

Before the
Administrative Hearing Commission
State of Missouri



IBM CORPORATION,)	
)	
Petitioner,)	
)	
vs.)	No. 12-0030 RS
)	
DIRECTOR OF REVENUE,)	
)	
Respondent.)	
)	

DECISION

IBM Corporation (“IBM”) is entitled to a use tax refund of \$158,359.10, plus statutory interest, for sales of equipment and software to MasterCard International, LLC (“MasterCard”). It is not entitled to a use tax refund for its sales of software licenses and software maintenance to MasterCard.

Procedure

IBM filed its complaint on January 6, 2012. The Director of Revenue (“the Director”) filed an answer on February 8, 2012. IBM filed a motion for partial summary disposition, accompanied by a statement of uncontroverted material facts and a memorandum in support, on June 19, 2013. The Director responded to the motion with a memorandum in opposition and a statement of his uncontroverted material facts, on July 26, 2013. We denied IBM’s motion on September 30, 2013. IBM filed a motion for reconsideration on October 8, 2013. The Director

filed a response to the motion on October 10, 2013. IBM filed a second motion for reconsideration, as to the software portion of its refund claim only, on October 17, 2013. We denied both motions for reconsideration on October 30, 2013.

We held a hearing on December 4, 2013. IBM was represented by Scott Browdy and Kendall Bryant of the Ryan Law Firm, LLP, and Thomas R. Schwarz, Jr. of Blitz, Bardgett & Deutsch, L.C. The Director was represented by Thomas Houdek and Roger Freudenberg. The case became ready for decision on May 9, 2014, the date the last written argument was filed.

Findings of Fact

Sales on Which MasterCard Paid Use Taxes to IBM

1. Between September 1 and September 29, 2008, IBM sold the following items to MasterCard:

Software-related items

- Software;
- Software renewals/licenses (which we interpret as being a license to use or continue to use software already bought); and
- Software maintenance agreements.

Hardware

- Servers;
- Tape and data cartridges;
- Memory;
- Cables;
- Disk drives;
- Backplanes;
- Processors;

- Ethernet adapters;
- Rack mounts;
- Power supplies;
- Media backplanes;
- Rails;
- Drawers; and
- Rack panels.

Hardware-related items

- Server rentals.

2. The invoices documenting the sale of software and software-related products are set out in this table:

Invoice date	Invoice number(s)	Item description	Tax paid (all amounts in dollars)	Other references in this decision
9/1/08	6211943 and 6211924 ¹	Software licenses ²	13,066.15	See “Missing Invoices 6211943 and 6211924” under “Evidentiary Issues” below.
9/1/08	6212593 ³	Software licenses ⁴	7,986.56	
9/29/08	6228513	Software licenses and maintenance ⁵	23,420.64	See “Did IBM Fail to Prove that MasterCard Received the Software Electronically?”

¹ See “Invoices 6211943 and 6211924” below.

² Testimony of Vernon Hoffman, Tr. 94.

³ So noted on chart attached to IBM’s refund claim (Director’s Exhibit A) and IBM’s summary spreadsheet (Joint Exhibit 2). The actual invoice, on page 15 of Joint Exhibit 1, shows invoice number KCM0908, but the dollar amounts and the description of the items sold match those in the other documents.

⁴ Tr. 95.

⁵ *Id.*

				in our conclusions of fact below.
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3. The invoices documenting the sale of hardware are set out in this table:

Date	Invoice number	Item description	Tax paid (all amounts in dollars)
9/24/08	EF20030	IBM power 5 processor	562.23
9/18/08	EGL0178	Tape and data cartridges	214.88
9/9/08	EHI0143	Tape and data cartridges	107.44
9/29/08	EI90036	Tape and data cartridges	795.99
9/1/08	Q57608L	Rental of mainframe computer	12,512.07
9/1/08	Q57618L	Rental of mainframe computer	295.11
9/1/08	Q57628L	Rental of mainframe computer	3,277.64
9/1/08	Q57648L	Rental of mainframe computer	102.72
9/1/08	Q57658L	Rental of mainframe computer	2,355.17
9/1/08	Q57678L	Rental of mainframe computer	6,167.71
9/1/08	Q679880	Rental of mainframe computer	6,713.25

4. The invoices documenting the sales or rentals of hardware and software on a single invoice are set out in this table:

Date	Invoice number	Item description	Tax paid (all amounts in dollars)
9/2/08	EGV0028	IBM Power P595 system	78,849.71 hardware,

		with software	7,587.13 software
9/2/08	PM01701	IBM computer system with software	10,278.22 total (no split between hardware and software)
9/8/08	PM02801 ⁶	IBM computer system with software	2,213.66 total (no split between hardware and software)
9/17/08	PM03201	IBM computer system with software	8,047.39 total (no split between hardware and software)
9/29/08	PM09601	IBM P570 computer system with software	15,676.14 hardware, 2,077.60 software

5. At all relevant times, MasterCard used these items in the following activities: ACS (authorization, clearing, and settlement), Stand-In, InControl, Fraud Scoring, and various warehouse products.

6. All software sold by IBM to MasterCard was electronically downloaded.⁷

ACS Services

7. The ACS services are referred to as MasterCard’s core products. They enable the processing of purchases using MasterCard-issued credit and debit cards.

8. In “authorization,” when a customer presents a credit or debit card to a merchant to make a purchase, the merchant sends information concerning the transaction to the merchant’s bank, which is called an “acquiring bank” because it acquires the debt incurred by the customer to the merchant.

⁶ So noted on IBM’s chart attached to IBM’s refund claim (Director’s Exhibit A) and IBM’s summary spreadsheet (Joint Exhibit 2). The actual invoice, on pages 22-25 of Joint Exhibit 1, shows invoice number PM0280A, but the dollar amounts and the description of the items sold match those in the other documents.

⁷ Testimony of Prashant Kondapaneni and Vernon Hoffman, Tr. 86, 100-01.

9. The acquiring bank sends that information to MasterCard, which sends it to the bank that issued the credit or debit card to the customer (called an “issuing bank” because it issued the card to the customer).

10. The issuing bank decides whether to accept or decline the transaction. For a credit card, the issuing bank is loaning the customer the money for the transaction, while for a debit card, the money is withdrawn from an account maintained by the customer with the issuing bank.

11. The issuing bank sends its decision to MasterCard.

12. MasterCard forwards the issuing bank’s decision to the acquiring bank, which forwards it to the merchant.

13. In “clearing,” merchants send periodic data concerning their transactions to their acquiring banks, which communicate the data to MasterCard.

14. MasterCard aggregates the data received from acquiring banks and calculates the sums due from each issuing bank to each acquiring bank. The net amount of funds owed by or to a particular bank is called a “settlement position.”

15. In “settlement,” MasterCard communicates the settlement positions it calculated to each bank. Banks owing money remit the amount owed to MasterCard’s settlement bank, which remits the money owed to each bank that is owed money, after deducting its fee.

*MasterCard’s Ancillary Services— Stand-In, InControl, Fraud Scoring,
and Warehouse Data Services*

16. MasterCard’s Stand-In service allows MasterCard to authorize transactions when the issuing bank cannot complete the authorization, for example, if the issuing bank’s computers are down for maintenance. The issuing bank provides MasterCard a set of parameters to determine whether a transaction should be authorized or declined, using the issuing bank’s parameters. If MasterCard approves a transaction through the Stand-In process, the issuer cannot decline the

transaction once MasterCard has made the decision. MasterCard charges fees for Stand-In services.

