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COURT OF APPEALS
DIVISION II

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STATE OF WASHINGTON
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83673-6
NO. 37718-7-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

QUALCOMM, INCORPORATED,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

QUALCOMM'S REPLY BRIEF

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I. INTRODUCTION

In the Brief of Respondent, the Department of Revenue ("Department") concedes for the first time in this proceeding that Qualcomm's OmniTRACS service includes both transmission and information processing and that, therefore, the "primary purpose" or "true object" test is the proper legal standard by which to determine whether the sales tax applies.

Having conceded the primary purpose test, however, the Department applies it to the individual pieces rather than the service as a whole. First, it argues that position reports and mobile messaging are "distinct and identifiable services" that can be bifurcated and analyzed separately. However, there is neither a factual or legal basis for bifurcation here. Second, instead of considering the integrated system containing hardware, software, data processing, and transmission when it considers the primary purpose, the Department ignores the hardware and software because they are sold separately.[1] However, neither the hardware nor the software is useful by itself. The hardware allows the truck to generate electrical signals that are meaningless without transmission to Qualcomm's facility where they are processed to produce data that can be

[1] Ironically, these items are sold separately because they are tangible personal property on which the sales tax clearly applies. This tax was collected and remitted and is not at issue.

imported, using Qualcomm's software, into the fleet management center computers and used to automate billing and other "back office" functions. In considering the purpose for which a customer buys Qualcomm's service, all of these capabilities must be considered because the customer is buying a system. To look only at transmission and then pronounce its primary purpose to be transmission is not intellectually honest. When viewed as a whole, it is obvious that the primary purpose for purchasing OmniTRACS is to obtain information about the purchaser's fleet of trucks, not incidental communication with the driver. Therefore, OmniTRACS is properly classified as an information service and the trial court must be reversed.

II. ARGUMENT

The central question in this case is whether OmniTRACS service, which monitors the location and condition of trucks and their loads, is "network telephone service" subject to retail sales tax or an information or data processing service not subject to sales tax. The relevant statute states that such service[2] does not include:

> Data processing and information services that allow data to be generated acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser ***where such purchaser's primary purpose for the***

[2] The current statute refers to "network telephone service" as "telecommunications service." The Department and Qualcomm agree that these phrases have the same scope. *See* Brief of Respondent at 13.

> ***underlying transaction is the processed data or information.***

RCW 82.04.065 (8)(a) (emphasis added). Qualcomm and the Department agree that, under this statute, as well as the Department's "long-standing interpretation," the key distinction is whether the company is selling the data being transmitted or instead is selling a method for transmitting the data." Brief of Respondent at 14. This is the "primary purpose" or "true object" test.

A. The True Object of OmniTRACS is Information.

Application of the "true object" test to Qualcomm's OmniTRACS shows that trucking companies buy OmniTRACS to obtain information about the location and condition of their fleet. If the main purpose of buying OmniTRACS were merely to transmit data, then one would not expect to need the service if the truck were close by or at least in cell phone range. However, even if the trucking company could communicate face to face with the truck driver, it would not know the geographic coordinates of the truck or the condition of the truck's engine, nor could it ascertain it by examining the truck. This information is created by Qualcomm. Qualcomm calculates the position of the truck using satellites and determines the condition of the truck by using data from sensors and the engine bus. Like the mechanic at the local garage using computerized

engine diagnostics, Qualcomm is performing a service quite apart from transmission and generating new and useful information.

The Department's own published guidance to taxpayers supports Qualcomm's position. Determination No. 05-0325, 27 WTD 99 (2008)[3] ("Insurance Claims Case") involved electronic claims processing. The taxpayer acted as an electronic intermediary between its customers, pharmacies and other medical service providers, and insurance carriers, relaying insurance coverage information to the customer and claims data to the insurance carrier. *Id.* at 2 of 7.

The taxpayer argued that its service streamlined claims submission by compiling all of the necessary information so that it was readily available to the medical provider, characterizing the services as "value-added Internet-based data processing services that provide medical professionals with instant access to various medical insurance information, and thereafter provide such medical professionals with a fully automated, error-free insurance claims submission process." *Id.* at 5 of 7.

