18-95
TAX TYPE: SALES & USE TAX
TAX YEAR: 7/1/2015 to 3/31/2017
DATE SIGNED: 08/19/2019
COMMISSIONERS: J. VALENTINE, R. ROCKWELL, L. WALTERS
EXCUSED: M. CRAGUN

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 18-95 Account No. ##### Tax Type: Sales & Use Tax Audit Period: 7/1/2015 to 3/31/2017 Judge: Phan

Presiding:
Jane Phan, Administrative Law Judge

Appearances:

For Petitioner:	REPRESENTATIVE FOR TAXPAYER-1, Manager State & Local Tax REPRESENTATIVE FOR TAXPAYER-2
For Respondent:	REPRESENTATIVE FOR RESPONDENT-1, Assistant Attorney General REPRESENTATIVE FOR RESPONDENT-2, Tax Audit Manager, Auditing Division REPRESENTATIVE FOR RESPONDENT-3, Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on March 28, 2019 for an Initial Hearing in accordance with Utah Code §59-1-502.5. The matter before the Commission is Petitioner's ("Taxpayer's") appeal filed pursuant to Utah Code §59-1-1410(9) of the decision made by Respondent ("Division") to deny a portion of the sales and use tax refund request submitted by the Taxpayer for the period of July 1, 2015 to March 31, 2017. The Division's original Statutory Notice denying the refund request had been issued on December 15, 2017. The Division had denied the entire amount of the refund requested by the Taxpayer, which had been $$$$$ in tax. Later, the Division audited the request and as a result of the audit and the exchange

of further information, the Division allowed $$$$$ of the request. At issue at the hearing was the $$$$$ of the request that continued to be denied by the Division.

APPLICABLE LAW

The Tax Commission applies the substantive law in effect during the audit refund period, which was July 1, 2015 through March 31, 2017. The parties did not point to any change of law during this period that would affect this appeal, although some provisions have been renumbered. This decision refers to the 2017 provisions of the law.

Sales and use tax is imposed at Utah Code Subsection 59-12-103(1) (2017) in relevant part:

> A tax is imposed on the purchaser as provided in this part on the purchase price or sales price for amounts paid or charged for the following transactions: (a) retail sales of tangible personal property made within the state . . .

For purposes of the above provision, "retail sale" is defined at Utah Code Subsection 59-12-102(109) (2017) as:

> "Retail sale" or "sale at retail" means a sale, lease, or rental for a purpose other than: (a) resale; . . .

"Sale" is defined at Utah Code Subsection 59-12-102(110) (2017) as:

> (a) "Sale" means any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property or any other taxable transaction under Subsection 59-12-103(1), for consideration.
> (b) "Sale" includes:
> (i) installment and credit sales;
> (ii) any closed transaction constituting a sale;
> (iii) any sale of electrical energy, gas, service, or entertainment taxable under this chapter;
> (iv) any transaction if the possession of property is transferred but the seller retains the title as security for the payment of the price; and
> (v) any transaction under which right to possession, operation or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made.

Utah Code §59-12-104 (2017) provides a number of exemptions from sales and use taxes, including an exemption for property purchased for resale as follows:

> Exemptions from the taxes imposed by this chapter are as follows:
> . . .
> (25) a product purchased for resale in this state, in the regular course of business, either in it its original form or as an ingredient or component part of a manufactured or compounded product.

