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NOT TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2009-CA-002012-MR

COMPUTER SERVICES, INC. APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 09-CI-00118

DEPARTMENT OF REVENUE,
FINANCE AND ADMINISTRATION
CABINET, COMMONWEALTH OF
KENTUCKY APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: CLAYTON, DIXON AND WINE, JUDGES.

DIXON, JUDGE: Appellant, Computer Services, Inc. ("CSI"), appeals from an opinion and order of the Franklin Circuit Court upholding the Kentucky Department of Revenue's decision that prewritten computer software purchased in 2002 was tangible personal property subject to sales and use tax.

CSI is a Kentucky Corporation that provides data management services to over 3,000 financial institutions across the nation. In June and July 2002, under a Master Agreement for Products and Services, CSI paid Unisys Corporation $3,645,717 for prewritten computer software, the hardware to run it, and the services required to install and maintain the system. CSI purchased the software for a 60-month term, at the conclusion of which it was required to either return, renew or destroy the software. Pursuant to Kentucky Revised Statutes (KRS) 139.160, Unisys initially collected sales and use tax from CSI on the purchases and remitted such to the Kentucky Department of Revenue ("Department"). However, Unisys subsequently sought a refund of $219,823.02 at CSI's request on the basis that the software portion of the purchase was not tangible personal property.

On July 3, 2007, the Department issued a final ruling denying the refund claim, finding:

> The software at issue is not some intangible right or property but is instead something that exists in a physical form that has a physical existence, takes up space on a tape, disc, or hard drive, makes physical things happen and can be perceived by the senses. It is therefore tangible personal property within the meaning of the sales and use tax law.

Unisys thereafter authorized CSI to pursue the tax refund in its own name. CSI then appealed the Department's ruling to the Kentucky Board of Tax Appeals ("Board"). On December 22, 2008, the Board upheld the Department's ruling, noting in pertinent part:

> CSI urges that this software delivery system is only incidentally tangible and that it is the software that is being used, not the tangible medium of delivery. The Board believes this to be a distinction without a difference. The software came loaded on a tangible medium, the only hardware upon which it could be used, also provided by Unisys as part of that which it delivered under the same Master Agreement for Products and Services. In effect, there is no difference between the sale of the medium and the message here and the sale of Window[s] 3.0 in a package at Wal-mart.

CSI subsequently sought review in the Franklin Circuit Court, arguing that the Board's decision was contrary to the sales and use tax laws in effect at the time of the purchase, as well as to the decision in *WDKY-TV v. Revenue Cabinet*, 838 S.W.2d 431 (Ky. App. 1992). However, by opinion and order rendered September 28, 2009, the circuit court disagreed with CSI and upheld the administrative agency's rulings. In so doing, the circuit court devoted much of the opinion to an analysis of Kentucky caselaw regarding statutory construction. The court applied federal caselaw relating to the deference afforded to an administrative agency's contemporaneous construction of a statute and ultimately determined that it was bound to follow the Department's interpretation of the law so long as it was reasonable. The court further ruled that the *WDKY-TV* decision was inapplicable to the facts herein and that it was reasonable for the Department to tax the software because it was delivered to CSI on a tangible medium. This appeal ensued. Additional facts are set forth as necessary.

The standard of review, when addressing an appeal from an administrative decision, "is limited to determining whether the decision was erroneous as a matter

of law." *McNutt Constr. v. Scott*, 40 S.W.3d 854, 861 (Ky. 2001). Kentucky Courts have long held that "judicial review of administrative action is concerned with the question of *arbitrariness* . . . . Unless action taken by an administrative agency is supported by substantial evidence it is arbitrary." *American Beauty Homes Corp. v. Louisville and Jefferson County Planning and Zoning Comm'n.*, 379 S.W.2d 450, 456 (Ky. 1964). Substantial evidence is defined as "that which, when taken alone or in light of all the evidence, has sufficient probative value to induce conviction in the mind of a reasonable person." *Bowling v. Natural Resources and Envtl. Protection Cabinet*, 891 S.W.2d 406, 409 (Ky. App. 1994).

