06-1038
SALES AND USE TAX
TAX YEARS: 2002, 2003, 2004, 2005
SIGNED: 04-07-2007
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, M. JOHNSON
PARTIAL CONCURRENCE AND PARTIAL DISSENT: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 06-1038 Account No. ##### Tax Type: Sales and Use Tax Audit Period: 01/01/02 – 06/30/05 Judge: Chapman

Presiding:
Kerry Chapman, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP., Owner
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing on January 29, 2008.

On June 27, 2006, Auditing Division ("Division") issued a Statutory Notice - Sales and Use Tax ("Statutory Notice") to the Petitioner for the audit period January 1, 2002 through June 30, 2005. In the Statutory Notice, the Division imposed $$$$$ in additional sales and use tax plus interest in the amount of $$$$$, for a total of $$$$$. No penalties were imposed.

At issue is the Division's assessment of sales tax on amounts paid for services the Petitioner

performed on computers and computer networks and for which it did not collect sales tax, as detailed on Schedule 2 of the Statutory Notice. The Division deemed these transactions to be taxable either: 1) because the services were for the taxable repair or renovation of tangible personal property or the taxable installation of tangible personal property in connection with other tangible personal property; or 2) because the Petitioner's invoices did not separate taxable services from nontaxable services.

For the Petitioner, PETITIONER REP. asks the Commission to reverse the Division's imposition of tax on these transactions because he believes his company's services are nontaxable. PETITIONER REP. also asks the Commission to consider that he consulted and followed the advice of CPAs in determining not to charge sales tax on the transactions at issue.

APPLICABLE LAW

I. Taxation of Repair or Renovation Services and Installation Services.

1. Until July 1, 2005, Utah Code Ann. §59-12-103(1)(g) provided for the imposition of sales and use tax on repairs or renovations of tangible personal property and certain installations of tangible personal property,[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:
> . . . .
> (g) amounts paid or charged for services:
> (i) for repairs or renovations of tangible personal property . . . .; or
> (ii) to install tangible personal property in connection with other tangible personal property . . . .

2. During the audit period, Utah Administrative Rule R865-19S-78 ("Rule 78")[2] provided as follows in pertinent part:

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1 Effective July 1, 2005, Section 59-12-103(1)(g) was amended and a definition of the term "repairs or renovations of tangible personal property" was added to Section 59-12-102. These statutory amendments became effective after the audit period and do not impact this appeal.

2 Rule 78 was amended on July 20, 2005 in recognition of the related statutory changes that became effective on July 1, 2005. Again, these changes occurred after the audit period and do not impact this appeal.

A. Charges for installation labor.
1. Amounts paid or charged for labor for installing tangible personal property in connection with other tangible personal property are subject to tax.
. . . .
B. Charges for labor to repair, renovate, wash, or clean.
1. Charges for labor to repair, renovate, wash, or clean tangible personal property are subject to sales tax. . . .
2. Charges for labor to service, repair or renovate real property, improvements, or items of personal property that are attached to real property as to be considered real property are not subject to sales tax. . . .

II. Computer Software.

3. Effective July 1, 2004, definitions of "computer software" and "prewritten computer software" were added to UCA §59-12-102 and for the remainder of the audit period, provided as follows:

(21) "Computer software" means a set of coded instructions designed to cause:
(a) a computer to perform a task; or
(b) automatic data processing equipment to perform a task.
. . . .
(67) (a) Except as provided in Subsection (67)(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 (67)(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 (67)(a) and except as provided in Subsection (67)(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 (67)(b)(iii)(A) is designed and developed to the specifications of a specific purchaser.
(c) Notwithstanding Subsection (67)(b)(iii), "prewritten computer software" does not include a modification or enhancement described in Subsection (67)(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.

4. Prior to June 29, 2004, Utah Admin. Rule R865-19S-92 ("Rule 92"), which concerns the sale of computer software and other related transactions, provided as follows in pertinent part:

> A. Definitions:
> 1. "Canned computer software" or "prewritten computer software" means a program or set of programs that can be purchased and used without modification and has not been prepared at the special request of the purchaser to meet their particular needs.
> 2. "Custom computer software" means a program or set of programs designed and written specifically for a particular user. The program must be customer ordered and can incorporate preexisting routines, utilities or similar program components. The addition of a customer name or account titles or codes will not constitute a custom program.
> . . . .
> 5. "Tangible personal property" includes canned computer software.
> B. The sale, rental or lease of canned or 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. Payments under a license agreement are taxable as a lease or rental of the software package. Charges for software maintenance, consultation in connection with a sale or lease, enhancements, or upgrading of canned or prewritten software are taxable.
> C. 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.
> D. Charges for services to modify or adapt canned computer software or prewritten computer software to a purchaser's needs or equipment are not taxable if the charges are separately stated and identified.

