IN THE
SUPREME COURT OF MISSOURI

SC91415

CUSTOM HARDWARE ENGINEERING

& CONSULTING, INC.,

Appellant,

v.

DIRECTOR OF REVENUE,

Respondent.

BRIEF OF RESPONDENT DIRECTOR OF REVENUE

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Custom Hardware's Business

Appellant Custom Hardware Engineering & Consulting, Inc. ("Custom Hardware") "performs computer hardware maintenance and repair on 'enterprise class' machines [–] large, sophisticated machines, like an IBM mainframe computer." Appellant's Appendix ("App.") at A2. Its customers, located in 32 states, include "both private corporations and governmental entities, federal and non-federal, within and without the state of Missouri." *Id.* They have various kinds of "enterprise class machines." *Id.*

Custom Hardware "enters into firm fixed price contracts with its customers for the service of preventive and remedial maintenance for their enterprise class machines." *Id.* Custom Hardware then provides the services, parts, and equipment required for such maintenance. *Id.* The parts range "from small, inexpensive items like a mouse, to large, expensive components like a central processing unit for a mainframe computer." *Id.*

In the process of developing bids, Custom Hardware analyzes the parts used by a potential customer's machines, and the likelihood that each part will have to be replaced during the contract period – a determination made by "analyzing the 'average meantime between failure' for necessary parts as established by the manufacturer and its own internal databases." *Id.*

Custom Hardware also, of course, looks at the price of labor and overhead and builds in a profit margin. *Id.* at A3.

Having entered into a contract with a customer, Custom Hardware purchases parts to fill the customer's needs. *Id.* Some of the parts are delivered from out-of-state vendors to out-of-state locations (*id.*); those parts and their purchase are not the subject of this appeal.

The parts at issue below were those that "were shipped to Custom Hardware's location in Fenton, Missouri, tested and certified, then shipped to (a) private customers outside Missouri; (b) federal government customers in and outside Missouri; (c) other governmental customers outside Missouri; and (d) state government customers in the state of Missouri." *Id.* In general, Custom Hardware purchases those parts and retains title to them until they are installed in the customers' machines. *Id.* Those parts that were purchased out of state, shipped to Fenton, then used out of state, "remained in the state for five to seven days, during which time they were tested and certified for use by CHE technicians." *Id.* at A4-5.

Payments and Assessment

Until the events leading to this case, Custom Hardware simply did not file use tax returns on its purchases of parts from out-of-state vendors. *Id.* at A3. The Director audited Custom Hardware for the period from April 2001 through March 2006. *Id.*

Given that Custom Hardware's business model and failure to pay use tax was consistent through that period, the Director and Custom Hardware agreed to use calendar year 2005 as a sample period rather than actually study each year. *Id.* The Administrative Hearing Commission (AHC) described the process:

> The Director reviewed 100% of [Custom Hardware's] fixed asset purchases during the audit period and assessed tax on them. She reviewed expensed purchases only for the 2005 calendar year, the sample period. After arriving at the 2005 total, she divided the amount by 12 to derive a monthly average purchase of expensed items, then extrapolated that over the entire audit period.

Id. Based on that analysis, the Director determined that Custom Hardware owed sales tax on some purchases – which Custom Hardware then paid. *Id.* The Director also determined that Custom Hardware owed use taxes, and proposed an assessment of "$19,765.49, with interest at $3,811.87 and additions of 5%, at $942.48, for a total of $24,519.84." *Id.*

AHC Proceedings

Custom Hardware paid the use tax amount under protest (*id.* at A4), then filed a complaint at the Administrative Hearing Commission (AHC),

challenging the assessment (*id*. at A1). The Commission held that Custom Hardware did not have to pay use tax on the parts it purchased for its federal contracts, finding that title passed upon purchase and that the State could not tax federal property. *Id*. at A22. The Director conceded that Custom Hardware did not owe tax on items that were delivered directly to out-of-state locations. *Id*. at A22. Otherwise the AHC upheld the Director – though the Commission did correct some of the Director's math, resulting in a final award of $57,030.77 on its purchases, additions of $2,396.55, and a credit of $24,519.84. *Id*. at A24.

