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**COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON**

GARTNER, INC.,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

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I. INTRODUCTION

This case involves the application of two recent additions to the state's retail sales tax and business and occupation (B&O) tax statutes. The first key addition is the "bundled transaction" statute added to the retail sales tax code in 2007, and the second is the "digital products" legislation adopted in 2009. In its opening brief, Gartner, Inc. (Gartner) omits any discussion of the bundled transaction statute—which controls over the common law "true object" test. Gartner also misapplies the plain language and legislative intent of the digital products law. When properly applied, these statutes support the trial court's grant of summary judgment to the Department of Revenue and its denial of Gartner's cross-motion.

A bundled transaction is the sale of two or more products for one nonitemized price. A bundled transaction is subject to retail sales tax if any of the component products making up the bundle is subject to the tax. The tax is measured by the full, nonitemized selling price. RCW 82.08.195(1). Thus, a seller that chooses to sell two or more products for a single price must collect retail sales tax on the full amount if any part of the transaction would be subject to the tax if sold separately.

Retail sales tax applies to the sale of a digital automated service. RCW 82.08.020(1)(b). A digital automated service is "any service transferred electronically that uses one or more software applications."

RCW 82.04.192(3)(a). The sale of access to an online searchable database of proprietary research materials by companies like Westlaw and LexisNexis is a prime example of a digital automated service, and Gartner's business activity fits squarely within that paradigm.

Gartner is a research and advisory company that creates detailed "information technology" (IT) research reports. The company posts electronic versions of its reports in a searchable database that is accessible through the Gartner.com website. Gartner sells access to its searchable database of research reports. It also sells professional "analyst inquiry" services. The company charges a nonitemized subscription fee for both services.

Gartner's business activity of selling access to its searchable database of research reports is a digital automated service under the controlling law. Moreover, under the plain language of the state's bundled transaction law, Gartner cannot avoid the tax consequences of its decision to bundle its retail-taxable digital automated service with its analyst inquiry service. The trial court correctly rejected each of Gartner's claims to the contrary and correctly denied the company's claim for refund. This Court should affirm.

II. RESTATEMENT OF THE ISSUE

Is Gartner's business activity of selling subscriptions to its online library of research reports a "digital automated service" under RCW 82.04.192(3)(a) and taxable as part of a "bundled transaction" under RCW 82.08.195(1)?

III. STATEMENT OF THE CASE

A. Gartner's Research Business Segment

Gartner is a well-known and highly respected research and advisory company that "delivers its principal products and services through three business segments: Research, Consulting, and Events." CP 543. Only the Gartner "Research" business segment is at issue in this tax refund case. CP 2.

Gartner's Research business segment provides its clients with "objective insights on critical and timely technology and supply chain" issues "through reports, briefings, proprietary tools, access to [its] analysts, peer networking services, and membership programs." CP 532. Gartner's clients include a wide variety of organizations interested in IT and supply chain issues, including nonprofit corporations, government agencies, and large Fortune 500 companies. CP 130. Gartner charges its clients an annual subscription fee for its Research products and services. CP 543; *see also* CP 581 (representative invoice). The annual subscription

permits an authorized user within the client's organization (referred to as the "seat-holder") to access Gartner research reports and to interact with Gartner personnel. CP 742. Only the named seat-holders can access the "highly proprietary" Gartner research reports, and even then "such access is limited." CP 742-43.

- 1. Gartner bundles access to its searchable library of research reports with the option to interact with its support personnel and research analysts.**

Gartner's Research business segment offers approximately fifteen different service packages. CP 550-51. The various service packages are tailored for different functions within a client's organization, from high level Chief Information Officers to more junior IT and supply chain staff. Examples include "Gartner for IT Leaders," "Gartner for Supply Chain Leaders," and "Gartner for Technical Professionals." CP 550.¹

The products and services included within a particular service package are detailed in three sales documents: the "service agreement" signed by the parties, the "Service Description" that pertains to the service

¹ Gartner's marketing materials provide a short description of each of its service packages. For example, Gartner describes "Gartner for IT Leaders" as "an indispensable strategic resource, delivering timely, reliable insight to guide your key decisions and get the most from your highest priority initiatives." CP 550. Similarly, "Gartner for Supply Chain Leaders delivers objective, actionable insight and best practices to help supply chain professionals build, manage, and transform their global supply chains – maximizing productivity, minimizing risks and driving revenue and competitive advantage." *Id.* And "Gartner for Technical Professionals provides in-depth, technical research for your project teams to help them deliver outstanding results on your IT strategy." *Id.*

package being purchased, and the “Usage Guidelines for Gartner Services.” *See* CP 553 (representative service agreement); CP 557 (representative Service Description); CP 559 (Usage Guidelines). Each service package offered by Gartner includes online access to proprietary research reports and the option to interact with Gartner support personnel and research analysts. *See e.g.*, CP 557 (the “Burton Classic” service package “provides access to Research published by coverage area via gartner.com and the option of scheduling dialogues with Analysts that support the Service”). While roughly 95 percent of Gartner’s clients purchase a service package that includes the option to interact with Gartner support personnel and research analysts, online access to Gartner’s library of proprietary research reports is a standard component of all Gartner service packages. CP 131; *see e.g.*, CP 748 (“Gartner for IT Executives CIO Signature” service package includes “Access to Gartner for IT Leaders content”); CP 753 (“Products Management & Marketing” service package includes access to “Gartner for Business Leaders content”).

Gartner’s proprietary research reports represent highly valued intellectual property. For this reason, “[c]lient access to Gartner Research Reports is strictly limited.” CP 742. Only the “seat-holder” named by a Gartner client is authorized to access Gartner’s online library of

proprietary content. CP 561; CP 742. An authorized seat-holder can access content in three ways. First, that seat-holder can click on a link provided in an email or instant message sent by a Gartner employee. CP 585. The link takes the seat-holder to the Gartner.com log-on page and, once the seat-holder logs on, to the specific research report. The second method allows a seat-holder to access Gartner content by clicking on a link contained within a research report. *Id.* Finally, the seat-holder can log onto the Gartner.com website and search for content using the website's search functions. *Id.*

All three methods of accessing Gartner research content require the seat-holder to log onto the Gartner website. Once the licensed seat-holder logs onto the Gartner.com site, that user is directed to the Gartner "portal" that relates to the particular service package purchased by the client. CP 605-06.² From the portal, the licensed user can access reports and other content that relate to the specific Research package that was purchased. For example, a licensed user of a client that has purchased the "Gartner for

² Gartner's online "IT Glossary" describes a "portal" as a "high-traffic website with a wide range of content, services and vendor links. It acts as a value-added middleman by selecting the content sources and assembling them in a simple-to-navigate and customize interface for presentation to the end user. Portals typically offer such services as Web searching, news, reference tools, access to online shopping venues, and communication capabilities including e-mail and chat rooms." Gartner IT Glossary > Portal, available online at <https://www.gartner.com/it-glossary/portal> (last visited 10/2/2018).

Technical Professionals” service package can access Gartner content specific to that product offering.

The various Gartner website portals allow licensed users to search for content, save and organize search results, identify specific areas of interest from a drop-down menu, and create and manage “alerts,” among other functions. CP 696 (describing basic functions of Gartner portals); *see generally* https://www.gartner.com/technology/media/it1_help.jsp (online video describing the functions and uses of the “Gartner for Technical Professionals” portal) (last viewed 10/2/2018). Gartner carefully tracks client access and use of content available through its various portals in order to verify that its Usage Guidelines are being followed. CP 624; CP 814. Gartner uses Lotus Notes to manage its online library of digital content and to track client access and use of its online library. CP 634.³

2. Gartner research reports are created for a large audience of clients, not customized for a specific client.

Gartner creates its research reports “through a rigorous process involving various stages of research, drafting, peer review, management review, external review, editing, revising, and publishing.” CP 584. The reports are not created at the request of any client and are not specific to a

³ Lotus Notes combines a number of software applications—including email, a database system, and a web server—into a single software suite. *See generally* CP 788 (print of webpage generally describing Lotus Notes database management software).

particular client. Instead, the reports are “commissioned internally by an agenda manager” and are of interest to a broad array of clients. CP 584; CP 619; *see also* CP 572 (example research report).

Research reports will typically remain available indefinitely on the Gartner online library, although readership of a particular report falls off significantly after 30 days. CP 631, CP 133-34.

B. Department Audit and Administrative Review, and Subsequent Procedural History

The Department audited Gartner for the January 2007 through December 2011 tax periods, resulting in an assessment of additional retail sales tax, use tax, and B&O tax, plus interest and penalties. CP 660. The Department concluded that subscription revenue derived from Gartner’s Research business segment involved the sale of a digital automated service, namely the sale of access to Gartner’s online searchable library of research reports. In accordance with tax reporting guidance the Department issued in November 2010, the Department assessed Gartner for unpaid retail sales tax owed on its sales of digital automated services beginning with the January 2011 tax reporting period. *See* CP 509 (Department Special Notice explaining that the Department would delay enforcement of the 2009 digital products legislation with respect to online searchable databases until January 1, 2011).

Gartner sought review of the audit findings with the Department's Appeals Division. After reviewing evidence and conducting two hearings, the Appeals Division upheld the audit findings. CP 694. It concluded that Gartner's business activity of selling subscriptions to its online library was a digital automated service and therefore subject to retailing B&O tax and retail sales tax. CP 700-703. Thereafter, Gartner paid the tax assessment and filed this de novo action for refund under RCW 82.32.180. CP 3.

Both parties moved for summary judgment. CP 5; CP 7. The trial court, the Honorable John C. Skinder, granted the Department's motion and denied Gartner's motion, concluding that there were no disputed issues of material fact and that the Department's application of the law to the undisputed facts "is the correct analysis." CP 829; VRP 29. This appeal followed. CP 832.

IV. ARGUMENT

Gartner raises only one assignment of error, claiming that the trial court erred when it granted summary judgment to the Department and not to Gartner. App. Br. at 3. The claim is unfounded.

A. Standard of Review

Gartner is seeking a refund of both B&O tax and retail sales tax under the provisions of RCW 82.32.180. That statute places the burden on Gartner to prove that the tax it paid was incorrect and to prove the correct

amount of tax owed. *Bravern Residential, II, LLC v. Dep't of Revenue*, 183 Wn. App. 769, 776, 334 P.3d 1182 (2014) (citing RCW 82.32.180).

The trial court denied Gartner's tax refund claim pursuant to cross-motions for summary judgment. This Court reviews a grant of summary judgment de novo, engaging in the same inquiry as the trial court.

Activate, Inc. v. Dep't of Revenue, 150 Wn. App. 807, 812, 209 P.3d 524 (2009). Summary judgment is appropriate when there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. CR 56(c).

Here, there were no disputed issues of material fact. Rather, this case involves application of tax statutes to the undisputed facts, which is a question of law. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011).

