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(FILE NO. 2007-SC-0653-D)

Commonwealth of Kentucky

Court of Appeals

NO. 2006-CA-001783-MR

FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE — APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 05-CI-00806

DUPLICATOR SALES AND SERVICE, INC.; KENTUCKY BOARD OF TAX APPEALS — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: KELLER AND VANMETER, JUDGES; GUIDUGLI,[1] SENIOR JUDGE.

KELLER, JUDGE: The Finance and Administration Cabinet, Department of Revenue (hereinafter "DOR") has appealed from the Franklin Circuit Court's Opinion and Order upholding the decision of the Kentucky Board of Tax Appeals that reversed its

[1] Senior Judge Daniel T. Guidugli, sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

assessment of sales and/or use tax against Duplicator Sales and Service, Inc. (hereinafter "Duplicator"). We affirm.

Duplicator and the DOR entered into the following joint stipulations in the administrative action underlying this appeal, which set up the factual background for this action:

> 1. Duplicator sells and leases, at retail, copiers, fax machines and other types of office equipment in Kentucky, as well as parts and supplies for the equipment.
>
> 2. Duplicator's customers include individuals, businesses, churches, governmental agencies and non-profit organizations.
>
> 3. In addition to selling and leasing equipment, Duplicator provides parts, supplies and maintenance for the equipment it sells or leases, either on a specific "per call" basis (that is, when called by a customer that does not have a warranty or maintenance agreement) or under a warranty or maintenance agreement.
>
> 4. If a customer desires a warranty or maintenance agreement, the customer pays a fee, typically on an annual or monthly basis.
>
> 5. In exchange for the fee, Duplicator agrees to provide parts and certain supplies (such as toner) when the customer needs them at no extra charge beyond the fee and to provide maintenance of the equipment.
>
> 6. The DOR conducted sales and use tax audits of Duplicator for periods that included March 1, 1998 through September 30, 1998.
>
> 7. As a result of the DOR's audits, sales and use tax assessments were issued against the Taxpayer.
>
> 8. The Taxpayer timely protested the assessments.

> 9. All issues and amounts owed pursuant to the assessments, including those related to the time period March 1, 1998 through September 30, 1998, have been resolved with the exception of the issues presented herein.
>
> 10. The amount of the tax assessment in controversy is $8,141.22.
>
> 11. The DOR issued its Final Ruling on this issue June 2, 2004.

The issue in this case is whether Duplicator was the consumer or retailer of the parts and supplies it used in fulfilling its warranty or maintenance contracts. Ultimately, the question is whether the parts and supplies are subject to sales tax, which would be assessed against Duplicator's customers that are subject to sales tax, or use tax, which would be assessed against Duplicator in every transaction, regardless of the tax status of the customer. For the reasons set forth below, we hold that such transactions constitute retail sales requiring the imposition of sales tax against the customers.[2]

In its Final Ruling, the DOR stated, in part, that "[w]hen parts are installed under the terms of the [service, maintenance and extended warranty] contract, a *use* of tangible personal property is made and tax is due from the persons performing the repair work under the contract based on the provider's cost price of the installed parts." (Emphasis added.) The DOR then determined that the parts at issue were consumed by Duplicator in the performance of the maintenance contracts and, thus, were subject to an assessment of a use tax. The DOR noted that Duplicator's "position regarding

[2] We note that the transactions at issue in the present case involve customers who are tax exempt and thus are not subject to sales tax.

comparable maintenance contracts with not-for-profit entities is inconsistent with how the company treats contracts with for-profit entities" and that Duplicator "does not dispute the tax it owes on the use of parts used to fulfill contracts with its commercial customers."

Duplicator appealed this decision to the Kentucky Board of Tax Appeals. Following a hearing and briefing by the parties, the Board entered an order in favor of Duplicator. In reviewing the maintenance contracts submitted as evidence, the Board stated,

> [T]he cost of the contract is directly tied to the anticipated number of copies to be made by Duplicator's customer. This strongly suggests that the actual 'consumption' of the parts and supplies is being made by the customer and Duplicator is just being paid for them over time. The taxable event occurs when the parts and supplies are transferred. KRS 139.120.