Rule 92 was amended on June 29, 2004, several days prior to the July 1, 2004 date on which the computer software definitions in Section 59-12-102 became effective. Although Section (C) of the rule was not amended and remains in effect, Section (D) and the portions of Section (A) cited above were deleted, as were the last two sentences of Section (B). Accordingly, beginning on June 29, 2004 and effective for the remainder of the audit period, Rule 92 provided as follows:

> . . . .
> B. The 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.

> C. 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.
> . . . .

III. Purchase Price or Sales Price.

5. Throughout the audit period, Section 59-12-102(21) (2002)[3] defined "purchase price" to mean "the amount paid or charged for tangible personal property or any other taxable transaction under Subsection 59-12-103(1), excluding only cash discounts taken or any excise tax imposed on the purchase price by the federal government."

DISCUSSION

The Petitioner sells computer equipment and provides various services associated with computer equipment. Not only does the Petitioner provide services that pertain to a single computer, but it also contracts to maintain and service entire computer networks and operating systems for various entities. PETITIONER REP. proffers that he was not concerned when the Division decided to audit his company's sale tax liability because he had followed the advice of CPAs in deciding which of his transactions were taxable. However, for the audit period, the Division determined that sales tax was due on approximately (#) transactions for which the Petitioner had provided various services and had not collected sales tax.

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3 In the 2003 General Session, the Legislature enacted Senate Bill 147 ("S.B. 147"), which included a modified definition of "purchase price" that was originally to become effective on July 1, 2004. In the 2004 Third Special Session, however, the Legislature enacted Senate Bill 3000, in which it delayed the effective date of the S.B. 147 definition of "purchase price" until July 1, 2005 and reinstated the cited definition of "purchase price." As a result, the definition of "purchase price" found in current law did not become effective until July 1, 2005, the day after the audit period at issue, and has no effect on this decision.

PETITIONER REP. proffers that approximately 95% of the transactions at issue involve services to "support" computers and keep them operational. He contends that these transactions are nontaxable pursuant to the version of Rule 92(D) that existed prior to June 29, 2004, which provided that "services to modify or adapt canned computer software or prewritten computer software to a purchaser's needs or equipment are not taxable if the charges are separately stated and identified."

First, the Commission will address the statute that imposes tax on services to repair or renovate tangible personal property and compare these services to those specifically deemed nontaxable under statute and rule. Second, the Commission will address the four types of transactions found on Schedule 2 of the Statutory Notice that the Petitioner specifically contested at the Initial Hearing.

I. Repairs and Renovations.

Section 59-12-103(1)(g)(i) specifically provides that services to repair or renovate tangible personal property are taxable. In *Union Pacific Railroad Co. v. Auditing Division*, 842 P.2d 876 (Utah 1992), the Utah Supreme Court interpreted the statute imposing tax on repairs or renovations of tangible personal property, stating that:

> Repair and renovation . . . suggest activities that "fix" an already manufactured product. To repair is to "restore by replacing a part or putting together what is torn or broken." To renovate is to "restore to a former better state." Webster's Ninth New Collegiate Dictionary 998 (1984). Drilling and milling the cross ties did not involve repairing existing cross ties or restoring the existing cross ties to a former better state.

Furthermore, in *South Central Utah Telephone Ass'n v. Auditing Div. of the Utah State Tax Comm'n*, 951 P.2d 218 (Utah 1997), the Court found that transactions for computer software maintenance contracts were taxable as the future repairs or renovations of tangible personal property.

