

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 17084
[Redacted])	
Petitioner.)	DECISION
)	
)	

On October 18, 2002, the Sales, Use and Miscellaneous Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] The Notice proposed additional sales tax, use tax and interest in the total amount of \$21,607 for the period September 1, 1999 through August 31, 2002. The taxpayer filed a timely appeal and petition for redetermination on December 18, 2002.

The taxpayer requested an informal conference, which was held on July 1, 2003. Based on that conference and additional discussions, the Commission reached an agreement with the taxpayer on certain issues and made the necessary adjustments to the work papers. The taxpayer remitted two partial payments prior to the informal hearing and one following the hearing. These amounts and their issues are no longer in dispute. This decision addresses the remaining issue.

DISCUSSION OF FACTS

The taxpayer is a designer and manufacturer of customized log home kits, registered with the State of Idaho as a retailer and obligated to collect sales tax. Potential log home kit buyers contract for preliminary design drawings from the taxpayer to conceptualize their log home ideas and enable the taxpayer to estimate the log home kit price. The auditor did not hold these transactions taxable.

If a customer wants to buy a log home kit, the taxpayer prepares final construction drawings and bills the customer for this drawing fee (approximately \$2 per sq. ft.) and the logs it builds from the drawings. During the period under audit, the taxpayer did not collect tax on the charges for the

final construction drawing fees that were billed to customers as part of completed log home packages. The taxpayer did add the appropriate sales tax to the price it charged for the log home components, and these amounts were remitted to the state. For reasons to be discussed, the Commission believes that the final construction drawings are services agreed to be rendered as part of the sale of tangible personal property and are subject to tax.

In the sales quote to each customer,

...professional fees charged by [the taxpayer] for final construction drawings are included in our log material quote....Below the line labeled 'Taxable Subtotal' is found the line labeled 'Drafting Charges.' [The taxpayer] separately states the cost of professional fees for final construction drawings from the cost of log materials (Petition for Redetermination, p. 3, December 18, 2002).

The taxpayer and the clients (or customers) agree by contract that all design and architectural works are the property of the taxpayer, protected under federal copyright law. The clients use the final construction drawings to obtain contractor bids and building permits and to assist lenders and appraisers in determining loan values. Following that,

[b]ased upon the [final] construction drawings, [the taxpayer's] designers prepare production drawings that are essential to the proper milling and cutting of the home.... They are part of the services rendered to the client by the [taxpayer's] design team (*supra*, p. 5).

Referring to the Idaho Sales Tax Act (Idaho Code §§63-3612, 63-3616 and 63-3619) in their petition, the taxpayer notes that tax is imposed on the sales price of tangible personal property when there is an exchange of title. The taxpayer contends that its drafting services (both preliminary and final) are not tangible personal property and that no exchange of title takes place since ownership of the drafted plans remains with the company.

Additionally, the taxpayer refers to Idaho Sales Tax Administrative Rule 011 (IDAPA 35.01.02.11) that addresses transactions where a mix of both tangible personal property and services

exist. Where there are consequential elements of both tangible personal property and service in one transaction, the taxpayer states, the cost for the separately stated service is not taxable. Throughout its petition, the taxpayer cites various court cases that are examined in this decision.

ANALYSIS AND CONCLUSIONS

Idaho imposes a tax on the sale of tangible personal property.

Sale. -- (1) The term "sale" means any transfer of title, exchange or barter, conditional or otherwise, of tangible personal property for a consideration and shall include any similar transfer of possession found by the state tax commission to be in lieu of, or equivalent to, a transfer of title, exchange or barter (Idaho Code §63-3612).

The Sales Tax Act defines "sales price" excerpted in relevant part below.

Sales price. -- (a) The term "sales price" means the total amount for which tangible personal property, *including services agreed to be rendered as a part of the sale*, is sold, rented or leased, valued in money, whether paid in money or otherwise, without any deduction on account of any of the following:

1. The cost of the property sold....
2. The cost of materials used, labor or service cost, losses, or any other expense (Idaho Code §63-3613, emphasis added).

The foregoing includes "services agreed to be rendered as part of the sale", as well as labor, service cost and "any other expense" in the amount subject to tax. By including the words, "services agreed to be rendered," the legislature expressly indicated that some services were intended to be part of the sales price subject to tax even if the charge for such services is stated separately from the charge for the property. Thus, the Commission concludes that the cost of the final construction drawings is reasonably included in the sales price. In order to conclude otherwise, those costs would be specifically excluded from the statutory definition of sales price.