The judicial standard of review of an agency's decision is largely deferential. KRS 13B.150(2) requires that when reviewing an administrative agency's decision, "[t]he court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact." "In its role as finder of fact, an administrative agency is afforded great latitude in its evaluation of the evidence heard and in the credibility of the witnesses, including its findings and conclusions of law." *Aubrey v. Office of Attorney General*, 994 S.W.2d 298, 309 (Ky. App. 1972). *See also Bowling*, 891 S.W.2d at 409-410. The court's role as an appellate court "is to review the administrative decision, not to reinterpret or to reconsider the merits of the claim, nor to substitute its judgment for that of the agency as to the weight of the evidence." *500 Associates, Inc. v. Natural Resources and Envtl. Protection Cabinet*, 204 S.W.3d 121, 131 (Ky. App. 2006) (citation footnote omitted). When it comes to an agency's findings of fact, "[a]s

long as there is substantial evidence in the record to support the agency's decision, the court must defer to the agency, even if there is conflicting evidence." *Id.* at 132.

Once a reviewing court has determined that the agency's decision is supported by substantial evidence, the court must then determine if the agency applied the correct rule of law to those factual findings in making its determination. If so, the final order of the agency has to be upheld. *Bowling*, 891 S.W.2d at 409-410. On the other hand, matters of statutory construction are subject to *de novo* review. Because statutory interpretation is a matter of law reserved for the courts, we are not bound by the circuit court's interpretation. *Halls Hardwood Floor Co. v. Stapleton*, 16 S.W.3d 327, 330 (Ky. App. 2000).

Prior to embarking on a discussion of the issues herein, it is necessary to provide a history of the relevant taxing provisions. Kentucky sales and use tax applies to all retail sales of tangible personal property that are not exempted by statute. KRS 139.120; *Delta Airlines, Inc. v. Revenue Cabinet*, 689 S.W.2d 14, 17 (1985). In 2002, at the time of CSI's purchase of the software in question, "tangible personal property" was defined as:

> [P]ersonal property which may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses and includes natural, artificial and mixed gases, electricity, water, and prepaid calling arrangements. For the purposes of this chapter, the term "prepaid calling arrangements" means any right to purchase communications service, which must be paid in advance and which enables the origination of calls using an access number or authorization code, whether

> manually or electronically dialed. "Prepaid calling arrangements" includes, but is not limited to, prepaid cards and prepaid accounts which are decremented as calls take place.

KRS 139.160.[1] Aside from the items relating to utilities and prepaid calling arrangements, the statute enumerated no particular types or categories of property, but encompassed the whole of tangible personal property. In addition, 103 Kentucky Administrative Regulations (KAR) Section 28:051, entitled "Leases and Rentals," provided that leases and rentals were taxable in the same manner as sales under KRS 139.120, and included leases or rentals of computer software and hardware, which the regulation itself classified as "tangible personal property." 103 KAR 28:051 § 2(1)(1).

At the hearing before the Board in this matter, Richard Dobson, the Department's Executive Director of the Office of Sales and Excise Taxes, testified that prior to 2004, the taxation of prewritten computer software was based solely upon the method in which it was delivered. The Department took the position that if the software was delivered on a physical, tangible medium, such as a disk or hard drive, the software itself was tangible property subject to sales tax. However, software electronically downloaded directly from the Internet and installed on a purchaser's computer was classified as intangible property that was exempt from taxation. Dobson explained that the Department's policy was based upon the fact that software downloaded from the Internet was not something that could be "seen, weighed, measured, felt or touched, or . . . in any other manner perceptible to the

[1] Repealed. 139.010(30), see page 16 of this opinion.

senses," and thus did not fit within the definition of "tangible personal property" found in KRS 139.160. Dobson conceded that the Department's taxing of essentially the same item based solely upon its method of delivery was inconsistent. Nevertheless, the Department followed this policy until July 2004, when KRS 139.160 was amended to specifically include prewritten computer software "regardless of the method of delivery" within the definition of "tangible personal property." It is within the context of the above provisions, that we will address each of the issues in turn

Before this Court, CSI first argues that the trial court erred in disregarding the decision in *WDKY-TV*. Specifically, CSI contends that the Department's policy of taxing software based upon its method of delivery was in direct contravention of the ruling in *WDKY-TV*, which CSI claims held that intangible property cannot be taxed simply because it is delivered on a tangible medium.