17. MasterCard's InControl service allows cardholders to set control spending limits on specific credit cards or credit card accounts. The cardholder sets the parameters through their bank, and the bank can initiate protocols like receiving a text message as to card activities or even shutting down credit card activity if the transaction does not meet the cardholder's criteria. The restrictions are sent from the issuer to MasterCard.

18. MasterCard's Fraud Scoring service uses other companies' models to predict whether a transaction may be fraudulent. The models are designed to recognize whether a transaction may be fraudulent by using multiple transactions so the model learns what constitutes a fraudulent transaction. Using the models and consumer transaction data, MasterCard computes a fraud score. Fraud Scoring assigns a score to each transaction authorization message sent to the issuing bank. The more transactions the model reviews, the more accurate the fraud scoring. Issuing banks integrate the fraud score when deciding whether to accept or decline the transaction. MasterCard requires issuing institutions to participate in Fraud Scoring.

19. MasterCard aggregates data concerning the transactions in a prior period (at least three years) it handles in what it calls a "warehouse." It aggregates that data into information of interest to banks, investors, and other customers. An example of a warehouse product is "Spending Pulse," which identifies spending patterns of customers, then uses those patterns to make predictions on the economy.

Conclusions of Law

This Commission has jurisdiction over appeals from the Director's final decisions.⁸ Our duty in a tax case is not merely to review the Director's decision, but to find the facts and to determine, by the application of existing law to those facts, the taxpayer's lawful tax liability for the period or transaction at issue.⁹ We may do whatever the law permits the Director to do, and we are bound to do what he must do.¹⁰

IBM seeks an exemption from use tax under § 144.054.2, which provides in relevant part:

In addition to all other exemptions granted under this chapter, there is hereby specifically exempted from the provisions of sections 144.010 to 144.525 and 144.600 to 144.761, and from the computation of the tax levied, assessed, or payable under sections 144.010 to 144.525 and 144.600 to 144.761, electrical energy and gas, whether natural, artificial, or propane, water, coal, and energy sources, chemicals, machinery, equipment, and materials used or consumed in the manufacturing, processing, compounding, mining, or producing of any product.

(Emphasis added.)

Evidentiary Matters

How We Determined What IBM Sold to MasterCard

The parties argued the facts as based on the assumption that IBM sells two types of items to MasterCard—computer hardware and computer software. However, the evidence presented at the hearing, and the documentation submitted by the parties, revealed more categories of items sold than the parties' arguments recognized. In particular, the record shows that in addition to software, IBM sold MasterCard software licenses and software maintenance agreements. This is potentially important because while Missouri case law regarding the taxability of software does not consider the other categories of items, 12 CSR 10-109.050 sets out taxability criteria for those items. We discuss those criteria below under "Taxation of Software-Related Products."

⁸ Section 621.050.1, RSMo 2000. Statutory references are to RSMo Cum. Supp. 2007 unless otherwise noted.

⁹ *J.C. Nichols Co. v. Director of Revenue*, 796 S.W.2d 16, 20-21 (Mo. banc 1990).

¹⁰ *State Bd. of Regis'n for the Healing Arts v. Finch*, 514 S.W.2d 608, 614 (Mo. App., W.D. 1974).

We used four sources to determine the nature of the items IBM sold: the testimony of MasterCard employees Prashant Kondapaneni and Vernon Hoffman, copies of invoices submitted as a joint exhibit,¹¹ a chart attached to IBM's refund claim it filed with the Director,¹² and a spreadsheet prepared by one of IBM's law firms summarizing what was sold.

These sources were sometimes inconsistent or incomplete in describing the items sold. When that happened, we relied on Kondapaneni's and Hoffman's testimony, the contents of the invoices, the chart attached to the claim, and the spreadsheet, in that order.

Missing Invoices 6211943 and 6211924

The Director argued that IBM failed to prove that it collected and remitted use tax on electronically downloaded software it sold to MasterCard. In support of that argument, it referred to the contents of two invoices, 6211943 and 6228513. Those invoices, she argued, contained notations that certain software-related items therein were "electronically delivered." We discuss the Director's argument further below under "Did IBM Fail to Prove that MasterCard Received the Software Electronically?"

Instead of submitting paper copies of exhibits submitted as joint exhibits, the parties submitted most of their exhibits in electronic form. Joint exhibit 1 consists of copies of invoices for the items IBM sold to MasterCard. However, invoices 6211943 and 6211924 were missing from that exhibit as submitted. At the hearing, the parties elicited testimony regarding both invoices. When IBM's witness Vernon Hoffman, a MasterCard employee, testified regarding invoice 6211924, he was referring to a spreadsheet summarizing the contents of the invoices.¹³ However, when another IBM witness, Prashant Kondapaneni, testified as to the contents of 6211943, we believe that he was looking at a copy of that invoice—a document not introduced

¹¹ Joint Exhibit 1.

¹² Director's Exhibit A.

¹³ Tr. 94.

into evidence. While counsel did not indicate in his question what exhibit the witness was looking at and testifying about, counsel's prefatory statement "And you'll see that there's another indication of software being electronically delivered"¹⁴ necessarily refers to the notation "electronically delivered" on the invoice itself.

Manufacturing Exemption of § 144.054.2

Cases applying § 144.054.2, as well as another, similar statute – § 144.030.2(5) – focus on one or more of these elements:

- Do the items bought or rented by the taxpayer qualify as *equipment*?
- Was the equipment used in *manufacturing*? and
- Was the equipment used in the manufacturing of a *product*?
-

Statutory Purpose and Construction

The Supreme Court has made no statement regarding the purpose of § 144.054.2. However, it has, in prior cases, made such a statement regarding a similar statute – § 144.030.2(5) and (6). That statute, the Supreme Court held, was intended "to encourage the production of items ultimately subject to sales tax and to encourage the location and expansion of industry in Missouri."¹⁵ *Southwestern Bell Tel. Co. v. Director of Revenue*, however, was the last Supreme Court opinion to make such a statement.

The Court's recent sales and use tax exemption cases make it clear that such exemptions are to be construed strictly, and the taxpayer claiming the exemption bears the burden of showing

¹⁴ Tr. 108.

¹⁵ *Concord Publ'g House v. Director of Revenue*, 916 S.W.2d 186, 190 (Mo. banc 1996), cited in *Southwestern Bell Tel. Co. v. Director of Revenue*, 182 S.W.3d 226, 230 (Mo. banc 2005) (referred to in this decision as "*Southwestern Bell II*"); *Lincoln Indus., Inc. v. Director of Revenue*, 51 S.W.3d 462, 465 (Mo. banc 2001); *Zip Mail Servs., Inc. v. Director of Revenue*, 16 S.W.3d 588, 590 (Mo. banc 2000).

that it falls within the statutory language.¹⁶ An exemption will be allowed only on clear and unequivocal proof.¹⁷ Any doubt is resolved in favor of taxation.¹⁸

The Court did not always implement this construction. As Chief Justice Price noted in his dissent in *Brinker Missouri, Inc. v. Director of Revenue*: “This Court repeatedly has allowed a broad interpretation of what output is sufficient to be considered manufacturing.”¹⁹ We look at the tension between these interpretive approaches below under “The Supreme Court’s Three Definitions of ‘Manufacturing.’”