ARGUMENT

I. Because testing and certifying goods for future use removes the goods from mere "temporary storage," the parts acquired by Custom Hardware were "used" in Missouri for purposes of the use tax. (Responds to Appellant's Point I.)

Custom Hardware argues that the parts fall outside the scope of the use tax because they are not "used" in Missouri, citing §§ 144.605(13) and 144.610.1[1] and claiming that the parts were just "temporarily stored" in Missouri. Custom Hardware presents a question that has never been posed directly to this Court: how to define "temporary storage" as that term is used in the definition of "use"? In arguing for a broad definition of "temporary storage," Custom Hardware cites a number of cases dealing with exemptions from sales and use tax that this Court has addressed – exemptions for "processing," "manufacturing," and "fabricating." But Custom Hardware makes no claim to those or any other exemptions; this appeal turns solely on the scope of the use tax as provided by §§ 144.605(13) and 144.610.1.

The definition of "use" in the use tax law is very broad – broader than the definition of "sale" in the largely parallel sales tax law. "Use" is defined as:

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[1] All statutory references are to RSMo 2000, unless noted otherwise.

> the exercise of any right or power over tangible personal property incident to the ownership or control of that property, except that it does not include the temporary storage of property in this state for subsequent use outside the state, or the sale of the property in the regular course of business ….

§ 144.605(13). In the context of this case, that definition poses two questions: Did Custom Hardware exercise any right or power incident to ownership or control over the parts while they were in Missouri? And, were the parts "temporarily stor[ed]" in Missouri? This Court has never expressly addressed how those two questions interact.

The facts as found by the AHC are sufficient to demonstrate that the answer to the first question is "yes." Custom Hardware did exercise the right, dominion, control, or power of ownership over the parts held in Missouri; it did not just put a package on a shelf, then take it off the shelf and ship it out. Parts are taken from their packaging, inspected, and tested – and if the tests are successful, certified prior to being installed in a customer's computer system. The testing was extensive; it took from five to seven days to complete. (Tr. 47). Custom Hardware, through its employees, completed this testing and made the decisions as to the suitability of the parts for installation in the computer systems. There was no guarantee that

any particular part Custom Hardware received would be found to be the right part, fully functional and otherwise satisfactory, and then be shipped for installation on a machine owned by one of Custom Hardware's customers. Thus the AHC did not find – and on this record, could not find – that Custom Hardware actually installed, whether in- or out-of-state, every good part that it ordered and received. It may have stored or returned the part, if a customer did not require it after all. Custom Hardware does not contest that a part found to be defective would not be "certified" for use and would not be used in completing any maintenance contract. The fate of the part – hold it, send it out for installation, discard it, or return it – is determined in Missouri.

Answering "yes" to the first question here is consistent with this Court's holding in *Fall Creek Const. Co. v. Director of Revenue*, 109 S.W.3d 165 (Mo. banc 2003). This Court decided *Fall Creek* after the 1999 enactment of the current version of § 144.605(13). The Court noted that federal regulation required Fall Creek to have "operational control" of an airplane in which it had fractional ownership. 109 S.W.3d at 172. The Court did not worry about the extent to which Fall Creek affirmatively exercised that control; it simply noted that the airplane had come to Missouri, and stated: "Operational control of an aircraft is a significant assumption of control and

responsibility and is clearly sufficient to constitute 'the exercise of any right or power,'" as required by § 144.605(13). 109 S.W.3d at 172.

We agree with Custom Hardware that the presence of federal regulations and the particular facts in *Fall Creek* create a situation that does not expressly answer the first question that § 144.605(13) poses. And in *Fall Creek*, the Court did not mention the concept of "temporary storage" – perhaps because it was apparent that the airplane was actually being used for transportation in and out of Missouri, not merely being stored here. But *Fall Creek* does support the conclusion that "right or power over" is to be given broad meaning – at least broad enough to cover the undisputed exercise of ownership rights over the parts at issue here.

