Services Under the Retail Sales and Use Tax Act:

Not as Exempt as You Think

One strategy for dealing with the problematic true object test has been to avoid it entirely by using two contracts . . . . The Supreme Court of Virginia's decision in the United Airlines case offers strong support for this strategy . . . .

by Kathleen McCormick

As politicians seek new revenue sources, a favorite target is services, commonly thought not to be taxable under Virginia's sales and use tax laws. The fact, however, is that the Department of Taxation has always applied the tax to certain services, and the list of truly nontaxable services is diminishing with increasingly aggressive audit practices. This article will provide an overview of Virginia's current treatment of services and will highlight some of the circumstances under which "nontaxable" services are taxed.

The Statutory Framework

The retail sales tax is imposed at the rate of 4 percent of the "gross sales price" on "every person who engages in the business of selling at retail . . . tangible personal property in this Commonwealth."[1] The statutory definitions of the key terms are:

- "Sale means any transfer of title or possession, or both, . . . of tangible personal property and any rendition of a taxable service for consideration . . ."
- "Sales price means the total amount for which tangible personal property and services are sold, including any services that are part of the sale . . ."
- "Retail sale . . . means a sale to any person for any purpose other than for resale in the form of tangible personal property or services taxable under this chapter . . ."[2]

Although the statute does not purport to tax most services,[3] the taxable "sales price" for tangible personal property is defined as including related services, even when a separate charge is made for them. The regulations make this an all-or-nothing proposition, depending on whether what is sold is property or a service. The challenge is identifying which is which, like separating the dancer from the dance.

Distinguishing Between Taxable and Nontaxable Sales: The True Object Test

The Supreme Court of Virginia, in considering the status of charges made by a television station for producing a commercial advertisement, adopted the following test: "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."[4] In that case, the television station (WTAR) argued that the true object of the transaction was the provision of a service.[5] In support of its position, WTAR presented an invoice itemizing the charges for studio time, art work, talent and dubs, but making no charge for the tangible film on which the advertisement was recorded.[6] Tracking statutory language expressly exempting services involving the transfer of property as an inconsequential ele-

ment,[7] WTAR argued that the film was an inconsequential element of the services required to create the advertisement.[8] The Court rejected this argument, holding that "the buyer was primarily interested in the completed film to be shown on the station rather than in the services involved in producing it."[9]

The tax department's regulation explains the Supreme Court's true object test as follows:

> In order to determine whether a particular transaction which involves both the rendering of a service and the provision of tangible personal property constitutes an exempt service or a taxable retail sale, the true object of the transaction must be examined. If the object of the transaction is to secure a service and the tangible personal property which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.[10]

While the statement of the true object test in this regulation and the *WTAR* opinion may work in theory, many have found the test to be result-oriented and seemingly determined not by the buyer's desire, but rather by the tax collector's "true object." For example, the tax department has concluded that the true object of the following transactions is the sale of tangible personal property: a tailor's charges for sewing a suit from a customer's cloth;[11] a photographer's or artist's charge for creating a photograph or portrait;[12] an engineer's charge for photogrammetric services in creating survey plats;[13] and an advertising agency's total charges for an ad campaign if even one drawing is produced.[14] In each case, the department determined the buyer's desire to be the property, not the service.

By contrast, the department has treated the following as nontaxable sales of professional or personal services: a lawyer's charge for creating a will or a brief; a financial planner's charge for creating a financial plan; and a marketing consultant's charge for creating a demographic report.[15] In these instances, the department necessarily has concluded that the transfer of the brief, will, financial plan or marketing report is an inconsequential component of the transaction, and that the buyer's real desire is the professional service, not the tangible product. How is one to decide, however, that a will—required by statute to be in writing—or a brief—required by Rules of Court to be in printed form—is inconsequential to the underlying service, but the paper of Ansel Adams' photograph or canvas of DaVinci's painting is not?

One strategy for dealing with the problematic true object test has been to avoid it entirely by using two contracts—one for the services and one for the tangible personal property. The Supreme Court of Virginia's decision in the *United Airlines* case offers strong support for this strategy in certain circumstances.[16] The Court considered whether United's provision of in-flight meals constituted a "resale," in that the airline could purchase the meals free of tax and sell them without tax in the interstate airways.[17] The Court concluded that there was no resale because the passenger gave no separate valuable consideration for the meal.[18] Specifically, the Court observed that United charged the same fare regardless of whether a meal was served, and that a passenger who declined a meal was not entitled to any reduction in fare.[19]

It follows from the analysis in *United Airlines*, that, so long as separate consideration supports the tangible personal property and services being sold, neither is a component of the sale of the other. Keeping in mind, however, the statutory definition of "sales price" and the holding in *WTAR,* merely separating statements of service charges from property charges is not enough. The transactions must be *separately bargained for consideration*; e.g., buying a mixed drink during the flight.