Equipment

IBM’s complaint divides the items it sold to MasterCard into “computers and related equipment” and “software.” Then at the hearing and in its post-hearing briefing, it changed the categories to “hardware” and “software” and, more importantly, argued that everything it sold was “equipment” for purposes of § 144.054.2.²⁰

In *Walsworth Publ’g Co. v. Director of Revenue*,²¹ *Lincoln Indus. Co.*,²² and *AAA Laundry & Linen Supply Co. v. Director of Revenue*,²³ the Supreme Court analyzed whether items bought were “equipment” for purposes of §§ 144.030.2(5) or 144.054.2. In *Walsworth Publishing*, the taxpayer claimed that phototypesetting paper used in its commercial printing process was “equipment” for purposes of § 144.030.2(5), but the Supreme Court held it was not equipment.²⁴ The Court referred to a prior edition of *Webster’s Third New International*

¹⁶ *Alberici Constructors, Inc. v. Director of Revenue*, 452 S.W.3d 632, 636 (Mo. banc 2015); *Aquila Foreign Qualifications Corp. v. Director of Revenue*, 362 S.W.3d 1, 3 (Mo. banc 2012).

¹⁷ *Branson Properties USA v. Director of Revenue*, 110 S.W.3d 824, 826 (Mo. banc 2003).

¹⁸ *Id.*

¹⁹ 319 S.W.3d 433, 442 (Mo. banc 2010) (internal citations and parenthetical comments omitted).

²⁰ IBM argued in the alternative that only the hardware qualified as equipment, and that the software was not subject to use tax because it was electronically downloaded. We consider this argument below under “Taxability of Software and Related Items.”

²¹ 935 S.W.2d 39 (Mo. banc 1996).

²² 51 S.W.3d 462 (Mo. banc 2001).

²³ 425 S.W.3d 126 (Mo. banc 2014).

²⁴ 935 S.W.2d 39 (Mo. banc 1996).

Dictionary, which defined “equipment” as “all the fixed assets other than land and buildings of a business enterprise. [Illustration:] <the plant, equipment, and supplies of the factory>.”²⁵

In *Lincoln Industrial*, the taxpayer argued that replacement parts it bought for a machine were exempt “equipment.” The Court disagreed, noting *Walsworth*’s definition of “equipment” as “fixed assets.”²⁶ The Court, however, based its holding on the fact that the taxpayer had not capitalized the parts as equipment on its books by depreciating them over a number of years.²⁷

In *AAA Laundry*, the taxpayer claimed that water treatment chemicals used in the taxpayer’s commercial laundering process were “equipment” for purposes of § 144.030.2(15).²⁸ Citing *Walsworth* and *Webster’s Third New Int’l Dictionary*, the Court disagreed, noting their requirement that “equipment” means “all the fixed assets other than land and buildings of a business enterprise,” and under that definition, “‘equipment’ must have a degree of permanence to the business.”²⁹

IBM does not take these authorities into account. If it had, it would have had to deal with the issue of how things like computer memory, cables, and tape and data cartridges could be said to be “fixed assets” under the Supreme Court’s analyses set out above.³⁰

It was spared such a challenge, however, because not only did the Director not argue against IBM’s characterization of power cords and computer memory as “equipment,” she admitted the portion of paragraph 8 of the complaint where IBM characterized its hardware sales as “a wide variety of computers *and related equipment*.”³¹ (Emphasis added.) When a party

²⁵ *Id.*, citing *Webster’s Third New Int’l Dictionary* 768 (1976). The current edition of that dictionary (unabr. 1986) adds this definition to that one: “the implements (as machinery or tools) used in an operation or activity : APPARATUS.” Page 768.

²⁶ 51 S.W.3d 462 (Mo. banc 2001).

²⁷ *Id.* at 466.

²⁸ 425 S.W.3d 126, 131 (Mo. banc 2014).

²⁹ *Id.* at 132.

³⁰ “Fixed asset” is defined as “a long-term asset used in the operation of a business or used to produce goods or services, such as equipment, land, or an industrial plant.” *Black’s Law Dictionary* 134 (9th ed.).

³¹ The paragraph reads in its entirety: “Petitioner sold MasterCard a wide variety of computers and related equipment, as well as a variety of software applications, that MasterCard used in performing these authorization, clearing, and settlement activities.” The Director admitted the portion of the paragraph ending with “related equipment,” and denied the remainder.

admits, in its answer, that allegations in a petition are true, the party makes a judicial admission as to that issue.³² A judicial admission “waives or dispenses with the production of evidence and concedes for the purpose of the litigation that a certain proposition is true.”³³ Applying the Director’s admission, we accept that the hardware IBM sold to MasterCard qualifies as “equipment” for purposes of § 144.054.2.

However, we cannot accept IBM’s argument that the software, software licenses, software maintenance agreements, and software support agreements it sold were also “equipment” for purposes of the exemption it seeks. We must give a common sense and practical interpretation for terms used in the sales and use tax exemption statutes.³⁴ Common sense dictates that software, software licenses, and software service agreements are not “equipment” under the Supreme Court’s application and definition of the term in *Walsworth Publishing, Lincoln Industrial*, and *AAA Laundry*. Accordingly, we conclude that those items are not “equipment” for purposes of § 144.054.2. We consider whether they are subject to use tax under “Taxability of Software and Related Items” below.

In summary, therefore, we conclude that the hardware IBM sold or rented to MasterCard was “equipment.”

Manufacturing

The Supreme Court’s Three Definitions of “Manufacturing”

Since 1970, the Supreme Court has applied three definitions of “manufacturing” as the term is used in §§ 144.030.2 and 144.054.2:

- “Organizing information through computer technology is manufacturing;”
-
-

³² *Stroup v. Leopard*, 981 S.W.2d 600, 604 (Mo. App. W.D. 1998).

³³ *Id.*, quoting *Hewitt v. Masters*, 406 S.W.2d 60, 64 (Mo. 1966).

³⁴ *State ex rel. Dravo Corp. v. Spradling*, 515 S.W.2d 512, 516 (Mo. 1974).

- “Manufacturing consists of the alteration or physical change of an object or material in such a way that produces an article with a use, identity, and value different from the use, identity, and value of the original;” and
- Only activities that can be described as “large-scale industrial activities” or “have an industrial connotation” can be considered as “manufacturing.”³⁵

IBM invokes the first definition and ignores the second, the Director invokes the second definition and ignores the first, and both ignore the third (and most recent) criterion. The Supreme Court has not rejected, abrogated, or otherwise limited any of these definitions; therefore, we must decide which one to apply in this case. If they can be harmonized (particularly the third definition with either of the first two), we will do so.³⁶

“Organizing/Computer” Definition of Manufacturing

The “organizing/computer” definition was first expressly stated in *Concord Publ’g Co. v. Director of Revenue*, where the Court cited *Bridge Data Co. v. Director of Revenue* as “establish[ing] that organizing information through computer technology is ‘manufacturing.’”³⁷ The Court reiterated the definition in *International Bus. Machs. v. Director of Revenue*, citing it as the only authority required for a finding that “manufacturing” occurred when a taxpayer used computers to receive and transmit data, perform calculations, and generate reports.³⁸

The Court then applied this definition in *DST Sys., Inc. v. Director of Revenue*,³⁹ and in two cases styled *Southwestern Bell Tel. Co. v. Director of Revenue* (“Southwestern Bell I”⁴⁰

³⁵ We refer to the first definition as the “use/identity/value/transformation” definition, adding “transformation” because, in many of the cases applying this definition, the Supreme Court asked whether a transformation occurred in the alleged manufacturing process, something we analyze below. We refer to the second definition as the “organizing/computer” definition, and refer to the third criterion as “industrial connotation.”