The Audit Division had focused on the transmission of the information in assessing tax, but the Appeals Division disagreed, holding

[3] *See* App. 1 hereto. Although the case was decided in 2005, the Department did not choose to publish it until July of 2008. Presumably, the Department must have considered its guidance more relevant in light of the new RCW 82.04.065, which became effective in July and clarified that the "primary purpose" test was to be used to classify services that combined transmission with information or data processing.

that the taxpayer provided access to insurance information, that it reformatted the information when necessary to facilitate the claims process, and provided reports on the process for its customers and therefore was not primarily a telecommunications service. *Id.* at 6 of 7.

A similar result was reached in Det. No. 98-202, 19 WTD 771 (2000)[4] ("Reservations System Case"), involving a travel reservation service. A travel agency leased computers to make reservations. The monthly fee was broken down into computer hardware, software license and support, and communications support—the charge for access to the reservation system and database. *Id.* at 772. The Audit Division assessed sales tax on the communications support charge reasoning that it included telephone line charges and was thus transmission. *Id.* at 775. The Appeals Division disagreed:

> In this case, we similarly believe that the true object of the $... monthly communication charge is for the ability to access the information in System's reservation system and to make the reservation with the service providers on behalf of Taxpayer's client. These services are information services and since the services are rendered through computer hardware or software, they fall within Rule 155's definition of "computer services."

Id. at 776.

[4] App. B-3 to Appellant's Opening Brief.

OmniTRACS, like the services in the Insurance Claims Case and Reservations System Case, provides access to new information. Qualcomm generates that information from raw data produced by the hardware it installs in each truck. While Qualcomm's customer owns the truck, it cannot determine the location or condition of the truck without sophisticated data processing that can take raw data points and produce information that can be understood by its computers and turned into invoices and reports.

B. Bifurcation is not Appropriate in this Case.

The Department argues that the true object test applies only when there is not a reasonable basis for bifurcating the charges. It argues that the automatic position reporting service should be considered separately from what it calls "mobile messaging."[5] This approach should be rejected for two reasons.

First, bifurcation was not raised below and neither party made a factual record from which the court could determine whether bifurcation was appropriate and how to segregate the revenue streams. *See Hansen v. Friend*, 118 Wn.2d 476, 824 P.2d 483 (1992) ("An appellate court will

[5] Inexplicably, the Department then concludes that the true object of both automatic position reporting and mobile messaging is transmission, thereby obviating the need to bifurcate. The fact that the Department raises this argument suggests an admission that position reporting is an information service, not transmission.

generally not consider arguments raised for the first time on appeal."). Second, to the extent there are facts in the record, they do not support bifurcation.

What the Department denominates as "mobile messaging" consists of more than simple electronic mail between the driver and the fleet operations center. Nor is "mobile messaging" separately priced or billed.

There are three distinct kinds of messages within the Department's "mobile messaging" category. The predominate category is "Macro" messages. CP 30, ¶ 6. Typical Macros include messages such as pick-up and delivery confirmations. *Id.* Variable data is entered by the driver and combined with the macro template to produce a readable message for the dispatch center. This allows for messages to be created in a "fill in the blank" style. *Id.* The software, which was also created and sold by Qualcomm, allows a driver to push a number of keys to signify common shipping terms. *Id.*

Macros allow customers to integrate OmniTRACS data with their other business computer systems. CP 31, ¶ 7, CP 82-83. By knowing exactly where specific key pieces of information are within a message, integration software can automate the handling of information – pulling key data elements out of the data transmission with Qualcomm's network management center ("NMC" or "NMF") and marrying these key elements

with data from other information systems. ¶CP 31, ¶ 7. This automates processes such as invoicing, much as the insurance claims software in the Department's determination automated claims submission. *See id.*

This category also includes messages generated by binary coded data sent between a mobile unit and a customer's computer via the NMC. CP 31, ¶ 10. This data, which is typically not human readable, includes performance information gathered from various points on a truck (including the computerized engine bus). *Id.* This information is routed by the NMC to other Qualcomm applications, allowing customers to monitor things such as driver performance, engine diagnostics, and truck location. *Id.* Another service offered by Qualcomm tracks events that occur on the truck, such as rapid and sustained truck deceleration, which are captured and transmitted by the Mobile to the NMC. *Id.*

Finally, a small part of what the Department labels "mobile messaging" consists of freeform messages, manually created by the driver or dispatch center and sent to the other. These are the only messages that resemble ordinary text messages or e-mail, and even they receive time stamps and location information from Qualcomm. Thus, it is simply not true that these three categories of OmniTRACS service involve primarily transmission and should be bifurcated from position reporting.