- (b) *The term "sales price" does not include any of the following:*
1. Retailer discounts allowed and taken on sales...
 2. Any sums allowed on merchandise accepted in payment of other merchandise...
 3. The amount charged for property returned by customers when the amount charged therefor is refunded...
 4. The amount charged for labor or services rendered in installing or applying the property sold...
 5. The amount of any tax (not including, however, any manufacturers' or importers' excise tax) imposed by the United States ...
 6. The amount charged for finance charges, carrying charges, service charges, time-price differential, or interest on deferred payment sales...
 7. Delivery and handling charges for transportation of tangible personal property to the consumer...
 8. Manufacturers' rebates...
 9. The amount of any fee imposed upon an outfitter as defined in section 36-2102, Idaho Code...
 10. The amount of any discount or other price reduction on telecommunications equipment when offered as an inducement to the consumer to commence or continue telecommunications service...
- (c) The sales price of a "new manufactured home" or a "modular building" as defined in this act shall be limited to and include only fifty-five percent (55%) of the sales price as otherwise defined herein.
- (d) Taxes previously paid on amounts represented by accounts found to be worthless may be credited upon a subsequent payment of the tax provided in this chapter...
- (e) Tangible personal property when sold at retail for more than eleven cents (\$.11) but less than one dollar and one cent (\$1.01) through a vending machine shall be deemed to have sold at a sales price equal to one hundred seventeen percent (117%) of the price which is paid for such tangible personal property...(Idaho Code §63-3613, emphasis added).

The Commission finds the forgoing statute to be unambiguous. The costs of labor and creativity that are part of the drawings billed with the log home kit are not within the legislated exclusions to sales price.

The taxpayer contends in its petition that for a sale to be taxable it must include a transfer of tangible personal property and an exchange of title. In its opinion, the final construction drawings are neither. The Commission respectfully suggests that the taxpayer misses the point. We seek to

uphold the provision of the Idaho Sales Tax Act that imposes a tax on the sale of tangible personal property without regard to certain underlying labor costs en route to the manufacture of the property, regardless of any separate statement on an invoice. Retail goods are inevitably the product of specialized processes, patented processes and reserved trademarks. The sale of a car, for example, is taxable, yet the purchase does not give the buyer a right to infringe on any patent or design feature that is part of the vehicle.

The taxpayer's petition emphasizes Idaho Sales Tax Administrative Rule 011, Retail Sales - Sale At Retail (IDAPA 35.01.02.011.02-.03), which speaks to mixed transactions. Mixed transactions involve the transfer of tangible personal property and the performance of a service. Rule 011 gives guidance for determining if a mixed transaction is a retail sale of tangible personal property, a sale of a service, or if there are consequential elements of both property and service.

In fact, the Commission relied on Rule 011, in part, to determine that the cost of the *preliminary* design drawings provided by the taxpayer was not taxable. These design drawings were, by agreement, a separate transaction from the final drawings, the latter being on the same invoice as the log kit. Rule 011 provides an example that is on point:

Example 3: An architect is hired to prepare construction plans for a house. He prepares the plans and delivers them to his client. ... this is a sale of services and the transfer of the tangible personal property, the plans, is inconsequential [to] the transaction. No sales or use tax is due on the sale of the plans (IDAPA 35.01.02.011.03c).

The taxpayer argues that there is no difference between the preliminary design drawings and the final construction drawings for purposes of taxation. Individuals employed by the taxpayer performed identical services. The Commission concludes otherwise because the final construction drawings are an integral part of a sale of tangible personal property, whereas the preliminary drawings are a separate transaction not tied to the transfer of consequential property. There is no

consequential transfer of tangible personal property with the preliminary design drawings, and there is no future obligation to buy tangible personal property from the taxpayer.

The taxpayer stated in the hearing that services are not taxable and that the Commission is opening an unintended area of tax liability by finding them so in the present case. The Commission, in the taxpayer's opinion, is singling out architectural services for tax when other services are not treated identically--in essence, a violation of equal protection.

The Commission observes that nothing in the present case arbitrarily selects architectural services for biased and unfair treatment relative to other professional services. The most immediate evidence of this is that the auditor did not hold the cost of the *preliminary* design fees taxable because these transactions do not obligate customers to the purchase of consequential tangible personal property. The Commission would hold similarly that a lawyer's preparation of a will or an accountant's preparation of a balance sheet would be a nontaxable service, but that the sale of a book on how to prepare wills or an accounting text, both a product of intangible creative endeavors, would be taxable. This treatment is borne out by a reading of examples provided in Rule 011 (IDAPA 35.01.02.011).

The Commission finds that the charges for the final construction drawings cannot be severed from the taxable amount charged for the resultant log kit, no more than underlying costs of doing business such as telephone, mortgage financing, and workers' labor would be if they were separately stated by the taxpayer. One would probably not disagree that the customer's intent is to buy a log home kit. Many intangible service elements and subsidiary costs are integral to the creation of the final product, none of which change the object of the transaction. Although the final construction drawings have a utility for the customer, they are by the taxpayer's admission both a benefit in the production process and essential to it.

The fact that the charge for the tangible personal property results mainly from the labor or creativity of its maker does not turn a sale of tangible personal property into a sale of services. The cost of any product includes labor and manufacturing skill (IDAPA 35.01.02.011.02).