Whenever a transaction involves property and substantial services, one should consider separating them into two contracts to avoid having both taxed under the "true object" test. For example, a major engineering study may be necessary to determine what type of system a company needs. If put in one contract with the system purchase, those services would seem to be "part of the [taxable] sale;" but if put in two contracts, especially if the ensuing contract for the system is separately bid or otherwise bargained for, then a strong position should exist for not taxing the services.

Recently, however, the tax department has challenged even this strategy in an apparent effort to further expand the sales taxability of services. Three rulings illustrate this progression. In the first, the tax commissioner applied the true object test to a "bundled" contract for the sale of computer

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software and training services.[20] He concluded that because the training services were not separately contracted for, the whole contract price, including the separately stated charge for training, was subject to tax. In light of *WTAR* and the department's regulation, this is the expected result.

In the second ruling, the taxpayer used two separate contracts—one for the licensing of its patented surgical method and one for the sale of the equipment used to perform the surgery.[21] Ignoring the separate contracts, the tax commissioner held that the licensing fees constituted a part of the sale of the equipment, and he assessed tax on the sum of the equipment sale price and the licensing fees. He concluded that the two contracts were not "independent" of one another.

The third ruling involved two separate contracts executed between the same parties on the same day—one for the sale of prewritten software and one for the modification of that software.[22] The commissioner, again combining the two contracts, concluded that the true object was the sale of the taxable software, and applied tax to the otherwise nontaxable modification services. The authority cited for the ruling is a statement from *Michie's Jurisprudence* that it is appropriate for a court to look to one contract in construing another contract that is part of the same "transaction." That statement is not relevant to application of the true object test.

Unless the commonwealth is seeking to expand the sales tax to encompass traditionally exempt services, the analysis should not turn on whether two contracts are "related," between the same parties, or even signed on the same day. After all, an airline can buy tax exempt a mixed drink and sell it to a passenger who buys his ticket for transportation services on the same day. Rather, the question should be whether there is a separately-bargained-for consideration supporting each transaction. This analysis may well support the results reached in each of the three rulings noted above. Whether this test is better in practice will depend on the tax collector's true object in terms of further extending Virginia's taxation of services. ⚖

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Endnotes:

1 *Va. Code* § 58.1-603. There is also a complementary use tax on "the use or consumption for tangible personal property in this Commonwealth." *Va. Code* § 58.1-604.

2 *Va. Code* § 58.1-602.

3 Two specific exceptions are the provision of meals and lodging. Moreover, the Act then provides an "exemption" for "[p]rofessional, insurance or personal service transactions which involve sales as inconsequential elements for which no separate charges are made." *Va. Code* § 58.1-609.5(1).

4 *WTAR Radio-TV Corporation v. Commonwealth*, 217 Va. 877, 883, 234 S.E.2d 245, 249 (1977).

5 *Id.*, 217 Va. at 884, 234 S.E.2d at 249.

6 *Id.* 217 Va. at 884, 234 S.E.2d at 249.

7 *Va. Code* § 58.1-609.5(1).

8 *WTAR*, 217 Va. at 882-883; 234 S.E.2d at 248.

9 *Id.*, 217 Va. at 884; 234 S.E.2d at 249.

10 23 VAC 10-210-4040D.

11 23 VAC 10-210-560B.

12 23 VAC 10-210-2050A & 23 VAC 10-210-4040D.

13 P.D. 95-90 (April 28, 1995).

14 *See* P.D. 85-125 (June 12, 1985) (stating old rule) & *Va. Code* § 58.1-609.6(5) (statute overruling old rule).

15 P.D. 93-128 (May 19, 1993).

16 *Commonwealth v. United Airlines*, 219 Va. 374, 248 S.E.2d 124 (1978).

17 *Id.*, 219 Va. at 381; 248 S.E.2d at 129.

18 *Id.*, 219 Va. at 383-384; 248 S.E.2d at 129-130.

19 *Id.*, 219 Va. at 383; 248 S.E.2d at 129.

20 P.D. 03-31 (April 9, 2003).

21 P.D. 03-37 (April 15, 2003).

22 P.D. 03-61 (August 19, 2003).