The Board then held that Duplicator had met its burden of proving that the parts and supplies transferred to its customers who were under maintenance agreements constituted a retail sale under KRS 139.120, as the activities constituted the transfer of tangible personal property for consideration.

The DOR filed a Petition of Appeal of the Board's adverse decision with the Franklin Circuit Court pursuant to KRS 131.340.[3] In an Opinion and Order entered August 22, 2006, the circuit court denied the DOR's appeal and affirmed the Board's decision. In so holding, the circuit court stated:

[3] Duplicator filed a notice of cross-appeal solely related to the Board's denial of its motion to introduce an affidavit from Pat Nash. Although Duplicator raised the issue in its brief, the circuit court did not mention this ruling and Duplicator has not raised the issue in the present appeal.

In this case, Revenue argues the Board erroneously characterized Duplicator's maintenance contracts that include the costs of parts and certain supplies (such as toner) as a transfer of "tangible personal property." The importance of the Board's characterization is that if a maintenance contract that includes parts and supplies was considered a service contract, then Duplicator must pay a "use" tax. Under the Board's decision, transfers of "tangible personal property" in maintenance contracts constitute a retail sale and are subject to sales tax.[4] For the reasons stated below, we affirm the Board's decision[.]

The crux of Revenue's argument is that Duplicator's maintenance contracts are actually service contracts and the parts and supplies included in those contracts are "used" by Duplicator thus subject to the "use" tax. Pursuant to KRS 13B.150(2)(c), this Court cannot overturn the Board's Order unless it is "without support of substantial evidence on the whole record."

As an initial matter, the Board found that Duplicator does not "use" the parts and supplies it provides under maintenance contracts; it merely transfers the parts and supplies to its customers. The cost of the transfer is included in the price of the maintenance contract based on the parts and supplies the customer wants included as well as the amount of copies the customer anticipates making. In other words, the Board found the maintenance contracts [are] properly considered a "transfer of tangible personal property" that is paid over time. The Board based those findings at least in part on the testimony of Mr. Pat Nash, Vice President of Operations at Duplicator and the parties' own stipulations. The Court finds that argument persuasive and based on substantial evidence in the record. As such, that finding shall not be overturned. (Footnote omitted.)

[4] Since tax exempt entities do not pay sales tax pursuant to KRS 139.145(1), they do not pay sales tax generated by a transfer of tangible personal property either. (Footnote 8 in original). (We assume that the circuit court meant to refer to KRS 139.495(1), as the statute it cited to does not exist. We note that this does not in any way affect the outcome of our opinion.)

Furthermore, the Board's Order has statutory support pursuant to the Sales and Use Statutes under KRS Chapter 139.

> KRS 139.100 states "Retail sale" means any sale, lease, or rental for any purpose other than for resale, sublease, or subrent in the regular course of business of tangible personal property.
>
> KRS 139.120(1) states: "Sale" means, the furnishing of any services, included in KRS 139.200 and any transfer of title or possession, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever, or tangible personal property for a consideration. . . .
>
> KRS 139.200 states: A tax is hereby imposed upon all retailers at the rate of six percent (6%) of the gross receipts derived from:
>
> (1) Retail sales, regardless of the method of delivery, made within this Commonwealth. . . .

Pursuant to the above statutes and the Board's Order, Duplicator pays sales tax on the parts and supplies it provides customers with maintenance agreements as well as those customers that buy parts and supplies without a maintenance agreement. The transfer of parts and supplies is properly considered a retail sale where payment is included in the price of the maintenance contract. That sale is properly subject to the sales tax with an exception for tax-exempt entitles under KRS 139.145(1)[sic].

Based on the plain meaning of the statutes and the finding that Duplicator fails to use the items supplied in the maintenance contracts, this Court finds the Board's Order [is] based on substantial evidence in the record as well as a proper interpretation of the law.

