) For purposes of Subsection (2)(d)(ii), books and records that a seller keeps in the seller's regular course of business includes books and records the seller keeps in the regular course of business for nontax purposes.
. . . .

2. Beginning January 1, 2009,[7] UCA §59-12-102(116)(c)(iv) provides that a "telecommunications service" does not include "data processing and information services," as follows:

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5 Subsection (1)(m), as cited, was also not in effect for the first portion of the refund period. It, too, became effective on January 1, 2009. Effective July 1, 2011 (after the refund period), the Legislature amended subjection (1)(m) and enacted a new definition of "product transferred electronically" now found in Section 59-12-102(94) (2013).

6 Subsequent to the refund period, subsection (2)(d)(ii) concerning bundled transactions has been renumbered.

7 This definition also did not come into effect until January 1, 2009, when UCA §59-12-103(1)(b) was also amended. Again, however, the only transaction that could be affected by the new definition is the

(c) "Telecommunications service" does not include:
. . . .
(iv) a data processing and information service if:
(A) the data processing and information service allows data to be:
(I) (Aa) acquired;
(Bb) generated;
(Cc) processed;
(Dd) retrieved; or
(Ee) stored; and
(II) delivered by an electronic transmission to a purchaser; and
(B) the purchaser's primary purpose for the underlying transaction is the processed data or information;

3. Utah Admin. Rule R865-19S-92 ("Rule 92")[8] provides guidance concerning the taxability of computer software and other related transactions, as follows:

> (1) "Computer-generated output" means the microfiche, microfilm, paper, discs, tapes, molds, or other tangible personal property generated by a computer.
> (2) The sale, rental or lease of custom computer software constitutes a sale of personal services and is exempt from the sales or use tax, regardless of the form in which the software is purchased or transferred. Charges for services such as software maintenance, consultation in connection with a sale or lease, enhancements, or upgrading of custom software are not taxable.
> (3) The sale of computer generated output is subject to the sales or use tax if the primary object of the sale is the output and not the services rendered in producing the output.

4. Utah law provides for a number of sales and use exemptions in Section 59-12-104. Section 59-12-104(14) provides, as follows in pertinent part:[9]

(14) (a) . . . . amounts paid or charged on or after July 1, 2006, for a purchase or lease by a

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COMPANY-2 transaction, which occurred after January 1, 2009.

8 Rule 92 was renumbered when it was amended effective January 1, 2009 to remove what had previously been subsection (B), which provided that "[t]he sale, rental or lease of prewritten computer software constitutes a sale of tangible personal property and is subject to the sales or use tax regardless of the form in which the software is purchased or transferred." This portion of Rule 92 was deleted when the Legislature added the cited version of Section 59-12-103(1)(m) in 2009.

A subsection (4) was added to the rule effective June 23, 2011 (after the refund period at issue). This portion of the rule, which addresses the location of a transaction involving the use of computer software, was not in effect for the refund period at issue in this appeal.

9 The cited version of Section 59-12-104(14) became effective in 2009. However, the prior version which was in effect for the first portion of the refund period also requires machinery or equipment and normal operating repair or replacement parts to have an economic life of three or more years in order to qualify for the exemption.

manufacturing facility . . . , of the following:
(i) machinery and equipment that:
(A) are used:
(I) for a manufacturing facility except for a manufacturing facility that is a scrap recycler described in Subsection 59-12-102(55)(b):
(Aa) in the manufacturing process;
(Bb) to manufacture an item sold as tangible personal property; and
(Cc) beginning on July 1, 2009, in a manufacturing facility described in this Subsection (14)(a)(i)(A)(I) in the state; or
(II) . . . ; and
(B) have an economic life of three or more years; and
(ii) normal operating repair or replacement parts that:
(A) have an economic life of three or more years; and
(B) are used:
(I) for a manufacturing facility in the state except for a manufacturing facility that is a scrap recycler described in Subsection 59-12-102(55)(b);
(Aa) in the manufacturing process; and
(Bb) in a manufacturing facility described in this Subsection (14)(a)(ii)(B)(I) in the state; or
. . . .