B. Gartner's Business Activity of Selling Subscriptions to its Online Library of Research Reports is a "Digital Automated Service" and is Taxed as Part of a "Bundled Transaction"

Washington imposes retail sales tax and retailing B&O tax on retail sales occurring in the state unless an express exemption applies. RCW 82.08.020; RCW 82.04.250. The term "retail sale" is defined in RCW 82.04.050 and includes sales to consumers of digital goods and digital automated services. RCW 82.04.050(8)(a). A "digital automated service" is "any service transferred electronically that uses one or more

software applications.” RCW 82.04.192(3)(a).⁴ Transferred electronically means “obtained by the purchaser by means other than tangible storage media.” RCW 82.04.192(8).

Gartner’s business activity of selling access to its online library of research reports is a digital automated service subject to retail sales tax and retailing B&O tax. Additionally, because Gartner bundles that service with its analyst inquiry service, retail sales tax is measured by the full, nonitemized selling price of the service package. Although Gartner completely ignores the “bundled transaction” statute in its opening brief, that statutory method controls over the common law “true object” test. Consequently, the company owed the tax at issue and is not entitled to the refund it is seeking.

1. Development of the 2009 digital products legislation and its application to online searchable databases.

This case involves the application of comprehensive digital products legislation enacted in 2009 to Gartner’s Research business segment. A discussion of the development of the applicable law is helpful in providing context.

The Legislature’s interest in the tax treatment of electronically delivered goods and services began in 2007 when it enacted sales and use

⁴ A copy of RCW 82.04.192 is provided as Appendix A.

tax exemptions pertaining to electronically delivered “standard financial information.” *See* Laws of 2007, ch. 182. Later in that same legislative session, the Legislature observed that the sales and use tax exemptions enacted in chapter 182 “relate[] to specific types of electronically delivered products and do[] not address the taxation of numerous other types of electronically delivered product.” Laws of 2007, ch. 522, § 136(3)(a). In order to better understand and address the tax policy issues relating to electronically delivered products, the Legislature authorized the Department of Revenue to lead a study committee to review specified issues including “the current excise tax treatment of electronically delivered products in the state of Washington and other states as well as the tax treatment of these products under the streamlined sales and use tax agreement.” *Id.*, § 136(3)(b)(iv).⁵

The study committee issued its final report in December 2008. CP 637. In that report, the committee did not put forward a specific legislative proposal. Rather, it identified “issues that should be addressed in proposals considered by the Legislature.” CP 639. Those issues included compliance with the streamlined sales and use tax agreement, the treatment of bundled digital products, and the different methods of obtaining digital products.

⁵ The streamlined sales and use tax agreement (SSUTA) “is a cooperative effort of 44 states, the District of Columbia, local governments and the business community” to simplify sales and use tax collection and administration. CP 652.

See CP 506 (2009 Final Bill Report pertaining to the digital products legislation, summarizing the committee report).

Among the issues raised and discussed in the report was the tax treatment of digital automated services. CP 643-44. As defined in the report, a digital automated service is “any service furnished via a computer network that involves an automated process and that utilizes one or more software applications.” CP 644. The term does not include “any service that primarily involves the application of human effort, and the human effort originated after the customer requested the service.” *Id.* Thus, for example, a help desk service that allows clients to “chat” with technicians by instant messaging would fall within the “primarily human effort” exception. *Id.* By contrast, “a searchable database of ‘help desk’ articles, tips, and Q&A’s would generally be considered digital automated services, the sale of which would be subject to retail sales tax” *Id.* The distinguishing feature between the live help desk and the searchable database of help desk articles is that the former involves the human effort of technicians occurring after a specific customer requested the service, while the latter involves an automated process available to a broad range of customers.

The report also addressed issues pertaining to the bundling of taxable and nontaxable services. CP 647. The term “bundling refers to the

packaging of taxable and nontaxable items for one nonitemized price.” *Id.* Under Washington law, “[i]f a seller engaged in electronic commerce bundles a nontaxable service with a taxable digital product and the taxable digital product is worth more than ten percent of the total value, the entire price would be taxable.” *Id.* (referring to RCW 82.08.190 and RCW 82.08.195, which were enacted in 2007). In short, the Legislature has placed the onus on the seller to separately state the amounts charged for the products it is selling. If a seller elects to sell distinct products for one nonitemized price, and one of the components of the transaction is subject to retail sales tax, the entire bundle is taxable. RCW 82.08.195(1).⁶

The study committee offered several alternatives for addressing bundled transactions. CP 648. Ultimately, however, the Legislature made no change to the state’s bundled transaction statutes, choosing to apply that law to bundled electronic commerce in the same manner as applied to all other sales transactions.

Although the 2008 committee report did not result in any change to the bundled transaction statutes, it was the impetus for other significant

⁶ The ten percent requirement discussed in the committee report is set out in RCW 82.08.190(4)(c). That provision allows a seller to establish that the taxable portion of a bundled transaction is de minimis. Specifically, the statute provides that a transaction “that otherwise meets the definition of a bundled transaction is not a bundled transaction if it . . . includes taxable products and nontaxable products and the purchase price or sales price of the taxable product is . . . ten percent or less of the total purchase price or sales price of the bundled products.” Gartner has not offered any evidence suggesting that the statutory de minimis exclusion applies here.

legislative action. Specifically, a few months after the report was issued, the Legislature enacted comprehensive legislation addressing electronically delivered goods and services. Laws of 2009, ch. 535, CP 444. The legislation was “the outgrowth of the work of the department and the study committee.” *Id.*, § 101(4), CP 446. The stated goals of the 2009 digital products legislation were to (1) protect the state’s sales and use tax base, (2) establish certainty in the tax treatment of electronically delivered products, (3) maintain conformity with the streamlined sales and use tax agreement, and (4) encourage economic development. *Id.*, § 101(3), CP 446. To achieve these goals, the Legislature amended the state’s sales tax, use tax, and B&O tax statutes to treat the sale of digital goods and digital automated services as retail sales. *Id.*, §§ 301 - 305, CP 448-462.

The Legislature also provided definitions of key terms, including “digital products,” “digital goods,” and “digital automated services.” *Id.*, § 201 (codified at RCW 82.04.192), CP 446-448. In general, and subject to certain statutory exceptions:

- A “digital product” means a digital good or digital automated service. RCW 82.04.192(7).
- A “digital good” is a sound, image, data, fact, information or any combination thereof that is transferred electronically. RCW 82.04.192(6)(a).
- A “digital automated service” is any service transferred electronically that uses one or more software applications. RCW 82.04.192(3)(a).

Common examples of digital goods are digital music, digital video files, and digital books. *See* WAC 458-20-15503(202)(a). Common examples of digital automated services are (1) web “crawler” services that use software applications to “crawl the internet” in search of specific content; (2) online gaming services that allow subscribers to play a game with other subscribers in real time, and (3) online credit reporting services. *See* WAC 458-20-15503(203)(a)(Example 2); WAC 458-20-15503(203)(a)(Example 5); WAC 458-20-15503(601)(Example 35).

While digital goods and digital automated services are both “digital products,” they are statutorily distinct types of digital products. *See* RCW 82.04.192(3)(b)(xvi) (the term “digital automated service” does not include “digital goods”). As a result, they are not subject to the same tax exemptions. For example, the sale of digital goods to a business is exempt from retail sale tax if the digital goods are purchased solely for a business purpose and the seller obtains a completed tax exemption certificate from the purchaser. RCW 82.08.02087. There is no equivalent tax exemption for sales of digital automated services.

The Department began implementing the new digital products legislation in a phased process designed to give taxpayers impacted by the new law an opportunity to seek guidance from the Department through letter ruling requests. CP 61. During that early implementation period, the

Department erroneously advised some taxpayers that the sale of access to an online searchable database did not qualify as a digital automated service. CP 509. To correct its error, the Department issued a Special Notice in November 2010 explaining that online searchable databases, such as online legal research services, are digital automated services. CP 509. The Department advised taxpayers that as of January 1, 2011, it would begin enforcing the policy of treating the sale of online searchable databases as a sale of a digital automated service. *Id.*

2. The activity of selling access to a searchable online database is a digital automated service.

Each service package offered by Gartner includes online access to its searchable database of research reports as well as the option for some level of personal service. *See* CP 561-64 (“Usage Guidelines” pertaining to access to Gartner research reports); CP 567-68 (“Usage Guidelines” pertaining to analyst inquiry service). Roughly 95 percent of Gartner’s clients opt to receive both services. CP 131. Gartner sells both services for one nonitemized price. CP 581; *see also* App. Br. at 8 (the services provided with each service package are sold for a “single Research Fee”).

Of the two services that Gartner bundles and sells to its clients, the first—selling access to its online searchable database—is a digital automated service under the express language of the 2009 digital products

legislation. RCW 82.04.192(3)(a) defines a digital automated service as “any service transferred electronically that uses one or more software applications,” except for those specific services excluded from the definition under subsection (3)(b) of the statute. A service is “transferred electronically” if it is obtained by the purchaser “by means other than tangible storage media.” RCW 82.04.192(8). Typically a service is transferred electronically via the use of “the public internet, a private network, or some combination.” WAC 458-20-15503(102).

The statute sets out three requirements. The product must be a service, must be transferred electronically, and must use one or more software applications. Each of those requirements is met here.

First, there is no dispute that Gartner’s business activity of providing access to its searchable database is a “service.” *See* CP 70 (Gartner confirms that its gross income from its Research business segment was subject to B&O tax under the “service and other” tax classification prior to the 2009 enactment of the digital products legislation). Second, the service is transferred electronically. CP 585. Third, Gartner uses web browsing software and database management software to automate and facilitate the service. CP 624; CP 634.

Gartner argues that its use of “software applications” provides no “additional functionality to the user beyond mere online access” and,

therefore, does not meet the third part of the digital automated service definition. App. Br. at 23. The claim is simply untrue. Seat-holders logging onto the Gartner website can search for content, save and organize search results, identify specific areas of interest from a drop-down menu, and create and manage “alerts,” all without any involvement from Gartner employees. CP 696. The process is entirely automated, as Gartner readily acknowledges on its website. *See* https://www.gartner.com/technology/media/it1_help.jsp (describing the functions of the “Gartner for Technical Professionals” portal) (last viewed 10/2/2018). And these automated functions are independent of the process Gartner uses to permit seat-holders to access research reports.

The automated process by which a client can search for, save, and organize content of interest is, by any definition, “additional functionality . . . beyond mere online access.” And while Gartner understates the various functions of its database management software in its opening brief, App. Br. at 25-26, it agrees that an online research service will fall within the definition of a digital automated service when that service provides “*additional functions*, such as search, retrieve, and storage capabilities.” App. Br. at 24 (emphasis added by Gartner) (quoting Department Special Notice issued November 2, 2010, CP 509).

Here, it is undisputed that Gartner's website permits licensed seat-holders to search for, retrieve, and store research, all without any human effort on the part of Gartner employees. *See* CP 696 (after logging into the Gartner.com website, seat-holders can search the website "by topic, date, or author to access relevant material" and can "select specific or 'trending' areas of interest for a drop-down menu, which customizes the search results in the Research Library according to the specific topics" selected by the seat-holder). In this respect, Gartner is no different from other online research service providers such as Westlaw, LexisNexis, and Bloomberg Law.