The small number of freeform messages does not require bifurcation. In the Reservations System Case, there were telephone line charges that were separately stated, but the Appeals Division nonetheless looked at the communications support charges as a whole:

> We further find that the telephone line charges are merely incidental to the information services being supplied by System and may not be bifurcated and separately taxed from the object of the transaction.

19 WTD at 776.

The hallmark of bifurcated activities is that they are "separately stated on the bill provided to the customer or on a price list or similar pricing schedule." Brief of Respondent at 20. Qualcomm's billing system does not break out these categories and thus, these categories cannot be bifurcated. Basic service, priced at $35 per month, includes only hourly position reporting. CP 185. But when a customer pays the additional $15 for enhanced service, the customer simply gets more messages—the messages may be macros, freeform messages, or data generated on the condition of the truck. CP 185, 196. Incremental charges for extra messages beyond the basic or enhanced service level similarly can result from all types of messages. CP 185. Thus there is no rational basis for dividing the services or resulting charges.

C. The Department's Analysis is Flawed in General.

The Department's argument is largely predicated on a false distinction between OmniTRACS service and the OmniTRACS system. The Department admits that the total system generates useful information about the operation of trucks. *Id.* at 27. But it claims that the separately priced hardware and software are responsible for the information and that the monthly service fee is simply for transmission. *Id.* at 24, 27. This factually and legally incorrect.

Factually, the Department ignores the role of Qualcomm's NMC. Citing to CP 242, the Department maintains that the Mobile unit itself generates the positioning information and simply transmits it through the NMC to the customer. The cited material, however, states: "When the [Mobile] receives the NMF-originated signals from these satellites, the [Mobile] makes measurements based on the difference between these two signals. The calculations are then transmitted back to the NMF which combines them with other information to calculate the [Mobile's] present position." It is obvious that Qualcomm's central computers perform the critical work and that no position information would exist without the NMC.

And even if some processing is done on the Mobile or the customer's computer using Qualcomm software, the Mobile and software

are of no use without the OmniTRACS service and vice versa. If the service were merely transmission, it could be replaced by cell phones or other wireless technology. But, in fact, OmniTRACS service integrates the components and the components will not work without it.

Legally, the situation is similar to that in *Community Telecable v. City of Seattle*, 164 Wn.2d 35, 42, 186 P.3d 1032 (2008), in which Seattle tried to separate the transmission component of internet service in order to apply the network telephone tax. The court held that the transmission component could not be analyzed apart from the overall service and noted that, even if it could, the transmission component would not be subject to tax as network telephone service because it "transforms" and "manipulates" the data being transmitted. *Id.* at 44. The same is true here.

The Department apparently believes that, because the customer has purchased the Mobile and the software, any data generated by them are simply the customer's own data, as if Qualcomm's highly sophisticated information processing facilities and patented technologies had nothing to do with it. The idea that the customer is the source of the information transmitted by OmniTRACS was specifically rejected by the Tennessee Court of Appeals, considering the identical facts:

> Here, that true object is to locate vehicles and determine their status. Second, as previously discussed, the undisputed facts of this case make evident that Qualcomm

> does in fact generate information apart from the content created by its customers and their drivers. This is, after all, the point of the OmniTRACS service: to locate vehicles without need for person-to-person communication. Moreover, its vehicle tracking function operates automatically and independently of any message that might be sent by or to a driver. Only when a "free form" message is sent can it be said that information from the customer predominates in importance over information generated by Qualcomm itself, but use of this capability, the parties agree, is relatively rare.

Qualcomm Inc. v. Chumley, No. 04-1127 IV, slip. op. at 10-11 (Tenn. Ct. App., Sep. 26, 2007) [Exhibit B, to Appellant's Opening Brief].

The Reservations System Case is also analogous. The reservations system required hardware, software, and communications support. The hardware and software were tangible personal property subject to the sales tax, but the communications support charges were primarily for the purpose of access to the information necessary to make reservations. In reaching that conclusion, the Department did not view communications support in isolation, which might have caused it to be classified as transmission; it necessarily viewed the system as a whole.

