

Cite as Det. No. 16-0374, 38 WTD 208 (2019)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of) D E T E R M I N A T I O N
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 No. 16-0374
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 Registration No. . . .
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RULE 15503; RCW 82.04.050(8); RCW 82.12.020(1)(e); RCW 82.04.192(3): RETAIL SALE – USE TAX – DIGITAL AUTOMATED SERVICES – DATA PROCESSING SERVICES. A service transferred electronically that uses one or more software applications, costs 1.6% of gross sales, and provides inventory management, communications, analytics, and point of sale reporting, is a digital automated service, rather than a data processing service, and is subject to use tax.

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.

Margolis, T.R.O. – A retailer of recorded movies and music (Taxpayer) seeks a refund of use tax paid on services purchased from an application service provider. We deny the petition.¹

ISSUE

Whether, under RCW 82.04.050(8) and RCW 82.12.020(1)(e), Taxpayer is subject to use tax on purchases of digital automated services . . .

FINDINGS OF FACT

Taxpayer operates multiple locations in Washington selling vinyl records, CDs, and DVDs. The Department of Revenue's Audit Division (Audit) reviewed Taxpayer's account for the period January 1, 2011, through December 31, 2013, and on November 17, 2015, assessed Taxpayer \$. . . The assessment comprise \$. . . in use tax and \$. . . in interest.

Audit assessed use tax on charges detailed in Taxpayer's computer expense account noted as [Analysis Services] which Audit determined were payments for digital automated services . . . upon which Taxpayer did not pay sales tax, that are subject to use tax. On December 9, 2015, Taxpayer filed a petition for review of the assessment, arguing that the payments at issue were made to . . . (Vendor) for the manipulation and analysis of Taxpayer's data, which Taxpayer

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

asserts is a service not subject to use tax.² Taxpayer further argues that while it purchased software that allows it to receive the services that purchase was separate, incidental, and immaterial in value.

Taxpayer provided a contract titled “Application Service Provider Agreement” between Vendor and Taxpayer. The contract explains that Vendor is an application service provider that licenses point of sale (POS) services used as part of an inventory management system. These services consist of five “Front-End” program components and one “Back End” component. The “Front End” components comprise [Register] (which controls sales registers); [Label] that generates price labels that can be read by [Register]; [FTP] which provides for communication between the Front-End and Back-End; [Office], which performs various functions including accessing sales data, allowing order creation, and providing for email; and, [Clarity], which performs various functions including reporting, online marketplace order picking, and point of sale functionality. The “Back End” is the [Analysis Server], which is a managed inventory program running on Vendor’s servers that stores and analyzes data. Taxpayer explains that it does not directly access the Back End, which extracts data from the Front End electronically and then analytic services are performed by the Back End software owned by Vendor. The contract’s fees schedule reads as follows (in pertinent part):

Ongoing Monthly Fees:

Analysis, Management, Software Usage, Remote Usage, Support, Database

1.6% of gross sales. . . .

Support/Consulting:

Twenty hours per month as included in your contract. . . .

(Emphasis in original.)

Taxpayer provided a sample invoice from Vendor, which describes the charges as “[Analysis Service] @ 1.6%.” The invoice notes “Out-of-state sale, exempt from sales tax” and includes no sales tax. Taxpayer also provided a letter from Vendor’s President. It explains that any payment for software would have occurred when Taxpayer became its client in 2007, and Taxpayer now pays for the amount of sales data that Vendor processes on Taxpayer’s behalf through Vendor’s cloud, regardless of the number of devices using the software and sending the data. Taxpayer argues that it is only paying for Back End services, which it asserts are comprised entirely of data processing services not subject to use tax.

ANALYSIS

RCW 82.08.020 imposes retail sales tax on each retail sale taking place within this state. RCW 82.12.020 imposes a corresponding use tax on retail sales of goods or services used within this state upon which retail sales tax has not been paid. RCW 82.04.050(8)(a) provides that retail sales include sales to consumers of [digital automated services] where the seller has granted the purchaser a right to use that is less than permanent, and where the purchaser is obligated to make continued payment as a condition of the sale. RCW 82.04.050(8)(b) provides that a retail sale of [digital automated services] under RCW 82.04.050(8)(a) includes any services provided by the

² On December 16, 2015, Taxpayer paid the assessment. Thus, we are treating this matter as a petition for refund.

seller exclusively in connection with [digital automated services], whether or not a separate charge is made for such services. RCW 82.12.020(1)(e) imposes a corresponding use tax where the sale of [digital automated services] was not subjected to retail sales tax.