A review of the transaction descriptions on Schedule 2 of the Statutory Notice indicates that many of the Petitioner's transactions appear to be for services to repair or renovate tangible personal property. For example, on the first page of Schedule 2, the following descriptions of January 2, 2002 transactions are

listed: 1) for COMPANY G, "Fixed PERSON A's email problem. . ."; 2) for COMPANY B, "Troubleshoot VPN connections. . ."; 3) for COMPANY C, "Troubleshot lost connection to internet . . ."; 4) for COMPANY D, "Called COMPANY D to troubleshoot error messages . . ."; 5) for PERSON B, "Troubleshot errors when workstation boots up . . ."; and 6) for PERSON C, "Troubleshot HP1200C printer with laptop."

In *Utah State Tax Commission Private Letter Ruling 05-018* (August 16, 2005), the Commission determined that "troubleshooting" and fixing prewritten software is the taxable repair or renovation of tangible personal property. The descriptions of the January 2, 2002 transactions listed above all suggest that tangible personal property was "fixed" because it was either broken and repaired or because it was restored to a former, better state. Without additional evidence to suggest otherwise, the Commission finds that transactions with these characteristics are taxable repairs or renovations of tangible personal property.

As a result, the Commission rejects the Petitioner's argument that services to repair or renovate tangible personal property should, instead, be deemed nontaxable services to modify or adapt prewritten computer software to a customer's needs or equipment, as set forth in the old version of Rule 92(D) or the current version of Section 59-12-102(67)(c). Nor does the Commission believe that repair or renovation services should be deemed nontaxable services "for software maintenance, consultation in connection with a sale or lease, enhancements, or upgrading," as set forth in the old version of Rule 92(B). To find otherwise would be to ignore the statute that imposes tax on repairs or renovations of tangible personal property.

II. Four Types of Transactions on Schedule 2 that the Petitioner Contests.

A. Configuring Computer. PETITIONER REP. proffers that a large number of the transactions listed on Schedule 2 concern charges to "configure" a computer or computer workstation so that it will operate. PETITIONER REP. explains that a new computer will not work until it is configured and

explains that configuring a computer generally includes the following services: 1) setting up login IDs and network authentications, such as user names and passwords; 2) setting up “networking protocols,” which enable an individual workstation and computer to communicate and work with the local network, the Internet, and email; 3) setting up spyware and virus scans; and 4) setting up calendars and contact systems.

PETITIONER REP. explained that his company performs these services on computers that it sells, as well as on computers that it has not sold. For computers that his company sells, PETITIONER REP. proffers that its “configuration services” charge is listed separately from any charges to purchase hardware and software. As an example of this type of configuration charge, PETITIONER REP. refers the Commission to transactions described as “NRT Agent setup” on page 13 of Schedule 2. PETITIONER REP. explains that these transactions relate to COMPANY A (“COMPANY A”) hiring his company to set up a workstation and computer for each new agent hired. PETITIONER REP. argues that such services should not be deemed taxable.

The Division, on the other hand, states that if the configuration services were associated with the sale of the computer, the services would be considered part of the taxable sale of tangible personal property, even if the service charge were stated separately. The Commission disagrees. The configuration services are not included in the price of a computer, and there is no evidence to suggest that the Petitioner requires a customer purchasing a computer to also purchase the configuration services. Furthermore, the Petitioner performs these services on computers it does not sell, as well. It is also conceivable that many computer purchasers either configure their computers themselves or have in-house staffs to perform such services. As a result, the Commission considers the configuration services, as described by the Petitioner, to be a separate and distinct transaction not included in the “purchase price” of a computer. Accordingly, the Commission must determine whether the Petitioner’s configuration services are taxable as either the repair or

renovation of tangible property or the installation of tangible personal property in connection with other tangible personal property.

The configuration services do not appear to be taxable repairs or renovations, as there is no indication that existing equipment is broken and needs to be fixed or restored to a former, better state. Nor does the Commission consider the configuration services described by the Petitioner to be the taxable installation of tangible personal property to tangible personal property. Although the Petitioner's configuration services may include the installation of certain spyware or virus programs to a computer, the Commission concludes, from the Petitioner's description, that the configuration services consist mainly of entering passwords and IDs, setting features on software to ensure that the computer will communicate with the computer network, and performing other similar nontaxable services. As a result, it appears that the installation of any free or existing spyware or virus scans is incidental to the other, nontaxable services. Accordingly, the Commission finds that the transactions on Schedule 2 that are described as NRT agent setups are nontaxable. The Division is ordered to remove these and any other similar transactions from its assessment.

