

No. SC90172

**IN THE SUPREME COURT
STATE OF MISSOURI**

WESTERN BLUE PRINT CO.,

Respondent,

v.

DIRECTOR OF REVENUE,

Appellant.

**Appeal from the Administrative Hearing Commission of Missouri
The Honorable John J. Kopp, Commissioner**

BRIEF OF RESPONDENT

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STATEMENT OF FACTS

In this appeal, the Director of Revenue (“Director”) asks this Court to reverse a decision of the Administrative Hearing Commission (“Commission”), which itself had overturned the Director’s assessment of additional sales tax against Western Blue Print Company (“Western”). At issue is whether Western should have charged, and remitted to the Department of Revenue, sales tax on the amount it charges customers to make electronic versions of paper documents.

The Commission succinctly described Western’s business:

Western scans and images customer documents onto computer disks for distribution to its customers. The customer provides its documentation in paper form to Western, who then scans and images the documents on its own CDs [“computer disks” or “compact disks”], which it then distributes to the customer. Western returns the original documents to the customer.

(LF 482).

While accurate, this summary does not fully describe Western’s business. When customers hire Western, a Western employee scans the customers’ documents using an imaging scanner. Western’s software lifts the images of those documents from the scanner and puts them in a “file format.” Software then transforms the file into data that is read by the computer’s disk burner, which in turn transfers (burns) the computer data onto a computer disk (CD). This disk is delivered to customers, who can then access the electronic versions of their documents with their own computers. (LF 481-83, 495).

The Commission found that Western separately charges for the scanning and creation of these electronic documents:

Western charges a stated price per page for each scanned item and also a stated price per folder for items that Western must remove from folders.

Western charges \$15 “per CD-Rom Master and 1 duplicate.” The \$15 charge is stated separately from the scanning fee on Western’s contracts.

(LF 482).

The Commission also found that several of Western’s contracts require it to provide additional services in which its own computers are used and the output is delivered to the customer. *Id.* This includes capturing, compressing and saving the page image data into its final form; indexing data; preparing an “‘Access Database’ run-time version document retrieved program”; converting publications into the Interactive Electronic Book .PDF file format for delivery to customers on CDs; and recording document images “onto CD for delivery and uploading into the customer’s dedicated PC; and other various services.” (LF 482-83).

Western did not collect or remit sales tax on the amount it received from its customers for these services. On November 14, 2006, the Director issued a final decision assessing Western unpaid sales tax of \$41,414.29 plus statutory interest for its services in converting documents to electronic form and returning the data on the computer disks to its customers. (LF 484).

Western appealed that assessment to the Commission. The Commission ruled in favor of Western on April 30, 2009. (LF 498). It concluded that neither the services

provided by Western nor the computer output provided by it in the form of CDs were subject to sales tax for two separate reasons. First, the Commission found that the “true object” of the transaction was not the sale of the CDs themselves, but the services provided by Western in making the customers’ paper documents available to them in electronic form. (LF 495). Second, the Commission determined that Western was in the business of producing the sort of “computer output” that is expressly exempt from taxation under Section 144.010.1(10). The Director appeals both of these conclusions. (LF 498).

ARGUMENT
RESPONSE TO POINT I

Standard of Review

This Court defers to the factual findings of the Commission if they are supported by the law and substantial evidence. *Missouri State USBC Ass’n v. Dir. of Revenue*, 250 S.W.3d 362, 363 (Mo. banc 2008). While the Commission’s interpretation of a tax law is reviewed *de novo*, “statutes imposing a tax must be strictly construed in favor of the taxpayer and against the taxing authority.” *American National Life Ins. Co. of Texas v. Dir. of Revenue*, 269 S.W.3d 19 (Mo. banc 2008); *American Healthcare Mgt., Inc. v. Dir. of Revenue*, 984 S.W.2d 496, 498 (Mo. banc 1999). As the Director recognizes, Missouri tax laws are strictly construed in favor of the taxpayer and it is the Director’s burden to show that the taxpayer falls under them. *Cook Tractor Co., Inc. v. Dir. of Revenue*, 187 S.W.3d 870, 872 (Mo. banc 2006).

I. Under this Court’s “True Object” Test, Western is Selling Non-Taxable Services, Not Tangible Finished Products.

The Director’s first point relied on is governed by two statutes – Section 144.020(1), which states that a “sales” tax is imposed on “every retail sale in this state of tangible personal property,” and Section 144.010(10), which provides that a “retail sale” or a “sale at retail” is “any transfer made by any person engaged in business as defined herein of the ownership of, or title to, tangible personal property to the purchaser.” The Commission correctly determined that Western was providing not tangible personal property, but services that fell outside the scope of these statutes. Accordingly, the services provided – scanning

the customers' documents, burning them onto a CD, and delivering the CD to the customer – were not subject to sales tax.