This appeal followed.

On appeal, the DOR asserts that the Board and circuit court erred, as a matter of law, in determining that the parts and supplies are transferred by Duplicator to its customer under its maintenance agreement, and that such transfers constitute retail sales. The DOR argues that Kentucky follows the essence of the transaction test in determining whether a given transaction is a sale or a service. The DOR's position is that Duplicator was providing a service and is subject to use tax, rather than acting as a retailer. In its brief, Duplicator relies upon the statutory language as well as upon the DOR's revenue circular describing the tax consequences of such transactions.

STANDARD OF REVIEW

As correctly stated in the DOR's brief, our standard of review is set forth in *Western Kentucky Coca-Cola Bottling Co., Inc. v. Revenue Cabinet*, 80 S.W.3d 787, 790-91 (Ky.App. 2001):

> When the outcome of a case turns on an issue of law, as in the instant matter, appellate review is *de novo*. There is no requirement that we grant any deference to the trial court where factual findings are not at issue. [*Scifres v. Kraft,* 916 S.W.2d 779, 781 (Ky.App. 1996) (citations omitted).] A determination of an issue of law is also presented where the question is one of statutory construction [*Interim Office v. Jewish Hosp. Healthcare,* 932 S.W.2d 388, 390 (Ky.App. 1996),] or where the relevant facts are undisputed and the dispositive issue thereby becomes the legal effect of those facts. [*See Mill Street Church of Christ v. Hogan,* 785 S.W.2d 263, 266-267 (Ky.App. 1990).]

The parties agree that there are no disputes as to the factual findings below. Therefore, we shall concentrate on the disputed issue of law.

ANALYSIS

A "sale" is defined as "the furnishing of any services included in KRS 139.200 and any transfer of title or possession, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration . . . [.]" KRS 139.120(1). A "retail sale" is further defined as "any sale, lease, or rental for any purpose other than resale, sublease, or subrent in the regular course of business of tangible personal property." KRS 139.100. A "use" is defined as including "the exercise of any right or power over tangible personal property incident to the ownership of that property, or by any transaction in which possession is given, except that it does not include the sale of that property in the regular course of business." KRS 139.190. We have also reviewed Revenue Circular 51C020, published in 1990 by the then-Revenue Cabinet to educate taxpayers on its policies. The Circular addresses these statutes and the applicable regulation in relation to sellers of service, maintenance, and extended warranty contracts:

> Service, maintenance and extended warranty contracts generally provide that the repairer will furnish labor and parts, if needed, for a fixed charge during the terms of the agreement. The fixed charge is payable at the time the contract is made.
>
> Retailers currently charging sales tax on the selling price of service, maintenance and extended warranty contracts must discontinue this practice. They must begin reporting and paying tax on the cost of all tangible personal property consumed in the fulfillment of service, maintenance and extended warranty contracts.

> Kentucky Revised Statute 139.200 imposes the tax on gross receipts from retail sales. KRS 139.100 defines "retail sale," in part, as "a sale for any purpose other than resale in the regular course of business of tangible personal property." KRS 139.120 defines "sale," in part, as "the transfer of title or possession, exchange, barter, lease or rental, conditional or otherwise, in any manner of by any means whatsoever, of tangible personal property for a consideration." Regulation 103 KAR 17:250, Repairers and reconditioners of personal property, provides that tax applies only to the selling price of parts and materials furnished in connection with repair work, if the value of parts and materials is substantial in relation to the total charge, and if the parts and materials are separately stated for labor charges on the invoice. The regulation further provides that if the labor and other services are not shown separately from the selling price of the property furnished, the entire charge shall be presumed to represent the sales price of the property and shall be subject to tax.
>
> Since no transfer or sale of specific tangible personal property is made at the time the service, maintenance and extended warranty contract is entered into, the contract price is not subject to tax. When parts are installed under the terms of the contract, a transfer of tangible personal property is made and tax is due from the person performing the repair work under the contract based on the cost price of the installed parts.
>
> Information in cabinet files indicates that retailers have, in some cases, applied tax to the service, maintenance or extended warranty contract price. However, a more detailed review of the general terms of a contract reveals that the sale of such a contract does not constitute a "retail sale" as defined in KRS 139.100 and 139.120.