Although the NRT agent setups generally show an invoice price of $$$$$ per setup, PETITIONER REP. also proffers that some setups can cost as much as $$$$$. To illustrate, he states that an engineering client may purchase a new computer and want all of his or her programs and information moved from the old computer to the new computer. PETITIONER REP. explains that the transfer of such information is very complicated because of the time needed to set up the programs and configure all features in the same way they existed on the old computer. PETITIONER REP. further states that his company may have to go and work on the configuration two or three times before it is correct. For the same reasons discussed above for the NRT agent setup charges, the Commission would conclude that these more complex configuration services are also nontaxable services.

B. "Fixing" Systems. PETITIONER REP. asks the Commission to rule on three specific services his company provides that he believes are nontaxable enhancements or adaptations of software that are nontaxable pursuant to Rule 92(D) (prior to June 29, 2004). First, PETITIONER REP. states that his company often provides services to reconfigure or set up a system that was incorrectly set up the first time by another party. Unlike the configuration services performed on new equipment, which is not broken or has a defect, these systems have a defect that the Petitioner is hired to fix or repair. For these reasons, the Commission finds such transactions are taxable repairs or renovations of tangible personal property. Accordingly, the Commission agrees that such transactions are taxable.

Second, PETITIONER REP. explains that his company is hired to "clean off" a virus from a computer. Services to remove viruses that have affected a computer's ability to function properly restores a computer to a "former better state" and, as a result, qualify as the taxable repair or renovation of a computer. Although there may be some viruses that do not "break" a computer, services to remove these viruses would also restore the computer to a "former better state" and, as a result, also qualify as a taxable repair or renovation of a computer. Accordingly, the Commission agrees that such transactions are taxable.

Third, PETITIONER REP. states there are circumstances where his company must remove all software and reload a computer from "scratch" in order for the computer to work properly again. Under these circumstances, the Petitioner's services are to fix a broken computer or restore a computer to a former, better state. Again, the Commission considers such services to be the taxable repair or renovation of tangible personal property. Accordingly, the Commission agrees that such transactions are taxable.

Nevertheless, the Commission recognizes that these matters are complex and that it would be productive for the Commission to issue a bulletin or adopt a rule to better explain the taxation of repairs and installations performed by the computer services industry, especially where those services are performed on software. As a result, the Commission finds that, under these specific circumstances, the tax on these three

types of transactions involving services performed on computer software will be imposed prospectively. Although the Commission will not require payment of tax on these transactions for purposes of this appeal, the Petitioner will be required to collect tax on such transactions prospective to the date a bulletin is issued or a rule is adopted that clarifies the transactions to be taxable.

C. The "COMPANY E" Transaction. PETITIONER REP. also contends that a specific transaction between the Petitioner and the COMPANY E ("COMPANY E") is nontaxable. The transaction, listed on page 1 of Schedule 2, is dated January 7, 20002 and concerns a $$$$$ charge for a "complete conversion of all (X) data to (X) table structures . . ." PETITIONER REP. explains that his company had previously written algorithm software for COMPANY E that enabled it doctors to predict the outcome of its surgeries. The Petitioner has not sold or marketed the software to any other customer. PETITIONER REP. further explains that this specific transaction entailed COMPANY E hiring his company to "fine-tune" the algorithm program so that its doctors would have the ability to receive data in a different format than had previously been available.

After hearing PETITIONER REP.'s explanation of this transaction, the Division states that it does not believe the transaction is taxable and would not object to the Commission ordering it to remove it from the assessment. The Commission finds that the transaction appears to be a service that has been deemed nontaxable pursuant to the current version of Rule 92(C). For these reasons, the Commission orders the Division to remove this specific transaction from its assessment.

D. Monthly Contract Charges. Approximately one-third of the assessment concerns contracts that the Petitioner entered into with entities such as COMPANY F and COMPANY A. Pursuant to these contracts, PETITIONER REP. states that his company charged the entities a monthly fee to maintain their computer networks and act as a network administrator. For most periods, the monthly fee paid by COMPANY F was $$$$$, while the monthly fee paid by COMPANY A was $$$$$.

