

Service vs. Tangible Personal Property

The differentiation between the sale of a service and the sale of tangible personal property can be enormously difficult and complex. The tax ramifications can be monumental.

Background

The Michigan Sales Tax Act does not allow a specific deduction from the "gross proceeds" of taxable sales of tangible personal property for costs of services. Michigan's sales and use taxes are imposed on activities related to retail sale of tangible personal property and the use or consumption of very specific services. Services taxed according to the Use Tax Act (MCL 205.93(a)) are:

1. "Intrastate telephone, telegraph, leased wire and other similar communications" and
2. "Rooms or lodging furnished by hotel-keepers, motel operators and other persons furnishing accommodations that are available to the public".

NO OTHER SERVICES ARE SUBJECT TO MICHIGAN SALES AND USE TAXES.

The true nature of the activity taking place within the transaction must be determined to distinguish whether a transaction is a sale of tangible personal property or a performance of a service. This has been a long-standing controversy in Michigan, but has never been addressed as a distinct issue. Other states have addressed the issue of distinguishing sales of tangible personal property from sales of services. The determination often relies upon judgment, but it is imperative to determine the tax consequences of transactions.

A source of controversy is whether transactions must be examined as a whole or, rather, the individual components. From a simplicity approach, looking at the whole would be easier. However, the statute looks at each transaction and each individual component. One transaction, contract, or sale may have components taxed as both a retail sale and also taxed as a service.

Importance of Distinction

The distinction between retailer and servicer is very important for purposes of Michigan sales tax and Michigan use tax. The difference in tax base can be enormous.

The retailer, a taxpayer selling tangible personal property to the final and ultimate consumer, is taxed on the total gross proceeds or selling price of the property. The term "gross proceeds" is the total of all sales made and the amount received or to be received in money, credits, subsidies, property or other money's worth in consideration of sales at retail within Michigan without any deductions.

The servicer, a taxpayer engaged in the business of repairing, improving, or altering tangible personal property owned by others, in which the value of the materials used is incidental or negligible, is taxed on the purchase price of the materials or supplies used or consumed.

The application of the Michigan Sales Tax Act and the Michigan Use Tax Act to retailers and servicers has not changed. However, new technology and the changing nature of the way taxpayer's are conducting business may cause a change in the way sales and use tax base is computed.

Retailer

"The term "retailer" includes all persons who sell to the last or final buyer, user or consumer. Manufacturers, jobbers, wholesalers and others are subject to the sales tax, if sales are made by them to the ultimate user or final buyer."

"The term "sale at retail" means any transaction by which is transferred for consideration the ownership of tangible personal property, when such transfer is made in the ordinary course of the transferor's business and is made to the transferee for consumption or use, or for any other purpose than for resale in the form of tangible personal property." (Rule 7 - Sale at Retail) "Consumer" means the person who shall have purchased tangible personal property for storage, consumption or use. A "consumer" is further defined as a person who does not purchase goods for sale. The buyer who disposes of goods in any other manner than by resale becomes the final consumer. He is the last person in the chain of transactions to make a purchase. The seller, who is the taxpayer under the sales tax act, is also the consumer for such articles used or consumed in the conduct of his business and sales made to him for his consumption or use are taxable. The fact that a person may be licensed by this department to sell at retail does not in itself exempt sales to such licensee."

"Sales for purposes of resale include sales of tangible personal property not to be consumed or used by the immediate purchaser but to be resold in the regular course of business by the purchaser: Provided, that property purchased for resale purposes which is not resold, but is used or consumed by the purchaser, is taxable on the delivered cost of the purchaser who shall remit the tax to the state."

Servicer

Persons regularly and exclusively engaged in the business of repairing, improving, or altering tangible personal property owned by others, in which the value of the material used is incidental or negligible, render a nontaxable service. Sales of equipment, materials, and supplies to such person, are taxable.

Sales for resale to a person who has a sales tax license and an established business of one of the following types are not taxable, but sales to such a person of all other tangible personal property are taxable: Automobile repairers or garages, electrical repairers, machinery repairers, upholsterers and furniture repairers, and shoe repairers.

Persons selling tangible personal property in addition to providing labor or service shall obtain a sales tax license and pay the tax on their sales of tangible personal property, including such property sold in connection with repair work. When both labor and service charges are involved in repair work for others, the retailer shall separately itemize the amount charged for the tangible personal property sold; otherwise, the tax shall apply to the total gross proceeds.

