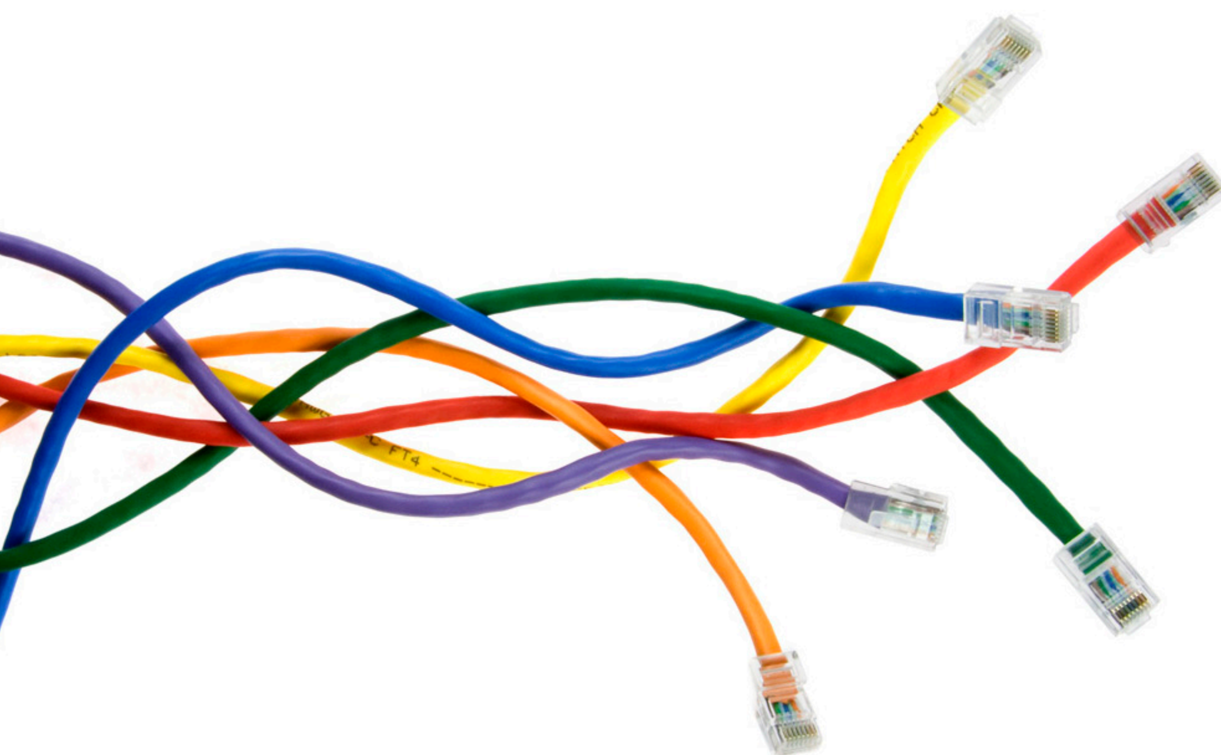
Washington's Business Tax Primary Purpose Test After Qualcomm Inc. v. Washington Dept. of Rev.



BY ANDREW COLSON, TAX SENIOR MANAGER, DELOITTE TAX LLP
STEPHANIE GILFEATHER, TAX CONSULTANT, DELOITTE TAX LLP

Analysis&Perspective

Business Privilege and License Taxes

The Washington Supreme Court's recent decision in *Qualcomm Inc. v. Washington Department of Revenue* threw the classification of some business activities for business and occupation tax purposes into question. In this article, authors Andrew Colson and Stephanie Gilfeather of Deloitte Tax LLP discuss the decision's implications for companies that provide a blend of hardware, software, and services in Washington state.

Washington's Business Tax Primary Purpose Test After *Qualcomm Inc. v. Washington Dept. of Rev.*

BY ANDREW COLSON AND STEPHANIE GILFEATHER

INTRODUCTION

For Washington state business tax purposes, the assignment of business activities into one of several taxable classifications can have significant consequences since tax rates differ among the classifications. The determination becomes difficult when a business is engaged in multiple activities that cover different Washington tax classifications. Such is the case for businesses that provide a blend of telecommunication and information services to their customers.