Moving to the second question, the record shows that each part was "temporarily stored" by Custom Hardware in Missouri – *i.e.*, between the day the part was received and the day it was shipped, except for the time that it was being unpackaged, inspected, tested, and repackaged, it was stored. Custom Hardware seems to argue that the mere fact that parts were stored for only a few days before or after testing means that those parts are excluded from the definition of "use." But a proper reading of the statute does not permit that interpretation.

Custom Hardware correctly describes the legislature's apparent objective in excluding "temporary storage" from "use": the exception draws a

line around the business of merely "maintain[ing] parts and equipment temporarily in this state and then ship[ping] them outside of this state for the ultimate use" (Appellant's Brief "App. Br." at 23), thus declining to extend the use tax to goods held briefly in a warehouse and distribution center such as those operated by Dollar General in Fulton and Walmart in Moberly. But the legislative objective, so defined, is fulfilled by drawing a bright line around "storage"; if Dollar General or Walmart starts moving away from mere storage, exercising the rights of owners to unpackage, test, and determine the fate of pieces of merchandise, they move the items across the line from untaxed to taxed.

Custom Hardware does not suggest a clear definition for "temporary storage." It does give some direction, however, urging the Director and the Court to look first at what Custom Hardware does with the parts, and then at what it does not do.

First, Custom Hardware argues that the statute requires the Director (and the Court) to look at "the purpose" for which the parts "were intended." App. Br. at 21; *see also* App. Br. at 24. But there is nothing in the statute to support that view. The broad definition of "use" covers all uses, not just the ultimate ones for which a part was manufactured or purchased. Ultimate use matters for various sales and use tax exemptions, but it is not part of the definition of the "use" in § 144.605(13).

In *R & M Enterprises, Inc. v. Director of Revenue*, 748 S.W.2d 171 (Mo. banc 1988), this Court rejected the premise that the ultimate use governs.[2] That case was decided when the definition read somewhat differently; the "except" clause in the definition did not refer to "temporary storage":

"… except that it does not include storage or the sale of property in the regular course of business." § 144.605(10), RSMo 1990. The Court said that "sample books" acquired by the taxpayer were "used," even though the books were acquired with "a fixed purpose of transshipping them in interstate commerce," when they were "delivered directly to the [taxpayer] at its principal office in Missouri, and, until it ships them to retailers, it has complete dominion and control over them." *Id.* at 172. The Court thus held that "dominion and control" were enough to place the books on the "used" rather than the "storage" side of the taxed/untaxed line. And Custom

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[2] Custom Hardware claims that *R & M* was reversed by this Court in *House of Lloyd, Inc. v. Director of Revenue*, 884 S.W.2d 271 (Mo. banc 1994). App. Br. at 31. But in *House of Lloyd*, the Court was dealing only with exemptions to the sales and use tax, not with the definition of "use" and its exception for "temporary storage." And the words "temporary storage" did not appear in the statute when *House of Lloyd* was decided.

Hardware does not deny that it exercised "dominion and control" over the parts while they were in Missouri.

Second, Custom Hardware directs our attention to things that it does not do with the parts in Missouri: *e.g.*, it does not add value (App. Br. at 21); it does not receive a "non-incidental benefit" (App. Br. at 22); it does not perform any "processing, fabricating or modifying" (App. Br. at 24); there is no "re-packing" the parts or equipment in different boxes (App. Br. at 25); and the parts were not "altered" (App. Br. at 26).[3] As a factual matter, those points are obvious; the AHC found, and the Director does not dispute, that the manner in which Custom Hardware exercised ownership or control over the parts was only in testing and certifying them for future use. Perhaps it is Custom Hardware's view that so long as the part does not undergo some physical change while it is in Missouri, it qualifies for "storage" regardless of what rights the purchaser exercises over it – unless the exercise qualifies as processing or manufacturing. But that is not what the statute says.

[3] Custom Hardware also claims that it does not receive a "non-incidental benefit." App. Br. at 22. But Custom Hardware does not explain, and it seems apparent that testing and certification is not just beneficial but essential to Custom Hardware's business.