Contractor vs. Servicer

The basic difference between a contractor and a servicer is in the type of property worked on. A contractor works on the real estate of others. A servicer works on tangible personal property of others.

Tax Issues of Servicers

Repairers working on the property of others, where the value of materials used is incidental or negligible, render a service. The taxpayer is not a retailer and is not required to obtain a sales tax license. The servicer pays tax on the purchase price of all materials and supplies used or consumed in providing the service.

Sales of equipment, materials, and supplies to servicers are taxable.

The taxpayer may be a servicer and a retailer. The taxpayer who sells tangible personal property in addition to providing labor or service shall obtain a sales tax license and pay the tax on their sales of tangible personal property.

If the taxpayer is engaged in more than one type of business, Rule 4 "Imposition Of Tax" requires separate books and records must be maintained. The taxpayer must be able to separate each type of business and determine the tax independently for each type of business.

Labor or service charges involved in maintenance and repair work on tangible personal property by others shall be separately itemized and the tax applied only to the amount charged for the tangible personal property sold. If the invoice to the customer is not itemized, the tax will apply to the entire invoice.

Critical Questions

In dealing with the question of service or sale of tangible personal property one may have to deal with the following questions:

- Creative service or sale of tangible personal property?
- Intellectual service or sale of tangible personal property?
- Personal service or sale of tangible personal property?
- Service on property of others or sale of tangible personal property?

Tests to Be Applied

In deciding the question of service or sale of tangible personal property we must first look at the material content. In Michigan, the tax is imposed on tangible personal property. However, the Michigan Courts has used three other tests discussed below.

Material Content Test

Should materials used or consumed by the taxpayer have an influence on the determination of sale vs. service?

The statute imposes the tax on the sale of tangible personal property. If the material content is insignificant, the transaction would most likely be considered a service.

The "material content" test should not be used alone to make the determination. The courts have deviated too often from this test. However, the "material content" test should be a starting point.

However, if there is no material content, the transaction should not be characterized as a sale of tangible personal property.

Real Object Test

The Michigan Tax Tribunal used the "real object test" as the sole test to determine the existence of a retail sale. In using this test, it looked to the objectives of the purchaser.

Shelby Graphics, Inc., Michigan Tax Tribunal Docket #83611.

Shelby Graphics is an advertising agency that produced signs and banners for Chatham's grocery stores. Shelby Graphics paid tax on the material cost of all tangible personal property used or consumed to provide the service and the signs and banners. The Department of Treasury held that 4% sales tax was due on the total gross proceeds from the sales of the signs and banners. Shelby Graphics provided design and creative services for the signs and banners.

The Michigan Tax Tribunal ruled "in attempting to affix the character of the transaction of the sale or service, the standard best aligned to Michigan's statutory sales tax framework appears to be the "real object" test. Clearly our sales tax act effectively imposes economic responsibility for the tax upon the consumer of goods. The "real object" test, in requiring that consideration be given to the intent of the purchaser in acquiring an item (the salient questions being whether the purchaser is seeking to obtain the services of the seller or is contracting for tangible end product), appropriately focuses upon the point at which the ultimate consumer comes into play".

Based on the "real object" test, the Michigan Tax Tribunal ruled that Chatham's purchased tangible personal property at retail from Shelby Graphics. The ruling held that Shelby Graphics was responsible for Michigan Use tax at the rate of 4% computed on the total gross proceeds from the sales of posters, banners, displays, and signs. From Michigan Department of Treasury Proposed draft of Revenue Administrative Bulletin - Service vs. Tangible Personal Property.

The Michigan Tax Tribunal in Shelby Graphics, Inc., v Michigan Department of Treasury, MTT Docket No. 83611, October 7, 1986, stated:

"By far the most pervasive test adhered to by courts confronted with the sales/service question is that commonly referred to as the 'real object' test... this standard calls upon the trier of fact to discern whether, from the perspective of the purchaser, the purpose of the transaction lies in the transfer of an end product or in the acquisition of services." (Emphasis added)

The Tribunal continued mentioning a quote of an earlier Ohio case by the Ohio Supreme Court in Federated Department Stores v Kosydar, 45 Ohio St 2d 1; 340 NE 2d 840 (1976):

"The real object sought by the buyer, i.e., the service per se or the property produced by the service...[to] determine if it was the buyer's object to obtain an act done personally by an individual as an economic service involving either the intellectual or manual personal effort of an individual, or if it was the buyer's object to obtain only the saleable end product of some individual's skill." (Emphasis in text)

In Emery Industries, Inc. v Limbach, 43 Ohio St. 3d 134, 539 NE 2d 608, 613 (1989), the Ohio Supreme Court characterized the real object test in the following manner:

"The true object test seeks the essential reason the buyer enters the transaction--either to obtain the service or the property produced by the service."