RCW 82.04.192(3)(a) states that [digital automated services] means any service transferred electronically that uses one or more software applications. WAC 458-20-15503 (Rule 15503) is the administrative rule that discusses the taxation of digital products, which include [digital automated services]. Rule 15503(203)(a) explains that [digital automated services] may include the following:

One or more software applications either prewritten or custom, as well as components that are similar to stand-alone digital goods. For example, an online information service may contain data, facts, or information the use of which is facilitated by one or more software applications that provide search capabilities and other functionality. Thus, digital automated services will include software and may include elements similar to stand alone digital goods, which operate together in an integrated fashion to provide an electronically transferred service.

However, [digital automated services] does not include data processing services as explained in RCW 82.04.192(3)(b)(xv). The statute defines “data processing service” as:

[A] primarily automated service provided to a business or other organization where the primary object of the service is the systematic performance of operations by the service provider on data supplied in whole or in part by the customer to extract the required information in an appropriate form or to convert the data to usable information. Data processing services include check processing, image processing, form processing, survey processing, payroll processing, claim processing, and similar activities.

Id. [See also *Qualcomm, Inc. v. Dep’t of Revenue*, 171 Wn.2d 125 (2011)(noting that the primary purpose test focuses on the real object of the transaction sought by the taxpayer’s customers and not just the transaction’s different parts).]

Rule 15503(303) Example 20 provides an example that illustrates when the exclusion does not apply. It reads as follows:

Bango Corp., in preparation for litigation, hires Company to use its automated technology to search Bango's computers and gather documents relevant to the lawsuit. Company's service also provides software tools that allow Bango to categorize, copy, store, and notate the gathered documents. Company's service is not data processing. The services performed primarily involve gathering data, and providing software tools that allow the customer to categorize, copy, store and notate documents in preparation for litigation. Accordingly, Company is selling a digital automated service generally subject to retail sales tax and retailing B&O tax.

The contract shows that the service at issue involves gathering sales and inventory data and the use of software tools that allow Taxpayer to track and analyze its purchase and sales activities.

This is akin to the service described in the example above that also involves gathering data and providing software tools. Both services go beyond the definition of data processing, which is limited to extracting the required information in an appropriate form or converting data to usable information. Rule 15503(303) Examples 21 and 22 provide examples of excluded data processing services, which in contrast to the service at issue, involve only the extracting and formatting of data from images of checks. In accord with these examples and the definition of data processing services, the service at issue is not data processing. *See Det. No. 11-0001, 32 WTD 93 (2013)* (The primary object of the online management services company's service is for it to provide its customers with [digital automated services], even though it initially imports a customer's data, and may convert existing data into reports.); *see also Det. No. 14-0276, 35 WTD 97 (2016)* (Taxpayer's computer program did not meet either definition of "data processing." It not only assembled the data but also evaluated it, through algorithms, in such a way as to predict the creditworthiness of potential borrowers.)

Taxpayer's argument that it is only paying for Back End data processing services, and Vendor's assertion that Taxpayer is only paying for the amount of sales data processed, is insufficient to establish that Taxpayer is not purchasing the [digital automated services] described in the contract. The primary object of this service is for Vendor to provide Taxpayer with [digital automated services], a service transferred electronically that uses one or more software applications. The service provides an extensive business solution in exchange for 1.6% of gross sales that includes inventory management, communications, analytics, and point of sale reporting. The service goes beyond mere data processing where the primary object is to extract or convert information. Taxpayer is purchasing a larger business solution that fits within [digital automated services], not merely data processing services similar to check processing, image processing, payroll processing, claim processing, and similar activities. Because Taxpayer purchased [digital automated services] which was not subjected to retail sales tax, we conclude that the assessment of use tax was correct and deny Taxpayer's petition for refund.³

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 30th day of November 2016.

³ Because we conclude that the service at issue is a [digital automated services], which is subject to retail sales tax and use tax, we do not reach the issue of whether this is also a bundled transaction subject to retail sales tax under RCW 82.08.195.