

BEFORE THE INTERPRETATION AND APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition        ) D E T E R M I N A T I O N  
for Refund of                         )  
                                       )               No.88-382  
                                       )  
                                       )  
                                       ) Registration No. . . .  
                                       )  
                                       )

[1] **RULE 155:** B&O TAX -- RETAILING -- COMPUTER SYSTEM --  
CUSTOMIZED SOFTWARE. Out-of-state taxpayer  
manufactures telecommunication equipment and the  
computer system out of state to operate the  
equipment. The taxpayer designs and installs  
customized software into the computer system which  
is sold as a complete unit and delivered to a  
Washington customer. The sale of a computer system  
with its associated software is subject to Retailing  
B&O tax. Rule 155.

Headnotes are provided as a convenience for the reader and are  
not in any way a part of the decision or in any way to be used  
in construing or interpreting this Determination.

Taxpayer Represented By: . . .

Date of Hearing: July 24,1986

NATURE OF ACTION:

Petition for refund of Service B & O taxes paid on the basis  
that the activity taxed was performed out of state and, if a  
tax is due, it is due on retailing in Washington which is at a  
lower tax rate.

FACTS AND ISSUES;

Krebs, A.L.J. -- [The taxpayer] is engaged in the  
manufacturing and sale of telecommunication equipment

consisting of central office switching equipment and private branch exchanges. The taxpayer is headquartered in . . . . The taxpayer has no manufacturing or research facilities in Washington. The taxpayer does sales, maintenance, installation and repairs of telecommunication and computer systems in Washington. The taxpayer registered with the Department of Revenue (Department) in January 1981.

On August 30, 1984, the Department issued Tax Assessment No. . . . asserting excise tax liability and interest due in the amount of \$ [X] less a credit of \$ [X] which resulted in a net amount due of \$ [X] which was paid in full. The assessment covered the audit period from October 1, 1982 through June 30, 1984. The tax liability resulted from the reclassification of amounts reported by the taxpayer as subject to Retailing business and occupation (B & O) tax to being subject to Service B & O tax. Additional later credits reduced the liability for the audit period to \$ [X] which amount is sought as a refund by the taxpayer.

The taxpayer seeks also a refund of \$ [X] tax paid as Retailing B & O tax on \$ [X] reported in its July 1984 tax return as part of \$ [X] reported as subject to Retailing B & O tax. The taxpayer's reason for this claimed refund is that the \$ [X] amount is "exempt custom software."

The taxpayer seeks also refunds (because of "exempt custom software") of taxes paid as Service B & O tax on the following monthly returns;

RETURN	TAXABLE AMOUNT	TAX PAID
March 1985	\$ [X]	\$ [X]
February 1985	[X]	[X]
January 1985	[X]	[X]
December 1984	[X]	[X]
November 1984	[X]	[X]
September 1984	[X]	[X]
		<hr/> \$ [X]

The total refund sought is \$ [X] ([X] plus [X] plus [X]) plus applicable interest.

The telephone systems which the taxpayer sells in Washington are specialized digital computers designed for automated switching of telephone calls as well as for custom calling features such as redial, call-forwarding and speed-calling. The customized telephone equipment, manufactured by the

taxpayer outside of Washington, requires computer programs (software) to operate. Computer software has to be designed to operate the equipment. The computer software is written outside of Washington. The taxpayer maintains a software library system outside of Washington involving some 4,000 modules of software with about three million computer instructions. Changes are made to the software to provide new features and services. All writing of software and recording to tapes are performed outside of Washington.

When the taxpayer receives an order for the equipment from a Washington customer, it manufactures the equipment outside of Washington and sells it along with the software loaded into the system/equipment to operate it. The taxpayer goes to its library of software functions and selects the software functions needed. The taxpayer then modifies the software or adds additional functions. The taxpayer then runs a test to see if the software does what the customer requires. If not, the taxpayer adds additional modifications to the software program and continues testing and modifying until the final software program evolves. The taxpayer stresses that what is done is not merely a modification of a pre-existing software program but a hybrid by building a new software program based mostly on pre-existing functions and features, and that the result is an extremely specialized software program which takes anywhere from several weeks to several months to complete.