³⁶ See *South Metro. Fire Prot. Dist. v. City of Lee’s Summit*, 278 S.W.3d 659, 666 (Mo. banc 2009) (where two statutory provisions covering the same subject matter are unambiguous standing separately but are in conflict when examined together, we must first attempt to harmonize them and give them both effect).

³⁷ 916 S.W.2d 186, 191 (Mo. banc 1996), citing *Bridge Data*, 794 S.W.2d 204, 206 (Mo. banc 1990).

³⁸ 958 S.W.2d 554, 556 (Mo. banc 1997). We refer to this opinion as “*IBM II*,” because we also cite a prior opinion captioned *International Bus. Machs. v. Director of Revenue*, at 765 S.W. 2d 611 (Mo. banc 1989), that we refer to as “*IBM I*.”

³⁹ 43 S.W.3d 799 (Mo. banc 2001).

⁴⁰ 78 S.W.3d 763, 766 (Mo. banc 2002).

and “Southwestern Bell II”⁴¹). While IBM argues that “The Missouri Supreme Court has held for over 20 years that organizing data through computer technology qualifies as ‘manufacturing,’”⁴² the Court has not applied the definition since *Southwestern Bell II* in 2005.

“Use/Identity/Value/Transformation” Definition of Manufacturing

The predecessor to the “use/identity/value/transformation” definition was first stated by the Supreme Court in *West Lake Quarry & Mat’l Co. v. Schaffner*.⁴³ Then in *Heidelberg Central, Inc. v. Director of Revenue*,⁴⁴ the Supreme Court stated another version of the definition.⁴⁵ The Court merged those definitions in *Galamet, Inc. v. Director of Revenue*,⁴⁶ where it created the definition, “[m]anufacturing consists of the alteration or physical change of an object or material in such a way that produces an article with a use, identity, and value different from the use, identity, and value of the original.”

The Court has sometimes also required a showing that a “transformation” occurred in the process in question for it to qualify as “manufacturing,” “producing,” or “processing” under § 144.030.2(5) or (6). The term “transformation” was first used in *AMF Inc. v. Spradling*.⁴⁷ This culminated in *Branson Props. USA, L.P. v. Director of Revenue*,⁴⁸ where the Court divided exemption cases into whether or not a transformation had occurred in order to determine whether the taxpayer qualified for an exemption.

Since *Branson Properties* in 2003, however, the Court has not applied this definition of “manufacturing.” To the contrary, when it reviewed our decision in *Fred Weber, Inc. v.*

⁴¹ 182 S.W.3d 226, 231 n.6 (Mo. banc 2005).

⁴² IBM’s post-hearing memorandum of law p. 9.

⁴³ “[W]hat constitutes manufacturing is... that if a process takes something practically unsuitable for any common use and changes it so as to adapt it to such common use, then such a process may be legally considered as manufacturing within the meaning of the tax exemption statutes.” 451 S.W.2d 140, 143 (Mo. 1970).

⁴⁴ 476 S.W.2d 502 (Mo. 1972).

⁴⁵ “[Manufacturing occurs when items are produced] for sale which have an intrinsic and merchantable value, and were in forms suitable for new uses.” 476 S.W.2d 502, 506 (Mo. 1972).

⁴⁶ 915 S.W.2d 331 (Mo. banc 1996).

⁴⁷ 518 S.W.2d 58 (Mo. 1974).

⁴⁸ 110 S.W.3d 824, 826 (Mo. banc 2003).

Director of Revenue, the Court reversed our decision that the taxpayer was entitled to a manufacturing exemption under § 144.054.2. We had based that decision on an application of the “use/identity/value/transformation” definition of “manufacturing.”⁴⁹ Instead, the Court applied the “industrial connotation” criterion we discuss below.⁵⁰

The Director has, in a way, adopted this criterion as the definition of manufacturing. We say “in a way” because she defines a “product” as “an output with a market value that has a use, identity, and value different from the use, identity and value of the original.”⁵¹

The “Industrial Connotation” Criterion

Nonetheless, we must take notice of what the Court did in *Fred Weber*— acknowledge that we applied a long-standing definition of “manufacturing,” then reject it in favor of an altogether different criterion. While the Court in *Brinker Missouri* did not use the term “industrial” as directly applicable to manufacturing, it clearly announced a new criterion, which it set out under the heading “Restaurants Prepare Rather than Manufacture Meals.”⁵² The Court rejected Brinker’s argument that it was entitled to an exemption under § 144.030.2, noting that “[i]n lay terminology, one does not speak of a restaurant as manufacturing or producing food or drink; instead, restaurants prepare, cook and serve food and drink to their customers.”⁵³

In *Aquila Foreign Qualifications Corp. v. Director of Revenue*, the Court states the “industrial” aspect of this criterion for the first time, saying:

The industrial connotations of [“processing” along with “manufacturing,” “compounding,” “mining,” and “producing”] in section 144.054.2 indicate that the legislature did not intend “processing” to include food preparation for retail consumption.[⁵⁴]

⁴⁹ 452 S.W.3d 628, 630-31 (Mo. banc 2015).

⁵⁰ *Id.*

⁵¹ Director’s brief p. 14.

⁵² 319 S.W.3d at 436.

⁵³ *Id.* at 438.

⁵⁴ 362 S.W.3d 1, 5 (Mo. banc 2012).

In the Court’s most recent decisions in cases where taxpayers sought exemptions for sales of bakery goods,⁵⁵ steel beams and other components used in building construction,⁵⁶ and rock base and asphalt used in road and parking lot paving,⁵⁷ it denied all relief to the taxpayers in each case, holding that baking, building construction, and paving were not “industrial activities.”

The common thread of these cases is that they require the activity in which the taxpayer engages to have an “industrial connotation,” by that measure, preparing restaurant meals, baking pizzas or bakery goods, laundering clothes, constructing buildings, or paving roads or parking lots are not “manufacturing” because those activities lack an “industrial connotation.”

*Missouri’s Definition and Application of the **Stare Decisis** Doctrine*

IBM argues that we must follow the “organizing/computer” definition of “manufacturing.” This argument invokes the doctrine of *stare decisis*. Under Missouri law:

The doctrine of *stare decisis* directs that, once a court has laid down a principle of law applicable to a certain state of facts, it must adhere to that principle and apply it to all future cases, where facts are substantially the same, regardless of whether the parties and property are the same. Under the doctrine, a court follows earlier judicial decisions when the same point arises again in litigation and where the same or analogous issue was decided in an earlier case, such case stands as authoritative precedent unless and until it is overruled.^[58]

Stare decisis imposes a duty on lower courts to follow decisions of the Supreme Court *en banc*.⁵⁹

The Supreme Court has applied *stare decisis* in sales and use tax exemption cases. In *AAA Laundry*, the Supreme Court noted that it “does not write on a blank slate in each and every tax case, and *stare decisis* plays as great a role in such cases as it does in every other area of the Court’s jurisprudence.”⁶⁰ It also applied *stare decisis* in *Union Elec. Co.* where it noted

⁵⁵ *Union Elec. Co. v. Director of Revenue*, 425 S.W.3d 118, 124 (Mo. banc 2014).

⁵⁶ *Ben Hur Steel Worx, LLC v. Director of Revenue*, 452 S.W.3d 624, 627 (Mo. banc 2015).

⁵⁷ *Fred Weber Co.*, 452 S.W.3d at 631.

⁵⁸ *Hinkle v. A.B. Dick Co.*, 435 S.W.3d 685, 688 (Mo. App. W.D. 2014) (internal citations omitted).