We must agree with the circuit court that CSI has oversimplified the holding in *WDKY-TV*. Therein, the issue was whether an intangible broadcasting right was made tangible, and therefore taxable, when purchased at the same time as the videotape that was used to deliver and transmit the broadcast. In determining that such was not tangible taxable property, a panel of this Court held:

> The Cabinet and the cases on which it relies have simply failed to perceive the distinction between the right to own an object and the right to make use of an object that one owns. For example, a bookstore buys individual copies of a book for resale, while a publishing house buys the right to make copies of a book; and an appliance store sells certain brand name appliances, while a manufacturer

> buys the right to make a brand of appliances. In each example, one party buys things and one party buys the intangible (meaning not capable of being "seen, weighed, measured, felt or touched" and not otherwise perceptible to the human senses, KRS 139.160) right to make reproductions of a thing.

WDKY-TV, 838 S.W.2d at 434.

CSI analogizes its software to the intangible broadcasting rights in *WDKY-TV*. It argues that as in *WDKY-TV*, there were two distinct purchases – the hardware, which CSI concedes is taxable, and the right to use the software for a specific period of time. However, in distinguishing *WDKY-TV*, the circuit court herein noted,

> CSI has misread the context surrounding the Court of Appeal's utilization of the word "use." The Court of Appeals was obviously not referring to the difference between outright ownership (e.g., purchase) and a limited right of ownership (e.g., license). Rather, the Court of Appeals was referring to the difference between ownership, whether limited or otherwise, and the right to "make use" of a copyright. . . . CSI had a limited right of ownership, i.e., a license. CSI did not have a right to "use," or more specifically "make use," e.g., reproduce, disseminate, etc., of the software.
>
> CSI also alleges that its "software licensing agreement with Unisys is more akin to a broadcast agreement than it is to a Bart Simpson T Shirt or a can of Pepsi or a Cadillac – which were examples of taxable tangible property listed by the Court in the *WDKY-TV* opinion." This point is simply incorrect. . . . . CSI acquired restricted ownership rights through its license agreement, that is, the right to "use" the software, but it did not acquire the right to "use" or "make use" of the software as articulated by the Court of Appeals in *WDKY-TV*. . . . Just as the purchaser of a Bart Simpson t-shirt "uses" his or her shirt, CSI "used" the software for

> its benefit, and consequently, for the benefit of its customers. The right to resell or dispose of the software is simply not relevant. Again, it is the right to "make use" of the property which is critical to *WDKY-TV*'s decision. With respect to this fundamental facet, CSI's license is plainly more like a Bart Simpson t-shirt than copyright. Thus, CSI's reliance on *WDKY-TV* is misplaced.

We agree that, contrary to CSI's interpretation, the *WDKY-TV* decision did not simply hold that intangible property delivered on a tangible medium was not taxable. The *WDKY-TV* Court explicitly made no finding on the applicability of taxing statutes to computer software:

> We make no decision here on the applicability of KRS 139.310 to computer software. The numerous computer software cases cited by the parties seem to fall into two basic categories: 1) those cases which say that a computer disk or tape is like a book and therefore taxable as tangible property (a result which we believe to be consistent with our reasoning); *see e.g. Hasbro Industries, Inc. v. Norberg*, 487 A.2d 124 (R.I.1985); and 2) those cases which say that computer software is intangible (a result which, although favorable to the appellant here, is at odds with our analysis; the results may be justifiable, however, on other grounds and for reasons not at issue here); *see e.g. First Nat. Bank of Springfield v. Dept. of Revenue*, 85 Ill.2d 84, 51 Ill.Dec. 667, 421 N.E.2d 175 (1981).

Id. at 434 (Footnote 5).

Here, CSI made no purchase analogous to broadcast rights. It purchased a "thing" - software that came installed on a tangible medium, the only hardware upon which it could be used. CSI acquired the right to use the software strictly for its own operations. It did not purchase the right to reproduce or distribute the

software. We discern no part of the purchase price that can be attributed to some intangible right that is separate from the right to possess and use the software. Thus, we agree with the trial court that the holding in *WDKY-TV* is inapplicable to the facts herein.

CSI next argues that the circuit court ignored the standard of review and the rules of statutory construction as set forth in *City of Maysville v. Maysville St. Ry. & Transfer Co.*, 128 Ky. 673, 108 S.W. 960 (1908), and *George v. Scent*, 346 S.W.2d 784 (Ky. 1961). Clearly, once the trial court determined that *WDKY-TV* did not apply, it was tasked with deciding whether, in the absence of any controlling Kentucky law, the Department's interpretation of the taxing statutes was reasonable.