The DOR first argues that Kentucky follows the "essence of the transaction" test to determine whether a transaction constitutes a sale of tangible personal property or a service. Duplicator does not dispute this statement of the law. However, Duplicator does dispute the DOR's assertion that the transactions at issue in this case are

services rather than sales and that the cases the DOR relies on are applicable. In *Stoner Creek Stud, Inc. v. Revenue Cabinet*, 746 S.W.2d 73 (Ky.App. 1988), this Court held that the acquisition of an oil painting constituted the nontaxable sale of professional services, based upon the Revenue Cabinet's prior interpretation that "the sale of an original photograph is primarily a sale of the photographer's professional services and is only incidentally a sale of the tangible personal property which comprises the finished work. The photographer is considered the consumer of the tangible property comprising the photographs." *Id.* at 76. Later, in *Woodward, Hobson & Fulton, LLP v. Revenue Cabinet*, 69 S.W.3d 476 (Ky.App. 2002), this Court was asked to consider whether a law firm was required to pay use taxes on medical and hospital record photocopies obtained from out-of-state providers. In determining that the transactions represented professional services that were not subject to use tax, the Court held that "providing copies of medical records is merely incidental to the service rendered[,]" which was actually the diagnosis and treatment provided through the medical provider's skills. *Id.* at 479.

We agree with Duplicator that the Board and the circuit court properly determined that the transfer of parts and supplies under the maintenance agreement constituted a retail sale of tangible personal property for a consideration, as opposed to a service. The DOR's policy, as set forth in the Circular, clearly supports Duplicator's position that such parts and supplies are transferred when they are installed, and a sales tax is implicated at that point. While the DOR argues that the Circular does not apply in this case, we note that in its Final Ruling, the DOR quoted the Circular, stating, in part:

"When parts are installed under the terms of the contract, a *use* of tangible personal property is made and a tax is due . . . ." (Emphasis added.) The DOR changed only one word; the DOR substituted the word "use" for "transfer," the word used in the Circular. Based upon the language of the Circular and the essence of the transaction in this case, it is apparent that Duplicator was engaged in retail sales of the parts and supplies it transferred under the maintenance contracts. Duplicator certainly did not consume the parts it installed or supplies it transferred, such as toner or drums. Rather, its customers consumed those parts over time as they used their copiers. The fee paid for the contract represented a prepayment or payment over time for the parts and supplies that Duplicator provided and was the consideration for the transfer of the tangible personal property. As such, the customers were required to pay sales tax on the parts and supplies provided, unless an exemption applied, as in the case before us. The circuit court and Board did not commit any error in so holding.

The DOR raises two other issues, one regarding Duplicator's erratic application of the tax laws and the other regarding its administrative construction of ambiguous statutory and regulatory provisions. We perceive no merit in either argument. As to the first, we agree with Duplicator that the record does not establish any inconsistency in the way Duplicator treats its customers, other than that it does not collect a tax from its tax-exempt customers. As to the second argument, the DOR relies upon the testimony of Richard Dobson, the Executive Director of the Office of Sales and Excise Taxes, that the essence of the transaction in warranty and maintenance agreements is

service, not a sale of tangible personal property. However, our review of the statutes and the Circular published by the then-Revenue Cabinet compels a different result.

For the foregoing reasons, we affirm the decision of the Franklin Circuit Court that upheld the Board's opinion holding that the transactions at issue constituted retail sales. Because the transactions at issue involved tax-exempt entities, no sales or use tax should have been assessed against Duplicator.

ALL CONCUR.

BRIEF AND ORAL ARGUMENT FOR APPELLANT:

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