For purposes of appeal proceedings regarding actions by the Utah State Tax Commission, Utah Code §59-1-1417 provides for the burden of proof and for statutory construction as follows:

> (1) In a proceeding before the commission, the burden of proof is on the petitioner . . .
>
> (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 Taxpayer is a technology company headquartered in Utah. It provides a cloud-based "software as a service (SaaS)" offering to its customers, which connects the customer's people, data and systems. The Taxpayer proffered this description of its SaaS offering in its prehearing brief[1] as follows:

> TAXPAYER provides cloud-based software as a service (SaaS) offering that digitally connects a business customer's people, data and systems to enable more efficient and more effective decision making to run the business. The SaaS offering pulls together the customer's data and information wherever it is located (e.g. on the customer's premises or in the cloud) and makes it available through the user's personal computing device (Laptop, phone, etc.).
> . . .
> TAXPAYER's cloud-based product is part of a movement in the technology sector to provide software solutions that are hosted in the cloud and not on customer on-site servers. Instead of customers purchasing software to own and host themselves, customers now pay to use software that is on-demand, has price elasticity, and does not come with large capital asset expenditures (server hardware, etc.). In a SaaS model, software must be on-demand and available at all times-whenever a customer might need it. Without this on-demand ability, the SaaS offering loses its competitive advantage and becomes less desirable than alternatives like on premise software.

The contested portion of the refund is for taxes that were paid by the Taxpayer when the Taxpayer purchased four items of software. This software was NAMES REMOVED. It was the Division's conclusion that the Taxpayer was the "last user" of these programs purchased and that these software programs were not used by the Taxpayer's customers. In fact, the Division pointed out that for the several other software programs that the Taxpayer had purchased and integrated into its offering that were used by the Taxpayer's customers, the Division concluded

[1] Petitioner Pre-Hearing Brief, March 14, 2019, pgs. 1-2.

that the Taxpayer's customers were the "last user" of those other programs and allowed the refund for those other programs. What was at issue in this appeal was the purchases of the four software programs for which the Division found the Taxpayer to be the last user.

There was not a dispute at the Initial Hearing regarding what the four software programs did and how they were used. It was also not disputed that the Taxpayer retained the right to use the programs and that there was no licensing or other contractual right issued or transferred to the Taxpayer's customers so that the customers could use these four programs. There was no transfer of title to the customers. The Taxpayer's customers did not interface with these programs. The programs were used by the Taxpayer to provide the SaaS offering to its customers. The Taxpayer had provided a statement regarding the four programs at issue from its Senior Director of Engineering, dated July 23, 2018,[2] and there was no information contrary to this statement presented at the hearing. The descriptions regarding the four software programs provided by the parties at the hearing and in their prehearing briefing and the amount of sales tax at issue from each purchase were the following:

1) NAME REMOVED ($$$$$):

NAME REMOVED is a log monitoring software that is used to aggregate activity logs into a single location from hundreds of servers that the Taxpayer's SaaS Program runs. This software interacts with and accesses all of the data and information the SaaS product generates. This software is essential in order for Taxpayer to meet its customer agreement requirements by assisting Taxpayer in resolving errors or issues early and keeping the SaaS product on demand. The Taxpayer describes this software in its Pre-hearing Brief as, "TAXPAYER uses the aggregated log activity to analyze customer issues and identify potential problems with the software code operating on the hosted servers. Without NAME REMOVED software, TAXPAYER simply would not be able to provide the product offering features of on-demand reliability and uptime which are necessary to satisfy the reliability requirements outlined in its customer agreements . . ."[3] The Division points out that it is actually the Taxpayer who is the user of this product and the purpose of the product is to assist the Taxpayer in resolving any errors or issues. The customer did not use, or interface with the product. The Taxpayer is the last user interacting with this program.

2) NAME REMOVED (Amount at issue: $$$$$):

NAME REMOVED is monitoring software that allows Taxpayer to monitor users' activity and view customers' experiences in Taxpayer's SaaS product. The Taxpayer's customers'

[2] Respondent's Exhibit AUD 009-0011.
[3] Petitioner's Pre-Hearing Brief, pg. 4.

