

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 19146
[Redacted])	
Taxpayer.)	DECISION
)	
)	

On August 26, 2005, the staff of the Sales, Use, and Miscellaneous Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (Taxpayer) proposing additional use tax, penalty, and interest for the period September 1, 1996, through August 31, 2003. In a letter dated October 27, 2005, the Taxpayer filed a timely appeal and petition for redetermination. The petition stated several disagreements of fact and law that the Taxpayer wished to discuss at a hearing. The Commission held a hearing at the Taxpayer’s request on February 22, 2006.

For reasons explained below, the Commission hereby issues this decision for an amended amount.

BACKGROUND

The Taxpayer is referred to as a [Redacted]. It has two [Redacted] in Idaho and each [Redacted] has one [Redacted]. The Taxpayer is a wholly-owned affiliate of an out-of-state holding company of [Redacted] operating in several states.

As its primary business, the Taxpayer uses its own [Redacted] to [Redacted]. At interchange sites the [Redacted] are transferred and continue on to their out-of-state destinations. In addition to [Redacted] the Taxpayer has revenue from the lease of [Redacted], and similar uses.

In Idaho, the sale, purchase, and use of tangible personal property is taxable unless an exemption applies (Section 63-3619, Idaho Code). In-state retailers and those out-of-state

retailers who have sufficient physical ties with this state to be classified as Idaho retailers are required to collect sales tax from their Idaho customers (Section 63-3611, Idaho Code). When an Idaho taxpayer makes purchases from non-resident retailers that have no obligation to collect sales tax, that taxpayer owes a use tax (Section 63-3621, Idaho Code). All states with a sales tax have a complementary use tax. Business taxpayers register with the Commission for a use tax number, enabling them to self-assess their use tax liability and periodically pay the Commission. During the period under audit, the Taxpayer that is the subject of this decision did not have a use tax number.

ISSUES

The Taxpayer agreed to certain audit findings and made two payments totaling \$420,489. In its petition for redetermination the Taxpayer listed disagreements with the audit findings. It claims three tax exemptions: (1) [Redacted] purchases and leases; (2) parts and equipment purchases used in the remanufacturing of [Redacted]; and (3) transfer of [Redacted] between related parties (the holding company and the Taxpayer). The first two exemptions are claimed under Sections 63-3622CC and 63-3622DD, Idaho Code. The third is claimed under Section 63-3622K, Idaho Code. The Taxpayer also claimed an exemption for: (1) data processing services; and (2) labor to improve real property.

Not all of these issues were addressed by the Taxpayer at the hearing. On August 9, 2006, the Taxpayer provided the Commission with a waiver of the latter's requirement to provide a final decision in this protest within 180 days of the hearing as required by Section 63-3045B(3), Idaho Code. The Taxpayer and the Commission have been in contact with one another several times since the hearing, but as of this writing the Taxpayer has not provided additional information in defense of its protest. This decision addresses those issues raised at the hearing and in the protest letter.

ANALYSIS

As noted earlier, an Idaho taxpayer owes a use tax on items it brings into this state if sales tax was not rightly paid to another jurisdiction, usually where the items were purchased (Section [Redacted], Idaho Code.) Exceptions do exist, and the Taxpayer claims the following exemption for the use of its [Redacted] and the use of equipment and parts to repair them:

[Redacted]

The auditor requested documentation showing that the Taxpayer paid tax on its out-of-state purchase of the [Redacted], but the Taxpayer was unable to provide it. Had such evidence existed, there would be no liability. Further, the Taxpayer did not provide an ownership history of the rolling stock to prove that the [Redacted] met the interstate commerce usage requirement of the exemption. Assuming, *arguendo*, that no tax was paid on the purchase and that the [Redacted] were used sufficiently in [Redacted] prior to being brought to Idaho, the question of tax rests on whether the [Redacted] were rebuilt or remanufactured in this state as required by the exemption statute.

The taxpayer asserts that it has rebuilt or remanufactured its [Redacted] in Idaho. The Commission disagrees with how the Taxpayer interprets the phrase “rebuilt or remanufactured in this state” (Section [Redacted], Idaho Code) for the purpose of qualifying for the exemption.

At the hearing, the Taxpayer stated that it rebuilds each of its [Redacted] by replacing or remanufacturing significant [Redacted] over approximately seven years. The [Redacted] are examples of systems the Taxpayer replaced in a staggered and modular fashion in what it believes complies with the statutory language.

The Commission does not view a drawn out or serial process of rebuilding or remanufacturing to be what the legislators had in mind when they enacted the exemption allowed

by Section [Redacted] Idaho Code, nor does the Taxpayer's view comport with this statute when viewed, as it must be, with the statute on use tax.

Use tax is due when storage, use or other consumption of tangible personal property takes place in Idaho:

Imposition and rate of the use tax -- Exemptions. -- An excise tax is hereby imposed on the storage, use, or other consumption in this state of tangible personal property acquired on or after July 1, 1965, for storage, use, or other consumption in this state ...

(a) Every person storing, using, or otherwise consuming, in this state, tangible personal property is liable for the tax. (Section 63-3621, Idaho Code)

Storage and use are defined as follows:

Storage – Use. – (a) The term "storage" includes any keeping or retention in this state for any purpose except sale in the regular course of business or subsequent use solely outside this state of tangible personal property purchased from a retailer.