Each element required under RCW 82.04.192(3)(a) is established by undisputed evidence. Consequently, Gartner's business activity of providing online access to its searchable database of research reports is a digital automated service as a matter of law unless one of the exceptions in RCW 82.04.192(3)(b) applies.

3. None of the exceptions in RCW 82.04.192(3)(b) apply.

RCW 82.04.192(3)(b) sets out sixteen exceptions to the definition of a digital automated service.⁷ The only exception Gartner seeks to invoke is the "primarily human effort" exception in subsection (b)(i). That

⁷ *See* Appendix A, p. 1-2.

subsection provides that a digital automated service does not include “[a]ny service that primarily involves the application of human effort by the seller, and the human effort originated after the customer requested the service.”

The purpose of the exception is to distinguish individualized professional services provided to a specific client, such as those performed by accountants, architects, and lawyers, from “canned” products made available on a general basis. CP 648. For example, “an electronic engineering report created at the customer’s request that reflects an engineer’s professional analysis, calculations, and judgment, which is sent to the customer electronically,” is a professional service, not a digital automated service. WAC 458-20-15503(302)(d). By contrast, “a searchable database of ‘help desk’ articles, tips, and Q&A would generally be considered digital automated services.” CP 644. The key distinction is whether the service provider is creating an individualized product at the request of a specific client (i.e., the engineering report described in WAC 458-20-15503(302)(d)) or a general product available to many (i.e., the searchable database of help desk articles described in the 2008 report).

Gartner argues that “Gartner Research” is a “professional service created and delivered by human effort.” App. Br. at 13-19. In making this argument, Gartner lumps together under the broad heading of “Gartner

Research” the two distinct services it sells to clients. When these two services are analyzed individually, Gartner’s claim that it only sells professional services is clearly incorrect.

As an initial matter, there is no dispute that the analyst inquiry service that Gartner offers to its clients is a professional service. That service is not transferred electronically and, therefore, does not meet one of the three required elements under RCW 82.04.192(3)(a). Gartner could easily segregate the amount it charges its clients for analyst inquiry service from the amount it charges for access to its online searchable database. If it did, there would be no room for any dispute. As a matter of law, the amount charged for the analyst inquiry service would be taxed as a professional service while the amount charged for access to the searchable database would be taxed as a retail sale of digital automated services.

But Gartner does not segregate the amount it charges for its services. Instead, the company has made the business decision to charge one nonitemized price. CP 581. As a matter of law and logic, that business decision does not permit Gartner to lump together the two services it sells for purposes of applying the “primarily human effort” exception to the “digital automated service” definition. *See* RCW 82.04.440(1) (“Every person engaged in activities that are subject to tax under two or more provisions of RCW 82.04.230 through 82.04.298, inclusive, is taxable

under each provision applicable to those activities”); *Impecoven v. Dep’t of Revenue*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992) (a person engaged in “separate but related activities” is “taxed on each activity unless exempted”).

The facts pertaining to Gartner’s sale of access to its online database verify that the service involves almost no human effort on the part of Gartner employees. Gartner has automated all aspects of the service. First, as discussed above, Gartner has automated the process by which a seat-holder can search for, save, and organize content of interest. Additionally, Gartner has automated the process used by seat-holders to access a particular research report. Specifically, seat-holders can access research reports by clicking on an embedded link in an email or in another research report, or by searching the Gartner website for desired content. CP 585. Of these various methods of accessing research reports, only the first (clicking on an embedded link in an email) involves some level of human effort by Gartner employees. The other two methods, clicking on a link in a research report and searching the Gartner website, involve no human effort by Gartner employees. Moreover, it is undisputed that accessing Gartner content by clicking on a link in an email makes up only “35% of total readership.” CP 134. Gartner points to no additional human activity involved in this aspect of its business.

Gartner's business activity of selling online access to its proprietary research reports is not equivalent to an electrical engineering firm creating a report at the request of a client, a lawyer drafting a will or sales contract at the request of a client, or a CPA firm that prepares audited financial statements at the request of a client. Rather, Gartner creates and publishes research reports of general interest to its clients and sells access to those reports through an automated process that involves minimal human effort. Accordingly, the company does not meet the exception in RCW 82.04.192(3)(b)(i).

4. The bundled transaction statute, not the common law “true object” test, is controlling.

Gartner argues that the two services it bundles and sells to its clients should be treated as a professional service because, in its view, its clients are primarily interested in the “insights and . . . hands-on interaction” they receive from Gartner’s “devoted client service delivery team.” App. Br. at 16. However, determining the subjective beliefs of Gartner’s numerous and diverse client base is not material in this tax refund action. This is so because the common law true object test does not apply under the facts of this case. The Legislature has developed a different approach to bundled transactions that is not dependent on whether one or the other service is the “true object.”

- a. *The common law true object test does not apply when components of a transaction are separable, as they are here.*

Determining the “true object” or “primary purpose” of a sales transaction is necessary only when the components of the transaction cannot reasonably be separated into taxable and nontaxable parts.

Goodyear Aircraft Corp. v. Arizona State Tax Comm’n, 402 P.2d 423, 427 (Ariz. Ct. App. 1965); Jerome Hellerstein & Walter Hellerstein, *State Taxation* ¶ 12.08[1][c] (3d ed. 1999).⁸ Examples include an artist’s painting, or a legal document drafted by an attorney, where the professional’s artistic or intellectual processes are embodied in a tangible form. In those circumstances, determining whether sales tax is owed on the sale may turn on whether the buyer’s true intent is to purchase the tangible property or the intangible service.

By contrast, the true object test is not necessary—and is typically not applied—when a sales transaction can be reasonably bifurcated into taxable and non-taxable components. Hellerstein and Hellerstein, ¶ 12.08[1][c]. This is consistent with the general rule under Washington’s excise tax laws that a taxpayer is taxable on each of its separate business

⁸ The relevant portion of the Hellerstein treatise is attached as Appendix B. The authors quote *California State Board of Equalization v. Advance Schools, Inc.*, 2 B.R. 231, 236 (Bankr. N.D. Ill. 1980), for the proposition that “the true object test should be used where the services and the property are inseparable,” not “where these two elements are distinct.” *Id.* at p. 12-87.

activities. RCW 82.04.440(1). It is also consistent with the manner in which our courts have applied the true object test. For instance, in *Qualcomm, Inc. v. Department of Revenue*, 171 Wn.2d 125, 249 P.3d 167 (2011) the Supreme Court expressly noted that the true object test applies “when an activity involves . . . components that cannot be reasonably separated.” *Id.* at 140. In that case, the message relay service at issue could not be reasonably separated into two distinct components and, as a result, the Court applied the subjective true object test to determine its proper tax classification. *Id.* However, other aspects of the sales transaction were separable and were taxed accordingly, namely the lease of hardware and software to the customer. *See id.* at 128, 130 (explaining that the hardware and software components of the OmniTRACS system were segregated from the message relay service and “Qualcomm paid retail sales tax on those [segregated] components”).

Another example of the proper application of the true object test is set out in the 2008 committee report that preceded the 2009 digital products legislation. At page 12 of the report the committee explained how the true object test would apply to determine whether a “fill in the blank” will represented professional services or a digital product.

Not all digital products, however, represent professional services. The key to determining whether a digital product is merely the representation of a professional service depends

on whether the true object of the transaction is the sale of professional services or of a digital product. This determination often turns on the amount of interactivity between the client and the professional. For example, a standard “fill in the blank” will drafted by an attorney and sold electronically via download to multiple customers would not be the representation of professional services and would be subject to retail sales tax. This is because the true object of the transaction is the sale of the digital product (the standard will form), not professional services that have been individualized for the client.

CP 648.⁹

The issue described in the committee report involved whether a single product—a downloadable “fill in the blank” will—represented a professional service or a digital product. It did not involve separate components of a bundled transaction. That issue was discussed earlier in the report under the heading “Bundled digital products.” CP 647. In that section of the report the committee explains that “Washington has adopted the SSUTA definitions relating to bundling.” *Id.* (referring to definitions in RCW 82.08.190). Under that statutory scheme, when two or more products are bundled and sold for one nonitemized price, and one of the products would be subject to retail sales tax if sold separately, the tax is

⁹ Gartner also quotes from this paragraph of the 2008 report. *See* App. Br. at p. 15 n.1. However, it quotes only one sentence. *Id.* When the paragraph is read as a whole and in context, it undercuts Gartner’s contention that its sales of online access to its canned research reports represent a professional services. Like the “fill in the blank” will discussed in the committee report, Gartner’s proprietary research reports “have not been individualized for the client” and are accessible by multiple clients.

measured by the full nonitemized selling price. RCW 82.08.195(1). That statutory method of dealing with bundled transactions, not the common law true object test, is controlling here. *See State ex rel. Madden v. Public Utility Dist. No. 1*, 83 Wn.2d 219, 221, 517 P.2d 585 (1973) (a statute designed to modify common law must be given effect).

- b. *Under RCW 82.08.195(1), a bundled transaction is subject to retail sales tax without regard to which of the distinct components is the "true object."*

A "bundled transaction" is defined as the retail sale of two or more products where the products are otherwise distinct and identifiable but are sold together for one nonitemized price. RCW 82.08.190(1)(a). The services at issue here—online access to Gartner's searchable database and the optional analyst inquiry service—meet the definition of a bundled transaction. The services are "distinct and identifiable," and are sold through an annual subscription at a single price. *See* CP 559 (Usage Guidelines distinguish access to research documents from analyst inquiry service); CP 581 (products sold for nonitemized price); CP 131 (not every client enters into a contract involving analyst inquiry services, confirming that the two services can be segregated).

Here, one of the components of the bundled transaction is online access to Gartner's searchable database of research reports, which fits squarely within the definition of a digital automated service. That service

is subject to retail sales tax. RCW 82.08.020(1)(b). As a result, under the express language of RCW 82.08.195(1), retail sales tax applies. There is no need to analyze the transaction further to determine which component might qualify as the “true object.” As a matter of statutory law, Gartner is not entitled to the sales tax refund it is seeking.

- c. *Application of the true object test is not material for purposes of determining whether Gartner has overpaid its B&O tax.*

RCW 82.08.195(1) provides that retail sales tax is owed on a bundled transaction where one of the components of the sale is subject to the tax. The statute does not specifically address B&O tax, which is imposed under a different chapter of the state’s excise tax code. Consequently, the common law true object test might be relevant in determining what B&O tax rate applies to a particular transaction that is not capable of being segregated into separate components. However, as the Department argued below, there is no need to address this issue in this case. *See* CP 780.