Aside from Shelby, supra., Michigan has little case law addressing the sales/service dilemma that develops or supports a method of analysis. Case law from other jurisdictions on many occasions use methods other than "real object", or contain contradicting determinations.

Michigan will formally adopt a "real object" method of differentiating sales transactions. This method will require that an answer to the following basic underlying question be found:

"From the perspective of an impartial third party, what is the purchaser seeking? A tangible end product produced by a service, or merely the service itself?"

Much of the experience of other jurisdictions in generating conflicting determinations utilizing "real object" tests would seem to stem from differing or totally lacking standards of application. The following are some general standards to aid in the "real object" determinations. The standards provided are not intended to be exclusive or all-inclusive, however they are intended to provide an indication of the general direction taken by the Department.

The Michigan Tax Tribunal rejected some standards of other jurisdictions in its opinion Shelby supra. by stating:

"For example, those criteria which premise a finding of a service transaction upon the existence of unique requirements on the part of the buyer, or upon any 'special order' relationship between buyer and seller, illegitimately create a distinction between customized goods and goods produced for mass purchase."

In 1940 the California Supreme Court in Bigsby v. Johnson, 99 California 2d 165; 99 Pacific 2d 268; quoted from an earlier Kentucky case, Cusick v. Commonwealth, 260 Ky 204; 84 SW 2d 14, (1940):

"Coming to the argument that a photographer is engaged in selling service, and that service is not taxable, it must not be overlooked that the chief value of many articles consists in the cost of the service and skill by which they are produced, rather than the cost of materials out of which they are made. Moreover, the situation is not the same as if the patron took an article to another to be repaired and paid only for the service rendered. One who desires a photograph of himself or his family does not contract simply for service. He desires the finished article, and that is what he buys and what the photographer sells." (Emphasis added)

Continued support for this position can be found in the Ohio Supreme Court decision in Emery, supra., with the statement:

"Even though a prospective purchaser may seek an accomplished photographer, he wants a photograph. He is seeking property. ...The overriding purpose of the purchaser in hiring the photographer is to obtain a picture to depict something."

Primary Value Test

Manatron, Inc., Michigan Tax Tribunal Docket #84131

Manatron is a Michigan corporation with its principle offices in Kalamazoo, Michigan. Its primary business activities entailed the provision of data processing services to its clients, the majority of which are governmental entities. The types of services offered range from preparation of payroll, to compilation of property tax assessment roles, to map drawing. In conjunction with the various services furnished by Manatron, certain forms of tangible personal property; binders, labels, forms, bills, paper, cards, checks and envelopes, either are, as Manatron states, sold to the purchaser of the service or, as the Department of Treasury submits, are used or consumed by Manatron in the course of fulfilling its service function.

In the case, several different taxation modes are possible:

1. Manatron may be found to be wholly in the service business, in which case the entirety of its purchases are subject to use tax unless otherwise exempt; or
2. Manatron may be found to be both a servicer and a seller at retail, in which case some of its purchases are subject to use tax, and some are not because they represent exempt purchases for resale (purposefully excluded is a third possibility, belief by the facts that Manatron is wholly engaged in sales at retail).

The issue presented for consideration, primarily one of fact, relates to the category into which Manatron falls and, if the second classification is found to be applicable, to ascertaining which of Manatron's purchases are part and parcel of the service, and which constitute legitimate sales at retail.

A determination of the category into which Manatron falls, servicer alone vs. part servicer/part retailer, is properly made through examination of the language of the contracts entered into between Manatron and its customers; in addition, consideration is afforded the specific situations and circumstances of the business transactions entered into.

The language of the contracts entered into with the customers was the language of service contracts, not sales contracts. The phrase "as required", which appeared in reference to the need for additional forms and supplies, was not an indication that customers at their option could obtain the forms and supplies from outside sources or from the corporation. The phrase meant that the corporation could purchase more forms and supplies as needed and pass on price increases from suppliers to customers.

Property listed under service headings was a component of the service. The cost of the property was relatively slight compared to the service. The mark-up on some items was so unusually high clearly the cost of the property was included in the cost of the service. Few customers needed the property apart from the service.