Andrew Colson, CPA, is a Senior Manager with Deloitte Tax LLP's Multistate Practice, resident in Seattle. Andrew can be reached at acolson@deloitte.com. Stephanie Gilfeather is a Tax Consultant with Deloitte Tax LLP's Multistate Practice, resident in Seattle. Stephanie can be reached at sgilfeather@deloitte.com.

The authors would like to acknowledge Mike Santoro (Senior Manager with Deloitte Tax LLP, Washington National Tax-Multistate), Fred Paladino (Director with Deloitte Tax LLP, Washington National Tax-Multistate), and Tom Godfrey (Director with Deloitte Tax LLP, Washington National Tax-Multistate) for their technical and editorial assistance in the preparation of this article.

This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

Copyright© 2011 Deloitte Development LLC. All rights reserved.

In a case of first impression, the recent Washington Supreme Court decision in *Qualcomm Inc. v. Washington Department of Revenue*[1] offers companies providing multiple services in the state guidance regarding the methodology for classifying their activities for Washington business tax purposes.

General Overview of Washington Excise Taxes

The State of Washington's major business taxes include the business and occupation (B&O) tax, the retail sales tax, and the complementary use tax. The B&O tax is based upon specified business activity classifications and is measured by the gross income of a business with no deductions for labor, materials, taxes, or other costs of doing business.

The B&O tax classification and resulting tax rate depends upon the nature of the business activities. A business must report multiple activities under different B&O tax classifications. The B&O tax is borne by the business and cannot be collected from customers.

The Washington retail sales tax applies to consumers of tangible personal property as well as some enumerated services. Businesses collect sales tax from their customers when making taxable Washington sales and report and remit that tax to the state. Consumers of tangible personal property generally owe the state use tax on taxable items used in Washington where no sales tax was collected.

In general, persons who sell tangible personal property are subject to B&O tax at either the ''retailing'' B&O tax classification with a rate of 0.471 percent of gross receipts or the ''wholesaling'' B&O tax classifica-

[1] *Qualcomm Inc. v. Wash. Dept. of Rev.*, 249 P.3d 167 (Wash. 2011).

tion with a rate of 0.484 percent of gross receipts. Service providers are generally subject to B&O tax at the ''service and other'' classification rate of 1.5 percent for periods prior to May 1, 2010. For periods after May 1, 2010, the ''service and other'' B&O tax classification rate is 1.8 percent.

Qualcomm Facts and Procedural History

During the relevant years at issue in *Qualcomm*, 1998–2001, the taxpayer sold its OmniTRACS system to trucking companies. The system was comprised of three general components:

- mobile communication terminals that were installed in customer trucks to collect vehicle and driver performance data (hardware);
- a relay service that transmitted data from the hardware to Qualcomm's network management facility where the data was processed, manipulated, and stored (service); and
- computer software installed on computers at a customer's dispatch center that allowed for the use of the data (software).

The hardware, service, and software components were interdependent, making each individual component effectively useless without the others. Qualcomm separately invoiced its customers a one-time charge for the hardware and software and charged a monthly fee for the service component. Separate invoicing was performed for Washington sales and use tax purposes to record the taxable hardware and software sales.

For the years at issue, Qualcomm paid B&O taxes at the ''service and other'' rate of 1.5 percent with respect to charges for the service component. Qualcomm did not collect or remit sales tax regarding the service component because information services were not subject to Washington's sales tax.

On audit, the Washington Department of Revenue (DOR) classified the service component as a network telephone service and assessed ''retailing'' B&O tax at a rate of 0.471 percent.[2] In addition, the DOR assessed Washington's sales tax on the service component because network telephone services were taxable as retail sales.

Qualcomm unsuccessfully challenged the assessment before the DOR's appeals division and then before a Washington trial court. The Court of Appeals of Washington upheld the trial court's decision. Qualcomm subsequently appealed the case to the Washington Supreme Court.

'Network Telephone Service' and 'Information Service'

At issue in *Qualcomm* was whether the service component was taxable as a ''network telephone service,'' subject to the ''retailing'' B&O tax classification and the retail sales tax; or as an ''information service,'' subject only to the ''service and other'' B&O tax classification. A definition of each is instructive.