PETITIONER REP. explains that during the audit period, his company would maintain these customers' networks and perform services that included: 1) making sure that the network was "optimized" (i.e., working efficiently); 2) maintain support packs and operating systems, which involves adding and deleting users, as necessary, from the network and maintaining security so that each user could only access the appropriate portion of the network; 3) clearing viruses from the network or from computers, as needed; and 4) troubleshooting other problems that would arise. PETITIONER REP. admits that his company did not invoice the separate services that it performed each month for each of these clients and that it has no records to detail the various services performed during the audit period.

The Division admits that some of these services would be nontaxable if separately stated and invoiced, such as adding and deleting users from a network. However, the Division also contends that other services performed by the Petitioner were for taxable repairs or renovations. Because the nontaxable services are not stated separately from the taxable services, the Division contends that the entirety of the monthly charges should be deemed taxable.

The Commission agrees with the Division. First, the Commission finds that some of the services the Petitioner performed under these contracts were for the taxable repair or renovation of tangible personal property. As explained earlier, fixing virus problems and troubleshooting other problems that arise with computer hardware and software are considered the repair or renovation of taxable tangible personal property. The Petitioner's monthly charge combines its charges for taxable services to repair or renovate tangible personal property with other charges, some of which appear to be nontaxable. Furthermore, there is no evidence to show how the monthly charge is apportioned between the taxable and nontaxable charges. Section 59-12-102(67)(c)(ii) and Rule 92(D) (prior to June 29, 2004) specify that a taxpayer must segregate nontaxable charges from taxable charges. Otherwise, the entire charge is taxable. In addition, Utah Admin. Rule R865-19S-22 specifies that a retailer shall keep and preserve complete and adequate records that are

necessary to determine the amount of sales and use tax for which the entity is responsible. The Petitioner has not provided evidence from which the Commission can determine the amount of the monthly charge that is nontaxable. For these reasons, the Commission agrees with the Division that the entirety of these monthly charges are taxable.

Nevertheless, earlier the Commission explained that it has decided to apply prospective compliance to certain taxable transactions that only involve services performed on software. At the hearing, the Division asked the Petitioner whether the services performed under the monthly contracts included services performed on hardware. The Petitioner proffered that it did not perform any services on hardware, except to pick up malfunctioning equipment and deliver it to the manufacturer to be fixed. Based on this information, it appears that the monthly charges only concerned taxable services performed on software, which the Commission has decided to tax prospectively, and nontaxable services. Under these circumstances, the Commission finds that an application of prospective compliance would be appropriate to the Petitioners' monthly contracts, as well. Accordingly, the Commission will not require the Petitioner in this appeal to pay over sales tax that it did not collect on the monthly contracts. However, the Petitioner will be required to collect tax on such monthly contracts prospective to the date a bulletin is issued or a rule is adopted that clarifies the services performed on software to be taxable.

ORDER

Based upon the foregoing, the Commission finds that the COMPANY E transaction on the first page of Schedule 2 is not subject to tax. In addition, the Commission finds that the transactions for configuration services that are described as NRT agent setups on Schedule 2 and any other similar transactions are not subject to tax. Furthermore, the Commission finds that it will apply prospective compliance only for the three types of transactions involving software that are described in Section (II)(B) ("Fixing Systems") and the taxable monthly charges that are described in Section (II)(D) (Monthly Contract

Charges). The Commission sustains the Division's assessment of tax on any other transactions at issue in the appeal. 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.

BY ORDER OF THE UTAH STATE TAX COMMISSION:

DATED this ________ day of _______________________, 2008.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

Partial Concurrence and Partial Dissent

I concur with my colleagues' conclusions on the items they have chosen not to tax. I specifically commend the conclusions reached on page ten and page 13 relating to "fixing systems" and "monthly contract charges" where my colleagues conclude taxes should be collected prospective to the date a bulletin is issued or a rule is adopted that clarifies the transactions that are taxable.

However, I respectfully dissent from my distinguished colleagues where they sustain "the Division's assessment of tax on any other transactions at issue in the appeal." The Petitioner made a good faith effort to correlate sales tax to his business operations and he testified he consulted and followed the advice of a CPA. The problem is there are just not clear guidelines. And a railroad decision is not enough to give this body any guidance on computer hardware and software systems.

I hold the Commission should abate all taxes and interest associated with this case. In addition, all audits in these matters should be suspended, until the Commission completes the rulemaking process and a bulletin is issued which establishes clear guidelines.

D'Arcy Dixon Pignanelli
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

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