⁵⁹ *Chavez v. Cedar Fair, LP*, 450 S.W.3d 291, 298 (Mo. banc 2014).

⁶⁰ 425 S.W.3d 126, 128 (Mo. banc 2014).

that “[o]n similar facts in *Aquila*, this Court rejected the argument that cooked items sold by Casey’s stores fall within the processing exemption. The Court here reaffirms *Aquila*’s holding that “processing,” as used in section 144.054.2, does not include in-store preparation of cooked goods for retail sale.”⁶¹

*Stare Decisis Criteria at Issue in this Case—
“Most Recent Pronouncement” and “Substantially Similar Facts”*

In resolving a conflict between prior *en banc* Supreme Court decisions, we are bound by the Court’s most recent pronouncement.⁶² In this case, as we set out below, the conflict arises because, under the “organizing/computer” definition, MasterCard engaged in manufacturing; under the “industrial connotation” criterion, it has not; and under the “use/identity/value/transformation” definition, some of its activities constitute manufacturing while others do not. If this were the only criterion, “industrial connotation,” as the last such criterion, would bind us.

As we state above, however, *stare decisis* applies when a higher court has laid down a principle of law applicable to a certain state of facts. The threshold question, therefore, is whether the facts in this case are substantially similar to those in *Bridge Data, Concord Publishing, IBM II, DST Systems*, and the two *Southwestern Bell* cases— and secondarily, whether the facts are not substantially similar to those affiliated with the other two definitions.

*Did MasterCard Engage in
“Organizing Information through Computer Technology?”*

While the Supreme Court stated in *Concord Publishing, IBM II, DST Systems*, and in the *Southwestern Bell* cases, that “organizing information through computer technology is manufacturing,” it did not, in any of those cases, do a particularized analysis of what activities constituted organizing information through computer technology such as, for instance, stating

⁶¹ *Union Elec. Co.*, 425 S.W.3d at 120 (internal citations omitted).

⁶² *State v. Williams*, 9 S.W.3d 3, 12 (Mo. App. W.D. 1999).

and applying a definition of “organizing.” To answer this question, then, we must look at what activities the Court found to constitute organizing in those cases. In *Bridge Data*, the activity was “collecting financial data and transmitting [that] data to customers.”⁶³ In *Concord Publishing*, the activity was creating a newspaper from text and pictures,⁶⁴ although the Court also noted that the case was “indistinguishable from *Bridge Data*. The computer layout system here is also used to process data and convey information to customers.”⁶⁵

IBM II and *DST Systems* share a common set of facts. There, DST conveyed information to customers, executed financial transactions, and converted information into reports and statements, including creating customized packages of print materials for those customers.⁶⁶ In the *Southwestern Bell* cases, Southwestern Bell transmitted voices over appreciable distances⁶⁷ and provided “vertical services” such as call waiting, call forwarding, and “billing services” that included billing analyses for customers.⁶⁸ The “manufacturing” also occurred in the conversion of the human voices into electronic impulses so that it can be transmitted and heard over distances.⁶⁹

The conclusion we reach from a study of these cases is that they encompass a fairly wide variety of computer-related activities, some of which were performed by MasterCard in this case. In all the cases except *Concord Publishing*, the taxpayers used computers as tools to convey information, just as MasterCard did in its authorization, clearing, Stand-In, and InControl services. In *IBM II* and *DST Systems*, the taxpayer used computers as computational and analytical tools, just as MasterCard did in its clearing, Fraud Scoring, and data warehousing

⁶³ 794 S.W.2d at 206.

⁶⁴ 916 S.W.2d at 188-89.

⁶⁵ *Id.* at 191.

⁶⁶ *International Bus. Machs.*, 958 S.W.2d at 558-59; *DST Sys.*, 43 S.W.3d at 801.

⁶⁷ *Southwestern Bell I*, 78 S.W.3d at 768.

⁶⁸ *Southwestern Bell II*, 182 S.W.3d at 235 n.16.

⁶⁹ *Southwestern Bell I*, 78 S.W.3d at 768.

services. Accordingly, we conclude that if we apply the “organizing/computer” definition, MasterCard engaged in “manufacturing.”

Did MasterCard Engage in Activities with an Industrial Connotation?

While neither party addressed this question, we think the answer is clear— MasterCard’s computer-related activities have no industrial connotation. The cases applying this criterion (*Brinker Missouri, Aquila, AAA Laundry, Union Electric, Ben Hur, and Fred Weber*) have one unifying characteristic— none of their activities have anything like an industrial connotation. Accordingly, if we apply the “industrial connotation” criterion, MasterCard was not engaged in manufacturing.

Did MasterCard Alter or Physically Change Objects or Materials to Produce Articles with New Uses, Identities, or Values (or, did it Transform Objects or Materials)?

The Director argues that MasterCard did not meet the requirements of this definition because most of its computer-related activities involved the mere transmission of information; in those instances, it argues, the output does not have a use, identity, or value different from the input. For clearing (where MasterCard takes data from the day’s transactions and computes how much is owed to or from each customer bank), the Director argues that MasterCard does nothing more than addition and subtraction, which is true so far as it goes, but the process requires thousands of such calculations each day.

IBM indirectly addresses this definition through its various assertions that MasterCard’s computers “manipulate,” “analyze,” and “validate” data as it passes through them. However, except for the clearing and data warehouse functions, it fails to demonstrate that what went into each process came out of it with a different use, value, or identity, or was transformed in any way.

Accordingly, were we to apply this definition, we would conclude that only the clearing and data warehouse functions possibly met the requirements of the definition.⁷⁰

Can any of the Three Definitions be Reconciled or Harmonized?

In two cases, the Court held that the “organizing/computer” and “use/identity/value/transformation” definitions were both satisfied. In *Concord Publishing*, not only did the Court hold that “organizing information through computer technology is manufacturing,” it also held that the conversion of text and pictures into a newspaper constituted a transformation.⁷¹ In *Southwestern Bell I*, the Court held that the taxpayer’s transmission of voices over appreciable distances involved a transformation (although the Court did not use that term); what came out was not the human voice that went in, but “a complete reproduction of it, with new value to a listener who could not otherwise hear or understand it.”⁷² This occurred when the voice was “‘manufactured’ into electronic impulses that can be transmitted and reproduced into an understandable replica.”⁷³

However, in neither case did the Court find that such a change or transformation was required to qualify for the manufacturing exemption. Instead, we read these analyses as setting out additional authority for the Court’s holding. The fact that these two definitions of “manufacturing” exist independently of each other is illustrated by the Court’s opinions in *IBM II* and *DST Systems*, where its holding was based exclusively on the principle that “organizing information through computer technology is manufacturing.”

In *Fred Weber*, the Court declined an opportunity to reconcile the “use/identity/value/transformation” definition with the “industrial connotation” criterion.

⁷⁰ Also, if we were to apply this definition as the rule of decision in this case, we would have the additional problem of whether IBM was entitled to the exemption if only one of the three parts of MasterCard’s core ACS service, and one of the four ancillary services, met the definitional requirements. Neither party addressed this issue, and we find no authority that we could apply.

⁷¹ *Concord Publ’g House*, 916 S.W.2d at 191.

⁷² *Southwestern Bell I*, 78 S.W.3d at 768.