D. The Tennessee Case is Exactly On Point.

The Department seeks to distinguish *Qualcomm, Inc. v. Chumley,* the Tennessee Court of Appeals analysis of Qualcomm's OmniTRACS service based on the same faulty distinction between the OmniTRACS system and OmniTRACS service. The Department insists that the facts

are "materially" different in the two cases because Tennessee considered the functionality of the system as a whole. Respondent's Brief at 29. However, the factual distinction between the system and the service is the same in both cases—the difference lies in whether the court considered the system as a whole or component by component. That difference is a legal one—the proper focus of the "true object" test used by both states. Tennessee properly considered the purpose of the system as a whole rather than its component parts.

The Department also speculates the Tennessee court adopted a more restrictive interpretation of telecommunications simply because it noted that OmniTRACS did not replace the need for cell phones. However, the Tennessee statute, cited in the Court's opinion, clearly includes data communications and wireless messaging systems like the paging system in *Western Telepage,* relied upon by the Department. The statutes are not materially different.

III. CONCLUSION

For the reasons stated above, this Court should reverse the trial court and grant summary judgment for Qualcomm, finding that its OmniTRACS service is not "network telephone service."

RESPECTFULLY SUBMITTED this 14th day of November, 2008.

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CERTIFICATE OF SERVICE

I, Shbien Cross, hereby certify and declare under penalty of perjury under the laws of the State of Washington that on November 14, 2008, I caused a copy of the foregoing document to be served via e-mail and United States first class mail on the following counsel for Respondent:

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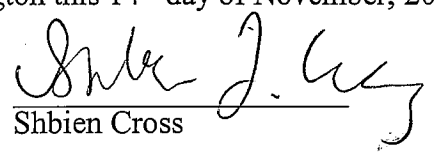
Executed at Seattle, Washington this 14th day of November, 2008.



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APPENDIX

Washington Tax Determination No. 05-0325

Case Information:

Docket/Court: 05-0325, Washington Dept. of Revenue Determination

Date Issued: 12/15/2005, 27 WTD 99

References: Cite as Det. No. 05-0325, 27 WTD 99 (2008)

RULE 155, RULE 245; RCW 82.04.065; ETA 544: RETAILING B&O TAX VS. SERVICE B&O TAX — CLASSIFICATION OF INCOME — PRIMARY NATURE — ELECTRONIC INSURANCE CLAIMS PROCESSING. In determining the proper classification of a taxpayer's income, we will consider the "primary nature" of the taxpayer's activities. If the primary nature of a taxpayer's activities was the transmission for hire of data via a telephone network or similar transmission system, the taxpayer's income would be subject to retailing B&O tax, and the taxpayer would be required to collect retail sales tax from its customers. In contrast, if the primary nature of the taxpayer's activities was information or internet services, the taxpayer's income would be subject to service B&O tax. Taxpayers, who provided electronic insurance claims processing services were providing information services subject to service B&O tax; however, separate charges for telephone lines, and canned software were properly classified under the retail classification and subject to retail sales tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

OPINION

C. Pree, A.L.J

BEFORE THE APPEALS DIVISION DEPARTMENT OF REVENUE STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of ...

DETERMINATION

No. 05-0325

Registration No. ...

Doc. No. .../Audit No. ...

Docket No. ...

Registration No. ...

Doc. No. .../Audit No. ...

Docket No. ...

STATEMENT OF THE CASE:

Taxpayers, who provide electronic insurance claims processing services, petition for correction of assessment. The Audit Division concluded that the taxpayers provide network telephone services subject to retail sales tax and retailing B&O tax and issued an assessment accordingly. We conclude that the taxpayers provided information services subject to service B&O tax; however, separate charges for telephone lines, canned software, and other items are properly classified under the retail classification and subject to retail sales tax. We remand the assessment to the Audit Division to allocate the taxpayers' income between retailing and service and to apportion the taxpayers' service income. [1]

ISSUE:

Did the taxpayers, who provide electronic insurance claims processing services, provide network telephone services subject to retail sales tax and retailing B&O tax or information services subject to service B&O tax?

FINDINGS OF FACT:

The Audit Division of the Department of Revenue reviewed [Company A's] records for the period of July 1, 1998, through May 31, 1999. [Company A] was acquired by [Company B] effective June 1, 1999. The Audit Division reviewed [Company B's] records for the period of January 1, 1997, through December 31, 2000.