The Tennessee Supreme Court captured this viewpoint eloquently.

There is scarcely to be found any article susceptible to sale or rent that is not the result of an idea, genius, skill and labor applied to a physical substance. A loaf of bread is the result of the skill and labor of the cook who mixed the physical ingredients and applied heat at the temperature and consistency her judgment dictated. A radio is the result of the thought of a genius, or several such persons, combined with the skill and labor of trained technicians applied to a tangible mass of substance. An automobile is the result of all these elements, and of patents, etc.; and so on, ad infinitum. If these elements should be separated from the finished product and the sales tax applied only to the cost of the raw material, the sales tax act would, for all practical purposes, be entirely destroyed. *Crescent Amusement Co. v. Carson*, 187 Tenn. 112, 213 S.W.2d 27, 29 (1948)

The taxpayer cites *Ryder* as a case in which the court agreed that the legislature contemplated a mixed transaction having consequential elements of a non-taxable service and tangible personal property. The case refers to the rental of pagers with separately stated access fees. (See, generally, *Ryder v. Idaho State Tax Commission*, 939 P.2d 564.) The Commission does not believe that this case is on point because the service did not contribute to the manufacturing process that created or improved the pagers. While one may or may not be offered without the other, both exist independently of one another in that neither is required for the other's existence.

The taxpayer cites as representative of the present case *Jackson Advertising Corporation* wherein a superior court in Maine ruled that the sale of products that are the result of a consequential application of professional services was not taxable. In that case, the court held that,

...like the custom software...each product has value only to its particular purchaser...the cost and the value of the products results largely from the hopefully successful application of [the seller's] creativity and professional skills....the principal value sought by the respective clients....was in the creative and professional services

provided...but involved materials of relatively little value (*Jackson Advertising Corporation v. State Tax Assessor*, Civil Action Docket No. CV-85-1289, 1987, p. 4).

This case is of no value because upon appeal by the Tax Assessor, *Jackson Advertising Corporation* was overturned with the Supreme Judicial Court of Maine stating,

...Jackson has failed to demonstrate that the decision of the Assessor is irrational, arbitrary, capricious or characterized by an abuse of discretion...(*Jackson Advertising Corporation v. State Tax Assessor*, 551 A.2d 1365).

Further, in *Jackson Advertising Corporation*, the transaction in question involved an inconsequential element of tangible personal property, whereas in the present case the object sought is consequential tangible personal property (i.e., logs). It bears repeating that Idaho law does not arbitrarily subject stand-alone services to tax when creativity and skill is conveyed with an inconsequential component of tangible personal property.

Another case the taxpayer brought to the attention of the Commission is *Old West Realty, Inc. v. Idaho State Tax Commission* (716 P.2d 1318). In this case the court notes that neither party raised any issue as to the transfer of title to books, the sale of which were the central issue of the litigation. The court concluded that there was a transfer of title, thus clearing a hurdle for the supposition that the transaction involving the books constituted a sale at retail under the Sales Tax Act.

By contrast, the taxpayer in the present case reminds us that there is no transfer of title to the final construction drawings and that by logical conclusion there is no sale within the meaning of the Sales Tax Act. Thus, in its opinion, there is no applicable tax. In response, we respectfully suggest that the taxpayer avoids our central contention that it is the logs that are tangible personal property; title is transferred, and the underlying service or labor used to create the logs is not, by statute, severable from the price subject to tax.

The taxpayer offered in the hearing that the Commission focuses too narrowly on “form” rather than the “substance” of the transaction. It suggests that if it formed two separate corporations, one corporation could provide final construction drawings to a client, who could then take those drawings to the second corporation for use in creating the log package. Under the Commission’s interpretation of the code, the taxpayer says, the first transaction would be a nontaxable service because there is an inconsequential transfer of tangible personal property. The log kit derived from those plans freely given by the client to the second company would have a sales price subject to tax that did not include the cost of the first transaction. Why, the taxpayer asks, should it be forced to create two separate legal entities to satisfy the Commission’s reliance on a technicality?

This decision is not the place to determine whether or not the taxpayer has, in conjecture, thought of a way to legally avoid the imposition of the amount of tax sought by the Commission. That is, the decision deals with the facts before it and not what could have been had something been done differently. As noted previously, the sale of a log home kit was tied to the provision of services which, although separately stated on a document presented to the customer, could not, in the opinion of the Commission, be severed from the amount subject to tax.

The Commission also finds the addition of interest to the taxpayer’s liability appropriate per Idaho Code § 63-3045. Interest on the Notice of Deficiency Determination has been updated to December 31, 2003.

WHEREFORE, the Notice of Deficiency Determination dated October 18, 2002, is hereby MODIFIED, and as so modified is APPROVED, AFFIRMED and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty and interest:

TAX	INTEREST	TOTAL
\$9,291	\$151	\$9,442

DEMAND for immediate payment is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2003, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