⁷³ *Id.*

Instead, it simply examined the process: determining that rock base and asphalt were materials, defining “processing,” “manufacturing,” “compounding,” and “producing” using definitions obtained from statute, case law, and the dictionary, concluding that the paving companies’ activities met all the definitions, and concluding that the paved road was a product.⁷⁴ Based on that examination, the Court concluded that the General Assembly intended that the plain and ordinary language of § 144.054.2 applied only to “industrial-type activities.”⁷⁵ Thus, the Court held, all of those terms— even the statutory definition of “processing”⁷⁶— had to be viewed from an “industrial connotation” perspective.

Accordingly, given the line of Supreme Court cases from *Brinker Missouri* to *Fred Weber*, we must conclude that the only way either of the earlier two definitions can be harmonized with the “industrial connotation” criterion is to interpret them as being subordinate to the latter criterion. However, in the “organizing/computer” line of cases from *Bridge Data* to *Southwestern Bell II*, the Supreme Court has laid down a principle law *applicable to the facts of this case*. That is the principle that *stare decisis* requires us to follow.

Product

A “product” is “an output with a market value.”⁷⁷ A product can be either tangible personal property or a service.⁷⁸ To prove that a particular good or service constitutes a “product,” the taxpayer does not have to actually market the product, but “it is incumbent on the taxpayer to prove the existence of a market, whether or not the product is actually marketed by

⁷⁴ 452 S.W.3d at 630-31.

⁷⁵ *Id.* at 631.

⁷⁶ “Processing” is defined in § 144.054.1 as “any mode of treatment, act, or series of acts performed upon materials to transform or reduce them to a different state or thing, including treatment necessary to maintain or preserve such processing by the producer at the production facility.”

⁷⁷ *Fenix Constr. Co. v Director of Revenue*, 449 S.W.3d 778, 780 (Mo. banc 2014); *E & B Granite, Inc v. Director of Revenue*, 331 S.W.3d 314, 316 (Mo. banc 2011).

⁷⁸ *E & B Granite*, 331 S.W.3d at 316, citing *International Bus. Mach. Corp. v. Director of Revenue*, 958 S.W.2d 554, 557 (Mo. banc 1998).

the taxpayer.”⁷⁹ A “market” is “a sphere within which price-making forces operate and in which exchanges in title tend to be followed by actual movement of goods.”⁸⁰ In *Fenix Constr. Co.*, the tilt-up walls were not “products” because they did not, themselves, have any market value.⁸¹ All of MasterCard’s services – ACS, Stand-In, InControl, Fraud scoring, warehouse services – are “products” by the Court’s analysis of the term.

IBM adopts the “output with a market value” definition. As we state above under “Manufacturing,” the Director conflates that definition with the “use/value/identity/transformation” definition of “manufacturing” (a product is “an output with a market value that has a use, identity, and value different from the use, identity and value of the original”). Accordingly, we consider the parties to agree on the definition of “product.”

We also agree with IBM’s assertion that the items MasterCard sells to customer banks and others— ACS, Stand-In, InControl, Fraud scoring, and warehouse services— are “products” under this definition.

Conclusion Regarding Exemptions under § 144.054.2

Because IBM sold or leased equipment to MasterCard that MasterCard used in manufacturing a product, IBM is entitled to a refund of the use tax it remitted on the sale or lease of that equipment.

Taxation of Software— § 144.610.1, Case Law, and 12 CSR 10-109.050

As we state above, the parties frame this case on the theory that two types of items were sold – hardware and software. However, the evidence shows that IBM sold not only software, but two other types of items that, while related to software, were something entirely different— software licenses and software maintenance agreements.

⁷⁹ *Mid-America Dairymen, Inc. v. Director of Revenue*, 924 S.W.2d 280, 283(Mo. banc 1996).

⁸⁰ *Webster’s Third New International Dictionary* 1383 (1986).

⁸¹ 449 S.W.3d at 781.

IBM's Argument and the Director's Response

IBM argues that the software it sold to MasterCard is not subject to use tax because MasterCard downloaded it electronically and did not receive it in a tangible medium. The Director counters that software received in a tangible medium is subject to tax, per 12 CSR 10-109.050, that § 144.610.1 imposes use tax on the use of tangible personal property, and that IBM failed to prove that MasterCard received the software electronically. Her primary argument is IBM's failure to prove the software was electronically downloaded.

Section 144.610.1

Section 144.610.1 provides in relevant part:

A tax is imposed for the privilege of storing, using or consuming within this state any article of tangible personal property...purchased on or after the effective date of sections 144.600 to 144.745 in an amount equivalent to the percentage imposed on the sales price in the sales tax law in section 144.020.

“Tangible personal property” is defined as “all items subject to the Missouri sales tax as provided in subdivisions (1) and (3) of section 144.020.”⁸² Section 144.020.1(1) covers “tangible personal property, excluding motor vehicles, trailers, motorcycles, mopeds, motortricycles, boats and outboard motors required to be titled under the laws of the state of Missouri and subject to tax under [§ 144.020.1(9)].” Section 144.020.1(3) describes “electricity or electrical current, water and gas, natural or artificial, to domestic, commercial or industrial consumers.”

The parties mention § 144.610 in their arguments, but do not apply it. However, we see its underpinnings (that only tangible personal property is subject to use tax) in the *TRES* case cited below.

⁸² There is no subsection 3 to the statute, but there are paragraphs (1) and (3) to subsection 1.

Missouri Case Law on Taxability of Software

In *James v. TRES Computer Sys.*,⁸³ a use tax case, the Supreme Court reviewed this Commission's decision that TRES' sale of computer software, loaded onto tapes, was not the sale of tangible personal property. This is the only case applying § 144.610 to sales of software. The Court framed the question as whether the software could become tangible personal property so as to be taxable under § 144.610 because of its presence on the tapes.⁸⁴ The Court held that it could not. The Court determined that because the tapes were disposable and were simply a medium of transmittal, what was really being sold was the data (the "ultimate object" test).⁸⁵ Supporting this conclusion was its finding that the information could have been conveyed by other means, suggesting that the transaction was the sale of an intangible service.⁸⁶ The *TRES* opinion also noted that, "*Given that there is no dispute that the data and programs sold are intangible personal property, the question is whether, by their presence on the tapes, they could become tangible personal property so as to be taxable under § 144.610.*"⁸⁷

In *International Bus. Machs. Corp. v. Director of Revenue*,⁸⁸ a sales tax case, when IBM's customers for software for its mini-computers and mainframe computers wanted software for those computers, they would select a program from a list in IBM's directory, and IBM would send the customer the program by disk, diskette, tape reels, or punch cards. IBM sought a refund of sales tax it collected on those sales, citing *TRES* as authority. The Supreme Court held that IBM's programs bore "little similarity to the programs in *Tres*," and that the media in which the software was loaded for delivery was, in fact, the ultimate object of the transaction.⁸⁹ Finally, as

⁸³ 642 S.W.2d 347 (Mo. banc 1982). *TRES* was limited, but not overruled, by *International Bus. Machs., Inc. v. Director of Revenue*, 765 S.W.2d 611 (Mo. banc 1989) ("IBM I").

⁸⁴ 642 S.W.2d at 348.

⁸⁵ *Id.* at 349.

⁸⁶ *Id.* at 350.

⁸⁷ *Id.* at 348 (emphasis added).

⁸⁸ 765 S.W.2d 611 (Mo. banc 1989) ("*IBM I*").