Changes in a piece of tangible personal property are addressed in exemptions from the use tax, just as they are addressed in exemptions from the sales tax. Indeed, all of the cases that Custom Hardware cites with regard to the treatment of the property deal with those exemptions. Custom Hardware cites no cases dealing with just inspection and certification; there are none. The closest case is *L & R Egg Co., Inc. v. Director of Revenue*, 796 S.W.2d 624 (Mo. banc 1990), but there inspection was in addition to cleaning. Here, neither the Director nor the AHC found that Custom Hardware was or was not adding value to, fabricating, processing, or manufacturing, nor whether the benefit to Custom Hardware of the inspections was only incidental. That is because none of those are elements in the test of what constitutes "temporary storage."

Custom Hardware's "point relied on" does not assert error by the AHC with regard to any exemption, merely with regard to whether "the items were only temporarily stored" – using the language of the exception in § 144.605(13). Because the parts were not "*only* temporarily stored," they were taxable.

II. The request that there be a use tax exemption for all items purchased that are eventually sold tax-free should be directed to the General Assembly. (Responds to Appellant's Points II and III.)

In its next two points, Custom Hardware pleads for a "reseller exemption." In neither of its "points relied on" nor the arguments that follow, does Custom Hardware cite any such exception. Perhaps Custom Hardware is addressing § 144.615(6), RSMo Supp. 2010, which provides a use tax exemption for "[t]angible personal property held by processors, retailers, importers, manufacturers, wholesalers, or jobbers solely for resale in the regular course of business." But regardless of the "reseller" exemption invoked, Custom Hardware correctly concedes that under a two-year-old precedent, *ICC Management, Inc. v. Director of Revenue*, 290 S.W.3d 699 (Mo. banc 2009), such an exemption is only available when the property at issue is purchased (or "used," for purposes of use tax) for a subsequent taxable sale. App. Br. at 34.

Custom Hardware's first basis for asking the Court to reverse *ICC Management* and recognize an exemption for the purchase or use of everything that is later sold, tax-free, found in its Point II, is that taxing purchases of items that are later resold not subject to tax could reduce the taxpayer's profits – maybe even result in the taxpayer losing money. But

that is an argument for the legislature, not the courts. And so far, at least, the legislature has given tax-exempt entities like school districts and churches only a partial break: they do not have to pay sales and use taxes on their purchases directly, but the prices that they pay must build in sufficient profit to cover taxes owed by the seller. That is true, of course, not just with regard to sales and use taxes, but with regard to property, excise, income, and other taxes. The legislature may choose to provide relief to those who sell to tax-exempt entities. To do so would be a benefit not only to vendors like Custom Hardware, but indirectly to those entities authorized to buy tax-free. But what is given with one hand is taken away with the other: the result would be less revenue for the State and for local governments that impose sales and use taxes, harming those who benefit from the services of State and local governments. Again, that balance is for the General Assembly to make.

In its Point III, Custom Hardware points to contracts it made with public entities that are not required to pay sales or use taxes. But those contracts change nothing. They merely reflect the law: Custom Hardware could not impose sales or use taxes on the governmental purchasers. The contracts say nothing about Custom Hardware's own tax liability. Nor could they; that is an issue between Custom Hardware and the Director of Revenue – and the General Assembly. Even if universities and other non-taxable

entities incorrectly said that Custom Hardware, too, was exempt from the payment of use taxes, such a statement cannot change the law nor bind the Director.

III. The AHC is authorized by statute to consider and increase a deficiency assessment. (Responds to Appellant's Point IV.)

Custom Hardware's next point is most notable for what it does not say: there is no claim that the AHC erred in any way in calculating what Custom Hardware actually should have paid. Thus Custom Hardware effectively concedes (assuming that the AHC and the Director are affirmed as to the legal points discussed above) that it should have paid "$57,030.77 on its purchases of parts it purchased for use in its fixed price maintenance contracts with private and government customers." App. at A24.