Former Wash. Rev. Code §82.04.065(2), applicable during the years at issue, defined ''network telephone service'' to mean ''the providing by any person of access to a local telephone network, local telephone network switching service, toll service, or coin telephone services, or the providing of telephonic, video, data, or similar communication or transmission for hire, via a local telephone network, toll line or channel, cable, microwave, or similar communication or transmission system.''

In 2007, the Legislature amended Wash. Rev. Code §82.04.065(2) and replaced the phrase ''network telephone service'' with ''telecommunications service.'' The new statute specifically excludes ''[d]ata processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser where such purchaser's primary purpose for the underlying transaction is the processed data or information.''[3]

An ''information service'' is defined as ''every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible medium.'' The term does not include a telephone service defined under Wash. Rev. Code §82.04.065.[4]

The Washington Supreme Court in *Qualcomm* found that the 2007 amendments were changes in terminology intended to preserve existing law regarding taxability and exemptions.[5] Drawing upon this reasoning, the court applied the 2007 amended language (regarding the primary purpose test and the information service exclusion from the meaning of a telecommunication service) to Qualcomm's facts concerning tax years 1998–2001.

Applying the 'Primary Purpose' Test

In its analysis, the Washington Supreme Court acknowledged that ''how to classify for tax purposes a service like Qualcomm's that includes elements of both a telecommunication and information service is a question of first impression in this court''[6] and determined that the statutory ''primary purpose'' test was the appropriate method to address this classification issue.[7] In applying the primary purpose test, the court found guidance in case law that utilized the analogous ''true object'' test to distinguish between nontaxable sales of services and taxable sales of tangible property by looking to the purpose for which a purchaser acquired the good or service.

While the parties in this case agreed that the primary purpose/true object test was the appropriate method to decide the classification issue, they disagreed regarding the unit to which the test should apply. The DOR asserted that the court should apply the test to only the service component of the OmniTRACS system. The DOR reasoned that the three components that comprised the system were separately invoiced and therefore they should be analyzed as separate activities. Because the service operated solely to transmit data, the

[2] While the DOR's position sought to subject the service component to the lower 0.471 percent B&O retailing rate, classifying the component as retail would allow the DOR to impose the retail sales tax on those activities.

[3] Wash. Rev. Code §82.04.065(27)(a) (emphasis added).

[4] Wash. Regs. §458-20-155.

[5] *Qualcomm Inc.*, 249 P.3d at 171.

[6] *Id.* at 172.

[7] *Id.* at 174.

DOR argued, the monthly service charges should constitute a telecommunication service.

Qualcomm argued that the primary purpose test should be applied to the OmniTRACS system as a whole, including the hardware and software, because each individual part could not be sustained as an independent purchase or service. Looking to the system as a whole, Qualcomm claimed that the system should be classified as an information service because its location calculations, time-and-date stamping, data packaging, organization, and data storage functions transformed and manipulated information rather than merely transmitting it. The service itself was the creation of information, and the purpose of a company buying the OmniTRACS system was to obtain a management tool rather than a telecommunications service. Further, the company argued that its separate invoicing of the individual components was not an acknowledgement of independent purchases by customers—Qualcomm was compelled to separately invoice system components because of Washington's sales and use tax rules.

The Washington Supreme Court agreed with Qualcomm's position that the ''true purpose of a company buying its integrated OmniTRACS system was to obtain'' an information service in the form of a ''management tool, not telecommunication service.''[8] As the court explained, ''The system provides a trucking company with detailed information about its trucks and drivers while they are away from the company's place of business.''[9] The court emphasized that:

> [this integrated system is what the Washington Legislature] contemplated . . . in the amended version of the statute at issue here. Services that ''allow data to be generated, acquired, stored, processed, or retrieved *and delivered by an electronic transmission*'' [are not taxable telecommunications services] where the purchaser's primary purpose ''*is* the processed data or information.''[10]

The court went on to state that even if the service component were viewed in isolation as the DOR suggests, ''it still appears to be primarily an information service rather than a telecommunications service,'' with the ''core function'' of providing up-to-date truck and driver status information to enable a customer to manage its trucking fleet.[11]

In reaching its decision, the court relied on principles that it had articulated previously in *Community Telecable of Seattle Inc. v. City of Seattle*.[12] In *Community Telecable*, the court determined that the taxpayer's cable internet service was not taxable as a ''network telephone service.'' The principal characteristic that made the service internet service, rather than ''network telephone service,'' was the transformation and manipulation of data, and the data manipulation was an integral and necessary part of the service.[13] Similar data manipulation was integral and necessary to the OmniTRACS system.