With respect to the issue here, [Company B] and [Company A (together "the taxpayers")] perform similar functions, *i.e.,* they act as electronic intermediaries between their customers and insurance carriers. Specifically, they sell software license and maintenance services, which enable their customers to determine the insurance coverage of their customers (*e.g.,* co-payment amounts and whether the prescribed drug is reimbursable under the particular insurance plan), and the taxpayers submit insurance claims on behalf of their customers....

The taxpayers have access to the insured's medical information from various insurance providers, which enables the taxpayers to provide insurance claims processing on a real-time basis. In providing these services to their customers, the taxpayers relay insurance coverage information to the customer and the claims data to the insurance carrier. The taxpayers do not have access to the insurance carrier's computers and have no input into the decision regarding whether to accept or deny insurance coverage. The insurance carrier processes claims and determines whether to authorize or reject a claim, and the taxpayers inform the customer of the insurance carrier's decision.

The transactions typically occur as follows. A customer needing a prescription filled provides a pharmacist with the prescription and the customer's medical insurance information. The pharmacist enters the information into a terminal, which is owned or leased by the pharmacy.

Using the taxpayers' licensed software, the terminal connects in real-time to the taxpayers' out-of-state operations center.

When the taxpayers receive the data from the pharmacy, their computers sort the data by insurance carrier and reformat the data to comply with the insurance carrier's claims processing requirements. The reformatting entails ensuring that the information is on the correct line and that sufficient information has been provided. If data are missing or incorrect, the taxpayers request complete, correct data from the pharmacy. The taxpayers reformat the data to ensure the successful transmission of the insurance claim to the appropriate insurance provider. The taxpayers then connect with the insurance carrier's information system (primarily through dedicated lease lines) and deliver the request. The insurance claim is typically filed at this time.

The taxpayers reject claims before they go to the insurance carrier if the claim does not meet ... guidelines (which involve the proper communication language) for electronic claims processing, [2] if the claim is from a pharmacy that is not one of the taxpayers' customers, or if the taxpayers do not have a relationship with the insurance carrier (which is rare). Sometimes, due to technical limitations, the insurance carrier may not be able to accept a real-time insurance claim submission. In these instances, the taxpayers will either submit a batch claim on a daily basis or at intervals agreed upon by the pharmacy.

After the insurance carrier responds to the claim, the taxpayers sometimes perform additional sorting and reformatting and deliver the response from the insurance company to the pharmacy.

The taxpayers' services are accomplished via a modem and phone line, over the internet. Thus, these services require the use of telephone lines to transmit data between the taxpayers and their customers. For an additional monthly charge, the taxpayers will obtain the telephone link for their customers. This monthly charge may be either fixed or variable, and is based on the taxpayers' telecom costs. The costs are [a very small amount] per transaction and comprise [a small percentage] of the taxpayers' total charges to pharmacies ..., hospitals and medical clinics. Rather than having the taxpayers obtain the telephone link, the customers may arrange for their own telecom connectivity to the taxpayers. The latter option is selected by some of the taxpayers' large customers.

The taxpayers' computer networks capture the data necessary for billing their customers and for providing reports to customers of their transaction activity (such as total transactions and accepted and rejected transactions). The taxpayers' computer operations center monitors the sorting and reformatting of the data for each transaction and monitors the telecom connectivity (where applicable) to ensure that the third-party telecommunications provider maintains connectivity.

The taxpayers' service virtually eliminates manual processing of paperwork. The reduction in paper claims results in time savings and lower administrative costs for the taxpayers' customers, as well as improved cash flow by streamlining the claims reimbursement process.

For an additional charge, in addition to the basic claims service described above, [Company B] provides pre and post edit premium services. These services allow its customers to impose business rules on their transaction submissions and responses and to monitor the claims process, which are intended to increase the customers' cost savings or income. These services include alerting the pharmacist regarding whether the [drug's code] number is current, a generic drug is available, and the submitted prescriber ID is valid; and alerting the customer regarding drug limitations or restrictions. These services also include allowing the customers to remotely access [Company B] databases to examine their transaction details and history, to capture financial response information to ensure that the customer is reimbursed at an acceptable level, and to determine if their charges to their customers are comparable to other pharmacies in their market area.