The Tax Tribunal reviewed several cases from which was developed the following factors in determining the presence or absence of a sale at retail: whether

1. The delivery or use of tangible personal property is incidental of the service transaction;
2. The primary value of the property is derived from the service performed;
3. The property is negotiated and contracted for separately from the service; and
4. The cost of property is incorporated within the cost of the service.

The Michigan Tax Tribunal ruled the corporation was liable for use taxes on tangible personal property it purchased if the property was used primarily to provide computer services to its customers, and was not liable if the property was purchased for resale to customers independently of any service. The Michigan Tax Tribunal ruled that Manatron was in business of providing computer services to its customers. Therefore, all tangible personal property purchased or consumed in the providing of these services was subject to the 4% Michigan use tax.

Incidental To Service Test

Catalina Marketing Sales Corporation v. Department of Treasury, Michigan Supreme Court #121673 and #121674

The Michigan Supreme Court rejected the Department of Treasury's narrow reading of the real object test. Under RAB 95-1 the question is whether, from the perspective of the client, the real object sought by the client was the purchase of the tangible good or the receipt of the services. The weakness of this test is that it is not consistent with the statutory definition of "sale at retail." The real object test focuses exclusively on the perspective of the purchaser. However, the purchaser's point of view is not given special consideration under the language of the statute. Instead, the statute's perspective is more broadly focused and requires a fuller analysis that weighs not only the perspectives of the parties to the sale, but also the nature of the product and service. This latter approach is subsumed within the "incidental to service" test articulated by the Court of Appeals in *Bd of Regents, supra*.

Accordingly, the Supreme Court adopts the “incidental to service” test for categorizing a business relationship that involves both the provision of services and the transfer of tangible personal property as either a service or a tangible property transaction. Under this test, “sales tax will not apply to transactions where the rendering of a service is the object of the transaction, even though tangible personal property is exchanged incidentally.” 85 CJS 2d, Taxation, § 2018, p 976. The “incidental to service” test looks objectively at the entire transaction to determine whether the transaction is principally a transfer of tangible personal property or a provision of a service. The sales tax is a tax on sellers for the privilege of engaging in the business of retail sales. If the consideration paid in a transaction is not paid for the transfer of the tangible property, but for the service provided, and the transfer of the tangible property is only incidental to the service provided, the transaction is not a sale at retail under MCL 205.51(b).

The court must objectively examine the totality of the transaction in determining whether it is subject to sales tax. When tangible goods or items are provided in conjunction with services, courts examine the totality of the transaction to determine its taxability. The essence of the transaction test specifically applies to those sales tax cases in which it is initially unclear whether the transaction mixes sales and services. For purposes of determining whether a transaction falls within a sales tax statute, the court considers whether the tangible personal property exclusively as the medium of transmission for an intangible product or service; if the intangible component is the true object of the sale, the intangible object does not assume the taxable character of a tangible medium. Where the item is the substance of the transaction, and the service or skill provided is merely incidental, the transaction is one for tangible personal property, to which sales tax may be applied. The focus belongs on the transaction, not the character of the participants. [68 Am Jur 2d, Sales and Use Taxes, § 62 pp 51-52.]

In determining whether the transfer of tangible property was incidental to the rendering of personal or professional services, a court should examine what the buyer sought as the object of the transaction, what the seller or service provider is in the business of doing, whether the goods were provided as a retail enterprise with a profit-making motive, whether the tangible goods were available for sale without the service, the extent to which intangible services have contributed to the value of the physical item that is transferred, and any other factors relevant to the particular transaction.

Summary

Several factors must be considered in determining whether a transaction is a retail sale or service.

1. Material Content - What is the material cost percentage of the total gross proceeds? If material is incidental or negligible, the transaction may be a service.
2. Real Object - What was the real object of the customer in making the purchase. Did the customer intend to purchase tangible personal property or a service?

3. Primary Value - Was the primary value of the customer's purchase that of a service or use of property.
4. Incidental To Service - Examine what the buyer sought as the object of the transaction, what the seller or service provider is in the business of doing, whether the goods were provided as a retail enterprise with a profit-making motive, whether the tangible goods were available for sale without the service, the extent to which intangible services have contributed to the value of the physical item that is transferred, and any other factors relevant to the particular transaction.

All of the above factors must be considered in making a determination as to whether the transaction is a retail sales or service. To properly make the determination, it is necessary to review documentation of the transaction. Documents to review include the purchase order, bid letter, contract, as well as the sales invoice.

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