[8] *Id.* at 175.

[9] *Id.*

[10] *Id.* (citing Wash. Rev. Code §82.04.065(27)(a)).

[11] *Qualcomm Inc.*, 249 P.3d at 176.

[12] *Community Telecable of Seattle Inc. v. City of Seattle*, 164 Wn.2d 35 (2008).

[13] *Qualcomm Inc.*, 249 P.3d at 176.

As recognized by the court in *Qualcomm*, the service component of the OmniTRACS system ''both collects and manipulates data and transmits that data to the customer.''[14] Focusing on these facts, the court concluded: ''When a service involves both telecommunications and information processing, we adopt the primary purpose of the purchaser test to determine the applicable tax rate. . . . [Applying this test,] we hold that . . . the service should be taxed as an 'information service' rather than a 'network telephone system.' ''[15] On this basis, the court reversed the Court of Appeals' decision and remanded the case to the trial court.

Relevant Developments

On Jan. 7, 2009, the DOR added a new administrative code section, Wash. Regs. §458-20-15501, which ''explains the business and occupation (B&O), retail sales, and use tax treatment of activities related to computer hardware, computer software, information service, and computer services.''[16] Part IV of that section provides guidance with respect to the ''taxation of information services and computer services'' and describes ''information services'' in a manner nearly identical to Wash. Regs. §458-20-155, the relevant provision at issue in *Qualcomm*.

Wash. Regs. §458-20-15501 also includes the following example:[17]

> VV Telephone, Inc., provides a satellite-based tracking and communications system that includes instant messaging between vehicles in transit and dispatch centers. Both the vehicles and the dispatch centers are operated by its customers, and information is both generated and received by the customers. This is not a sale of information service. *The true object of the transaction is the transmission of data between the vehicles and the dispatch centers through VV's communications system. VV is providing telecommunications services* subject to retailing B&O tax, and it must collect retail sales tax on the sale of telecommunications services. See [Wash. Regs.] §82.32.520 for sourcing of telecommunications services.
>
> *Emphasis added.*

The example in the administrative code section above appears to be drafted to address facts similar to those at issue in the *Qualcomm* case. However, given the 2011 decision in *Qualcomm*, finding on the facts in that case, ''the service should be taxed as an 'information service' rather than a [telecommunications service] ,'' the example above appears to have limited precedential value at this time. To foreshadow the legislative changes noted below, it is worth noting that the relevant definition of ''information service''[18] has not changed in this context.

Legislative developments in 2009 and 2010[19] add complexity to the current analysis in this area. Specifically, the legislature added, defined, and then clarified

[14] *Id.*

[15] *Id.* at 176-177.

[16] 2009-01 Wash. St. Reg. 64 (2009).

[17] Wash. Regs. §458-20-15501(401)(a)(ii)(D).

[18] Wash. Regs. §458-20-155 and Wash. Regs. §458-20-15501(401)(a)(i).

[19] 2009 Wash. Laws Ch. No. 535 (H.B. 2075) and 2010 Wash. Laws Ch. No. 111 (H.B. 2620), respectively.

a new term, ''digital products,'' for purposes of state taxation including, and separately defined, ''digital goods'' and ''digital automated service.''[20] Thus, effective July 26, 2009, ''digital products'' are subject to Washington sales and use tax.[21] Additionally, ''every person engaging within [Washington] state in the business of making sales at retail or wholesale of digital goods, digital codes, digital automated services, or [other specified] services'' is subject to the B&O tax at either the retailing or wholesaling tax rate.[22]

''Information service,'' as noted above, is not one of the other specified services subject to the Washington B&O or sales and use tax. However, in evaluating the new definitions of ''digital goods'' and ''digital automated services,'' a suggestion could be made that the inclusionary provisions in either or both of those terms could, arguably, include some ''information services.''