5. UCA §59-1-1417 (2013) provides that the burden of proof is generally upon the petitioner in proceedings before the Commission and guidance on how statutes are to be construed, as follows:

(1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
(a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
(b) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
(c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
(i) required to be reported; and
(ii) of which the commission has no notice at the time the commission mails the notice of deficiency.
(2) Regardless of whether a taxpayer has paid or remitted a tax, fee, or charge, the commission or a court considering a case involving the tax, fee, or charge shall:
(a) construe a statute imposing the tax, fee, or charge strictly in favor of the taxpayer; and
(b) construe a statute providing an exemption from or credit against the tax, fee, or charge strictly against the taxpayer.

## DISCUSSION

The Commission will address each of the categories of transactions and/or individual transactions the taxpayer is still contesting.

1) Exemption - Manufacturing Replacement Parts. The taxpayer asks the Commission to refund use tax it accrued on replacement parts that it claims to use in the manufacturing process at its manufacturing facility. The refund claim for these transactions should be denied. First, the taxpayer admits that none of these items has a useful life of three or more years. Sections 59-12-104(14)(a)(i)(B) and 104(a)(ii)(A) provide that the exemption is available only for machinery and equipment and normal operating repair or replacement parts that have an economic life of three or more year. Because the replacement parts at issue have an economic life of less than three years, they do not qualify for the exemption. Second, even if these items were not disqualified on the basis of economic life, the taxpayer has provided no information about the items to show that they are actually used in the manufacturing process. For these reasons, this portion of the taxpayer's refund claim should be denied.

2) Nontaxable Service – Bundled Software Maintenance Charge. The taxpayer indicated that it self-accrued $$$$$ of use tax on $$$$$ of "bundled" charges for software maintenance that included both taxable software upgrades and nontaxable maintenance services. Because a portion of the bundled transaction is nontaxable, the taxpayer believes that it would be appropriate to refund at least a portion of the $$$$$ of tax. This refund request should also be denied.

First, Section 59-12-103(2)(d)(ii)(A) provides that the entire bundled transaction is subject to transaction unless the taxpayer is able to identify the portion of the transaction that is not subject to taxation. The taxpayer admitted that it could not identify which portions of the transaction were subject to taxation and which ones were not subject to taxation. Accordingly, the entire bundled transaction is subject to taxation. Second, even if the taxpayer had been able to segregate the transaction into separate parts, no information was provided to show that the services it determined to be nontaxable were actually nontaxable. For these reasons, the Commission should find that no refund is warranted on this transaction.

3) Nontaxable Service – Engineering Services. The taxpayer claims that $$$$$ of use tax it self-accrued on a $$$$$ charge for "professional engineering services" should be refunded because such services are clearly nontaxable. Based on the limited information provided at the Initial Hearing, this portion of the refund claim should also be denied.

The taxpayer stated that the invoice description of "professional engineering services" clearly shows that this transaction is for nontaxable services. However, the services appear to be related to software because the transaction was on the same invoice as the transaction for the bundled software maintenance charge discussed in the prior section. Many transactions involving software are subject to taxation, while others are not. A description on an invoice is often insufficient to show whether the transaction is one that is taxable or nontaxable, especially when the transaction concerns software services. The Commission has noted in *Private Letter Ruling 10-012* (December 7, 2012) ("*PLR 10-012*")[10] that a seller's "reference to the term 'services' may not actually characterize the nature of the products or transactions. For our analysis, we consider each item's overall characteristics when determining whether the item is a non-taxable service or a taxable sale of either tangible personal property or another taxable item."

The taxpayer has the burden of proof in this matter. The taxpayer did not meet this burden because it provided no information about the overall characteristics of these engineering services so that the Commission can determine whether they are taxable or nontaxable. For these reasons, this portion of the taxpayer's refund claim should also be denied.