Western provides a service that simply happens to be delivered on a tangible CD. The customer is not interested in purchasing a CD; it instead is purchasing Western's service of converting paper documents to an electronic form. In circumstances like these, where a tangible object is part of a transaction in which non-taxable services are also provided, the question arises whether the entire transaction is taxable. Over the years this Court has developed the "true object" test to answer this question. *See, e.g., James v. TRES Computer Systems*, 642 S.W.2d 347 (Mo. banc 1982).¹ This test focuses "on the essentials of the transaction to determine the real object the buyer seeks." *Sneary v. Dir. of Revenue*, 865 S.W.2d 342, 345 (Mo. banc 1993). In *Sneary*, the court explained how the test applies to cases like this:

Under the test, this Court has recognized a class of transactions in which tangible personal property serves exclusively as the medium of transmission for an intangible product or service.

If the "true object" of the transaction is the purchase of a non-taxable service rather than the sale of tangible personal property, the mere transmission of tangible personal property as part of the services provided will not make the transaction a "sale at retail." *Id.* at 349.

¹*See also Bridge Data Co. v. Dir. of Revenue*, 794 S.W.2d 204 (Mo. banc 1990); *K&A Litho Process v. Dir. of Revenue*, 653 S.W.2d 195 (Mo. banc 1983).

Here, the Commission correctly found that making paper documents available in electronic form is the true object of transactions at issue. (LF 495). The CDs were simply the vehicle customers used to load the electronic documents onto their own computers. *Id.* Indeed, as the Commission found, other methods of delivering the electronic data to the customers could have been used. *Id.*

In *James*, this Court came to the same conclusion on similar facts. There, the Court considered whether the sale of \$135,000 worth of custom data and computer programming sold on computer tapes worth \$50 was taxable personal property. *James*, 642 S.W.2d at 348. Central to the Court's conclusion was the use to be made of the tangible (the tapes) and intangible (the programs) components and their relationship to each other. *Id.* at 349. The Court held that the tapes were simply a medium of transmittal – a mere incident to the sale of the data – and that the sale of data was really the core transaction. *Id.* The Court noted that the seller could have transmitted the data electronically, dispensing altogether with any tangible component to the transaction. *Id.* at 349-50. The taxpayer was thus liable for the sales tax only on the \$50 tapes.²

This case is indistinguishable from *James*. Western's customers hire it not to prepare CDs, but to convert the customers' paper images into electronic data. Customers can then

² Admittedly, a similar conclusion could be drawn here that the \$15 CDs were taxable, but the Director does not argue that Western is liable for back taxes on the price of the CDs themselves. She instead is simply trying to leverage the incidental use of CDs in Western's business to recover taxes on the entire amount of services provided.

dispose of large volumes of paper and retain the electronic versions for their records. The labor required to scan and convert the documents is extensive. In some cases, this involves scanning full magazines page by page. Western then reconfigures the data electronically, formats it onto a CD, and uses the CD to deliver the data to the customer. As the Director recognizes, computer technology continues to improve dramatically, and the final step in Western's services of "burning" the CD is often no longer necessary. The computer data can be sent to customers digitally through the internet, and can be stored on the customers' own computers, without even generating actual CDs. This fact simply highlights the true object of Western's work, which is to provide electronic copies of customers' paper documents.

The Director argues that *Gammaitoni v. Dir. of Revenue*, 786 S.W.2d 126 (Mo. banc 1990), not *James*, should dictate the outcome here. In *Gammaitoni*, the taxpayer, Videotech, produced, edited, and duplicated instructional videotapes. 786 S.W.2d at 128. Videotech created content that could only be accessed by the videotapes. *Id.* at 129-30. Thus, those videos – tangible finished products made for distribution – were the true object of the transaction and were subject to sales tax. *Id.*

Far from supporting the Director, *Gammaitoni* confirms why *James* demands that the Commission's decision be affirmed. This Court recognized in *Gammaitoni* that the actual magnetic tapes at issue in *James*, like the CDs here, were not what the customers wanted. Instead, the customers sought customized programs or data. It was the customization that made the transaction a service, not simply that the taxpayer had initially created the information. *Id.* at 129-130; compare *International Business Machines Corp. v. Dir. of*

Revenue, 765 S.W.2d 611, 613 (Mo. banc 1989) (“*IBM*”) (distinguishing custom programs from standardized programs, deeming the sale of the latter taxable).