requirement is to have Taxpayer monitor the cloud environment to resolve issues in a timely manner. This software analyzes the activity data and identifies the issues creating the errors with the SaaS product in real time. "Without being able to identify the issues with the system, it would be inevitable that the system would have outages, which goes contrary to TAXPAYER's customer agreements."[4] The Division disallowed this refund because the Taxpayer, not the Taxpayer's SaaS customer, was the "last user" of this program. The Division points out that this program was used by the Taxpayer to monitor the performance of the SaaS product. The customer did not use, or interface with the NAME REMOVED software. It was the Taxpayer that was the last user interacting with this program. The Taxpayer acknowledges that the customer did not come into contact with or interact with this software, but "it is running in the background helping to sustain the reliability and uptime features of TAXPAYER's product offering."[5]

3) NAME REMOVED ($$$$$):

NAME REMOVED is an incident management tool that notifies Taxpayer's engineering team when issues arise and facilitates faster response times. "This software sends alerts by calls, emails, and messages. The software's purpose is to quickly and efficiently alert an engineer of issues with the reliability and uptime features of TAXPAYER's cloud-based product offering. As TAXPAYER is a large company, there are many departments and employees, which makes NAME REMOVED an integral part of helping TAXPAYER comply with its agreements as NAME REMOVED routes communications to the correct person in the correct department depending on the issue."[6] Taxpayer's agreement with its customers requires that Taxpayer address system issues timely and efficiently such that the SaaS product is on-demand. The Division disallowed this refund because Taxpayer, not Taxpayer's customer, was the last user of NAME REMOVED. The Division points out that NAME REMOVED is used by Taxpayer to notify Taxpayer's engineering team of any issues with its SaaS product. Taxpayer's customer does not use or interface with NAME REMOVED. However, the Taxpayer argues that NAME REMOVED is running in the background to preserve the reliability and uptime features of TAXPAYER's SaaS product.

4) NAME REMOVED ($$$$$):

NAME REMOVED collects data from the performance of the Taxpayer's SaaS product and presents that data in chart/dashboard format for Taxpayer's review. Taxpayer's customer agreements require that the SaaS product be monitored for errors and all errors are resolved

[4] Petitioner's Pre-Hearing Brief, pg. 4.
[5] Id., pg. 4.
[6] Petitioner's Pre-Hearing Brief, pg. 4.

timely. The NAME REMOVED software allows TAXPAYER to detect system errors and improve efficiencies. The Taxpayer explains in its Pre-Hearing Brief, pg. 5, "NAME REMOVED is more of a preventative tool to allow engineers to see what parts of the offering are starting to fault or are likely to fault. This allows engineers to run patches before running into downtimes which could jeopardize customer satisfaction and compliance with the customer agreement." It was the Division's conclusion that the Taxpayer, not the Taxpayer's customers, was the "last user" of NAME REMOVED. NAME REMOVED was used by the Taxpayer to monitor the performance of the SaaS product and collect data for Taxpayer to use to review the performance of the product. Taxpayer's customers did not use, or interface with the product.

The Taxpayer argues in this matter that the Tax Commission should refund the sales tax that the Taxpayer had paid when it purchased these four items of software because its purchases of this software were exempt from sales tax under Utah Code §59-12-104(25) as a purchase for resale. It was the Taxpayer's contention that all four items of software were necessary for the Taxpayer's SaaS offering and even if these particular software programs were not utilized or did not interface directly with the Taxpayer's customers, they were always running in the background and were essential to the Taxpayer's SaaS product to sustain the reliability and uptime or on-demand product availability.

The Taxpayer cites as support for its position *Utah State Tax Commission Private Letter Ruling No. 13-003* (12/04/2013).[7] In that Private Letter Ruling the Tax Commission did consider a "Cloud Collaboration Service Offering ("Offering")" that was similar to the SaaS offering at issue in this appeal and an issue addressed was whether the Offering itself and the amount the customer paid for the Offering was subject to sales tax. The Tax Commission had concluded, at page 15, that "the sales of the Offering to customers located in Utah are taxable under 59-12-103(1)(a)." The facts in *PLR No. 13-003* were such that the taxpayer had purchased the hardware and software outside of Utah. *PLR No. 13-003* also discussed that taxpayers' purchase of software, which that taxpayer used to provide its Offering. The Commission notes in *PLR No. 13-003* that the taxpayer's purchases of the software necessary to provide the Offering are not subject to Utah sales and use tax because the purchases occurred outside of Utah. The Tax Commission does go on to state as dicta in *PLR No. 13-003,* at page 17, "If the purchases were to occur within Utah, then the purchases of the software ***might*** qualify for the Utah resale exemption