⁸⁹ *Id.* at 613-14.

is appropriate here, the Court found that IBM had “failed to carry its burden of proof of establishing the software in question to be either ‘customized’ or a ‘service’ which would bring it within the holding of *TRES*.”⁹⁰

In addition to its analysis of whether the taxpayer was entitled to a manufacturing exemption, the Supreme Court in *Bridge Data* had to determine whether Bridge Data’s software sales were subject to use tax. In that case, Bridge Data delivered its software to its customers by telephone, magnetic tape, floppy disks, or punch cards. This Commission held that the software delivered by telephone or tape that the customer had to return to Bridge Data was not subject to tax, but the software delivered by media that the customer could keep was subject to tax.⁹¹ This Commission also found that the software delivered by media that the customer could keep was canned, not custom software.⁹² The Supreme Court affirmed this Commission’s decision that “[*IBM I*], not *TRES*, was the governing authority.”⁹³ As with *IBM I*, the Court did not cite any statutes in making its decision.

In summarizing the holdings of those cases, we see that in *TRES*, the court held that the software was nontaxable because the true object of the transaction was the software itself, not the medium of delivery; in *IBM I* and *Bridge Data*, the medium (i.e., floppy disks, tapes, or punch cards) was held to be the ultimate object of the sale, so the sale was taxable. In none of these cases, however, did the Court hold that software itself could ever be tangible personal property. Instead, they hold that software delivered to the customer in a tangible medium can be taxable if the true object of the transaction was not merely the software itself, but the medium of delivery.

⁹⁰ *Id.* at 614.

⁹¹ *Bridge Data*, 794 S.W.2d at 206.

⁹² *Id.*

⁹³ *Id.* at 207.

12 CSR 10-109.050

This regulation, titled “Taxation of Computer Software Programs,” is the most detailed Missouri law regarding taxation of software, in that it provides when not only software itself, but software licenses and maintenance agreements, may be taxed. We apply regulations to the extent they are not inconsistent with the statutes.⁹⁴ However, *Bridge Data* also cautions us that “[t]axes may be authorized only by statute, and the director may not add to, subtract from, or modify the revenue statutes by regulation.”⁹⁵

IBM cites 12 CSR 10-109.050(3)(A) as stating that software purchased off the shelf in “canned” form is tangible personal property, but software delivered electronically is not. At all relevant times,⁹⁶ that regulation provided:

Tax applies to the sale of canned programs delivered in a tangible medium which are transferred to and retained by the purchaser. Examples of canned programs delivered in a tangible medium would include coding sheets, cards, magnetic tape, CD-ROM or other tangible electronic distribution media on which or into which canned programs have been coded, punched or otherwise recorded.

The “off the shelf” language refers to paragraph (2)(A) of the regulation, which at all relevant times provided:

(A) Canned programs--Canned programs are standardized programs purchased “off the shelf” or are programs of general application developed for sale to and use by many different customers with little or no modifications. These may include programs developed for in-house use and subsequently held or offered for sale or lease. A program may be a canned program even if it requires some modification, adaptation or testing to meet the customer’s particular needs.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ 12 CSR 10-109.050 was revised in 2014. See 39 Mo. Reg. pp. 495-97 (Feb. 18, 2014) for the text of the amendment, which became effective July 30, 2014. We apply the pre-2014 version of the regulation.

However, IBM’s interpretation of the regulation mistakes the “off-the-shelf” phrase in the definition of “canned” software as if it described a box pulled from a physical shelf. In fact, “off-the-shelf” has a dictionary definition of “available as a stock item : not specially designed or custom-made <~ software>.”⁹⁷ This meaning is consistent with the second clause of the first sentence: “programs of general application developed for sale to and use by many different customers with little or no modifications.”

Furthermore, the regulation distinguishes “canned programs” from “customized programs,” defined in paragraph (2)(B) as follows:

Customized programs are programs developed to the special order of a customer. The real object sought by a purchaser of customized programs is the service of the seller and not the property produced by the service of the seller.

This distinction becomes important in light of paragraph (1), which provides:

In general, the sale of canned computer software programs is taxable as the sale of tangible personal property. The sale of customized software programs, where the true object or essence of the transaction is the provision of technical professional service, is treated as the sale of a nontaxable service.

Thus, the distinction between canned and customized software in the regulation is not in how it is delivered, but whether the software was a stock item or was custom-made. In this case, however, we have no evidence indicating whether the software IBM sold to MasterCard was “canned” or “customized” software under the above definitions.

Letter Ruling 7074

IBM cites the Director’s Letter Ruling 7074 as affirming the proposition that if software is delivered electronically and there is no transfer in any tangible medium, there is no sale of personal property and the transaction is not subject to sales or use tax. However, the Director rightly counters that under 12 CSR 10-1.020(7), such letter rulings apply only to the applicant

⁹⁷ *Merriam-Webster’s Collegiate Dictionary* 11th ed. 862 (2004).

who sought the ruling. Since IBM failed to show that it had sought the ruling, it has no force here.

Did IBM Fail to Prove that MasterCard
Received the Software Electronically?

As we point out under “Evidentiary Issues” above, the Director points out that some of the items on IBM’s invoices 6211943 and 6228513 contain the notations “electronically delivered.” That fact, and the absence of such notation on any of the items on any of the other items on any of the other invoices, constitutes half of her factual support for her argument that IBM failed to prove electronic delivery of its software. The other half of that support is the testimony of an IBM tax manager, Dawn Rivers, who testified that IBM had a “taxability matrix” that indicated whether or not an item was taxable in a particular jurisdiction.⁹⁸

We agree that it certainly is a mystery why IBM’s invoices would mark a few of its software-related items as “electronically delivered,” not mark the rest of those items that way, then claim that all of its software was electronically delivered. Also, Rivers’ testimony that IBM knew or thought it knew which of its items were taxable in each jurisdiction lends credence to the Director’s argument.

IBM made no attempt to solve the mystery. Instead, it merely asserted that the invoices also showed that none of the software-related items marked “electronically delivered” showed that any tax was charged on those items, and reasserted the testimony of its witnesses Kondapaneni and Hoffman that it delivered all its software to MasterCard electronically.

⁹⁸ Tr. 37. The question was asked in the context of the Director’s allegation that IBM erred in how it reported use tax collected for one location. See “DOR’s argument that IBM failed to properly indicate the amount of use tax collected for items purchased for use in MasterCard’s Kansas City facility” below.

The Director’s theory, while logical, is still only a theory. IBM’s assertion is based on sworn testimony of two witnesses. We are charged with finding the relevant facts of this case, and need proof, but that proof need only be by a preponderance of the evidence.⁹⁹

Our Decision in *FileNet Corp. v. Director of Revenue*

In *FileNet Corp. v. Director of Revenue*,¹⁰⁰ we were presented with a similar problem to the software issue in this case. In that case, FileNet delivered what was, according to the regulatory definition, canned software to its customers under a “load and leave” protocol; a FileNet employee would connect a hard drive to the customer’s business and load it from the hard drive onto the customer’s computer. As such, it did not fit the requirements of 12 CSR 10-109.050(3)(A) because it was not “delivered in a tangible medium to the purchaser,” but because it was canned software, it also was not customized software as described in 12 CSR 10-109.050(2)(A).¹⁰¹

Because the FileNet transaction did not fit into any category in the regulation, this Commission analyzed it under the larger issue of whether the software was tangible personal property and decided that it was not. We noted that under *TRES Computer, IBM I*, and *Bridge Data*, the issue was whether the true object of the transaction was the acquisition of something tangible like a tape or disk, and decided that it was not.

This Commission’s previous decisions do not have precedential authority,¹⁰² but we do not mention it for that purpose. Rather, that case, like this one, required us to decide the case on the basis of the underlying statute and case law, because the Director’s regulation, while quite detailed, did not determine whether the software was taxable. In this case, we were missing a basic piece of information— was IBM’s software “canned” under the regulation’s definition?