Gartner contends that the entire amount it charges for its bundled services should be taxed as a “professional service” subject to the “service and other” B&O tax rate. However, the B&O tax rate imposed on general service activity is much higher than the rate imposed on the sale of digital automated services. *Compare* RCW 82.04.290(2) (service and other B&O

tax imposed at the rate of 1.5%) *with* RCW 82.04.257 (tax imposed on retail sales of digital products at the rate of 0.471%). Thus, even if the Court were to accept Gartner's arguments pertaining to the "true object" of its two services, the company would owe more B&O tax, not less.

The purpose of summary judgment is to avoid an unnecessary trial when there are no genuine issues of material fact. *Jacobsen v. State*, 89 Wn.2d 104, 108, 569 P.2d 1152 (1977). "A 'material fact' is one upon which the outcome of the litigation depends." *Id.* Here, the outcome of Gartner's B&O tax refund claim does not depend on which of the two services the company bundles and sells to its clients is the true object. Regardless of what might be proved at trial, the company clearly has not *overpaid* its B&O taxes. Because resolution of the dispute is not material, the trial court correctly granted summary judgment in favor of the Department. This Court should affirm.

5. Gartner misunderstands or misapplies examples provided in Department administrative rule 15503.

While the undisputed facts establish that Gartner's sale of access to its online research database is a digital automated service under the express language of RCW 82.04.192(3)(a), Gartner nonetheless claims that it falls outside the statutory definition because the automated functions of its website are not of the type described in Example 3 of the

Department's administrative rule implementing the digital products law.

See App. Br. at 25 (quoting in part WAC 458-20-

15503(203)(a)(i)(Example 3)). The example states:

XYZ provides an online service that uses one or more software applications to facilitate the use of news and information with features such as: Research history, natural and Boolean searching, industry chat forums, chart creation, document and word flagging, and information organizing folders. In this example software features facilitate the search of the news or information. XYZ's service is a digital automated service the sale of which is subject to retail sales tax and retailing B&O tax.

WAC 458-20-15503(203)(a)(i)(Example 3).

Gartner mistakenly characterizes the example as adding a requirement that software must facilitate the client's use of information gleaned "from the Internet or third-party databases" and not from the service providers "own content." App. Br. at 25. But the example says no such thing. Gartner simply perceives qualifications and limitations that do not exist in Example 3, and that do not exist in the statute.

Additionally, to the extent Gartner believes that an online searchable research service must provide all of the *same functions* listed in Example 3 in order to qualify as a digital automated service, the company is confusing what is sufficient with what is necessary. Our Supreme Court has expressly rejected this type of logical fallacy in other tax cases. See *Flight Options, LLC v. Dep't of Revenue*, 172 Wn.2d 487, 496, 259 P.3d

234 (2011) (“Flight Options confuses a sufficient condition with a necessary one”). The automated functions of Gartner’s website are sufficient under the statute, which requires that the service use software applications to facilitate the service. RCW 82.04.192(3)(a). Example 3 adds no additional requirements to that statutory definition.

Moreover, the various examples in Rule 15503 are intended “only as a general guide.” WAC 458-20-15503 (preamble). The tax consequences of any particular situation “must be determined after a review of all the facts and circumstances.” *Id.* When Example 3 is read as a whole and in the context it was intended, it does not support Gartner’s claim that an online research service must fit precisely within the hypothetical facts described therein before it will qualify as a digital automated service. Conflating sufficient “functionality” with necessary “functionality,” as Gartner does here, is not a valid reason to reverse the trial court’s ruling in favor of the Department.

Finally, Gartner’s reliance on another example in Rule 15503, Example 4, is also misplaced. *See* App. Br. at 25-26 (arguing that Example 4 supports its position that its sale of access to its digital library of research reports is not a digital automated service). That example states:

Company sells digital music files (i.e., digital goods) on its web site. In order to locate specific digital music files customers may use a free software based search function

that is integrated into Company's web site. Customers may also find the digital music files they are seeking by clicking on a series of links to get to the desired music file.

Company's software based search function associated with the sale of the digital music file does not transform the sale of the digital music file into a digital automated service.

Company is selling a digital good (i.e., music file) subject to retail sales tax and retailing B&O tax.

WAC 458-20-15503(203)(a)(i)(Example 4).

The example involves a company that sells digital music files, which is a paradigm digital good. *See* CP 507 (2009 Final Bill Report explaining that digital goods include "electronically delivered music, books, and movies"). The company provides free search software to assist customers in finding desired digital music files, but that free service is not part of the purchase-sale transaction. The only sale in Example 4 is the sale of digital music files for valuable consideration. The website's search capability was not part of the sale and was not used to facilitate any *service* being purchased by the buyer. For this reason, the example is not germane to Gartner's business model, as the Department correctly explained in the final determination it issued to Gartner. CP 700.

Unlike the hypothetical facts in Example 4, Gartner is selling a service that allows seat-holders to "customize the search parameters in the Research Library" CP 701. Because these "search and customization capabilities are automated (by software), access to the Research Library is

a digital automated service subject to retail sales tax.” *Id.* Nothing in Rule 15503’s Example 4 undercuts the Department’s analysis or the trial court’s holding that Gartner’s refund claim fails as a matter of law.

C. Federal Law does not Preempt Washington’s Digital Products Legislation.

To avoid what it contends would be a conflict between state and federal law, Gartner suggests that the Court “should reject DOR’s construction of the digital products law” and apply some different, unspecified construction. App. Br. at 29. The argument fails.

1. Gartner fails to offer evidence of a conflict and, therefore, does not meet its burden of establishing a violation of the Internet Tax Freedom Act.

Gartner’s preemption claim is based on the federal Internet Tax Freedom Act. That Act is codified as a note to 47 U.S.C. § 151 and provides that “No State . . . may impose . . . [m]ultiple or discriminatory taxes on electronic commerce.” 47 U.S.C. § 151 note § 1101(a)(2). Simply stated, the law prohibits additional or non-uniform taxes on goods, services, or information delivered electronically than applied to the same or similar goods, services, or information purchased through traditional means such as from a “brick and mortar” retail store or mail-order catalog. *Id.* at § 1105(2)(A)(i)-(iii). Gartner contends that application of the Washington digital products legislation to its business activity of selling

online access to its searchable database of research reports is “discriminatory” within the meaning of the federal law because it changed the manner in which that business activity is taxed. App. Br. at 27.

Gartner’s analysis is superficial and flawed. A change to a state’s tax laws does not run afoul of the Internet Tax Freedom Act’s anti-discrimination requirement. Rather, Gartner must show that the state law “is not generally imposed and legally collectible . . . on transactions involving similar property, goods, services, or information accomplished through other means” or “imposes an obligation to collect or pay the tax on a different person . . . than in the case of transactions . . . accomplished through other means.” 47 U.S.C. 151 note §§ 1105(2)(A)(i), (iii). This requires analysis of the challenged law as applied to substantially similarly businesses. *Cf. General Motors Corp. v. Tracy*, 519 U.S. 278, 298, 117 S. Ct. 811, 136 L. Ed. 2d 761 (1997) (“any notion of discrimination assumes a comparison of substantially similar entities”); *Washington v. United States*, 460 U.S. 536, 544-45, 103 S. Ct. 1344, 75 L. Ed. 2d 264 (1983) (“The State does not discriminate against the Federal Government and those with whom it deals unless it treats *someone else* better than it treats them”) (emphasis added).

Providing access to an online searchable database is not an activity that can be accomplished through non-electronic means. Thus, there is no

“offline” equivalent to the business activity engaged in by Gartner or its competitors. Moreover, under the 2009 digital products legislation, the sale of access to an *online* searchable database to Washington consumers is classified as a retail sale and is taxed accordingly. That tax treatment applies evenly and consistently to all businesses that provide substantially similar services, CP 509. Because Gartner is taxed just like every other person engaged in similar business activity within the state, there is no discrimination within the meaning of the federal law. *See Community Telecable of Seattle, Inc. v. City of Seattle*, 136 Wn. App. 169, 189, 149 P.3d 380 (2006) (Seattle’s telephone utility tax did not violate the Internet Tax Freedom Act because it applied “uniformly to companies engaged in the telephone business” within the City), *rev’d on other grounds*, 164 Wn.2d 35, 164 Wn.2d 35 (2008).

Federal preemption is strongly disfavored. For this reason, our Supreme Court “adhere[s] to a rigorous analysis” of federal preemption claims so as to “uphold state sovereignty to the maximum extent, tempered only by the mandate of the supremacy clause of the United States Constitution.” *Hue v. Farmboy Spray Co.*, 127 Wn.2d 67, 77, 896 P.2d 682 (1995). Consistent with that policy, Washington courts start with the presumption that a challenged state law is not preempted “unless that is the clear and manifest purpose of Congress.” *Id.* at 78 (internal

quotation and citation omitted). The presumption against preemption dictates that when Congress “expressly addresses state authority in a federal law, the preemptive scope of the federal law should not be extended any further by resort to an implied preemption analysis.” *Id.* at 79. Rather, the express federal law must be given a “fair but narrow reading.” *Id.* (quoting *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 524, 112 S. Ct. 2608, 120 L. Ed. 2d 407 (1992)).

Gartner’s argument concerning the Department’s application of the state’s digital products legislation to the undisputed facts of this case does not establish express preemption under a “fair but narrow reading” of the Internet Tax Freedom Act. Discrimination under that Act must fairly be read to mean actual discrimination as between substantially similar business entities—a showing Gartner has not met. As a result, the Washington law as applied to Gartner’s sales of access to its online searchable database is not preempted.

2. Congress cannot directly preempt a state tax.

Even if Gartner had presented evidence of actual discrimination between its business activity and the activity of a substantially similarly business, its preemption claim would still fail. Gartner relies on a federal law that purports to *directly regulate* whether a state can impose a tax, which is not a permitted exercise of congressional authority. *See Murphy*

v. National Collegiate Athletic Ass'n, ___ U.S. ___, 138 S. Ct. 1461, 200 L. Ed. 2d 854 (2018) (Congress cannot directly regulate the states).

Consequently, the federal law cannot be applied as a vehicle to undermine or invalidate the state tax policy decisions made by our Legislature.

“Federal law preempts state law when state law operates in a field that is completely occupied by federal law or when state law conflicts with federal law.” *West v. Seattle Port Comm'n*, 194 Wn. App. 821, 830, 380 P.3d 82 (2016). The preemption doctrine is based on the supremacy clause of the United States Constitution. U.S. Const. art. VI, cl. 2; *see generally Inlandboatmen v. Dep't of Transp.*, 119 Wn.2d 697, 701-02, 836 P.2d 823 (1992) (discussing preemption doctrine). For years it has been presumed that the supremacy clause permitted Congress nearly unlimited authority to preempt a state's tax laws even though Congress itself has no authority to impose a state tax. *See, e.g.*, Interstate Income Tax Act of 1959, 15 U.S.C. § 381 (federal law limiting the authority of states to impose net income taxes on certain out-of-state businesses). But that longstanding belief does not survive careful scrutiny.