The second case cited by the Director here, *Universal Images, Inc. v. Missouri Dept. of Revenue*, 608 S.W.2d 417 (Mo. banc 1980), is likewise inapposite. That case found that advertisements on motion picture film were tangible property because the film was essential to be able to display the advertisements on movie screens. Thus, it could not be said that the film was incidental to the transaction. *Universal Images*, 608 S.W.2d at 420.

The Director tries to analogize to *Gammaitoni* and *Universal Images* by arguing that the information here was not a product of Western’s work and thus is somehow not the true object of the transaction. She argues that Western does nothing more than take pictures of its customer’s paper documents and place them on a CD. This argument misses the point. First, as explained, the process is far more elaborate. Western creates, through a detailed process, digital electronic versions of a customer’s paper documents so the customer can access and use them electronically.

Further, the issue in cases like *Gammaitoni*, *Universal Images*, and *IBM* is not present here. In those cases the Court was trying to determine the true object of transactions that involved nearly identical content that had been produced for numerous customers and delivered in tangible form. *See Gammaitoni*, 786 S.W.2d at 128 (videotape); *Universal Images*, 608 S.W.2d at 420 (film) *IBM*, 765 S.W.2d at 613 (computer tape). But this case does not involve the repeated sale of identical content. Quite the contrary, Western takes a particular customer’s documents and makes electronic versions of them. The CDs themselves are not in any sense finished products designed for distribution. They instead are

nothing more than the means of transferring to customers the electronic version of their documents that they desire. Thus the CDs are incidental to the transaction's purpose true purpose—the conversion of tangible documents into electronic data. This case is thus far closer to cases like *James* and *K&A Litho* than to *Gammaitoni* and *Universal Images*.

The Director also speculates that the CDs might have some intrinsic value to the customers. But nothing in the record supports this claim, and the Commission rightly rejected it. The simple fact that a CD may be chosen as the delivery vehicle for electronic data is wholly incidental and cannot transform what is otherwise a non-taxable service into a taxable sale of tangible property.

The “true object” of Western's business was providing a valuable service, not selling CDs. The Commission's decision should be affirmed for this reason alone.

RESPONSE TO POINT II

Standard of Review

A taxpayer has the burden of showing it is entitled to an exemption, and exemptions are strictly construed against the taxpayer. *Branson Props. USA, L.P. v. Dir. of Revenue*, 110 S.W.3d 824, 825 (Mo. banc 2003).

II. Western's Sales of CDs are Separately Exempt from Taxation Because They are “Computer Output” as Set Forth in § 144.010.1(10).

The Commission's decision should be affirmed as set out above under the “true object” test. But a separate ground supports the Commission's holding – as the Commission also correctly found, even if Western somehow had been selling tangible personal property

rather than services, its sales were of “computer output,” which is exempt from the definition of “sale at retail” in section 144.010.1(10).

Section 144.010(10) states in pertinent part:

The selling of computer printouts, computer output or microfilm or microfiche and computer-assisted photo compositions to a purchaser to enable the purchaser to obtain for his or her own use the desired information contained in such computer printouts, computer output on microfilm or microfiche and computer-assisted photo compositions shall be considered as the sale of a service and not as the sale of tangible personal property.

Section 144.010.1(10).

Although there is no dispute here that the electronic form of paper documents on a CD is “computer output,” the Director argues that the statute’s exemption is not for “computer output,” but only for “computer output *on microfilm or microfiche.*” She arrives at this conclusion by brushing aside the obvious typographical error in the statute. When the statute attempts to repeat the phrase by referring to “*such ...computer output or microfilm or microfiche*” used in the first clause, it inexplicably replaces the word “or” with the word “on,” so that second clause reads “contained in such computer printouts, computer output *on* microfilm or microfiche and computer-assisted photo compositions.” Section 144.010(10) (emphasis added).

The Director’s reading brings the first and second clauses of the statute into conflict. The first “rule of statutory interpretation is to give effect to legislative intent as reflected in the plain language of the statute.” *Gash v. Lafayette County*, 245 S.W.3d 229, 332 (Mo.

banc 2008). And the law favors a construction in harmony with reason and common sense and that avoids unreasonable and absurd results. *In re B.C.H.*, 718 S.W.3d 158 (Mo. App. 1986). Here there is no rational basis for limiting the scope of the exemption solely to computer output that happens to be on “microfilm or microfiche,” technologies that are hardly (if ever) used today to transmit “computer output,” if indeed they ever were. This is especially true when the exemption is phrased in terms that almost precisely describe Western’s business, i.e., selling “computer output...to enable the purchaser to obtain for his or her own use the desired information.” It makes no sense to read a statute clearly intended to *exempt* from taxation Western’s *precise business* in a way that leads to *taxation*.