In *City of Maysville,* Kentucky's then-highest court adopted the general rule of resolving doubtful language in statutes imposing taxes in favor of the taxpayer, stating,

> It is elementary that taxing laws will not be enlarged by intendment, and no property will be held as embraced within the terms of a taxing statute by mere implication. To impose taxes on property requires a clear and explicit command of the sovereign power; and the courts will never strain a taxing statute in order to make it embrace property which would otherwise not fall within its purview.

128 Ky. 673, 682, 108 S.W. 960, 962. The appellate courts of this Commonwealth have properly continued to apply this elementary rule of tax imposition. *See WDKY-TV*, 838 S.W.2d at 433. Again, in *George v. Scent*, the Court noted:

> Taxing laws should be plain and precise, for they impose a burden upon the people. That imposition should be explicitly and distinctly revealed. If the Legislature fails so to express its intention and meaning, it is the function of the judiciary to construe the statute strictly and resolve doubts and ambiguities in favor of the taxpayer and against the taxing powers. This is particularly so in the matter of pointing out the subjects to be taxed. (Citations omitted, emphasis added).

346 S.W.2d 784, 789.

CSI argues that rather than construing the statutes strictly and resolving all doubts and ambiguities in favor of the taxpayer, the circuit court herein instead applied the doctrine of contemporaneous construction to effectively find that the software was subject to sales tax simply because the Department said it was. In *Revenue Cabinet v. Lazarus, Inc*., 49 S.W.3d 172 (Ky. 2001), the Court observed:

> The doctrine of contemporaneous construction means that where an administrative agency has the responsibility of interpreting a statute that is in some manner ambiguous, the agency is restricted to any long-standing construction of the provision of the statute it has previously made. "Practical construction of an ambiguous law by administrative officers continued without interruption for a very long period is entitled to controlling weight." *Grantz v. Grauman*, 302 S.W.2d 364 (Ky. 1957).

Lazarus, 49 S.W. 3d at 174 (quoting *GTE v. Revenue Cabinet*, 889 S.W.2d 788, 792 (1994)). In applying the doctrine of contemporaneous construction herein, the trial court noted:

> [T]he Court has a choice. First, it can habitually apply strict construction to "ambiguous" tax statutes which

> impose a tax burden and resolve these ambiguities in favor of the taxpayer. *George v. Scent*, 346 S.W.2d 784, 789 (Ky. 1961). Likewise, the Court will be forced to habitually resolve ambiguities granting an exemption in favor of the government. *Id.* In the alternative, the Court can take a more sensible approach and attempt to resolve the ambiguity with the assistance of agency expertise. Obviously, there is only one rational conclusion. An agency's interpretation must be afforded deference before the Court shifts to a strict construction of tax statutes.

Certainly, an agency's interpretation of a statute is entitled to great deference only when the statute is in some manner ambiguous. However, CSI contends that in 2002, the statute was unambiguous as the definition of tangible personal property did not contain a clear directive that computer software was to be taxed.

In the 2002 version of KRS 139.160, only six specific items were included within the definition of "tangible personal property" – natural, artificial, and mixed gases, electricity, water, and prepaid calling arrangements. To accept CSI's position, that unless the statute provided a clear directive an item was not subject to taxation, would undoubtedly lead to an absurd result. Clearly, the legislature did not intend for sales and use tax to apply only to the six enumerated items. Rather, the statute leaves to the Department the interpretation of how the remainder of personal property sales fit into the general definition of "tangible personal property," which included a broad catch-all phrase for property that was "in any other manner perceptible to the senses."

In our view, the resolution of this case turns not upon the *WDKY-TV* decision, but rather upon the language of the statute at the time of CSI's purchase.

The *WDKY-TV* Court noted that it found nothing within KRS 139.160 that purported to tax "intangible" property as tangible, other than services associated with the transfer of tangible property. 838 S.W.2d at 432. However, in 2000, after the decision in *WDKY-TV* but prior to the purchase at issue, KRS 139.160 was amended to include prepaid calling arrangements, which are clearly intangible in nature.

Much confusion exists concerning categorizing software for sales and use tax purposes. Apparently this conundrum extends across the nation as,

> There is a split among the jurisdictions as to whether computer software is tangible property subject to a personal property tax or intangible property, not capable of being taxed.
>
> In many jurisdictions, for purposes of a business personal property tax or a municipal tangible personal property tax, computer software is intangible property.