The right to tax is among the most important attributes of state sovereignty. *Department of Revenue of Or. v. ACF Indus.*, 510 U.S. 332, 345, 114 S. Ct. 843, 127 L. Ed. 2d 165 (1994). Furthermore, under established principles of dual sovereignty that are “implicit in the

American constitutional framework and made explicit in the Tenth Amendment,” Congress does not have free rein to control the basic functions of state government. *Guillen v. Pierce County*, 144 Wn.2d 696, 732, 31 P.3d 628 (2001) (*Guillen I*), *rev’d on other grounds*, *Pierce County v. Guillen*, 537 U.S. 129, 123 S. Ct. 720, 154 L. Ed. 2d 610 (2003) (*Guillen II*).¹⁰ Therefore, Congress does not have unfettered authority to preempt a state tax. Rather, the federal law must meet established constitutional standards. *See generally*, Michael T. Fatale, *Common Sense: Implicit Constitutional Limitations on Congressional Preemptions of State Tax*, 2012 Mich. St. L. Rev. 41, 44 (2012) (discussing history and purpose of the federal constitution’s Commerce Clause and the Necessary and Proper Clause, opining that congressional preemption of state tax laws must be consistent with that history and purpose, and discussing ways “to protect the states from federal overreaching in various contexts”).

One established constitutional standard that applies to a federal law purporting to preempt a state law is the “anticommandeering doctrine.”

¹⁰ The United States Supreme Court did not address dual sovereignty or the import of the Tenth Amendment in protecting states from congressional overreach—concepts fundamental to the Washington Supreme Court’s reasoning in *Guillen I*. *See Guillen II*, 537 U.S. at 148 n.10 (declining to address dual sovereignty or arguments pertaining to the Tenth Amendment). Instead, the Court ruled that the confidentiality provision at issue—which was part of a broad federal highway safety program—was reasonably “aimed at improving safety in the channels of commerce and increasing protection for the instrumentalities of interstate commerce” and, therefore, properly fell within Congress’ express Commerce Clause powers. *Guillen II*, 537 U.S. at 147.

This constitutional principle is based on the language of the Tenth Amendment, which provides that “powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” U.S. Const. amend. X. The United States Supreme Court has explained that while the Tenth Amendment does not bar the federal government from regulating individual conduct, it does prevent the federal government from “commandeering” the institutions of state government for its own purposes. *Printz v. United States*, 521 U.S. 898, 933, 117 S. Ct. 2365, 138 L. Ed. 2d 914 (1997); *New York v. United States*, 505 U.S. 144, 188, 112 S. Ct. 2408, 120 L. Ed. 2d 120 (1992).

The anticommandeering doctrine was most recently applied in *Murphy*, which involved a challenge to the federal Professional and Amateur Sports Protection Act. *Murphy*, 138 S. Ct. at 1468. That federal law generally made it unlawful for a state or other governmental entity to authorize sports gambling. *Id.*; *see generally* 28 U.S.C. § 3702(1). The law included “grandfather” provisions that allowed sports gambling in Nevada casinos and also allowed other limited state sponsored forms of sports gambling. *Murphy*, 138 S. Ct. at 1471; 28 U.S.C. § 3704(a)(1)-(2). However, with only a few exceptions, state sponsored sports gambling was prohibited.

New Jersey had long imposed its own state-law ban on sports gambling. *Murphy*, 138 S. Ct. at 1469. However, in 2014 the state passed a law that repealed certain aspects of its laws prohibiting sports gambling. *Murphy*, 138 S. Ct. at 1472.¹¹ That 2014 state law was attacked by the major professional sports leagues and the NCAA, who asserted that it was preempted by the federal Professional and Amateur Sports Protection Act. *Id.* The state countered that the federal law “unconstitutionally infringed the State’s sovereign authority” to end its longtime ban on sports gambling. *Id.* at 1471.

The Supreme Court sided with New Jersey. It held that the federal law violated the anticommandeering doctrine by impermissibly issuing “direct orders to the governments of the States.” *Id.* at 1476. The Court explained that before a federal law could preempt state law, the federal law must “represent the exercise of a power conferred on Congress by the Constitution” and also “be best read as [a provision] that regulates private actors” and not the states. *Id.* at 1479. Direct regulation of the states is not among the legislative powers granted to Congress by the Constitution. *Id.*

¹¹ The 2014 law repealed those provisions of state law prohibiting the “placement and acceptance of wagers” on sporting events by persons 21 years of age or older at in-state horseracing tracks or at Atlantic City casinos. *Id.* The 2014 law was enacted after an earlier failed attempt to “affirmatively authorize” limited sports gambling in the state. *See id.* at 1471-72 (discussing 2012 New Jersey law and the litigation that followed). However, the Supreme Court found that, in the context of sports gambling, there was no significant difference between “repealing” a prior ban and “affirmatively authorizing” the activity. *Id.* at 1474.

at 1476. As a result, the federal law at issue in *Murphy* was incompatible with the “fundamental structural decision incorporated into the Constitution . . . to withhold from Congress the power to issues orders directly to the States.” *Id.* at 1475.

3. The Internet Tax Freedom Act is an impermissible direct regulation of state taxing authority.

In light of the High Court’s decision in *Murphy*, it is evident that Congress overstepped its authority when it enacted the Internet Tax Freedom Act. That Act cannot be fairly read as regulating private actors. Instead, the law directly regulates state governmental entities and officials when it dictates that “No State . . . may impose . . . discriminatory taxes on electronic commerce.” 47 U.S.C. § 151 note § 1101(a). Congress has improperly “commandeered” state laws in order to favor a particular industry, which is not permitted under the Tenth Amendment.

That is not to suggest that states are free to impose discriminatory taxes. A tax that discriminates against out-of-state businesses in favor of instate businesses would run afoul of established Commerce Clause principles. See *Arizona Public Service Co. v. Snead*, 441 U.S. 141, 149, 99 S. Ct. 1629, 60 L. Ed. 2d 106 (1979) (upholding a federal law prohibiting state taxes on the generation or transmission of electricity that result in a greater tax burden on electricity consumed outside the state). Preventing

the states from favoring in-state actors over similarly situated out-of-state actors was central to the creation of the Commerce Clause and is the hallmark of the Supreme Court's modern dormant Commerce Clause jurisprudence. *See General Motors Corp.*, 519 U.S. at 299 ("the dormant Commerce Clause's fundamental objective" is to preserve "a national market for competition undisturbed by preferential advantages conferred by a State upon its residents"); Fatale, 2012 Mich. St. L. Rev. at 63-65 (the purpose of the Commerce Clause was to prevent economic protectionism among the States). Thus, discriminatory state tax treatment of an out-of-state business simply because of its status as an out-of-state business is unlawful even when Congress has not acted.

But Washington's digital products law does not favor in-state businesses over their out-of-state counterparts. It applies evenly to all businesses making sales to Washington consumers. Thus, the Washington law is not discriminatory in the constitutional sense. Its only vice, if it can be called a vice, is that it attempts to establish a retail sales tax system that is neutral with respect to "industry, content, and delivery method." Laws of 2009, ch. 535, § 101(2), CP 446.

Congress, of course, may choose to favor one industry over another when enacting *federal tax laws*. It may also attempt to influence state behavior through its Spending Clause powers so long as the financial

incentives offered to the states are reasonably related to a valid federal interest. *South Dakota v. Dole*, 483 U.S. 203, 207-08, 107 S. Ct. 2793, 97 L. Ed. 2d 171 (1987). But what Congress cannot do is *dictate* as a matter of *state tax policy* its preference to favor one industry over another, or one delivery method over another. A state tax law that does not “discriminate” in the sense of favoring in-state commerce over out-of-state commerce is not something that implicates a genuine Commerce Clause concern. And, consistent with *Murphy* and with the principle of dual sovereignty that is key to the American constitutional framework, Congress exceeds its authority when it directly prohibits a state tax based on congressional notions of what type of industry or what type of activity the sovereign states should be allowed to tax.

Because Congress exceeded its proper constitutional authority when it enacted the Internet Tax Freedom Act, that Act cannot form the basis for invalidating Washington’s digital products legislation as applied to Gartner’s sale of access to its searchable database of research reports.

D. Gartner’s Alternative Claim that it is Selling Digital Goods is Incorrect and was Properly Rejected by the Trial Court

Gartner argues in the alternative that its business activity consists of selling digital goods, not digital automated services. App. Br. at 29-31. The claim has no support in the record and was properly rejected below.

As previously discussed, the 2009 digital products legislation created two categories of digital products: digital goods and digital automated services. RCW 82.04.192(7); WAC 458-20-15503(201). The principal difference between the two types of digital products is that a digital good consists solely of images, sounds, data, facts, information or any combination thereof that is transferred electronically, while a digital automated service involves the use of one or more software applications to facilitate the use of a service. WAC 458-20-15503(203)(a)(i). A digital automated service can, and often does, involve components that, standing alone, would qualify as a digital good. WAC 458-20-15503(203)(a). However, a digital automated service includes as an additional component one or more software applications that facilitate the service. *Id.*

Gartner does not sell digital goods; it sells a subscription service that allows clients to access highly proprietary electronic content (research reports) through its website. The content is contained in a searchable database that uses database management software and website browsing software to facilitate the client's use of the service. The use of software to manage the content and automate the process of locating, retrieving, and organizing documents in a searchable database is a prime example of a digital automated service. *See* CP 507 (one of the specific types of digital automated services described in the 2009 Final Bill Report was a

“searchable database”). Thus, under both the plain language of the statute and its legislative history, subscription-based research products such as those offered by Westlaw (legal research), RIA Checkpoint (tax and accounting information and analysis) Bloomberg Law (legal and business information and analysis), and Gartner Research (IT and supply chain analysis), are digital automated services subject to retail sales tax and retailing B&O tax. Gartner’s claim to the contrary is inconsistent with the undisputed facts, was correctly rejected by the trial court, and should be rejected in this appeal.

V. CONCLUSION

For the reasons set forth, the Department respectfully requests that the Court affirm the superior court’s order granting summary judgment to the Department.

RESPECTFULLY SUBMITTED this 29th day of October, 2018.

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 29th day of October, 2018, at Tumwater, WA.



Jamie Falter, Legal Assistant

APPENDIX A

RCW 82.04.192**Digital products definitions.**

(1) "Digital audio works" means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones.

(2) "Digital audiovisual works" means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any.

(3)(a) "Digital automated service," except as provided in (b) of this subsection (3), means any service transferred electronically that uses one or more software applications.