Custom Hardware's argument in point IV is apparently being made in this Court for the first time. In Custom Hardware's view, the amount of the Director's post-audit assessment is a ceiling on the taxpayer's liability when the matter comes to the AHC on a request for refund. In other words, Custom Hardware argues that the AHC proceeding does not reopen the tax liability question, but is limited to the question of whether the taxpayer is entitled to a refund of the amount paid under protest, or some lesser amount. That argument misconstrues the role of the AHC.

In *J.C. Nichols Co. v. Director of Revenue*, 796 S.W.2d 16 (Mo. banc 1990) (an income tax apportionment case, not a sales or use tax case), this Court held that the AHC is not bound by the Director's decision with regard to a notice of deficiency. Custom Hardware cites *J. C. Nichols*, as well as

Matteson v. Director of Revenue, 909 S.W.2d 356, 360 (Mo. banc 1995). In Custom Hardware's view, however, those cases apply only to deficiency proceedings. Custom Hardware bases that claim on language in the opinions and in § 143.611.1 referring to "deficienc[ies] proposed" by the Director. And Custom Hardware is right that the "payment under protest" statute, § 143.631.4, does not use the word "proposed."

But Custom Hardware's argument ignores the statute that defines the AHC's role and the obligations of the parties in Revenue cases, § 621.050. Under that section, in "any proceeding" involving the Director and a taxpayer there may be an increase in the deficiency originally assessed – except that the Director takes over the burden of showing that the taxpayer owes the additional amount:

> … In any proceeding before the administrative hearing commission under this section the burden of proof shall be on the taxpayer except for the following issues, as to which the burden of proof shall be on the director of revenue:
>
> …
>
> (3) Whether the taxpayer is liable for any increase in a deficiency where such increase is asserted initially after the notice of deficiency was mailed and a protest filed ….

§ 621.050.2. There is no question that this was a "proceeding before the administrative hearing commission under" § 621.050 – the only section that provides for AHC consideration of Revenue matters. The Director asserted, "after the notice of deficiency was mailed and a protest filed," that the original amount had been miscalculated. The Director thus bore the burden of proving that point. The AHC acted on that proof.

Authorizing the AHC to so act is consistent with the view that the AHC is, in effect, re-making the Director's decision. Indeed, this Court, in a case cited by Custom Hardware, has explained that "*[i]f* no petition is filed [with the AHC], the Director's determination becomes final." *Commercial Bank of St. Louis Co. v. James*, 658 S.W.2d 17, 23 (Mo. banc 1983). When Custom Hardware chose to pursue an appeal, its action precluded the Director's assessment from becoming "final," and though Custom Hardware could claim the benefits of a new decision, it would also bear the burdens.

Again, Custom Hardware does not dispute the AHC's calculation, nor does it question whether the Director bore its burden. By statute, then, the AHC was authorized to "increase the deficiency." That there is no language in the "payment under protest" law about "proposed" rather than "final" decisions by the Director is irrelevant.

IV. Because Custom Hardware owes taxes, it also owes the pertinent additions. (Responds to Appellant's Point V.)

Finally, Custom Hardware argues that it should not be assessed additions pursuant to § 144.250.3, RSMo Supp. 2010. The AHC, as Custom Hardware notes, imposed additions only as to the failure to pay use tax on parts used to fulfill contracts with private parties – excusing Custom Hardware from additions as to parts used to fulfill contracts with public entities. App. Br. at 45. Custom Hardware's argument that it should not be responsible even for the limited additions imposed by the AHC is based solely on the grounds addressed in Appellant's Points I-IV, and our points I-III. The Court should affirm as to the additions, then, for the same reasons it should affirm as to the points discussed above.

CONCLUSION

For the reasons stated above, the Administrative Hearing Commission's decision should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE AND COMPLIANCE

I hereby certify that a true and correct copy of the foregoing was filed electronically pursuant to Rule 103 and Court Operating Rule 27 through Missouri CaseNet, this 1st day of September, 2011, to:

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The undersigned further certifies that the foregoing brief complies with the limitations contained in Rule 84.06(b) and that the brief contains 4,144 words.

The undersigned further certifies that the labeled disk, simultaneously filed with the hard copies of the brief, has been scanned for viruses and is virus-free.

/s/ *James R. Layton*
Solicitor General