84 C.J.S. *Taxation* § 127. This issue is the subject of an *American Law Reports* article which noted,

> In 1969, IBM announced a separate pricing policy for software; no longer would computer software be "bundled" with the cost of the hardware. The taxation of this now distinct component became a matter of dispute between taxing authorities which treated the computer software as tangible personal property subject to sales and use taxes and taxpayers who argued that the software was intangible. The majority of courts which addressed this issue in the decade subsequent to "unbundling" held that computer software was intangible. In the last decade, however, a number of courts have taken a contrary position.

Linda A. Sharp, Annotation, *Computer Software or Printout Transactions as Subject to State Sales or Use Tax,* 36 A.L.R. 5th 133 (1996). This annotation examines how various jurisdictions have grappled with the difficulty in attempting to classify software in terms of "tangibility." Jurisdictions which have determined that software is intangible have primarily focused on the idea that the purchaser is buying knowledge, not a physical object, so that the mode of transmittal is irrelevant in determining taxability; rather it is the compilation, synthesis, organization and creation of information that has value - things which are inherently intangible. *Id.* at 144-148.

Generally, those jurisdictions holding that software is tangible and thus subject to sales and use tax have, similarly to the Department's position, stressed the recorded nature of the information contained in "magnetic tapes" which renders software tangible. *Id.* at 148-154. It would seem to us these courts reach to extraordinary lengths in their efforts to support statutes similar to our own by permitting taxation of items as tangible which are in reality intangible. To classify one item in such a way as to impose a significant tax consequence while one item is exempt merely because of the mode of delivery makes little sense.

Regardless, our own legislature has since chosen, perhaps by necessity given the rapidly changing technology in today's society, to create what can only be termed a legal "fiction," by specifically rendering intangible software now most certainly tangible. In 2004, KRS 139.160 was amended to include prewritten computer software in its definition of tangible property, regardless of the method

of delivery.[2] Thus, it is obvious that whether an object is tangible or intangible is of little consequence when the legislature has deemed it tangible for tax purposes.

With this principle in mind, we turn to KRS 139.160, as it existed at the time of the transaction herein. As previously stated, the statute included as examples of personal property subject to tangible sales taxes: natural, artificial and mixed gases, electricity, water, and prepaid calling arrangements. Clearly, these items are outside the traditional ideas of tangible personal property. One cannot imagine something more intangible than gas, electricity or prepaid calling arrangements. Therefore, it is more than plausible that our legislature intended the tangible tax to extend to computer software. Moreover, the accompanying regulations specifically include computer software within enumerated examples of tangible property. Thus, the Department had ample legislative authority to levy taxes against computer software under KRS 139.160.

Furthermore, although the decisions in *City of Maysville* and *George* hold that tax laws should be construed in favor of the taxpayer, a panel of this Court in *J. Sutter's Mill, Inc. v. Revenue Cabinet*, 793 S.W.2d 838, 839-840 (Ky. App. 1990), noted:

> The Appellant reminds us that tax laws must be strictly construed in favor of the taxpayer. . . . However, we must also take into account KRS 139.260, which provides that "it shall be presumed that all gross receipts are subject to the [sales] tax until the contrary is established." This throws the burden of establishing "the contrary" squarely upon the taxpayer. (Citations omitted).

[2] Currently, this statute has been repealed and the content is largely located in KRS 139.010(30).

CSI failed to convince the Department, the Board, or the circuit court of "the contrary." Given the language of KRS 139.160, along with its corresponding regulations, we are of the opinion that at the time CSI made its purchase in 2002, taxing software as tangible property was proper.

Finally, CSI argues that the circuit court failed to consider that the General Assembly changed the law in 2004 to include prewritten computer software within the definition of "tangible personal property." CSI believes that this is a clear indication that the software was not subject to taxation in 2002. We disagree.

Richard Dobson testified at the hearing before the Board that the change in the law that occurred in 2004 was intended to remove the distinction that was being made with software based on its method of delivery. In other words, it was intended to clarify that the Department should tax *all* prewritten computer software "regardless of method of delivery," a phrase added to KRS 139.160(a) in the same amendment that added prewritten computer software to the list of enumerated examples of tangible personal property. As previously noted, CSI has provided no indication, and we find none, that all prewritten computer software was exempt from the sales and use tax provisions prior to 2004.

For the foregoing reasons, we affirm the opinion and order of the Franklin Circuit Court.

ALL CONCUR.

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