(b) "Digital automated service" does not include:

(i) Any service that primarily involves the application of human effort by the seller, and the human effort originated after the customer requested the service;

(ii) The loaning or transferring of money or the purchase, sale, or transfer of financial instruments. For purposes of this subsection (3)(b)(ii), "financial instruments" include cash, accounts receivable and payable, loans and notes receivable and payable, debt securities, equity securities, as well as derivative contracts such as forward contracts, swap contracts, and options;

(iii) Dispensing cash or other physical items from a machine;

(iv) Payment processing services;

(v) Parimutuel wagering and handicapping contests as authorized by chapter 67.16 RCW;

(vi) Telecommunications services and ancillary services as those terms are defined in RCW

82.04.065;

(vii) The internet and internet access as those terms are defined in RCW 82.04.297;

(viii) The service described in RCW 82.04.050(6)(c);

(ix) Online educational programs provided by a:

(A) Public or private elementary or secondary school; or

(B) An institution of higher education as defined in sections 1001 or 1002 of the federal higher education act of 1965 (Title 20 U.S.C. Secs. 1001 and 1002), as existing on July 1, 2009. For purposes of this subsection (3)(b)(ix)(B), an online educational program must be encompassed within the institution's accreditation;

(x) Live presentations, such as lectures, seminars, workshops, or courses, where participants are connected to other participants via the internet or telecommunications equipment, which allows audience members and the presenter or instructor to give, receive, and discuss information with each other in real time;

(xi) Travel agent services, including online travel services, and automated systems used by travel agents to book reservations;

(xii)(A) A service that allows the person receiving the service to make online sales of products or services, digital or otherwise, using either: (I) The service provider's web site; or (II) the service recipient's web site, but only when the service provider's technology is used in creating or hosting the service recipient's web site or is used in processing orders from customers using the service recipient's web site.

(B) The service described in this subsection (3)(b)(xii) does not include the underlying sale of the products or services, digital or otherwise, by the person receiving the service;

(xiii) Advertising services. For purposes of this subsection (3)(b)(xiii), "advertising services" means all services directly related to the creation, preparation, production, or the dissemination of advertisements. Advertising services include layout, art direction, graphic design, mechanical preparation, production supervision, placement, and rendering advice to a client concerning the best methods of advertising that client's products or services. Advertising services also include online referrals, search engine marketing and lead generation optimization, web campaign planning, the

acquisition of advertising space in the internet media, and the monitoring and evaluation of web site traffic for purposes of determining the effectiveness of an advertising campaign. Advertising services do not include web hosting services and domain name registration;

(xiv) The mere storage of digital products, digital codes, computer software, or master copies of software. This exclusion from the definition of digital automated services includes providing space on a server for web hosting or the backing up of data or other information;

(xv) Data processing services. For purposes of this subsection (3)(b)(xv), "data processing service" means 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. Data processing does not include the service described in RCW **82.04.050(6)(c)**; and

(xvi) Digital goods.

(4) "Digital books" means works that are generally recognized in the ordinary and usual sense as books.

(5) "Digital code" means a code that provides a purchaser with the right to obtain one or more digital products, if all of the digital products to be obtained through the use of the code have the same sales and use tax treatment. "Digital code" does not include a code that represents a stored monetary value that is deducted from a total as it is used by the purchaser. "Digital code" also does not include a code that represents a redeemable card, gift card, or gift certificate that entitles the holder to select digital products of an indicated cash value. A digital code may be obtained by any means, including email or by tangible means regardless of its designation as song code, video code, book code, or some other term.

(6)(a) "Digital goods," except as provided in (b) of this subsection (6), 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.

(b) The term "digital goods" does not include:

(i) Telecommunications services and ancillary services as those terms are defined in RCW **82.04.065**;

(ii) Computer software as defined in RCW **82.04.215**;

(iii) The internet and internet access as those terms are defined in RCW **82.04.297**;

(iv)(A) Except as provided in (b)(iv)(B) of this subsection (6), the representation of a personal or professional service in electronic form, such as an electronic copy of an engineering report prepared by an engineer, where the service primarily involves the application of human effort by the service provider, and the human effort originated after the customer requested the service.

(B) The exclusion in (b)(iv)(A) of this subsection (6) does not apply to photographers in respect to amounts received for the taking of photographs that are transferred electronically to the customer, but only if the customer is an end user, as defined in RCW **82.04.190(11)**, of the photographs. Such amounts are considered to be for the sale of digital goods; and

(v) Services and activities excluded from the definition of digital automated services in subsection (3)(b)(i) through (xv) of this section and not otherwise described in (b)(i) through (iv) of this subsection (6).

(7) "Digital products" means digital goods and digital automated services.

(8) "Electronically transferred" or "transferred electronically" means obtained by the purchaser by means other than tangible storage media. It is not necessary that a copy of the product be

physically transferred to the purchaser. So long as the purchaser may access the product, it will be considered to have been electronically transferred to the purchaser.

(9) "Specified digital products" means electronically transferred digital audiovisual works, digital audio works, and digital books.

(10) "Subscription radio services" means the sale of audio programming by a radio broadcaster as defined in RCW **82.08.02081**, except as otherwise provided in this subsection. "Subscription radio services" does not include audio programming that is sold on a pay-per-program basis or that allows the buyer to access a library of programs at any time for a specific charge for that service.

(11) "Subscription television services" means the sale of video programming by a television broadcaster as defined in RCW **82.08.02081**, except as otherwise provided in this subsection. "Subscription television services" does not include video programming that is sold on a pay-per-program basis or that allows the buyer to access a library of programs at any time for a specific charge for that service, but only if the seller is not subject to a franchise fee in this state under the authority of Title 47 U.S.C. Sec. 542(a) on the gross revenue derived from the sale.

[2017 c 323 § 514; 2010 c 111 § 203; 2009 c 535 § 201.]

NOTES:

Tax preference performance statement exemption—Automatic expiration date exemption—2017 c 323: See note following RCW 82.04.040.

Purpose—Retroactive application—Effective date—2010 c 111: See notes following RCW 82.04.050.

Intent—2009 c 535: "(1) In 2007, the legislature directed the department of revenue (department) to conduct a study of the taxation of electronically delivered products (digital products). In conducting the study, the department was assisted by a committee comprised of legislators, academics, and individuals representing different segments of government and industry (the "study committee").

(2) At the conclusion of the study, the department issued its final report December 5, 2008. The final report noted that any recommendations to the legislature should promote the following goals: (a) Simplicity and fairness; (b) conformity with the streamlined sales and use tax agreement; (c) neutrality regardless of industry, content, and delivery method while taking the purchaser's underlying property rights into account; (d) consideration given to the revenue impact of potential changes to the tax base; (e) consideration given to the impact caused by the pyramiding of business inputs; (f) maintaining or enhancing the competitiveness of businesses located in Washington; and (g) maintaining certainty, consistency, durability, and equity despite changes in technology and business models.

(3) While the department's final report did not contain recommendations for the legislature, the report's conclusion notes that the study committee found that legislation implementing digital products tax policy is necessary in 2009 to: (a) Protect the sales and use tax base; (b) establish certainty in our tax code; (c) maintain conformity with the streamlined sales and use tax agreement; and (d) encourage economic development.

(4) This act is the outgrowth of the work of the department and the study committee. The purpose of this act is to implement those findings of the study committee noted in subsection (3) of this section. This act also takes into account the goals noted in subsection (2) of this section.

Moreover, this act contains specific provisions to: (a) Provide protections for taxpayers who failed to pay or collect tax on digital products for periods before July 26, 2009; and (b) promote the location of server farms and data centers in this state by preventing the department from considering a person's ownership of, or rights in, digital goods or digital codes residing on servers located in this state in determining whether the person has nexus with this state for purposes of the taxes imposed in Title 82 RCW." [2009 c 535 § 101.]

Construction—2009 c 535: "This act does not have any impact whatsoever on the characterization of digital goods and digital codes as tangible or intangible personal property for purposes of property taxation and may not be used in any way in construing any provision of Title 84 RCW." [2009 c 535 § 1201.]

Construction—2009 c 535: "The repeals in sections 515 and 623 of this act do not affect any existing right acquired or liability or obligation incurred under the statutes repealed or under any rule or order adopted under those statutes nor do they affect any proceedings instituted under them." [2009 c 535 § 1203.]

APPENDIX B

STATE TAXATION

II

Sales and Use, Personal Income, and Death and Gift Taxes and Intergovernmental Immunities

Third Edition

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purchases for resale to their customers. As a consequence, they pay no sales tax on such purchases.¹⁰⁶ Under these circumstances, it is possible that there would be no tax on the building contractor's purchases or sales. However, if the state treats the contractor as consuming the building materials in rendering construction services to its customers, the contractor pays the sales tax on the purchase of materials, unless the state explicitly exempts from tax purchases of building materials for use in construction for exempt or immune organizations.¹⁰⁷

¶ 12.08 TESTS FOR DISTINGUISHING SALES OF TANGIBLE PERSONAL PROPERTY FROM SALES OF SERVICES OR INTANGIBLES

[1] The "True Object," "Real Object," or "Dominant Purpose" Test

In interpreting the sales and use tax statutes, state tax administrators and the courts have experienced great difficulty in drawing the line between taxable sales of tangible personal property, on the one hand, and nontaxable sales of services or intangibles, on the other hand, when the property transferred to the buyer is largely the result of personal services or embodies substantial intangible value. At the two poles, there is no great difficulty. Thus, when a lawyer draws a will, an accountant prepares an annual report, or an architect draws up plans for a building, there is ordinarily no problem in concluding that services have been rendered,¹⁰⁸ even though in each case the client or customer receives a document that constitutes tangible personal property.

At the other pole, if one subscribes to a loose-leaf tax service or if one orders the production of an advertising brochure, few people would quarrel with the view that these transactions constitute sales of tangible personal property. Nevertheless, the loose-leaf service embodies valuable intangible information collected by the editors, and the advertising brochure is the result of extensive and often expensive labor, while the paper on which the tax service and the brochures are printed involves relatively minor expense.¹⁰⁹

¹⁰⁶ See ¶ 15.07[1].

¹⁰⁷ See ¶ 15.07[1].

¹⁰⁸ But see *Sneary v. Director of Revenue*, 865 SW2d 342 (Mo. 1993) (sales of architectural illustrations taxable as sales of tangible personal property). See generally ¶ 13.02[5].

¹⁰⁹ In some states, there are explicit provisions in the sales tax laws taxing information services. See ¶¶ 13.03[1][b], 15.13.

As usual, the tough problems lie in between the two extremes. Thus, the courts have addressed such questions as whether an optometrist renders a service or is making a sale when he furnishes his customer with eyeglasses that he has prescribed;¹¹⁰ whether an artist who is commissioned to paint a portrait is making a sale;¹¹¹ and whether providing customized computer software constitutes a sale of tangible personal property or of a service.¹¹²

A number of states have adopted the rule that the test of whether a transaction constitutes a taxable sale of tangible personal property or a nontaxable sale of services is whether the purchaser's "true object," "real object," or "dominant purpose" was to acquire the finished product or the service. As one court declared:

The test applied by a preponderance of the authorities from other jurisdictions with sales tax statutes similar to our [Virginia] statute is: If the "true object" sought by the buyer is the services per se, the exemption is available, but if the true object of the buyer is to obtain the property produced by the service, the exemption is not available.¹¹³

¹¹⁰ See ¶ 13.02[3].

¹¹¹ See *infra* ¶ 12.08[2].

¹¹² See ¶ 13.06.