For an additional charge, in addition to the basic claims service described above, [Company A] provided "audit" services to increase productivity, recover revenue, improve billing accuracy, maximize reimbursement, and reduce customers' administrative costs. The additional services included online verification of reimbursement, online laboratory requisitions, results reporting, and automated flagging of abnormal results (a quality control service). In addition, through various software packages, [Company A] offered ... services, which were designed to improve the recovery of lost revenues, and provide feedback regarding managed care contract management and negotiations.

The taxpayers' charges to their customers typically include transaction service charges, which are broken down based on the payer contacted and the number of times each payer was contacted; real time switching charges, which are comprised of dial up charges and lease line charges on a per-transaction basis; and lease line charges for one-time installation costs. The taxpayers also charged software license fees and [fees] for software installation. The Audit Division characterized all of these transactions as retail sales. With respect to the software charges, the Audit Division cited WAC 458-202-155 (Rule 155), which characterizes sales of canned software as retail sales. With respect to the remaining charges, the Audit Division concluded that the taxpayers provided network communications, *i.e.,* the transmission of data for hire, which is a retail activity. The Audit Division explained, "The primary purpose of the transmission charges billed to [the taxpayers'] customers, is for the transmission of electronic data via a secure, confidential means." [3]

The Audit Division agreed with the taxpayers that some of their charges were properly subject to service B&O tax. Specifically, the Audit Division concluded that income [Company A] received from the audit services described above, as well as consulting services and training, were properly subject to Service B&O tax. In the [Company B] audit, the Audit Division determined that transaction charges for point of sale insurance coverage information [4] and charges for pre and post edit services and other similar activity was subject to service B&O tax, when separately stated from the transmission charges. The taxpayers, on the other hand, contend all of their income is subject to service B&O tax and, accordingly, apportionable.

ANALYSIS:

The issue in this case involves the proper B&O tax classification of the taxpayers' income. The Audit Division contends the taxpayers' income is properly taxed under the retailing classification (and subject to retail sales tax) either because it involves a license to use canned software or because it involves "network telephone services." The taxpayers, on the other hand, contend their income is properly subject to the service classification either because it involves "computer services" or "internet services."

In determining the proper classification of the taxpayers' income, we will consider the "primary nature" of the taxpayers' activities. *See, e.g.,* ETA 544.04.08.245 (ETA 544); Det. No. 04-0023E, 23 WTD 206 (2004). ETA 544 explains, "The Department considers the primary nature of the activity in establishing the tax classification applicable; Incidental services of a possibly different classification, unless clearly identified and billed, will not affect the tax classification so established." Thus, the ETA concluded, a telephone answering service is not generally engaged in network telephone business activities, even though some of the activities it performs, when isolated from the primary or general business activity, would satisfy the retail sale definition. The ETA continues:

> As a general practice, when no itemized or separate billing for manual or electronic switching, cross connecting, cross accessing, or other possibly retail service is provided, the Department will not impute or allocate any such charges or itemization from the gross services billed by the telephone answering service business. The telephone answering business would continue to be liable for Service business and occupation tax on all its gross receipts.

> However, if the Department determines that the primary nature of the activity has become one of retail services, as outlined above, warranting thereby a reclassification of tax, <u>or</u> that incidental retail services such as manual or electronic switching or cross connecting of lines and networks are separately billed, the receipts of such clearly identified retail activities will be taxed as retail sales, subject to the Retailing business and occupation tax and retail sales tax.

(Emphasis original.) We will next analyze each of the classifications set forth above to determine which best represents the "primary nature" of the taxpayers' activities and whether the taxpayers separately billed any incidental services, which should be taxed under a different classification.

<u>Information Services.</u> Gross income from "computer services" is subject to tax under the service classification. WAC 458-20-155 (Rule 155); *see* RCW 82.04.290. Rule 155 defines "computer services" as "every method of providing information services through the use of computer hardware and/or software." Rule 155, in turn, defines "information services" as follows:

> every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible medium.
>
> The term does not include transfers of tangible personal property such as computer hardware or standard prewritten software programs. Neither does the term include telephone service defined under RCW 82.04.065 and WAC 458-20-245....

<u>Network Telephone Services.</u> Generally, persons rendering "telephone service" to consumers are taxable under the retailing classification and are required to collect retail sales tax from their customers. *See* RCW 82.04.065; WAC 458-20-245 (Rule 245). Telephone services include "network telephone service," which is defined as follows:

> "Network telephone service" means the providing by any person of access to a telephone network ..., or the providing of telephonic ..., data, or similar communication or transmission for hire, via a telephone network, toll line ..., or similar communication or transmission system. "Network telephone service" includes the provision of transmission to and from the site of an internet provider via a telephone network, toll line ..., or similar communication or transmission system.