(b) The term "use" includes the exercise of any right or power over tangible personal property incident to the ownership or the leasing of that property or the exercise of any right or power over tangible personal property by any person in the performance of a contract, or to fulfill contract or subcontract obligations, whether the title of such property be in the subcontractor, contractor, contractee, subcontractee, or any other person, or whether the titleholder of such property would be subject to the sales or use tax, unless such property would be exempt to the titleholder under section 63-3622D, Idaho Code, except that the term "use" does not include the sale of that property in the regular course of business. (Section 63-3615, Idaho Code)

Viewing the two previously cited use tax statutes together, the Commission would reasonably impose tax on the use of any parts replaced in [Redacted], defining such isolated replacement as a repair. The exemption allowed in Section [Redacted], Idaho Code, is for remanufacturing, which the Commission views as a significant from the “ground up” process, involving virtually every system of the [Redacted], necessitating their removal from the commerce stream for an uninterrupted and extended period of time. Had the legislature

envisioned that a piecemeal replacement of parts over time, however major, would satisfy the exemption, it would have plainly mentioned “repair” in defining the exemption. “Rebuild” and “remanufacture” must mean something different.

Consistent with how Idaho’s courts have viewed exemptions, the Commission views them narrowly. Tax exemptions existing only by legislative grace are to be strictly construed against the party claiming the exemption. Kwik Vend Inc. v. Koontz, 94 Idaho 166, 483 P.2d 928 (1971); Upper Columbia Mission Society v. Kootenai County, 93 Idaho 880, 477 P.2d 503 (1970.)

The replacement of major [Redacted] systems over a long time period introduces an element of uncertainty. If a [Redacted] was sold or destroyed before the completion of its remanufacture, for example, that Taxpayer’s rebuild/remanufacture process would be interrupted, and the administration of the exemption would be defeated. Would, for example, the use of the parts incorporated up to that point be retrospectively taxable? Since the process envisioned by the Taxpayer could take up to seven years, how would the Commission be able to enforce the collection of tax on items that were purchased beyond its three year statute of limitations (Section 63-3633(a), Idaho Code)? The statutes do not contemplate such events, lending credence to the Commission’s position that the rebuild and remanufacture process is not the aggregate of multiple repairs over time.

Thus, the Commission holds that the use of the Taxpayer’s [Redacted] in Idaho is taxable. Similarly, the use of any parts or equipment to repair the [Redacted] over time is taxable, and the Taxpayer cannot qualify for the exemption cited below:

[Redacted]The auditor disallowed the exemption for the lease and related-party transfers of [Redacted] between the Taxpayer and its holding company because he could not determine if

the transferor holding company paid tax on its purchase of the [Redacted] prior to the lease and transfer transactions. Such tax payment would allow an exemption under the following statute:

Occasional sales. (a) There are exempted from the taxes imposed by this chapter occasional sales of tangible personal property...

- (4) The sale, lease or rental of a capital asset in substantially the same form as acquired by the transferor and on which the initial transferor has paid sales or use taxes pursuant to section 63-3619 or 63-3621, Idaho Code, when the owners of all of the outstanding stock, equity or interest of the transferor are the same as the transferee or are members of the same family within the second degree of consanguinity or affinity. (Section 63-3622K, Idaho Code)

The Taxpayer protests the auditor's holding of tax on periodic billings for what it characterizes as an on-going data services agreement. A vendor provides the Taxpayer with continuous access to its data bases to help the Taxpayer manage its inventory of [Redacted]. Based on the invoices that reflect software upgrades, the auditor concluded that some of the periodic cost is for a license to use canned or off-the-shelf software. The cost to use such software is taxable because software is defined by the legislature as tangible personal property. "The term 'tangible personal property' includes any computer software which is not a custom computer program." (Section 63-3616(b))

Based on the available facts, the auditor reasonably concluded that the software was not custom and that its sale was therefore taxable. Further, since the invoices did not segregate any charges to the Taxpayer that may not be taxable, such as optional software support agreements, the entire periodic charges were held taxable:

- b.** If the maintenance contract is optional to the purchaser of canned software, then the portion of the contract fee representing upgrades or new software is subject to sales tax if the fees for support services and upgrades are separately stated. If the fees are not separately stated the entire charge for the maintenance contract is subject to sales tax. (IDAPA 35.01.02.027.05.b)

The final area of disagreement involved transactions claimed by the Taxpayer to be nontaxable because they include labor to improve real property. The taxpayer referenced two line items in the audit work papers that specified real property [Redacted] repair labor. The auditor reduced one taxable amount by an identifiable labor charge. For the other, he had no information to determine a possible reduction.

Absent additional information to the contrary, the Commission finds the deficiency prepared and later adjusted to be an accurate representation of the Taxpayer's use tax liability for the period September 1, 1996, through August 31, 2003.

The Bureau added interest and penalty to the sales and use tax deficiency. The Commission reviewed this addition and found it to be appropriate per Sections 63-3045 and 63-3046, Idaho Code.

WHEREFORE, the Notice of Deficiency Determination dated August 26, 2005, as MODIFIED, is APPROVED, AFFIRMED, and MADE FINAL.

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

<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
\$604,440	\$30,222	\$151,110	\$ 785,772
		Less Payment	<u>(420,489)</u>
		Amount Due	<u>\$ 365,283</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Taxpayer's right to appeal this decision is included with this decision.

DATED this ____ day of _____, 2007.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2007, 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]

Receipt No.