¹¹³ *WTAR Radio-TV Corp. v. Commonwealth*, 217 Va. 877, 234 SE2d 245, 249 (1977); see also *Houghton Mifflin Co. v. State Tax Comm'n*, 373 Mass. 772, 370 NE2d 441 (1977); *Questar Data Sys., Inc. v. Commissioner of Revenue*, 549 NW2d 925 (Minn. 1996); *Koch v. Kosydar*, 32 Ohio St. 2d 74, 290 NE2d 847 (1972); *Sneary v. Director of Revenue*, 865 SW2d 342 (Mo. 1993); *New England Tel. & Tel. Co. v. Clark*, 624 A2d 298 (RI 1993); *Janesville Data Co. v. Wisconsin Dep't of Revenue*, 84 Wis. 2d 341, 267 NW2d 656 (1978). See generally E. Bialczak, "The True Object Test Applied to States' Sales Tax on Information Services," 10 *J. State Tax'n* 46 (Winter 1991).

The Maryland court has adopted the following position:

If the article sold has no value to the purchaser except as a result of services rendered by the vendor and the transfer of the article to the purchaser is an actual and necessary part of the service rendered, then the vendor is engaged in the business of rendering service and not in the business of selling at retail. If the article sold is the substance of the transaction and the service rendered is merely incidental to and an inseparable part of the transfer to the purchaser of the article sold, then the vendor is engaged in the business of selling at retail, and the tax which he pays for the privilege of engaging in such business is measured by the price which the purchaser pays for the article and the service incident thereto.

Quotron Sys., Inc. v. Comptroller of the Treasury, 287 Md. 178, 411 A2d 439, 443 (1980).

Some states, including Pennsylvania, have incorporated the “dominant purpose” or “true object” test into their statutes,¹¹⁴ and others, including California, have incorporated such tests into their regulations.¹¹⁵

The cases seeking to apply the “true object,” “real object,” or “dominant purpose” test reveal the weaknesses of that approach. Several decisions of the Ohio Supreme Court have held that the real object of transfers of cards and printouts of bank transactions and other data was the transfer of tangible personal property.¹¹⁶ On the other hand, in *Bullock v. Statistical Tabulating*

¹¹⁴ The Pennsylvania statute says:

Where tangible personal property or services are utilized for purposes constituting a “use,” as herein defined, and for purposes excluded from the definition of “use,” it shall be presumed that such property or services are utilized for purposes constituting a “sale at retail” and subject to tax unless the user thereof proves to the department that the predominant purposes for which property or services are utilized do not constitute a “sale at retail.”

Pa. Stat. Ann. tit. 72, § 7201(o)(5) (West Supp. 1999).

¹¹⁵ The California regulation provides:

The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. . . . Thus, the transfer to a publisher of an original manuscript by the author thereof for the purpose of publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of his creation. However, the tax would apply to the sale of mere copies of an author’s works or the sale of manuscripts written by other authors where the manuscript itself is of particular value as an item of tangible personal property and the purchaser’s primary interest is in the physical property. Tax would also apply to the sale of artistic expressions in the form of paintings and sculptures even though the work of art may express an original idea since the purchaser desires the tangible object itself; that is, since the true object of the contract is the work of art in its physical form.

Cal. Code Regs. tit. 18, § 1501 (RIA through July 1999). The California courts have construed this regulation in *Navistar Int’l Transp. Corp. v. State Bd. of Equalization*, 8 Cal. 4th 868, 884 P2d 108, 35 Cal. Rptr. 2d 651 (1994), discussed in ¶ 13.08[3]; *Simplicity Pattern Co. v. State Bd. of Equalization*, 27 Cal. 3d 900, 615 P2d 555, 167 Cal. Rptr. 366, (1980); discussed in ¶ 13.07[2][a]; *A&M Records v. State Bd. of Equalization*, 204 Cal App 3d 358, 250 Cal. Rptr. 915 (2d Dist. 1988), discussed in ¶ 13.07[2][a]; and *Capitol Records, Inc. v. State Bd. of Equalization*, 158 Cal. App. 3d 582, 204 Cal. Rptr. 802 (3d Dist. 1984). See also 1 Colo. Code Regs. § 201-5 (Special Reg. 42) (“Service Enterprises”) (RIA through July 1999) (“real object”). The Michigan Department of Revenue has issued guidelines for applying the “real object test” in differentiating between the sale of a service and the sale of tangible personal property. Dep’t of Treasury Rev. Administration Bull. 1995-1, Feb. 14, 1995.

¹¹⁶ *Miami Citizens Nat’l Bank & Trust Co. v. Lindley*, 50 Ohio St. 2d 249, 364 NE2d 25 (1977); *Lindner Bros., Inc. v. Kosydar*, 46 Ohio St. 2d 162, 346 NE2d 690 (1976); *Citizens Fin. Corp. v. Kosydar*, 43 Ohio St. 2d 148, 331 NE2d 435 (1975).

Corp.,¹¹⁷ a closely analogous case, the Texas court held that when a customer brought raw data to a data processor and received cards containing the data, there was no taxable sale of tangible personal property, saying:

[T]he true object of this transaction is not the data processing *card* as contended by the comptroller, but the purchase of *coded or processed data*, an intangible.

The customer brings in raw data which is conceded by both parties to be an intangible item, but perceptible to humans. The customer then buys Plaintiff's capabilities in effecting a translation of the data such that it becomes perceptible to a computer. The essence of the transaction for the customer is an intangible product, coded data, and Plaintiff's capabilities in making the translation or coding.¹¹⁸

The Idaho Supreme Court considered a similar question in a case involving a use tax assessed against a company engaged in the business of computing transportation charges for common carriers and furnishing them with printed transportation tariff schedules, either in loose-leaf or bound volume form, that it purchased from the publisher.¹¹⁹ The common carriers used the data furnished by the taxpayer to justify their rates before the Interstate Commerce Commission. The taxpayer separately stated the fees for computing transportation charges and those for furnishing tariff schedules. The fees for the transportation charge computations constituted the larger part of the fees.

The state asserted that a tax was due on the printing charges for the tariffs, not for the separate charges for the computation service. The court applied the "real object" test, which the Idaho regulations incorporated, in determining whether the transaction involved a sale of tangible personal property or the sale of services. The court concluded that the real object of the transaction was the transfer of tangible personal property. In so concluding, the court relied heavily on the existence of separate fees for the printed tariff schedules, which it found to be "clear evidence that the tangible personal property was not incidental to the service, but was the real object of the transaction."¹²⁰

The court distinguished the *Bullock* case on the following ground:

The court recognized that the element of service was the essence of the transaction. In the [*Bullock*] case, the customer had the raw data, but needed to have it processed and translated into a computer format. However, in the instant action, the customer did not have the raw data, but was in need of the information. Therefore, in addition to providing the

¹¹⁷ *Bullock v. Statistical Tabulating Corp.*, 549 SW2d 166 (Tex. 1977).

¹¹⁸ *Bullock*, 549 SW2d 166, 168 (Tex. 1977) (emphasis in original).

¹¹⁹ *Consolidated Freightways Corp. v. Idaho Dep't of Revenue & Taxation*, 112 Idaho 652, 735 P2d 963 (1987).

¹²⁰ *Consolidated Freightways*, 112 Idaho 652, 735 P2d 963, 967 (1987).

physical printout of the information, the tariff bureau is providing [the taxpayer] with the sought-after information, which is the real object of the transaction.¹²¹

The Idaho court reached the right result, but, in our view, for the wrong reason. The court erroneously applied the “real object” test to the case. The court should have treated the rendition of the services and the transfer of the printed tariffs as separate transactions. Had it done so, its conclusion would have followed easily, without the need to determine the real object of the overall transaction. The transfer of the printed tariffs—the only question before the court—was clearly a sale of tangible property.¹²²

Some courts have sought to develop objective guidelines for ascertaining whether the true object of a transaction is a sale of tangible personal property, the sale of a service, or a sale or license of intangible property.¹²³

[a] The Insignificance of the Value of Materials, as Compared With the Value of Services, Going Into a Product

One of the tests that some courts have used in determining whether a transaction involves the sale of property or the sale of services is the relative significance of the cost or value of the materials, as compared with the value of the services, that contribute to a product. Thus, in *Washington Times-Herald, Inc. v. District of Columbia*,¹²⁴ a leading case from the U.S. Court of Appeals for the District of Columbia, the taxpayer, a newspaper publishing company, contracted with several syndicates for its supply of comic strips. The syndicates carried out these contracts by sending the taxpayer fiber matrices (mats) bearing impressions of the current sequence of the strips. The taxpayer paid the syndicates for the comic strip mats amounts that greatly exceeded the price of the blank mats. Relying on the statutory exemption for “[p]rofessional, insurance, or personal service transactions which involve sales as inconsequential elements for which no separate charges are made,”¹²⁵ and on a regulation providing that a sale is an “inconsequential element” where the price of the

¹²¹ *Consolidated Freightways*, 112 Idaho 652, 735 P2d 963, 967 (1987).

¹²² The Chief Justice of the Idaho Supreme Court dissented on the ground, inter alia, that “a genuine question exists as to whether [the taxpayer] provided the schedules incidental to a service.” *Consolidated Freightways*, 112 Idaho 652, 735 P2d 963, 973 (1987) (Shepard, C.J., dissenting).

¹²³ The same or similar factors have also been employed to distinguish sales of tangible personal property from sales of services by courts that do not use the true object or dominant purpose test.

¹²⁴ *Washington Times-Herald, Inc. v. District of Columbia*, 94 US App. DC 154, 213 F2d 23 (DC Cir. 1954).

¹²⁵ *Washington Times-Herald*, 94 US App. DC 154, 213 F2d 23, 24 (DC Cir. 1954) (quoting the statute).

tangible personal property is less than 10 percent of the amount charged for the services rendered, the court held that the transaction was exempt, declaring:

The syndicates sold to the Times-Herald the right to reproduce one time the work of artists who make the drawings. They simply sold the professional and personal services of the artists whom they had under contract and in so doing transferred title to the mats, of inconsequential value, from which the drawings could be reproduced. The price was paid for the artists' work, i.e., for the right to reproduce the impressions on the mats—not for the mats themselves. The newspaper bought the creation of the artist—not the material on which it was impressed—and the right to reproduce it. Without that right, the comic strip mats would be entirely worthless.¹²⁶

Many years ago, in a statement that has been widely quoted since, the North Dakota Supreme Court identified the fallacy in this view that a transaction constitutes a service if the value of the materials that go into the product is inconsequential as compared to the value of the services involved:

[T]here is no article, fabricated by a machine or fashioned by the human hand, that is not the fruit of the exercise and application of individual ability and skill. And few, indeed, are the instances where the greater part of the cost thereof is not chargeable, to personal service directly or remotely applied.¹²⁷

Indeed, if one were to accept and apply the rule that the characterization of a transaction as a sale of property or services depended on the relative value of each, it would cast doubt on much of the established law of sales taxation. Thus, if one commissions a highly paid artist to do a portrait, or a Parisian couturier to design and produce an exclusive gown, one might easily conclude that the price was paid for the artist's or designer's services, while the canvas and paint and, in some instances, the materials in the dress, are of inconsequential value. Similarly, one could reasonably argue that subscription fees for tax and financial services are paid not for the paper on which the information is printed, but for the services of the editors in gathering data, analyzing problems, and setting forth the results. Yet sales taxes are generally imposed on such transactions, despite the comparatively small part of the cost paid for the materials.