10 Redacted versions of certain private letter rulings that the Commission has issued can be reviewed at http://www.tax.utah.gov/commission-office/rulings.

4) Nontaxable Service – COMPANY-1 Transactions. The taxpayer indicated that on four transactions with COMPANY-1, it self-accrued approximately $$$$$ of use tax on "bundled" charges for software maintenance that included both taxable items or services and nontaxable maintenance services. Because a portion of the bundled transactions are nontaxable, the taxpayer believes that it would be appropriate to refund at least a portion of the tax it self-accrued. This refund request should also be denied.

Again, as discussed in Section 2) above, Section 59-12-103(2)(d)(ii)(A) provides that the entire bundled transaction is subject to taxation unless the taxpayer is able to identify the portion of the transaction that is not subject to taxation. The taxpayer admitted that it could not identify which portions of the transactions were subject to taxation and which ones were not subject to taxation. Accordingly, the entirety of each of the four bundled transactions at issue is subject to taxation. Again, even if the taxpayer had been able to segregate the transactions into separate parts, no information was provided to show that a portion of any of the transactions was not subject to taxation. For these reasons, the Commission should find that no refund is warranted for any of these transactions.

5) Nontaxable Services - COMPANY-2. The taxpayer stated that it self-accrued $$$$$ of use tax on a transaction for $$$$$ to acquire the right to access an on-line database provided by COMPANY-2. The taxpayer stated that it uses the on-line database to access and retrieve specifications for specific COMPANY-2 parts. The taxpayer stated that it did not download any software.

Although the Division argued that transactions to access on-line databases are taxable, the Commission has found otherwise. In *PLR 10-012*, the Commission responded to a seller who asked if its "services" to provide customers access to its database was subject to taxation. In this ruling, the Commission considered the subscription fees that the seller charged a customer to access the seller's database, to run searches on it, and to create reports from it and found that the primary object of the transaction was the use of the database. The Commission also found that the use of the database was not taxable, in part, because "telecommunications service," as defined in Section 59-12-102(116)(c)(iv), does not include a data processing and information service if the service allows data to be acquired, generated, processed, retrieved, or stored and to be delivered by electronic transmission to a purchaser, if the primary purpose for the underlying transaction is the processed data or information. The Commission also based its ruling on the fact that no provision in Section 59-12-103 specifically listed data processing and information services as a taxable service.

Nevertheless, in the same ruling, the Commission determined that the primary object of another of the same seller's "services" was for taxable tangible personal property, not for nontaxable services. Again, the Commission has found that a seller's "reference to the term "services" may not actually characterize the nature of the products or transactions. When the COMPANY-2 invoice at issue is analyzed, the transaction's description is not clearly for a subscription fee to access and use a database. Instead, the transaction appears to relate to a manual and to concern charges for revisions to all copies of the manual for a one-year period. If the taxpayer has purchased one or more copies of a manual from COMPANY-2, this transaction may relate to acquiring revisions to these manuals. The taxpayer stated that it does not download software from COMPANY-2, but it is unknown if the taxpayer downloads any or all portions of these manual revisions. If it does, the transaction may be taxable under Section 59-12-103(1)(m), which provides that amounts charged for a product that is transferred electronically is subject to taxation, if the product were taxable if transferred in a manner other than electronically. Purchasing "hard" copies of a manual or revisions to a manual would be subject to taxation under Section 59-12-103(1)(a). For these reasons, the taxpayer has provided insufficient information to determine whether the taxpayer's transaction with COMPANY-2 is taxable or nontaxable. Because the taxpayer has the burden of proof, the Commission should not refund this portion of the taxpayer's claim.

**Conclusion**. The taxpayer has not met its burden to show that any of the transactions remaining at issue are nontaxable. Accordingly, the Commission should deny the taxpayer's appeal and sustain the

Division's decision to deny $$$$$ of the taxpayer's refund request concerning self-accrued use tax.

____________________________________
Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission denies the taxpayer's appeal in its entirety. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this ________ day of ________________________, 2014.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner