

12-2455
TAX TYPE: SALES & USE TAX
TAX YEARS: 10/08 THROUGH 9/11
DATE SIGNED: 6-5-2014
COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO
COMMISSIONER D. DIXON DISSENTS
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>TAXPAYER, Petitioner,</p> <p>vs.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.</p>	<p>INITIAL HEARING ORDER</p> <p>Appeal No. 12-2455</p> <p>Account No. ##### Tax Type: Sales & Use Tax Audit Period: 10/08 – 9/11</p> <p>Judge: Phan</p>
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Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE-1 FOR TAXPAYER, Head of Tax
Accounting, TAXPAYER, By Telephone
REPRESENTATIVE-2 FOR TAXPAYER, Senior Tax Manager,
NAME Technologies, By Telephone

For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney
General
RESPONDENT, Director, Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on January 13, 2014, for an Initial Hearing in accordance with Utah Code §59-1-502.5. At issue before the Commission is Petitioner's ("Taxpayer") appeal of a sales and use tax audit deficiency issued by Respondent ("Division") for the period of October 1, 2008 through September 30, 2011. The Statutory Notice –Sales and Use Tax was issued on August 15, 2012. The amount of the audit deficiency was \$\$\$\$\$ in sales and use tax with interest accrued as of the date of the notice in the amount of \$\$\$\$\$. Interest continues to accrue on the unpaid balance.

APPLICABLE LAW

Sales and use tax are imposed under Utah Code 59-12-103(1)(2009)¹ as follows in pertinent part:

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;
- . . .
- (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; (ii) used; or (iii) consumed; and
- (m) amounts paid or charged for a sale:²
 - (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 (B) of a repair or renovation 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; and (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.

"Tangible personal property" is defined at Utah Code 59-12-102(108)(2009) as follows:

- (a) Except as provided in Subsection (108)(d) or (e), "tangible personal property" means personal property that: (i) may be: (A) seen; (B) weighed; (C) measured; (D) felt; or (E) touched; or (ii) is in any manner perceptible to the senses.
- (b) "Tangible personal property" includes: (i) electricity; (ii) water; (iii) gas; (iv) steam; or (v) prewritten computer software.³
- . . .
- (d) "Tangible personal property" does not include a product that is transferred electronically.⁴

Section 59-12-102(48) defines "lease" or "rental" as follows in pertinent part:

¹ The Commission cites to the 2009 version of the Utah Code unless otherwise noted. There were some revisions during the audit period at issue in this appeal and some renumbering of subsections.
² Subsection (m) became effective on January 1, 2009. Near the end of the audit period, effective July 1, 2011, subsection (m) was amended and a new definition enacted for "product transferred electronically" now found in Section 59-12-102(94) (2013).
³ Effective July 1, 2011, Section 59-12-102(108)(b)(v) was amended to "prewritten computer software, regardless of the manner in which the prewritten computer software is transferred."
⁴ This statute came into effect January 1, 2009, at the same time Utah Code Sec. 59-2-103(1)(m) was adopted to impose a tax directly on products transferred electronically.

(48)(a) "Lease" or "rental" means a transfer of possession or control of tangible personal property or a product transferred electronically for:

- (i) (A) a fixed term; or
(B) an indeterminate term; and
- (ii) consideration. . . .

Section 59-12-102(77) defines "prewritten computer software," as follows:

(77)(a) Except as provided in Subsection (77)(b)(ii) or (iii), "prewritten computer software" means computer software that is not designed and developed:

- (i) by the author or other creator of the computer software; and
- (ii) to the specifications of a specific purchaser.
- (b) "Prewritten computer software" includes:
 - (i) a prewritten upgrade to computer software if the prewritten upgrade to the computer software is not designed and developed:
 - (A) by the author or other creator of the computer software; and
 - (B) to the specifications of a specific purchaser;
 - (ii) notwithstanding Subsection (77)(a), computer software designed and developed by the author or other creator of the computer software to the specifications of a specific purchaser if the computer software is sold to a person other than the purchaser; or
 - (iii) notwithstanding Subsection (77)(a) and except as provided in Subsection (77)(c), prewritten computer software or a prewritten portion of prewritten computer software:
 - (A) that is modified or enhanced to any degree; and
 - (B) if the modification or enhancement described in Subsection (77)(b)(iii)(A) is designed and developed to the specifications of a specific purchaser.
- (c) Notwithstanding Subsection (77)(b)(iii), "prewritten computer software" does not include a modification or enhancement described in Subsection (77)(b)(iii) if the charges for the modification or enhancement are:
 - (i) reasonable; and
 - (ii) separately stated on the invoice or other statement of price provided to the purchaser.

Section 59-12-102(94) defines "sale," as follows in pertinent part:

(94) (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:
 -
 - (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 Admin. Rule R865-19S-92 ("Rule 92") 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.

Utah Code Ann. §59-12-211, which became effective January 1, 2009, provides the location of certain transactions, as follows in pertinent part:⁵

- (1) As used in this section:
 - (a) (i) "Receipt" and "receive" mean:
 - (A) taking possession of tangible personal property;
 - (B) making first use of a service; or
 - (C) for a product transferred electronically, the earlier of:
 - (I) taking possession of the product transferred electronically; or
 - (II) making first use of the product transferred electronically.

....

- (2) Except as provided in Subsections (8) and (13), if tangible personal property, a product transferred electronically, or a service that is subject to taxation under this chapter is received by a purchaser at a business location of a seller, the location of the transaction is the business location of the seller.
- (3) Subject to Subsection (10), and except as provided in Subsections (7), (8), (9), (11), and (13), if tangible personal property, a product transferred electronically, or a service that is subject to taxation under this chapter is not received by a purchaser at a business location of a seller, the location of the transaction is the location where the purchaser takes receipt of the tangible personal property or service.
- (4) Subject to Subsection (10), and except as provided in Subsections (7), (8), (9), (11), and (13), if Subsection (2) or (3) does not apply, the location of the

⁵ In 2011, Section 59-12-211(12) was added to clarify the location of a transaction involving the use of computer software (but not the transfer of a copy of that software) is generally the address of the purchaser, as follows:

- (12) (a) Notwithstanding any other provision of this section and except as provided in Subsection (12)(b), if a purchaser uses computer software and there is not a transfer of a copy of that software to the purchaser, the location of the transaction is determined in accordance with Subsections (4) and (5).

....

transaction is the location indicated by an address for or other information on the purchaser if:

- (a) the address or other information is available from the seller's business records; and
 - (b) use of the address or other information from the seller's records does not constitute bad faith.
- (5) (a) Subject to Subsection (10), and except as provided in Subsections (7), (8), (9), (11), and (13), if Subsection (2), (3), or (4) does not apply, the location of the transaction is the location indicated by an address for the purchaser if:
- (i) the address is obtained during the consummation of the transaction; and
 - (ii) use of the address described in Subsection (5)(a)(i) does not constitute bad faith. . . .

. . . .
(14) This section does not apply to:

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- (c) a retail sale of tangible personal property or a product transferred electronically if:
 - (i) the seller receives the order for the tangible personal property or product transferred electronically in this state;
 - (ii) receipt of the tangible personal property or product transferred electronically by the purchaser or the purchaser's donee occurs in this state;
 - (iii) the location where receipt of the tangible personal property or product transferred electronically by the purchaser occurs is determined in accordance with Subsections (3) through (5); and

. . . .
The burden of proof is upon the petitioner in this proceeding pursuant to §59-1-1417 as follows:

- (1) In a proceeding before the commission, the burden of proof is on the petitioner

DISCUSSION

At the hearing the Taxpayer's representatives conceded to much of the audit and asked that the Taxpayer be assessed only the \$\$\$\$ to \$\$\$\$ in tax that accrued after the Commission issued a Private Letter Ruling in October 2010.⁶ It was the Taxpayer's contention that it should not be assessed the tax for the period prior to this Private Letter Ruling because the law was

⁶ At the hearing the representatives for the Taxpayer had argued there had been a Private Letter Ruling issued by the Utah State Tax Commission in October 2010 and that the opinion had been requested in 2008. However, on the Petition for Redetermination form the Taxpayer had listed Private Letter Ruling 10-011. Private Letter Ruling 10-011 was issued on February 24, 2012. The ruling was in response to a request letter dated October 8, 2010. It appears this was the Private Letter Ruling that the Taxpayer's representatives were referencing at the hearing.

unclear prior to the ruling, the Private Letter Ruling was based on new law and the Taxpayer would not have had notice that the transactions were subject to sales tax.

At issue was a monthly service fee the Taxpayer asserts was charged its customers for data storage, but which the Division asserted was for software. The Taxpayer did not provide much information about this product, but the Division provided a copy of the Product Terms of Use from the Taxpayer's website. Paragraph 2.1 of the copy states, "TAXPAYER shall provide online access to Customer Data for restoration and recovery purposes . . ." From what was discussed, the customer would back up its data by storing it on Taxpayer's server via the internet. This could be for a period of a month, months or years. According to the description in the Product Terms of Use, the Taxpayer's End User Client Software would have to be installed on the customer's system by the Taxpayer and the customer would have a license to use the software. The software was necessary for the customer to back up or save its data onto the Taxpayer's server. There could be no data storage without the software. The Taxpayer stated at the hearing that it did charge and remit sales tax on the charge for the software, but it did not charge tax on the monthly fee which it asserted was for the storage on its server. However, the Division argued that for many contracts there was no charge for the software, there was only a charge for the monthly fee. The Division considered the monthly fee to be for the software license and not a storage fee. The Taxpayer did not provide any contracts or other documents as evidence at the hearing and there was no information on what percentage of contracts had charged a cost for the software separately from the data storage fee, although the Taxpayer asserted at the hearing the fee was for data storage.

During the audit period, the Taxpayer had not charged its customers tax on the fee at issue and its representatives indicated that they were unaware tax would be owed on the fee. They argued that it was completely unclear that this fee was taxable prior to the issuance of the October 2010 Private Letter Ruling. They indicate that after the audit, customers had argued that sales tax should not be charged on this fee and they have been able to point to the Private Letter Ruling to explain why tax was charged. Secondly, the Taxpayer's assert that the Private Letter Ruling was based on new or revised statutory provisions, but they did not point out any specific revisions or provide legal argument on how that change would have affected the tax.

At the hearing the Division provided a copy of Private Letter Ruling 10-011 which appears to be the ruling to which the Taxpayer referred. However, the ruling was issued on February 24, 2012, after the audit period. The representative for the Division pointed out that a Private Letter Ruling is an interpretation of the law as it existed at that time, that it does not establish new law or new precedence. The Division's representative also asserts that the law in

effect for the Private Letter Ruling was substantially the same law in effect during the whole audit period.

It was the Division's contention that the fee at issue was, in fact, a charge for the lease of the Taxpayer's software. The Division points out that Utah Code 59-12-103(1) imposes sales tax on the amounts paid for leases of tangible personal property. It was the Division's argument in its brief that 'tangible personal property' includes prewritten computer software, regardless of the manner in which the prewritten software was transferred under Utah Code Sec. 59-12-102(123)(b)(v).⁷ The taxpayer did not dispute that the software would be considered prewritten computer software.

The Division also pointed to Utah Code Sec. 59-12-211 that specifies that the location of the transaction is the address for the purchaser. So for the purchasers in Utah the transaction was subject to tax. Again this was not a point refuted by the Taxpayer at the hearing. Further the Division points to Utah Code Sec. 59-1-1417 which states that the burden of proof would be on the Taxpayer.

After reviewing the arguments of the parties and what little factual evidence that was submitted, based on the case that the Taxpayers actually argued at this hearing the Taxpayer's appeal should be denied. At the hearing the Taxpayers acknowledged that based on October 2010 Private Letter Ruling they were subject to the tax, but prior to that the law was unclear and they should not have to pay the tax. It does appear that the Private Letter Ruling the Taxpayer refers to was PRL 10-011 and was actually issued February 24, 2012, after the audit period. A logical extension of the Taxpayer's argument would be a request for the entire audit to be abated. However, the Division is correct in its discussion regarding the effect of a Private Letter Ruling. It is an interpretation of the law in effect at the time the ruling is issued. A Private Letter Ruling does not change the existing law and it does not establish a new law or procedure, it instead says this is how the current law applies to this stated set of facts.

The Taxpayer had asserted that the law had changed so that the Private Letter Ruling 10-011 was based on the new law. The Taxpayer does not point to any specific provision of law that had been revised and how the revision would change the taxability. The Division argues the law was the same as during the audit period. There were some revisions to the law during the audit period and after, as noted in the Applicable Law Section listed above. These revisions were discussed in PLR 10-011. However, assuming the Division's assertion that this fee was for prewritten computer software transferred electronically from January 1, 2009 to June 30, 2011,

⁷ Respondent's Pre-Hearing Brief, pg. 5. Respondent is referring to the current version of the code. The provisions in effect during the audit period are listed above in the applicable law.

this would have been taxable as a product transferred electronically. Effective July 1, 2011, it would have been taxable as a sale or lease of “tangible personal property” under 59-12-103 and 59-12-102(113)(b)(v). There does not appear to be a substantive change to affect the taxability in this matter.

Additionally, the fact that the Taxpayer was not aware of what the law was or found the law unclear is not a basis to abate tax. This places the responsibility on taxpayers to be aware of the law. If the Taxpayer was unsure, the Taxpayer could have requested a Private Letter Ruling from the Commission.

For these reasons the Taxpayer’s arguments as presented at the hearing do not support an abatement or reduction of the audit deficiency.

What the Taxpayers did not argue at the hearing⁸ was that the object of the transaction at issue was really to provide a service, that being to preserve and protect the customer’s data and that the software was merely incidental to that service. PLR 10-011 is not the only Private Letter Ruling dealing with various internet based service charges. PLR 07-013⁹ dealt specifically with the provision of data protection or back up services and based on the facts in that case found them to not be subject to tax. The Commission previously discussed a number of the Private Letter Rulings in *Utah State Tax Commission Initial Hearing Order 10-2086*, issued August 16, 2013. This Order is not being cited herein for the conclusion, as a Formal Hearing has been requested. Therefore, the Initial Hearing Order is not the final determination from the Commission in that *Appeal 10-2086* and the decision has not been redacted and posted on line. Instead the following excerpt is provided so the Taxpayer is aware of Private Letter Rulings that were available. *Initial Hearing Order 10-2086*, starting at pg. 13 noted:

The Commission has applied the primary object of the transaction test to other circumstances involving online transactions. On some occasions, the Commission has determined that the primary object of the transaction was the tangible personal property, not the services. For example, *PLR 10-011* concerned a seller who provided a number of web-based “services” to its customers that enabled subscribers to have remote computer access to attend and participate in meetings online and to attend online webinars. The Commission found that when that seller sells its web-based services, “it in substance grants Subscribers the right to use the [seller’s] proprietary software under a lease or contract.” Because the involvement of the seller’s employees appeared to be limited to setting up and maintaining its customers’ accounts, the Commission found that

⁸ The Taxpayer did not submit any briefing of its argument prior to or at the hearing.

⁹ Private Letter Rulings are available to the public in a redacted format at <http://tax.utah.gov/commission-office/rulings>.

the primary object of the transaction was for the use of the seller's software and not for services provided by the seller.

On other occasions, the Commission has found that the primary object of the transaction was for nontaxable services and that any tangible personal property (such as prewritten computer software or computer-generated output) that the customer used or received was incidental to the transaction. For example, in *USTC Private Letter Ruling 07-013* (Dec. 21, 2007), the Commission considered services that a seller provided to backup and protect a customer's computer files. Although the customer downloaded software provided by the seller, the Commission considered the software to be incidental to the nontaxable backup and protection services that were the primary object of the transaction.

Similarly, in *USTC Private Letter Ruling 11-001* (September 9, 2011), the Commission considered a seller who provided authentication services for entities seeking to perform secure electronic commerce and communications over the internet. Although a customer received tangible personal property from the seller, specifically a digital certificate file provided online, the Commission found that the tangible personal property (i.e., the digital certificate file) was incidental to the nontaxable authentication services that were the primary object of the transaction.

In addition, in *USTC Private Letter Ruling 11-006* (January 12, 2012), the Commission considered the taxability of a seller's online human resource services to assist its customers' human resource departments in the job application and hiring process. In this ruling, the seller provided its clients with a web link that connected a client's potential job applicants to the seller's server via the internet. The job applicant would fill out a questionnaire on the seller's website, and the seller would use its computer system to process and analyze all job applicants' responses, ranking the applicants on their probability for success in the job. The seller's customers were granted access to this information for a limited time, and the customers were able to retrieve the final reports. The Commission considered that the seller's customers had very limited access to the seller's software and that the customers had no control over how the seller analyzed the data provided by the applicants. Given these circumstances, the Commission determined that the seller's transactions were nontaxable because the primary object of the transaction was research and analysis services that were provided to produce the final reports and that the computer-generated output (i.e., the reports) was incidental to these services.

Transactions Involving the Use of a Seller's Online Database. In *Private Letter Ruling 10-012* (December 7, 2012) ("*PLR 10-012*"), the Commission responded to a seller who asked if its "services" to provide customers with commercial information about the financial condition of businesses was taxable.

....

In this ruling, the Commission first addressed 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. Although this service involved access to both computer software and a database, the Commission found that the use of the database was the primary object of the transaction. It also found that the use of the database was not taxable, in part, because of the definition of "telecommunications service."

The Private Letter Rulings were available for review by the Taxpayer on line at <http://tax.utah.gov/commission-office/rulings>. It is unknown whether the Taxpayer's representatives were not aware of these Private Letter Rulings, or were aware but concluded that they would not apply based on the facts of the Taxpayer's transactions. The Division had submitted a Pre-Hearing Brief in which it outlined its position that this was a sale or lease of prewritten software and as such was subject to tax.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Tax Commission denies the Taxpayer's appeal of the Sales and Use Tax Audit for the period of October 1, 2008 through September 30, 2011.

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

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

COMMISSIONER DIXON DISSENTS

It is undisputed the Taxpayer provides back-up data and storage. The Taxpayer stated there could be no data storage without the Taxpayer's software. This suggests the software assists the Taxpayer in properly transferring and storing the data of its customers. The software is essential to the services the Taxpayer provides, but the object of the transaction between the Taxpayer and customers is data transfer and storage. Admittedly, the record is void of why the software is essential to the data storage services the Taxpayer provides, but the information provided still seems to support the Taxpayer is providing services similar to those considered in Private Letter Ruling 07-013 issued December 21, 2007. In PLR 07-013 although the customer downloaded software provided by the seller, the Commission found the software to be incidental to the nontaxable backup and protection services that were the primary object of the transaction. On the information provided, I respectfully disagree with my colleagues and would abate the audit against the Taxpayer.

D'Arcy Dixon Pignanelli
Commissioner

Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.