[7] The Tax Commission has more recently considered the resale exemption at Utah Code Subsection 59-12-104(25) and issued its decision in *Findings of Fact, Conclusions of Law and Final Decision, Appeal No. 16-105* (October 29, 2018), although the this appeal did not involve computer software.

found in 59-12-104(25), but those for the hardware would not (emphasis added)."[8] The PLR explains, at page 17, that the "hardware cannot qualify for the exemption found in 59-12-104(25) because the use of the hardware is not resold."

In the subject appeal, the Taxpayer argues that this dicta supports its contention that the four software items discussed above could qualify for the exemption, but *PLR No. 13-003* uses the term "might qualify." To qualify for sales and use tax exemption, the purchases would have to meet the requirements of the exemption. Utah Code Subsection 59-12-104(25) provides for an exemption from sales tax for "a product purchased for resale in the regular course of business, either in its original form or as an ingredient or component part of a manufactured or compounded product." The Division argues that the four software programs at issue in this matter were not purchased for resale. The Taxpayer purchased these items for the Taxpayer to use to provide its service to the customer. Utah Code Subsection 59-12-102(108) defines "sale" as "any transfer of title" and it specifically includes "any transaction under which right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract." The facts in this case indicate that the Taxpayer retains the right to use the software at issue and that the customers are not issued a license or otherwise use these programs themselves. They are used by the Taxpayer to provide the services that the Taxpayer sells as part of its SaaS product. The Division points to the test set out by the Utah Supreme Court to determine whether a product was "purchased for resale as an ingredient or component part" of the final product sold. In *E.C. Olsen v. State Tax Commission*, 168 P.2d 324, 330 (Utah 1946) the court held the test to be, "Are the articles involved consumed by the processor as the last user?" In *Union Portland Cement Co. v. State Tax Commission*, 170 P.2d 164, 171 (Utah 1946) the Court stated that the purchase for resale exemption "does not exempt property which is consumed by the manufacturer as last user."[9]

Reviewing the facts in this appeal and the applicable law, the Division has correctly applied this test to the four software programs at issue, which were not resold to the Taxpayer's customers and instead used by the Taxpayer. As noted by the Division, under Utah Code Sec. 59-1-1417 the Taxpayer has the burden of proof and exemptions are strictly construed against a taxpayer. The Taxpayer has not met this burden to establish that title transferred to its customers or the customers were the last user of the software at issue in this appeal. This is an exemption

[8] The Tax Commission had considered the resale exemption at Utah Code Subsection 59-12-104(25) and issued its decision in *Findings of Fact, Conclusions of Law and Final Decision, Appeal No. 16-105* (October 29, 2018).

[9] The Division also cites to *Hardy v. State Tax Com'n*, 561 P.2d 1064 (Utah 1977); *BJ-Titan Services v. State Tax Com'n*, 842 P.2d 822 (Utah 1992); and *Gull Laboratories, Inc. v. Utah State Tax Com'n*, 936 P.2d 1082 (Utah 1997).

issue and therefore strictly construed against the Taxpayer. The Taxpayer's appeal and request for the further refund should be denied.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Taxpayer's appeal requesting the further sales and use tax refund in addition to the amount already agreed to by the Division for the period of July 1, 2015 through March 31, 2017 is denied. 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, or emailed, 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

or emailed to:
taxappeals@utah.gov

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

DATED this _____day of _____, 2019.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Rebecca L. Rockwell
Commissioner

Lawrence C. Walters
Commissioner