Using the B&O tax definitions, for example, digital automated service ''means any service transferred electronically that uses one or more software applications,'' except as excluded by statute.[23] Digital goods ''means sounds, images, data, facts, or information, or any combination thereof, transferred electronically, including, but not limited to, specified digital products and other products transferred electronically not included within the definition of specified digital products,'' except as excluded by statute.[24] Specified digital products are ''electronically transferred digital audio-visual works, digital audio works, and digital books.''[25] The term ''digital products'' means ''digital goods and digital automated services.''[26] A range of statutory exclusions, which could be viewed as further complicating the potential analytical conundrum in this context, are provided with respect to the definitions of digital automated service and, separately, digital goods.[27]

In light of the definitional ambiguity and potential overlap created by legislation noted above (and prior to the *Qualcomm* decision), it is important to note that the DOR ''anticipates rule making to explain the impacts of the 2009 and 2010 legislation, and to address other tax issues related to computer hardware, computer software, and computer services. The department is considering a repeal of Rule 155, an amendment to Rule 15501, and adoption of two new rules (Rules 15502 and 15503) to provide updated tax reporting guidance in this area.''[28]

Despite these developments, *Qualcomm* continues to be analytically instructive for at least two significant purposes. First, it provides guidance for transactions occurring before July 26, 2009, that involve a blend of telecommunication and information services. Second, the decision provides a useful framework for applying the primary purpose test in other hybrid transactions.

Purchase of Information Services Before July 26, 2009

Washington taxpayers receiving services that blend telecommunications with information services may want to review their tax positions in light of the *Qualcomm* decision. To the extent that an application of the primary purpose test could re-categorize services from telecommunication to information services, such services may be exempt from sales tax, but subject to a higher rate of B&O tax for the service provider.

Customers that paid use tax on such services may be eligible for a refund directly from the DOR.[29] If the customer paid sales tax to its retailer, then the customer should request a refund of the sales tax paid from the retailer to which it originally paid that tax.[30] The customer may request a sales tax refund directly from the DOR only after it has requested a refund from the retailer.[31]

If a retailer that collected sales tax on services later determined to be excluded from or not subject to sales tax, and appropriately provides refunds to customers, the retailer can request a refund from the DOR by amending its excise tax return or applying for a refund.[32]

Businesses that paid sales tax on such information services may also have improperly paid B&O tax at the lower ''retailing'' classification rate of 0.471 percent for periods before July 26, 2009. The proper classification for these hybrid information services was the ''service and other'' rate of 1.5 percent.[33] Taxpayers who paid B&O tax at the lower rate may have additional B&O tax liability along with related penalties and interest.

CONCLUSION

The *Qualcomm* decision may potentially provide a refund opportunity for purchasers of information services prior to Washington's July 2009 law change.

Additionally, for taxpayers that provide a blend of products and services, the *Qualcomm* decision may serve as a framework to determine the taxable category of such transactions. *Qualcomm* stands for the premise of looking to the purchaser's ''primary purpose for the underlying transaction'' to determine the taxable classifications that apply under Washington's B&O and retail sales taxes.

---

[20] 2009 Wash. Laws Ch. No. 535 (H.B. 2075) Section 201 adding Wash. Rev. Code §82.04.192 (B&O tax definitions) and Section 301 (imposition of sales/use taxes on digital products).

[21] Wash. Rev. Code §82.08.020 and Wash. Rev. Code §82.12.020.

[22] Wash. Rev. Code §82.04.257.

[23] Wash. Rev. Code §82.04.192(3)(a).

[24] Wash. Rev. Code §82.04.192(6)(a).

[25] Wash. Rev. Code §82.04.192(9).

[26] Wash. Rev. Code §82.04.192(7).

[27] Wash. Rev. Code §82.04.192(3)(b) and Wash. Rev. Code §82.04.192(6)(b).

[28] 2011-03 Wash. St. Reg. 3 (2011); *see* http://apps.leg.wa.gov/documents/laws/wsr/2011/02/11-02-077.htm.

[29] Wash. Rev. Code. §82.32.060.

[30] Wash. Regs. §458-20-229(4).

[31] Wash. Regs. §458-20-229(4); *see* DOR's *Apply for a tax refund* page at http://dor.wa.gov/content/fileandpaytaxes/applyforataxrefund/.

[32] *Id.*

[33] Note that a temporary surcharge of 0.3 percent has been added to the ''service and other'' B&O tax classification applicable from May 1, 2010, to June 30, 2013.

Copyright ©