By using the adjective “such,” the statute plainly intends for the first and second clauses to be identical. The word “such” is used to describe the prior list of nouns in the prior clause, *i.e.*, “computer printouts, computer output or microfilm or microfiche”; the aberrant use of “on” in the second clause cannot obviate or limit the plain meaning of the first clause, especially when a limitation of computer output *solely* to “microfilm or microfiche” defies common sense.

The General Assembly more likely meant to use the word “or” and not the word “on” in that second clause, so that both clauses read “computer output or microfilm or microfiche.” This clerical error in the statute should not limit the types of computer output that are exempt from the sales tax. *Deimeke v. State Highway Commission*, 444 S.W.2d 480, 482 (Mo. 1969) (“The general rule, and the one followed in this state, is that verbal inaccuracies or clerical errors or misprints in statutes will be corrected by the court whenever necessary in order to effectuate the clear intent of the Legislature.”). Further, as the

Commission noted, this Court has never endorsed the limitation on “computer output” now suggested by the Director. This Court in *Zip Mail Services, Inc. v. Dir. of Revenue*, 16 S.W.3d 588, 591 (Mo. banc 2000), instead correctly stated what seems plain: that the statute applies to exempt *all* “computer output,” not just “computer output *on* microfilm or microfiche” as the Director now suggests.

The Director argues that to read the statute as the Commission did would make the exemptions for “microfilm or microfiche” superfluous because “computer output” would necessarily include microfilm and microfiche as well as computer printouts. The Commission’s finding does no such thing. As noted, neither microfilm nor microfiche are themselves “computer output.” Computer output, like electronic documents burned onto CDs by a computer, is a wholly distinct category from microfilm and microfiche, technologies that actually predate *computers* by many years.

While it is not a picture of clarity, this statute, like all others, must be construed by divining the legislature’s intentions from the language it used. Section 144.010(10) suggests that computer printouts, computer output, microfilm and microfiche, and computer-assisted photo compositions are all things the legislature felt were exempt from sales and use taxes. As the Director points out, until the General Assembly clarifies section 144.010(10), this Court is bound to enforce it as written.

Nor is the Director’s superficial analysis of the history of computing particularly helpful. Although the Director discusses magnetic and paper tape and punch cards as being early examples of “computer output,” she conspicuously fails to mention either microfilm or microfiche, no doubt because these formats were *not* generally associated with computer

output at all. Typically, microfilm and microfiche are simply analog pictures of existing documents that are greatly reduced in size, and it would make sense to exempt them from retail sales, just as it would make sense to exempt computer output. There is no discernible connection between these formats and *any* sort of computer output, which is typically digital rather than analog in nature. Without that connection, it makes considerably more sense to read the statute as distinguishing between, rather than linking, “computer output” on the one hand, and “microfilm and microfiche” on the other.

Taking the language of the statute at face value, and accounting for the obvious clerical error, provides a straightforward answer: “Computer output” is not subject to sales tax in Missouri, as this Court has already suggested in *Zip Mail Services*. Because the CDs produced by Western were “computer output” and thus covered by § 144.010.1(10), there was no retail sale of tangible personal property as set out in Point I, and Western’s transactions were expressly exempt from sales tax. Although Western should clearly prevail here because the true object of its business is providing services rather than tangible personal property, the decision below can separately be affirmed based on the exemption in § 144.010.1(10).

CONCLUSION

The Commission's decision was correct. The CDs Western uses to deliver the electronic versions of documents to its customers are not the "true object" of the transaction under this Court's consistent precedent. The CDs also represent "computer output" and thus should be separately exempt from the sales tax under section 144.010.1(10). The Commission's decision should be affirmed in all respects.

Respectfully submitted,

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**CERTIFICATE OF COMPLIANCE WITH MISSOURI
SUPREME COURT RULE 84.06(B) AND RULE 84.06(G)**

The undersigned certifies that the foregoing brief complies with the limitations contained in Missouri Supreme Court Rule 84.06(b) and, according to the word count function of Word by which it was prepared, contains 3,322 words, exclusive of the cover, the Certificate of Service, this Certificate of Compliance, the signature block and the appendix.

The undersigned further certifies that the diskette filed herewith containing this Brief of Respondent in electronic form complies with Missouri Supreme Court rule 84.06(g) because it has been scanned for viruses and is virus-free.

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CERTIFICATE OF SERVICE

I hereby certify that a two copies of the above and foregoing was mailed, U.S. Mail,
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