¹²⁶ *Washington Times-Herald*, 94 US App. DC 154, 213 F2d 23, 24 (DC Cir. 1954). Accord *Southern Bell Tel. & Tel. Co. v. Department of Revenue*, 366 So. 2d 30 (Fla. Dist. Ct. App. 1978), cert. denied, 368 So. 2d 1365 (Fla. 1979), discussed in ¶ 13.05[2].

¹²⁷ *Voss v. Gray*, 70 ND 727, 298 NW 1, 4 (1941). See also *People v. Grazer*, 138 Cal. App. 2d 274, 291 P2d 957, 960 (3d Dist. 1956); *Crescent Amusement Co. v. Carson*, 187 Tenn. 112, 213 SW2d 27, 29 (1948).

[b] The Distinction Between the Intangible Content of Property and the Property Itself

Another test that some courts employ in drawing the line between taxable and nontaxable sales is whether the purchaser's true object is the intangible content of property or the physical property itself. The Minnesota Supreme Court used such a test in a case dealing with the taxability of the rental of mailing lists.¹²⁸ Most of the mailing lists were in the form of Cheshire (gummed) tapes, gummed labels, and heat transfers, which are physically separated and attached to the mailing envelopes and covers. Some of the lists, however, were typewritten. The court held that the rental of the typed lists was "merely incidental to the use of the incorporeal information contained in those lists"¹²⁹ and, therefore, was not taxable. On the other hand, the Cheshire tapes, gummed labels, and heat transfers were taxable, because in the court's view:

In these instances there is a use of the tangible property of the medium distinct from the use of the typed mailing lists, in that the tapes and labels are physically separated and attached to the envelopes. In such a case, the physical manifestation of the property is itself used . . . not merely the intangible information. This distinction is, in our opinion, sufficiently great to justify a different treatment for tax purposes of the typed mailing lists and the other rental mailing lists in the form of Cheshire tapes, gummed labels, and heat transfers.¹³⁰

Such refinements in taxability, depending on the mechanics of transferring names and addresses to mailing wrappers, are inappropriate in the eminently practical world of taxation. There is no sound reason in tax policy for subjecting lists in the form of Cheshire tapes, gummed labels, or heat transfers to sales tax, while not taxing typewritten mailing lists. On the contrary, such narrow mechanical distinctions in determining liability for sales tax purposes confer an unwarranted competitive advantage on one method of conducting a business as compared with a slightly different method. As a Pennsylvania

¹²⁸ *Fingerhut Prods. Co. v. Commissioner of Revenue*, 258 NW2d 606 (Minn. 1977). See ¶ 13.03[2] for a detailed discussion of the mailing list cases.

¹²⁹ *Fingerhut*, 258 NW2d 606, 610 (Minn. 1977).

¹³⁰ *Fingerhut*, 258 NW2d 606, 610 (Minn. 1977). The New Jersey Tax Court held that the rental of mailing lists furnished on magnetic tapes is not subject to sales tax. "Plaintiff is leasing information. It is not leasing tangible personal property. The tapes which are tangible personal property and which transmit the information are only incidental to the underlying transaction between the parties." *Spencer Gifts, Inc. v. Director, Div. of Taxation*, 182 NJ Super. 179, 440 A2d 104, 118 (1981). The court also said: "Here the court finds, based on stipulations between the parties, that there was no consideration for the magnetic tapes themselves." *Spencer Gifts*, 182 NJ Super. 179, 440 A2d 104, 117 (1981).

court stated in rejecting the Commonwealth's refusal to apply the state's sales tax exemption for printed matter to word processing:

The Commonwealth urges that we resolve the issue primarily by contrasting the technology of the taxpayer's process with the technology of those other processes traditionally accepted as printing, i.e., letterpress, offset printing and the like. . . .

We cannot discern a reasonable relationship between a purely technological distinction and a sound legislative purpose. The Commonwealth has offered no cogent explanation as to why the legislature might wish the favorable light of exclusion to shine upon one technological approach to reproduction and not upon another.¹³¹

Moreover, the rationale on which the Minnesota court based its holding—that the physical use of tangible property is taxable but that the nonphysical use of the intangible content of the property is not taxable, if that nebulous distinction can be drawn at all—runs counter to well-established sales tax principles.¹³² Thus, if a subscriber purchases a loose-leaf tax service, the transaction is taxable despite the fact that the subscriber does not transfer the printed pages to his or her briefs or memoranda in the way that the taxpayer transferred the gummed labels to envelopes in the Minnesota case.¹³³ Instead, the subscriber uses the information contained in the printed pages of the tax service by reading them, in much the same way that a typist reads the typewritten mailing lists and types the envelopes. Similarly, when one purchases a book to read or a painting to view, the transactions are taxable despite the fact that there is no physical use of the property in the sense that the Minnesota court employed that concept. Consequently, the physical use test employed by the Minnesota court is not a meaningful or satisfactory basis for distinguishing taxable sales of tangible personal property from nontaxable sales of intangible content.



[c] Services Coupled With a Transfer of Separate Property

In deciding whether a transaction involves the sale of tangible personal property or the sale of services, courts sometimes confuse services that are

¹³¹ Commonwealth v. AJ Wood Research Co., 60 Pa. Commw. 225, 431 A2d 367, 368–369 (1981). The issue was whether the exemption in the sales tax statute for printing covered word processing. The Commonwealth urged that it did not, but the court rejected that contention.

¹³² This is not to suggest that the Minnesota court is alone in its view. For example, some of the computer software cases have adopted the distinction between the incorporeal content of an article and the physical property itself. See ¶ 13.06.

¹³³ With the frequent use of duplicating machines, however, we often come very close to such a physical transfer of printed materials.

separate and apart from the property transferred or licensed with services that are embodied in the property. One may illustrate this point by comparing two different types of transactions—the licensing of motion picture films by producers to exhibitors, and transactions engaged in by landscape designers. Motion picture producers employ a large amount of expensive talent in producing films, including directors, actors, and others. Since the results of such work are embodied in the films that are delivered to exhibitors, however, most states tax motion picture rentals as licenses to use tangible personal property.¹³⁴

Landscape designers also use services in preparing the land and planting trees, shrubs, and flowers. Although they transfer shrubs, trees, and plants to their customers, the services are not embodied in those articles in the typical case in which landscape designers purchase trees and shrubs from a nursery. The trees and shrubs are thus separate and apart from the services, except for the service involved in planting them, in contrast to the motion picture negative and prints, which embody the services. Consequently, if a landscape designer separates the price of the trees and shrubs from the planting and other service charges, the sales tax will apply only to the price of those articles. No sales tax will be payable on the general landscaping work or the planting of trees and shrubs.¹³⁵

Some courts have recognized that the “true object” test (whatever its merit) should be applied only to cases in which the services are embodied in the tangible article transferred to the buyer. A bankruptcy case involving a California sales tax assessed against a correspondence school raised that question.¹³⁶ The taxpayer offered a large number of courses in drafting, electrical service, radio and television repair, and other trades. As part of each course, the student received books, printed lessons, and, where applicable, training kits and tools. The taxpayer charged tuition for each course, without separate charges for such items.

¹³⁴ See ¶ 13.07[4][a].

¹³⁵ *Swain Nelson & Sons Co. v. Department of Fin.*, 365 Ill. 401, 6 NE2d 632 (1937). In *Levine v. State Tax Comm'n*, 144 AD2d 209, 534 NYS2d 522 (3d Dep't 1988), the court set aside an assessment against a caterer for flowers and flower arrangements purchased for use in connection with catered meals, which New York taxes, NY Tax Law § 1105(d)(i) (McKinney Supp. 1999), on the ground that they were purchased for resale. The State Tax Commission contended that “the flowers were a service performed” by the caterer “and not a resale.” *Levine*, 144 AD2d 209, 534 NYS2d 522, 524 (3d Dep't 1988). The court rejected that contention on the ground that under the regulation, “[w]here a person, in the course of his business operations, purchases tangible personal property . . . which he intends to sell, either in the form in which purchased, or as a component part of other property or services, the property . . . which he has purchased will be considered as purchased for resale.” *Levine*, 144 AD2d 209, 534 NYS2d 522, 523 (3d Dep't 1988) (quoting NY Comp. Codes R. & Regs. § 526.6[c][1]).

¹³⁶ *Advance Schools, Inc. v. California State Bd. of Equalization*, 2 Bankr. 231 (ND Ill. 1980).

The taxpayer contended

that the true object of its contracts was the educational service rather than the personal property transferred, and that a single contract calling for both the rendition of services and the transfer of property cannot be taxable in part and nontaxable in part. Debtor argued that if the transaction is severed, the true object test would be rendered meaningless; it would no longer be necessary to determine the overall object of the mixed contract, as each part would then be treated separately.¹³⁷

The court disagreed:

The Debtor's reliance on the true object test is misplaced. The test is appropriate where the services rendered are inseparable from the property transferred that is, where the services, so to speak, find their way into the property. All the examples used in Regulation 1501 to illustrate the true object test involve transactions in which the services become an integral part of the property; e.g., the artist's skill and labor are embodied in his painting; the record keeping, tax, and similar services of a firm which performs business advisory services are embodied in the forms, binders, and other property transferred during the course of the transactions. . . .

Thus, the true object test should be used where the services and the property are inseparable and is inapplicable where these two elements are distinct.¹³⁸

The correspondence school rendered services that were separate and apart from, and not embodied in, the books, lessons, or other tangible property provided. These services included grading examinations, monitoring the students' progress, and consulting with instructors by mail or telephone. The court sustained the tax only on the "deemed retail prices"¹³⁹ of the property furnished to the students.

[d] Substantial Use of Machinery and Equipment as Indicative of Sales of Tangibles

In applying the "true object" test, some courts have taken the position that if a transaction primarily involves manual or intellectual labor and not the substantial use of machinery or equipment, it constitutes a service whose sale is

¹³⁷ *Advance Schools*, 2 Bankr. 231, 235 (ND Ill. 1980).

¹³⁸ *Advance Schools*, 2 Bankr. 231, 235-236 (ND Ill. 1980). The court cited *Good-year Aircraft Corp. v. Arizona State Tax Comm'n*, 1 Ariz. App. 302, 402 P2d 423 (1965), in which the seller tested and destroyed airplane subassemblies in order to develop engineering information for the purchaser. The court sustained the tax only with respect to the destroyed property, not the engineering services.

¹³⁹ *Advance Schools*, 2 Bankr. 231, 234 (ND Ill. 1980).

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