RCW 82.04.065; *see also* Rule 245. Thus, as the Audit Division contends, if the primary nature of the taxpayers' activities was the transmission for hire of data via a telephone network, such income is subject to retailing B&O tax, and the taxpayers would be required to collect retail sales tax from their customers.

The Audit Division noted that the taxpayers provide their customers with a telecommunications link to access a local taxpayer network. According to the taxpayers, the Audit Division reached this conclusion because the taxpayers offer each customer "the convenient option of having [the taxpayers] obtain the underlying telecommunications service

required for its Internet connectivity. When [taxpayers'] customers select this option, [taxpayers] allocate a percentage portion of the underlying telecommunications costs of such connectivity to each customer in the form of a monthly fee." The taxpayers admit that their Internet-based services require the use of telephone lines to transmit data between them and their customers, but argue the "'true object" of their services is not the use or provision of telecommunication services, or the mere "transmission of data" as suggested by the Audit Division, but that such service is merely incidental to their various medical information services. The taxpayers argue that their primary service streamlines the claims submission process by compiling health insurance, medical provider, and billing information, and making such information, via the Internet, readily available to the medical professional for timely, accurate prescription servicing and subsequent insurance claim processing.

The taxpayers characterize their business as "perform value-added, Internet-based data processing services ... that provide ... medical professionals with 'instant access' to various medical insurance information, and thereafter provide such medical professionals with a fully automated, error-free insurance claims submission process." The taxpayers emphasize that their customers do not believe that they are contracting for a network telephone service because a local or national telecommunications company "undoubtedly already provides such services to them." Instead, the taxpayers argue, their customers "contract for convenient, efficient, medical data processing services that allow medical professionals to focus on their core competencies." The taxpayers emphasize that they are not in the business of "merely transmitting data"; instead, they are "in the business of collecting processing, and manipulating data, as a convenience for ... customers." The taxpayers reason that to provide this service, data must necessarily be transmitted via some medium, but the taxpayers do not provide "access" or "medium" to its customers within the scope of RCW 82.04.065. "Rather," the taxpayers note, "such access is provided to [Company B] as a vendor who merely utilizes the services of a telephone company or Internet service provider in order to perform its own service for its customers."

The Audit Division further characterized the taxpayers' exchange of data in real-time with their customers as transmitting data for hire, as contemplated by RCW 82.04.065. The Audit Division concludes the taxpayers are "clearly ... hired to transmit data or information for hire .... [T]he transmission of data over a local telephone network, or similar communication or transmission service, is contained within the definition of 'network telephone service.'"

The taxpayers argue such an interpretation is contrary to legislative intent. The taxpayers cite Western Telepage, Inc. v. Tacoma, 140 Wn.2d 599, 998 P.2d 884 (2000) , in support of their argument that the legislative intent was to extend the scope of the network telephone tax, in addition to traditional telephone companies, to companies providing telecommunications services in the wake of federal deregulation of the telecommunications industry. In *Western Telepage,* the court stated:

> The legislature intended to complete what it had begun in 1981, *i.e.* the deregulation of the telephone business and the equalization of tax burdens on all businesses engaging in the telephone business without regard to whether the business was regulated or nonregulated.

In issuing the assessments, the Audit Division relied on Det. No. 00-159E, 20 WTD 372 (2001). In that determination, the taxpayer operated a shared wide area network ("WAN") (a system in which computers on the system can communicate with other computers on the system). Shared WANs share data transmission resources and may also share computer processing resources. Each computer on the WAN was linked by data transmission facilities utilizing either leased lines or packet-switched networks. The taxpayer's customers had computers on their premises that were linked to the taxpayer's shared WAN. We concluded that the taxpayer's shared WAN services were network telephone services. We explained:

> Taxpayer clearly transmits data or information for hire. Taxpayer's customer supplies the data or information, and Taxpayer's shared WAN transmits the data from a computer in one location to a different computer in another location. The fact that taxpayer may contract with an underlying telecommunications carrier for the telephone lines that actually transmit the data is not determinative. What is determinative, however, is that the customer holds Taxpayer responsible for the eventual transmission of the computer data or information to its final destination. If the computer data is not received, the customer would look to Taxpayer for restitution and/or compensation and not the underlying carrier.