⁹⁹ See *Kerwin v. Missouri Dental Bd.*, 375 S.W.3d 219, 229-30 (Mo. App. W.D. 2012).

¹⁰⁰ No. 07-0146 RS, 2010 WL 3781988 (Missouri Administrative Hearing Comm’n, Aug. 20, 2010, Dandamudi, C.).

¹⁰¹ *FileNet Corp.*, 2010 WL 3781988 at *17-19.

¹⁰² *Central Hardware Co. v. Director of Revenue*, 887 S.W.2d 593, 596 (Mo. banc 1994).

The Software is Not Taxable Because
it was not Tangible Personal Property

Section 144.610.1 imposes use tax on tangible personal property. In this case, the undisputed testimony of IBM's witnesses Kondapaneni and Hoffman that the software was not delivered in any tangible medium necessarily assumes the obvious fact that the software itself was not tangible. Because it was not tangible, it could not be "tangible personal property" for purposes of § 144.610.1.

As a result, we conclude that the software IBM sold to MasterCard was not tangible personal property. Therefore, it was not subject to use tax.

Taxation of Software-Related Products (Licenses and Maintenance)

IBM's witness Vernon Hoffman testified that the items set out on invoices 6211943, 6211924, and 6212593 were not software, but software licenses. He also testified that the items on invoice 6228513 also were not software, but software licenses and software maintenance agreements.¹⁰³ Unlike software, we do not have to look beyond 12 CSR 10-109.050 to find criteria for taxability of these types of items. Subsections (3)(B), (E), and (F) provide those criteria, as follows:

(B) Tax applies to the entire amount charged to the customer for canned programs. Where the consideration consists of *license fees* or royalty payments, *all license fees* or royalty payments, present or future, whether for a period of minimum use or for extended periods, *are includable in the measure of the tax*. Tax does not apply to the amount charged to the customer for customized programs.

* * *

(E) Program installation, training, and *maintenance* of software services are taxable under the following circumstances:

1. The purchase of the services is mandatory under the terms of an agreement to purchase software;

¹⁰³ Tr. 94-95.

2. Even though the purchase of the services is not mandatory under a software purchase agreement, the purchase of the services is taxable if canned program updates are included in the purchase price for the services and the services are not separately stated; or

3. The purchase of the services, though not part of a mandatory agreement to purchase software, is included in the total price for the purchase of software and the services are not separately stated.

(F) Program installation, training and *maintenance* of software services are not taxable under the following circumstances:

1. The purchase of the services is not mandatory under a software purchase agreement and the services are separately stated on the purchase invoice from software or other items purchased; or

2. The services are purchased separately from software or other tangible personal property.

(Emphasis added.)

Subsection (3)(B) makes licenses for canned software taxable, while subsections (E) and (F) set out when software maintenance, without regard to the software’s “canned” or “customized” status, is or is not taxable.

The Supreme Court instructs that there are two components to the burden of proof: the burden of producing (or going forward with) evidence and the burden of persuasion.¹⁰⁴ As to these items, IBM not only did neither one, but failed to raise any sort of legal argument why it was entitled to a refund for these items. Therefore, we deny IBM’s refund claim as to software licenses or maintenance agreements.

The Director’s Other Arguments

The General Assembly Failed to Create an Exemption for Financial Transactions

One of the Director’s arguments is a variation of the “industrial connotation” criterion we discuss above— that because the General Assembly did not specifically exempt financial transactions under § 144.054.2, MasterCard has not engaged in “manufacturing.” The Supreme

¹⁰⁴ *Kintzenbaw v. Director of Revenue*, 62 S.W.3d 49, 53 (Mo. banc 2001).

Court has used a variation of this argument before, in *Ben Hur Steel Worx* (“Had the General Assembly meant for “construction” activities to be included in § 144.054.2, it would have used terminology associated with construction activities.”),¹⁰⁵ and *Fred Weber, Inc.* (“[H]ad the General Assembly intended for § 144.054.2 to cover retail food sales [in *Aquila*], it would have used language such as “preparing,” “furnishing,” or “serving.”).¹⁰⁶

We acknowledge the Director’s point. The Supreme Court’s recent pronouncements about the General Assembly’s lack of intent to create an exemption are variations of its generally narrow interpretation of tax exemptions. Had the Court not already pronounced (and never overruled, abrogated, disapproved, or narrowed) the “organizing/computer” definition of manufacturing that specifically applies in this case, the Director’s argument would be stronger. But because that rule of decision remains, *stare decisis* requires that we apply it.

IBM’s Alleged Error in Attributing Use Tax to the Proper Location

As we understand it, the Director’s brief alleges that IBM erroneously reported use tax for one of the locations where some of the items were used. As a result of this error, the Director argues, “Because IBM failed to properly file its original return, IBM cannot show that use tax was erroneously paid for a location for where tax was not remitted.”¹⁰⁷ In response, IBM asserts that it adequately collected and remitted tax on the items it sold to MasterCard.

The error appears to be that IBM’s facility in the Kansas City area, located at 11530 Northwest Ambassador, Kansas City, Missouri, is located in Platte County. IBM’s use tax return for September 2008¹⁰⁸ identifies two instances where use tax for Kansas City locations was reported. For one instance, the tax rate is shown as 7.475%, while for the other instance, the tax rate is shown as 6.6%. However, Rivers, after consulting the Director’s sales/use tax rate table,

¹⁰⁵ 452 S.W.3d at 627.

¹⁰⁶ *Id.* at 631.

¹⁰⁷ Director’s brief p. 38.

¹⁰⁸ Director’s Exhibit B.

admitted that the use tax rate for that portion of Kansas City located in Platte County was 7.975%.¹⁰⁹ The error, the Director pointed out (and Rivers admitted), was that none of the taxes reported on the return showed a rate of 7.975%.

While this possibly means that IBM erroneously computed its tax on the return, it does not mean that it “cannot show that use tax was erroneously paid for a location for where tax was not remitted.” And even if it could, the Director fails to allege, much less show, the consequences of such an error. Therefore, we find no merit in the Director’s argument.

Calculation of Refund Amount

As we set out above, we concluded that IBM was entitled to refunds of the use tax it remitted for equipment it sold or leased to MasterCard that MasterCard used to manufacture products, and for the software it sold to MasterCard. However, it is not entitled to a refund for the use tax it remitted for software licenses or maintenance agreements. By our calculation, IBM remitted \$33,629.26 for equipment shown on invoices EF20030, EGL0178, EHI0143, EI90036, MGV0036, Q57608L, Q57618L, Q57628L, Q57648L, Q57658L, Q57678L, and Q679880. It remitted \$124,729.84 for the following invoices, which described mixed sales of equipment and software: EGV0028, PM01701, PM02801, PM03201, and PM09601. It is entitled to the sum of those amounts as a refund, or \$157,834.10, plus applicable interest.

By our calculation, IBM remitted use tax totaling \$44,473.35 for invoices 6211943, 6211924, 6212593, and 6228513. However, because the items sold there were software licenses or software maintenance, IBM recovers none of that amount.

¹⁰⁹ Director’s Exhibit C; see Tr. 34.

Summary

IBM is entitled to a refund of use tax in the amount of \$158,359.10, plus applicable interest.

SO ORDERED on April 21, 2015.

\s\ Sreenivasa Rao Dandamudi
SREENIVASA RAO DANDAMUDI
Commissioner