The taxpayer points to RCW 82.04.290 as imposing the Service B & O tax upon persons "engaging within this state in any business activity other than...those enumerated." Because no portion of the writing of the software occurs in Washington, the taxpayer asserts that the service activity is not taxable in Washington. Furthermore, the taxpayer asserts that the activity of writing the software outside of Washington lacks nexus with Washington to allow Washington to impose the B & O tax, apportioned or otherwise, on this activity and therefore is contrary to the due process provision of the Fourteenth Amendment to the U.S. Constitution.

Alternatively, the taxpayer contends that the gross receipts from the software sales in Washington should be subjected to the Retailing B & O tax of RCW 82.04.250, and that the refund sought be limited to the difference between taxation under Service B & O and Retailing B & O plus interest. The taxpayer bases this contention on the fact that it does have nexus in Washington for its selling activities in Washington.

The issue is whether the taxpayer's activity of writing customized software outside of Washington, installed in the computer system manufactured outside of Washington, and then sold and delivered as a complete system to a customer in Washington, is subject to Service B & O tax, Retailing B & O tax or no tax at all.

#### DISCUSSION:

[1] WAC 458-20-155 (Rule 155), . . . , in pertinent part provides:

The term "computer system" means a functional unit, consisting of one or more computers and associated software...

...

The term "software" means programs...and any associated documentation pertaining to the operation of a computer system.

...

#### BUSINESS AND OCCUPATION TAX

...

RETAILING: All sales...including computer systems..., to users, are subject to the retailing classification of business and occupation tax measured by the gross proceeds of sales derived therefrom.

...

SERVICE: Persons who charge for...computer services (other than retailing or wholesaling as defined above) are subject to the service and other activities classification of business and occupation... (Emphasis supplied.)

In this case, the taxpayer manufactures telecommunication equipment outside of Washington. The taxpayer designs the computer software outside of Washington to operate the equipment and installs the software before shipping the equipment to its Washington customer. The taxpayer sells the equipment as a complete unit with the software already loaded

into the computer system that operates the telecommunication equipment.

In our opinion, the taxpayer is engaged in selling "computer systems" which are subject to Retailing B & O tax (Rule 155) rather than being involved purely in providing professional services in the nature of designing and writing customized software.

Tax Assessment No. . . . , issued August 30, 1984, was not based upon an examination of the taxpayer's records and business activities by an auditor of the Department. The assessment was based upon an examination of the taxpayer's tax returns by the Department's excise tax examiner who reclassified amounts reported by the taxpayer under the Retailing B & O tax to the Service B & O tax as "customized software per Excise Tax Bulletin 515.04.155" (ETB 515) . . . . However, ETB 515 does not discuss specifically the sale of "computer systems" which include associated software. Rather, ETB 515 discusses only software --- Service B & O taxable when written to meet a particular customer's specific needs (customized software) and retail sales taxable when a standard prewritten package program.

Because we have concluded that the taxpayer's business activity in question is the sale of "computer systems" subject to Retailing B & O tax, we find that the excise tax examiner's reclassification to Service B & O was in error. The taxpayer is entitled to a refund of \$ [X] paid per assessment plus statutory interest.

With respect to the refund of \$ [X] of Retailing B & O tax paid for the July 1984 tax period, we must deny the refund because the software was integrated into the "computer system" sold and properly subject to Retailing B & O tax.

With respect to the refund of \$ [X] of Service B & O tax paid in connection with the monthly tax returns for the September 1984 through March 1985 periods (excluding October 1984) as detailed in the Facts and Issues part of this Determination, the taxable amounts reported as subject to Service B & O tax will be reclassified as subject to Retailing B & O tax and the difference in tax will be refunded to the taxpayer plus statutory interest. The sales tax liability arising from the reclassification will be waived because the taxpayer did not collect sales tax pursuant to the written instructions given in Tax Assessment No. . . . . The written instructions

referred to ETB 515 which stated that retail sales tax does not apply to the sale of customized software.

Because we have concluded that the amounts received on the taxpayer's sale of computer systems which included the installed customized software are properly subject to Retailing B & O tax rather than Service B & O tax, it is not necessary to discuss the taxpayer's arguments as to why the amounts received are not subject to Service B & O tax.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part as detailed above in the granting of and denial of refunds. The file is being referred to the Department's Taxpayer Account Administration section for computation of the refund plus statutory interest and issuance thereof to the taxpayer.

DATED this 18th day of October 1988.