In contrast, the taxpayers cite Det. No. 98-202, 19 WTD 771 (2000), in support of their argument that the fact that they use telephone lines to transmit data does not change the "true object" of their activities from information services to network telephone services. Det. No. 98-202 involved a travel agency that leased a computer to make reservations. The monthly fee it paid was broken down into computer hardware, software license and support, and communication support (which was a charge for having access to the reservation system and database). The

reservation system allowed the taxpayer to receive current information on airline, hotel, and rental car availability and prices and to book the reservation with the service provider. The monthly charge included but did not separately state the cost of telephone lines necessary to connect the taxpayer's terminal to the reservation system.

In Det. No. 98-202, the Audit Division assessed retail sales tax on the travel agency's entire payment to the reservation service because it contended that the inclusion of the telephone line charges converted the entire charge to network telephone services. However, the Department concluded that the communication support charge was properly classified under the service classification because it involved a charge for providing computer services. The Department further concluded that the telephone line charges were only incidental to the services the taxpayer received and could not be bifurcated and taxed separately from the "true object" of the transaction, which was the ability to access the information in the reservation system to make reservations.

We conclude that Det. No. 98-202 is closely analogous to the facts here. Specifically, the taxpayers here provide pharmacies and hospitals access to insurance information and submit insurance claims for their customers. In submitting the claims, the taxpayers reformat the data as necessary. The taxpayers then report back to their customers whether their claims were approved or denied. Similarly, the taxpayer in Det. No. 98-202 received access to reservation information, was able to submit reservation requests, and received information regarding whether the reservations were accepted.

In reaching this conclusion, we distinguish Western Telepage, Inc. v. City of Tacoma, 140 Wn.2d 599, 998 P.2d 884 (2000) . At issue in that case was whether the taxpayer's provision of paging services was subject to tax as network telephone services. The paging service transmitted numeric and alpha-numeric messages to customers. Generally, a numeric message was transmitted in response to a telephone call made to a customer's pager access number; a telephone company would then transmit the call to the taxpayer's paging terminal. Alpha-numeric messages were prompted by messages sent to the paging terminal via modem, dictation to a live operator, and email. For either the numeric or alpha-numeric messages, the taxpayer's paging terminal sent a microwave (radio) transmission to the pager device, advising the caller to return a call to the specified telephone number or transmitting the brief alpha-numeric message. The court concluded such services were properly classified as network telephone services because they transmitted data or similar communication by microwave. In other words, the taxpayer provided the medium over which the data was communicated. As explained above, the taxpayers' services do not entail simply providing the medium for the transmission of data; instead, the taxpayer provides new information to its customers.

Similarly, we distinguish Det. No. 88-193, 5 WTD 347 (1988). [5] In that determination, the taxpayer received its income from transmitting data from an earth station to a satellite and from a satellite to a hub. Like the taxpayer in *Western Telepage,* the taxpayer in Det. No. 88-193 provided the medium for transmitting data. There was no evidence that the taxpayer added any information to the data provided by its customers.

Accordingly, we conclude that ... the taxpayers' income ... from data processing and related services ... is subject to Washington taxation under the service classification.

... The taxpayer is entitled to apportion its income subject to tax under the service classification if it maintains "places of business" both within and without this state. *See* RCW 82.04.460....

CONCLUSIONS OF LAW AND DISPOSITION:

The taxpayers' petition is granted in part and denied in part.

Dated this 15 th day of December, 2005.

1

Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

2

The taxpayers do not change the communication language of the data, *i.e.,* the taxpayers' function is not to make their customer's language compatible with that of the insurance company.

3

However, in a prior audit of [Company A], the Audit Division taxed the "electronic interchange" transactions *i.e.,* the electronic insurance claim processing, under the service classification. In the current audit of [Company A] the Audit Division accepted this income as reported under the service classification. However, [Company B] was instructed to report this income under the retailing classification and to pay retail sales tax effective September 1, 2002, based on the Audit Division's conclusion that these services were properly characterized as network telephone services.

4

This information allows the pharmacist to check insurance coverage, but does not entail the submission of a claim.

5

See also Det. No. 92-363, 12 WTD 519 (1992).

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